SECOND AND FINAL REPORT ON

BASE EROSION AND PROFIT SHIFTING

FOR THE MINISTER OF FINANCE

Intended use of this document:

The Davis Tax Committee is advisory in nature and makes recommendations to the Minister of Finance. The Minister will take into account the report and recommendations and will make any appropriate announcements as part of the normal budget and legislative processes.

As with all tax policy proposals, these proposals will be subject to the normal consultative processes and Parliamentary oversight once announced by the Minister.

THE DAVIS TAX COMMITTEE

September 2016

Dear Minister

We, as the Members of the Davis Tax Committee, have the honour and privilege to provide you with this report which has been:

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DAVIS TAX COMMITTEE: EXECUTIVE SUMMARY OF SECOND INTERIM REPORT ON BASE EROSION AND PROFIT SHIFTING (BEPS): OECD BEPS PROJECT FROM A SOUTH AFRICAN PERSEPECTIVE: POLICY PERSPECTIVES AND RECOMMENDATIONS FOR SOUTH AFRICA*

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1 INTRODUCTION

In October 2015 OECD released the final package on the *Base Erosion and Profit Shifting* (BEPS) Action Plan containing 15 Actions that address base erosion and profit shifting opportunities available to multinational enterprises (MNEs). The comprehensive package of measures in the 15 Actions are designed to be implemented domestically and through treaty provisions in a coordinated manner, supported by targeted monitoring and strengthened transparency. It is intended that the implementation of the BEPS package will better align the location of taxable profits with the location of economic activities and value creation, and improve the information available to tax authorities to apply their tax laws effectively.[1] The implementation of the measures is to be effected as follows:

(a) Minimum standards: These were agreed upon by OECD and G20 countries to tackle issues in cases where no action by some countries would have created negative spill overs (including adverse impacts of competitiveness) on other countries.[2] Thus, all OECD and G20 countries commit to consistent implementation of minimum standards in the following Action Points:

- Harmful tax practices (Action 5)
- Preventing treaty shopping (Action 6)
- Country-by-country reporting (Action 13)
- Improving dispute resolution (Action 14)

(b) Common approaches and best practices for domestic law: Countries have agreed on certain best practices and common approaches to address certain BEPS concerns. This will facilitate the convergence of national practices for interested countries. Over time, the implementation of such agreed common approaches, would enable further consideration of whether such measures should become minimum standards in the future. Action points with best practices are:

- Hybrid mismatch arrangements (Action 2)
- Controlled foreign company rules (Action 3)
- Limiting base erosion through Interest expenses (Action 4)
- Mandatory disclosure of aggressive tax planning (Action 12)

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1 OECD OECD/G20 2015 BEPS Explanatory Statement in para 11.

2 OECD OECD/G20 2015 BEPS Explanatory Statement in para 11.

(c) Action points that reinforce international standards: A set of agreed guidance has been agreed upon which reflects the common understanding and interpretation of international tax standards in the OECD Model Tax Conventions. Under this category fall:

- Action points that have resulted in the revision of OECD Transfer Pricing Guidelines (Actions 8-10)
- Action points that will result in the revision of the OECD Model Tax Convention (Action 7 - on permanent establishment status; and Action 2 – dual resident hybrid entities).

(d) Analytical reports:

- Action 1: Address the tax challenges of the digital economy
- Action 11: Establish methodologies to collect and analyse data on BEPS and the actions to address It
- Action 15: Develop a multilateral instrument

The minimum standards, best practice guidelines and international standards have far reaching consequences: the proposals require countries to improve the coherence of their tax systems to protect against base erosion and profit shifting practices; some proposals require countries to impose substance requirements on multinational groups that wish to access low tax regimes; while others require countries to improve transparency and access to information concerning international tax planning practices of multinational enterprises.

1.1 BEPS recommendations for South Africa should be based on a clear South African international tax policy

The purpose of the DTC BEPS report is to provide recommendations on how South Africa can incorporate the OECD's minimum standards, best practice guidelines and international standards on BEPS into its international tax framework. Providing such recommendations requires providing clarity and perspectives on what South Africa's international tax policy should be. It is important that any recommendations to curtail BEPS and any laws enacted to curtail the same are not crafted from reactionary approach to what was going on globally, but these ought to evolve from an international tax policy that takes cognisance of the special circumstances of South Africa's economy (that portray aspects of both a developed and developing economy), its status as an emerging economy on the African continent, its administrative capacity, trade partners as well as its socio-geo-political circumstances.

This is important because, the 15 Actions of the OECD BEPS Project deals with different dimensions in the international tax planning practices of multinational enterprises which could affect countries in different ways, depending on whether the country is a predominately source based country (largely attracts foreign direct investment) or a predominately residence country (from which investments flow to other countries). South Africa's economy falls in both categories. In many respects, South Africa is a source country where activities of multinationals are being carried out as it still relies heavily on foreign direct investment. However, South Africa is also a residence state to many home grown MNEs, and it is a base country to many intermediate MNEs for further investment into the rest of Africa.

- As a residence country, Actions 2, 3, 5, 8, 9 and 10 contain proposals that have serious implications for South Africa that is home to multinational groups.
- As a source country Actions 1, 4, 6 and 7 contain proposals that South Africa may have to adopt to address its base erosion concerns.
- Actions 12, 13 and 14 encourage more information sharing between countries so both the residence home and source countries are able to assess whether their taxes have been avoided.

Providing recommendations to address BEPS in South Africa is thus dependent on analysing a range of international tax policy considerations, which are likely to be particularly challenging for an emerging economy like South Africa that has a significant group of home-grown multinational enterprises while still relying heavily on foreign direct investments for its access to technology and capital. Thus in South Africa, the adoption and implementation of BEPS Action Points contains important trade-offs that require careful considerations.

South Africa will have to develop a balanced approach as it responds to BEPS challenges. South Africa's BEPS approach should encourage the competitiveness of home grown multinationals' that expanding abroad but this has to be weighed against profit shifting opportunities that are likely to increase with such an expansion. Since the country needs foreign direct investment and the associated access to technology and capital, South Africa has to effectively protect its source tax base against the associated base erosion concerns. In addition, since South Africa has ambitions to position its self as a gateway for investment into Africa, it has to consider how this ambition fits in the context of the OECD/G20 BEPS Action Plan.

2 ACTION 1: ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY

Because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes. The digital economy and its business models present however some key features which are potentially relevant from a tax perspective.

2.1 BEPS issues in the digital economy

While the digital economy and its business models do not generate unique BEPS issues, some of its key features exacerbate BEPS risks. Accordingly it was agreed to:

- Modify the list of exceptions to the definition of PE to ensure that each of the exceptions included therein is restricted to activities that are otherwise of a "preparatory or auxiliary" character.
- Introduce a new anti-fragmentation rule to ensure that it is not possible to benefit from these exceptions through the fragmentation of business activities among closely related enterprises.
- It was also agreed to modify the definition of PE to address circumstances in which artificial arrangements relating to the sales of goods or services of one company in a multinational group effectively result in the conclusion of contracts, such that the sales should be treated as if they had been made by that company.
- The revised transfer pricing guidance on intangibles, also make it clear that legal ownership alone does not necessarily generate a right to all (or indeed any) of the return that is generated by the exploitation of the intangible, but that the group companies performing the important functions, contributing the important assets and controlling economically significant risks, as determined through the accurate delineation of the actual transaction, will be entitled to an appropriate return.
- The recommendations on the design of effective CFC include definitions of CFC income that would subject income that is typically earned in the digital economy to taxation in the jurisdiction of the ultimate parent company.

It is expected that the implementation of these measures, as well as the other measures developed in the BEPS Project (e.g. minimum standard to address treaty shopping arrangements, best practices in the design of domestic rules on interest and other deductible financial payments, application to IP regimes of a substantial activity requirement with a "nexus approach"), will substantially address the BEPS issues exacerbated by the digital economy at the level of both the market jurisdiction and the jurisdiction of the ultimate parent company, with the aim of putting an end to the phenomenon of so-called stateless income.

2.2 Broader direct tax challenges raised by the digital economy

The digital economy also raises broader tax challenges for policy makers. These challenges relate in particular to nexus, data, and characterisation for direct tax purposes, which often overlap with each other. The OECD discussed and analysed a number of potential options to address these challenges, and concluded that:

- The exceptions to PE status will be modified in order to ensure that they are available only for activities that are in fact preparatory or auxiliary in nature that was adopted as a result of the work on Action 7 of the BEPS Project is expected to be implemented across the existing tax treaty network in a synchronised and efficient manner via the conclusion of the multilateral instrument that modifies bilateral tax treaties under Action 15.

The OECD does not recommend any special rule for direct taxation of digital economy activities. Nevertheless, the OECD came up with certain options regarding the taxation for the digital economy and left it open for countries to include, in their domestic law. These options are:

(i) a new nexus in the form of a significant economic presence that would allow countries to tax activities in the digital economy,
(ii) a withholding tax on certain types of digital transactions and
(iii) an equalisation levy.

Countries could, introduce any of these three options in their domestic laws as additional safeguards against BEPS, provided they respect existing treaty obligations, or in their bilateral tax treaties. In other words, countries that chose to adopt such measures are requested to note that existing tax treaty obligations would override the impact of these domestic measures. Adoption as domestic law measures would require further calibration of the options in order to provide additional clarity about the details, as well as some adaptation to ensure consistency with existing international legal commitments.

2.3 Broader indirect tax challenges in the digital economy

The digital economy also creates challenges for value added tax (VAT) collection, particularly where goods, services and intangibles are acquired by private consumers from suppliers abroad. The OECD discussed and analysed a number of potential options to address these challenges and concluded that:

- The collection of VAT/GST on cross-border transactions, particularly those between businesses and consumers, is an important issue. Countries are thus recommended to apply the principles of the International VAT/GST Guidelines and consider the introduction of the collection mechanisms included therein.
- In particular, the implementation of the B2C guidelines would allow the countries where the customers are resident to charge VAT/GST on the sale of digital content from abroad.

2.4 Factors that South Africa should take note of with regards to adopting the OECD VAT/GST guidelines

Although the specific recommendation on VAT/GST would allow countries where the customers are located to collect VAT/GST due on digital transactions, the implementation of these guidelines could be costly, as it is unlikely that countries would be able to implement a system that deals with digital transactions in a comprehensive manner because of the following considerations:

- It is not entirely clear who will bear the burden of the additional taxes – would it be the customers who will end up paying for these?
- It can be administratively complex to implement rules that require tax administrations in the countries where the customers are located to collect VAT/GST on all forms of digital transactions.
- Enforcement could be difficult for certain segments of the economy, and more so if there is no comprehensive system that imposes VAT/GST on all digital transactions in the same way.

2.5 Next steps

Given that these conclusions may evolve as the digital economy continues to develop, it is important to continue working on these issues and to monitor developments over time. To these aims, the work will continue following the completion of the other follow-up work on the BEPS Project. This future work will be done in consultation with a broad range of stakeholders, and on the basis of a detailed mandate to be developed during 2016 in the context of designing an inclusive post-BEPS monitoring process. A report reflecting the outcome of the continued work in relation to the digital economy should be produced by 2020.

2.6 DTC recommendations on direct taxes for the digital economy in South Africa

Since the challenges that South Africa faces with respect to taxation of the digital economy are of an international nature, it is recommended that South Africa adopts the OECD recommendations.

- ➢ The proposals by the OECD to change the definition of a PE in double tax treaties will help to address this matter. It is also important for South African legislators to note that technology is continuously changing, developing and evolving. In adopting any e-commerce legislation, it is crucial to understand the technology and ensure that South Africa does not implement taxing provisions which are attached to a particular type of technology because by the time the provision is promulgated the technology in question may be obsolete and redundant. To enable South Africa to impose tax on non-resident suppliers of goods and services via e-commerce to South African customers, new source rules that deal with the taxation of the digital economy need to be enacted.
- ➢ The current scope of the source rules under section 9 of the Income Tax Act needs to be expanded to include rules that cover proceeds derived from the supply of digital goods and services derived from a source in South Africa. The new rules should be based on payor principle (like a royalty). The rules could for instance provide that digital goods or services are sourced where the

recipient who pays for the digital goods or services is based,[3] which would be where the South African tax-resident; physically present in South Africa, is at time of supply. The rules should also aim to clarify the characterisation of the typical income flows from digital transactions. Enacting of such rules would create the basis from which South Africa can apply the OECD recommendations on the taxation of the digital economy.

- The recommended new source rules for non-resident suppliers of goods and services via e-commerce to South African customers should cover the situation where physical goods and services are delivered or rendered in South Africa and for which payment is made electronically to a non-resident (consider, for example, where payment is made to a non-resident, but where the service is rendered in South Africa, or where goods are delivered in South Africa, but payment is made to a non-resident). This would create the foundation for South Africa to tax non-residents on such goods and services, subject to the application of any tax treaty and the revised nexus rules contained therein, and provide for a level playing field between foreign and domestic suppliers of similar goods and services. However any such services should be deemed to not be from a South Africa source where they do not meet the South Africa sourced rule. This is crucial in order to provide double tax relief to South African resident providers of such services and create a level playing field.[4]
- Apart from the gap in the source rules, there are also administrative concerns. Currently non-residents are required to submit tax returns for trade carried on through a South African PE. If SARS cannot assess whether a non-resident has a PE in South Africa, how will such non-residents be taxed? The lack of data in respect of inbound flows, as well as the lack of discernment between inbound and outbound flows, has resulted in little evidence indicating tax abuse as a result of the digital economy in South Africa. SARS doesn’t keep a separate register for inbound foreign companies. There is a need to isolate and focus on foreign multi-nationals and get them to submit tax returns.
- Rules should be enacted that require non-resident companies with South African sourced income (excluding certain passive income) to submit income tax returns even if they do not have a PE in South Africa. This would ensure that such non-residents are included in the tax system. To ensure that such non- residents register with SARS, a system should be created that imposes an obligation on a resident that transacts with a non-resident to withhold tax on any payment to a non-resident otherwise they would be penalised.
- To alleviate the compliance burden on non-residents having to submit comprehensive tax returns, notwithstanding that they may not be liable to tax in South Africa, an alternative measure would be introduce a self-assessment

3 SAIT: Comment on DTC First Interim BEPS Report (March 2015) Slide 14 of the Power Point Presentation.

4 PWC “Comment on DTC BEPS First Interim Report” (30 March 2015) at 9.

system for income tax purposes. A further possibility would be for a non-resident to be able to apply for a ruling to the effect that it is not liable to tax in South Africa on its specific facts and circumstances and to be relieved of the obligation to submit tax returns for so long as there is no change in the circumstance (including the law).[5]

- South Africa's existing source rules need to be aligned to accounting mechanisms and should not rely too heavily on tax law to attempt to reconcile and determine tax liability. The use of a single IT14 return does not support the BEPS identification specifically with regard to separate disclosure of inbound investment flows. This information disclosure should be based on fact. There should, therefore, be variations of the IT14 return e.g. IT14F for inbound companies since a one-size-fits-all approach doesn't appear to be working. The IT14 also needs to be re-designed as it starts out with legal questions instead of factual (accounting) questions.

- From a policy perspective, it is also important to create a level playing field so that South African companies dealing with digital goods and services are able to compete with the likes of Google. This is what prompted the concerns of Kalahari's e-books complaints. It should be noted that it is not in the interest of countries like Germany or the USA to allow the expansion of the PE concept to grant source states a wider scope to tax profits of digital businesses, since this would simply reduce the profits of the German or USA digital companies which may be taxed in the home state as the residence state would be required to give foreign tax credits in respect of such source tax.[6] In view of the strong presence of such digital companies in the highly developed OECD countries, it may be very difficult to obtain international consensus which is required before such major amendments could be made to DTAs.

2.7 DTC recommendations on addressing administrative challenges in the digital economy in South Africa

The OECD Final Report on the digital economy points out that the borderless nature of digital economy produces specific administrative issues around identification of businesses, determination of the extent of activities, information collection and verification, and identification of customers. [7] These issues are outlined below paragraph 10 of the report attached. The recommendations for South Africa regarding the administrative challenges of the digital economy are as follows:

- South Africa recently signed the OECD Mutual Administrative Assistance in Tax Matters Convention which aims for information sharing among signatories in matters of tax. SARS should actively utilise the procedures established

5 PWC "Comment on DTC BEPS First Interim Report" (30 March 2015) at 9.
6 R Pinkernell "Internationale Steuergestaltung im Electronic Commerce" 494 (2014) *Institut Finanzen und Steuern, Schrift* at 168.
7 OECD/G20 2015 Final Report on Action 1 in Box 7.1 at 105.

under the Convention and similar provisions under applicable DTAs to ensure the frequent and efficient exchange of information and assistance with the enforcement of tax collection.

- Since most of the challenges that e-commerce poses to the legislation relate to difficulties of identifying the location of taxpayers and their business transaction, it is recommended that this Income Tax Act be amended to provide that the provisions of the Electronic Communications and Transactions Act 25 of 2002 be taken into account for detection and identification purposes, so as to ensure tax compliance for taxpayers involved in e-commerce. However the administrative and compliance costs with respect to enforcing and implementing taxing provisions must not outweigh the benefits received with respect to the taxation raised. The legislators should also be aware of implementing a system which, realistically, cannot be effectively enforced.
- SARS can also obtain information for purposes of identifying digital businesses carrying on activities in South Africa using the exchange of information tools provided for in treaties. While the major players such as Google and Amazon are well known, the nature of the digital economy is such that new players appear on a continuous basis. Other avenues of obtaining third party information from domestic sources in relation to digital transactions should be explored. In this regard, consultations should be held with the financial institutions to investigate the feasibility of providing information related to electronic transactions with non-residents and which could be provided to SARS through the IT3 mechanism. However, any such mechanism should not impose an excessive compliance burden on the financial institutions relative to the benefit to SARS.[8]

2.8 DTC recommendations on addressing BEPS in the digital economy with respect to indirect taxes

With respect to indirect taxes, the OECD called on countries to ensure the effective collection of VAT/GST with respect to cross-border supply of digital goods and services. The 2015 OECD Final Report on the digital economy explains how the digital economy can be used to circumvent indirect taxes and it provides recommendations to curb base erosion. The report notes that if the OECD's "Guidelines on place of taxation for B2B supplies of services and intangibles" are not implemented, opportunities for tax planning by businesses and corresponding BEPS concerns for governments in relation to VAT may arise with respect to:

- remote digital supplies to exempt businesses, and

[8] PWC "Comments on DTC BEPS First Interim Report" (30 March 2015) at 10.

- remote digital supplies acquired by enterprises that have establishments (branches) in more than one jurisdiction (MLE) that are engaged in exempt activities. [9]

Currently uncertainty exists as to the treatment of services that are capable of being delivered electronically but that are not specifically provided for in the Regulations. For example, there is no clear distinction between telecommunication services and electronic services. Some overlap is possible. Such a clear distinction between electronic services and telecommunication services, each with its own place-of-supply rules can be found in modern VAT systems such as Canada and New Zealand as well as established VAT systems in the EU.

- There are generally no place of supply rules in South Africa. Suppliers providing services to SA consumers are subject to the registration threshold. This has been extended to include services supplied electronically.
- It is recommended that "telecommunication services" should be specifically defined, and clear and specific place-of-supply rules for telecommunication services should be incorporated in the Income Tax Act. These provisions should be in line with the OECD principles on the harmonisation of global VAT/GST rules.
- Regulations should be refined further in order to allow for a comprehensive understanding and appreciation of the ambit of thereof.
- While the list of services in the Regulations does not provide for adequate definitions, which causes some confusion, the definitions in the Regulations, as they stand, may not necessarily require further amendments. However, further guidelines providing clarification should accompany the Regulations. These guidelines should be updated regularly to ensure that new technology cannot escape the VAT fold.
- It remains uncertain if the list of electronic services in the Regulations can be interpreted so as to include the supply of online advertising. It is recommended that the guidelines referred to above should clarify this issue.
- It is recommended that the Regulations be refined further to allow for a comprehensive understanding and appreciation of the ambit thereof.

With respect to the place of supply rules, the OECD recommends that the use and enjoyment principle may be applied in cases where the special place-of-supply rules (applicable to electronically supplied services) lead to double or non-taxation, or market distortions. In other words, the use and enjoyment principle should only be applied in exceptional circumstances. A provision to this effect came into operation in the EU on 1 January 2015.[10]

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9 OECD/G20 2015 Final Report on Action 1 in para 197.

10 Article 59a of Council Directive 2008/8/EC.

- While the reverse-charge mechanism applies as a backstop to the registration mechanism, it remains uncertain under what circumstances the reverse-charge mechanism will apply. It further remains uncertain under what circumstances the use-and-enjoyment principle will take precedence over the place-of-supply proxies in the case of the supply of electronic services. It is recommended that clarity should be given on whether the use-and enjoyment principle should apply as a backstop where the place-supply-proxies lead to double or non-taxation, or market distortions. It is recommended that the VAT Act be amended in line with the OECD proposals and Article 59a Council Directive 2008/8/EC.

The OECD recommends that B2B and B2C transactions should be treated differently.

- In South Africa the differentiation between B2B and B2C transactions are, in principle, in line with the OECD recommendations. However, the existing rules do not make a clear distinction between B2B and B2C transactions. It is our understanding that the Regulations follows National Treasury's (NT) intention that B2C transactions are captured by the special provisions and that B2B transactions will be captured by the 'imported services' provisions. For this purpose, the Regulations must accurately define what is included in the scope of 'electronic services' so as to clearly distinguish between B2B and B2C transactions.
- NT is of the view that not having the distinction actually broadens the SA VAT net since the onus is now on the supplier to levy VAT. B2C transactions will lead to no input tax claim if the recipient is not registered for VAT. B2B transactions are subject to the normal input tax provisions of the VAT Act.
- South African VAT legislation generally only deals with who the supplier is and what the supply is. The VAT implications usually flow from that rather than from who the recipient is (i.e. business or consumer). Note however that there are instances where VAT implications are dependent on who the recipient is, for example with respect to zero-rated exports.

The reverse-charge mechanism, which is essentially self-assessment mechanism, relies on the integrity of the taxable entity to account for output VAT on the import of intangibles in so far as they are acquired to make exempt supplies or for final consumption. It would generally be difficult for revenue authorities to verify the accuracy of the taxpayer's self-assessed tax return in the absence of practical evidence reflecting the actual use of the intangibles.

- In the case of B2B transactions, the recipient vendor can only account for VAT on the imported electronic services in so far as the services are not used in the making of taxable supplies (in other words, when the recipient vendor is the final consumer). This relies heavily on the vendor's interpretation of what constitutes "in the making of taxable supplies". It is recommended that, in the case of B2B transactions, the recipient vendor must, in terms of the reverse-charge mechanism account for VAT on all imported services irrespective of it being applied in the making of taxable supplies. The recipient vendor should claim an input VAT deduction in cases where such a deduction is allowed.

- It is however acknowledged that the new changes (TLAB 2014) to the VAT Act that require the foreign supplier to register for VAT in SA eliminates this problem to a large extent. The supplier levies VAT on the supply and the recipient is subject to the normal input tax provisions of the VAT Act.

The differentiation between B2C and B2B transactions create an additional administrative burden on foreign suppliers. The foreign supplier burdened with the duty to register, collect, and remit South African VAT on affected transactions must verify the VAT vendor status of the customer. This is virtually impossible. Verifying the customer's identity and VAT registration status requires costly technology which is not widely accessible and which most suppliers simply cannot afford to implement.

- Foreign suppliers of electronic services are burdened with the task of identifying the recipient's VAT vendor status. No guidelines exist and foreign suppliers of electronic services run the risk of penalties being imposed on unintended non-taxation. It is recommended that guidelines similar to the EU guidelines must be drafted. However, provision must be made that where the foreign supplier is unable to determine the VAT status of the recipient, the supplier may deem the recipient a non-vendor. Furthermore, where the foreign supplier has followed the guidelines, no penalty should be imposed where the supplier incorrectly identified the recipient's VAT status.

Foreign suppliers of electronic services must register as VAT vendors when their supply of electronic services "imported" to South Africa exceeds R50 000. This differentiation is justified by SARS in that is aimed at levelling the playing field between domestic and foreign suppliers of electronic services.

- The differentiation in thresholds that apply to domestic vendors and foreign suppliers of electronic services raises concerns. Although the differentiation can be justified in that it is aimed at the protection of domestic markets, further research is necessary to determine whether the differentiation, in fact, balances out the assumed market distortions. In the interim, it is recommended that the VAT registration threshold for foreign suppliers of electronic services should be reconsidered to give effect to tax neutrality.

The OECD recommends that the simplified registration regime for the cross-border supply of intangibles should not require the supplier to have a physical presence or fixed establishment in the country of supply.[11] The South African VAT registration

[11] OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 12 http://www.oecd.org/ctp/consumptiontax/17851117.pdf.

system does not provide for a simplified registration process for suppliers of cross-border intangibles. Vendors must, amongst other requirements, have a fixed establishment with a physical presence in the Republic. The current vendor registration regime is inconsistent with the simplified registration proposal. However, certain concessions were made in respect of foreign suppliers of electronic services in terms of the *VAT Registration Guide for Foreign Suppliers of Electronic Services.*[12]

Although the concessions made by SARS to streamline the VAT registration of foreign suppliers of electronic services is in line with the OECD guidelines, the registration process should be closely monitored and reviewed on a regular basis to ensure that the process remains compliant with the OECD simple registration guidelines. Despite the simplified registration process afforded by SARS, many foreign suppliers are still unaware of their obligations in terms of the Act.

The OECD recommends that in addition to a simplified registration process, a simplified electronic self-assessment procedure should be available to non-resident suppliers of cross-border intangibles.[13] It is arguable whether the concession to register foreign suppliers of electronic services on the payment basis provides for a simplified assessment procedure. While the VAT201 form can be submitted electronically on the e-file system, the difficulty and administrative burden associated therewith is not diminished. It must be noted that Treasury has announced concessions to reduce compliance costs for foreign businesses to prevent these business from withdrawing from South Africa.

- With regards to foreign suppliers, SARS has issued Guidelines for completing the VAT 201. SARS reports that to date 96 foreign taxpayers have registered with SARS. VAT returns are being submitted monthly and that the compliance rate of submitted returns is approximately 87%. To encourage increases registrations and to increase the rate of compliance, it is recommended that measures should be taken to lessen the administrative burdens of completing VAT 201. As foreign suppliers of electronic services are not eligible for a VAT refund, it is recommended that an abridged VAT 201 should be developed specifically for foreign suppliers of electronic services.
- The option of payment or collection agents (whether acting as agents or third party services providers) to be appointed and registered as VAT vendors for and on behalf of foreign businesses must be considered.

A non-resident supplier of electronic services will face various compliance challenges, *inter alia*, costly once-off changes in its invoicing system is required to

[12] SARS (2014) *VAT Registration Guide for Foreign Suppliers of Electronic Services* http://www.sars.gov.za/AllDocs/OpsDocs/Guides/VAT-REG-01-G02%20-%20VAT%20Registration%20Guide%20for%20Foreign%20Suppliers%20of%20Electronic%20Services%20-%20External%20Guide.pdf.

[13] OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 13 http://www.oecd.org/ctp/consumptiontax/17851117.pdf.

ensure that invoices reflect a) the term ‘tax invoice’; b) the name, address and VAT registration number of the supplier; c) an individual serialized number and date on which the invoice is issued; d) a description of the services supplied; and e) the consideration of the supply and the amount of VAT expressed as 14 per cent of the value of the supply. Some concessions have been announced. The foreign supplier of ‘electronic services’ is allowed to submit an abridged invoice (the details of the recipient is not required. However, the invoice must still be issued in ZAR currency. In most instances the cost and payment of the ‘electronic services’ is made in foreign currency. The supplier is, accordingly, required to calculate and express the amount in ZAR. In terms of the Binding General Ruling on electronic services, the ZAR amount must be calculated in accordance with the Bloomberg or European Central Bank rate on the day that the tax invoice is issued. This can result in accounting differences where the supplier’s system has a set exchange rate or where the system operates on monthly averages.

- The foreign supplier of electronic services is required to issue an invoice compliant with the invoice requirements in the VAT Act. Although this SA requirement is in line with the EU VAT Directive, this requirement would require other non-EU suppliers to change their invoicing system. The requirement to issue an invoice, based on the requirements of an invoice in terms of the VAT Act, should be re-considered.
- The foreign supplier of electronic services is required to display (on their website or online shopping portal) prices in South African Rand and the price so displayed must include VAT at 14 per cent. This would require the supplier to change its accounting and invoicing system. It is recommended that the requirement to display prices (on the website or shopping portal) in South African Rand inclusive of VAT should be reconsidered.
- Clause 103 of the TLAB 2014 and the Explanatory memorandum is addressing this matter.
- Foreign suppliers of ‘electronic services’ must account for VAT on the payment basis. This creates accounting problems where the supplier’s accounting system is set up to account on the invoice basis.

Another impractical administrative concern relates to VAT branch registration and the requirement to maintain a separate independent accounting system. To expect foreign suppliers of electronic services to maintain a separate independent accounting system with respect to supplies falling within the South African VAT net, so as to ensure that supplies occurring outside of South Africa do not fall within the South Africa VAT net, is not practical. This is an extremely burdensome requirement.

- It is recommended that legislation around VAT branch registration and the requirement to maintain a separate independent accounting system should be revised. Foreign suppliers of electronic services should be entitled to register a VAT branch but should not be required to maintain a separate independent accounting system. A proviso should be added to this requirement to apply to foreign suppliers of electronic services, whereby, instead of maintaining an independent accounting system, the foreign supplier or electronic services should merely be required to produce financial accounts which reflect the supplies made to residents in South Africa or where payment was made from a South African bank account.

Enforceability of registration remains the chief challenge. In the absence of definitive rules and international cooperation, tax collection from non-compliant offshore suppliers would be difficult to enforce. In addition, transparency in cases where registration can be enforced would be difficult to achieve. For example, does SARS have extra-territorial powers to conduct audits on non-resident suppliers to ensure the accuracy of tax returns? Furthermore, is SARS able to enforce penalties, interest, or other punitive measures against non-compliance in foreign jurisdictions?

- In the absence of international cooperation, the collection of VAT and enforcing the registration mechanism would be impossible. The negotiation of multilateral treaties, as opposed to bilateral treaties, must be undertaken to ensure greater international and regional cooperation.

In the absence of guidelines, determining the place of supply/consumption for digital deliveries is cumbersome. Various methods of locating the customer's place of residence can be applied. Verification tests should not irritate customers, or significantly slow down the transaction process.

- The OECD recommends that the registration model should be applied as an interim measure to balance-out market distortions. In contrast, SARS is of the view that the registration model is the final/optimum solution. It is recommended that the registration model should be applied as an interim measure aimed at balancing out existing market distortions. Alternative VAT collection models should be explored. This, however, goes to the basic design of the VAT system and the impact of the extent to which the principles of the OECD VAT/GST Guidelines can be achieved.

With respect to alternative collection models:

- The reverse-charge mechanism is an ineffective tool to levy and collect VAT on cross-border trade in digital goods. The registration model, in theory, provides for a better VAT collection model. However, the registration model overly burdens the supplier and enforcement of the registration model remains problematic. Although in terms of SARS records about 96 foreign supplies have registered to date, this number and the collected revenue could be increased if an alternative model is considered. The implementation of the RT-VAT system should be considered as an alternative VAT collection mechanism where the registration and reverse-charge mechanisms are found to be ineffective tax collection models. As the model remains to be tested, extensive further research into the viability of the RT-VAT system should be undertaken.

2.9 Further recommendations

- In its design of VAT legislation dealing with e-commerce, South Africa should ensure its laws are in line with international developments. It should not reinvent the wheel and draft provisions that are not internationally aligned.
- It is important that South Africa monitors the OECD recommendations and international developments and that it amends its legislation accordingly to ensure it is internationally aligned.
- There are concerns that the VAT amendments with respect to e-commerce do not comply with the principle of neutrality which requires that taxation should seek to be neutral and equitable between forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations, carrying out similar transactions, should be subject to similar levels of taxation.
- It is recommended that the administrative burden on foreign suppliers of electronic services, who do not otherwise have a presence in South Africa but who satisfy the compulsory requirements to register for VAT, need to be reviewed and reconsidered to ensure that the amendments addressing electronically supplied services are effectively and efficiently imposed and enforced. The administrative burden imposed on foreign suppliers of electronic services should minimise the administrative costs for both the taxpayer and SARS as far as possible. In a volatile economy, new tax rules should not be drafted so as to negatively impact on international trade or create additional market distortions. While we recommend that new tax rules should be in line with the OECD principles and international best practice, new tax rules should not merely slave-follow international trends in developed countries. Extensive research on the economic impact of new tax rules on the economy of developing countries should be undertaken and considered before these new rules are implemented.

2.10 DTC recommendations on Bitcoins and other crypto-currencies for South Africa

- Whilst the use of virtual currencies such as Bitcoins is not yet widespread in South Africa, it is growing and South African legislators would be wise to consider the potential impact of virtual currencies like Bitcoins on tax compliance and to monitor international developments to determine the most suitable approach for in South Africa.
- Exchange controls seem at least in the short term - a major defence against BEPS in relation to e-commerce, digital products, virtual currencies, virtual currencies (e.g. Bitcoin), IP royalty payments and other forms of intangible

related transfer functions. However statutory provisions will be needed in the long run.

3 ACTION 2: NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS

Action 2 of the BEPS Action Plan focuses on neutralizing the tax benefits of hybrid mismatch arrangements. For this purpose, OECD recommends that countries adopt co-ordination rules under their domestic law. Hybrid mismatch arrangements exploit differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term deferral. These types of arrangements are widespread and result in a substantial erosion of the taxable bases of the countries concerned. They have an overall negative impact on competition, efficiency, transparency and fairness.

3.1 Part I

Part I of the report sets out recommendations in respect of payments made under a hybrid financial instrument or payments made to or by a hybrid entity. It also recommends rules to address indirect mismatches that arise when the effects of a hybrid mismatch arrangement are imported into a third jurisdiction. The recommendations take the form of linking rules that align the tax treatment of an instrument or entity with the tax treatment in the counterparty jurisdiction but otherwise do not disturb the commercial outcomes. The rules apply automatically and there is a rule order in the form of a primary rule and a secondary or defensive rule. This prevents more than one country applying the rule to the same arrangement and also avoids double taxation.

The recommended primary rule is that countries deny the taxpayer’s deduction for a payment to the extent that it is not included in the taxable income of the recipient in the counterparty jurisdiction or it is also deductible in the counterparty jurisdiction. If the primary rule is not applied, then the counterparty jurisdiction can generally apply a defensive rule, requiring the deductible payment to be included in income or denying the duplicate deduction depending on the nature of the mismatch.

The report recognises the importance of co-ordination in the implementation and application of the hybrid mismatch rules to ensure that the rules are effective and to minimise compliance and administration costs for taxpayers and tax administrations. To this end, it sets out a common set of design principles and defined terms intended to ensure consistency in the application of the rules.

3.2 Part II

Work on Action 6 also address BEPS concerns related to dual resident entities. The OECD recommends that cases of dual residence under a tax treaty would be solved on a case-by-case basis rather than on the basis of the current rule based on the place of effective management of entities.

- This change, however, will not address all BEPS concerns related to dual resident entities, domestic law changes are needed to address other avoidance strategies involving dual residence.
- The Commentary to the OECD MTC will also be revised that treaty benefits are not granted where neither State treats, under its domestic law, the income of such an entity as the income of one of its residents.

3.3 Policy considerations that South Africa should take into account before adopting the OECD recommendations on Action 2

In examining the recommendations in Action 2 for implementation in South Africa's domestic law and tax treaties, measures to limit deductibility of hybrid payments need to weigh the benefits of base protection against hybrid mismatches with a number of other factors, such as:

- The technical requirements to trace and link deductibility of payments with treatment in the counterparty jurisdictions can be complex and resource intensive.
- The interaction with BEPS Action 4 has to be considered – where countries intend to adopt a stricter interest limitation rule, what additional benefits would BEPS Action 2 bring, considering the complexity of these proposals?
- The interaction with BEPS Action 12 has to be considered – South Africa already has mandatory disclosure rules (Reportable arrangements rules) in place which can provide a more effective mechanism in targeting hybrid mismatch arrangements?
- What to do with the other base erosion and profit shifting techniques? For example, multinationals can achieve the same effect as hybrid mismatch arrangements using conventional debt if they can have their intro-group lenders located in tax havens. Dealing with hybrid mismatch arrangements without dealing with tax haven entities is unlikely to have any real impact on base erosion, as the same outcome can be created using conventional debt arrangements.

In examining the OECD recommendations in Action 2 South Africa would have to consider whether including hybrid receipts as income is likely to bring about additional policy considerations, such as:

- What is the impact of such a limitation on the competitiveness of home grown multinationals? If as a source state South Africa does not deny a deduction for hybrid payments, countries that chose to adopt the defensive measures would restrict access to the associated benefits for their home grown multinationals, when multinationals from other countries may be free to enjoy these benefits.

3.4 DTC recommendations on Action 2 for South Africa

3.4.1 Recommendations on hybrid entity mismatches for South Africa

The provisions in the Income Tax Act that deal with "foreign partnerships" (for instance the definition of the same in section 1, the reference to foreign partnerships in s 24H) ensure that the tax treatment of hybrid entities in South African in line with international practice. Nevertheless, South Africa's legislation on hybrid entities is still behind the G20 and there is need for further reform of the provisions to ensure that any tax planning schemes that entail hybrid entities as a mechanism for double non-taxation (as well as potentially giving rise to double taxation) are curtailed. Thus will require:

- Further refinement of domestic rules related to treatment of hybrid entities;
- There is need for specific double tax treaty anti-avoidance clauses.

In light of the OECD 2015 Report on hybrid mismatches, South Africa should make appropriate domestic law amendments. Similarly South Africa should adopt the OECD tax treaty recommendations with regard to hybrid entity mismatches and adopt appropriate anti-avoidance treaty provisions.

3.4.2 Recommendations on hybrid instrument mismatches for South Africa

Although South Africa has various provisions (discussed in the main report on Action 2) that deal with hybrid instruments, the pertinent issue is the lack of local and international matching of a deduction in one country to the taxability in another, especially as this relates to the participation exemption (section 10B of Income Tax Act).

- ➢ South Africa's interventions to hybrid mismatches lead to mismatches of their own and could result in double taxation or double non-taxation. The approach has been rather piecemeal, which has resulted in a plethora of provisions as is evident from the extent of those listed in the report. As part of the reform process to deal with hybrid mismatches, this plethora of instruments should be consolidated into a clear and concise approach and any unnecessary anti-avoidance provisions eliminated.[14]

- ➢ The legislators should consider introducing or revising specific and targeted rules denying benefits in the case of certain hybrid mismatch arrangements. In doing so, the legislators should ensure that the rules

[14] PWC "Comments on DTC BEPS First Interim Report" (30 March 2015) at 17.

must be simplified to deal with legal principles rather than specific transactions. The new rules should be aligned with the OECD recommendations and introduced as necessary and appropriate for South Africa with due regard to resource constraints and unnecessary legislative complexity.[15]

- SARS should introduce or the revise disclosure initiatives targeted at certain hybrid mismatch arrangements. To ensure the success of such disclosure rules, it is important that the rules are clear, free of loopholes, carry sufficient penalty for non-compliance and are adequately enforced. Such rules can be effective, either insofar as reporting is concerned or as a deterrent to aggressive tax planning. To address the compliance burden on taxpayers it is important that the rules should be targeted precisely at arrangements that are of concern and not formulated so broadly that they result in arrangements that present little or no risk to the tax base having to be reported and overwhelming both taxpayers and SARS.[16]

- It should be noted however that disclosure programs are never successful and are overly burdensome from a compliance perspective.
- The hybrid debt and interest rules require attention as they are not linked to the tax treatment in the hands of the counterparty and may themselves lead to mismatches and double taxation. A rule needs to be put in place that links the hybrid rules to the treatment in foreign counties. This would prevent tax abuse in cases where there is a denial of deduction in South Africa but not in other countries.
- The rules governing the deductibility of interest need to be developed holistically and without a proliferation of too many sections within the Act. The focus should be based on a principle rule and one should not have to apply many different sections to a transaction when assessing whether or not interest is deductible. The key policy requirement is an emphasis on mismatch rather than merely attacking a particular type of instrument.
- From the analysis of the international jurisdictions, it is clear that OECD rules and in particular, the UK rules, focus on a deductibility mismatch or other clear tax leakage. This is, it is submitted, correct and is a different approach from what was adopted in sections 8E to 8FA of the Act which look purely at substance over form, without enquiring whether mischief exists. In other words, it makes no sense to alter the tax treatment of an instrument where no obvious leakage arises – such as in circumstances where a deduction is matched by a taxable receipt, or a non-deductible payment is exempt.

15 PWC “Comments on DTC BEPS First Interim Report” (30 March 2015) at 17.
16 PWC “Comments on DTC BEPS First Interim Report” (30 March 2015) at 17.

- NT contends that the rules do not concern themselves with specific tax structures but rather look to those terms of an instrument and/or arrangement that would not ordinarily be found in either an equity instrument or debt instrument. Nevertheless, there is need to ensure that sections 8E to 8FA do not overly place emphasis on the type of mischief being controlled rather than on the substance of the instrument in question. NT further contends that sections 8E to 8FA are structured to capture the "low-hanging" fruit. Hurdles for the application of these provisions range from the presence of guarantees and assurances that are only necessary in debt arrangements (8EA) to unreasonably long repayment periods for debt (8F) and the non-payment of obligations or increases in payment obligations (8FA) when the debtor attains financial stability. However these provisions are quite complex and unclear.
- Section 23M is a mismatch measure as contemplated in the OECD requirements. However, in its structure it also operates as a matching measure for interest deductions. In other words, an interest deduction is limited (and not denied) until that point in time that the corresponding interest income is subject to South African tax in the hands of the recipient of the interest. However the provision is quite complex and its workings unclear.
- It is strongly recommended that South Africa moves away from anti-avoidance sections aimed at particular transactions and establish anti-avoidance principles which can be applied to a broad range of transactions without undue technicality; even if there is a risk that one or two transactions fall through the cracks, a principal approach to drafting legislation is significantly preferential to a transaction-by-a-transaction approach which we currently appear to have. An example of this as explained in the sub-heading on ss 8F and 8FA, is that ss 8F and 8FA unintentionally provide a solution to the problems encountered in 8E and 8EA. This is type of unintentional tax effect arises due to overly complex tax legislation.
- The inconsistencies between hybrid debt and hybrid equity rules should be addressed. For instance there should be alignment with respect to security for equity as is the case for debt.
- There is need for specific double tax treaty anti-avoidance clauses. It is however important that the rules are in line with international best practices otherwise they would result in double taxation or double non-taxation of income.
- South Africa needs to monitor OECD recommendations on hybrid mismatches and adapt domestic provisions as appropriate. There is a danger of moving too quickly and undertaking unilateral changes no matter how small, considering the potential knock-on impact for foreign investment.

3.4.3 General recommendations on hybrid mismatches

It is apparent that South Africa has anticipated several of the recommendations in the OECD 2015 Reports on Hybrid Mismatch Arrangements, as it has incorporated provisions into the Act which achieve or are designed to achieve the objectives of OECD with regard to BEPS Action 2.

- However, legislative simplicity is critical in this complex area of tax. Thus while South Africa may be considered at the forefront in achieving OECD objectives with regard to BEPS Action 2, caution should be exercised around the complicated hybrid equity provisions (sections 8E and 8EA) of the Act, which may operate in a contradictory fashion vis-á-vis the hybrid debt provisions (sections 8F and 8FA) and create the risk of potential abuse with reference to section 8F.
- As regards the commerciality of sections 23M and 23N of the Act, there is a concern that the limitation on interest deductibility embodied in these sections may unduly impede business transactions to the potential detriment of the economy. If South Africa hopes to attract foreign direct investment and be competitive on the African continent, it must not hamper trade unnecessarily. In this regard one must view with circumspection the Public Notice issued by SARS listing transactions[17] that constitute reportable arrangements for purposes of section 35(2) of the Tax Administration Act;[18] which is intended to be supplementary to any previous notices issued in this regard, and extends the existing listed reportable arrangements, which include certain hybrid equity and debt instruments in terms of sections 8E of the Act.
- Further, as regards balancing the BEPS risk and attracting foreign direct investment, South Africa should aim to increase its pull on and compete for a larger stake in the investments flowing into its BRIC counterparts.
- Since it remains essential to achieve equilibrium between nurturing cross-border trade and investment while simultaneously narrowing the scope of tax avoidance, some guidance may be gleaned from the UK's recent approach to "manufactured payments" where it removed the anti-avoidance legislation and instead focussed on applying the matching principle. This approach is preferable for revenue authorities and taxpayers alike.
- It is noted that to date emphasis has been predominantly on interest deductibility and the receipt of interest and/or dividends, with minimal focus on other forms of income and/or deductions. As a port of last call to combat base erosion and profit shifting as envisaged in BEPS Action 2, South Africa may resort to the GAAR,[19] which is designed to capture tax avoidance that is not caught by the specific anti-avoidance provisions of the Act. The

17 GN 608 in GG 39650.

18 No 28 of 2011.

19 Section 80A – L of the Act, which must be read in conjunction with the reportable arrangements provisions in the Tax Administration Act.

Commissioner's discretion in determining the tax consequences of any impermissible avoidance arrangement is virtually unfettered, which one hopes will be limited by the courts in practice. Reference may also be had to the body of case law dealing with simulated or disguised transactions - the substance over form debate and the requirement that a transaction is required to be underpinned by a commercial purpose.[20]

- It is submitted for South African purposes, that focus should be honed on mismatches that erode the South African tax base within the DTA context.

4 ACTION 3: DESIGNING EFFECTIVE CONTROLLED FOREIGN COMPANY RULES

Controlled foreign company (CFC) rules respond to the risk that taxpayers with a controlling interest in a foreign subsidiary can strip the base of their country of residence and, in some cases, other countries by shifting income into a CFC. Without such rules, CFCs provide opportunities for profit shifting and long-term deferral of taxation.

Since the first CFC rules were enacted in 1962, an increasing number of jurisdictions have implemented these rules. However, existing CFC rules have often not kept pace with changes in the international business environment, and many of them have design features that do not tackle BEPS effectively. In response to the challenges faced by existing CFC rules, the *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan, OECD, 2013) called for the development of recommendations regarding the design of CFC rules. The OECD 2015 Final Report on Action 3 sets out recommendations in the form of building blocks. These recommendations are not minimum standards, but they are designed to ensure that jurisdictions that choose to implement them will have rules that effectively prevent taxpayers from shifting income into foreign subsidiaries.

4.1 The six building blocks for the design of effective CFC rules

- **Definition of a CFC** – CFC rules generally apply to foreign companies that are controlled by shareholders in the parent jurisdiction. The report sets out

20 *Roschcon (Pty) Ltd v Anchor Auto Body Builders CC* (49/13) [2014] ZASCA 40 (31 March 2014) in which the court held that in determining whether a transaction was simulated or disguised, it was necessary to "establish whether the parties to the transaction actually intended the agreement that they had entered into should have effect in accordance with its terms; whether the parties to the contract intended to give effect to it according to its tenor." It commented obiter that one of the most common forms of tax avoidance is where the parties to a contract attempt to disguise its true nature in order to qualify for a tax benefit that would not have been available if the true contract between them were revealed. Shongwe JA, citing Zandberg v Van Zyl 1919 AD 302 at 309, stated that "(o)ur courts require no statutory powers to ignore pretence of this kind, and the law will always give effect to the real transaction between the parties."

recommendations on how to determine when shareholders have sufficient influence over a foreign company for that company to be a CFC. It also provides recommendations on how non-corporate entities and their income should be brought within CFC rules.

- **CFC exemptions and threshold requirements** – Existing CFC rules often only apply after the application of provisions such as tax rate exemptions, anti-avoidance requirements, and *de minimis* thresholds. The report recommends that CFC rules only apply to controlled foreign companies that are subject to effective tax rates that are meaningfully lower than those applied in the parent jurisdiction.
- **Definition of income** – Although some countries' existing CFC rules treat all the income of a CFC as "CFC income" that is attributed to shareholders in the parent jurisdiction, many CFC rules only apply to certain types of income. The report recommends that CFC rules include a definition of CFC income, and it sets out a non-exhaustive list of approaches or combination of approaches that CFC rules could use for such a definition.
- **Computation of income** – The report recommends that CFC rules use the rules of the parent jurisdiction to compute the CFC income to be attributed to shareholders. It also recommends that CFC losses should only be offset against the profits of the same CFC or other CFCs in the same jurisdiction.
- A**ttribution of income** – The report recommends that, when possible, the attribution threshold should be tied to the control threshold and that the amount of income to be attributed should be calculated by reference to the proportionate ownership or influence.
- **Prevention and elimination of double taxation** – One of the fundamental policy issues to consider when designing effective CFC rules is how to ensure that these rules do not lead to double taxation. The report therefore emphasises the importance of both preventing and eliminating double taxation, and it recommends, for example, that jurisdictions with CFC rules allow a credit for foreign taxes actually paid, including any tax assessed on intermediate parent companies under a CFC regime. It also recommends that countries consider relief from double taxation on dividends on, and gains arising from the disposal of, CFC shares where the income of the CFC has previously been subject to taxation under a CFC regime.

The above building blocks can be designed by countries to ensure that they will have rules that effectively prevent their home-grown multinationals from shifting income into foreign low-tax subsidiaries. However, the OECD recommendations recognise that each country prioritises policy objectives differently. Countries have to design CFC rules that combat BEPS while taking into account the policy objectives of their overall tax system and international legal obligations. Once implemented, the recommendations will ensure that countries will have effective CFC rules that address BEPS concerns.

4.2 Policy considerations that South Africa should take into account before adopting the OECD recommendations on Action 3

For an emerging economy country South Africa, that already has CFC rules, any considerations to adopt of tighter CFC rules, or to re-design its CFC rules needs to take into account not only its ability to combat BEPS, but also:

- The competitiveness of its home grown multinational enterprises and their ability to compete globally are inherently linked to the design of CFC rules. Tighter CFC rules have the effect of taxing home grown multinationals based on the domestic tax rules and imposing on them domestic tax burden, regardless of their countries of destination. When the outbound activities of multinational enterprises are taking place in countries that impose a lower tax burden, the profits they derive from these countries would be taxed under the CFC rules based on their home country tax rules. Multinationals from countries without CFC rules or more lenient CFC rules would, on the other hand, be subject to the lower tax burden. As a result, tighter CFC rules can adversely affect the ability of home-grown multinationals to compete in low tax markets.
- Compliance and administrative costs. Tighter CFC rules carry with them significant compliance costs as CFC profits have to be recalculated based on home country tax rules. CFC tax returns have to be filed by taxpayers, and then collected, managed and audited by tax administrations. As such, tighter CFC rules would also carry significant costs for the tax administrations.

4.3 DTC recommendations on CFC rules for South Africa

The DTC Report on Action 3 evaluates each of these policy and design considerations, together with the proposals made in relation thereto, against South Africa's prevailing CFC legislation, and makes certain recommendations:

- ➢ CFC rules are the subject of much international debate and the prospects of major change on the international front. South Africa should adopt the position of protecting its own interests. It should follow and not lead or set the trend. South Africa's CFC legislation is also very sophisticated and comparable to other G20 countries; there is thus no need to strengthen this legislation at this stage. In summary, since South Africa already has robust CFC legislation, the DTC recommends that it should not be significantly changed until it is clear what other countries intend to do.

The recommendations, set out below, thus only deal with further recommendations where action is recommended in relation to a specific aspect, and not where the recommendation in the detailed DTC Report on Action 3 is to leave the legislation as is:

- In the past, South Africa treated trusts as controlled foreign entities for purposes of legislation relating to controlled foreign companies. However, given the inability to neatly establish a legal connection in terms of the CFC legislation's imputation methodology, despite the *de facto* control, the legislation, which included foreign trusts as controlled foreign entities, was removed soon after its insertion.[21] Given that certain companies held by foreign trusts are consolidated for accounting purposes under IFRS, it is recommended that consideration be given to imputing the income of these companies to the 'parent' South African company, based on the IFRS methodology for consolidation (i.e. in terms of a defined method of imputation). However, prior to implementing this recommendation, reference should be had to the Final DTC Estate Duty report[22] for its recommendations, in order to ensure that any such recommendations are consistent.
- The South African CFC regime currently applies both a tax rate threshold - the 75 per cent comparable South African tax exception, which applies to all forms of CFC income-and a *de minimis* form of relief.[23] The current *de minimis* relief is largely limited to alleviating otherwise tainted passive income from triggering section 9D imputation, when it likely relates to working capital attendant on an operating business (activities of a foreign business establishment, as defined). More specifically, this exception applies only to remove section 9D imputation in the case of financial instrument income not exceeding five per cent of a CFC's total receipts and accruals excluding passive type income.[24] It is thus considered that the current South African regime covers this aspect satisfactorily, and follows the recommendation of BEPS Action 3, through adopting the combined *de minimis* approach and low effective tax rate rules, and should be maintained. It is recommended, however, that consideration be given to the method adopted by South Africa for determining the effective tax rate, as set out in the final Action 3 Report. Furthermore, consideration needs to be given to whether the exemption provided when the actual tax paid by the CFC in its country of residence exceeds 75% of the South African tax that would have been paid applying South African tax principles to the CFC's income, is appropriate given the

21 'The initial CFC legislation in 2001 referred to "controlled foreign entities" (CFEs) as opposed to CFCs, since it included foreign trusts as entities, whose income required attribution. The definition was changed to refer to CFC in 2002 and, thus, trusts were removed from the section, which then referred to companies. The first version of the 2011 Tax Laws Amendment Bill once again attempted to include trusts in the CFC regime, but the wording was poor and it was removed prior to promulgation'(p668: International Fiscal Association *Cahiers de droit fiscal international* Volume 98a-The taxation of foreign passive income for group companies-South Africa Branch Reporter: Deborah Tickle.

22 See First DTC Estate Duty Report (accessed 10 April 2016) at http://www.taxcom.org.za/docs/20150723%20DTC%20First%20Interim%20Report%20on%20Estate%20Duty%20-%20For%20public%20comment%20by%2030%20September%202015.pdf. Final Report to be accessed on this site, once released.

23 Section 9D(9A)(a)(iii).

24 Section 9D(9A)(a)(iii).

global trend of reducing tax rates, for example, the UK plans to reduce the statutory tax rate to 16% by 2020, and the average rate of corporate tax in 2015 for Europe was 20.24% e.g. Ireland 12.5%, Hungary19%, and Asia 21.91% e.g. Singapore 17%,and Thailand 20%,[25] unless the South African tax rate is likewise reduced.

(It should also be noted that, should South Africa significantly lower its corporate tax rate to compete with other lower tax jurisdictions, the risk of diversionary profits is, in any event, reduced).

- At a mechanical level, the question is whether the current South African CFC regime requires enough substance under the foreign business establishment test to meet the policy objective of having meaningful CFC local activity. At a technical level, the "foreign business establishment" test generally requires the business: (i) to be conducted through a physical structure, (ii) to be suitably staffed with on-site managerial and operational employees, (iii) to be suitably equipped to conduct primary operations, (iv) to have suitable facilities, and (v) that the business be located outside South Africa for a purpose other than the avoidance of South African tax.[26] Although the numerical size of these tests can sound intimidating, more aggressive taxpayers may appear to satisfy the test with as little as one managerial employee, one operational employee, a small fixed office (which may even be shared) and a modest amount of office equipment. It is therefore recommended that a review of the substance requirement may be appropriate. It is further recommended, in this regard, that a further inquiry of the tax base risks associated with outsourcing needs to be explored before some form of automatic tainting could be legislatively imposed to this practice.
- A side issue involving intellectual property may be the artificial labelling of certain portions of intellectual property income as ancillary services in order to avoid CFC imputation. This form of artificial labelling works best when the local countries involved treat services preferentially vis-à-vis royalties, but in some cases local royalties may be preferred. Given the flexible characterisation of these amounts as ancillary services or royalties, it is recommended that ancillary services should be classified as royalties under the South African tax provisions relating to CFCs (section 9D) (or at least if the amounts are characterised as royalties for local country tax purposes).

4.4 Other recommendations

- The South African CFC regime is largely in line with CFC systems used by many developed countries in Europe, North America, East Asia and the Pacific. Like all CFC systems, the regime is trying to protect the tax base

[25] KPMG Corporate Tax Rate Survey.
[26] See section 9D(1) definition of "foreign business establishment".

without unduly interfering with the global competitiveness of South Africa's global listed multinationals. This balance is a core reason for the regime's complexity. Although the regime can be theoretically tightened, competitive constraints have been a very limiting factor. Many European systems have softened their CFC systems since 2000. Countries such as the UK and Netherlands (major competitors in the region) have fairly light CFC regimes. Given South Africa's limited status on the global stage, South Africa cannot afford to be a leader in this field but must follow the practice set by others. Consideration could be given to adopting a regime similar to that of the UK or Netherlands in order to improve South Africa's tax competitiveness in the long term. This step or approach should, however, be taken with caution, as simplification at this late stage of a long protracted period of development of CFC legislation may open loopholes in the regime that could compromise the fiscus.

- South Africa's CFC rules are very stringent, particularly in respect of anti-diversionary rules which create practical anomalies especially with respect to the limitation relating to foreign dividend participation. This make rules difficult to enforce practically. Care should be taken to ensure that the CFC rules are not made so onerous that they pose excessive compliance burden to South African based companies.
- Care should also be taken to ensure that the rules are not so rigid that they hinder legitimate business establishments. This is particularly so with regard to service income anti-diversionary rules for the foreign business exemption. The legislators should therefore consider refining the anti-diversionary rules as necessary.
- South African CFC rules are some of the most sophisticated and complicated within the G20. A trend that needs to be curtailed is the fact that over the last few years the legislators have resorted to explaining the working of complex legislation in Explanatory Memoranda that have no legal effect, but the law is not clear. Efforts should be made to ensure that the legislation itself is clear. Consideration should be given to simplifying the legislation so as to reduce the cost of administration for business.

It should, however, be borne in mind that policy considerations other than tax (e.g. political stability, labour laws, immigration rules, access to electricity, investment security, etc.) need to be dealt with in order to improve South Africa as a country *to* which companies wish to migrate rather than *from* which they wish to migrate. Thus, the considerations set out above merely ensure that the legislation serves its purpose as an anti-avoidance measure and a deterrent for diverting income in line with the recommendations set out in the OECD Action 3 report and go no further than this.

Should South Africa seriously wish to embark upon a programme of attracting foreign direct investment as one of the means of fulfilling its goals, as set out under the National Development Plan, to create employment and improve the opportunities for the poor to be uplifted, these other policy matters need first to be addressed. The tax regime will then, in its current form, naturally provide increased taxes for other social spending. In line with this overall objective, though, and once the other policies have been attended to, a more competitive tax rate and CFC regime (similar to that in the UK or Netherlands) might well support such initiatives.

5 ACTION 4 LIMITING BASE EROSION INVOLVING INTEREST DEDUCTIONS AND OTHER FINANCIAL PAYMENTS

Base Erosion and Profit Shifting (BEPS) risks in this area may arise in three basic scenarios:

- Groups placing higher levels of third party debt in high tax countries.
- Groups using intragroup loans to generate interest deductions in excess of the group’s actual third party interest expense.
- Groups using third party or intragroup financing to fund the generation of tax exempt income.

Action 4 of the *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan, OECD, 2013) called for recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense. This report analyses several best practices and recommends an approach which directly addresses the risks outlined above.

- The recommended approach is based on a fixed ratio rule which limits an entity’s net deductions for interest and payments economically equivalent to interest to a percentage of its earnings before interest, taxes, depreciation and amortisation (EBITDA).
    - As a minimum this should apply to entities in multinational groups. To ensure that countries apply a fixed ratio that is low enough to tackle BEPS, while recognising that not all countries are in the same position, the recommended approach includes a corridor of possible ratios of between 10% and 30%. The report also includes factors which countries should take into account in setting their fixed ratio within this corridor.
- Recognising that some groups are highly leveraged with third party debt for non-tax reasons, the recommended approach proposes a group ratio rule alongside the fixed ratio rule. This would allow an entity with net interest expense above a country’s fixed ratio to deduct interest up to the level of the net interest/EBITDA ratio of its worldwide group. Countries may also apply an uplift of up to 10% to the group's net third party interest expense to prevent double taxation. A country may also choose not to introduce any group ratio rule, in that case, it should apply the fixed ratio rule to entities in multinational and domestic groups without improper discrimination.

- The recommended approach also allows countries to supplement the fixed ratio rule and group ratio rule with other provisions that reduce the impact of the rules on entities or situations which pose less BEPS risk, such as:
    - A *de minimis* threshold which carves-out entities which have a low level of net interest expense.
    - An exclusion for interest paid to third party lenders on loans used to fund public-benefit projects, subject to conditions.
    - The carry forward of disallowed interest expense and/or unused interest capacity (where an entity's actual net interest deductions are below the maximum permitted) for use in future years.

The amount of intragroup interest and payments economically equivalent to interest is also affected by transfer pricing rules. Revisions to Chapter I of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations under Actions 8-10 of the BEPS Action Plan (OECD, 2013), contained in the OECD Report *Aligning Transfer Pricing Outcomes with Value Creation* (OECD, 2015), limit the amount of interest payable to group companies lacking appropriate substance to no more than a risk-free return on the funding provided and require group synergies to be taken into account when evaluating intragroup financial payments.

5.1 Policy considerations that South Africa should take into account before adopting the OECD recommendations on Action 4

For an emerging economy like South Africa which relies on foreign capital, adopting measures to curtail base eroding interest deductions requires taking into consideration other important factors such as:

- How do the interest limitation rules affect costs of borrowing in capital importing countries, to the extent that non-deductibility of borrowing costs is likely to have an adverse impact on real costs of borrowing?
- How do the rules interact with the arm's length principle in section 31 of the Income Tax Act, as well as under its tax treaty obligations? (article 9 of treaties based on the OECD Model Tax convention).
- Tighter interest deductibility rules are likely to cause multinationals to rely more on other forms of base erosion payments, such as payments for technology and services. Furthermore, existing OECD standards require source countries to eliminate withholding taxes on cross border royalties and services. South Africa has to consider how to deal with the likely increase in the use of these base e6rosion payments when interest deductibility is restricted, since the OECD has not considered limiting the deductibility of such payments? [27]

[27] Consultation by the DTC with Shee Boon, Manager, Tailored Tax Courses and Research Services, IBFD, the Netherlands.

5.2 DTC recommendations on Action 4 for South Africa

Limiting BEPS due to interest deductions is a high priority for South Africa due to the potential risk of loss to the fiscus due to such avoidance strategies by multinationals. South Africa employs various provisions to curb the avoidance of tax using interest and similar instruments, including transfer pricing and thin capitalisation provisions, and various recharacterisation and provisions that limit the deductibility of interest.

5.2.1 Recommendations on the effectiveness of arm's length principle in preventing BEPS due to excessive interest deductions

The OECD recommended that the arm's length test should only apply to the pricing of the debt i.e. the interest rate. It may be preferable in the South African context to retain the approach of evaluating the extent of debt (i.e. thin capitalization) and the debt pricing (i.e. the interest rate) separately. In doing so, exchange control requirements should be borne in mind.

- The Draft Interpretation Note on Thin Capitalisation creates uncertainties with taxpayers due to the fact that it has remained a draft since its release in March 2013. This has created concern for foreign investors as reliance on a draft of this nature is problematic.

The DTC recommends that the Guidance from SARS should be changed to be in line with that of the OECD and international thinking as a matter of urgency, and be finalised to avoid uncertainty of its application. It is important that the use of thin capitalisation rules to prevent BEPS resulting from excessive interest deductions is in line with what is recommended by the OECD, as different rules between different countries could lead to double taxation. In finalising or redrafting this draft, the DTC recommends that SARS considers the following:

- Simplification of rules;
- Consistency with the OECD recommendations and international precedent on the Final Report;
- Transfer pricing rules for interest rate should take into account outcome of the GE and Chevron cases on relevance of parent credit ratings;
- Introducing ways of reducing the administrative burden for taxpayers with a low risk of BEPS through interest deductions. These could be one or all of the below:
    - Introduction of a safe harbour; and
    - Threshold based upon loan value or another measure whereby taxpayers falling below such a threshold would not have to comply with the rules.
- How to treat start-up operations where loan funding is required;
- Compliance cost for investors.

It is recommended that a "safe harbour" with a fixed ratio be introduced in section 31 or the Interpretation Note to provide non-residents that are funding local entities with guidance as to reasonable levels of debt versus equity.
It is further recommended that legislation and Interpretation Notes be released together, first in draft and then in final form.

5.2.2 Recommendations on exchange controls

It is recommended that the interest cap between SARB and SARS should be aligned. Interest rates allowable from a SARB perspective are potential indicators of risk from a South African transfer pricing perspective.

The DTC's recommendation is further that a taxpayer should determine what interest rate would be acceptable from a Transfer Pricing perspective. If acceptable, then it should be allowed by SARB. Alternatively SARS should indicate what interest rates it would allow, and then those should be allowed from an exchange control perspective.

5.2.3 Recommendation on withholding tax on interest

Although the OECD rejected the use of withholding taxes on interest as not suitable for preventing BEPS relating to excessive interest deductions unless the rates are aligned with the corporate tax rate. Nevertheless, the withholding tax on interest became effective in South Africa with effect 1 March 2015. Although OECD countries reject withholding taxes, they are used by source countries to ensure allocation of taxing rights to the source jurisdiction. As such, despite the OECD's rejection of withholding taxes as a measure of preventing BEPS, it is considered that the withholding tax serves an important role in the South African tax system, that being protecting the South African tax base by ensuring its ability to tax interest sourced in South Africa.

- To that end, from a treaty context, it is recommended that the treaties with zero or low interest withholding tax rates be renegotiated to afford South Africa a full taxing right to such interest. It is noted, however, that renegotiation of tax treaties is a time consuming process, and should perhaps be done in a holistic manner where the objective is to achieve more than just one objective.

5.2.4 Recommendation on interest deductibility

Recognising the complexities and uncertainties for potential investors as to what level of interest deductibility they would be entitled to in any particular year it is recommended that a proper analysis be made to determine whether reliance on deduction limitation rules is appropriate.

5.2.5 Recommendation on incurral and accrual of interest

Section 24J was originally introduced into the Income Tax Act principally to regulate the incurral and accrual of interest in respect of "instruments". The provisos to rules relates to the definition of "yield to maturity". However as explained in the detailed report below, the wording of the provisos is wider than their intended ambit as expressed in the Explanatory Memorandum. It is recommended that:

- The rules relating to incurral and accrual of interest in section 24J be reconsidered, without widening the definition of interest, to ensure that the rules do not adversely apply to transactions where there is no tax avoidance purpose.
- The appropriate mechanism to remedy this problem is to add a requirement that, for example, there must be a purpose of avoiding tax before the provisos apply, or to include some other explicit reference to the tax avoidance mischief identified in the Explanatory Memorandum.
- The definition of interest is apposite. There should not be any amendment to the definition of interest for the purpose of interest withholding tax that could broaden the definition further than the current definition that includes the definition in para (a) and (b) of the definition of interest in section 24J(1).
- It is also not recommended that a further withholding tax on derivative payments should be imposed. This would constitute an unusual withholding tax from an international perspective and could adversely impact on foreign direct investment.

5.2.6 Recommendations on hybrid interest and debt instruments

Both section 8F and section 8FA of the Income Tax Act re-characterise interest as dividends in both the paying and receiving entities in certain circumstances. These provisions are effective in preventing excessive interest deductions in respect of inbound transactions, but not outbound transactions. In respect of outbound transactions these provisions mean that a South African resident, instead of receiving taxable interest, receives a tax exempt dividend.

- The re-characterisation in respect of outbound debt instruments falling within the provisions of section 8F or section 8FA of the Income Tax Act should be changed to refer to "foreign dividends". Such foreign dividends would therefore only be exempt if they qualify for the more onerous exemption criteria set out in section 10B of the Income Tax Act.
- In addition in all circumstances these transactions should be subject to the provisions of section 8EA of the Income Tax Act. There has been much time spent on section 8EA of the Income Tax Act, but these rules can now be circumvented by taking security over a hybrid debt instrument falling into the provisions of section 8F or section 8FA of the Income Tax Act.

These recommendations are intended to improve and enhance the South African tax system's ability to curb tax avoidance using interest and similar payments.

6 ACTION 5: COUNTERING HARMFUL TAX PRACTICES MORE EFFECTIVELY, TAKING INTO ACCOUNT TRANSPARENCY AND SUBSTANCE

More than 15 years have passed since the publication of the Organisation for Economic Co-operation and Development's (OECD) 1998 Report *Harmful Tax Competition: An Emerging Global Issue* and the underlying policy concerns expressed then are as relevant today as they were then. Under Action 5 of the OECD *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan, OECD, 2013), the OECD called on countries to:

> *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. It will take a holistic approach to evaluate preferential tax regimes in the BEPS context. It will engage with non-OECD members on the basis of the existing framework and consider revisions or additions to the existing framework.*

The 2015 Final Report on Action 5 focuses defining the substantial activity requirement to assess preferential regimes, looking first at intellectual property (IP) regimes and then other preferential regimes. The work has focuses on improving transparency through the compulsory spontaneous exchange of certain rulings that could give rise to BEPS concerns in the absence of such exchanges.

6.1 Requiring substantial activity for preferential regimes

Countries agreed that the substantial activity requirement used to assess preferential regimes should be strengthened in order to realign taxation of profits with the substantial activities that generate them. Several approaches were considered and consensus was reached on the "nexus approach". This approach was developed in the context of IP regimes, and it allows a taxpayer to benefit from an IP regime only to the extent that the taxpayer itself incurred qualifying research and development (R&D) expenditures that gave rise to the IP income. The nexus approach uses expenditure as a proxy for activity and builds on the principle that, because IP regimes are designed to encourage R&D activities and to foster growth and employment, a substantial activity requirement should ensure that taxpayers benefiting from these regimes did in fact engage in such activities and did incur actual expenditures on such activities. This same principle can also be applied to other preferential regimes so that such regimes would be found to require substantial activities where they grant benefits to a taxpayer to the extent that the taxpayer undertook the core income-generating activities required to produce the type of income covered by the preferential regime.

6.2 Improving transparency

In the area of transparency, a framework covering all rulings that could give rise to BEPS concerns in the absence of compulsory spontaneous exchange has been agreed. The framework covers six categories of rulings: (i) rulings related to preferential regimes; (ii) cross border unilateral advance pricing arrangements (APAs) or other unilateral transfer pricing rulings; (iii) rulings giving a downward adjustment to profits; (iv) permanent establishment (PE) rulings; (v) conduit rulings; and (vi) any other type of ruling where the FHTP agrees in the future that the absence of exchange would give rise to BEPS concerns. This does not mean that such rulings are *per se* preferential or that they will in themselves give rise to BEPS, but a lack of transparency in the operation of a regime or administrative process can give rise to mismatches in tax treatment and instances of double non-taxation. For countries which have the necessary legal basis, exchange of information under this framework will take place from 1 April 2016 for future rulings and the exchange of certain past rulings will need to be completed by 31 December 2016. The Report also sets out best practices for cross-border rulings.

6.3 Review of preferential regimes

A total of 43 preferential regimes have been reviewed, out of which 16 are IP regimes. The Report contains the results of the application of the existing factors in the 1998 Report, as well as the elaborated substantial activity and transparency factors, to the preferential regimes of members and associates. However, the elaborated substantial activity factor has so far only been applied to IP regimes. In respect of substantial activity the IP regimes reviewed were all considered inconsistent, either in whole or in part, with the nexus approach as described in this report. This reflects the fact that, unlike other aspects of the work on harmful tax practices, the details of this approach were only finalised during the BEPS Project while the regimes had been designed at an earlier point in time. Countries with such regimes will now proceed with a review of possible amendments of the relevant features of their regimes. The OECD's work on reviewing preferential regimes will continue, recognising also that regimes that were assessed before the substantial activity requirement was elaborated may need to be reassessed.

NOTE: The recommended OECD approach allows multinational enterprises to enjoy low (or even zero) tax on their income if (a) they carry out R&D activities that generate the income in the low (or even zero) tax country; and (b) the country is committed to exchange the rulings that it issued under such low tax regimes (as well as other rulings) with its treaty partners. The OECD approach does not outlaw low or zero tax regimes completely. [28]

6.4 Next steps

The elements of a strategy to engage with countries other than OECD Members and BEPS Associates in order to achieve a level playing field and avoid the risk that the work on harmful tax practices could displace regimes to third countries is outlined in the Report, together with the status of discussions on the revisions or additions to the existing framework. These aspects of the work will be taken forward in the context of the wider objective of designing a more inclusive framework to support and monitor the implementation of the BEPS measures. An ongoing monitoring and review mechanism covering preferential regimes, including IP regimes, and the transparency framework has been agreed and will be put in place.

6.5 Policy considerations that South Africa should take into account before adopting the OECD recommendations on Action 5

For an emerging economy like South Africa, the recommendations in Action 5 have to be considered from different perspectives. As a home country for its own multinational enterprises, these recommendations leave room for profit shifting activities. The issues that a home country like South Africa has to consider in the context of Action 5 are:

- How do the substance requirements in Action 5 compare with how intangibles related returns are attributed under the arm's length principle as recommended in Action 8 of the BEPS Action Plan?
- Taken together, whether the substance requirements imposed under Action 5 and Action 8 on low tax intangibles regimes provide sufficient protection from profit shifting activities of home grown multinationals?
- What is the role of tighter CFC rules contemplated in Action 3, if any, in limiting intangibles related profit shifting activities of their home grown multinationals, taking into account the competitiveness consideration and other policy objectives?

From the perspective of South Africa being a source country, OECD recommendations do not contain any limitation on base erosion payments in the form of royalties and other intangibles related payments. Multinational enterprises can continue to make deductible payments even though the recipients are subject to low or zero tax regimes. Even though South Africa has a withholding tax on royalties, this would be subject to zero withholding tax at source under tax treaties based on the OECD Model Tax Convention (some treaties however take a different

28 Consultation by the DTC with Shee Boon, Manager, Tailored Tax Courses and Research Services, IBFD, the Netherlands.

position). In this context, as source country South Africa has to consider the following:

- Are the substance requirements and transparency measures recommended in Action 5 sufficient as a base protection measure for source countries against royalties and intangibles related payments, taking into account the withholding taxes imposed on such income under their domestic law and tax treaties?
- Whether additional measures for protection against base eroding royalties and intangibles related payments are necessary in the light of the recommendations in Action 5? If so, what are the effects of such measures on the real costs of technology?

South Africa is positioning itself as a gateway to less developed countries in their region. From this perspective, Action 5 contains recommendations for the design of low tax regimes that conform to internationally accepted standards. In this regard, South Africa needs to consider:

- What are the benefits and costs of its headquarter company regime in conformity with recommendations in Action 5?
- Whether the design of its headquarter company regime in compliance with recommendations in Action 5 in mind would generate a net benefit for the economy? [29]

6.6 DTC Recommendations on Action 5 for South Africa

South Africa is an associate country to the OECD BEPS project. Thus, the requirement for "substantial activity" needs to be examined in South Africa, for instance, with respect to the country's headquarter company regime. The important thing for South Africa is, however, to ensure it continues to balance its international obligations to prevent harmful tax competition, and also to ensure it preserves the competitiveness of the economy.

From the angle of preserving the competitiveness of the economy, the headquarter company regime has, however, not been very successful. South Africa has been reluctant to participate in international tax competition and this has hindered its ability to fully establish itself as the gateway to Africa. There are also other factors which might affect the decision of foreign investors when deciding whether to choose South Africa as a regional headquarter location, most notably exchange controls, labour law policy, availability of guaranteed power sources, and immigration requirements (specifically the obtaining of work permits).[30]

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[29] Consultation by the DTC with Shee Boon, Manager, Tailored Tax Courses and Research Services, IBFD, the Netherlands.

[30] PWC "Comment on DTC BEPS First Interim Report (30 March 2015) at 19.

While South Africa should be concerned about preventing harmful tax competition, it should move cautiously to protect its competitiveness since many major countries are not willing to give up their special tax regimes, such as corporate rate reductions and patent boxes (identified in Action 5 as harmful), which are designed to attract investment so as to remain competitive. For example, the United Kingdom has reduced its corporate rate to 20% and is continuing a phased reduction.[31] South Africa must, thus, take care not to be a “first mover” in terms of the BEPS reform associated with harmful tax practices.

South Africa already has regimes that are designed to encourage investment into the country in the form of urban and industrial development zones, as well as the proposed special economic zones. It would appear, however, that these will fall within the categories of low risk “disadvantaged areas”,[32] which are discussed in the Final Report on Action 5. Furthermore, these are physical investments rather than mobile activities which are the concern of the OECD Report.[33] Care should be taken to ensure that this remains the case and that the necessary disclosure is made to the FHTP and, if considered necessary, potentially, spontaneous exchange of information is made.

Thus, to the extent that certain tax preferences exist (with economic benefits outweighing the tax loss), these preferences should not be automatically repealed in the expectation that the OECD will follow up on them.

Of importance will be South Africa’s continued transparency with regards to its laws and rulings.

The DTC makes the following recommendations for South Africa:

- It is important that South Africa balances its international obligations not to engage in harmful tax practices with the need to preserve the competeveness of the economy. More so, as the National Development Plan provides that South Africa should aspire to be a gateway for investment in Africa. There is potential for substantial job creation and tax revenue to the Government in the form of VAT and employees’ tax from which South Africa would benefit, as long as it ensures that it complies with the OECD’s substance requirements. The bottom line is that BEPS is both a risk and an opportunity for South Africa.
- From a tax perspective, consideration should be given to instituting a reduced corporate income tax rate for headquarter companies which meet minimum substance requirements. (It may, however, be necessary to align this rate for

31 L Shepperd “What should the OECD do about Base Erosion?” Copenhagen precise of 2013 International Fiscal Association annual Congress” 9/9/2013.

32 OECD/G20 2015 Final Report on Action 5 at 65.

33 PWC “Comment on DTC BEPS First Interim Report “(30 March 2015) at 19.

all companies in order for such rate not to be viewed as a harmful tax practice. However, this would need to be evaluated in terms of the DTC Reports as a whole).

This would make South Africa more attractive as a destination for regional headquarters. While this may result in the perception that there will be a notional cost related to corporate income tax foregone, the direct and indirect spin-offs of an increased number of such companies (that would otherwise go elsewhere) which would result in increased tax revenues, as well as from increased employment taxes, consumption taxes and profit taxes of suppliers should outweigh such perceived forgone taxes.

It is, however, important that any revised headquarter regime be bundled with a package of measures to address all of the impediments and externalities associated with the choice of South Africa as a location for regional headquarters, including with respect to exchange control (although there is relief for headquarter companies, better alignment with the tax regime is required), labour law policy, availability of power and immigration.[34]

- To ensure the headquarter regime is in line with Action 5, reforms to the provisions should be considered, that incorporate minimum levels of substance as required by the OECD, so that it does not slip into the area of a harmful tax practice. It is therefore important that South Africa considers revising its criteria of for headquarter companies in line with the OECD recommendations.

With respect to tax rulings in South Africa, Chapter 7 of the Tax Administration Act 28 of 2011 (TAA), sets out provisions dealing with “advance rulings”. Basically these categories of advance rulings allow taxpayers to obtain clarity and certainty on the Commissioner’s interpretation and application of the tax laws on proposed transactions. The OECD’s framework covers only spontaneous exchange of information on taxpayer specific rulings. In the South African context these would include binding private rulings.

- It is thus recommended that, in line with the OECD Recommendations on exchange of information regarding tax rulings, SARS notifies other tax authorities, on a timely and spontaneous basis, of the existence of a binding private ruling relating to the headquarter company regime, and any other regime that could be viewed as a harmful tax practice based on the filters provided, or where there is uncertainty, where SARS is aware that it affects residents in another country. This is especially so where such a ruling provides for a downward adjustment that would not be directly reflected in the company's financial accounts.

[34] PWC “Comment on DTC BEPS First Interim Report (30 March 2015) at 19.

- It is further recommended that South Africa's tax authorities ensure that they do not sanction tax rulings relating e.g. to the headquarter company regime that foster harmful practices and hamper transparency. This could cover secret rulings that enable taxpayers to get tax haven results even if the country may have a tax system with an acceptable tax rate.
- Although not currently available in South Africa, the DTC recommends that the resources be sought to put an APA option in place, for purposes of enhancing its transfer pricing regime (in particular to provide taxpayers with certainty- see DTC reports on Actions 8-10) and thus consideration needs to be given to the practices that would need to also be put in place so as not to contravene the harmful tax practices principles set out in the OECD Action 5 Report.
- The DTC furthermore recommends that SARS' capacity be increased to enable it to satisfy the requirements of the spontaneous exchange of information whenever this should be required in terms of the conclusions reached by the forum for harmful tax practices of the OECD.

The Action 5 Report calls for confidentiality of any information exchanged. It recommends that provisions must be in place in the receiving country to protect the confidentiality of the information that is exchanged.

- In the case of South Africa, Chapter 6 of the TAA provides detailed provisions relating to "confidentiality of information". These provisions must be applied to ensure confidentiality with respect to exchange of information on tax rulings in South Africa.
- South Africa and other African countries could consider extending the automatic exchange of information arrangements currently reached to ensure a level playing field amongst them. This could be facilitated through the Africa Tax Administration Forum.

7 ACTION 6: PREVENTING THE GRANTING OF TREATY BENEFITS IN INAPPROPRIATE CIRCUMSTANCES

Treaty abuse rules entails the use of treaty shopping schemes, which involve strategies through which a person who is not a resident of a State attempts to obtain benefits that a tax treaty concluded by that State grants to residents of that State, for example by establishing a letterbox company in that State. The OECD 2015 Final Report covers various recommendations to curtail treaty abuse.

Currently, the main specific treaty provision that is applied in South Africa's treaties to curb conduit company treaty shopping is the "beneficial ownership" provision as set out in article 10, which deals with dividends, article 11 which deals with interest and article 12 which deals with royalties. However the effectiveness of the beneficial ownership provision in curbing treaty shopping is now questionable in light of certain international cases such as the decisions in Canadian cases of *Velcro Canada Inc. v*

The Queen[35] *and Prevost Car Inc. v Her Majesty the Queen.*[36] Paragraph 12.5 of the Commentary on Article 10 provides that: "whilst the concept of "beneficial ownership" deals with some forms of tax avoidance (*i.e.* those involving the interposition of a recipient who is obliged to pass on the dividend to someone else), it does not deal with other cases of treaty shopping and must not, therefore, be considered as restricting in any way the application of other approaches to addressing such cases" (such as those explained below). Nevertheless, the OECD does not recommend that the beneficial ownership provision should be completely done away with. The provision can still be applied with respect to income in articles 10, 11 and 12 but it cannot be relied on as the main provision to curb treaty shopping.

- Where that is the case, in the South African context, it is important that SARS should address the practical application or implementation of the tax treaty by coming up with measures of how a beneficial owner is to be determined. This could be achieved by introducing measures such as:
  - Beneficial Ownership Certificate;
  - Tax Registration Form;
  - Permanent Establishment Confirmation Form.
  - A definition of beneficial ownership in section 1 of the Income Tax Act, which is in line with the treaty definition as set out in the OECD MTC.

7.1 OECD recommendations for the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances

To prevent the granting of treaty benefits in inappropriate circumstances, the OECD notes that a distinction has to be made between:

a) Cases where a person tries to circumvent the provisions of domestic tax law to gain treaty benefits. In these cases, treaty shopping must be addressed through domestic anti-abuse rules.[37]

b) For cases where a person tries to circumvent limitations provided by the treaty itself, the OECD recommends treaty anti-abuse rules, using a three-pronged approach:
   (i) The title and preamble of treaties should clearly state that the treaty is not intended to create opportunities for non-taxation or reduced taxation through treaty shopping.[38]
   (ii) The inclusion of a specific limitation-of-benefits provisions (LOB rule), which is normally included in treaties concluded by the United States and a few other countries
   (iii) To address other forms of treaty abuse, not being covered by the LOB rule (such as certain conduit financing arrangements), tax treaties should

[35] 2012 TCC 57.
[36] 2008 TCC 231.
[37] OECD/G20 2015 Final Report on Action 6 in para 15.
[38] OECD/G20 2015 Final Report on Action 6 in para 19.

include a more general anti-abuse rule based the principal purposes (PTT) rule.

The OECD acknowledges that each rule has strengths and weaknesses and may not be appropriate for all countries.[39] Nevertheless, the OECD recommends that at a minimum level, to protect against treaty abuse, countries should include in their tax treaties an express statement that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements.[40] This intention should be implemented through either:

- using the combined LOB and PPT approach described above; or
- the inclusion of the PPT rule or;
- the inclusion of LOB rule supplemented by a mechanism (such as a restricted PPT rule applicable to conduit financing arrangements or domestic anti-abuse rules or judicial doctrines that would achieve a similar result) that would deal with conduit arrangements not already dealt with in tax treaties. [41]

7.2 Policy considerations that South Africa should take into account before adopting the OECD recommendations on Action 6

The OECD recognised that countries need a degree of flexibility to choose the right mix of measures, taking into account their own policy objectives.

For an emerging economy like South Africa, the insertion of these anti-abuse provisions in Its tax treaties would allow it to deny granting treaty benefits when it is inappropriate to do so. This power, however, must be exercised with care, taking into account the other important objective of tax treaties to prevent double taxation and foster foreign direct investments.

The other relevant policy and practical considerations include:

- Anti-avoidance provisions in tax treaties can create uncertainty that may be detrimental to foreign direct investments. In this context, South African has to consider the likely impact of such anti-avoidance rules on foreign direct investments, and whether the adverse impact is justified in the context of concerns over treaty abuse?
- Whether the country's tax administration has sufficient capacity to monitor and implement these anti-avoidance rules effectively?
- South Africa has to consider whether the implement these rules should be effected through negotiations with other countries on a bilateral basis, or

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39 OECD/G20 2015 Final Report on Action 6 in para 21.
40 OECD/G20 2015 Final Report on Action 6 in para 22.
41 OECD/G20 2015 Final Report on Action 6 in para 21.

multilaterally via the development of a multilateral instrument envisaged in Action 15. [42]

7.3 DTC recommendations regarding adopting the OECD treaty anti-abuse rules for South Africa

Where taxpayers circumvent the provisions of domestic tax law to gain treaty benefits, treaty shopping must be addressed through domestic anti-abuse rules

- However to prevent treaty override disputes the OECD recommends that the onus is on countries to preserve the application of these rules in their treaties.[43]
- South Africa should ensure it preserves the use of the application of domestic ant- avoidance provisions in its tax treaties.

<u>On the common intention of tax treaties:</u>

- It is recommend that in line with this recommendation, South Africa ensures that all its treaties refer to the common intention that its treaties are intended to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements. The costs and challenges of re-negotiating all treaties will be alleviated by signing the multilateral instrument that is recommended under Action 15 which will act as a simultaneous renegotiation of all tax treaties.

<u>Feasibility of applying the LOB provision in South Africa</u>

- The proposed LOB is modelled after the US LOB provision. Essentially, the LOB provision requires that treaty benefits (such as reduced withholding rates) are available only to companies that meet specific tests of having some genuine presence in the treaty country. However such an LOB provision has not been applied in many DTAs other than those signed by the USA, and even then, the provisions vary from treaty to treaty. South Africa for instance has an LOB provision in article 22 of its 1997 DTA with the USA.[44] The structure of the LOB provision as was set out in the September 2014 the OECD Report[45] on Action 6 was however criticised for its complexity. Even in the US, application of the LOB has given rise to considerable difficulties in practice and is continuously being reviewed and refined.[46] In its 2015 Final Report, the OECD

[42] Consultation by the DTC with Shee Boon, Manager, Tailored Tax Courses and Research Services, IBFD, the Netherlands.

[43] Arnold at 245

[44] Published in Government Gazette No. 185553 of 15/12/1997.

[45] OECD/G20 Base Erosion and Profit Shifting Project “Preventing the Granting of Treaty Benefits in Inappropriate Circumstances Action 6: 2014 Deliverable” (2014).

[46] PWC “Comment on DTC BEPS First Interim Report (30 March 2015) at 20.

considered some simplified versions of LOB provisions to be finalised in 2016.[47]

- If the simplified versions of the LOB provision are found feasible when complete, South Africa should consider adopting the same.

Feasibility of applying the PPT test in South Africa

- The PPT rule requires tax authorities to make a factual determination as to whether the principle purpose (main purpose) of certain creations or assignments of income or property, or of the establishment of the person who is the beneficial owner of the income, was to access the benefits of a particular tax treaty.
- As alluded to above, the factual determination required under the "principle purpose test" is similar to that required to make an "avoidance transaction" determination under the GAAR in section 80A-80L of the Income Tax Act – in particular, whether the primary purpose of a transaction (or series of transactions of which the transaction was a part) was to achieve a tax benefit, broadly defined. Since the two serve a similar purpose, the GAAR can be applied to prevent the abuse of treaties. Based on that one could argue that there is no need for South Africa to amend its treaties to include a PPT test since the GAAR could serve a similar purpose. Nevertheless, much as the OECD Final Report clearly explains that domestic law provisions can be applied to prevent treaty abuse, there could be concerns of treaty override if South Africa applies it GAAR in a treaty context. Besides South Africa's GAAR may not be exactly worded like a similar provision with its treaty partner. It is thus recommended that South Africa inserts a PPT test in its tax treaties.[48] Required re-negotiation of treaties can be effected by signing the Multilateral Instrument that could have a standard PPT test as is recommended in Action 15 of the OECD's BEPS Project.

7.4 OECD recommendations regarding other situations where a person seeks to circumvent treaty limitations

The OECD recommends targeted specific treaty anti-abuse rules fully discussed in paragraph 4.2 of the report below.

- It is also recommended that South Africa ensures its tax treaties also cover the targeted specific treaty anti-abuse rules in specific articles of its tax treaties (as pointed out in the OECD Report discussed in the attached) to prevent treaty abuse where a person seeks to circumvent treaty limitations. For example:

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47 OECD/G20 2015 Final Report on Action 6 in para 25.

48 Arnold at 245.

7.5 OECD recommendations in cases where a person tries to abuse the provisions of domestic tax law using treaty benefits

The OECD notes that many tax avoidance risks that threaten the tax base are not caused by tax treaties but may be facilitated by treaties. In these cases, it is not sufficient to address the treaty issues: changes to domestic law are also required (see discussion in paragraph 4.3 of the Report below).

- The OECD notes that its work on other aspects of the Action Plan, in particular Action 2 (Neutralise the effects of hybrid mismatch arrangements), Action 3 (Strengthen CFC rules), Action 4 (Limit base erosion via interest deductions and other financial payments) and Actions 8, 9 and 10 dealing with Transfer Pricing has addressed many of these transactions. [49]
- The DTC recommendations in respect to each of these Action Points is covered in the DTC Reports that deal with the same.

7.6 OECD recommendations on tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country or to terminate one

- ➢ South Africa should also take heed of the OECD recommendations on tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country or to terminate one. These are discussed in paragraph 4.5 of the Report below.

7.7 DTC recommendations on treaty shopping for South Africa

7.7.1 Treaty shopping and tax sparing provisions

South Africa's treaties with tax sparing also encourages "treaty shopping".[50] Generous tax sparing credits in a particular treaty can encourage residents of third countries to establish conduit entities in the country granting the tax incentive.[51]

- ➢ It is acknowledged that tax treaties are not generally negotiated on tax considerations alone and often countries' treaty policies take into account their political, social and other economic needs.[52] Nevertheless, care should be taken to adhere to international recommendations when designing tax sparing provisions, so as to prevent tax abuse. The OECD recommends that such designs should follow the form set out in its 1998 Report on Tax Sparing.

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49 OECD/G20 2015 Final Report on Action 6 in para 54.

50 H Becker & FJ Wurm *Treaty Shopping: An Emerging Tax Issue and its Present Status in Various Countries* (1988) 1; S Van Weeghel *The Improper Use of Tax Treaties with Particular Reference to the Netherlands and The United States* (1998) 119.

51 Arnold & McIntyre at 53.

52 Weeghel at 257-260.

- The problem in the older treaties may be resolved by renegotiation of the treaty or through a protocol. The protocol should, for instance, ensure that the relevant tax sparing provision refers to a particular tax incentive and should contain a sunset clause or expiry date to ensure that it is not open to abuse.[53]
- As the process of removing or modifying existing tax sparing provisions to prevent such abuses is often slow and cumbersome,[54] South Africa's legislators should ensure that future tax sparing provisions are drafted circumspectly.
- It is thus desirable for South Africa to adhere to the OECD's recommendations and best practices in drafting tax sparing provisions.
- All the obsolete tax sparing provisions should be brought up to date with the current laws if they are still considered necessary.

7.7.2 Low withholding tax rates in tax treaties encourage treaty shopping

A number of withholding taxes have been introduced in South Africa.[55] It is hoped that these will be instrumental in eliminating base erosion. Treaties with low tax jurisdictions with zero or very low withholding tax rates have been a major treaty shopping concern for South Africa. However measures are underway to adopt South Africa's its tax treaty negotiation policy to cater for the new policy on withholding taxes. Currently, all tax treaties with zero rates are under renegotiation so that they are not used for treaty shopping purposes.

- It is recommended that when re-negotiating the new limits for treaty withholding tax rates, caution is exercised since high withholding taxes can be a disincentive to foreign investment. Equilibrium must be achieved between encouraging foreign investment and protecting South Africa's tax base from erosion.

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53 RJ Vann & RW Parsons "The Foreign Tax Credit and Reform of International Taxation" (1986) 3(2) *Australian Tax Forum* 217.

54 Para 76 of the OECD commentary on art 23A & 23B.

55 The following withholding taxes apply in South Africa:
- The interest withholding tax; levied in terms of section 50A-H of the Act at a rate of 15% with effect from 1 March 2015 in respect of interest that is paid or becomes due and payable on or after that date.
- The dividend withholding tax levied in terms of section 64D – N of the Act, introduced from years of assessment commencing 1 April 2012 at a rate of 15%.
- The withholding tax on royalties (which was historically levied under repealed section 35(1) of the Act at a final rate of 12%), now levied at a rate of 15% in terms of section 49A – G of the Act with effect from 1 January 2015 in respect of royalties that are paid or become due and payable on or after such date;
- The withholding tax on foreign entertainers and sportspersons which is levied at a rate of 15% in terms of section 47A – K of the Act, with effect from 1 August 2006;
- The withholding tax on the disposal of immovable property by non-resident sellers levied in terms of section 35A of the Act, at a rate of 5% if the non-resident is an individual, 7.5% if the non-resident is a company and 10% if the non-resident is a trust with effect from 1 September 2007.

For a detailed discussion of South Africa's withholding tax regime please refer to: AW Oguttu "*An Overview of South Africa's Withholding Tax Regime*" TaxTalk (March/April 2014).

7.7.3 Treaty shopping: accessing capital gains benefits

A resident of a country which has no DTA or a less beneficial DTA with South Africa could make an investment in a property holding company in South Africa via a country, such as the Netherlands, in order to protect the eventual capital gains realized on the sale of the shares from South African capital gains tax. Treaties based on the OECD MTC provide in article 13(4) that the Contracting State in which immovable property is situated may tax capital gains realised by a resident of the other State on shares of companies that derive more than 50 per cent of their value from such immovable property. [56] However in Article 13(4) of the Dutch/South African DTA, only the Netherlands may impose tax on the gains realized from the sale of shares in a South African company. In the Netherlands, the gain on the sale of the shares should enjoy the protection under the Dutch participation exemption, and it is possible to extract the gain from the Dutch intermediate company without incurring withholding tax. The OECD Final Report on Action 6 (see discussion in paragraph 4.2 of the Report below) recommends that countries should ensure that there treaties have the anti-abuse provision in article 13(4) of the OECD Model Convention.[57] Paragraph 28.5 of the Commentary on Article 13 provides that States may want to consider extending the provision to cover not only gains from shares but also gains from the alienation of interests in other entities, such as partnerships or trusts, which would address one form of abuse.

- The OECD noted that Article 13(4) will be amended to include such wording. [58]
- In cases where assets are contributed to an entity shortly before the sale of the shares or other interests in that entity in order to dilute the proportion of the value of these shares or interests that is derived from immovable property situated in one Contracting State. The OECD noted that Article 13(4) also will be amended to refer to situations where shares or similar interests derive their value primarily from immovable property at any time during a certain period as opposed to at the time of the alienation only. [59]
- These anti-abuse provisions can be adopted by South Africa if it signs the envisaged multilateral instrument under Action 15, which will alleviate the need to renegotiate all its double tax treaties to cover these changes.

7.7.4 Treaty shopping and dual resident entities

The concept of "dual residence" could be used to avoid the dividends withholding tax (DWT) in South Africa. In terms of the current article 4(3) of the OECD model convention, a dual resident entity is deemed to be resident where its place of

56 OECD/G20 2015 Final Report on Action 6 in para 41.
57 OECD/G20 2015 Final Report on Action 6 in para 41.
58 OECD/G20 2015 Final Report on Action 6 in para 42.
59 OECD/G20 2015 Final Report on Action 6 in para 43.

effective management (POEM) is located. If a company incorporated in South Africa is effectively managed in the United Kingdom (UK), it will be deemed to be a resident of the UK for purposes of the DTA between South Africa and the UK. A UK resident parent company can thus avoid South African DWT on dividends derived from its South African subsidiary by transferring the effective management of the subsidiary to the UK. The subsidiary will then be treated as a UK tax resident which is not subject to DWT in terms of section 64C of the ITA.

- It should be noted though that the subsidiary will incur a CGT exit tax in South Africa in terms of section 9H of the ITA and paragraph 12(2)*(a)* of the Eighth Schedule to the ITA. The provision would for instance apply if a company moves its place of effective management out of South Africa.
- The OECD Final Report on Action 6 (see paragraph 4.3 of the Report below) notes that the OECD will make changes to the OECD MTC to the effect that treaties do not prevent the application of domestic “exit taxes”.[60]
- It should also be noted that the OECD recommends that the current POEM rule in article 4(3) will be replaced with a case-by-case solution of these cases.[61] The competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its POEM the place where it is incorporated and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any treaty benefits. [62]
- South Africa can adopt this change in its tax treaties if it signs the multilateral instrument envisaged under Action 15, which will alleviate the need to renegotiate all double tax treaties.

7.7.5 Treaty shopping and permanent establishment concept

The permanent establishment concept (as set out in article 5) of most South African DTAs does not include a building site or construction or assembly project if the project does not exist for more than twelve months (in some DTAs, e.g. the DTA with Israel, the period is limited to six months). A resident of those contracting States will, therefore, not be subject to South African tax on building or construction activities if the specific project does not last longer than twelve months (six months for residents of Israel). A resident of the other contracting state could split up the project into different parts, which are performed by different legal entities, thus allowing the fuller project to be performed in South Africa without incurring a tax liability in South Africa.

- It should be noted that treaty abuse through splitting-up of contracts to take advantage article 5 of the OECD Model Convention[63] will be curtailed by the

60 OECD/G20 2015 Final Report on Action 6 in para 65-66.
61 OECD/G20 2015 Final Report on Action 6 in para 47.
62 OECD/G20 2015 Final Report on Action 6 in para 48.
63 OECD/G20 2015 Final Report on Action 6 in para 29.

OECD recommendation that the Principle Purpose Test rule that will be added to the model convention in terms of the OECD Report on Action 7 (*Preventing the Artificial Avoidance of Permanent Establishment Status*, 2015).[64]

- Concerns about renegotiating all its tax treaties will be alleviated if South Africa signs the envisaged multilateral instrument under Action 15.

7.7.6 Treaty shopping involving dividend transfer transactions

Taxpayers can get involved in dividend transfer transactions, whereby a taxpayer entitled to the 15 per cent portfolio rate of Article 10(2)(b) may seek to obtain the 5 per cent direct dividend rate of Article 10(2)(a) or the 0 per cent rate that some bilateral conventions provide for dividends paid to pension funds.[65] The concern is that Article 10(2)(a) does not require that the company receiving the dividends to have owned at least 25 per cent of the capital for a relatively long time before the date of the distribution. This may encourage abuse of this provision, for example, where a company with a holding of less than 25 per cent has, shortly before the dividends become payable, increased its holding primarily for the purpose of securing the benefits of the provision, or where the qualifying holding was arranged primarily in order to obtain the reduction. [66]

- The OECD concluded that in order to deal with such transactions, a minimum shareholding period before the distribution of the profits will be included in Article 10(2)(a).
- Additional anti-abuse rules will also be included in Article 10 to deal with cases where certain intermediary entities established in the State of source are used to take advantage of the treaty provisions that lower the source taxation of dividends.[67]
- These anti-abuse provisions can be adopted by South Africa if it signs the envisaged multilateral instrument under Action 15, which will alleviate the need to renegotiate all its double tax treaties to cover these changes.

7.7.7 Issues pertaining to migration of companies

In the case of *CSARS v Tradehold Ltd,*[68] *a* South African company was “migrated” to Luxembourg from a tax perspective. This had the effect of capital gains which had accumulated in the company during the period that it was a resident of South Africa being taxable only in Luxembourg. Luxembourg then did not exercise its domestic tax law to tax any such gain. As a result of the decision in this case, South Africa’s domestic law was amended in order to prevent such arrangements. Specifically,

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[64] OECD/G20 2015 Final Report on Action 6 in para 30.

[65] See paragraph 69 of the Commentary on Article 18 and also OECD/G20 2015 Final Report on Action 6 in para 34.

[66] OECD/G20 2015 Final Report on Action 6 in para 35.

[67] OECD/G20 2015 Final Report on Action 6 in para 37.

[68] (132/11) [2012] ZASCA 61.

section 9H of the Income Tax Act states that, *inter alia*, where a company that is a resident ceases to be a resident, or a controlled foreign company ceases to be a controlled foreign company, the company or controlled foreign company must be treated as having disposed of its assets on the date immediately before the day on which that company so ceased to be a resident or a controlled foreign company, for an amount equal to the market value of its assets.

- It is worth noting that the OECD Final Report on Action 6, the OECD intends to make changes to the OECD MTC to the effect that treaties do not prevent the application of domestic "exit taxes". [69]

7.7.8 Issues pertaining to dividend cessions

Shortly after the introduction of dividends tax in section 64D of the Income Tax Act, various transactions were entered into by non-resident shareholders of South African shares in order to mitigate the tax. In particular, non-resident shareholders of listed South African shares in respect of which dividends were to be declared transferred their shares to South African resident corporate entities. The dividends were therefore declared and paid to the South African resident corporate entities which claimed exemption from dividends tax on the basis that, as set out in section 64F(1) of the Income Tax Act, the entities constituted companies which were residents of South Africa.

- The provisions of section 64EB of the Act were therefore introduced in August 2012 which adequately deal with such transactions since, *inter alia*; they deem the "manufactured dividend" payments to constitute dividends which are liable for dividends tax.

7.7.9 Base erosion resulting from exemption from tax for employment outside the Republic

Section 10(1)(o)(ii) of the Income Tax Act, exempts from tax any remuneration received or accrued by an employee by way of any salary, leave pay, wage, overtime pay, bonus, gratuity, commission, fee, emolument, including an amount referred to in paragraph(i) of the definition of gross income (fringe benefits) subject to certain conditions. Section 10(1)(o) was implemented along with the residence basis of taxation in 2001. It was supposed to be reviewed after 3 years. More than ten years have passed without a review. The concern about the provision is that there are many South Africans working abroad but whose home is still South Africa, so the exemption takes away the right for South Africa to tax on a residence basis. Because of the section 10(1)(o) exemption, an SA resident individual working in a foreign tax free country will not pay tax anywhere in the world on his/her remuneration for services rendered if he/she meets the 183 day (broken) and 60 day (continuous) outside SA requirements per tax year. At present it is not clear as to how many

[69] OECD/G20 2015 Final Report on Action 6 in para 65-66.

taxpayers are taking advantage of the exemption. SARS does not have reliable statistics on this matter. In a double tax treaty context, article 15 of treaties based on the OECD MTC deals with income from employment. It is recommended that either:

- The exemption should be withdrawn and a foreign tax rebate granted if foreign tax is imposed on the basis that the ongoing income stream should be taxable in RSA, even if the capital is invested abroad, or the exemption is amended to only apply where the employee will be taxed at a reasonable rate in the other country.

7.7.10 Base erosion that resulted from South Africa giving away its tax base

Some foreign jurisdictions, especially in Africa, are incorrectly claiming source jurisdiction on services (especially management services) rendered abroad and yet those services should be considered to be from a South African source. These foreign jurisdictions are withholding taxes from amounts received by South African residents in respect of services rendered in South Africa. The withholding taxes are sometimes imposed even if a treaty that exists between South Africa and the foreign country specifies otherwise, in that the treaties do not have an article dealing with management fees or South African residents have no permanent establishments in these countries. This resulted in double taxation. In 2011, the section 6*quin* special foreign tax credit for service fees was introduced to operate to offer relief from double taxation on cross-border services for South African multinational companies that render services to their foreign subsidiaries. National Treasury noted that section 6*quin* was intended to be a temporal measure. However the section amounted to South Africa effectively eroded its own tax base as it was obliged to give credit for taxes levied in the paying country. In the 2015 Tax Laws Amendment Act the section 6*quin* special foreign tax credit was withdrawn with effect from 1 January 2016.[70] National Treasury's reason for the change was that the special tax credit regime was a departure from international tax rules and tax treaty principles in that it indirectly subsidised countries that do not comply with the tax treaties. South Africa was the only country in the world that provided for this kind of tax concession. This provision effectively encouraged its treaty partners not to abide by the terms of the tax treaty and it resulted in a significant compliance burden on the South African Revenue Service. Some taxpayers also exploited this relief by claiming it even for other income such as royalties and interest that are not intended to be covered by this special tax credit.[71] Mutual Agreement Procedure (MAP) under tax treaties is the forum that ought to be used to solve such problems. There have been concerns that the withdrawal of section 6quin could undermine South Africa as a location for headquarters and could see banking, retail, IT and telecommunication companies relocating their service centres elsewhere. The tax credit under section 6quin was

70 Section 5 of the Draft Taxation Laws Amendment Bill 2015.
71 Explanatory Memorandum to the Taxation Laws Amendment Bill, 2015.

reasoned to be one of the reasons why such service companies based their headquarters in South Africa.[72]

In order to mitigate against such concerns and any double taxation that could be faced by South African taxpayers doing business with the rest of Africa, section 6*quat*(1C) Income Tax Act has been amended to allow for a deduction in respect of foreign taxes which are paid or proved to be payable without taking into account the option of the mutual agreement procedure under tax treaties. All tax treaty disputes should be resolved by competent authorities through mutual agreement procedure available in the tax treaties. In terms of SARS Interpretation Note 18, the phrase "proved to be payable" should be interpreted as an "unconditional legal liability to pay the tax." The concern though is whether the deduction method will offer the required taxpayers relief. The word "paid" as used in the section could be interpreted as requiring an "unconditional legal liability to pay the tax". If so, there would be no relief in cases where tax is incorrectly withheld (e.g. contrary to treaty provisions).

- To avoid such a situation, it is recommended that the wording in the previous 6*quin*, should be reintroduced in section 6quat1(C) which gives access to the section if tax was "levied" or "imposed" by a foreign government.
- It is submitted that the rationale behind the introduction of section 6*quin* remains valid; in that it was intended to make South Africa an attractive as a headquarter location. However this does not detract from the fact that it resulted in the erosion of its own tax base.
- South Africa's need to develop a coherent policy in respect of treaty negotiation and interpretation, especially with respect to its response to Africa's needs. SARS is encouraged to actively engage with the African countries which are incorrectly applying the treaties with the objective of reaching agreement on the correct interpretation and application of the treaties. South African taxpayers should not be subjected to double taxation simply because SARS is not able to enforce binding international agreements with other countries.[73]
- South African has a model tax treaty which informs its treaty negotiations. This model treaty should be made publicly available and any treaties that provide for the provision of taxing rights on technical service fees should be renegotiated insofar as possible to bring them in line with the model in this regard.[74]
- As noted above, the Mutual Agreement Procedure (MAP) under tax treaties is the forum that ought to be used to solve problems arising from the improper application of the treaty, such as in this case, where treaty services rendered

[72] Business Day "MTN Warns Against Removing African Tax Incentive". Available at http://www.bdlive.co.za/business/technology/2015/09/17/mtn-warns-against-removing-african-tax-incentive accessed 21 October 2015.

[73] PWC "Comments on DTC BEPS First Interim Report" (30 March 2015) at 22.

[74] PWC "Comments on DTC BEPS First Interim Report" (30 March 2015) at 22.

by South African residents in treaty countries ought to be taxed in South Africa but those countries still impose withholding taxes on services rendered in these countries despite the fact that the DTAs with these countries do not have an article dealing with management fees or South African residents have no permanent establishments in these countries. MAP has however not been effective in Africa.

- It is recommended that solving this problem, that is affecting intra-Africa trade, will require organisations such as ATAF to play a significant role.

7.7.11 Treaty shopping that could be encouraged by South Africa's Head Quarter Company regime

South Africa has a Head Quarter Company (HQC) regime under section 9I and of the ITA. The objective of the HQC regime is to promote the use of South Africa as the base for holding international investments. Thus headquarter companies are, for example, not subject to CFC rules, transfer pricing and thin capitalisation rules. Dividends declared by a HQC are exempt from dividends withholding tax. HQCs are exempt from the interest withholding tax. Royalties paid by a HQC are not subject to the withholding tax on royalties. A HQC must also disregard any capital gain or capital loss in respect of the disposal of any equity share in any foreign company, provided it held at least 10% of the equity shares and voting rights in that foreign company. The HQC will thus be subject to tax by virtue of its incorporation in South Africa, but the various exemptions from withholding taxes and the transfer pricing rules should have the impact that the HQC would not effectively be subject to any tax.

Since the HQC will be "liable to tax by virtue of its incorporation", it will generally be entitled to the benefits of the South African DTA network,[75] it could encourage treaty shopping by non-residents.

- The question arises whether a court could conceivably condemn a treaty shopping scheme by a non-resident to access a DTA with South Africa if the South African Legislator has effectively sanctioned treaty shopping by non-residents to access South African DTAs with other countries.

8 ACTION 7: PREVENTING THE ARTIFICIAL AVOIDANCE OF PERMANENT ESTABLISHMENT STATUS

8.1 Artificial avoidance of PE status through *commissionaire* arrangements and similar strategies

[75] Article 1 of the UK/South Africa DTA, which is the typical requirement to qualify as a resident of South Africa for DTA purposes.

A *commissionaire* arrangement may be loosely defined as an arrangement through which a person sells products in a State in its own name but on behalf of a foreign enterprise that is the owner of these products. Through such an arrangement, a foreign enterprise is able to sell its products in a State without technically having a permanent establishment to which such sales may be attributed for tax purposes and without, therefore, being taxable in that State on the profits derived from such sales. Since the person that concludes the sales does not own the products that it sells, that person cannot be taxed on the profits derived from such sales and may only be taxed on the remuneration that it receives for its services (usually a commission).

A foreign enterprise that uses a *commissionaire* arrangement does not have a permanent establishment because it is able to avoid the application of Art. 5(5) of the OECD Model Tax Convention, to the extent that the contracts concluded by the person acting as a *commissionaire* are not binding on the foreign enterprise. Since Art. 5(5) relies on the formal conclusion of contracts in the name of the foreign enterprise, it is possible to avoid the application of that rule by changing the terms of contracts without material changes in the functions performed in a State.

Similar strategies that seek to avoid the application of Art. 5(5) involve situations where contracts which are substantially negotiated in a State are not formally concluded in that State because they are finalised or authorised abroad, or where the person that habitually exercises an authority to conclude contracts constitutes an “independent agent” to which the exception of Art. 5(6) applies even though it is closely related to the foreign enterprise on behalf of which it is acting.

As a matter of policy, where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise should be considered to have a taxable presence in that country unless the intermediary is performing these activities in the course of an independent business. Changes will be effected to Art. 5(5) and 5(6) and the detailed Commentary thereon to address *commissionaire* arrangements and similar strategies by ensuring that the wording of these provisions better reflect this underlying policy

8.2 Artificial avoidance of PE status through the specific exceptions in Article 5(4)

Depending on the circumstances, activities previously considered to be merely preparatory or auxiliary in nature may nowadays correspond to core business activities. In order to ensure that profits derived from core activities performed in a country can be taxed in that country. Article 5(4) will be modified to ensure that each of the exceptions included therein is restricted to activities that are otherwise of a “preparatory or auxiliary” character.

BEPS concerns related to Art. 5(4) also arise from what is typically referred to as the "fragmentation of activities". Given the ease with which multinational enterprises (MNEs) may alter their structures to obtain tax advantages. Article 5(4) will be modified to include an anti-fragmentation rule that clarifies that it is not possible to avoid PE status by fragmenting a cohesive operating business into several small operations in order to argue that each part is merely engaged in preparatory or auxiliary activities that benefit from the exceptions of Article 5(4).

8.3 Splitting of contracts to avoid PE status

The exception in Art. 5(3), which applies to construction sites, has given rise to abuses through the practice of splitting-up contracts between closely related enterprises. The Principal Purposes Test (PPT) rule that will be added to the OECD Model Tax Convention as a result of the adoption of the Report on Action 6 (*Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*)[1] will address the BEPS concerns related to such abuses. For States that are unable to address the issue through domestic anti-abuse rules, a more automatic rule will be included in the Commentary as a provision that should be used in treaties that do not include the PPT or as an alternative provision to be used by countries specifically concerned with the splitting-up of contracts issue.

8.4 Follow-up work, including on issues related to attribution of profits to PEs

- The definition of PE that are included in this report will be among the changes proposed for inclusion in the multilateral instrument
- Follow-up work on attribution of profits issues related to Action 7 will be carried on with a view to providing the necessary guidance before the end of 2016, which is the deadline for the negotiation of the multilateral instrument.

8.5 Factors that South Africa should take note of regarding the OECD recommendations on Action 7

Although the OECD recommendations attempt to fix the current PE rules, they stop short of introducing new PE concepts for business models in digital economy and global supply chains that are more challenging for source countries. For an emerging economy like South Africa that seeks to enforce its source taxing rights under these business models, there are some questions that remain unanswered:

- Whether these OECD recommendations on PE are sufficient to ensure that source countries collect their fair share of taxes from the activities of multinational enterprises in their countries, or do they need an alternative concept under their domestic law?
- Whether the use of withholding taxes is appropriate as an alternative way to exercise their taxing rights?

- If alternative mechanisms/concepts are used by source countries to exercise their taxing rights, how do these mechanisms interact with their existing and future tax treaty obligations? [76]

8.6 DTC recommendation regarding Action 7 for South Africa

Where the South African Revenue Service (SARS) is not able to pin down the existence of a PE in terms of the current OECD rules, South Africa's source rules should be made strong enough to ensure that the activities of such non-residents in South Africa are taxed on a source basis.

- In this regard, it is recommended that South Africa's source rules in section 9 of the Income Tax Act are refined in line with the OECD 2015 recommendations on Action 7 to ensure they capture all income that is derived by non-residents from goods or services used or consumed in South Africa.

There are concerns in South Africa over the inability for SARS to detect and monitor whether PEs have been established in South Africa. This is especially so where non-residents engage in activities that are allegedly of a temporary nature, such as service activities or, for instance, consultants offering engineering services, or other technical or specialised services. Then there are also challenges where non-residents may escape PE status on allegations of being involved in preparatory or auxiliary activities. This is especially so when non-residents set up representative offices in South Africa. Various solutions to these detection problems could be considered, including the following:

- A system could be put in place to ensure such non-residents are brought into the tax system through filing tax returns. This will ensure that SARS is aware of the business activities of such non-residents in the country. Lack of proper registration means that certain foreign entities are improperly avoiding South African tax altogether.
- Since these representative offices would be renting some offices in South Africa, an obligation could be placed on residents who rent out properties for non-residents to use as representative offices, to ensure they file tax returns.

In South Africa, a PE is defined in section 1 of the Income Tax Act, as defined from time to time in Article 5 of the OECD Model Tax Convention. It should also be noted that South African courts have taken cognizance of the OECD Commentary in interpreting the scope of DTA provisions.

- In this regard, it is recommended that South Africa adopts the new OECD Guidelines on the meaning of the PE concept – even as section 1 of the

[76] Consultation by the DTC with Shee Boon, Manager, Tailored Tax Courses and Research Services, IBFD, the Netherlands

Income Tax Act clearly provides that PE concept will be defined in South Africa as it is defined from time to time in the OECD Model Tax Convention.

A company that is not tax resident in South Africa but conducts business in South Africa through a PE is taxable in South Africa on the income of that PE that is sourced in South Africa.[77] The reduction of the rate of income tax applicable to non-resident companies from 33% to 28% means that it is more tax efficient for a foreign company to conduct its South African operations through a PE located in South Africa, than to establish a South African subsidiary because the subsidiary would be liable to normal corporate tax at 28% and the dividends paid by a resident subsidiary to a non-resident company are also subject to dividends withholding tax at 15% if there is no tax treaty in place or, where a treaty is in place, the rate of dividends tax may be reduced in terms of an applicable treaty. This uneven playing field in favour of PEs in the form of branches costs the South African fiscus a loss in potential tax revenue.

- ➢ It is recommended that above concerns could be corrected by an introduction of a tax on branch profit remittances. It is recommended that South Africa should consider the legal, constitutional and DTA implications of introducing such a tax.

As is discussed in detail in the main report attached hereto, the concept of a "foreign business establishment" in section 9D(1) of the Act which (deals with controlled foreign companies) is key to the base erosion issues. The foreign business establishment exemption is therefore fundamental in determining what amounts are attributed to, and taxed in, South Africa. To address PE concerns relating to foreign business establishments it is noted and recommended that:

- ➢ The exemption from tax in respect of income arising in a controlled foreign company with a foreign business establishment is correct as a policy matter.
- ➢ Transfer pricing principles together with PE attribution principles should be used to test whether the correct amounts are attributable to the foreign business establishment. In this regard section 9D(9)(b) should be re-considered and consideration should be given to applying the transfer pricing rules and profit attribution principles contained in double tax agreements to the determination of whether amounts qualify for the foreign business establishment exemption.

On a tax policy level, it is important that South Africa does not emphasise legislative amendments to tax laws applicable to outbound MNEs, (for example, CFC rules), over tax laws applicable to inbound MNEs (for example, PE rules and source rules). It is necessary to balance legislation so as to ensure that South African companies

[77] See part I section 4(f) of the Taxation Laws Amendment Act 7 of 2010. See also Olivier L 'The "Permanent Establishment" requirement in an International and Domestic Taxation Context: An Overview' (2002) *SALJ* 866.

are not overtaxed in comparison to non-residents, which would affect their competitiveness. South African outbound MNEs should not be taxed and audited disproportionately higher compared to inbound MNEs. It is therefore recommended that:

- The current source rules should be revamped to ensure that they adequately enable SARS to determine when a PE exists so that SARS is able to determine how profits must be attributable to such PEs. Some countries, such as the UK, which is a member of the OECD and signs treaties based on the OECD MTC (as is the case with South Africa) has enacted rules relating to the tax treatment of branches in order to attend to these challenges. South Africa should emulate the UK by enacting provisions which clearly explain the tax treatment of PEs in South Africa. The rules should complement the PE definition in section 1 of the Act and further explain that the OECD rules for attributing profits to PEs would be applied. The rules that require non-residents carrying on business in South Africa to register with SARS aid enforce the source rules in this regard. As a residual matter the normal source rules and/or withholding taxes would apply for those that don't meet the PE threshold.
- Government should consider the prevalence of *commissionaire* type arrangements to determine the extent of the risk to the South African fiscus.
- South Africa should adopt the OECD recommendations on changes to the MTC and ensure that its double tax treaties are amended as deemed appropriate in line with changes to the OECD MTC.
- It is recommended that South Africa should consider the legal, constitutional and DTA implications of introducing a tax on branch profit remittances.

9 ACTIONS 8-10: ALIGNING TRANSFER PRICING OUTCOMES WITH VALUE CREATION

The OECD 2015 Final Reports on Actions 8-10 will result in changes to the Transfer Pricing Guidelines.

- For intangibles, the guidance clarifies that legal ownership alone does not necessarily generate a right to all (or indeed any) of the return that is generated by the exploitation of the intangible. The group companies performing important functions, controlling economically significant risks and contributing assets, as determined through the accurate delineation of the actual transaction, will be entitled to an appropriate return reflecting the value of their contributions.
- The revised guidance also addresses the situation where a capital-rich member of the group provides funding but performs few activities. If this associated enterprise does not in fact control the financial risks associated with its funding (for example because it just provides the money when it is asked to do so, without any assessment of whether the party receiving the money is creditworthy), then it will not be allocated the profits associated with

the financial risks and will be entitled to no more than a risk-free return, or less if, for example, the transaction is not commercially rational and therefore the guidance on non-recognition applies.

- The report also contains guidance on transactions involving commodities as well as on low value-adding intra-group services.

9.1 Policy perspectives and important matters for South Africa to take note of with respect to Actions 8-10

The OECD recommendations in Actions 8, 9 and 10 strengthen the application of the arm's length principle to limit the opportunities for multinational enterprises to shift profits through related party transactions. This is done, firstly, by requiring a careful delineation of the contracts and conduct of the parties involved in transactions between associated enterprises. The arm's length principle can be used to disregard transactions between associated enterprises where they lack commercial rationality. This non-recognition principle may apply, for example, where a capital rich member of a multinational group provides funding in a commercially non-rational manner.

Secondly, the arm's length principle is also used to ensure that profits are allocated to locations where contributions are made to the generation of these profits, as evidenced from the conduct of the parties involved. For intangibles, in particular, this means that group companies performing important functions, controlling economically significant risks and contributing assets will be entitled to an appropriate return reflecting the value of their contributions. Neither legal ownership, nor provision of funding, would entail any share in the intangible related returns.

Finally, tax administrations are empowered to make *ex post* adjustments in relation to hard to value intangibles in certain circumstances. This approach aims to resolve the information asymmetry between taxpayers and tax administrations when dealing with such intangibles. The OECD argues that such an approach is consistent with the arm's length principle as third parties often rely on price adjustment clauses in contracts dealing with hard to value intangibles.

Taken together, these measures based on the arm's length principle would entail a set of substance requirements for multinational enterprises that aim to shift profits away from countries where their values are created. As such, these measures should be considered useful for an emerging economy like South Africa in dealing with the profit shifting activities of their home-grown multinationals.

Notably, however, no additional measures were proposed to deal with the deductibility of base erosion payments such as services and royalties. Existing guidelines on intra-group services (and the conditions for disregarding intra-group service charges) were re-produced without significant changes in their scope. Thus, it is unclear whether the OECD recommendations would have any impact on the base erosion opportunities of foreign multinationals in this regard.[78] From these perspectives, South Africa may have to consider:

- Whether additional measures are needed to safeguard its tax base against base erosion payments such as royalties and services; in particular, when these payments are made to low tax, low function entities?
- What is the role of withholding taxes on potential base erosion payments made to low tax, low function entities?
- If additional measures are used to limit base erosion payments in the forms of services and intangibles, what safeguards are necessary to deal with potential double taxation that may arise when home countries seek to re-attribute and tax the income under the arm's length principle? Similarly, how do these measures relate to existing and future treaty obligations? [79]

9.2 General on transfer pricing in South Africa

South Africa has transfer pricing legislation in section 31 of the Income Tax (Act 58 of 1962) (the ITA). As the OECD recommends, South Africa applies the arm's length principle to curb transfer pricing. The legislation focuses on cross-border transactions, operations, schemes, agreements or understandings that have been effected between, or undertaken for the benefit of, connected persons.

If the terms or conditions made or imposed by the connected persons 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 benefitted must be calculated as if the terms and conditions had been at arm's length. To determine an arm's length price South Africa makes use of the methods set out in the OECD Transfer Pricing Guidelines,[80] which are also set out in SARS Practice Note 7.[81] This process is designed to combat the shifting of profits which should rightly be taxed in South Africa, to elsewhere.

Transfer pricing is a key focus area for SARS and an integral part of the Compliance Programme announced and reiterated by the Ministers of Finance (in office at various times). It is not currently possible to reliably calculate the extent of base erosion and profit shifting as a result of transfer pricing schemes either globally or in South Africa.

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78 Consultation by the DTC with Shee Boon, Manager, Tailored Tax Courses and Research Services, IBFD, the Netherlands.

79 Consultation by the DTC with Shee Boon, Manager, Tailored Tax Courses and Research Services, IBFD, the Netherlands.

80 OECD *Transfer Pricing for Multinational Enterprises and Administrations* (July 2010).

81 SARS Practice Note No. 7 in par 9.1.2 - 9.1.3.

The main DTC Report on Actions 8, 9, 10 and 13 attempts to follow a logical order when addressing these Actions by dealing first with Action 9, on the basis that it lays down the framework for the principles to be applied for ensuring that the outcomes are in line with value creation. Only thereafter are Actions 8 and10 covered and, finally, Action 13, follows.

9.3 DTC recommendations on South Africa's transfer pricing rules, in general as well as recommendations on Action 9: Assure transfer pricing outcomes are in line with value creation with regard to risks and capital

Based on the general discussion on the current legislative position in South Africa, set out in part 3 of the detailed DTC Report, and the discussion in part 4: Action 9: Assure Transfer Pricing Outcomes are in Line with Value Creation with regard to Risks and Capital the DTC recommends that:

- Although the OECD report on Actions 8 to10 indicates that further work is still to follow, based on the DTC's analysis of the recommended changes to be made to the Transfer Pricing Guidelines as a consequence of the Action 8 to10 OECD Report, and in line with the recommendations on the OECD Action 13 Report, in order to reduce the incidence of income not being taxed in South Africa when the risks, functions and values actually take place here, South Africa adopts all the OECD recommendations pertaining to transfer pricing rules and documentation.
- the South African legislators ensure that section 31 of the ITA refers to the OECD guidelines, on the basis that it is obligatory to apply these guidelines for companies that are part of a group that falls above the threshold (EU750mn) requiring country-by-country reporting, but also recommended for smaller companies. Thus, as part of the mandatory application for groups above the threshold, it is recommended that all the documentation requirements should also be compulsory in terms of the legislation. This will ensure global consistency of application and documentation for such groups, as is recommended by the OECD, and foster a system on which foreign investors can rely (in line with the National Development Plan).
- at least one legally Binding General Ruling (BGR), as provided for in section 89 of the Tax Administration Act, 2011, be enacted on section 31. Without departing from the OECD Transfer Pricing Guidelines, the suggested General Ruling should include a set of principles reflecting the South African reality e.g. to define the method for converting the threshold amount to SA Rands.
- when taxpayers perform benchmarking studies to arrive at an arm's length price, due to the absence of local comparable data, it only be mandatory to take to make adjustments to the results as a consequence of location savings advantages/disadvantages, following the issue of guidance by SARS/

Treasury in the BGR, as to how to make the specific adjustments for South Africa's specific circumstances.[82]

- for the purposes of providing certainty to inbound investors where loans are not significant, the BGR defines a safe harbour e.g. specified debt to equity ratio (or refers to the calculation set out in section 23M of the ITA), together with an interest rate (e.g. prime +2% - or in line with prevailing EXCON requirements) for inbound loans not exceeding, say, R100mn. In this manner inbound investors will not need to spend significant amounts on professional fees to determine an arm's length amount for loans below the pre-defined limit.
- the implementation of an Advanced Pricing Agreement (APA) regime, which would also provide certainty for investors. In order to introduce the option for APAs to be obtained in South Africa, SARS will be need to be given the resources to build an APA unit.
- SARS ensures that the enforcement capacity of its transfer pricing unit is adequate. It should also ensure that there is sufficient transfer pricing training and capacity building in its transfer pricing unit to audit the results.[83]

To reiterate the last point, above, the adoption of the recommendations set out above, however, requires "sufficient transfer pricing resources at SARS to provide the guidance and to audit the results".[84]

The DTC, however, cautions that, although the objective of the transfer pricing rules, proposed by the OECD, is to secure the taxation of the profits of MNE's in those countries where the functions, risks, and value lie, South Africa could be a net loser in the equation if it fails to successfully lure MNE's to the country, due to other unattractive non-tax practices and policies.

9.4 DTC recommendations on Action 8: Assure transfer pricing outcomes are in line with value creation with regard to intangibles

Action 8: Assure Transfer pricing outcomes are in line with value creation with regard to intangibles, focuses on determining the location of income and costs in the locations where the development, enhancement, maintenance, protection and exploitation of intangibles are capable of and actually take place, the DTC recommends that:

- South Africa adopts the principles set out in the OECD Action 8 Report in order to align with its trading partners' methodologies relating to intangibles, but that like the OECD, it reserves its rights to review and refine the

[82] Per recommendation by Deloitte 26 July 2015 at 7.
[83] Per SACTWU submission 18 August 2015 at 4.
[84] Per SACTWU submission 18 August 2015 at 4.

methodology over time, as it becomes clear whether it satisfies the correct allocation of profits principle.

- Greater transparency of the exchange control rules be considered.[85] The exchange control legal and regulatory framework that exists between the SARB and the delegated powers of the Authorised Dealers (and the DTI) results in the rules relating to the import, export and the use of intellectual property not being readily available, and not being consistently applied, to persons wishing to apply them properly.
- OECD's BEPS Action 8, which requires countries to enact legislation to prevent transfer pricing using intangibles, may not require major legislative attention in South Africa at this stage, since current exchange controls restrict the outbound movement of intangibles and royalty payments. In addition, South African CFC rules exclude intangibles from the CFC exemption benefits, section 23I of the ITA is an anti-avoidance provision which prohibits the claiming of an income tax deduction in respect of "tainted IP", and the "beneficial ownership" requirement in the royalty article (12) of DTAs can also be applied to deny the reduced withholding tax treaty rate if the recipient lacks substance. This can be further reinforced by cross boarder reporting rules on intangibles.
- Any future developments of EXCON rules for IP (and specifically any liberalisation of these rules) be carefully considered from a transfer pricing point of view. As indicated above, South African developed IP cannot be readily exported without Exchange Control or the Department of Trade and Industry (DTI) approval and royalty rates are often capped. Therefore Ideally EXCON policy development in this area should be informed by tax (and specifically transfer pricing) considerations.
- Care be taken, when developing tax legislation on transferring of intangibles, to ensure that the legislation is not so restrictive that it limits South Africa's ambitions to be a global player in the development of IP. It may for instance be advisable to revisit South Africa's R&D tax incentive to ensure that it is comparable to that in South Africa's trading partners.
- As a separate but related point, Government considers the attractiveness of South Africa as a destination for intangible related activity and consequent intangible related returns. The Key factors that influence South Africa's attractiveness as:
    - The effective tax rate of the South African operations (considering all tax factors);
    - The certainty of tax treatment;
    - The availability of local skills; and
    - The ability of foreign skills to sustainably migrate to South Africa. On this point current immigration laws and their application do not promote

[85] PWC "Comments on DTC BEPS First Interim Report" (30 March 2015) at 23.

the attraction of highly skill individuals to South Africa. The impact of this can be to limit the case for greater intangible returns to SA.[86]

9.5 DTC recommendations on ACTION 8: with respect to cost contribution arrangements

The OECD Transfer Pricing Guidelines set out various methods which are considered to be acceptable for determining the arm's length principle. One of these, which is, at times, used when different group companies are involved in contributing to the same transaction e.g. in particular, the development of IP, is the cost contribution method. Guidelines of how this method may be applied more effectively are set out in Action 8. Based on the discussion on such cost contribution arrangements, in the DTC's detailed report on Actions 8-10, the DTC recommends that:

- Notwithstanding that CCA's may be rarely seen in the South African context, as such arrangements arise offshore and may include South African entities, South Africa adopts the proposed guidelines for CCA's and ensures that it has sufficient exchange of information agreements in place to be able to derive the information that it requires should the taxpayer not be forthcoming.
- In line with the other recommendations, this recommendation again requires that SARS has the necessary resources and training to evaluate CCAs and obtain the necessary information.

9.6 DTC recommendations on Action 10: ensure transfer pricing outcomes are in line with value creation: other high risk transactions

As indicated above, the OECD Transfer Pricing Guidelines set out various methods which are considered to be acceptable for determining the arm's length principle. Another one of these, which the OECD thought required clarification, is the Transactional Profit Split Method (TPSM), which may be used in the context of global value chain, but which is often considered a method of last resort i.e. when no other 'one-sided' method appears to provide a suitable result e.g. in highly integrated operations, due to the complexities around applying it. Based in the discussion on this method, in the DTC detailed Report on Actions 8-10, the DTC recommends that:

- South Africa does not attempt to issue its own guidelines regarding the TPSM, but waits for the outcome of the OECD work still to be performed.
- The absence of local South African comparables should not be considered the determinant that the TPSM is the most appropriate method. The availability of all data should first be assessed. Failure to do so will lead to all countries that have no data adopting the TPSM, which will potentially give rise

[86] PWC "Comments on DTC BEPS First Interim Report" (30 March 2015) at 23.

to corresponding double taxation and transfer pricing disputes risks.[87] This could potentially detriment inward investment to South Africa.

- South African Regulators consider the need for publication of data by South African companies, or for SARS and/or Stats SA to issue information, based on data available to them, that may be suitably be used for South African comparability purposes. Such data is common in the rest of the World, and is what the currently available databases[88] are based upon.

9.7 DTC recommendations on Action 10: provide protection against common types of base eroding payments such as management fees and head office expenses - low value added intra group services; commodity transactions

(a) Low value added services

A major BEPS concern among many developing countries in which MNE enterprises operate, including South Africa and other African countries, is that these enterprises claim deductions for various head office expenses such as management, technical and service fees, often leaving little or no profit in the paying country. Based on the discussion on this issue in the DTC detailed report on Actions 8-10, the OECD recommends that:

- In line with other countries, and to ensure the success of the simplified approach, South Africa adopts the simplified approach for low value added services, as defined. This approach is based on the actual cost of the services (with a pre-determined suitable allocation key) plus a standard mark-up, recommended to be 5%, as proposed by the OECD, but also implements a suitable threshold for the amount of such services, to which this method can be applied . The level of this threshold to be evaluated once the further OECD work is complete.
- SARB be approached to align with this approach.
- In line with the Minister of Finance's 2016 Budget Speech, the services withholding tax be scrapped.

(b) Commodities

Developing countries, including South Africa, have identified commodities as of critical importance to them insofar as BEPS challenges are concerned. Action 10 recommends the application of comparable uncontrolled price (CUP) method for pricing such transactions for transfer pricing purposes and advises that this may be determined using quoted prices with suitable comparability adjustments. Based on

87 Deloitte submission to DTC July 2015 at 6.
88 E.g. Bureau van Dijk's Amadeus; Thompson Reuters; Royaltysource; Lexisnexis; Onesource; (all commonly used by taxpayers and tax authorities globally).

the discussion in of the DTC detail Report on Actions 8-10, the DTC recommends that:

- South Africa follows the OECD Guidelines on Commodities, including the additional guidelines, set out in Actions 8-10, with particular reference to quoted prices[89] and dates on which to apply these, as well as necessary adjustments, taking into account the comparability factors mentioned in the report (and others), and uses these as the basis on which to establish a benchmark price. Such a price should be one that results in an appropriate level of profit for the affiliate based on its activities in the country, and taking into account the value it creates for the MNE as a whole. This includes the benefits of providing a source of supply combined with the management of stocks and of ultimate delivery, and access to raw materials which is a type of location-specific advantage;
- SARS consults with Industry to understand the “quoted price” data, its origins and how MNE’s actually price the sale of commodities through the value chain, as well as South Africa’s location in the context of key markets, the transport logistics and demurrage risks in order to determine the situations when it might be appropriate to apply the “deemed pricing date”;[90]
- SARS issues guidance on the nature of adjustments that would be expected to be made to the quoted price, from a South Africa specific perspective, and only make such adjustments mandatory once such guidance has been issued;
- South African considers the implementation of Advanced Pricing Agreements to ensure certainty for both taxpayers and SARS.
- SARS has the resources to apply these Guidelines, in particular, to facilitate the timely conclusion of APA/MAP procedures with respect to commodity transactions to ensure non-double taxation. In addition, the SARS resources are sufficiently trained.

9.8 DTC recommendations on Advance Pricing Agreements in the South African context

There are various types of Advance Pricing Agreements (APAs) which may be reached between taxpayers and their own revenue authorities and, potentially, also another revenue authority where the other side of a transaction takes place. Such agreements generally increase certainty for taxpayers and tax authorities regarding the transfer pricing amounts of a particular transaction, and thereby encourage trade. Based on the discussion in DTC detailed report on Actions 8-10, the DTC recommends that:

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89 The EFF’s submission to the Davis Tax Committee supports the recommendation of the application of the quoted price (Sixth method) in South Africa at 31 and 39.

90 Deloitte submission to DTC: 26 July 2015 at 5.

- SARS considers putting in place an APA regime in South Africa, subject to it ensuring it has adequate resources.
  (It will be noted that this recommendation appears in other parts of this Report as it supports other areas discussed).

10 ACTION 13 TRANSFER PRICING DOCUMENTATION AND COUNTRY-BY-COUNTRY REPORTING

Action 13 of the *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan, OECD, 2013) requires the development of "*rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business. The rules to be developed will include a requirement that MNEs provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template".* In response to this requirement, a three-tiered standardised approach to transfer pricing documentation has been developed.

- First, the guidance on transfer pricing documentation requires multinational enterprises (MNEs) to provide tax administrations with high-level information regarding their global business operations and transfer pricing policies in a "master file" that is to be available to all relevant tax administrations.
- Second, it requires that detailed transactional transfer pricing documentation be provided in a "local file" specific to each country, identifying material related party transactions, the amounts involved in those transactions, and the company's analysis of the transfer pricing determinations they have made with regard to those transactions.
- Third, large MNEs are required to file a Country-by-Country Report that will provide annually and for each tax jurisdiction in which they do business the amount of revenue, profit before income tax and income tax paid and accrued. It also requires MNEs to report their number of employees, stated capital, retained earnings and tangible assets in each tax jurisdiction. Finally, it requires MNEs to identify each entity within the group doing business in a particular tax jurisdiction and to provide an indication of the business activities each entity engages in.

Taken together, these three documents (master file, local file and Country-by-Country Report) will require taxpayers to articulate consistent transfer pricing positions and will provide tax administrations with useful information to assess transfer pricing risks, make determinations about where audit resources can most effectively be deployed, and, in the event audits are called for, provide information to commence and target audit enquiries. This information should make it easier for tax administrations to identify whether companies have engaged in transfer pricing and other practices that have the effect of artificially shifting substantial amounts of income into tax-advantaged environments.

Some countries would strike that balance in a different way by requiring reporting in the Country-by-Country Report of additional transactional data (beyond that available in the master file and local file for transactions of entities operating in their jurisdictions) regarding related party interest payments, royalty payments and especially related party service fees. Countries expressing this view are primarily those from emerging markets (Argentina, Brazil, People's Republic of China, Colombia, India, Mexico, South Africa, and Turkey) who state they need such information to perform risk assessment and who find it challenging to obtain information on the global operations of an MNE group headquartered elsewhere.

Countries participating in the OECD/G20 BEPS Project agreed on the core elements of the implementation of transfer pricing documentation and Country-by-Country Reporting. This agreement calls for:

- The master file and the local file to be delivered by MNEs directly to local tax administrations.
- Country-by-Country Reports should be filed in the jurisdiction of tax residence of the ultimate parent entity and shared between jurisdictions through automatic exchange of information, pursuant to government-to-government mechanisms such as the multilateral Convention on Mutual Administrative Assistance in Tax Matters, bilateral tax treaties or tax information exchange agreements (TIEAs). In limited circumstances, secondary mechanisms, including local filing can be used as a backup.

These new Country-by-Country Reporting requirements are to be implemented for fiscal years beginning on or after 1 January 2016 and apply, subject to the 2020 review, to MNEs with annual consolidated group revenue equal to or exceeding EUR 750 million. It is acknowledged that some jurisdictions may need time to follow their particular domestic legislative process in order to make necessary adjustments to the law.

In order to facilitate the implementation of the new reporting standards, an implementation package has been developed consisting of model legislation which could be used by countries to require MNE groups to file the Country-by-Country Report and competent authority agreements that are to be used to facilitate implementation of the exchange of those reports among tax administrations.

Jurisdictions are called upon to introduce, necessary, domestic legislation in a timely manner. They are also encouraged to expand the coverage of their international agreements for exchange of information. Mechanisms will be developed to monitor jurisdictions' compliance with their commitments and to monitor the effectiveness of the filing and dissemination mechanisms. The outcomes of this monitoring will be taken into consideration in the 2020 review.

10.1 Policy perspectives that South Africa has to take into consideration with respect to Country-by-country reporting

The OECD clarifies that the precise content of the country by country report needs to reflect a balance between the information needs of tax administrations and concerns about inappropriate use of the information and the compliance costs and burdens imposed on businesses. While emerging economies like South Africa press for more information from foreign multinationals to satisfy their information needs, it is important to recognise that their home grown multinationals would incur significant costs in order to comply with similar rules. For an emerging economy like South Africa, in trying to balance these policy considerations, the issues to be considered are:

- What are the potential costs imposed on home grown multinationals if the transfer pricing documentation requirements (especially the requirements to prepare the master file and country by country reports) become mandatory?
- What are the potential costs imposed on home grown multinationals if the country by country reports are exchanged automatically with the countries in which the multinationals have activities?
- How could the design of transfer pricing documentation requirements and the associated exchange of information take into account the trade-offs between the costs for home grown multinationals and the benefits for tax administrations? [91]

10.2 DTC recommendations on Action 13: re-examine transfer pricing documentation

That taxpayers supply sufficient documentation to enable Revenue authorities to determine how business operate globally and where transfer pricing risks may arise is considered a critical aspect of the work performed by the OECD team working on the Action Plan.

Based on the discussion on detailed DTC Report on Action 13, and the fact that this is considered to be a Minimum Standard in terms of the OECD implementation guidelines, the DTC recommends that:

- Preparing a master file, local file and country-by-country reporting be compulsory for large Multinational businesses is legislated via reference to the OECD Guidelines in section 31. In line with the OECD Guidelines, MNE groups with annual consolidated group revenue in the immediately preceding fiscal year of €750 million (converted at year end) could be considered to be large MNEs.

[91] Consultation by the DTC with Shee Boon, Manager, Tailored Tax Courses and Research Services, IBFD, the Netherlands

- A Binding General Ruling be issued setting out *inter alia* how the conversion be performed locally e.g. based on SARS average rates for the year.
- As the OECD recommends, with regard to compliance matters under the heading "materiality", disproportionate and costly documentation requirements should not imposed on SMEs (groups with consolidated turnover less than the defined threshold (currently EU750)). SMEs should not be required to produce the same amount of documentation that might be expected from larger enterprises. Such documentation could be recommended but not obligatory, leaving the amount of transfer pricing documentation produced to support the pricing to the relevant SME group. However, SMEs could be obliged to provide information about their material cross-border transactions in their tax returns to facilitate risk assessment (as is presently the case), and upon a specific request of the tax administration in the course of a tax examination or for further transfer pricing risk assessment purposes. It is however important that definition of material transactions be clarified.
- SARS revises PN 7 to be in line with the OECD revised Transfer Pricing Documentation Guidelines in Chapter V and recommended for companies that are part of smaller groups. The OECD's recommendation that countries should adopt a standardised approach to transfer pricing documentation that follows a three-tiered structure consisting of a master file, a local file and country-by-country reporting could be adopted in South Africa, as a recommendation even for groups of companies with turnover below the OECD threshold.
- although with regard to country-by country reporting, South Africa, along with other emerging economies, is of the view that the country-by-country report should require additional transactional data (beyond that available in the master file and local file for transactions of entities operating in their jurisdictions) regarding related party interest payments, royalty payments and especially related party service fees in order to perform risk assessments where it is found challenging to obtain information on the global operations of an MNE group headquartered elsewhere, since the OECD plans to take these views into consideration and review the implementation thereof no later than end of 2020, South Africa monitors the OECD's final recommendations in this regard and then implements them, but remains in line with the prevailing OECD guidelines at any particular time. This will ensure consistency of treatment of companies in groups globally. Furthermore, as the country-by country report is designed to provide information for risk assessment only the relevant authority (e.g. SARS) would still be in a position to ask for detailed information regarding any particular transaction paid/received by the local company.
- For the purposes of providing certainty to inbound investors where loans are not significant, the revised PN7 defines a safe harbour e.g. debt to equity ratio (or in line with s23M), together with interest rate (e.g. prime +2% - or in line with prevailing EXCON requirements) for inbound loans not exceeding, say, R100mn. In this manner inbound investors will obtain the certainty they need

regarding loan requirements without having to expend significant amounts to determine an arm's length amount for loans below the pre-defined limit.

- The various provisions in the Tax Administration Act which deal with confidentiality, which include sections 21, 56 and Chapter 6 of the Tax Administration Act be strengthened in line with the OECD recommendations. The OECD recommends that tax administrations should take all reasonable steps to ensure that there is no public disclosure of confidential information (trade secrets, scientific secrets, *etc.*) and other commercially sensitive information contained in the documentation package (master file, local file and country-by-country report).
- SARS clarifies what its expectations are with respect to the timing of submission of each of the three reports, in line with the OECD recommendations. The OECD notes that practices regarding the timing of the preparation of the documentation differ among countries. The OECD however recommends that the local file should be finalised no later than the due date for the filing of the tax return for the fiscal year in question. The master file should be updated by the tax return due date for the ultimate parent of the MNE group. And that the country-by-country report, should be submitted when the final statutory financial statements and other financial information are finalised, which may be after the due date for tax returns for a given fiscal year.
- clear guidance should be issued on *which* group company has the legal obligation to retain what transfer pricing documentation. In this respect a distinction should be made between in-bound and outbound groups. [92] The OECD recommends that taxpayers should not be obliged to retain documents beyond a reasonable period consistent with the requirements of domestic law at either the parent company or local entity level. In South Africa, the rules in relation to retention of documents are contained in Chapter 4 of the Tax Administration Act 28 of 2011, particularly sections 29 to 32 which deal with "returns and records". It is thus probably not necessary, other than as recommended here, for SARS to provide additional detail as regards retention of documents except to the extent that it is considered necessary to have rules which are specific to transfer pricing documentation.
- SARS considers including guidance in the recommended update to the Practice Note 7 and the BGR with regard to the requirement of frequency of documentation updates. The OECD recommends that transfer pricing documentation be periodically reviewed in order to determine whether functional and economic analyses are still accurate and relevant and to confirm the validity of the applied transfer pricing methodology. Furthermore that the master file, the local file and the country-by-country report should be reviewed and updated annually. And that database searches for comparables be

92 PWC "Comments on DTC BEPS First Interim Report" (30 march 2015) at 23.

updated every 3 years. It is recommended that SARS adhere to these recommendations.

- Clarity be provided in in the legislation or the revised PN 7/BGR that the secondary adjustment mechanism results in a tax equivalent to the 15% withholding tax with no DTA relief available.
- SARS considers coming up with additional measures to encourage compliance. Apart from imposing penalties on taxpayers, the OECD recommends that another way for countries to encourage taxpayers to fulfil transfer pricing documentation requirements is by designing compliance incentives. For example, where the documentation meets the requirements and is timely submitted, the taxpayer could be exempted from tax penalties or subject to a lower penalty rate if a transfer pricing adjustment is made and sustained, notwithstanding the provision of documentation.
- SARS continues to reinforce and expand its highly skilled transfer pricing team, including not only lawyers and accountants but also business analysts and economists, to ensure an understanding of commercial operations. This will require that measures are taken to identify, employ and retain skilled personnel especially in the regions.
- SARS improves Information required from corporates via the ITR14 submissions so that timely decisions can be made on the risk assessment of companies, and any consequent queries and adjustments, especially SME's that are not compelled to compile country by country reporting information. The guidance provided by SARS in the Tax Return Guide in respect of the relevant information is often unclear and needs significant improvement. In addition, the Tax Return Guide is updated once in a while, however, taxpayers are not notified of these updates, which may result in a taxpayer completing transfer pricing related disclosure following specific guidance, but at the time the tax return is submitted via e-filing, the guidance (or even the question in the tax return) may have changed without the taxpayer being sufficiently notified of this.[93]
- The collection and sharing of data be extended to include other holders of vital information such as exchange control information about capital outflows collected by the South African Reserve Bank.
- Care be taken to ensure that even when SARS builds a data base, taxpayers such as financial institutions can still make use of non-publically available data so that they are able to defend their positions against these comparables, since with respect to financial institutions, financial data available to SARS usually includes publically available and non-publically available data. This will also minimise the uncertainties for taxpayers with respect to updating their data and other administrative issues surrounding data keeping.[94]

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93 SAICA "Comment on DTC Ist Interim BEPS Report" (31 March 2015) para 26.

94 Comments submitted to the DTC by the Banking Association South Africa (BASA) on the "DTC First Interim Report on BEPS Action 1" (25 March 2015) at 2.

- The use of safe harbour rules, which can be easily applied and documented be considered.

11 ACTION 11: MEASURING AND MONITORING BEPS

It is commonly accepted that multinationals engage in activities that are intended to shift profits from jurisdictions where they do business to low tax jurisdictions and thereby erode tax bases of their residence or source countries. So far, not much attention has been paid to measuring the scale and impact of tax avoidance resulting in base erosion and profit shifting ("BEPS"). The OECD concedes that although measuring the scale of BEPS proves challenging because the complexity of BEPS and the serious limitations of data, it is now known that the fiscal effects of BEPS are significant.[95] The adverse fiscal and economic impacts of base erosion and profit shifting (BEPS) have been the focus of the OECD/G20 BEPS Project since its inception. While anecdotal evidence has shown that tax planning activities of some multinational enterprises (MNEs) take advantage of the mismatches and gaps in the international tax rules, separating taxable profits from the underlying value-creating activity, the *Addressing Base Erosion and Profit Shifting* report (OECD, 2013) recognised that the scale of the negative global impacts on economic activity and government revenues have been uncertain.

The OECD concedes that although measuring the scale of BEPS proves challenging given the complexity of BEPS and the serious data limitations, it is now known that the fiscal effects of BEPS are significant.[96] The findings of the work performed since 2013 highlight the magnitude of the issue, with global corporate income tax (CIT) revenue losses estimated between 4% and 10% of global CIT revenues, i.e. USD 100 to 240 billion annually. Given developing countries' greater reliance on CIT revenues, estimates of the impact on developing countries, as a percentage of GDP, are higher than for developed countries.

In addition to significant tax revenue losses, BEPS causes other adverse economic effects, including tilting the playing field in favour of tax-aggressive MNEs, exacerbating the corporate debt bias, misdirecting foreign direct investment, and reducing the financing of needed public infrastructure.

11.1 OECD six indicators of BEPS

In light of the above, the OECD Report adopts six indicators of BEPS activity that highlight BEPS behaviours using different sources of data, employing different metrics, and examining different BEPS channels. When combined and presented as

95 OECD/G20 2015 Final Report on Action 11 at 15.
96 OECD/G20 2015 Final Report on Action 11 at 15.

a dashboard of indicators, they confirm the existence of BEPS, and its continued increase in scale in recent years.

- ***The profit rates of MNE affiliates located in lower-tax countries are higher than their group's average worldwide profit rate.*** For example, the profit rates reported by MNE affiliates located in lower-tax countries are twice as high as their group's worldwide profit rate on average.
- ***The effective tax rates paid by large MNE entities are estimated to be 4 to 8½ percentage points lower than similar enterprises with domestic-only operations***, tilting the playing-field against local businesses and non-tax aggressive MNEs, although some of this may be due to MNEs' greater utilisation of available country tax preferences.
- ***Foreign direct investment (FDI) is increasingly concentrated****.* FDI in countries with net FDI to GDP ratios of more than 200% increased from 38 times higher than all other countries in 2005 to 99 times higher in 2012.
- ***The separation of taxable profits from the location of the value creating activity is particularly clear with respect to intangible assets, and the phenomenon has grown rapidly***. For example, the ratio of the value of royalties received to spending on research and development in a group of low-tax countries was six times higher than the average ratio for all other countries, and has increased three-fold between 2009 and 2012. Royalties received by entities located in these low-tax countries accounted for 3% of total royalties, providing evidence of the existence of BEPS, though not a direct measurement of the scale of BEPS.
- ***Debt from both related and third-parties is more concentrated in MNE affiliates in higher statutory tax-rate countries.*** The interest-to-income ratio for affiliates of the largest global MNEs in higher-tax rate countries is almost three times higher than their MNE's worldwide third-party interest-to-income ratio.

These BEPS indicators confirm that profit shifting is occurring, is significant in scale and likely to be increasing, and creates adverse economic distortions. The limitation of currently available data remains a serious constraint in the effectiveness of the proposed indicators. Additionally, in the general examination of profit shifting, the said indicators being no exception, it has been found to be difficult to separate the effects of BEPS from real economic factors and the effects of deliberate tax policy choices.[97]

Action 11 acknowledges the existence of other empirical studies that cement their position on that occurrence of BEPS through transfer pricing, strategic location of intangibles and debt and treaty abuse. Furthermore, empirical analysis indicates that BEPS adversely affects competition between businesses, levels and location of debt,

97 OECD/G20 Final Report on Action 11 at 16.

the location of intangible investments, and causes fiscal spillovers between countries and wasteful and inefficient expenditure of resources on tax engineering. The empirical analysis in this report, along with several academic studies, confirms that strong anti-avoidance rules reduce profit shifting in countries that have implemented them.

Unfortunately, the said studies and all analyses of BEPS are severely constrained by the limitations of the currently available data. The available data is not comprehensive across countries or companies, and often does not include actual taxes paid. In addition to this, the analyses of profit shifting to date have found it difficult to separate the effects of BEPS from real economic factors and the effects of deliberate government tax policy choices. Improving the tools and data available to measure BEPS will be critical for measuring and monitoring BEPS in the future, as well as evaluating the impact of the countermeasures developed under the BEPS Action Plan.

While recognising the need to maintain appropriate safeguards to protect the confidentiality of taxpayer information, the OECD Final Report on Action 11 makes a number of recommendations that will improve the analysis of available data. Some of the information needed to improve the measurement and monitoring of BEPS is already collected by tax administrations, but not analysed or made available for analysis. The focus of the report's recommendations in this area is on improved access to and enhanced analysis of existing data, and new data proposed to be collected under Actions 5, 13 and, where implemented, Action 12 of the BEPS Project.

The OECD Final Report on Action 11 recommends that the OECD work with governments to report and analyse more corporate tax statistics and to present them in an internationally consistent way. For example, statistical analyses based upon Country-by-Country Reporting data have the potential to significantly enhance the economic analysis of BEPS. These improvements in the availability of data will ensure that governments and researchers will, in the future, be better able to measure and monitor BEPS and the actions taken to address BEPS.

As a result, the OECD Action 11 Report emphasises the notion that improving tools and data available to measure BEPS will be critical for measuring and monitoring BEPS in the future, as well as evaluating the impact of countermeasures developed in the OECD Action Plans. These sentiments are seen and reiterated throughout the entire text of the Report and reflected in the six proposed recommendations for improving BEPS data collection and analysis. While the need to improve the economic and fiscal analysis of BEPS requires greater access to this data, the Report suggests that any recommendations around the availability of data in the future must take into account the need to protect the confidentiality of taxpayer information and minimise the administrative burden for governments and taxpayers.[98]

11.2 DTC recommendations for South Africa with respect to Action 11

The DTC considers that it is essential for South Africa to measure the scale and economic impact of BEPS in South Africa. It is acknowledged that so far there is no measuring and monitoring system for BEPS in South Africa and, therefore, the scale of BEPS and the economic impact thereof are not known. As such it is impossible to determine whether more or less resources should be placed towards the curbing of BEPS.

The recommendations made by the OECD, in this regard, mainly place on governments the obligation to enhance the collection and maintenance of information that would help determine the extent of BEPS and therefore the economic impact of BEPS. In the absence of a monitoring and measuring system for BEPS in South Africa, it is recommended that South Africa should adopt the recommendations of the OECD in developing the monitoring and measuring system.

It is noted that the OECD an obligation on itself to "*continue to produce and refine analytical tools and BEPS indicators to monitor the scale and economic impact of BEPS and to evaluate the effectiveness and economic impact of BEPS countermeasures".* This recommendation places no obligation or expectation of action on the governments, therefore no recommendation is made in that regard. Along with the other similar recommendations of the OECD, the DTC therefore recommends that:

- South Africa works with the OECD to publish, on a regular basis, a new Corporate Tax Statistics publication, which would compile a range of data and statistical analyses relevant to the economic analysis of BEPS in an internationally consistent format. This publication could include aggregated and anonymised statistical analyses prepared by the National Treasury based on data collected under Action 13 Country-by-Country Reports. South Africa already publishes comprehensive data on tax collections by segment of taxpayer, which is to be complimented. It has the systems in place to determine much more from the information that can be collected via tax returns. It is therefore recommended that that South Africa publishes a new Corporate Tax Statistics report in line with this OECD Recommendation.
- South Africa works with the OECD to produce periodic reports on estimated revenue impacts of proposed and enacted BEPS countermeasures.

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98 OECD/G20 Final Report on Action 11 at 250.

- The South African government improves the public reporting of Business Tax Statistics particularly for MNEs.
- South Africa continues to make improvements in non-tax data relevant to BEPS such as the broadening country coverage and improving data on FDI associated with resident special purpose entities, trade in services and intangible investments.
- South Africa considers current best practices and explores new approaches to collaborating on BEPS research with academics and other researchers. The government could encourage more research on MNE activity within the South African Revenue Service, the National Treasury, Statistics South Africa and by academic researchers, to improve the understanding of BEPS and to better separate BEPS from real economic effects and non-BEPS tax preferences.

12 ACTION 12: REQUIRE TAXPAYERS TO DISCLOSE THEIR AGGRESIVE TAX PLANNING ARRANGEMENTS

The OECD notes that lack of timely, comprehensive and relevant information on aggressive tax planning strategies is one of the main challenges faced by tax authorities worldwide. Early access to such information provides the opportunity to quickly respond to tax risks through informed risk assessment, audits, or changes to legislation or regulations. Action 12 of the OECD 2013 *Action Plan on Base Erosion and Profit Shifting* recognises the benefits of tools designed to increase the information flow on tax risks to tax administrations and tax policy makers. It therefore called for recommendations regarding the design of mandatory disclosure rules for aggressive or abusive transactions, arrangements, or structures, taking into consideration the administrative costs for tax administrations and businesses and drawing on experiences of the increasing number of countries that have such rules.

The 2015 OECD Final Report on Action 12 provides a modular framework that enables countries without mandatory disclosure rules to design a regime that fits their need to obtain early information on potentially aggressive or abusive tax planning schemes and their users. The recommendations in this Report do not represent a minimum standard and countries are free to choose whether or not to introduce mandatory disclosure regimes. Where a country wishes to adopt mandatory disclosure rules, the recommendations provide the necessary flexibility to balance a country’s need for better and more timely information with the compliance burdens for taxpayers. The Report also sets out specific recommendations for rules targeting international tax schemes, as well as for the development and implementation of more effective information exchange and co-operation between tax administrations. A summary of the main aspects of the Report is as follows:

12.1 Design principles and key objectives of a mandatory disclosure regime

Mandatory disclosure regimes should be clear and easy to understand, should balance additional compliance costs to taxpayers with the benefits obtained by the tax administration, should be effective in achieving their objectives, should accurately identify the schemes to be disclosed, should be flexible and dynamic enough to allow the tax administration to adjust the system to respond to new risks (or carve-out obsolete risks), and should ensure that information collected is used effectively.

The main objective of mandatory disclosure regimes is to increase transparency by providing the tax administration with early information regarding potentially aggressive or abusive tax planning schemes and to identify the promoters and users of those schemes. Another objective of mandatory disclosure regimes is deterrence: taxpayers may think twice about entering into a scheme if it has to be disclosed. Pressure is also placed on the tax avoidance market as promoters and users only have a limited opportunity to implement schemes before they are closed down. Mandatory disclosure regimes both complement and differ from other types of reporting and disclosure obligations, such as co-operative compliance programmes, in that they are specifically designed to detect tax planning schemes that exploit vulnerabilities in the tax system early, while also providing tax administrations with the flexibility to choose thresholds, hallmarks and filters to target transactions of particular interest and perceived areas of risk.

12.2 Key design features of a mandatory disclosure regime

In order to successfully design an effective mandatory disclosure regime, the following features need to be considered: who reports, what information to report, when the information has to be reported, and the consequences of non-reporting. In relation to the above design features, the Report recommends that countries introducing mandatory disclosure regimes:

- impose a disclosure obligation on both the promoter and the taxpayer, or impose the primary obligation to disclose on either the promoter or the taxpayer;
- include a mixture of specific and generic hallmarks, the existence of each of them triggering a requirement for disclosure. Generic hallmarks target features that are common to promoted schemes, such as the requirement for confidentiality or the payment of a premium fee. Specific hallmarks target particular areas of concern such as losses;
- establish a mechanism to track disclosures and link disclosures made by promoters and clients as identifying scheme users, as this is also an essential part of any mandatory disclosure regime. Existing regimes identify these through the use of scheme reference numbers and/or by obliging the promoter to provide a list of clients. Where a country places the primary reporting obligation on a promoter, it is recommended that they also introduce

scheme reference numbers and require, where domestic law allows, the production of client lists;

- link the timeframe for disclosure to the scheme being made available to taxpayers when the obligation to disclose is imposed on the promoter; link it to the implementation of the scheme when the obligation to disclose is imposed on the taxpayer;
- introduce penalties (including non-monetary penalties) to ensure compliance with mandatory disclosure regimes that are consistent with their general domestic law.

12.3 Coverage of international tax schemes

There are a number of differences between domestic and cross-border schemes that make the latter more difficult to target with mandatory disclosure regimes. International schemes are more likely to be specifically designed for a particular taxpayer or transaction and may involve multiple parties and tax benefits in different jurisdictions, which can make these schemes more difficult to target with domestic hallmarks. In order to overcome these difficulties, the Report recommends that:

- Countries develop hallmarks that focus on the type of cross-border BEPS outcomes that cause them concern. An arrangement or scheme that incorporates such a cross-border outcome would only be required to be disclosed, however, if that arrangement includes a transaction with a domestic taxpayer that has material tax consequences in the reporting country and the domestic taxpayer was aware, or ought to have been aware, of the cross-border outcome.
- Taxpayers that enter into intra-group transactions with material tax consequences are obliged to make reasonable enquiries as to whether the transaction forms part of an arrangement that includes a cross-border outcome that is specifically identified as reportable under their home jurisdictions' mandatory disclosure regime.

12.4 Enhancing information sharing

Transparency is one of the three pillars of the OECD/G20 BEPS Project and a number of measures developed in the course of the Project will give rise to additional information being shared with, or between, tax administrations. The expanded Joint International Tax Shelter Information and Collaboration Network (JITSIC Network) of the OECD Forum on Tax Administration provides an international platform for an enhanced co-operation and collaboration between tax administrations, based on existing legal instruments, which could include co-operation on information obtained by participating countries under mandatory disclosure regimes.

12.5 Mandatory disclosure rules in South Africa and recommendations to enhance their effectiveness

South Africa has Reportable Arrangements provisions in Part B of the Tax Administration Act 28 of 2011 (TAA - fully discussed in the main report below), which are supposed to work as an "early warning system" for SARS, allowing it to identify potentially aggressive transactions when they are entered into. Over the years the SARS Unit responsible for Reportable Arrangements started managing the listed Reportable Arrangements in a more proactive manner, which has resulted in an increase in the number of arrangements reported in line with SARS expectations. SARS statistics on Reportable Arrangements[99] show that between 2009 and first quarter of 2016, 838 arrangements have been reported (see details in paragraph 9.2 of the Report below).

The OECD recommends that where a country places the primary reporting obligation on the promoter, it should introduce scheme reference numbers and require the preparation of client lists in order to fully identify all users of a scheme and to enable risk assessment of individual taxpayers.[100] South Africa has a dual reporting system. in term of section 38 of the TAA, the "promoter" has the primary obligation to report. If there is no promoter in relation to the "arrangement" or if the promoter is not a resident, the "participants" must disclose the information.

- In light of the dual reporting mechanism in South Africa, and in the interest of not placing administrative burdens on taxpayers to submit client lists, it is recommended that client lists should not be introduced in South Africa. Such information could be easily accessed from the disclosures submitted by the participants in terms of section 38 of the TAA. It should also be noted that SARS Form RA 01 for Reporting Reportable Arrangements contains detailed aspects of what must be disclosed by a participate or a promoter – the information that would be provided on completion of these Forms is broad enough to capture what could be required from client lists. It should, however be noted that the RA01 Form available on the SARS website refers to pre-TAA legislation and is, thus, not up to date with current law (see below). It is recommended that it be updated.
- Section 38 of the TAA provides that an arrangement must be disclosed in the prescribed form. Disclosing the arrangement in any other manner than with the prescribed form would therefore not constitute compliance to the TAA. Form RA-01 expressly stipulates that it is the form in which to report arrangements in terms of sections 80M – 80T of the ITA. Sections 80M – 80T were repealed by the TAA in 2011. No form exists in terms of the TAA with which to disclose reportable arrangements. It is, thus, important that SARS

[99] SARS "Tax Avoidance and Reportable Arrangements Unit". See reportable@sars.gov.za.
[100] OECD/G20 2015 Final Report on Action 12 in para 172.

urgently provides a form that is line with the current law. Without a valid prescribed form, it is impossible to comply with the provisions.

The OECD provides certain recommendations regarding structuring monetary penalties for non-disclosure. It recommends that in setting penalty levels:

- Jurisdictions may take into account factors such as whether negligence or deliberate non-compliance or tax benefit may be linked to the level of penalties levied.
- Penalties should be set at a level that maximises their deterrent value without being overly burdensome or disproportionate.
- Consideration should be given to percentage based penalties based upon transaction size or the extent of any tax savings.[101]

In South Africa, section 212 of the TAA, sets out the penalties "a participant" to a reportable arrangement is liable for in case of failure to disclose the reportable arrangement. Section 34(c) of the TAA defines a "participant" as "any other person who is a party to an arrangement". However the TAA does not explain who is included or excluded in the term "party to an arrangement". It is for instance not clear whether it includes beneficiaries of discretionary trusts. If the phrase "a party to an arrangement" is interpreted so widely, there are concerns that SARS may impose unfair and unjust penalties on innocent persons i.e. those who have no knowledge of the actions of the trust. It should be noted though (in line with the OECD recommendations on penalties) that in terms of section 217 of the TAA, SARS does apply some discretion in the way the section 212 reportable arrangements penalties are levied. Section 217(2) provides that SARS may "remit the 'penalty' or a portion thereof if appropriate, up to an amount of R2000 if SARS is satisfied that:

(i) reasonable grounds for non-compliance exist; and
(ii) the non-compliance in issue has been remedied".

Specific recommendations on certain issues regarding penalties in South Africa's reportable arrangements provisions:

➢ As mentioned above, the reportable arrangements penalty provision - section 212(1) of the TAA - stipulates that participant who has the duty to report the arrangement but fails to do so is liable for the penalty 'penalty', for each month that the failure continues (up to 12 months), in the amount of—
(*a*) R50 000, in the case of a 'participant' other than the 'promoter'; or
(*b*) R100 000, in the case of the 'promoter'.
However, the conjunction "or" used between subsections 1(a) and 1(b) makes it unclear whether only one person will be held liable for the penalty, in the corresponding amount, or whether all persons will be held liable simultaneously, in the amount applicable to their role in the arrangement. It is not clear whether SARS imposes a penalty on each of the promoters or if the

[101] OECD/G202015 Final Report on Action 12 in para 183.

penalty will be imposed jointly and severally. It is suggested that the legislation be made clearer.

- The penalties have serious economic implications for participants and promoters. Non-disclosure by a promoter for up to 12 months could amount to penalties of 1.2million (100, 000 per month). It is possible that the amount could even be higher if a promoter is involved in more than one arrangement that must be reported. With such hefty penalties, it is important that SARS ensures that the provisions are well worded and clear, so that taxpayers are not left to their own devices to interpret what was meant. It is also important that SARS raises more awareness to taxpayers about the reportable arrangements provisions especially regarding the penalties for not complying with the provisions.

The OECD notes that many countries have lower numbers of disclosures of international schemes because the way international schemes are structured and the formulation of some countries' disclosure regimes may not be effective in curtailing BEPS in a cross-border context, since such structures typically generate multiple tax benefits for different parties in different jurisdictions. [102] In South Africa, Government Gazette No. 39650 issued on 3 February 2016 which has extended the scope of reportable arrangements, has the potential of making the rules more appropriate from a BEPS angle, as much of what BEPS is concerned with relates to commercial arrangements. For example, paragraph 2.3 of the Gazetted list covers any arrangement in terms of which a person that is a resident makes any contribution or payment on or after the date of publication of this notice to a trust that is not a resident and has or acquires a beneficial interest in that trust. Section 37 of the TAA also provides that if the promoter of a scheme is not a resident, all other "participants" (whether resident or non-resident) must disclose the information regarding to the arrangement to SARS.

- Nevertheless more needs to be done to ensure the provisions are more effective in preventing BEPS.
- There are however concerns about the phrasing of the reporting provisions listed in Government Gazette No. 39650 of 3 February 2016. As is explained fully in the main report below, wording of certain terms and phrases in the provisions is not clear. For example it is important that SARS clarifies the meaning of terms such as "beneficial interest" and "contribution or payment" where a resident makes a contribution to a non-resident trust. The lack of clarity has implications on who is liable to report. It is uncertain whether a beneficiary of a discretionary trust in terms of which it is completely within the discretion of the trustees whether or not any distribution will be made to a specific beneficiary, has a beneficial interest. Unless the trustees have decided to vest any capital or income in the beneficiary, that beneficiary only

[102] OECD/G20 2015 Final Report on Action 12 in para 227.

has a contingent right, which is no more than a *spes* - a hope or an expectation.

- Where reporting in the case of a trust applies where "the value of that interest exceeds or is reasonably expected to exceed R10 million", there are some uncertainties as to how this value is to be determined. One may not be sure when the value is likely to exceed R10 million at any point in the future, and thus when there is the obligation to report.[103] Even if the value of the interest of a beneficiary can be established and even if can be expected to exceed the threshold, there are numerous factors which could influence the value: changes in the exchange rate, a decrease or crash in the markets, a discretionary distribution made to another beneficiary, *et cetera*. SARS need to come up with a more concrete, rather than a very broad, way of determining the value.
- Paragraph (c) of the definition of participant provides that "any other person who is a party to an arrangement" is a participant. However the TAA does not explain who is included or excluded in the term "party to an arrangement". It is, for instance, not clear whether it includes beneficiaries of discretionary trusts i.e. persons who are appointed beneficiaries but have no other connection or discourse with the trust and, thus, may have no knowledge of the trust's activities. If the phrase "a party to an arrangement" is interpreted so widely, it may impose unfair and unjust penalties on innocent persons.

The OECD notes that there is a need to ensure that the generic hallmarks for disclosure discriminate between schemes that are wholly-domestic and those that have a cross-border component.[104]The OECD specifically points out the ineffectiveness (in a cross-border context) of disclosure regimes that require reportable schemes to meet a formal threshold condition for disclosure (such as the *main benefit* or *tax avoidance* test) since some cross-border schemes may not meet this threshold if the taxpayer can demonstrate that the value of any domestic tax benefits was incidental when viewed in light of the commercial and foreign tax benefits of the transaction as a whole.[105] In South Africa section 36(3)(a) and (b) make it clear that an arrangement is reportable if the main purpose, or one of the main purposes, of entering into the arrangement is to obtain a tax benefit (i.e. the intention of the taxpayer); or if the arrangement is entered into in a specific manner or form that enhances or will enhance a tax benefit (i.e. even if there is no intention but the result is a tax benefit).

- Thus both the intention to gain a tax benefit and the result of a tax benefit without intention are taken into consideration; the South African rules are

[103] *SARS gazettes new list of arrangements deemed reportable,* News & Press: Tax Talk (22 September 2015). Available at http://www.thesait.org.za/news/251710/SARS-gazettes-new-list-of-arrangements-deemed-reportable-.htm accessed 9 June 2016.

[104] OECD/G20 2015 Final Report on Action 12 in para 227.

[105] OECD/G20 2015 Final Report on Action 12 in para 229.

not dependent on the "main purpose to obtain a tax benefit" as the threshold condition for disclosure. Thus even though a taxpayer can reason that the value of any domestic tax benefits was incidental (not main purpose) when viewed in light of the commercial and foreign tax benefits of the transaction as a whole, the arrangement is still reportable, in light of section 36(b), if it is entered into in a specific manner or form that enhances or will enhance a tax benefit.

The OECD notes that cross-border tax planning schemes are often incorporated into broader commercial transactions such as acquisitions, refinancing or restructuring and they tend to be customised so that they are taxpayer and transaction specific, and may not be widely-promoted in the same way as a domestically marketed scheme. Thus generic hallmarks that are primarily focussed at promoted schemes that can be easily replicated and sold to a number of different taxpayers may not be effective in curtailing BEPS. [106] In this regard, the OECD recommends the use of specific hallmarks to target cross-border tax schemes to address particular tax policy or revenue risks in the country. Examples include leasing and income conversion schemes which can apply equally in the domestic and cross-border context.

- Although South Africa has specific hallmarks in section 35(1) of the TAA; as well as arrangements listed by the Commissioner by public notice in section 35(2) of the TAA, the DTC recommends that more international schemes be targeted that could cause potential loss of revenue – for example conversion, restructuring, acquisition schemes and other innovative tax planning techniques.
- In targeting more international schemes, cognisance could be taken of the challenge the OECD points to, of ensuring that, in the design of specific hallmarks, the relevant definition is sufficiently broad to pick up a range of tax planning techniques and narrow enough to avoid over-disclosure. To effectively deal with this challenge the OECD suggests that focus should be placed on *outcomes* that raise concerns from a tax policy perspective, rather than the techniques that are used to achieve them (e.g. using the effects-based, approach of the USA, that extends the disclosure obligations to "substantially similar" transactions). [107]

The OECD recommends that countries should have a broad definition of "arrangement" that includes offshore tax outcomes. The definition of "arrangement" in section 34 of the TAA states that it "means any transaction, operation, scheme, agreement or understanding (whether enforceable or not)". Although this definition does not specifically refer to offshore arrangements, the use of the word "any" implies that it includes both domestic and offshore arrangements. Reference to

[106] OECD/G20 2015 Final Report on Action 12 in para 230.
[107] OECD/G20 2015 Final Report on Action 12 in para 232.

offshore outcomes is also indicated in section 37, which provides that if there is no promoter in relation to the "arrangement", or if the promoter is not a resident, all other "participants' must disclose the information.

- Perhaps to make this offshore implication much more clear, the legislation should consider re-drafting the definition of an arrangement to specifically state that the word "any" covers both domestic and offshore outcomes.
- The rules that apply to domestic schemes for identifying the promoter, and for determining who has the primary disclosure obligation, should also apply in the international context.

To ensure there are no undue administrative burdens on domestic taxpayers, disclosure obligations should not be placed on persons that are not subject to tax in South Africa, or on arrangements that have no connection with South Africa. At the same time, disclosure obligations should not be framed in such a way as to encourage a taxpayer to deliberately ignore the offshore aspects of a scheme simply to avoid disclosure. [108]

- Taxpayers should only be required to disclose information that is within their knowledge, possession or control. They can however be expected to obtain information on the operation and effect of an intra-group scheme from other group members. Outside of the group context, a reporting taxpayer should not be required to provide any more information than the taxpayer would be expected to have obtained in the course of ordinary commercial due diligence on a transaction of that nature. **[109]**

The OECD recommends that information that should be required to be disclosed in respect of domestic schemes should be the same as the information required for cross-border schemes. Such information should include information about the operation of the scheme including key provisions of foreign law relevant to the elements of the disclosed transaction. **[110]** Where information about the scheme is held offshore and may be subject to confidentiality or other restrictions that prevent it from being made available to the person required to make disclosure then;

- Domestic taxpayers, advisors and intermediaries should only be required to disclose the material information about the scheme that is within their knowledge, possession or control.
- In the case where the person holds only incomplete information about the scheme or is unable to disclose such information, that person should be required, to the extent permitted by domestic law, to:
  - Identify the persons with possession or control of that information; and

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108 OECD/G20 2015 Final Report on Action 12 in para 234.
109 OECD/G20 2015 Final Report on Action 12 in para 235.
110 OECD/G20 2015 Final Report on Action 12 in para 253.

- certify that a written request for that information has been sent to such persons. [111]
- If this is applied by SARS, it can then use this certification as the basis of an exchange of information request under the relevant double tax treaty or under a Tax Information Exchange Agreement (TIEA) that may have been signed with a country.

The OECD does recommend the use of monetary thresholds, set at levels that avoid over-disclosure, to filter-out irrelevant or non-material disclosures. [112] In South Africa, Government Gazette No 39650 issued on 3 February 2016 which lists reportable arrangements and excluded arrangements excludes from the rules any arrangement referred to in s 35(1) of the if the aggregate tax benefit which is or may be derived from that arrangement by all participants to that arrangement does not exceed R5 million.

- ➢ It is important that this limit is reviewed regularly taking into consideration cross-border perspectives.

13 ACTION PLAN 14: MAKE DISPUTE RESOLUTION MECHANISMS MORE EFFECTIVE

The OECD recommends that the introduction of the measures developed to address base erosion and profit shifting pursuant to its 2013 *Action Plan on Base Erosion and Profit Shifting* should not lead to unnecessary uncertainty for compliant taxpayers and to unintended double taxation. Improving dispute resolution mechanisms is therefore an integral component of the work on BEPS issues. Article 25 of the OECD Model Tax Convention provides a Mutual agreement procedure (MAP) mechanism, independent from the ordinary legal remedies available under domestic law, through which the competent authorities of the Contracting States may resolve differences or difficulties regarding the interpretation or application of the Convention on a mutually-agreed basis. MAP is of fundamental importance to the proper application and interpretation of tax treaties, in order to ensure that taxpayers entitled to the benefits of the treaty are not subject to taxation by either of the Contracting States which is not in accordance with the terms of the treaty. Action 14 of the BEPS Action Plan, which deals with making dispute resolution mechanisms effective, aims to strengthen the effectiveness and efficiency of the MAP process. The aim is to minimise the risks of uncertainty and unintended double taxation by ensuring the consistent and proper implementation of tax treaties, including the effective and timely resolution of disputes regarding their interpretation or application through the mutual agreement procedure.

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111 OECD/G20 2015 Final Report on Action 12 in para 236.
112 OECD/G20 2015 Final Report on Action 12 in para 244.

Countries have agreed to important changes in their approach to dispute resolution, in particular by:

- Developing to a minimum standard with respect to the resolution of treaty-related disputes,
- committing to rapid implementation of the minimum standard, and
- Ensuring effective implementation of MAP through the establishment of a robust peer-based monitoring mechanism that will report regularly through the Committee on Fiscal Affairs to the G20.

The minimum standard will:

- Ensure that treaty obligations related to the mutual agreement procedure are fully implemented in good faith and that MAP cases are resolved in a timely manner;
- Ensure the implementation of administrative processes that promote the prevention and timely resolution of treaty-related disputes; and
- Ensure that taxpayers can access the MAP when eligible.

The minimum standard is complemented by a set of best practices. The monitoring of the implementation of the minimum standard will be carried out pursuant to detailed terms of reference and an assessment methodology to be developed in the context of the OECD/G20 BEPS Project in 2016. In addition to the commitment to implement the minimum standard by all countries adhering to the outcomes of the BEPS Project, 20 OECD member countries have declared their commitment to provide for mandatory binding MAP arbitration in their bilateral tax treaties as a mechanism to guarantee that treaty-related disputes will be resolved within a specified timeframe. The OECD notes that this represents a major step forward as together these countries were involved in more than 90 percent of outstanding MAP cases at the end of 2013, as reported to the OECD.

13.1 Policy perspectives that South Africa has to take into consideration regarding MAP

The measures to ensure effective MAP (for example the arbitration procedure under MAP) have been perceived by developing countries in general as unfavourably in the past. However, the importance of these initiatives is likely to increase in the context of other BEPS related initiatives. As such, a commitment to the initiatives outlined in this Action is an integral part of the BEPS package. Although a commitment to the initiatives in Action 14 may carry with it some challenges and additional costs, South Africa’s home grown multinationals would also benefit from these initiatives. To ensure effective implementation of MAP South Africa has to assess:

- Whether the benefits of an effective dispute resolution process, including a commitment to binding arbitration, would outweigh the costs of such initiatives, taking into account the likely impact on home grown multinationals?

13.2 DTC recommendations to ensure effective MAP for South Africa

For South Africa to determine the approach it will take with respect to Action 14, it has to consider its treaty partners and its stated economic policy to begin a gateway to foreign investment into Africa. MAP has not been very effective among African countries. South Africa has participated in a minimal number of MAP processes, presumably because of taxpayers have not applied for MAP and also due to capacity issues. Even though South Africa has a wide network of double tax treaties it has only 3 treaties which include binding arbitration clauses: These are the treaties with Canada,[113] Netherlands[114] and Switzerland.[115] Nevertheless, MAP is likely to become increasingly important as more treaties are concluded with less developed countries and the process becomes more accessible and reliable. As a developing country, it would be in the interest of South Africa to make use of the UN Guide to MAP under Tax treaties[116] whose primary focus is on the specific needs and concerns of developing countries and countries in transition, and would be instrumental for South Africa to follow in ensuring effective MAP. This UN Guide seeks to provide countries that have little or no experience with MAP with a practical guide to that procedure.[117]

- South Africa should adopt the OECD minimum standards with respect to MAP.
- SARS needs to be more active in supporting South African taxpayers during MAP processes. This is especially so in treaties involving African countries where the MAP process is not developed and is not effectively applied. A critical need in this regard relates to cases where some African countries incorrectly claim source jurisdiction on services (especially management services) rendered abroad and yet those services should be considered to be from a South African source. These countries levy withholding taxes from amounts received by South African residents in respect of services rendered in South Africa. The withholding taxes are sometimes imposed even if a treaty between South Africa and the relevant country does not have an article dealing with management fees or and even if South African residents do not have permanent establishments in these countries. In response to the double taxation concerns that South African taxpayers face and to encourage investors to see South Africa as an attractive headquarter location, National

113 SARS "Convention Between The Republic of South Africa and Canada For The Avoidance of Double Taxation And The Prevention Of Fiscal Evasion With Respect to Taxes on Income" Gazette No. 17985, Date of entry into force 30 April 1997.

114 SARS "*Convention Between The Republic Of South Africa And The Kingdom Of The Netherlands For The Avoidance Of Double Taxation And The Prevention Of Fiscal Evasion With Respect To Taxes On Income And On Capital* Government" Government Gazette No. 31797, Date of entry into force 28 December 2008.

115 SARS "Convention Between The Republic Of South Africa And The Swiss Confederation For The Avoidance Of Double Taxation With Respect To Taxes On Income" Government Gazette No. 31967 Date of entry into force 27 January 2009.

116 UN "Guide to Mutual Agreement Procedure in Tax Treaties" (2012). Available at http://www.un.org/esa/ffd/tax/gmap/Guide_MAP.pdf accessed 16 May 2014.

117 Ibid.

Treasury enacted section 6*quin* which provides a rebate for management fees and technical service fees even though use of MAP in double tax treaties is the right forum that should have been employed to resolve these concerns. However South Africa residents had little success in challenging these matters with the tax authorities of the other countries and yet SARS was also not able to enforce the proper application of the treaties with these countries.[118] Although section 6*quin* ensured that South African taxpayers are not subjected to double taxation,[119] its application implied that South Africa had departed from the tax treaty principles in the OECD MTC in its treaties with the relevant countries, in that it has given them taxing rights over income not sourced in those countries. As a result, South Africa effectively eroded its own tax base as it is obliged to give credit for taxes levied in the paying country. In terms of 2015 Taxation Laws Amendment Act, National Treasury repeal of section 6*quin* from years commencing on or after 1 January 2016.[120] National Treasury explains that South Africa is the only country with a provision (like s 6*quin*) which goes against international tax and tax treaty principles in that it indirectly subsidises countries that do not comply with tax treaties and that it is a compliance burden for SARS. National Treasury also had concerns that some taxpayers were abusing the relief offered by the section. As noted above MAP under tax treaties is the forum that ought to be used to solve such problems. As a member of the African Tax Administration Forum (ATAF) which promotes and facilitates mutual cooperation among African tax administrators), South Africa should strongly advocate for ATAF to ensure that member countries enforce their treaty obligations and ensure that taxpayers can access MAP.

- To ensure the effectiveness of MAP it is important that the performance measures against which officials working on MAP are measured should not be based on factors such as revenue obtained. Such officials should have a different reporting structure to that of the SARS audit team, because of the fact that, in a MAP case, a portion of tax will inevitably be given up by the competent authority. This is highlighted in the OECD Final report on Action 14 which provides that "countries should not use performance indicators for their competent authority functions and staff in charge of MAP processes based on the amount of sustained audit adjustments or maintaining tax revenue".[121]
- To ensure the effectiveness of MAP, when an application for MAP is made, it must be referred to an independent and separate unit that deals with MAP, not to e.g. the transfer pricing audit unit. This is in line with the OECD recommendation on Action 14 which states that "countries should ensure that the staff in charge of MAP processes have the authority to resolve MAP cases

118 PWC "Comments on DTC BEPS First Interim Report" (30 March 2015) at 22.
119 Ibid.
120 Section 5 of the Draft Taxation Laws Amendment Bill 2015.
121 OECD/G20 2015 Final Report on Action 14 in para 28.

in accordance with the terms of the applicable tax treaty, in particular without being dependent on the approval or the direction of the tax administration personnel who made the adjustments at issue or being influenced by considerations of the policy that the country would like to see reflected in future amendments to the treaty."[122]

- Attention should be given to intensive recruitment and robust training of personnel by SARS to deal with MAP issues. This will, in turn, clearly require that funding be made available. A lack of sufficient resources (whether staff, training, funding, etc.) will inevitably result in unsatisfactory outcomes and a backlog of cases due to delays by the competent authority in processing such cases. Outsourcing could possibly be considered as a temporary solution.
- Since most MAP cases deal with transfer pricing matters, it is important for South Africa to include the Article 9(2) secondary adjustment in those tax treaties where it has not yet been included.
- Advance pricing agreements (APAs) lessen the likelihood of transfer pricing disputes. Lack of an APA program in South Africa is an inhibitor to foreign direct investment as it removes the opportunity to seek certainty on transactional pricing, particularly when Multinationals expand into the rest of Africa. It is acknowledged that there are scarce resources within the transfer pricing arena to enable a separate and independent unit to deal with APA's. A possible temporary measure could be to outsource this to recognised experts with oversight by senior SARS officials. When APA are adopted, consideration should be given to the possibility of combining MAP proceedings for a recurring transfer pricing issue with a bilateral APA with rollback. This would be in line with the OECD recommendation that "countries with bilateral advance pricing arrangement (APA) programmes should provide for the roll-back of APAs in appropriate cases, subject to the applicable time limits (such as statutes of limitation for assessment) where the relevant facts and circumstances in the earlier tax years are the same and subject to the verification of these facts and circumstances on audit".[123]
- SARS should not influence taxpayers to waive the right to MAP not should taxpayers be prohibited, as part of settlement negotiations, from escalating the portion of tax suffered to the competent authority for relief from double taxation. This would amount to a unilateral decision, without due regard to the spirit of the double tax treaties or the treaty partner.
- Although South Africa has guidelines and regulations on domestic dispute resolution and litigation, there is no guidance on how to resolve disputes through the treaties. There is confusion as to how SARS approaches this, who the appropriate competent authority is and how the process should be followed. For instance some countries will suspend domestic resolution

[122] OECD/G20 2015 Final Report on Action 14 in para 27.
[123] OECD/G20 2015 Final Report on Action 14 in para 33.

processes pending the outcome of a MAP appeal whereas other countries require the domestic remedies to be exhausted before entertaining a MAP appeal. Clear guidance on when SARS will entertain MAP needs to be given together with an appropriate process guide for taxpayers similar to the guide issued for domestic resolution. Such guidance should be clear and transparent, not unduly complex and appropriate measures should be taken to make such guidance available to taxpayers. The Guidance should contain information such as:

- When will MAP be applied;
- Applicable time limits in which a taxpayer can approach the Competent Authority;
- Who the Competent Authority is;
- What documents are required to be submitted with any application for MAP;
- Interaction of MAP with domestic legislation;
- Estimated timelines; and
- Liabilities of the Competent Authority.

➢ Since most disputes concern transfer pricing, it is important that SARS Interpretation Note on Transfer Pricing is finalised. Clear guidance should also be provided with respect to thin capitalisation rules. Other MAP disputes relating to controlled foreign company rules (CFC) and interest deductibility could be prevented by simplifying the complex CFC rules and the interest deductibility provisions.

➢ The current audit procedure in South Africa includes two aspects of an enquiry, a risk assessment process which is to determine whether an audit is warranted, and a full audit process. The roles and responsibilities of these two are becoming blurred in certain circumstances, which places the taxpayer in a position of uncertainty as to whether the matter is under audit or not. The respective roles and responsibilities therefore need clarifying and SARS should be required to inform the taxpayer as to whether their matter is under audit or not.

➢ Further the audit process often creates problems for taxpayers in that SARS often requires extremely detailed information from a taxpayer, in a relatively short period of time, without any timeline or time commitment being placed on SARS to respond resulting in an unreasonably long time passing, this needs to be addressed through better audit governance measures.

➢ The timing for applying for MAP needs to be clarified. Under Article 25(1) of the OECD UN MTC where a person considers that the actions of one or both contracting states results or will result in taxation that is not accordance with the provisions of the treaty, that person may irrespective of any remedies available under domestic law, present his case to the competent authorities of the contracting states in which he is resident (or the state in which he is a national). The case has to be brought to the attention of the competent authorities within three years from the first notification that the relevant tax is not in accordance with the provisions of the treaty. In South Africa, the timing is not clear and it appears that that the domestic rules govern the process and acceptance of such applications. It is understood that with scarce resources it would be inefficient to entertain a domestic appeal and competent authority application simultaneously. SARS needs to clarify the time when it will entertain a competent authority application, that is, whether it is once the taxpayer's objection has been disallowed, or at the same time as the appeal. This needs to be clarified in some form of binding, written communication. In this regard, it is recommended that SARS keeps to the time limit as is recommended in the OECD Commentary on Article 25(1). Further, to the extent the domestic appeal is suspended pending the outcome of the MAP, this should be clearly stated in the guidance, together with advice on payment suspension.

- In relation to the "Pay now, argue later" principle currently applied by the SARS, if a MAP matter take years before being resolved, SARS should be cognisant of the fact that not permitting the suspension of payment pending the outcome of MAP can be extremely detrimental to the taxpayer. The OECD recommended best practice on Action 14 to ensure taxpayers can access MAP, is that countries should take appropriate measures to provide for a suspension of collections procedures during the period a MAP case is pending. Such a suspension of collections should be available, at a minimum, under the same conditions as apply to a person pursuing a domestic administrative or judicial remedy. [124] This recommendation should be followed in South Africa.
- Many developing countries, do not consider themselves yet ready for mandatory binding arbitration in the international taxation context. India and Brazil made it clear in the BEPS discussions on the matter that they would not be involved in binding mandatory arbitration.[125] Developing countries are very wary of adopting binding arbitration provisions in their tax treaties, since normally in arbitration cases the winning country gets the tax revenue and the other loses. Mandatory binding arbitration is considered unfair since it entails entrusting decisions involving often millions of dollars to a secret and unaccountable procedure of third party adjudication. Developing countries hold the view that arbitration can only be effective and accepted if the rules to be applied are clear, and if the procedures are open and transparent, including the publication of reasoned decisions. As a developing country, these matters should be of concern to South Africa too. For that matter, South Africa should call for measures to be in place to make the arbitration process more transparent and it should only commit to the process if the rules are clear and transparent. Until the MAP arbitration process is made more

[124] OECD/G20 2015 Final Report on Action 14 in para 50.
[125] UN Committee of Experts on International Cooperation in Tax Matters "Secretariat Paper on Alternative Dispute Resolution in Taxation" (8 October 2015) in para 21.

transparent, South Africa should also be cautious about committing to an arbitration provision in the envisaged Multilateral Instrument under Action 15 of the OECD BEPS Action Plan. If South African becomes a party to the Multilateral Instrument, it should register a reservation not to commit to mandatory arbitration until the concerns regarding this process are rectified.

- Since mandatory arbitration is viewed by the OECD and taxpayers as a means of speedily resolving MAP, South Africa should call for international measures to be put in place to ensure transparency in the arbitration procedures:
  - South Africa should join the call for an international panel of arbitrators, for instance under the auspicious of the United Nations to be formed that comprises a panel of members from both developing and developed countries. Decisions of such a panel would be considered neutral and fair to the interests of all countries.
  - At regional level, South Africa should recommend that a pool of arbitrators be formed, with the necessary skills and qualifications, from among ATAF member countries. The ATAF member countries could then draw on arbitrators from that pool in cases where the MAP was between two ATAF-member countries. We note in this regard that a similar idea is successfully implemented under the EU Arbitration Convention, which pool comprises a pool of arbitrators appointed from EU member states.
  - South Africa should call for MAP results and agreements reached (even the "anonymised" versions) to be published annually, which could be in redacted manner (removing aspects that could raise confidentiality concerns) – this will provide further guidance and proactively resolve other potential future disputes.
  - Exchange of existing best practices between SARS and other revenue authorities should be strongly encouraged. South Africa should in particular adopt the OECD recommendation regarding Best Practice 1 (inclusion of Article 9(2) in its tax treaties); Best Practice 2 (adopt appropriate procedures to publish MAP agreements reached); Best Practice 5 (implement procedures that permit, after an initial tax assessment, taxpayer requests for the multiyear resolution through the MAP of recurring issues with respect to filed tax years, where the relevant facts and circumstances are the same); Best practice 6 (take appropriate measures to provide for a suspension of collections procedures during the period a MAP case is pending); Best Practice 7 (take appropriate measures to provide for a suspension of collections procedures during the period a MAP case is pending); Best Practice 8 (published MAP guidance explaining the relationship between the MAP and domestic law administrative and judicial remedies); Best Practice 9 (publish MAP Guidance which provides that taxpayers will be allowed access to the MAP where double taxation arises in the case of bona fide taxpayer-initiated foreign adjustments permitted under the domestic laws of a treaty

partner); Best Practice 10 (publish guidance on the consideration of interest and penalties in the MAP).

14 ACTION 15: DEVELOP A MULTINATIONAL INSTRUMENT

Globalisation has exacerbated the impact of gaps and frictions among different countries' tax systems. The endorsement of the 2013 OECD *Action Plan on Base Erosion and Profit Shifting* by the Leaders of the G20 in Saint-Petersburg in September 2013 shows unprecedented political support to adapt the current international tax system to the challenges of globalisation. Many of the principles that underpin international tax principles are imbedded in the tax treaties which are based on a set of common principles designed to eliminate double taxation that may occur in the case of cross-border trade and investments. However, the principles in the current network of bilateral tax treaties were developed back in the 1920s when the first soft law Model Tax Convention developed by the League of Nations was developed. Although both the OECD and the UN model tax conventions have been subsequently updated over the years, some of the contents of those model tax conventions as reflected in thousands of bilateral agreements among jurisdictions, have been superseded by developments in globalisation. As a result, some features of the current bilateral tax treaty system facilitate base erosion and profit shifting (BEPS) and need to be addressed.

Beyond the challenges faced by the current tax treaty system on substance, the sheer number of bilateral treaties makes updating the current tax treaty network highly burdensome.[126] Even where a change to the OECD Model Tax Convention is consensual, it takes a substantial amount of time and resources to introduce it into most bilateral tax treaties. As a result, the current network is not well-synchronised with the model tax conventions, and issues that arise over time cannot be addressed swiftly. Without a mechanism to swiftly implement them, changes to models only make the gap between the content of the models and the content of actual tax treaties wider. This clearly contradicts the political objective to strengthen the current system by putting an end to BEPS, in part by modifying the bilateral treaty network. Doing so is necessary not only to tackle BEPS, but also to ensure the sustainability of the consensual framework to eliminate double taxation. For this reason, governments have agreed to explore the feasibility of a multilateral instrument that would have the same effects as a simultaneous renegotiation of thousands of bilateral tax treaties.

Action 15 of the BEPS Action Plan provides for an analysis of the tax and public international law issues related to the development of a multilateral instrument to enable countries that wish to do so to implement measures developed in the course

[126] OECD 2013 "Action Plan on Base Erosion and Profit Shifting" at 24.

of the work on BEPS and amend bilateral tax treaties. On the basis of this analysis, interested countries will develop a multilateral instrument designed to provide an innovative approach to international tax matters, reflecting the rapidly evolving nature of the global economy and the need to adapt quickly to this evolution. The goal of Action 15 is to streamline the implementation of the tax treaty-related BEPS measures. This is an innovative approach with no exact precedent in the tax world, but precedents for modifying bilateral treaties with a multilateral instrument exist in various other areas of public international law. Drawing on the expertise of public international law and tax experts, the OECD Report on Action 15 explored the technical feasibility of a multilateral hard law approach and its consequences on the current tax treaty system. It identified the issues arising from the development of such an instrument and provided an analysis of the international tax, public international law, and political issues that arise from such an approach. The Report also concluded that a multilateral instrument is desirable and feasible, and that negotiations for such an instrument should be convened quickly. Based on this analysis, a mandate for the formation of an ad hoc Group to develop a multilateral instrument on tax treaty measures to tackle BEPS was approved by the OECD Committee on Fiscal Affairs and endorsed by the G20 Finance Ministers and Central Bank Governors in February 2015. The ad hoc Group is open to participation from all interested countries on an equal footing and is served by the OECD Secretariat. The ad hoc Group begun its work in May 2015 with the aim to conclude its work and open the multilateral instrument for signature by 31 December 2016. Participation in the development of the multilateral instrument is voluntary and does not entail any commitments to sign such instrument once it has been finalised. Although participation in the development of such an instrument is voluntary, countries that participate do not necessarily have to sign the instrument once it has been finalised.

14.1 Policy perspectives that South Africa has to take into consideration regarding the multilateral instrument

For an emerging economy like South Africa, all the treaty recommendations in the BEPS Action Plan require careful assessment with regards to their costs and benefits. This assessment is difficult enough to make in the context of a bilateral tax treaty, let alone a multilateral one. On the other hand, on some of the base protection measures recommended in the BEPS Action Plan, South Africa may find it attractive to be able to renegotiate its existing treaty network all at once. This benefit would only be fully realised if most, if not all, their treaty partners are also signatories to the multilateral instrument.

Developing countries and emerging economies are encouraged to participate in the negotiations of this multilateral instrument on a voluntary basis. The related policy consideration is:

- What are the costs and benefits for South Africa to participate in the negotiation of the multilateral convention?

Once the multilateral instrument is negotiated, however, the question will arise as to whether South Africa should proceed to sign the instrument. Depending on the composition of the negotiated instrument, there may be different answers to the following policy consideration:

- What are the costs and benefits for South Africa to sign the multilateral convention?

14.2 DTC recommendations for South Africa regarding the multilateral instrument

As a G20 country and as a member of the OECD BEPS committee, South Africa is supportive of the proposed OECD multilateral instrument that is intended to amend numerous bilateral treaties via a single instrument. South Africa is one of over 80 countries that form the ad hoc Group created for the development of a multilateral instrument.[127]

- ➢ It is in the interest of South Africa to participate the development of the Multilateral Instrument as the country will gain experience as to how the multilateral instrument is intended to work. This experience will enable the country to give special consideration to which provisions in the instrument it can reservations on..
- ➢ Before South Africa signs the multilateral instrument, it should take cognisance of its economic and socio-geopolitical special circumstances. Cognisance should also be taken of the fact that South Africa has signed treaties with some countries that are based on the OECD MTC and others based on the UN MTC. The OECD MTC embodies rules and proposals by developed capital exporting countries so it favours capital exporting countries over capital importing countries. Treaties based on the OECD MTC normally eliminate double taxation by requiring the source country to give up some or all of its tax on certain categories of income earned by residents of the other treaty country.[128] The UN MTC favours capital importing countries over capital exporting countries and it generally imposes fewer restrictions on the tax jurisdiction of source countries.[129] It is not clear how these diverging interests will be protected in a multilateral instrument (despite the op-in/opt-out proposals); and whether the interests of developing countries will be addressed in the multinational instrument. It would therefore be worthwhile for South Africa to adopt a "wait and see" approach as it gauges how other developing and emerging economies are proceeding on the matter. The UN is currently working on a revised MTC

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127 OECD "Multilateral instrument for BEPS tax treaty measures: the Ad hoc Group". Available at http://www.oecd.org/tax/treaties/multilateral-instrument-for-beps-tax-treaty-measures-the-ad-hoc-group.htm accessed 4 April 2016.

128 BJ Arnold and M.J. McIntyre, *International Tax Primer* (Kluwer Law International, 2002), 109.

129 Ibid.

to be released in 2017 that would take into perspective the BEPS implications. It will be worthwhile for South Africa to first consider the UN recommendations as to how developing countries should respond to the changes.

- The OECD notes that countries have gained some experience in the working of multilateral instruments through the Multilateral Convention on Mutual Administrative Assistance in Tax Matters,[130] which was open to developing countries in 2011.[131] Although there has been an increase in the number of countries that have signed the Multilateral Convention, significant work in administrative capacity building is still required for many developing countries, before they can be admitted as parties to the Convention.
- Administrative capacity will once again be a major hindrance for many developing countries to be part of the BEPS Action 15 multilateral instrument. On 3 November 2011, South Africa signed, but has not yet ratified the Multilateral Convention on Mutual Administrative Assistance in Tax Matters.[132] South Africa has therefore not gained experience from this multilateral instrument. There are however other regional multilateral instruments South Africa has signed. South Africa is a member of the African Tax Administration Forum (AFAF) which promotes and facilitates mutual cooperation among African tax administrators. ATAF has come up with an African Agreement on Mutual Assistance in Tax Matters - a legal instrument to allow African Tax Administrations to assist each other in tax matters.[133]
- South Africa is also a party to the SADC Agreement on Assistance in Tax Matters signed in 2012 and dealing exclusively tax administration matters. It is important that South Africa gauges its experience from its involvement in these regional instruments to determine whether it is ready to sign the multilateral instrument. As much as it is important for South Africa as a member of G20 and OECD BEPS Sub-committee to be associated with the BEPS initiatives, protection of South Africa's economic interests in light of its special circumstances as developing country is of paramount importance.

130 OECD 'Convention on Mutual Administrative Assistance in Tax Matters'. Available at http://www.oecd.org/tax/exchange-of-tax-information/conventiononmutualadministrativeassistanceintaxmatters.htm (accessed on 9 May 2013).

131 Ibid.

132 Croome op cit note 220 at 1.

133 ATAF "Twenty one African Countries finalise Mutual Assistance Agreement in collecting taxes" (2 August 2012). Available at http://content.ataftax.org/Ataf/KodiKaticontentWeb.nsf/0/B4357C40821E9FDA42257AC9004DBE61?OpenDocument accessed 14 March 2014.

DAVIS TAX COMMITTEE: SECOND INTERIM REPORT ON BASE EROSION AND PROFIT SHIFTING (BEPS) IN SOUTH AFRICA: INTRODUCTION

(i) THE DAVIS TAX COMMITTEE

Following the announcement by the Minister of Finance in the 2013 Budget to set up a tax review committee, the Davis Tax Committee (DTC)[1] was formed on 17 July 2013 to inquire into the role of South Africa's tax system in the promotion of inclusive economic growth, employment creation, development and fiscal sustainability. The DTC is expected to take into account recent domestic and international developments and, in particular, the long term objectives of the National Development Plan. On the international front, the DTC is required to address concerns about "base erosion and profit shifting" (BEPS), especially in the context of corporate income tax, as identified by the OECD and G20. In this regard, the DTC set up a BEPS Sub-committee which prepared this report that sets out the DTC's position as at 30 May 2016.[2]

(ii) ACKNOWLEDGEMETS

The DTC BEPS Sub-committee consulted with various stack holders on how BEPS issues should be addressed with from a South African perspective. These include: Business representatives, trade unions, civil society organisations, tax practitioners, SARS, National Treasury, the South African Reserved Bank, members of international bodies and academics, who have been involved through meetings where they presented their views and through submissions of technical reports on various BEPS Actions Plans.

INSTITUTION	SUBMISSION
Free Market Foundation	Presentation to DTC
SACTWU	Presentation to DTC
COSATU	Presentation to DTC
Oxfam	Presentation to DTC

1 Chaired by Judge Denis Davis: Members Prof Annet Wanyana Oguttu, Prof Matthew Lester, Prof Ingrid Woolard, Ms. Nara Monkam, Ms. Tania Ajam, Prof N Padia, Professor Thabo Legwaila and Professor Deborah Tickle. Two officials, one from the National Treasury, Mr Cecil Morden, and Mr Kosie Louw from the South African Revenue Service, serve as ex-officio members in a technical, supportive and advisory capacity. National Treasury and SARS also provide secretarial and logistical support to the Committee.

2 The BEPS Sub-committee is Chaired by Prof Annet Wanyana Oguttu (College of Law, University of South Africa; Qualifications: LLD in Tax Law - UNISA, LLM with Specialisation in Tax Law - UNISA), LLB - Makerere University, Uganda, H Dip in International Tax Law - University of Johannesburg). Member: Prof Thabo Legwaila (LLD) University of Johannesburg; Prof Deborah Tickle (Chartered Accountant with IRBA and SAICA; Director at KPMG; Qualification: B.Com Honours Taxation - University of Cape Town).

FEDUSA	Presentation to DTC
Economic Freedom Fighters	Presentations to DTC
Business Unity South Africa	Presentation to DTC
American Chamber of Commerce in South Africa	Comment on DTC BEPS Interim Report
The Banking Association South Africa	Presentation and Report sent to DTC
Tax Justice Network	Presentations to DTC
SARS	Presentation to DTC and Technical Reports
National Treasury	Presentation to DTC and Technical Reports
South African Reserve Bank	Presentation and Technical Report
African Tax Administration Forum	Discussions with DTC
Academy for Public Finance	Presentations to DTC
OECD	Presentation to DTC
UN Economic Commission for Africa	Presentation to DTC
Webber Wentzel Attorneys	Presentation to DTC
Deloitte & Touche	Technical Report
SAIT	Presentations to DTC, comments on DTC BEPS 1st Interim Report
SAICA	Comments on DTC BEPS 1st Interim Report
KPMG	Presentation, Technical Report, Comments on DTC BEPS Interim Report
PWC	Presentation to DTC
ENS	Technical Report
Bowman Gilfillan	Technical Report
Cliffe Dekker Hofmeyr Inc	Technical Report
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BACKGROUND INFORMATION AND SOUTH AFRICA'S CONCEPTUAL FRAMEWORK

(vi) ABBREVIATONS

CFC	Controlled Foreign Company Legislation
DTC	Davis Tax Committee
ATAF	African Tax Administration Forum
FDI	Forum Direct Investment
GVC	Global Value Chains
MNE	Multinational Enterprises
R&D	Research and Development
PE	Permanent Establishment
BEPS	Base Erosion and Profit Shifting

BACKGROUND INFORMATION ON BEPS AND SOUTH AFRICA'S CONCEPTUAL FRAMEWORK

1 INTRODUCTION

Over the last few years, there has been public concern engineered by non-governmental organisations[1] that was heightened by a steady stream of stories in the media about companies paying little or no corporation tax in the countries they do business in. Examples cited include investigations by the UK House of Lords Committee on Fiscal Affairs[2] on corporations such as Google, Amazon, Starbucks, Thames Water, Vodafone and Cadbury (before takeover by Kraft). These investigations showed that the amount of corporation tax a company pays in any one country can be determined by how aggressively the company seeks to shift its profits to other low countries. The effect is to make corporation tax payments in a given country largely voluntary for multinational companies. For instance, Starbucks volunteered extra payment of taxes in the UK after bad publicity. [3]

In light of these developments, at the 2012 G20 leaders' summit in Mexico, the national leaders explicitly referred to "the need to prevent base erosion and profit shifting".[4] This message was reiterated by the UK Chancellor of the Exchequer, plus the German and French Ministers of Finance, who issued a joint statement, calling for coordinated action to strengthen international tax standards and for states to back the Organization for Economic Development's (OECD) efforts to identify loopholes in tax laws.[5] The United States (US) President Barack Obama voiced similar concerns in the 2012 President's Framework for Business Tax Reform, in which he said that "empirical evidence suggests that income-shifting behaviour by multinational corporations is a significant concern that should be addressed by tax reform".[6]

Responding to these concerns, in February 2013 the OECD released a Report entitled "Addressing Base Erosion and Profit Shifting"[7] (BEPS) in which it is noted

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1 Christian Aid "Death and Taxes: The True Toll of Tax Dodging" (May 2008) 21-23. Available at http://www.christianaid.org.uk/images/deathandtaxes.pdf; accessed on 28 September 2010; Tax Justice Network "Economic Crisis + Offshore". Available at http://www.taxjustice.net/cms/front_content.php?idcat=136 accessed on 6 June 2010; Tax Justice Network "Tax Us if You Can – The True Story of a Global Failure, London" (2005).

2 UK House of Lords Committee on Fiscal Affairs "Tackling Corporate Tax Avoidance In A Global Economy: Is A New Approach Needed?" (July 2013) in the Summary.

3 Ibid.

4 G20 Leaders' Declaration Los Cabos Mexico 2012. Available at http://g20mexico.org/images/stories/temp/G20_Leaders_Declaration_2012.pdf accessed 3 August 2013.

5 OECD "Addressing Base Erosion and Profit Shifting" (2013) at 14.

6 Ibid.

7 Ibid.

that BEPS constitutes a serious risk to tax revenues, tax sovereignty and tax fairness for OECD member countries and non-members alike".[8]

The OECD explains that "BEPS relates to arrangements that achieve low or no taxation by shifting profits away from the jurisdictions where the activities creating those profits take place or by exploiting gaps in the interaction of domestic tax rules where corporate income is not taxed at all. No or low taxation is not *per se* a cause of BEPS, but becomes so when it is associated with practices that artificially segregate taxable income from the generate it."[9]

Subsequently an Action Plan of the OECD, with 15 comprehensive actions was released in July 2013.

There thus been ongoing political debate in many countries on how aggressive tax planning might be tackled, what the potential impact is for business, public finances and economies, and the implications of proposed changes to both international standards and domestic laws.[10]

- At the May 2013 European Union Summit,[11] the EU Council reiterated its intention to accelerate its Action Plan to strengthen the fight against tax fraud, tax evasion and aggressive tax planning.[12]
- In Australia, in order to improve the transparency of Australia's business tax system, on 3 April 2013 the Australian Treasury released a discussion paper calling for public comment on proposals to "improve the transparency of Australia's business tax system".[13]
- On 31 July 2013, the UK House of Lords released a Report[14] entitled "Tackling Corporate Tax Avoidance in a Global Economy: Is a new Approach needed?" in which recommendations were made to, among others, review the UK's corporate tax regime and to come up with new approaches to ensure effective corporate taxation.
- India's Minister of Finance, announced in his Budget Speech on 28 February

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8 Ibid.

9 OECD/G20 BEPS Project "Action 11: Measuring and Monitoring BEPS" (2015 Final Report) at 42

10 UK House of Lords Committee on Fiscal Affairs "Tackling Corporate Tax Avoidance In A Global Economy: Is A New Approach Needed?"(July 2013) in the Summary.

11 European Commission "An Action Plan to Strengthen the Fight against Tax Fraud and Tax Evasion" (12 June 2012) available at http://ec.europa.eu/taxation_customs/resources/documents/taxation/tax_fraud_evasion/com_2012_722_en.pdf accessed 29 August 2013.

12 European Commission "An Action Plan To Strengthen The Fight Against Tax Fraud And Tax Evasion" (12 June 2012).

13 Australian Government: Treasury "Improving the Transparency of Australia's Business Tax System" (3 April 2013). Available at http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2013/040.htm&pageID=003&min=djba&Year=&DocType= accessed 29 August 2013.

14 UK House of Lords Committee on Fiscal Affairs "Tackling Corporate Tax Avoidance In A Global Economy: Is A New Approach Needed?" (July 2013) in the Summary.

2013 that a Tax Administration Reform Commission would be set up to review the application of tax policies and tax laws and submit periodic reports that can be implemented to strengthen the capacity of India's tax system.[15]

- Political attention over the BEPS issues was expressed in meetings such as:
  - G20 Leaders, 19 June 2012, Los Cabos;
  - G20 Finance Ministers, 4-5 November 2012, Mexico City;
  - BRICS joint Communiqué, 18 January 2013;
  - G20 Finance Ministers Meeting, 15-16 February 2013, Moscow;
  - G20 Finance Ministers Meeting, 18-19 April 2013, Washington DC;
  - EU Council, 22 May 2013, Brussels;
  - G8 Leaders Meeting, 13-14 June 2013, Lough Erne;
  - G20 Finance Ministers Meeting, 18-19 July 2013, Moscow; and
  - G20 Leaders Meeting, 4-5 September 2013, St. Petersburg.

In South Africa, the terms of reference of the Davis Tax Committee (DTC) which was formed by the Minister of Finance on 17 July 2013 required the Committee to address concerns about BEPS especially in the context of corporate income tax, as identified by the OECD and G20.

1.1 THE GIST OF THE OECD REPORT

The OECD Report on BEPS[16] notes that, although globalisation has boosted trade, increased foreign direct investments and has encouraged the free movement of capital and labour, it has also resulted in the shift of manufacturing bases from high-cost to low-cost locations.[17] These developments have encouraged multinational enterprises (MNEs) to exploit the legal arbitrage opportunities due to asymmetries in the tax laws of different countries so as to minimise their global tax burdens. The aggressive tax positions taken by these MNEs impact on countries' corporate income tax regimes since MNEs represent a large proportion of global GDP.[18] Even though there are many ways in which domestic tax bases can be eroded, a significant source of base erosion is profit shifting[19] which focuses on moving profits to where they are taxed at lower rates and expenses to where they are relieved at higher rates.[20] MNEs often argue that they have a responsibility towards their shareholders to legally reduce the taxes their companies pay. They blame governments for coming

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15 Press Information Bureau Government of India Ministry of Finance "Government Sets-up Tax Administration Reform Commission Under Dr. Parthasarathy Shome" (26 August 2013) available at http://pib.nic.in/newsite/PrintRelease.aspx?relid=98626 accessed 29 August 2013.

16 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 7.

17 Ibid.

18 Ibid.

19 OECD "Addressing Base Erosion and Profit Shifting" (2013) at 5.

20 OECD "Addressing Base Erosion and Profit Shifting" (2013) at 39.

up with incoherent tax policies and designing tax systems that provide incentives for BEPS. [21]

The OECD BEPS Report states that "what is at stake is the integrity of the corporate income tax".

- BEPS undermine competition. MNEs have competitive advantages over enterprises that operate at domestic level (especially small and medium size enterprises). [22]
- BEPS may lead to an inefficient allocation of resources by distorting investment decisions towards activities that have lower pre-tax rates of return, but higher after-tax rates of return.
- BEPS undermine the integrity of the tax system. It discourages tax morality and has encouraged a perception that the system is unfair. [23] This in turn undermines voluntary compliance by all taxpayers. [24]
- The loss of tax revenue as a result of BEPS leads to critical under-funding of public investment that could help promote economic growth.

1.2 UNDERSTANDING MODERN BUSINESS MODELS

The OECD notes that for countries to curtail BEPS they have to understand modern business models and how MNEs operate in a globalised economy. 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 expenses and costs, including tax expenses. [25]

- There has been a shift from country-specific operating models to global models based on matrix management organisations and integrated supply chains that centralise several functions at a regional or global level.[26]
- There is increased growth in the service component of the economy, and of digital products that may be delivered over the internet, making it possible for businesses to locate many productive activities in geographic locations that are distant from the physical location of their customers. [27]
- There has been increased importance placed on group policies and strategies. Today's MNEs undertake their activities within a framework of group policies and strategies that are set by the group as a whole. Individual group companies

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21 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 13.
22 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 8.
23 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 13.
24 OECD "Addressing Base Erosion and Profit Shifting" (2013) at 8.
25 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 27-28.
26 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 25.
27 Ibid.

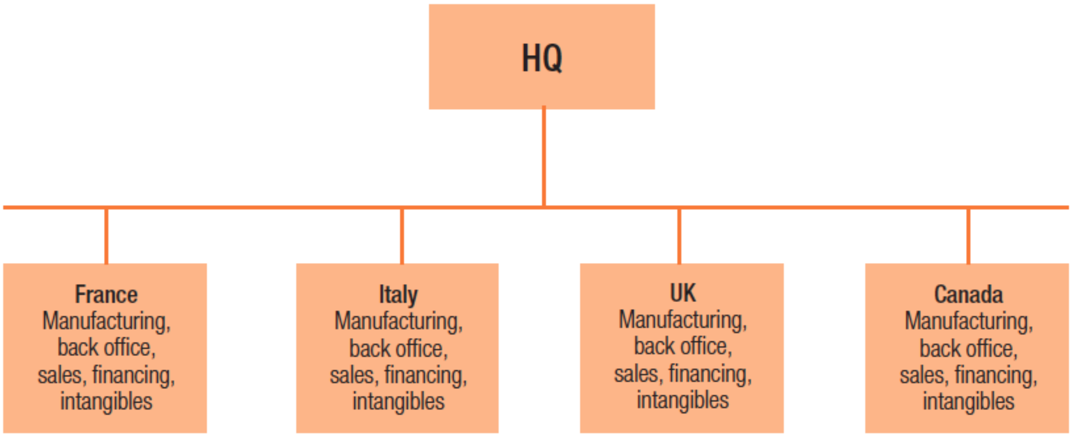
forming the group operate as a single integrated enterprise following an overall business strategy.

- The management structures of MNEs are now geographically dispersed. Rather than being located in a single central location, reporting lines and decision-making processes go beyond the legal structure of the MNE. [28]
- Global Value chains (GVCs), characterised by the fragmentation of production across borders, have become a dominant feature of today's global economy.[29] The rise of GVCs has changed the notion of what economies do and what they produce. Rather than talking about the export of goods and services, increasingly the relevant talk is about tasks and stages of production. In a world where stages and tasks matter more than the final products being produced, GVCs challenge orthodox notions of where economies find themselves on the value-added curve. Increased importance is now placed where most of the value of a good or service is typically created, which is where upstream activities such as product design, research and development (R&D) or production of core components occur, or in the tail-end of downstream activities where marketing or branding occurs. Knowledge-based assets, such as intellectual property, software and organisational skills, have become increasingly important for competitiveness and for economic growth and employment.[30]

Figure 1 below illustrates the traditional structure of a multi-national enterprise, prevailing in the 1960-1980s, which consisted of parent companies and stand-alone subsidiaries. In this illustration, each multi-national enterprise has relative operational autonomy regarding manufacturing and production, service, back office, financial and intangibles, sales & marketing. In this model, each subsidiary generates profits in line with the economic substance of its activities.

[28] OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 25.
[29] OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 26.
[30] OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 27.

FIGURE 1: TRADITIONAL STRUCTURE OF A MULTINATIONAL ENTERPRISE



The above model, however, is no longer relevant to understand how MNEs operate today. It is important to recognise that the emergence of global value chains, production, back office services and sales are on the whole separated from sales and marketing to take advantage of regional and country-specific competitive advantage.

1.3 INADEQUACIES OF CURRENT INTERNATIONAL CORPORATE TAX RULES THAT DEAL WITH BEPS

Over the years jurisdictions have taken action to amend their own domestic tax systems by enacting anti-avoidance mechanisms, such as thin capitalisation rules, controlled foreign corporations legislation, anti-treaty abuse clauses, general anti-avoidance legislation, anti-hybrid, tax disclosure requirements, and transfer pricing rules. However, these piecemeal actions have often failed to keep pace with the changing business environment.[31] Domestic rules for international taxation and internationally agreed standards are still grounded in an economic environment characterised by a lower degree of economic integration across borders. They have not kept pace with today's environment of global taxpayers, characterised by the increasing importance of intellectual property as a value-driver and by constant developments in the digital economy.[32]

Although there are cases of illegal abuses (which are the exception rather than the rule), MNEs engaged in BEPS comply with the legal requirements of the countries involved, in that they use legal methods to circumvent the application of a country's tax law. As businesses increasingly integrate across borders, the tax rules often remain uncoordinated; so businesses come up with structures which are technically

31 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 47.
32 Ibid.

legal but which take advantage of asymmetries in domestic and international tax rules.[33] Governments recognise these and also recognise that a change in this legal framework can only be achieved through international co-operation". [34]

For long, governments have acknowledged that the interaction of domestic tax systems can lead to overlaps in the exercise of taxing rights that can result in double taxation. So, principles to address double taxation were developed in a treaty context. However, the interaction of domestic tax systems can also result in double non-taxation altogether. [35] Many international tax concepts "were built on the assumption that one country would forgo taxation because another country would be imposing tax. In the modern global economy, this assumption is not always correct, as planning opportunities may result in profits ending up untaxed anywhere".[36]

1.4 THE EXTENT OF THE BEPS PROBLEM INTERNATIONALLY AND ITS IMPACT ON CORPORATE TAXES

The OECD notes that although there is abundant circumstantial evidence that BEPS behaviours are widespread and that they result in the erosion of the countries corporate tax base, it is difficult to reach solid conclusions about how much BEPS actually occurs. There are however several studies and data indicating that there is increased segregation between the location where actual business activities and investment take place and the location where profits are reported for tax purposes.[37]

Beyond evidence like that by the investigations by the UK House of Lords Committee on Fiscal Affairs,[38] some non-governmental organisations have attempted to clarify the problem of tax avoidance and to provide a proxy for the scale of base erosion and profit shifting behaviour. Such include the 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.[39] For developing countries Oxfam, a non-profit organisation, attributes a revenue loss of USD50 billion to tax avoidance by multinationals.[40] Although the question of how much revenue is lost due to profit shifting is highly interesting for the

33 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 49.
34 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 27-28.
35 OECD "Addressing Base Erosion and Profit Shifting" (2013) at 5.
36 OECD "Addressing Base Erosion and Profit Shifting" (2013) at 47.
37 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 15.
38 UK House of Lords Committee on Fiscal Affairs "Tackling Corporate Tax Avoidance In A Global Economy: Is A New Approach Needed?"(July 2013) in the Summary.
39 R Murphy "The Missing Billions - the UK Tax Gap" (2008) *Touchstone Pamphlet* No. 1. Available at http://www.tuc.org.uk/touchstone/Missingbillions/1missingbillions.pdf.
40 Oxfam "Tax Havens: Releasing the Hidden Billions for Poverty Eradication" (2000) Oxfam GB Policy Paper. Available at http://oxfamilibrary.openrepository.com/oxfam/bitstream/10546/114611/1/bp-tax-havens-010600-en.pdf.

public, methodological flaws underlying the estimates by some of these studies prevent them from being very reliable. There is no accurate estimate of the amount of profits shifted.[41]

Due to the challenges of adopting the international corporate tax system to suit the modern MNE business models, some commentators have argued for the scrapping of corporate taxes. These arguments are supported by the fact that, across the OECD, corporate income tax raises on average around 3% of GDP or about 10% of total tax revenues. However in developing countries corporate taxes amount to over 25% of total revenues.[42] Corporate income taxes are important for developing countries because:

- Collecting tax on profits at the corporate level is less cumbersome than taxing individual income tax.[43] Otherwise they would have to rely entirely on the regressive VAT;
- Corporate taxes are an important "backstop" to the personal income tax, in the absence of the corporate tax rich individuals would be able to park their money in corporations and defer taxes indefinitely;
- The corporate tax might be needed to avoid excessive income shifting between labour income and capital income; and
- The corporate tax also acts as a withholding tax on equity income earned by non-resident shareholders, which might otherwise escape taxation in the source country.[44]

1.5 BEPS AND ILLICIT FINANCIAL FLOWS

The problem of BEPS has to be distinguished from illicit financial flows. There have been various documents released by non-governmental organisations which have come up with estimates to provide a proxy for BEPS behaviour by equating BEPS to illicit finical flows.

Global Financial Integrity released a Report in which it noted that the tide of tax and illicit capital flight from African economies is estimated between $50billion and $80 billion per annum and in some cases revenue lost exceeds the level of aid received by developing countries.[45] On the situation in South Africa, Global Financial Integrity

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41 C Fuest, C Spengel, K Finke, J Heckemeyer, H Nusser "Profit shifting and 'aggressive' tax planning by multinational firms: Issues and options for reform" (2013) *Discussion Paper No. 13-078* at 9.

42 RS Avi-Yonah "Hanging Together: A Multilateral Approach to Taxing Multinationals". Available at available at: http://ssrn.com/abstract=2344760 accessed 24 May 2015.

43 J Owens "What is meant by a Competitive Tax Environment?" Presentation before Davis Tax Committee (19 September 2013).

44 OECD "Fundamental Reform of Corporate Income Tax" (2007) No.16.

45 African Tax Administration Forum "Twenty One African Countries finalise Mutual Agreement in Collecting Taxes". Available at http://www.internationaltaxreview.com/Article/3075315/ATAF-countries-sign-new-tax-cooperation-agreement.html accessed 26 June 2013.

also released a report in which it noted that the country has lost out on billions in tax revenue in the past decade as large corporations, wealthy individuals and criminal syndicates removed nearly R1-trillion out of the country. Global Financial Integrity notes that South Africa suffered "illicit financial flows" totalling more than $122-billion between 2003 and the end of 2012.[46] Noting further that in 2012 alone $29.1-billion left the country under the radar.[47]

There is, however, no universally agreed definition of “illicit financial flows” and its boundaries are disputed. The term generally implies the movement of money in a way that contravenes the laws or regulations of a country. Such moved money can be product of illegal activities, such as tax evasion, organized crimes, customs fraud, money laundering, terrorist financing, and bribery. As indicated above, some definitions have included flows from certain corporate tax avoidance practices, such as tax base erosion and profit shifting, which are legal.[48] The OECD acknowledges that although there are cases of illegal abuses (which are the exception rather than the rule), MNEs engaged in BEPS generally comply with the legal requirements of the countries involved, in that they use legal methods to circumvent the application of country’s tax law.

The exceptions could cover cases where taxpayers secretly conceal their foreign investments from their domestic tax authorities blurring the dividing line between illegal tax evasion and tax avoidance. In the past, taxpayers made use of banking secrecy rules that operated in tax-haven jurisdictions and some low-tax countries, by which the ownership of assets, or income, or their business transactions are kept from the knowledge of the tax authorities.[49] It is such activities, which are difficult to monitor due to the secrecy involved, that have prompted some civil society organisations to equate the resultant BEPS to illicit financial flows. Banking secrecy is however a thing of the past as, in terms of the OECD’s standards of transparency and exchange of information on tax matters, low tax and tax-haven jurisdictions are expected to exchange information about investments by other country residents in those jurisdictions.[50]

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46 Times Live “Billions of rands leave SA under the radar” Available at http://www.timeslive.co.za/thetimes/2015/01/11/billions-of-rands-leave-sa-under-the-radar accessed 9 March 2015.

47 Ibid.

48 Gene Rowe, Fergus Bolger, Rachel Payne, Esther Shubert Policy Options for Addressing Illicit Financial Flows: Results from a Delphi Study at 4.

49 United Nations Ad Hoc Group of Experts on International Co-operation in Tax Matters *International Cooperation in Tax Matters Guidelines for International Cooperation Against the Evasion and Avoidance of Taxes (With Special References to Taxes on Income, Profits, Capital, and Capital Gains*) (1984, Department of International Economic and Social Affairs, United Nations New York) at 18.

50 OECD “Tax Co-operation Towards a Level Playing Field: 2007 Assessment by the Global Forum on Taxation”. Available at www.oecd.org/document/29/0,3343,fr_2649_201185_39473821_1_1_1_1,00.html – 27k (last accessed on 9 April 2015).

In its 2014 Report on "Illicit Financial Flows from Developing Countries Between 2003 and 2012" Global Financial Integrity rightly states that the point of concern is capital flight, which includes both licit and illicit capital, noting that licit capital flight is recorded and tracked, significantly lowering the probability that it has a corrupt or criminal source. In contrast, illicit financial flows are by nature unrecorded, and cannot be used as public funds or private investment capital in their country of origin".[51]

It is important to clarify that from an international tax law perspective BEPS, which entails utilizing tax laws within legal parameters, cannot be equated with illicit (illegal) financial flows. BEPS results from perceived weakness in the international tax laws which are exploited by MNEs as well as the lack of administrative capacity to fully assess and audit international tax risks. Where taxpayers get involved in tax evasion – which is illegal, this can contribute to illicit financial flows. Tax evasion usually involves the non-disclosure of income, rendering of false returns and the claiming of unwarranted deductions.[52] Even though South Africa, like other developing countries, faces significant challenges that impact on revenue collection as a result of illicit financial flows, equating BEPS to illicit financial flows fosters confusion in understanding international tax principles and in finding solutions to the problem of capital flight.

Although all financial flows (whether illicit or licit) have an impact on revenue collection, the legal solutions to resolving licit BEPS issues are different from those required to resolve illicit financial flows. Curtailing BEPS requires reforming the international tax system and coming up with anti-tax avoidance measures – which is what the OECD BEPS Project is all about, whereas curtailing illicit financial flows requires criminal sanctions. It should also be noted that there is no one tax avoidance measure that can be used to effectively curtail all BEPS schemes. Transfer pricing legislation, that is required to curtail transfer pricing schemes, cannot be applied to curtail treaty abuse; nor can one apply controlled foreign company rules that are used to prevent the deferral of taxes, to curtail schemes involving excessive deductions of interest. That is why the BEPS Action Plan has various Actions requiring countries to come up with different anti-avoidance rules that can be applied to curtail BEPS that arises from the various tax avoidance schemes.

In the case of illicit financial flows, the very use of the term illicit implies that the illegal nature of such activities calls for criminal action. Illegal tax evasion is a

51 Dev Kar and Joseph Spanjers, Global Financial Integrity **"**Illicit Financial Flows from Developing Countries: 2003-2012" (December 2014) in para 2. Available at http://www.gfintegrity.org/wp-content/uploads/2014/12/Illicit-Financial-Flows-from-Developing-Countries-2003-2012.pdf accessed 22 June 2015.

52 D Meyerowitz *Meyerowitz on Income Tax* (2008) at 29.1.

criminal matter, not a BEPS matter. Tax evasion has to be proved in terms of the relevant country's Penal Codes, as would be the case for any other criminal activities resulting in illegal movements of money. Illicit financial flows through "trade mis-invoicing", which was estimated by Global Financial Integrity in 2012 to account for nearly 99% of illicit financial outflows from Africa,[53] is not a BEPS matter and it should not be confused with the concept of "transfer pricing" - a BEPS matter.

Trade mis-invoicing falls under the category of revenue laws that deal with customs. It is a customs fraud that involves buyers and sellers presenting fraudulent documentation to customs officials. They falsify the value of their trade by under or over invoicing their trade documents to be less or more than the actual market value in order to circumvent the payment of customs duties.[54] The 2014 UNCTAD Trade and Development Report[55] notes that illicit flows of capital through developing countries, due to trade mis-invoicing is one of the most pressing challenges facing policymakers, since it costs countries billions of dollars in revenue. The UNCTAD report[56] recommends that in order to prevent channel financing, through trade mis-invoicing, governments need to resort to capital management measures, including capital controls.[57]

There is no doubt that as is the case with BEPS, international cooperation is required to address illicit financial flows. Indeed at the August 2014 US/Africa Leader's Summit, the US President Obama expressed concern about illicit financial flows from Africa. This resulted in an agreement between the US and some African countries to form a partnership on curbing illicit financial flows from African economies.[58] There is also no doubt that transparency, through the use of exchange of information between countries will play a great role in exposing both BEPS and illicit finical flows, however under the currently legal framework equating illicit financial flows to BEPS is a misconception of the law and addressing BEPS under the umbrella of the illicit financial flows is not in line with International tax law norms.

In the Outcome document of the United Nations "Third International Conference on Financing for Development" held in Addis Ababa 13 to 16 July 2015,[59] the Heads of State and Government and High Representatives affirmed as follows:

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53 Kar & Spanjers, Global Financial Integrity "Illicit Financial Flows from Developing Countries" op cit note 78.

54 Times Live "Billions of Rands leave SA under the Radar" op cit note 85.

55 UNCTAD "Trade and Development: Global Governance and Policy Space for Development" (2014).

56 Ibid.

57 Ibid.

58 Global Financial Integrity "GFI Welcomes New US - Africa Partnership to Combat Illicit Finance" op cit note 83.

59 United Nations "Outcome document of the Third International Conference on Financing for Development: Addis Ababa Action Agenda" (13 to 16 July 2015) para 23. Available at http://www.un.org/ga/search/view_doc.asp?symbol=A/CONF.227/L.1 accessed 17 August 2015.

> "We will redouble efforts to substantially reduce illicit financial flows by 2030, with a view to eventually eliminating them, including by combating tax evasion and corruption through strengthened national regulation and increased international cooperation. We will also reduce opportunities for tax avoidance, and consider inserting anti-abuse clauses in all tax treaties. We will enhance disclosure practices and transparency in both source and destination countries, including by seeking to ensure transparency in all financial transactions between Governments and companies to relevant tax authorities. We will make sure that all companies, including multinationals, pay taxes to the Governments of countries where economic activity occurs and value is created, in accordance with national and international laws and policies".

To help combat illicit flows, the participants agreed to invite the International Monetary Fund (IMF), the World Bank and the United Nations to assist both source and residence countries.[60] They also agreed to "identify, assess and act on money-laundering risks, including through effective implementation of the Financial Action Task Force standards on anti-money-laundering/counter-terrorism financing. At the same time, they committed to encourage information-sharing among financial institutions to mitigate the potential impact of the anti-money-laundering and combating the financing of terrorism standard on reducing access to financial services".[61] With respect to licit financial flows, involving tax avoidance the Outcome document of the United Nations "Third International Conference on Financing for Development" welcomed the work of the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes, and the work of the OECD on base erosion and profit shifting.[62]

1.6 ACKNOWLEDGING SOUTH AFRICA'S POSITION IN AFRICA

South Africa is the only African country that is a member of the G20. Although it is not a member of the OECD and only has OECD observer status,[63] it is a member of the OECD BEPS Committee. This does not necessarily mean that South Africa's presence on this committee is representative of the interests of all African countries. The economic development of African countries varies immensely and so is the level of development of their tax laws. There are also varying levels of administrative

60 United Nations "Outcome document of the Third International Conference on Financing for Development: Addis Ababa Action Agenda" (13 to 16 July 2015) para 24. Available at http://www.un.org/ga/search/view_doc.asp?symbol=A/CONF.227/L.1 accessed 17 August 2015.

61 United Nations "Outcome document of the Third International Conference on Financing for Development: Addis Ababa Action Agenda" (13 to 16 July 2015) para 24. Available at http://www.un.org/ga/search/view_doc.asp?symbol=A/CONF.227/L.1 accessed 17 August 2015.

62 United Nations "Outcome document of the Third International Conference on Financing for Development: Addis Ababa Action Agenda" (13 to 16 July 2015) para 28. Available at http://www.un.org/ga/search/view_doc.asp?symbol=A/CONF.227/L.1 accessed 17 August 2015.

63 L Olivier & M Honiball International Tax a South African Perspective (2014) at 9.

capacity to deal with the challenges associated with implementing international tax reforms.[64]

Nevertheless, as a major power on the African continent, it important that South Africa champions the cause of Africa in the OECD BEPS committee. As a member of the G20, South Africa plays an important role in conveying the views of African economies.[65] Due to the fact that South Africa has made major investments on the African continent and the fact that it has signed many tax treaties with other African countries, it is important that South African is seen as a leader in the BEPS debates in Africa. It is within South Africa's interest as a country aspiring to be the "Gateway for investment into Africa" to use its membership of the G20 and OECD BEPS sub-committee to set the "tone" in Africa around key OECD recommendations on BEPS and to also play a key role to ensure a consistent African view on BEPS issues.[66]

South Africa should also take note of the fact that as it plays a leading role as a net exporter of investment capital to the rest of Africa, other African countries view South Africa as a threat and they have taken a long-term protectionist view of their tax systems since South Africa's investments into the rest of Africa often make local African activities non-viable. Aggressive BEPS legislation that does not take this into perspective could actually work to the detriment of South Africa as a regional gateway.[67]

1.7 OECD'S RECOMMENDATIONS ON HOW TO ADDRESS BEPS

The OECD BEPS Report notes that "because many BEPS strategies take advantage of the interface between the tax rules of different countries, it may be difficult for any single country, acting alone, to fully address the issue. Furthermore, unilateral and uncoordinated actions by governments responding in isolation could result in the risk of double – and possibly multiple – taxation for business. This would have a negative impact on investment, and growth and employment globally".[68] Though governments may have to provide unilateral solutions, there is value and necessity in providing an internationally co-ordinated approach. Collaboration and co-ordination will not only

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64 G20 Development Working Group Domestic Resource Mobilisation "G20 Response to 2014 Reports on Base Erosion and Profit Shifting and Automatic Exchange of Information for developing Countries" (2014) Available at https://g20.org/wp-content/uploads/2014/12/16%20G20%20response%20to%202014%20reports%20on%20BEPS%20and%20AEOI%20for%20developing%20economies.pdf accessed 4 March 2015.

65 G20 Development Working Group Domestic Resource Mobilisation "G20 Response to 2014 Reports on Base Erosion and Profit Shifting and Automatic Exchange of Information for developing Countries" (2014) at 15. Available at https://g20.org/wp-content/uploads/2014/12/16%20G20%20response%20to%202014%20reports%20on%20BEPS%20and%20AEOI%20for%20developing%20economies.pdf accessed 4 March 2015.

66 American Chamber of Commerce in South Africa "Comments on the First DTC Interim Report on Base Erosion and Profit Shifting (March 2015) at 3.

67 SAIT "Comments on DTC First Interim BEPS Report" (March 2015) at 2.

68 OECD "Addressing Base Erosion and Profit Shifting" (2013) at 8.

facilitate and reinforce domestic actions to protect tax bases, but it is also key to providing comprehensive international solutions that may satisfactorily respond to the issue.

Co-ordination will also limit the need for individual jurisdictions applying certain unilateral tax measures. Nevertheless jurisdictions may also provide more stringent unilateral actions to prevent BEPS than those in the co-ordinated approach.[69] A holistic approach has to be adopted in order to properly address the issue of BEPS, and government actions should be comprehensive and deal with all the different aspects of the issue. A comprehensive approach which is globally supported should draw on an in-depth analysis of the interaction of all the identified OECD pressure points. Although co-ordination will be key in the implementation of any solution, countries may not all use the same instruments to address the issue of BEPS.[70]

A summary of the OECD 15 point Action Points is as follows:

- Action 1: Address the Tax Challenges of the Digital Economy
- Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements
- Action 3: Strengthen Controlled Foreign Companies Rules
- Action 4: Limit Base Erosion via Interest Deductions and Other Financial Payments
- Action 5: Counter Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance
- Action 6: Prevent Treaty Abuse
- Action 7: Prevent the Artificial Avoidance of PE Status
- Action 8: Assure that Transfer Pricing Outcomes are in Line With Value Creation / Intangibles
- Action 9: Assure that Transfer Pricing Outcomes are in Line With Value Creation / Risks and Capital
- Action 10: Assure that Transfer Pricing Outcomes are in Line With Value Creation / Other High-Risk Transactions
- Action 11: Establish Methodologies to Collect and Analyse Data on BEPS and the Actions to Address It
- Action 12: Require Taxpayers to Disclose Their Aggressive Tax Planning Arrangements
- Action 13: Re-examine Transfer Pricing Documentation
- Action 14: Make Dispute Resolution Mechanisms More Effective
- Action 15: Develop a Multilateral Instrument

The 15 actions points can be identified along three key pillars:

- Actions that introduce coherence in the domestic rules that affect cross-border activities;

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69 Ibid.

70 OECD “Addressing Base Erosion and Profit Shifting” (2013) 7-8.

- Actions to reinforce substance requirements in the existing international standards; and
- Actions to improve transparency as well as certainty.

The 15-point Action Points to address BEPS aim to ensure that profits are taxed where economic activities generating the profits are performed and where value is created. The results of the OECD work are ultimately expected to be reflected in a variety of forms, including:

- Changes in the OECD Model Tax treaty
- Changes in the OECD transfer pricing guidelines
- Amendments to bilateral and multilateral agreements to be considered by countries
- Changes in domestic tax laws and administration policies by individual countries.

When evaluating the BEPS Action Plan as a whole it is often difficult to arrange the Actions into a logical order in one's mind. The DTC has therefore set them out, below, in an order that is somewhat easier to follow, in order to provide the reader with some sense of context.

The starting point for determining whether counter-measures for BEPS are needed is to determine whether BEPS really is an issue. **Action 11** (**Measuring & Monitoring BEPS**) performs an ***Analysis*** of what data is available to evaluate the global impact of BEPS, and aims to explain the 'why?' for the BEPs initiative. In the Action 11 report lost tax revenue is estimated to be between $100bn and $240bn per annum, globally, due to BEPS, but it is clear that available information is inadequate to determine figures with any degree of accuracy. Action 11 identifies six recommendations for increased capability for data (stats) collection (South Africa is included) and also identifies five categories, containing six indicators of BEPS type activities, giving direction for counter-measures addressed in other actions.

The next step is to look into how ***Avoidance*** takes place in more detail. **Action 5** thus examines what form **Harmful Tax Practices** (HTP) take. It does this by identifying HTP through a review of tax regimes. Out of 43 regimes reviewed, Action 5 indicates that 16 HTP related to intellectual property (IP). Action 5 advises that it will be important to adopt a "nexus' approach for IP and makes clear that no new entrants to such regimes will be tolerated after 30 June 2016. In addition it requires that tax authorities exchange, with other tax authorities that may be affected, all rulings issued to taxpayers after 1 April 2016.

To counter ***Avoidance*** facilitated by the current double tax treaty regime, the OECD then takes a look at the ability of taxpayers to abuse tax treaties under its own guidelines. It therefore addresses this under **Action 6- Treaty Abuse.** The aims of this Action is to ensure treaty benefits are not provided in inappropriate circumstances, by proposing that the title and preamble of the Model Tax Convention should clearly state that the joint intention of the parties to a tax treaty is to eliminate double taxation without creating opportunities for tax evasion and avoidance. Furthermore by the inclusion of clauses in treaties relating to: limitation of benefits; and the insertion of a principal purpose test. It also looks at how to remove conduit arrangements and third country PE's, provides for a minimum holding period for WHT relief, suggests a clarification for immoveable property companies; and a dual residence tie breaker modification.

The Action Plan then addresses specific *Methods for Countering Identified Avoidance.*

- It starts, in Action 1, by addressing BEPS Issues in the Digital Economy, which presents key features that exacerbate BEPS concerns (mobility, reliance on data, etc.). The Task Force on the Digital Economy will continue its work and aim to issue a report by 2020.
- Thereafter, in Action 2, it looks at neutralising mismatches arising from Hybrid Mismatches using "hybrid instruments" (loan in one country, equity in another) or "hybrid entities" (transparent in one country, opaque in another), and aligned to this it looks at other problems relating to Interest Deductions, in Action 4. This action sets out three potential approaches: group-wide rule, fixed ratio rule, or combination of the two.
- Action 3 looks at what effective Controlled Foreign Companies (CFC) rules should look like and sets out "building blocks" for effective CFC rules, encouraging all countries to adopt such rules.
- Action 7 provides counter measures against the avoidance of creation of Permanent Establishments and suggests new rules for dependent and independent agents, well as for what constitutes auxiliary services, by addressing fragmentation, contract splitting.
- Actions 8-10 address Transfer pricing principles. They aim at allocating income in line with value creation, capital and risk. They also address commodity transactions, intangibles, and low value-adding intra-group services.
- Of critical importance to the Action Plan is the ability of tax authorities to identify when BEPS is taking place, and how to address disputes between countries so the Plan then addresses *Disclosure and Dispute resolution*
- Action 12 aims to design Mandatory Disclosure rules for perceived aggressive tax planning.
- Action 13 aims to enhance transparency of transfer pricing for revenue authorities, by setting out the Transfer Pricing Documentary Requirements. It recommends a three-tiered approach: Master File (Blueprint of MNE group), Local File (additional detail and economic analyses) and Country-by-Country Report (summary data).

- Action 14 then sets out Dispute Resolution Mechanisms. It aims to improve the effectiveness of the Mutual Agreement Procedures, recommends advanced Pricing agreements for transfer pricing, recommends minimum standards for resolution and establishment of a monitoring mechanism, and identifies best practices.
- Finally, in order for the entire Action Plan to become reality within as short a time as possible Action 15 provides for a Multilateral Instrument which is referred to, or may be used by, all the other Actions. Action 15 facilitates *Implementation.* Action 15 aims to streamline tax treaty related BEPS measures, by removing the need to renegotiate very many treaties. There are 90 countries participating although, currently, there is no commitment to sign; and countries can sign with reservations.

In terms of the OECD "Action Plan on Base Erosion and Profit Shifting", addressing BEPS is critical for most countries and must be done in a timely manner, so as to prevent the existing consensus based international tax framework from unravelling, which would increase uncertainty for businesses at a time when cross-border investments are more necessary than ever. The OECD recommended that the pace of the project must be rapid so that concrete actions can be delivered quickly since governments need time to complete the necessary technical work and achieve widespread consensus. Work of 15-point Action points was generally to be done over a period of two years, from 2014 to 2015. The work delivered by the OECD Committee on Fiscal Affairs, which brought together 44 countries on an equal footing (all OECD members, OECD accession countries (of which South Africa is a part), and G20 countries), adopted the first seven deliverables in 2014 and the rest in 2015. The OECD notes that developing countries and other non-OECD/non-G20 economies have been extensively consulted through regional and global fora meetings and their input has been fed into the work. [71]

Regional tax organisations such as the African Tax Administration Forum, the *Centre de rencontre des administrations fiscales* and the *Centro Interamericano de Administraciones Tributarias*, joined international organisations such as the International Monetary Fund, the World Bank and the United Nations, to contribute to the work. Developing countries also engaged extensively via a number of different mechanisms, including direct participation in the Committee on Fiscal Affairs. Business representatives, trade unions, civil society organisations and academics were also been very involved through opportunities to comment on discussion drafts. The work on the Action points reflects consensus on a number of solutions towards eliminating double non-taxation due to BEPS.[72]

71 OECD/G20 Base Erosion and Profit Shifting Project Neutralise the Effects of Hybrid Mismatch Arrangements: Action 2: 2014 Deliverable (2014) at 3.

72 OECD/G20 Base Erosion and Profit Shifting Project Neutralise the Effects of Hybrid Mismatch Arrangements: Action 2: 2014 Deliverable (2014) at 3.

These measures will give countries the tools they need to ensure that profits are taxed where economic activities generating the profits are performed and where value is created, while giving business greater certainty. The measures will apply once they are implemented, either in domestic laws or in the network of bilateral tax treaties. At this stage it is not known the extent to which the action points will result in realistic action by each country's tax authorities.

2 ADDRESSING BEPS IN LIGHT OF SOUTH AFRICA'S CONCEPTUAL FRAMEWORK

2.1 SOUTH AFRICA'S NATIONAL SOVEREIGNTY AND CONSTITUTIONAL PERSPECTIVES

It has to be acknowledged that "tax policy is an expression of national sovereignty, and each country is free to devise its tax system in the way it considers most appropriate."[73] "Every jurisdiction is free to set up its corporate tax system as it chooses. States have the sovereignty to implement tax measures that raise revenues to pay for the expenditures they deem necessary. An important challenge is the need to ensure that tax does not produce unintended and distortive effects on cross-border trade and investment or that it distorts competition and investment within each country by disadvantaging domestic players.

In a globalised world where economies are increasingly integrated, domestic tax systems designed in isolation are often not aligned with each other, thus creating room for mismatches. As already mentioned, these mismatches may result in double taxation and may also result in double non-taxation.[74] From a government perspective, globalisation means that domestic policies, including tax policy, cannot be designed in isolation, *i.e.* without taking into account the effects on other countries' policies and the effects of other countries' policies on its own ones. Nowadays, the interaction of countries' domestic policies becomes fundamental.[75]

In drafting tax rules to address BEPS in South Africa, the legislators have to take cognisance of the fact that that the Constitution of the Republic of South Africa, 1996 (the Constitution) is the supreme law of the Republic; law or conduct inconsistent with it is invalid.[76] When interpreting domestic legislation (which includes tax laws) South African courts are constitutionally bound to follow an interpretation consistent with international law. Section 233 of the Constitution states that "when interpreting legislation, every court must prefer any reasonable interpretation of the legislation

73 OECD "Addressing Base Erosion and Profit Shifting" (2013) at 28.
74 OECD "Addressing Base Erosion and Profit Shifting" (2013) at 39.
75 OECD "Addressing Base Erosion and Profit Shifting" (2013) at 28.
76 Section 2 of the Constitution of the Republic of South Africa, 1996.

that is consistent with international law over any alternative interpretation that is inconsistent with international law". The BEPS Action Plan entails various issues that converse international law. This is especially so where those matters are dealt with in the context of double tax treaties, that are classified as international agreements, and which have to be interpreted by customary international law interpretation rules.[77] In interpreting tax treaties, a South African court would have to take into consideration two particular aspects of customary international law: firstly, the Vienna Convention on the Law of Treaties, 23 May 1969 and secondly, the Commentary on the OECD MTC.[78] Although South Africa is not a party to the Vienna Convention, South African courts are guided by this Convention with respect to South Africa's treaty relations. The Vienna Convention is largely a codification of customary international law; it applies to all treaties and not only to countries that have signed the convention.[79]

2.2 IS SOUTH AFRICA BOUND TO FOLLOW THE OECD ACTION PLAN?

The OECD is an international organisation established in 1961 to contribute to economic development and growth in its member countries. The organisation seeks to promote economic development by issuing publications and statistics on various topics, such as competition, corporate governance, electronic commerce, trade and taxation. Through its publications, the OECD chooses the tools of dialogue, consensus, peer review and pressure in order to encourage economic development and change in the market economy. Though the primary focus of the OECD is on member countries, its additional goals of contributing to the expansion of world trade and the development of the world economy affect non-members as well.[80] The OECD often calls on non-member countries to associate themselves with its recommendations.

As stated above, South Africa is not a member country of the OECD. It was, however, awarded OECD observer status in 2004,[81] and is a member of the OECD BEPS Committee. Although the OECD's recommendations and the Commentary on its Model Tax Convention are not legally binding, South African courts have recognised and applied the OECD Commentary.[82] In *ITC 1503*[83] it was held that a treaty must be interpreted according to the common law rules pertaining to the interpretation of statues as well as the OECD Commentary. South Africa's Income Tax Act defines the "permanent establishment" concept (a matter relevant to BEPS)

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77 K Vogel *Double Tax Conventions* (1997) in the Introduction in par 28.

78 L Olivier & M Honiball International Tax: A South African Perspective (2014) at 311-312.

79 Olivier & Honiball International Tax: A South African Perspective (2014) at 307.

80 OECD "History of the OECD". Available at http://www.oecd.org/document/63/0,2340,and_2649_201185_1876671_1_1_1_1,00 accessed 14 October 2014.

81 L Olivier & M Honiball International Tax a South African Perspective (2014) at 9.

82 *SIR v Downing* 1975 (4) SA 518 at 525 (AD).

83 53 SATC 342 at 348.

with reference to the OECD definition.[84] South African Revenue Service (SARS) Practice Note 7 which deals with transfer pricing (a matter that is pertinent to BEPS) refers to the OECD Transfer Pricing Guidelines. Since the OECD recommendations have become a globally accepted standard, and as member of the G20[85] and the OECD BEPS Committee, it is important for South Africa to work together with the international community to come up with a holistic approach to properly address the BEPS issues.

Even though BEPS is a global concern, the nature of BEPS is not uniform for all countries. Schemes that work to undermine the European tax base often do not coincide with the African paradigm. South Africa itself is different given its "BRICS" country status. On the one hand, South Africa has a modern economy (especially in the financial sector) with a significant number of companies based in the country. On the other hand, South Africa is still struggling to emerge from its roots as an unequal society and is surrounded by developing countries in ranging stages of development. The net result for the South African tax system is a split world. South Africa has a wide OECD treaty network with developed countries around the world, which could lead one to conclude that South Africa's BEPS issues are the same as those stated by the OECD. Nonetheless, even in this world, South Africa retains a fairly strong level of Exchange Control. South Africa is also geographically distant from transactions associated with the OECD BEPS debate and has not yet attained the status of a knowledge economy.[86]

It is therefore recommended that in addressing the BEPS concerns, the unique circumstances of South Africa have to be taken into consideration. This requires a consideration of South Africa's National Development Plan (discussed below) and a clear understanding of what is at stake in this country before legislative action can be taken. The BEPS concerns and challenges that other countries such as the UK or US face may not necessarily be the concerns and challenges that South Africa faces. So there is need for appropriate and customised solutions. Any BEPS remedy from the South African perspective needs to be supported by a fact base that sheds light on how big the relevant BEPS problem is in South Africa, and then legal responses can follow. The DTC acknowledges that not all the solutions to BEPS are legislative in nature, some solutions require political intervention.[87]

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84 Sec 1 of the Income Tax Act. The court in *SIR v Downing* (1975 (4) SA 518 (A) made reference to the OECD meaning of the "permanent establishment concept".

85 The G20 is the group of finance ministers and central bank governors from 20 economies. It consists of: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, México, Russia, Saudi Arabia, South Africa, Korea, Turkey, the United Kingdom, United States and European Union. See Wikipedia "The G-20 Major Economies". Available at http://en.wikipedia.org/wiki/G-20_major_economies accessed 28 July 2014.

86 SAIT "Comments on DTC's First Interim Report on BEPS" (March 2015) at 1.

87 SAICA "Comments on DTC Ist Interim BEPS Report" (31 March 2015) para 3.

2.3 SOUTH AFRICA'S NATIONAL DEVELOPMENT PLAN: FISCAL AND ECONOMIC POLICY

South Africa's NDP[88] sets the country's overall economic strategy and policy. The NDP requires that South Africa develops fiscal and economic policies that encourage foreign direct investment (FDI) to foster economic growth. In order to stimulate economic growth in line with NDP, South Africa needs to develop a fiscal policy that supports its economic vision.

- The fiscal policy should not work in a vacuum. It has to be crafted in the context of the country's economic policy, the NDP and the Constitutional objectives.
- The tax policy should not prevent economic growth. It should foster an increase in tax revenues, an increase in tax base and the creation of jobs in South Africa.
- The tax policy should not adversely affect South Africa as a suitable foreign investor destination.
- Measures adopted to counter BEPS should therefore not be counterproductive to the Constitutional and economic objectives of the government.

2.4 TO WHAT EXTENT IS BEPS A PROBLEM IN SOUTH AFRICA?

Since the country rejoined the global economy after democratic elections in 1994, there has been increased international interest in South Africa, which has encouraged its citizens to actively participate in, and become reintegrated into, the global economy. Although there are many locally-owned and foreign-owned companies that do not engage in aggressive tax practices,[89] the heightened global trade competition and the mobility of capital in the world have encouraged South African residents, both individuals and corporations, to make considerable investments offshore, and to look for ways of minimising their global tax exposure. It is, however, difficult to reach solid conclusions about how much BEPS actually occurs in South Africa and what exactly the tax gap is.

2.4.1 SARS Statistics

Corporate taxes as a percentage of GDP in South Africa grew strongly from 1999/00 to 2008/09 from 2.4% to 6.9%. This was primarily for three reasons - significant base-broadening reforms such as the introduction of the residence basis of taxation and capital gains tax, the closure of loopholes and increased enforcement and compliance.[90] These figures do not mean that BEPS were not taking place before, but they do indicate that the reform measures taken could have had an impact on the extent of BEPS. However SARS' statistics below indicate that corporate revenues in

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88 South Africa: National Planning Commission "National Development Plan: Vision for 2030 (11 November 2011).

89 SAIT "Comments on DTC's First Interim Report on BEPS" (March 2015) at 1.

90 PWC "Comments on DTC 1st Interim Report on BEPS" (30 March 2015) at 2.

South Africa took a down turn after the 2008 global financial crisis. Although these statistics do not imply that BEPS did not take place before the financial crisis they may provide some useful indications that perhaps BEPS are occurring. The graph from SARS below shows that the contribution of corporate taxes to GDP declined over the last 6 years.

Table 1: Corporate tax statistics

Year	Actual	% Year-on-year change	% of tax revenue	% of GDP
	R million	%	%	%
2007/08	141 635	17.9%	24.7%	6.8%
2008/09	167 202	18.1%	26.7%	7.3%
2009/10	136 978	-18.1%	22.9%	5.6%
2010/11	134 635	-1.7%	20.0%	4.9%
2011/12	153 272	13.8%	20.6%	5.2%
2012/13	**160 896**	**5.0%**	**19.8%**	**5.0%**

2.4.2 National Treasury's Report

The SARS table above is in line with National Treasury Budget of 2013, which shows that corporate tax revenue in South Africa declined from 7.2% of GDP in 2008/9 to 5.5% in 2009/10 and 4.9% in 2010/11. This decline in corporate tax revenue was a major concern for government. This ratio recovered marginally in 2011/12 to 5.1%, but went down to 4.9% in 2012/13.[91]

2.4.3 South African Reserve Bank Data

In an effort to make sense of the magnitude of the BEPS problem, reference is made below to data from the South African Reserve Bank (SARB) which provides an indication as to the measure of payments directed offshore as recorded by the Bank. The table below from SARB illustrates overall trends for non goods transaction values categorised in calendar years with the focus on the larger transactions as per the classification criteria. The time frame under consideration covers the period of the financial market meltdown as well as the immediate aftermath.

Table 2: Non goods payments for calendar years 2008 to 2011

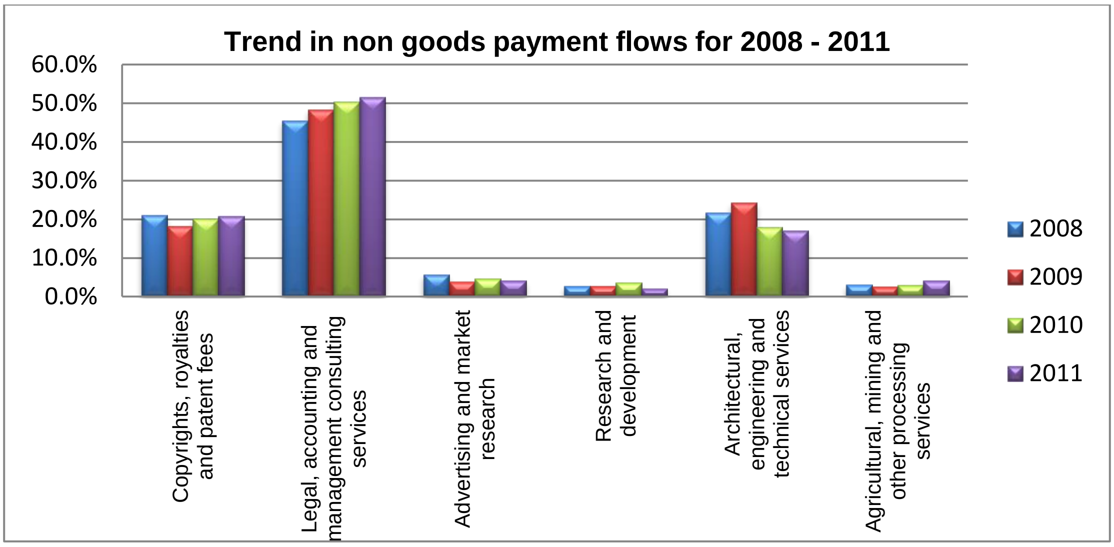
	2008 R	2009 R	2010 R	2011 R	Grand Total R
Copyrights, royalties and patent fees	9,193,024,882	9,972,557,798	10,218,632,767	11,753,572,186	**41,137,787,633**
Legal, accounting and management	19,907,138,985	26,404,401,495	25,567,916,347	29,086,527,270	**100,965,984,097**

91 National Treasury *Budget* (2013).

consulting services					
Advertising and market research	2,514,255,525	2,079,309,530	2,322,484,579	2,376,620,700	**9,292,670,334**
Research and development	1,190,891,326	1,465,932,525	1,881,655,361	1,194,421,583	**5,732,900,794**
Architectural, engineering and technical services	9,502,199,748	13,261,681,931	9,140,177,372	9,580,166,654	**41,484,225,705**
Agricultural, mining and other processing services	1,357,914,436	1,372,840,085	1,534,995,130	2,360,485,454	**6,626,235,105**
Grand Total	43,665,424,902	54,556,723,364	50,665,861,555	56,351,793,847	**205,239,803,668**
% Movement		**24.94%**	**-7.13%**	**11.22%**	

From the above table it appears that nearly 50% of all payments flowing out of the country relates to legal, accounting and management consulting services. This classification is followed by copyrights, royalties and patent fees, which also showed significant growth over the same period. The figure below, also from SARB, depicts the same results.

Figure 1: Trend in non goods payments



The above trends show that overall, just after the financial crisis in 2008, outflows increased by nearly one quarter. It is a well known fact that the South African economy did not feel the full brunt of the aftermath of the financial crises, but it seems peculiar that legal, accounting and management consulting services increased by nearly R6.5bn (an increase of 32.6%) and engineering and technical services by R3.7bn (an increase of 39.5%) during this period. Consumption increases during the aftermath of a global financial crisis also seem odd in the wake of sluggish economic activity, uncertainty and falling commodity prices. Cognisance of the bill for the 2010 World Cup must be considered but, it is submitted, the quantum of these monetary flows might not be explained by a singular event.

The above is also highlighted by the contribution table below which also shows that since 2008, legal, accounting and management consulting services increased disproportionately in relation to the other non-goods payments.

Figure 2: Non-goods contribution to overall payment flows

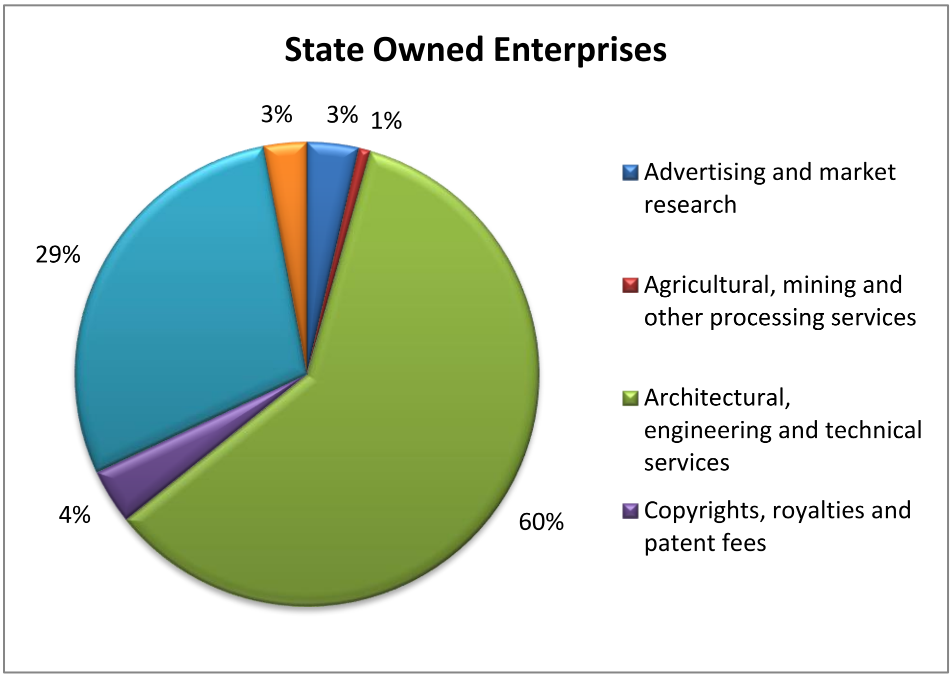
	2008	2009	2010	2011
Copyrights, royalties and patent fees	21.1%	18.3%	20.2%	20.9%
Legal, accounting and management consulting services	45.6%	48.4%	50.5%	51.6%
Advertising and market research	5.8%	3.8%	4.6%	4.2%
Research and development	2.7%	2.7%	3.7%	2.1%
Architectural, engineering and technical services	21.8%	24.3%	18.0%	17.0%
Agricultural, mining and other processing services	3.1%	2.5%	3.0%	4.2%

From the analyses above, it is apparent that the prevalence of these non-goods transactions is not limited to specific industries or sub industries. An industry cluster of particular interest is the state owned or controlled enterprises which have been identified as significant players in cross border trade as well as posing potential transfer pricing risk. The 2011 UNCTAD report[92] states that there are at least 650 state-owned MNEs globally, constituting an important emerging source of Foreign Direct Investment (FDI). There are more than 8,500 foreign affiliates spread across the globe, bringing them in contact with a large number of host economies. While relatively small in number (less than 1% of all MNEs), their FDI is substantial, reaching roughly 11% of global FDI flows in 2010. Reflecting this, State-owned MNEs made up 19 of the world's 100 largest MNEs.

The analysis undertaken confirms the observation, in South Africa, that state-owned MNEs are a major player within the context of non-goods transactional flows. The state owned enterprises' major non-goods transactions are made up of payments for engineering and technical services (60% or R18.4bn) and management services (29% or R8.9bn) as illustrated below.

92 UNCTAD World Investment Report (2011).

Figure 3: State Owned Enterprises' non goods payments



Considering these two transaction types in relation to the entire non-goods transaction flow data, the following salient points emerge:

- State owned enterprises consumption of non-goods transactions differs from the general trend in the following aspects:
  - Nearly 50% of the overall payments is for legal, accounting and management consulting services;
  - The next two major consumption transactions are for copyright, royalties and patent fees (20%) and architectural, engineering and technical services (20%);
- The state owned enterprises are the largest consumers of engineering and technical services: 44% of the data set; and
- Management service consumption is considerably less, at 9% of the data set.

In addition, to the impact state owned enterprises have on non-goods transactional flows, an analysis was made of the taxpayers with the major non-goods payments. As previously stated, payments originate throughout the economy, however, the prevalence of payments out of the manufacturing and mining sectors is not surprising. Illustrated in the table below are the top 16 entities within the SA economy which accounted for over 50% of the non-goods payments (R100.3bn) of the sample analysed.

Table 4: Top non-goods payments

Industry Group	Advertising and market research	Agricultural, mining and other processing services	Architectural, engineering and technical services	Copyrights, royalties and patent fees	Legal, accounting and management consulting services	Research and development	Grand Total
Manufacturing	103,963,323	252,192,447	9,632,809,730	299,087,970	31,417,895,649	1,055,172,148	**42,761,121,267**
Mining	-	2,477,818,846	280,220,907	-	16,494,974,030	407,938,871	**19,660,952,654**
Electricity, Gas & Water			11,849,136,095		3,366,728,564		**15,215,864,659**
Telecoms, Media, Entertainment	-	-	124,284,239	9,102,986,645	-	-	**9,227,270,883**
Financial Services	366,376,301				3,619,685,317		**3,986,061,618**
Wholesale & Retail	221,656,001		40,782,811		3,341,932,625		**3,604,371,436**
Transportation			1,616,940,601	79,533,317	1,233,935,605	24,656,230	**2,955,065,753**
Construction			2,899,162,359				**2,899,162,359**
Total	**691,995,625**	**2,730,011,293**	**26,443,336,741**	**9,481,607,931**	**59,475,151,789**	**1,487,767,249**	**100,309,870,629**

Around 60% of the non-goods payments are for what are broadly referred to "management services", followed by nearly 30% spend on engineering and technical services. Manufacturing companies made up nearly 43%, with close to 20% in the mining cluster. Although this is a sample, the overall trend is consistent with the stated observations.

The magnitude and prevalence of cross border non-goods transactions are clear. It poses a serious threat to the fiscus insofar as tax revenue is concerned, and is an indication that erosion of the tax base through avoidance schemes and practices could be taking place. The magnitude of the transactions, although always expected to be large, is material, and constant reviews in respect of assurance interventions and tracking should become the norm.

From the above, it is clear that the industry cluster relating to state owned enterprises has a significant bearing on the magnitude of the non-goods transactional flows and the correct treatment thereof. As such, in respect of consuming services from abroad, a permanent establishment (PE) risk exists for the offshore service providers.

Summary of the data from the SARB[93]

Categories	Percentage Increase from 2008 to 2011	Impact
Intellectual Property	Under 10% per annum	Non-significant
Legal, accounting and management consulting services	Approximately 50% aggregate increase	Biggest stated concern
Advertising and market research	Declined	Non-significant
R&D	Approximately 3%	Non-significant
Architectural, engineering and technical services	Approximately 8%	Non-significant
Agriculture, mining etc.	Approximately 29%	Significant

Although the above data on non-goods payments indicates that there could be BEPS risks:

- It is important to determine how much of the non-goods payments are made by South African residents to connected persons. Since these are subject to arm's length provisions under section 31 of the income Tax (which falls squarely under the BEPS concerns). Payments made to non-connected persons are assumed to be at arm's length, and thus falling outside the BEPS project.[94]
- More data is clearly needed, that shows a country-by-country analysis of outflows in the case of interest, royalties, leases and services. Payments to low-tax countries will clearly be a sign of concern, especially when those locations lack meaningful substance. Only in this way can we have some hope of aiming at the more significant targets. Without such data South Africa could be undertaking major reforms solely based upon sporadic anecdotal evidence. The end-result will be a significant wastage of resources and new compliance burdens falling upon the wrong targets. [95]

For a balanced view on BEPS in South Africa, it is important to acknowledge that while tax avoidance exists, and there are some MNE and "boutique firms" that could be involved in aggressive tax planning, there are many MNEs whose business transactions that do not involve any kind of BEPS.

93 Adopted from SAIT's "Comments on DTC First BEPS Interim Report" (March 2015).
94 American Chamber of Commerce: Comments on DTC First BEPS Interim Report (March 2015) Slide 3 of Power Point Presentation.
95 SAIT "Comments on DTC BEPS Interim Report" (March 2015) at 2.

- Many MNE companies assert that their involvement with tax organisations in South Africa are focused on core compliance rather than tax planning. It is acknowledged that, over the years many companies have taken far less aggressive positions, due to the growing audit risk, administrative costs of defending positions and reputational risk. However some company tax directors may take aggressive positions to preserve "expected" levels of tax (often if the original estimate is in error). [96]

2.4.4 The National Planning Commission's views

The National Planning Commission argues that the uncompetitive goods and service markets in South Africa are a result of the pattern of economic growth under apartheid and sanctions-induced isolation. [97] The existence of the uncompetitive markets has led to relatively high profit margins for enterprises but very little new investment or innovation. Authors Aghion et al[98] support the argument of the National Planning Commission, that mark-ups are significantly higher in South African manufacturing industries than they are in corresponding industries worldwide. The authors tested the consequences of this low level of product market competition on productivity growth and found that high mark-ups have a large negative impact on productivity growth in the South African manufacturing industry and employment creation.[99] Clearly this shows the paradox that on one hand companies make high profit margins, while on the other hand corporate tax revenues decline.

2.4.5 Recommendation on Measuring South Africa's Tax Gap

Suggestions have been made that perhaps South Africa should emulate the UK which, in light of the Vision Statement in the HMRC's Strategic Plan 2012–2015 plan, enlisted the IMF in 2013,[100] to assess the UK's tax gap. The goals of the UK tax gap analysis are to assess the loss of tax revenue, support efficiency and support perceptions of fairness. The HMRC's tax gap analysis programme is one of the most comprehensive studies of tax gap estimates internationally.[101] The HMRC defines the tax gap as the difference between tax collected and the tax that should be collected if all individuals and companies complied with the letter of the law and the spirit of the law as set out by Parliament's intention in enacting law.[102] Assessing South Africa's

96 SAIT "Comments on DTC BEPS First Interim Report" (March 2015) at 2; American Chamber of Commerce in South Africa: Comments on DTC BEPS Interim Report (March 2015) at 9.
97 National Planning Commission *National Development Plan 2030* (2012).
98 P Aghion, M Braun & F Fedderke "Competition and Productivity Growth in South Africa" (2008) 16(4) *Economics of Transition* at 741-68.
99 Ibid.
100 IMF "United Kingdom: Technical Assistance Report - Assessment of HMRC's Tax Gap Analysis" (August 2013).
101 Ibid.
102 HMRC "Measuring tax gaps 2012, Tax gap estimates for 2010-11.

tax gap would provide SARS with a useful indicator as to where the tax gaps are and where limited SARS resources should be directed for maximum effect.[103]

2.5 BALANCING THE PROTECTION OF THE TAX BASE AND THE ENSURING THE COMPETITIVENESS OF THE ECONOMY

Addressing the BEPS concerns from a South African perspective requires that the country strengthens and/or develops measures to prevent BEPS as identified in the OECD BEPS Action Plan. However, these measures should not be adopted without taking into consideration the need to encourage FDI in light of the NDP and also the need to preserve the competitiveness of South Africa's economy on the international scene. A balance has to be struck.

It should however be noted that although tax is a factor in investment decisions there are other factors (or key determinants) that investors take into account, such as infrastructure, labour stability, economic prospects and political stability. As such, tax operates at the margins of investment decisions where, all things being equal, it could tip an investment decision in favour of or against a country as a location for foreign direct investment. Importantly, it is not just a factor in foreign investment decisions, but also a factor in domestic investment decisions as to whether a domestic company should invest in its home country or elsewhere.[104]

Tax competition, like other forms of competition, requires governments to provide an environment that is conducive to economic growth.[105] In practice, most taxes (not just the corporate income tax) can have an impact on competitiveness.[106] In considering how tax policy can help to generate economic growth and prosperity, each country's tax system cannot be considered in isolation. In open economies where capital is mobile across boundaries, and multinational enterprises play an increasing role in international trade and investment, tax regimes and tax rates potentially can have a significant influence on decisions about the location of production and investment.[107] The liberalisation of trade and capital markets has resulted in increased competition and encouraged MNEs to move capital where profitability is greatest. Countries are increasingly competing as locations for FDI and, as a result, are under pressure to reduce taxes to increase the return on investment, particularly their corporate income tax rate.[108] The revenue derived from corporate taxes in most developing countries is largely contributed to by taxes from FDI. Developing countries, and emerging economies, on the other hand,

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103 PWC "Comments on DTC BEPS First Interim Report" (30 March 2015) at 6.
104 Ibid.
105 J Owens "What is meant by a Competitive Tax Environment?" Presentation before Davis Tax Committee (19 September 2013).
106 Ibid.
107 Ibid.
108 Ibid.

acknowledge that FDI is a source of economic development and modernisation, income growth and employment.[109]

2.5.1 Methods of encouraging FDI

Two common methods of encouraging FDI are, firstly, providing tax incentives and offering tax holidays. South Africa has seldom offered tax holidays, preferring the tax incentive option. Studies by the IMF, the World Bank and the OECD show that tax holidays are a less effective way to generate new investment than incentives in the form of tax credits.[110] Furthermore, the studies show that certain types of incentives provide more opportunities for tax planning than others. South Africa needs a clear tax policy on the use of tax incentives to attract FDI. Such policy should take into consideration the best practice guidelines in the design of tax incentives.[111] Tax incentives should not erode the tax base by applying in circumstances where the investment would take place without the incentive. Such a scenario simply amounts to a give-away of the tax base. An assessment of the effectiveness of all existing incentives and any proposed new incentives is thus required.[112]

It should be noted that the use of local tax incentives is a political decision as a result of each country's sovereign right to determine its fiscal policy. In coming up with guidelines for tax incentives, it must be acknowledged that although the use of marginal tax rates is normally used politically as the benchmark for determining tax beneficial treatment for both international and local operations, this approach is not illustrative of the actual rationale for doing business in a particular country or whether that particular country is less tax beneficial. It is possible that a country that provides tax incentives but has a 28% marginal tax rate could be more tax favourable than a country that provides no tax incentives but has a 15% marginal rate.

All these factors have to be taken into consideration in designing policy guidelines on tax incentives that will preserve the competiveness of the economy.[113]

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109 OECD "Foreign Direct Investment for Development: Maximizing Benefits Minimising Costs (2002) at 3.4.

110 OECD, Tax Incentives for Investment—A Global Perspective: Experiences in MENA and Non-MENA Countries 4 (Draft, 2007), available at http://www.oecd.org/dataoecd/51/17/38758855.pdf.

111 Best practice guidelines in the design of tax incentives required that governments ensure: (1) the transparency of investment tax Incentives; (2) the publication of the availability of tax incentives, how they are applied in practice, and the terms of their availability; (3) there should a clear methodology to measure the cost of tax incentives targeted at both domestic and international investment and agree to publish these on a regular basis in a format that facilitates international comparisons; (4) assessment should be made of the effectiveness of such measures and this information should be made public. See J Owens "What is meant by a Competitive Tax Environment?" Presentation before Davis Tax Committee (19 September 2013).

112 PWC "Comments on DTC Ist Interim BEPS Report" (31 March 2015) at 6.

113 SAICA "Comments on DTC Ist Interim BEPS Report" (31 March 2015) in para 10.

The DTC will deal with the question of incentives in the South African tax legislation, in detail, in terms of a separate Report for this purpose.

2.5.2 The danger to South Africa of unilateral action

In responding to the OECD BEPS concerns, it must be realised that South Africa cannot take action without considering the global environment and other countries' responses to the concerns. Globalisation has affected countries' tax policies and many of them have changed their tax policies to stay competitive. South Africa should not pre-empt or unilaterally respond to BEPS action points until OECD member states have reached consensus on measures to address BEPS and clear guidance has been issued in this regard.

The unilateral introduction of domestic legislation in anticipation of global reforms could result in a less investor friendly tax environment and may place South Africa at a disadvantage compared to other jurisdictions without BEPS legislation, in attracting much needed foreign direct investment. Competitive pressure using tax policies is evident. Three examples of this trend are:

- All G7 and BRICS economies have lowered their corporate tax rates since 2000 (with the exception of the US, which, because of its size and attractiveness, has been able until now to resist this trend). [114]
- There has been a move away from worldwide systems to territorial systems of taxing corporations. In 2009, the UK and Japan replaced worldwide tax systems with territorial tax systems, while the US maintains a worldwide system. Territorial systems are typically accompanied by provisions (such as CFC rules) to prevent base erosion and income shifting. [115] Making this decision is a key policy issue and it depends on where a country wants to be on a spectrum that runs from a pure worldwide system to a pure territorial system. [116]
- Changes in international trends in the taxation of dividend income, with many European countries moving to classical or shareholder relief systems, and away from imputation systems under which dividends are taxed at a lower rate at the personal level. In many countries, dividends are taxed at the personal shareholder level, at lower rates than the personal income tax rates that are levied on wage income. One reason for reducing the effective tax rate on dividends has been that it is potentially the rate faced by equity investors in a new business (since such a business does not have retained profits from existing business activities available to reinvest). [117]

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114 J Owens & C Sanger "Global Trends in Taxation" Presentation to the Davis Tax Committee (19 September 2013) at 2.
115 Ibid.
116 Ibid.
117 Ibid.

If South Africa is to remain competitive in this globalised economy, it has to develop a balanced tax policy that ensures that it attracts FDI. South Africa cannot afford to proceed too hastily with the OECD Action Plan while other countries are taking a “wait and see” approach, relaxing their laws to attract investment and changing their policies in order to remain competitive.

2.5.3 The approach for developing a competitive tax policy

In developing a competitive tax policy in light of BEPS, the DTC recommends that South Africa’s legislators:

- Take cognisance of the country’s place in the global economy as an emerging economy in Africa. In light of the NDP, South Africa has to develop tax policies that will enable it to be well positioned as a base for further investment into Africa, the continent which is acknowledged as the new frontier for global investment. South Africa needs to maintain and enhance its “Gateway status” for multinational company investments in the African Continent.[118] Cognisance should also be given to the competition that South Africa faces from other African countries in this regard;
- Take cognisance of South Africa’s major trading partners and the countries from which its main investors come;
- Give consideration to key industries such as the mining and manufacturing sectors which form the backbone of the South African economy, because these are largely reliant on foreign funding for expansion;
- Try to avoid introducing measures to counter the BEPS risk which, if applied across all sectors of the economy, might undermine the stated objectives of the NDP to increase private sector investment in labour intensive areas and to stimulate the development of a more diversified economy.
- In responding to BEPS, ensure that South Africa does not create tax policies or an administrative environment that harms the increasingly fragile flow of FDI to South Africa.[119]

2.6 ADDRESSING BEPS REQUIRES ADHERING TO THE PRINCIPLES OF A GOOD TAX SYSTEM

Designing tax rules to prevent BEPS requires that those rules comply with the principles of a good tax system. These principles are: equity, efficiency, certainty and simplicity.[120]

<u>Equity:</u>

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118 American Chamber of Commerce in South Africa “Comments on the First DTC Interim Report on Base Erosion and Profit Shifting (March 2015) 1-2.

119 Ibid.

120 RM Sommerfeld, SA Madeo, KE Anderson & BR Jackson *Concepts of Taxation* (1993) at 10; WA Raabe & JE Parker *Taxation Concepts for Decision Making* (1985) at 14.

- International equity requires that a country should ensure that it gets its fair share of revenue from cross-border transactions. This entails protecting a country's tax base by developing domestic laws that are fair and impartial; imposing equal tax burdens on taxpayers with equal income, without reference to the source of the income, and by making those burdens commensurate with the ability of taxpayers to pay. For example, a group of related companies should be charged the same tax as a single company engaging in comparable activities.
- Equity requires justice and equal treatment of domestic and foreign companies. A country's fiscal policy could either adhere to a doctrine of "capital import neutrality"[121] or "capital export neutrality".[122] South Africa endeavours to design its laws to comply with the principle of capital export neutrality. An example of this is the controlled foreign company (CFC) legislation which is generally designed to guard against the unjustifiable erosion of the domestic tax base by the export of investments to non-resident corporations.

<u>Efficiency:</u>

- Efficiency requires minimum distortion in the allocation of resources. Efficiency is lost if the corporate tax system distorts corporate finance and investment behaviour.
- Transfer pricing legislation helps to ensure efficiency by preventing the manipulation of profits and losses in different locations. Efficiency also requires accountability for taxes, as this affects tax morality.

<u>Certainty:</u>

- Certainty of the tax system is important for foreign investors. Certainty goes hand in hand with administrative efficiency and low compliance and administrative costs. Thus, in designing any rules to counteract BEPS, consideration needs to be given to the cost of compliance versus the benefit to the fiscus. For example, the documentation requirements (for instance, with respect to transfer pricing) should not be too onerous for taxpayers and it should not hamper the ease of doing business in South Africa.
- Certainty also requires that changes made to tax laws should apply prospectively, not retrospectively. Retrospective legislation should be used as an exception and not the norm. Retrospective taxation has the undesirable

121 Capital-import neutrality implies that a country should avoid international tax laws that might cause its multinational companies to bear higher effective tax burdens in foreign markets than the multinational companies of other countries.

122 Capital-export neutrality suggests that a country should design its international tax laws so as to neither encourage nor discourage outflows of capital. An example is worldwide taxation of residents. Many countries adopt measures to encourage capital inflow rather than outflow. However prudent policy makers caution excessive measures that discourage capital outflow. Excessively high withholding taxes on dividends, interest and royalties paid to non-residents are likely to discourage foreign investment.

effect of creating major uncertainties in the business environment and constituting a significant disincentive for persons wishing to do business.[123] If changes are to be made, transitional arrangements need to be included in the rules to enable investors to change so that they comply with the new provisions.

- The time frame within which tax legislation is discussed has become shorter while the law has become more complex. In publishing proposed changes to legislation in the BEPS context, the authorities should provide as much time as possible for discussion and debate by all interested sectors on the implications, always within the context of the NDP.
- Interpretation of the laws in the form of interpretation notes should be issued at the same time as the legislation. However, legislation should be drafted clearly instead of requiring reliance on explanatory memorandums and interpretation notes which are not legally binding. This, of course, applies to all tax legislation, not just that relating to BEPS.

<u>Simplicity:</u>

- Simplicity requires that corporate tax laws are not too complex. The legislation should be clear and unambiguous; easy to administer and to comply with.
- The Tax Administration Act 28 of 2011 was intended to simplify tax administration and reduce red tape; this should be a basic tenet of its application.
- The introduction of the electronic filing system has significantly improved the payment of taxes and simplified the system of filing tax returns. However, there are still issues relating the electronic submission of documents. For example, it is not clear when a taxpayer is deemed to have received notice from SARS.
- Corporations consider the accrual accounting rules, the capitalisation of assets and the sensitivity to timing to be the main sources of corporate income tax complexity and therefore of corporate compliance costs. [124] Corporate complexity is also caused by the different treatment between debt and equity, the existence of different types of legal forms that are taxed differently and the tax rules with respect to business restructurings.[125]
- It goes without saying that the general principle of simplicity, the absence of which is illustrated by the above examples, must apply to any BEPS related legislation.

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123 Ministry of Corporate Affairs Department in India "Report of the Committee for Reforming the Regulatory Environment For Doing Business in India" (Sept 2013) in para 7.8.

124 OECD "Fundamental Reform of Corporate Income Tax" (2007) No.16.

125 Ibid.

2.7 THE ROLE OF GOOD TAX ADMINISTRATION IN PROTECTING THE TAX BASE AND ENSURING A COMPETITIVE ECONOMY

Good tax administration can contribute to a competitive economy. Raising tax revenues in a way that is broadly accepted as "fair" is more likely to achieve high levels of voluntary compliance. A tax administration that is not open to corruption and that implements tax law consistently and impartially makes the tax regime predictable and reduces the extent to which it might discourage investment. Efficiency in tax administration reduces the amount of an economy's resources that have to be devoted to revenue collection. [126]

Tax compliance can be ensured by improving the relationship between taxpayers and the tax authorities. Effective tax compliance will only be achieved if it is combined with good taxpayer service and where there is a constructive and transparent dialogue between tax authorities, taxpayers and their advisors.[127] An adversary relationship between assessing authorities and the taxpayers is counterproductive. In 2007, OECD's Forum on Tax Administration developed the principle of an "Enhanced Relationship" between taxpayers, their advisors, and revenue authorities.[128] Adhering to this principle helps administrators find the right balance between service and enforcement; recognising that good service plus good enforcement is the most effective way to achieve good voluntary compliance. [129]

It is recommended that South Africa should endorse the OECD principle of "Enhanced Relationship". In this enhanced environment it becomes easier for governments and business to agree on the best way to achieve a business friendly tax environment while at the same time protecting the tax base. Countries that have this relationship in place will be more attractive to MNEs.[130] Reference should also be made to the DTC Report to be issued on tax administration, in this regard.

To achieve this, it is important for SARS to continue building its administrative capacity by recruiting and maintaining high quality staff- a tax administration is only as good as its staff.[131] This point is a key theme throughout the recommendations made on the detailed evaluations of the BEPS actions.

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126 J Owens "What is meant by a Competitive Tax Environment?" Presentation before Davis Tax Committee (19 September 2013).

127 Ibid.

128 OECD "Forum on Tax Administration: Information Note: General Administrative Principles: Corporate Governance and Tax Risk Management" (7-8 July 2009). Available at http://www.oecd.org/dataoecd/37/19/43239887.pdf.

129 OECD "The Enhanced Relationship: OECD Tax Intermediaries Study: Working Paper (6 July 2007). Available at http://www.oecd.org/dataoecd/59/61/39003880.pdf. J Owens "What is meant by a Competitive Tax Environment?" Presentation before Davis Tax Committee (19 September 2013).

130 J Owens "What is meant by a Competitive Tax Environment?" Presentation before Davis Tax Committee (19 September 2013).

131 Ibid.

In addition, the incentivisation system in which gross tax collections are treated as a major indicator of good performance should be stopped as there is a perception that it fosters corruption and abuse of the system. [132]

The role of the tax administration in protecting the tax base should however be balanced with the necessity not to overburden taxpayers with increasing compliance tax burdens as these compound administrative costs for taxpayers. Even though the notion of enhanced cross-border documentation must be supported as a measure to protect against BEPS and to enhance audits, any documentation requirements must be analysed and publicly discussed. Improper forms lead to excessive compliance burdens with little benefit for the Government.

Requesting information for information's sake becomes a costly exercise that can actually hinder audit (with taxpayers using excessive information to flood the audit review). Form design is not easy because it requires an understanding of technical business processes that government officials sometimes lack. Hence, a joint government/business collaboration would be more effective. It is important to keep in mind the notion of materiality to the extent possible. Large business often use simplifying cost-plus assumptions for a variety of miscellaneous items just as a matter of administrative ease without regard to tax. Unless some form of materiality is introduced, the cost of compliance (e.g. additional employees and computer systems) will easily outweigh the cost of the underlying tax, especially for smaller items.[133]

2.8 THE ROLE OF EXCHANGE CONTROLS IN CURTAILING BEPS

The DTC report on BEPS cannot be complete without reference to South Africa's exchange control implications for BEPS. The relationship between capital flows and exchange control regulations has long occupied policy makers in South Africa, ever since exchange controls were introduced in South Africa in the form of Emergency Finance Regulations at the outbreak of the Second World War in 1939. [134] The intention was protect South Africa's foreign exchange reserves. [135] During the apartheid era, exchange controls on residents were tightened in response to the large-scale capital outflows.[136] Strict exchange controls applied to prevent the flow of funds from South Africa. However, since 1997 the exchange controls have been

[132] Ministry of Corporate Affairs Department in India "Report of the Committee for Reforming the Regulatory Environment For Doing Business in India" (Sept 2013).
[133] SAIT "Comments on DTC First Interim Report on BEPS" (March 2015) at 4.
[134] Exchange Control Manual para C; BK Spitz *Exchange Control Encyclopedia* (2002 Service Issue 4) at Part at 2-1.
[135] Ibid.
[136] L Olivier & M Honiball *International Tax: A South African Perspective* 4 ed (2008) at 524.

gradually relaxed, and it is intention of National Treasury that the liberalisation and deregulation of exchange controls will continue.[137]

Exchange controls ensure the timeous repatriation into the South African banking system of certain foreign currency acquired by residents of South Africa, whether through transactions of a current or of a capital nature; and they also prevent the loss of foreign currency resources through the transfer abroad of real or financial capital assets held in South Africa.[138] The Regulations prohibit any foreign exchange transaction unless a specific exemption for such a transaction has been granted by the Treasury or by a person authorised by the Treasury. The Regulations also state that any exemption from the provisions of the Regulations is subject to the terms and conditions under which such an exemption is granted.

Permissions are contained in the Exchange Control Rulings (Rulings) and, if not provided for in the Rulings, specific permission has to be obtained from the Treasury or from a person authorised by the Treasury, namely the Financial Surveillance Department (FinSurv) of the South African Reserve Bank (SARB). FinSurv then considers such applications in terms of policy guidelines formulated by the Treasury, in conjunction with FinSurv.

As a general rule exchange controls are based on the premise that all transactions must take place at a fair and market related price on an arms-length basis. The majority of foreign exchange transactions are authorised by the Authorised Dealers in foreign exchange (ADs) and/or Authorised Dealers in foreign exchange with limited authority (ADLAs) in accordance with the provisions applicable to such transactions as outlined in the Rulings. Reliance is therefore placed on the ADs and ADLAs to ensure compliance with the terms and conditions under which such permissions were granted. The concept of a fair and market related price presents a degree of difficulty especially when it involves transactions which take place on an over-the-counter basis (i.e. the underlying goods, assets etc. are not listed on a formal exchange). Reliance is, thus, sometimes placed on the resident party to confirm the arm's length nature of the transaction.

In recent years it has become a practice for certain capital transactions entered into by South African resident individuals to be subject to a tax clearance process, but capital transactions by corporates as well as current account transactions do not require specific tax clearance in order for exchange control permission to be granted for such transactions. In addition, it has become the practice of the authorized dealers to request confirmation from the corporate's auditors, that the payments

137 MM Katz (chairman) *Fifth Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa* (1997) ('Katz Commission Report') at 4.

138 South African Reserve Bank 'Exchange Control Manual' para E.

(especially of management fees) are in line with transfer pricing principles and reflect the arm's length price.

It should however be noted that the Exchange Control Regulations ("Regulations") do not make any specific provision insofar as the curtailing of BEPS is concerned. Nevertheless, exchange controls have played a defense role against BEPS in South Africa especially with regards to e-commerce, digital products, virtual currencies, intellectual property royalty payments and other forms of intangible related transfer functions.

In this regard, exchange controls complement the tax legislation intended to counter BEPS by preventing the outflow of capital from the country that could lead to the depletion of the tax base.[139] Indeed, the Regulations are flexible enough to incorporate anti-BEPS measures. In this regard, the Minister of Finance has directed that, the liberalisation of exchange controls should be aimed at an end result which would protect the tax base, bolster anti-money laundering efforts and promote prudential regulation. Nevertheless, there are concerns that the South African Reserve Bank's approach to virtual currencies which opt out of the current National Payments System could have an implication for BEPS. It is also possible that relaxing requirements for foreign entities that have bank accounts in South Africa may have illicit financial outflows and money laundering implications.

2.8.1 Examples of how exchange controls have been applied in South Africa to counter various BEPS schemes

Foreign loans: All loans coming into South Africa are subject to thin capitalisation rules as is the case with tax i.e., interest is capped at prime +2% for related party loans and prime +3% for third party funding. Our loan policy, which states that South African entities with offshore subsidiaries may not establish entities back into South Africa, assists in preventing the South African entity from moving its tax base to a foreign jurisdiction.

Imports: A general exchange control requirement is that all import transactions must be substantiated by documentary evidence including evidence to the effect that goods have in fact been cleared through Customs at some point in time. It is the responsibility of the ADs to ensure import transactions are executed in a manner compliant with permissions granted and upon presentation of documentary evidence.

[139] AW Oguttu Curbing Offshore Tax Avoidance: The Case of South African Companies and Trusts (2007) UNISA LLD Thesis at 431.

In this regard, miss-invoicing/under-invoicing of goods at Customs is a matter that execrates BEPS. The 2014 UNCTAD "Trade and Development"[140] Report notes that illicit flows of capital through developing countries due to trade mis-invoicing is one of the most pressing challenges facing policymakers, since it costs these countries billions of dollars in revenue. The report showed that under-invoicing of imports and over-invoicing of exports, where buyers or sellers falsify the value of trade to be less than the actual market value can be used to disguise foreign investment and avoid capital controls. The UNCTAD recommends that in order to prevent channel financing, governments need to resort to capital management measures, including capital controls.[141]

South Africa's Reserve bank's investigations show that under-invoicing takes place in order to circumvent the payment of import duties and that fraudulent documentation is presented to ADs in order to effect payment for imports. In recent cases freight payments were used to disguise the settlement of import payments. In all the cases under investigation documentation was forged or falsified. Research has revealed that there is substantial discrepancy between the value of outward payments for imports and value of goods declared to Customs by the entities under investigation. The Reserve Bank also suspects that in some instances outward payments declared as import or freight payments have been used to exit funds from South Africa, which funds may be the proceeds of other criminal activities. Many of the transactions under investigation were cash funded (i.e. the ZAR leg) which raises suspicion as to the origin of the funds as well as whether such funds were properly declared for income tax purposes. Certain of the transactions also appear to have the makings of money laundering schemes which involve multiple entities and individuals.

In an effort to curb the submission of false documentation to ADs, FinSurv introduced the Imports Verification System (IVS). Essentially this system allows the relevant AD to verify the authenticity of a South African Revenue Service ("SARS") Customs Release by validating a unique Movement Reference Number (MRN) as annotated on the relevant Customs Release. The current system, however, does not validate the document in terms of the Customs Value indicated thereon.

Loop structures: Loop structures are tax-avoidance and exchange control schemes whereby South African residents invest in offshore trusts that, in turn, reinvest funds in South African businesses in which the original investors have a stake.[142] Loop

140 UNCTAD "Trade and Development: Global Governance and Policy Space for Development" (2014).

141 Ibid.

142 L du Preez 'No Sign of Extension to Amnesty Yet' (8 November 2003). Available at http://www.persfin.co.za/index.php?fSectionId=&fArticleId=280017 accessed on 20 March 2007. Wiseman Khuzwayo, Business Report 'FirstRand's loop legal – Dippenaar' (September 9, 2007). Available at http://www.busrep.co.za/index.php?fArticleId=4023192 accessed on 20 March 2009.

structures are considered to be in breach of exchange control regulations as capital is essentially exported through the subsequent growth in value of the company. The regulations prohibit South African residents from holding their local assets via offshore structures or from placing their legal foreign assets at the disposal of another South African resident.[143]

Individual remittances via ADLAs: The Reserve bank's investigations into transactions in terms of which foreign nationals remit funds abroad through ADLAs in respect of income earned from their employment in South Africa have revealed various exchange control contraventions. The fact that many of these transactions were funded by way of cash deposits (in many cases amounts of up to Rand 500 000) into the client accounts of ADLAs raised further concerns regarding possible money laundering as well as tax evasion by the individuals involved. It also became clear during investigations that almost none of the individuals conducted bank accounts in South Africa, which FinSurv finds strange, taking into account the fact that many of them remitted substantial amounts abroad claiming it was part of their South African earnings.

2.8.2 Actions from an Exchange Control Perspective to Address the BEPS Concerns in South Africa

- FinSurv monitors cross-border flows and shares information with SARS and the Treasury on a regular basis.
- The Treasury has introduced various policies to encourage South African individuals, corporates and institutional investors to use South Africa as a base for diversifying through domestic channels. One example of this being the Holdco regime (Treasury Management Company), which brings flows back into South Africa from all offshore entities, which would have previously been transferred to tax havens such as Mauritius, Isle of Man or some other jurisdictions.

2.8.3 How the Reserve Bank Works Together with other Government Agencies to Monitor Financial and Capital Flows

- FinSurv works closely with the Tax Policy Unit at the Treasury when it receives requests for corporate restructures to ensure that the tax base is protected when making decisions.
- FinSurv normally receives comprehensive reports from various South African corporates with financial statements of all their offshore entities. It is thus able

143 Exchange Control reg 10(1)*(c);* Exchange Control Circulars D417 and D405. For details see generally AW Oguttu "Curbing Offshore Tax Avoidance: The Case of South African Companies and Trusts" (2007, UNISA LLD Thesis) chapter 9.

to report various forms of cross-border information to the Treasury because it is in a position to monitor financial and capital flows in and out of South Africa.

- When FinSurv relaxes controls or grants approvals outside of policy, it works closely with the tax authorities. Where gaps in policy are identified, FinSurv makes recommendations to the tax authorities.
- As exchange controls are relaxed, FinSurv ensures that it has discussions with the Tax Policy Unit at the Treasury and with SARS to highlight any reforms that could potentially have implications for the South African tax base.
- FinSurv provides various forms of cross-border information, so it is in a position to monitor financial and capital flows, in and out, of South Africa. FinSurv is, however unable to identify what component, if any, of BEPS may be contained in the various categories of transactions.
- It is recommended that a review be conducted of all SARS and SARB forms in terms of cross-border flows. SARB has a fair amount of information, that SARS can make use of in improving cross-border information flow especially once the new cross-border withholding tax regimes take effect. Operational control of ongoing reporting of these outflows may itself close a fair amount of avoidance, followed by more targeted legislation. It is therefore recommended that SARS should get assistance from foreign revenue authorities that have successfully created a cross-border monitoring system.[144]

2.8.4 Recommendations on how the SARB can assist in the efforts against BEPS

- The production of a Tax Clearance Certificate be made compulsory for certain types of high risk transactions involving individuals e.g. gifts above a certain threshold etc.
- Urgent steps are taken to improve efforts to prevent the circumvention of rules, which efforts would require closer and pro-active collaboration between SARS and FinSurv.
- Various types of schemes that are used by corporates i.e. hybrids, foreign tax generalisation etc. be disclosed to FinSurv, to assist with the detection of such schemes when approving requests.

Although some of the recommendations above may be construed to be a tightening of exchange controls or creating red tape, it must be noted that BEPS is not illegal, nor does it necessarily amount to a contravention of the exchange control regulations for the relevant transaction to be deemed invalid.[145] This was confirmed in the Supreme Court of April case of Oilwell v Protec[146] where it was held that:

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144 SAIT "Comments on DTC First Interim BEPS Report" (March 2015) at 3.
145 PWC "Comments on DTC First Interim BEPS Report" (30 March 2015) at 8.
146 (295/10) [2011] ZASCA 29 (18 March 2011).

> "The Regulations are, accordingly, for the public interest and not to protect any private interests. They were adopted for the sake of The Treasury and not for the sake of disgruntled or disaffected parties to a contract. This is apparent from the penalty provision. But more importantly, it appears from regs 22A, 22B and 22C. They provide that any money or goods in respect of which a contravention has been committed may be attached by The Treasury; these may be forfeited to the State; and any shortfall may be recovered by The Treasury from not only persons involved in the commission of the offence but also from anyone enriched or who has benefited as a result thereof. *To add irremediable invalidity to the transaction would amount to overkill* and as Kriek J said, it would lead to 'greater inconveniences and impropriety'". (our emphasis)

2.9 OVERVIEW OF MEASURES IN PLACE TO CURTAIL BEPS IN SOUTH AFRICA

It has to be acknowledged that over the years, South Africa has made good progress in devising tax laws to deal with BEPS. South Africa's legislation in this regard is comparable to many developed countries; in fact, in many respects South Africa has done better than many developed economies. This has been augmented by the fact that:

- National Treasury and SARS are regularly engaged in international tax debates which have ensured that South Africa's tax policy is in line with internal norms. This ensures predicable tax results for MNE operating in the country.
- South Africa has an annual legislative cycle that ensures annual amendments to the Act, which enables businesses to plan for these changes and to make comment on the same.
- South Africa's e-filing system ensures an efficient filing of tax returns and payment of tax liabilities. SARS continued use of technology will ensure an efficient revenue collection mechanism

Considering all the legislation in place and the competitive edge the country has to maintain, South Africa may wonder whether it is necessary to tighten its laws any further or introduce new laws:

(i) Efforts to curtail BEPS can be traced back to the Katz Commission,[147] appointed in 1997 to inquire into the ability of the tax structure of South Africa to deal with the consequences of the globalisation of trade. The Commission recommended the introduction of the residence basis of taxation.[148] This basis of taxation, which was implemented in 2000, has been instrumental in curtailing erosion of the tax base, especially in light of South Africa's re-entry into the global economy after its first democratic elections in 1994.

(ii) South Africa has in place various specific anti-avoidance provisions to address

147 MM Katz (chairman) *Fifth Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa* (1997) at 4.

148 Ushered in by the Revenue Laws Amendment Act 59 of 2000 (the Amendment Act) which amended the Income Tax Act.

BEPS. These include: the controlled foreign company (CFC) rules,[149] transfer pricing and thin capitalisation[150] rules, rules to deal with hybrid instruments, reportable arrangements [151] rules, and the Voluntary Disclosure Programme.[152] These provisions have been instrumental in curtailing erosion of the South African tax base.

(iii) In addition, South Africa can address BEPS by applying its general anti-avoidance rules and the substance over form principles, even though these general provisions are mainly applied in the domestic arena.

(iv) South Africa's tax treaties also contain provisions (such as the beneficial ownership provision) which can be applied to curtail the abuse of South Africa's treaties by third country residents.

(v) The Exchange Control rules are also instrumental in curtailing BEPS.

Despite all of these provisions, tax planners constantly seek to be one step ahead of tax administrations, coming up with various schemes that take advantage of the loopholes in the law. To curtail these schemes, the legislators often come up with *ad hoc* amendments, which have complicated the tax legislation and have unsuspectingly opened up further loopholes - and the cycle goes on.

It must be made clear that the main concern of the OECD BEPS Action Plan is about addressing in-bound issues which involve foreign multinationals investing in a country without paying their fair share of corporate income tax to that country. However, responding to these BEPS issues should not be seen as discouraging foreign investment. The goal is to ensure that the multinationals pay their fair share of tax, based on amounts that are economically attributable to their activities in the local country. It should also be noted many of BEPS concerns have been dealt with previously by the OECD and in some respects there is nothing new in the rules, but what is new is their application and that the rules need to be implemented in the way that was intended. The need to enforce these rules has also necessitated the proposals for significantly increase in exchange of information in tax matter and also mandatory disclosure rules to enable tax authorities to monitor the implementation.

Countries can ensure the preservation of the taxable income base of inbound investment, either by limiting local deductions (interest, dividends and royalty fees) and curtailing incentives by quantifying the real benefit. Although the issues pertaining to out-bound investments (for instance the Action Plan to strengthen CFC legislation) are connected to the BEPS in-bound concerns, outbound investments are not the main focus of the BEPS Action Plan. It is thus necessary to ensure a balance between *revenue collection* and *growth*. It is vital that South Africa, while

[149] Section 9D of the Income Tax Act 58 of 1962 as amended.
[150] Section 31 of the Income Tax Act 58 of 1962 as amended.
[151] Sections 34-39 of the Tax Administration Act 28 of 2011.
[152] Sections 225-233 of the Tax Administration Act 28 of 2011.

ensuring that it collects its fair share of taxes on inbound investment, also creates the right environment to encourage foreign investment. In particular it is important to take note of the following:

- In adopting the OECD recommendations on BEPS, it is necessary that the envisaged legislation be first evaluated to ensure effectiveness of South Africa's tax environment.
- Care needs to be taken not to introduce fragmented and uncoordinated tax measures that address specific tax issues instead of dealing with the fundamental tax concerns. This can result in creating uncertainties and complicating the tax laws. A consistent tax policy must be maintained, instead of the trend over the last few years of introducing provisions and then withdrawing the policy position a few years later. This hampers confidence in the tax system. An example is the recent announcement in the 2015 Budget speech to tighten CFC rules and the withdrawal of the withholding tax on service fees. It is important that SARS is not seen to be "auditing legislation" rather than maintaining a predicable tax policy framework. [153]

2.10 OTHER FACTORS THAT SHOULD BE TAKE INTO CONSIDERATION TO ENSURE COMPREHENSIVE PROTECTION AGAINST BEPS IN SOUTH AFRICA

Comprehensive protection against BEPS in South Africa must occur at multiple levels.

2.10.1 BEPS protection at policy level

(a) Clear policy on tax incentives

South Africa has seldom offered tax holidays, preferring the tax incentive option. Studies by the IMF, the World Bank and the OECD show that tax holidays are a less effective way to generate new investment than incentives in the form of tax credits.[154] The subject of tax incentives in not dealt with in the OECD BEPS Actions however as alluded to in paragraph 2.5.1 above, some tax incentives can provide more opportunities for BEPS to occur. South Africa offers quite a few tax incentives to foreign investors. Tax incentives entail "any tax provision granted to a qualified investment project that represents a favourable deviation from the provisions applicable to investment projects in general." [155] The economic theory is that tax

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153 American Chamber of Commerce in South Africa "Comments on the First DTC Interim Report on Base Erosion and Profit Shifting (March 2015) at 4.

154 OECD, Tax Incentives for Investment—A Global Perspective: Experiences in MENA and Non-MENA Countries 4 (Draft, 2007), available at http://www.oecd.org/dataoecd/51/17/38758855.pdf.

155 Fleischer, (2002).

incentives act as a tool for encouraging foreign investments. However, it has been observed that tax incentives distort resource allocation leading to some sub-optimal investment decisions and are therefore harmful to long term growth, since the country loses out in revenue foregone. It is also argued that tax incentives are not the primary determinants of the decision to invest. Most investors base their investment decisions not only on economic and commercial factors but also on institutional and regulatory factors. Despite these concerns, internationally there has been not much attention given to developing guidelines on tax incentives.

It is encouraging to note that in 2014 the G20 has called upon the IMF, OECD, UN and World Bank Group to work jointly to present a report in on options for low income countries on the efficient and effective use of tax incentives for investment.[156] It is therefore important that South Africa follows up on these developments and considers the best practice guidelines in the design of tax incentives.[157] Developing a clear tax policy on the use of tax incentives will be instrumental in preventing any resultant BEPS.

(b) Clear treaty negotiation policy

Improper use of tax treaties can be a major source of BEPS. South Africa has a wide network of double tax treaties, some of which are with low tax jurisdictions and can be a major source of BEPS. The list of double tax treaties on the SARS' website as at 30 May 2015 shows that South Africa has entered into 75 double tax treaties (DTT), which have been published in the Government Gazette, 21 of these DTTs are with African countries. Another 36 treaties are in the process of negotiation or have been finalised but not yet signed.[158]

Many of the BEPS concerns raised globally stem from overly generous tax treaties. In the 1990s, South African government officials had a tendency to push for

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[156] G20 Development Working Group "Domestic resource Mobilization: G20 Response to 2014 base Erosion and Profit Shifting and Automatic Exchange of Information for Developing Economies" (2014) at 7. Available at https://g20.org/wp-content/uploads/2014/12/16%20G20%20response%20to%202014%20reports%20on%20BEPS%20and%20AEOI%20for%20developing%20economies.pdf accessed 1 April 2015.

[157] Best practice guidelines in the design of tax incentives required that governments ensure: (1) the transparency of investment tax Incentives; (2) the publication of the availability of tax incentives, how they are applied in practice, and the terms of their availability; (3) there should a clear methodology to measure the cost of tax incentives targeted at both domestic and international investment and agree to publish these on a regular basis in a format that facilitates international comparisons; (4) assessment should be made of the effectiveness of such measures and this information should be made public. See J Owens "What is meant by a Competitive Tax Environment?" Presentation before Davis Tax Committee (19 September 2013).

[158] SARS "Double taxation agreements (DTAs) & protocols". Available at Visit http://www.sars.gov.za/Legal/International-Treaties-Agreements/DTA-Protocols/Pages/default.aspx accessed 5 March 2015.

international agreements as a way of showing the world that South Africa was ending its long period of international isolation. The UN has advised that the ability to negotiate favourable treaty provisions depends a lot on the treaty negotiating power of the relevant country. In general, developed countries are better skilled in negotiating tax treaties than undeveloped countries.[159] The United Nations notes that:

> "Developing countries, especially the least developed ones, often lack the necessary expertise and experience to efficiently interpret and administer tax treaties. This may result in difficult, time-consuming and, in a worst case scenario, ineffective application of tax treaties. Moreover, skills gaps in the interpretation and administration of existing tax treaties may jeopardize developing countries' capacity to be effective treaty partners, especially as it relates to cooperation in combating international tax evasion. There is a clear need for capacity building initiatives, which would strengthen the skills of the relevant officials in developing countries in the tax area and, thus, contribute to further developing their role in supporting the global efforts aimed at improving the investment climate and effectively curbing international tax evasion".[160]

It is important that South Africa has a clear policy on treaty negotiation and that it ensures that the knowledge and technical capacity of its treaty negotiators are sufficient so that it avoids concluding treaties that are not in its favour, because they reflect the position of the other contracting state. There are two main Models employed internationally in the drafting of treaties: the OECD Model Tax Convention (OECD MTC) and the UN Model Tax Convention between Developed and Developing Countries (UN MTC). The OECD MTC embodies rules and proposals by developed capital exporting countries. It thus favours capital exporting countries over capital importing countries. Treaties based on the OECD MTC normally eliminate double taxation by requiring the source country to give up some or all of its tax on certain categories of income earned by residents of the other treaty country.[161] The UN MTC favours capital importing countries over capital exporting countries. It generally imposes fewer restrictions on the tax jurisdiction of source countries. For instance, it does not contain specific limitations on withholding tax rates on dividends, interest, and royalties imposed by the source country.[162]

South Africa also has a model tax treaty that is used as a basis for negotiating its treaty position. This model treaty is a template used as a starting point when embarking on a treaty negotiation.[163] Nevertheless, most of South Africa's treaties are largely based on the OECD MTC. In some treaties, the Contracting states have negotiated some treaty provisions that are based on the UN MTC. Since South Africa

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159 PWC, EuropeAID 'Implementing the Tax and Development Policy Agenda: Final Report on Transfer Pricing and Developing Countries' (2011) at 21.

160 United Nations 'Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries' (United Nations, 2013) at iii.

161 B.J. Arnold and M.J. McIntyre, *International Tax Primer* (Kluwer Law International, 2002), at 109.

162 Ibid.

163 Oliver & Honiball at 272; Mazansky "South African Treaty Network – Why is South Africa the Meat in the Sandwich? (2009) Bulletin for International Tax 48.

is generally a net capital importing counties, it is generally within its interest to sign treaties based on the UN MTC.

South Africa should accordingly utilise the BEPS era to renegotiate its “riskier” treaties with low-tax jurisdictions. Tax treaties are designed to reduce double tax – not to create a tax vacuum. To this end, the DTC recommends that South Africa joins the OECD effort to revise tax treaty interpretations, update treaties and cautiously monitor other countries moves on the multi-lateral instrument process (under Action 15) so that overall weaknesses in the treaty system is corrected.

2.10.2 BEPS Protection at Administrative level

At an administrative level, the use of proper forms should be attended to, to ensure proper detection of BEPS.

- Currently the IT14 Company Tax Form makes no distinction between a local company versus a foreign company operating in South Africa, except a box checkmark. It is important that SARS divides the two into separate audit tracks.
- Instead SARS has implemented form IT14-SD which has resulted in additional compliance costs for MNEs.[164]
- Forms should also be created for all cross-border withholding taxes.
    - There is a form in progress for outgoing interest
    - A form is need for outgoing royalty

2.11 OECD VIEWS ON HOW BEPS RECOMMENDATIONS ARE TO BE IMPLEMENTED

The OECD notes that a better understanding of how the BEPS recommendations are implemented in practice could reduce misunderstandings and disputes between governments. Greater focus on implementation and tax administration is mutually beneficial to governments and business. [165]

The OECD BEPS Project culminated in a comprehensive package of measures which are designed to be implemented domestically and through treaty provisions in a coordinated manner, supported by targeted monitoring and strengthened transparency. The implementation of the BEPS package will better align the location of taxable profits with the location of economic activities and value creation, and

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164 American Chamber of Commerce in South Africa: Comments on DTC First Interim BEPS Report (March 2015).

165 OECD BPS Project “Addressing the Tax Challenges of the Digital Economy” (2015 Final Report) at 4.

improve the information available to tax authorities to apply their tax laws effectively.[166]

(a) Minimum standards

Minimum standards were agreed in particular to tackle issues in cases where no action by some countries would have created negative spill overs (including adverse impacts of competitiveness) on other countries. [167] Thus all OECD and G20 countries (which includes South Africa) have committed to consistent implementation of minimum standards in the following Action Points:

- Harmful tax practices (Action 5)
    - A revitalised peer review process will address harmful tax practices, including patent boxes where they include harmful features, as well as a commitment to transparency through the mandatory spontaneous exchange of relevant information on taxpayer-specific rulings which, in the absence of information exchange, could give rise to BEPS concerns.
- Preventing treaty shopping (Action 6)
- Country-by-country reporting (Action 13)
    - Standardised Country-by-Country Reporting and other documentation requirements will give tax administrations a global picture of where MNE profits, tax and economic activities are reported, and the ability to use this information to assess transfer pricing and other BEPS risks, so they can focus audit resources where they will be most effective
- Improving dispute resolution (Action 14)
    - For mutual agreement procedures (MAP), agreement on a minimum standard to secure progress on dispute resolution has been reached.

(b) Common approaches and best practices for domestic law

In other cases countries have common approaches, which will facilitate the convergence of national practices in interested countries. In these areas, countries have agreed on certain best practices. Countries are expected to converge over time through the implementation of the agreed common approaches, thus enabling further consideration of whether such measures should become minimum standards in the future. Action points with best practices are:

- hybrid mismatch arrangements (Action 2)
    - domestic legislation and related treaty provisions where necessary to neutralise hybrid mismatches which undermine their tax base or the tax base of their partners.

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166 OECD OECD/G20 Base Erosion and Profit Shifting Project Explanatory Statement (2015) in para 11.

167 Ibid.

- Controlled foreign company rules (Action 3)
  - Building blocks for effective CFC rules
- Limiting base erosion through Interest expenses, for example via intra-group and third party loans that generate excessive deductible interest payments (Action 4)
- Mandatory disclosure of aggressive tax planning (Action 12)
  - Guidance based on best practices for countries which seek to strengthen their domestic legislation relating to mandatory disclosure by taxpayers of aggressive or abusive transactions, arrangements, or structures.

(c) Action points that reinforce international standards to eliminate double taxation, in order to stop abuses and close BEPS opportunities

This translates into a set of agreed guidance which reflects the common understanding and interpretation of provisions based on Article 9 of both the OECD and UN model tax conventions. Under this category fall:

- Action points that have resulted in the revision of OECD Transfer Pricing Guidelines (Actions 8-10)
- Action points that will result in the revision of the OECD Model Tax Convention (Action 7 - on permanent establishment status, Action 2 – dual resident hybrid entities).

(d) Analytical reports

- Action 1: Address the tax challenges of the digital economy
- Action 11: Establish methodologies to collect and analyse data on BEPS and the actions to address It
- Action 15: Develop a multilateral instrument

2.12 CONCLUSION AND REMARKS ON DETAILED ANNEXURES DISCUSSING THE BEPS ACTION POINTS

As South Africa takes stock of its current legislation and considers how this should be adopted or what other legislation should be enacted in order to protect its tax base from BEPS, care should be taken to adhere to the OECD's warning against countries taking unilateral action as this may result in double taxation, which could risk making South Africa unattractive as a destination for foreign direct investment. Unilateral measures may also create further opportunities for avoidance.

Attached to this main introductory report are annexures that analyse the OECD BEPS Action Plans (issued in final form on October 5 2015) from a South African perspective. The structure of discussion of each Action Plan in the relevant annexure is as follows:

- Background information about the BEPS concern that the Action Plan addresses;
- A description of the OECD Action Plan regarding that BEPS concern;
- Previous and ongoing OECD work/recommendations on how to address that BEPS concern;
- An overview of how other countries have addressed the concern, where relevant;
- A discussion as to whether the relevant the specific BEPS practice is an issue in South Africa and the effectiveness of the legislation in place (if any) to address the concern.
- In light of the OECD's recommendations on how to address the relevant BEPS practice, and in light of international developments regarding the practice, recommendations are made as to how South Africa should position itself to effectively address it.
- Once again it is reiterated that the DTC recommends that South Africa, other than where it is committed to adopt BEPS Action proposals, takes a very cautious approach to BEPS. It should be a follower that monitors the trends and developments on the international scene regarding BEPS rather than be a leader that pioneers BEPS provisions that have not been tested in any other country.[168]

[168] American Chamber of Commerce in South Africa "Comments on the First DTC Interim Report on Base Erosion and Profit Shifting (March 2015) 1-2.

ANNEXURE 1

DAVIS TAX COMMITTEE: SECOND INTERIM REPORT ON BASE EROSION AND PROFIT SHIFTING (BEPS) IN SOUTH AFRICA

SUMMARY OF DTC REPORT ON ACTION 1: ADDRESS THE TAX CHALLENGES OF THE DIGITAL ECONOMY

The digital economy is the result of a transformative process brought by information and communication technology (ICT), which has made technologies cheaper, more powerful, and widely standardised, improving business processes and bolstering innovation across all sectors of the economy.

Because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes. The digital economy and its business models present however some key features which are potentially relevant from a tax perspective. These features include mobility, reliance on data, network effects, the spread of multi-sided business models, a tendency toward monopoly or oligopoly and volatility. The types of business models include several varieties of e-commerce, app stores, online advertising, cloud computing, participative networked platforms, high speed trading, and online payment services. The digital economy has also accelerated and changed the spread of global value chains in which MNEs integrate their worldwide operations.

BEPS issues in the digital economy

While the digital economy and its business models do not generate unique BEPS issues, some of its key features exacerbate BEPS risks. These BEPS risks were identified and the work on the relevant actions of the BEPS Project was informed by these findings and took these issues into account to ensure that the proposed solutions fully address BEPS in the digital economy. Accordingly,

- It was agreed to modify the list of exceptions to the definition of permanent establishment (PE) to ensure that each of the exceptions included therein is restricted to activities that are otherwise of a “preparatory or auxiliary” character, and to introduce a new anti-fragmentation rule to ensure that it is not possible to benefit from these exceptions through the fragmentation of business activities among closely related enterprises. For example, the maintenance of a very large local warehouse in which a significant number of employees work for purposes of storing and delivering goods sold online to customers by an online seller of physical products (whose business model relies on the proximity to customers and the need for quick delivery to clients) would constitute a PE for that seller under the new standard.

- It was also agreed to modify the definition of PE to address circumstances in which artificial arrangements relating to the sales of goods or services of one company in a multinational group effectively result in the conclusion of contracts, such that the sales should be treated as if they had been made by that company. For example, where the sales force of a local subsidiary of an online seller of tangible products or an online provider of advertising services habitually plays the principal role in the conclusion of contracts with prospective large clients for those products or services, and these contracts are routinely concluded without material modification by the parent company, this activity would result in a PE for the parent company.
- The revised transfer pricing guidance makes it clear that legal ownership alone does not necessarily generate a right to all (or indeed any) of the return that is generated by the exploitation of the intangible, but that the group companies performing the important functions, contributing the important assets and controlling economically significant risks, as determined through the accurate delineation of the actual transaction, will be entitled to an appropriate return. Specific guidance will also ensure that the transfer pricing analysis is not weakened by information asymmetries between the tax administration and the taxpayer in relation to hard-to-value intangibles, or by using special contractual relationships, such as a cost contribution arrangement.
- The recommendations on the design of effective CFC include definitions of CFC income that would subject income that is typically earned in the digital economy to taxation in the jurisdiction of the ultimate parent company.

It is expected that the implementation of these measures, as well as the other measures developed in the BEPS Project (e.g. minimum standard to address treaty shopping arrangements, best practices in the design of domestic rules on interest and other deductible financial payments, application to IP regimes of a substantial activity requirement with a “nexus approach”), will substantially address the BEPS issues exacerbated by the digital economy at the level of both the market jurisdiction and the jurisdiction of the ultimate parent company, with the aim of putting an end to the phenomenon of so-called stateless income.

Broader tax challenges raised by the digital economy

The digital economy also raises broader tax challenges for policy makers. For the direct taxes, these challenges relate in particular to nexus, data, and characterisation for direct tax purposes, which often overlap with each other. The OECD discussed and analysed a number of potential options to address these challenges, including through an analysis of their economic incidence, and concluded that:

- The option to modify the exceptions to PE status in order to ensure that they are available only for activities that are in fact preparatory or auxiliary in nature that was adopted as a result of the work on Action 7 of the BEPS

Project is expected to be implemented across the existing tax treaty network in a synchronised and efficient manner via the conclusion of the multilateral instrument that modifies bilateral tax treaties under Action 15.

- The OECD considered some options to determine nexus for the digital economy namely (i) a new nexus in the form of a significant economic presence, (ii) a withholding tax on certain types of digital transactions, and (iii) an equalisation levy, were recommended at this stage. It is expected that the measures developed in the BEPS Project will have a substantial impact on BEPS issues previously identified in the digital economy that certain BEPS measures will mitigate some aspects of the broader tax challenges.
- Countries could, introduce any of these three options in their domestic laws as additional safeguards against BEPS, provided they respect existing treaty obligations, or in their bilateral tax treaties. Adoption as domestic law measures would require further calibration of the options in order to provide additional clarity about the details, as well as some adaptation to ensure consistency with existing international legal commitments.

For indirect taxes the digital economy also creates challenges particularly where goods, services and intangibles are acquired by private consumers from suppliers abroad. The OECD noted that:

- The collection of VAT/GST on cross-border transactions, particularly those between businesses and consumers, is an important issue. Countries are thus recommended to apply the principles of the International VAT/GST Guidelines and consider the introduction of the collection mechanisms included therein. It is expected that as a result of the measures developed in the BEPS Project, consumption taxes will be levied effectively in the market country.

Next steps

Given that these conclusions may evolve as the digital economy continues to develop, it is important to continue working on these issues and to monitor developments over time. To these aims, the work will continue following the completion of the other follow-up work on the BEPS Project. This future work will be done in consultation with a broad range of stakeholders, and on the basis of a detailed mandate to be developed during 2016 in the context of designing an inclusive post-BEPS monitoring process. A report reflecting the outcome of the continued work in relation to the digital economy should be produced by 2020.

RECOMMENDATIONS ON DIRECT TAXES FOR THE DIGITAL ECONOMY IN SOUTH AFRICA

Since the challenges that South Africa faces with respect to taxation of the digital economy are of an international nature, it is recommended that South Africa adopts the OECD recommendations.

- The proposals by the OECD to change the definition of a PE in double tax treaties will help to address this matter. It is also important for South African legislators to note that technology is continuously changing, developing and evolving. In adopting any e-commerce legislation, it is crucial to understand the technology and ensure that South Africa does not implement taxing provisions which are attached to a particular type of technology because by the time the provision is promulgated the technology in question may be obsolete and redundant. To enable South Africa to impose tax on non-resident suppliers of goods and services via e-commerce to South African customers, new source rules that deal with the taxation of the digital economy need to be enacted.
- The current scope of the source rules under section 9 of the Income Tax Act needs to be expanded to include rules that cover proceeds derived from the supply of digital goods and services derived from a source in South Africa. The new rules should be based on payor principle (like a royalty). The rules could for instance provide that digital goods or services are sourced where the recipient who pays for the digital goods or services is based,[1] which would be where the South African tax-resident; physically present in South Africa, is at time of supply. The rules should also aim to clarify the characterisation of the typical income flows from digital transactions. Enacting of such rules would create the basis from which South Africa can apply the OECD recommendations on the taxation of the digital economy.
- The recommended new source rules for non-resident suppliers of goods and services via e-commerce to South African customers should cover the situation where physical goods and services are delivered or rendered in South Africa and for which payment is made electronically to a non-resident (consider, for example, where payment is made to a non-resident, but where the service is rendered in South Africa, or where goods are delivered in South Africa, but payment is made to a non-resident). This would create the foundation for South Africa to tax non-residents on such goods and services, subject to the application of any tax treaty and the revised nexus rules contained therein, and provide for a level playing field between foreign and domestic suppliers of similar goods and services. However any such services should be deemed to not be from a South Africa source where they do not

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[1] SAIT: Comment on DTC First Interim BEPS Report (March 2015) Slide 14 of the Power Point Presentation.

meet the South Africa sourced rule. This is crucial in order to provide double tax relief to South African resident providers of such services and create a level playing field.[2]

- Apart from the gap in the source rules, there are also administrative concerns. Currently non-residents are required to submit tax returns for trade carried on through a South African PE. If SARS cannot assess whether a non-resident has a PE in South Africa, how will such non-residents be taxed? The lack of data in respect of inbound flows, as well as the lack of discernment between inbound and outbound flows, has resulted in little evidence indicating tax abuse as a result of the digital economy in South Africa. SARS doesn't keep a separate register for inbound foreign companies. There is a need to isolate and focus on foreign multi-nationals and get them to submit tax returns.
- Rules should be enacted that require non-resident companies with South African sourced income (excluding certain passive income) to submit income tax returns even if they do not have a PE in South Africa. This would ensure that such non-residents are included in the tax system. To ensure that such non- residents register with SARS, a system should be created that imposes an obligation on a resident that transacts with a non-resident to withhold tax on any payment to a non-resident otherwise they would be penalised.
- To alleviate the compliance burden on non-residents having to submit comprehensive tax returns, notwithstanding that they may not be liable to tax in South Africa, an alternative measure would be introduce a self-assessment system for income tax purposes. A further possibility would be for a non-resident to be able to apply for a ruling to the effect that it is not liable to tax in South Africa on its specific facts and circumstances and to be relieved of the obligation to submit tax returns for so long as there is no change in the circumstance (including the law).[3]
- South Africa's existing source rules need to be aligned to accounting mechanisms and should not rely too heavily on tax law to attempt to reconcile and determine tax liability. The use of a single IT14 return does not support the BEPS identification specifically with regard to separate disclosure of inbound investment flows. This information disclosure should be based on fact. There should, therefore, be variations of the IT14 return e.g. IT14F for inbound companies since a one-size-fits-all approach doesn't appear to be working. The IT14 also needs to be re-designed as it starts out with legal questions instead of factual (accounting) questions.
- From a policy perspective, it is also important to create a level playing field so that South African companies dealing with digital goods and services are able to compete with the likes of Google. This is what prompted the concerns of Kalahari's e-books complaints. It should be noted that it is not in the interest of countries like Germany or the USA to allow the expansion of the PE concept

[2] PWC "Comment on DTC BEPS First Interim Report" (30 March 2015) at 9.
[3] PWC "Comment on DTC BEPS First Interim Report" (30 March 2015) at 9.

to grant source states a wider scope to tax profits of digital businesses, since this would simply reduce the profits of the German or USA digital companies which may be taxed in the home state as the residence state would be required to give foreign tax credits in respect of such source tax.[4] In view of the strong presence of such digital companies in the highly developed OECD countries, it may be very difficult to obtain international consensus which is required before such major amendments could be made to DTAs.

Addressing administrative challenges in the digital economy in South Africa

The OECD Final Report on the digital economy points out that the borderless nature of digital economy produces specific administrative issues around identification of businesses, determination of the extent of activities, information collection and verification, and identification of customers.[5] These issues are outlined below paragraph 10 of the report attached. The recommendations for South Africa regarding the administrative challenges of the digital economy are as follows:

- South Africa recently signed the OECD Mutual Administrative Assistance in Tax Matters Convention which aims for information sharing among signatories in matters of tax. SARS should actively utilise the procedures established under the Convention and similar provisions under applicable DTAs to ensure the frequent and efficient exchange of information and assistance with the enforcement of tax collection.
- Since most of the challenges that e-commerce poses to the legislation relate to difficulties of identifying the location of taxpayers and their business transaction, it is recommended that this Income Tax Act be amended to provide that the provisions of the Electronic Communications and Transactions Act 25 of 2002 be taken into account for detection and identification purposes, so as to ensure tax compliance for taxpayers involved in e-commerce. However the administrative and compliance costs with respect to enforcing and implementing taxing provisions must not outweigh the benefits received with respect to the taxation raised. The legislators should also be aware of implementing a system which, realistically, cannot be effectively enforced.
- SARS can also obtain information for purposes of identifying digital businesses carrying on activities in South Africa using the exchange of information tools provided for in treaties. While the major players such as Google and Amazon are well known, the nature of the digital economy is such that new players appear on a continuous basis. Other avenues of obtaining third party information from domestic sources in relation to digital transactions should be explored. In this regard, consultations should be held with the financial institutions to investigate the feasibility of providing information

4 R Pinkernell "Internationale Steuergestaltung im Electronic Commerce" 494 (2014) *Institut Finanzen und Steuern, Schrift* at 168.

5 OECD/G20 2015 Final Report on Action 1 per Box 7.1 at 105.

related to electronic transactions with non-residents and which could be provided to SARS through the IT3 mechanism. However, any such mechanism should not impose an excessive compliance burden on the financial institutions relative to the benefit to SARS.[6]

ADRESSING BEPS IN THE DIGITAL ECONOMY WITH RESPECT TO INDIRECT TAXES

With respect to indirect taxes, the OECD called on countries to ensure the effective collection of VAT/GST with respect to cross-border supply of digital goods and services. The 2015 OECD 2015 Final Report on the digital economy explains how the digital economy can be used to circumvent indirect taxes and it provides recommendations to curb base erosion. The report notes that if the OECD's "Guidelines on place of taxation for B2B supplies of services and intangibles" are not implemented, opportunities for tax planning by businesses and corresponding BEPS concerns for governments in relation to VAT may arise with respect to:

- remote digital supplies to exempt businesses, and
- remote digital supplies acquired by enterprises that have establishments (branches) in more than one jurisdiction (MLE) that are engaged in exempt activities. [7]

Recommendations for South Africa

Currently uncertainty exists as to the treatment of services that are capable of being delivered electronically but that are not specifically provided for in the Regulations. For example, there is no clear distinction between telecommunication services and electronic services. Some overlap is possible. Such a clear distinction between electronic services and telecommunication services, each with its own place-of-supply rules can be found in modern VAT systems such as Canada and New Zealand as well as established VAT systems in the EU.

- There are generally no place of supply rules in South Africa. Suppliers providing services to SA consumers are subject to the registration threshold. This has been extended to include services supplied electronically.
- It is recommended that "telecommunication services" should be specifically defined, and clear and specific place-of-supply rules for telecommunication services should be incorporated in the Income Tax Act. These provisions should be in line with the OECD principles on the harmonisation of global VAT/GST rules.
- Regulations should be refined further in order to allow for a comprehensive understanding and appreciation of the ambit of thereof.

[6] PWC Comments on "DTC BEPS First Interim Report" (30 March 2015) at 10.
[7] OECD/G20 2015 Final Report on Action 1 in para 197.

- While the list of services in the Regulations does not provide for adequate definitions, which causes some confusion, the definitions in the Regulations, as they stand, may not necessarily require further amendments. However, further guidelines providing clarification should accompany the Regulations. These guidelines should be updated regularly to ensure that new technology cannot escape the VAT fold.
- It remains uncertain if the list of electronic services in the Regulations can be interpreted so as to include the supply of online advertising. It is recommended that the guidelines referred to above should clarify this issue.
- It is recommended that the Regulations be refined further to allow for a comprehensive understanding and appreciation of the ambit thereof.

With respect to the place of supply rules, the OECD recommends that the use and enjoyment principle may be applied in cases where the special place-of-supply rules (applicable to electronically supplied services) lead to double or non-taxation, or market distortions. In other words, the use and enjoyment principle should only be applied in exceptional circumstances. A provision to this effect came into operation in the EU on 1 January 2015.[8]

- While the reverse-charge mechanism applies as a backstop to the registration mechanism, it remains uncertain under what circumstances the reverse-charge mechanism will apply. It further remains uncertain under what circumstances the use-and-enjoyment principle will take precedence over the place-of-supply proxies in the case of the supply of electronic services. It is recommended that clarity should be given on whether the use-and enjoyment principle should apply as a backstop where the place-supply-proxies lead to double or non-taxation, or market distortions. It is recommended that the VAT Act be amended in line with the OECD proposals and Article 59a Council Directive 2008/8/EC.

The OECD recommends that B2B and B2C transactions should be treated differently.

- In South Africa the differentiation between B2B and B2C transactions are, in principle, in line with the OECD recommendations. However, the existing rules do not make a clear distinction between B2B and B2C transactions. It is our understanding that the Regulations follows National Treasury's (NT) intention that B2C transactions are captured by the special provisions and that B2B transactions will be captured by the 'imported services' provisions. For this purpose, the Regulations must accurately define what is included in the scope of 'electronic services' so as to clearly distinguish between B2B and B2C transactions.
- NT is of the view that not having the distinction actually broadens the SA VAT net since the onus is now on the supplier to levy VAT. B2C transactions will

8 Article 59a of Council Directive 2008/8/EC.

lead to no input tax claim if the recipient is not registered for VAT. B2B transactions are subject to the normal input tax provisions of the VAT Act.

- South African VAT legislation generally only deals with who the supplier is and what the supply is. The VAT implications usually flow from that rather than from who the recipient is (i.e. business or consumer). Note however that there are instances where VAT implications are dependent on who the recipient is, for example with respect to zero-rated exports.

The reverse-charge mechanism, which is essentially self-assessment mechanism, relies on the integrity of the taxable entity to account for output VAT on the import of intangibles in so far as they are acquired to make exempt supplies or for final consumption. It would generally be difficult for revenue authorities to verify the accuracy of the taxpayer's self-assessed tax return in the absence of practical evidence reflecting the actual use of the intangibles.

- In the case of B2B transactions, the recipient vendor can only account for VAT on the imported electronic services in so far as the services are not used in the making of taxable supplies (in other words, when the recipient vendor is the final consumer). This relies heavily on the vendor's interpretation of what constitutes "in the making of taxable supplies". It is recommended that, in the case of B2B transactions, the recipient vendor must, in terms of the reverse-charge mechanism account for VAT on all imported services irrespective of it being applied in the making of taxable supplies. The recipient vendor should claim an input VAT deduction in cases where such a deduction is allowed.
- It is however acknowledged that the new changes (TLAB 2014) to the VAT Act that require the foreign supplier to register for VAT in SA eliminates this problem to a large extent. The supplier levies VAT on the supply and the recipient is subject to the normal input tax provisions of the VAT Act.

The differentiation between B2C and B2B transactions create an additional administrative burden on foreign suppliers. The foreign supplier burdened with the duty to register, collect, and remit South African VAT on affected transactions must verify the VAT vendor status of the customer. This is virtually impossible. Verifying the customer's identity and VAT registration status requires costly technology which is not widely accessible and which most suppliers simply cannot afford to implement.

- Foreign suppliers of electronic services are burdened with the task of identifying the recipient's VAT vendor status. No guidelines exist and foreign suppliers of electronic services run the risk of penalties being imposed on unintended non-taxation. It is recommended that guidelines similar to the EU guidelines must be drafted. However, provision must be made that where the foreign supplier is unable to determine the VAT status of the recipient, the supplier may deem the recipient a non-vendor. Furthermore, where the foreign supplier has followed the guidelines, no penalty should be imposed where the supplier incorrectly identified the recipient's VAT status.

Foreign suppliers of electronic services must register as VAT vendors when their supply of electronic services "imported" to South Africa exceeds R50 000. This differentiation is justified by SARS in that is aimed at levelling the playing field between domestic and foreign suppliers of electronic services.

- The differentiation in thresholds that apply to domestic vendors and foreign suppliers of electronic services raises concerns. Although the differentiation can be justified in that it is aimed at the protection of domestic markets, further research is necessary to determine whether the differentiation, in fact, balances out the assumed market distortions. In the interim, it is recommended that the VAT registration threshold for foreign suppliers of electronic services should be reconsidered to give effect to tax neutrality.

The OECD recommends that the simplified registration regime for the cross-border supply of intangibles should not require the supplier to have a physical presence or fixed establishment in the country of supply.[9] The South African VAT registration system does not provide for a simplified registration process for suppliers of cross-border intangibles. Vendors must, amongst other requirements, have a fixed establishment with a physical presence in the Republic. The current vendor registration regime is inconsistent with the simplified registration proposal. However, certain concessions were made in respect of foreign suppliers of electronic services in terms of the *VAT Registration Guide for Foreign Suppliers of Electronic Services.*[10]

Although the concessions made by SARS to streamline the VAT registration of foreign suppliers of electronic services is in line with the OECD guidelines, the registration process should be closely monitored and reviewed on a regular basis to ensure that the process remains compliant with the OECD simple registration guidelines. Despite the simplified registration process afforded by SARS, many foreign suppliers are still unaware of their obligations in terms of the Act.

The OECD recommends that in addition to a simplified registration process, a simplified electronic self-assessment procedure should be available to non-resident suppliers of cross-border intangibles.[11] It is arguable whether the concession to register foreign suppliers of electronic services on the payment basis provides for a simplified assessment procedure. While the VAT201 form can be submitted electronically on the e-file system, the difficulty and administrative burden associated therewith is not diminished. It must be noted that Treasury has announced

9 OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 12 http://www.oecd.org/ctp/consumptiontax/17851117.pdf .

10 SARS (2014) *VAT Registration Guide for Foreign Suppliers of Electronic Services* http://www.sars.gov.za/AllDocs/OpsDocs/Guides/VAT-REG-01-G02%20-%20VAT%20Registration%20Guide%20for%20Foreign%20Suppliers%20of%20Electronic%20Services%20-%20External%20Guide.pdf

11 OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 13 http://www.oecd.org/ctp/consumptiontax/17851117.pdf.

concessions to reduce compliance costs for foreign businesses to prevent these business from withdrawing from South Africa.

- With regards to foreign suppliers, SARS has issued Guidelines for completing the VAT 201. SARS reports that to date 96 foreign taxpayers have registered with SARS. VAT returns are being submitted monthly and that the compliance rate of submitted returns is approximately 87%. To encourage increases registrations and to increase the rate of compliance, it is recommended that measures should be taken to lessen the administrative burdens of completing VAT 201. As foreign suppliers of electronic services are not eligible for a VAT refund, it is recommended that an abridged VAT 201 should be developed specifically for foreign suppliers of electronic services.
- The option of payment or collection agents (whether acting as agents or third party services providers) to be appointed and registered as VAT vendors for and on behalf of foreign businesses must be considered.

A non-resident supplier of electronic services will face various compliance challenges, *inter alia*, costly once-off changes in its invoicing system is required to ensure that invoices reflect a) the term 'tax invoice'; b) the name, address and VAT registration number of the supplier; c) an individual serialized number and date on which the invoice is issued; d) a description of the services supplied; and e) the consideration of the supply and the amount of VAT expressed as 14 per cent of the value of the supply. Some concessions have been announced. The foreign supplier of 'electronic services' is allowed to submit an abridged invoice (the details of the recipient is not required. However, the invoice must still be issued in ZAR currency. In most instances the cost and payment of the 'electronic services' is made in foreign currency. The supplier is, accordingly, required to calculate and express the amount in ZAR. In terms of the Binding General Ruling on electronic services, the ZAR amount must be calculated in accordance with the Bloomberg or European Central Bank rate on the day that the tax invoice is issued. This can result in accounting differences where the supplier's system has a set exchange rate or where the system operates on monthly averages.

- The foreign supplier of electronic services is required to issue an invoice compliant with the invoice requirements in the VAT Act. Although this SA requirement is in line with the EU VAT Directive, this requirement would require other non-EU suppliers to change their invoicing system. The requirement to issue an invoice, based on the requirements of an invoice in terms of the VAT Act, should be re-considered.
- The foreign supplier of electronic services is required to display (on their website or online shopping portal) prices in South African Rand and the price so displayed must include VAT at 14 per cent. This would require the supplier to change its accounting and invoicing system. It is recommended that the requirement to display prices (on the website or shopping portal) in South African Rand inclusive of VAT should be reconsidered.

- Clause 103 of the TLAB 2014 and the Explanatory memorandum is addressing this matter.
- Foreign suppliers of 'electronic services' must account for VAT on the payment basis. This creates accounting problems where the supplier's accounting system is set up to account on the invoice basis.

Another impractical administrative concern relates to VAT branch registration and the requirement to maintain a separate independent accounting system. To expect foreign suppliers of electronic services to maintain a separate independent accounting system with respect to supplies falling within the South African VAT net, so as to ensure that supplies occurring outside of South Africa do not fall within the South Africa VAT net, is not practical. This is an extremely burdensome requirement.

- It is recommended that legislation around VAT branch registration and the requirement to maintain a separate independent accounting system should be revised. Foreign suppliers of electronic services should be entitled to register a VAT branch but should not be required to maintain a separate independent accounting system. A proviso should be added to this requirement to apply to foreign suppliers of electronic services, whereby, instead of maintaining an independent accounting system, the foreign supplier or electronic services should merely be required to produce financial accounts which reflect the supplies made to residents in South Africa or where payment was made from a South African bank account.

Enforceability of registration remains the chief challenge. In the absence of definitive rules and international cooperation, tax collection from non-compliant offshore suppliers would be difficult to enforce. In addition, transparency in cases where registration can be enforced would be difficult to achieve. For example, does SARS have extra-territorial powers to conduct audits on non-resident suppliers to ensure the accuracy of tax returns? Furthermore, is SARS able to enforce penalties, interest, or other punitive measures against non-compliance in foreign jurisdictions?

- In the absence of international cooperation, the collection of VAT and enforcing the registration mechanism would be impossible. The negotiation of multilateral treaties, as opposed to bilateral treaties, must be undertaken to ensure greater international and regional cooperation.

In the absence of guidelines, determining the place of supply/consumption for digital deliveries is cumbersome. Various methods of locating the customer's place of residence can be applied. Verification tests should not irritate customers, or significantly slow down the transaction process.

- The OECD recommends that the registration model should be applied as an interim measure to balance-out market distortions. In contrast, SARS is of the view that the registration model is the final/optimum solution. It is recommended that the registration model should be applied as an interim measure aimed at balancing out existing market distortions. Alternative VAT collection models should be explored. This, however, goes to the basic design of the VAT system and the impact of the extent to which the principles of the OECD VAT/GST Guidelines can be achieved.

With respect to alternative collection models:

- The reverse-charge mechanism is an ineffective tool to levy and collect VAT on cross-border trade in digital goods. The registration model, in theory, provides for a better VAT collection model. However, the registration model overly burdens the supplier and enforcement of the registration model remains problematic. Although in terms of SARS records about 96 foreign supplies have registered to date, this number and the collected revenue could be increased if an alternative model is considered. The implementation of the RT-VAT system should be considered as an alternative VAT collection mechanism where the registration and reverse-charge mechanisms are found to be ineffective tax collection models. As the model remains to be tested, extensive further research into the viability of the RT-VAT system should be undertaken.

Further recommendations

- In its design of VAT legislation dealing with e-commerce, South Africa should ensure its laws are in line with international developments. It should not reinvent the wheel and draft provisions that are not internationally aligned.
- It is important that South Africa monitors the OECD recommendations and international developments and that it amends its legislation accordingly to ensure it is internationally aligned.
- There are concerns that the VAT amendments with respect to e-commerce do not comply with the principle of neutrality which requires that taxation should seek to be neutral and equitable between forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations, carrying out similar transactions, should be subject to similar levels of taxation.
- It is recommended that the administrative burden on foreign suppliers of electronic services, who do not otherwise have a presence in South Africa but who satisfy the compulsory requirements to register for VAT, need to be reviewed and reconsidered to ensure that the amendments addressing electronically supplied services are effectively and efficiently imposed and enforced. The administrative burden imposed on foreign suppliers of electronic services should minimise the administrative costs for both the taxpayer and SARS as far as possible.
- In a volatile economy, new tax rules should not be drafted so as to negatively impact on international trade or create additional market distortions. While we recommend that new tax rules should be in line with the OECD principles and international best practice, new tax rules should not

merely slave-follow international trends in developed countries. Extensive research on the economic impact of new tax rules on the economy of developing countries should be undertaken and considered before these new rules are implemented.

Recommendations on Bitcoins and other crypto-currencies

- Whilst the use of virtual currencies such as Bitcoins is not yet widespread in South Africa, it is growing and South African legislators would be wise to consider the potential impact of virtual currencies like Bitcoins on tax compliance and to monitor international developments to determine the most suitable approach for in South Africa.
- Exchange controls seem at least in the short term - a major defence against BEPS in relation to e-commerce, digital products, virtual currencies, virtual currencies (e.g. Bitcoin), IP royalty payments and other forms of intangible related transfer functions. However statutory provisions will be needed in the long run.

ADDRESSING BASE EROSION AND PROFIT SHIFTING IN SOUTH AFRICA
DAVIS TAX COMMITTEE INTERIM REPORT

DTC REPORT ON ACTION 1: ADDRESS THE TAX CHALLENGES OF THE DIGITAL ECONOMY

Table of Contents

1 BACKGROUND

Long before the OECD, released its 2013 BEPS Action 1 on the challenges of the digital economy, concerns had been raised over the last two decades about global computer-based communications that cut across territorial borders, creating a realm of human activity that undermines the feasibility and legitimacy of laws based on geographic boundaries. This is especially so with regard to transactions are conducted electronically (e-commerce) over the internet, which ignore international boundaries, since "place" has little meaning in the networked world.[1] E-commerce has been described as the wide array of commercial activities carried out by electronic means that enable trade without the confines of geographical boundaries.[2] E-commerce changes the distribution of taxable activities; it poses challenges to the jurisdiction to tax income and alters the balance of taxing authority, and results in the erosion of countries' tax bases.[3]

The OECD has over the years shown particular concern about the challenges that e-commerce poses to taxation, in particular about the challenges to the tax treaty rules for taxing business profits, which apply the permanent establishment (PE) concept as a basic nexus/threshold rule for determining whether or not a country has taxing rights with respect to the business profits of a non-resident taxpayer. The PE concept as defined in article 5 of the OECD Model Tax Convention refers not only to a substantial physical presence in the country concerned, but also to situations where the non-resident carries on business in the country concerned via a dependent agent. However, developments brought about by the digital economy are putting increasing pressure on the PE concept since it is based on the place from which wealth originates as the primary basis for taxation. Nowadays it is possible to

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[1] AW Oguttu & BA van der Merwe "Electronic Commerce: Challenging the Income Tax Base" (2005) 17 *SA Mercantile Law Journal* 305–339; DR Johnson & D Post "Law and Borders: The Rise of Law in Cyberspace" (1996) 48 *Stanford Law Review* at 1367 and at 1370-1371; N Cox "The Residence of Cyberspace and the Loss of National Sovereignty" (2002) 11 *Information & Communication Technology Law* 241 at 244-245.

[2] R Doernberg & L Hinnekens *Electronic Commerce and International Taxation* (1999) at 3; JW Fawcett, JM Harris & M Bridge *International Sale of Goods in the Conflict of Laws* (2005) at 493; SARS Discussion Document: *Electronic Commerce and South African Taxation* (March 2000) at 5; Department of Communications *Green Paper on E-commerce: Making it Your Business* (2000) at 9; RA Westin *International Taxation of Electronic Commerce* (2000) at 2; RL Doernberg, L Hinnekens, W Herrerstein & J Li *Electronic Commerce and Multi-jurisdictional Taxation* (2001) at 9; Suddards at 257.

[3] R Doernberg & L Hinnekens *Electronic Commerce and International Taxation* (1999) at 341-343; H Suddards *E-commerce: A Guide to the Law of Electronic Business* (1999) at 255; JJB Hickey, R Mathew & C Rose *E-commerce: Law Business and Tax Planning* (2000) at 261.

be heavily involved in the economic life of another country by doing business with customers located in that country via the internet, without having a taxable presence therein (such as substantial physical presence or a dependent agent). In an era where non-resident taxpayers can derive substantial profits from transactions with customers located in another country, current rules cannot ensure a fair allocation of taxing rights on business profits.[4]

Countries' tax authorities look more to traditional concepts such as how many employees the company has on the ground and how much risk a company is assuming in the country.[5] The identification of the necessary requirements to establish the existence of a PE of a non-resident entity (and of the required principles to attribute the profits to the PE) encounters difficulties in e-commerce. In particular, there are hindrances in identifying a "place of business" since the business activity is carried out through the network and so tracking a connection between an online transaction and a specific geographical location may be difficult.[6]

The highly mobile nature of e-commerce and the ability of residents to establish offshore companies could also lead to tax-driven migration of businesses to low-tax jurisdictions.[7] The anonymous nature of e-commerce also brings new challenges to tax compliance. E-commerce creates the following difficulties: in the identification and location of taxpayers, the identification and verification of taxable transactions and the ability to establish a link between taxpayers and their taxable transactions, thus creating opportunities for tax avoidance.[8] This is especially so with the development of various electronic payment methods such as Bitcoin, a decentralized digital currency that enables instant payments to anyone, anywhere in the world.[9]

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4 OECD "Report on Base Erosion and Profit Shifting" (2013) at 36.

5 J Arora & LE Shepherd "Adjusting Jurisdictional Concepts for E-commerce Tax Analyst 8 October 2013. Available at http://services.taxanalysts.com/taxbase/tni3.nsf/(Number/2013+WTD+195-1?OpenDocument&Login accessed 29 October 2013.

6 P Valente "Permanent Establishments and Jurisdiction to Tax: Debates in Italy" Tax analysts: World Tax Daily (3/9/2010)..

7 R Buys & F Cronjé *Cyber law: The Law of the Internet in South Africa* 2 ed (2004) at 301.

8 SARS Discussion Document at 31; Hickey *et al* at 257; RL Doernberg, L Hinnekens & W Herrerstein W & J Li *Electronic Commerce and Multi-Jurisdictional Taxation* (2001) at 388 - 389; R Buys & F Cronje *Cyber law: The Law of the Internet in South Africa* 2 ed (2004 at 307.

9 Bitcoin uses public – key cryptography which relies on peer-to-peer net-working technology and proof-of-work to process and verify payments. It operates with no central authority issuing money or tracking transactions, rather, these functions are carried out collectively by the network. The supply of bitcoins is regulated by software and the agreement of users of the system and cannot be manipulated by any government, bank, organization or individual Building upon the notion that money is any object, or any sort of record, accepted as payment for goods and services and repayment of debts in a given country or socio-economic context, Bitcoin is designed around the idea of using cryptography to control the creation and transfer of money, rather than relying on central authorities. See "Bitcoin" https://en.bitcoin.it/wiki/Bitcoin accessed 2 October 2013; "Public Key cryptography" http://en.wikipedia.org/wiki/Public-key_cryptography.

2 PREVIOUS OECD WORK TO ADDRESS SOME OF THE ABOVE CHALLENGES

The first initiative by the OECD to deal with the taxation of e-commerce commenced with the Turku conference of November 1997[10] which initiated work on developing taxation framework conditions for electronic commerce. The matters discussed at this conference culminated in the 1998 OECD report entitled: "Electronic Commerce: Taxation framework Conditions" which was discussed at the Ottawa conference.[11] In this report, the OECD noted that the taxation principles which guide governments in relation to conventional commerce should also guide them in relation to electronic commerce. These taxation principles are:[12]

Neutrality*:* Taxation should seek to be neutral and equitable between forms of electronic commerce and between conventional and electronic forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.
Efficiency*:* Compliance costs for taxpayers and administrative costs for the tax authorities should be minimised as far as possible.
Certainty and Simplicity*:* The tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where and how the tax is to be accounted.
Effectiveness and Fairness: Taxation should produce the right amount of tax at the right time. The potential for tax evasion and avoidance should be minimised while keeping counteracting measures proportionate to the risks involved.
Flexibility: The systems for taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments. [13]

Equity is also an important consideration within a tax policy framework. Equity has two main elements; horizontal equity and vertical equity. Horizontal equity suggests that taxpayers in similar circumstances should bear a similar tax burden. Vertical equity suggests that taxpayers in better circumstances should bear a larger part of the tax burden as a proportion of their income. Equity may also refer to inter-nation equity which is concerned with the allocation of national gain and loss in the international context and aims to ensure that each country receives an equitable share of tax revenues from cross border transactions.

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10 An International Conference and Business-Government Forum organised by the OECD and the Government of Finland in co-operation with the European Commission, Japan and BIAC on "Dismantling the Barriers to Global Electronic Commerce" held in Turku, Finland, 19-21 November 1997.

11 OECD "Electronic Commerce: Taxation Framework Conditions" as presented to Ministers at the OECD Ministerial Conference whose theme was" *A Borderless World: Realising the Potential of Electronic Commerce"* on 8 October 1998*. Available at* *http://www.oecd.org/tax/consumption/1923256.pdf, accessed 6 November 2014.*

12 OECD "Electronic Commerce: Taxation Framework Conditions" in para 9.

13 OECD "Electronic Commerce: Taxation Framework Conditions" in para 9.

The OECD noted that the challenge facing revenue authorities is how to implement these broad taxation principles identified in a rapidly changing e-commerce environment. With respect to international tax arrangements, the 1998 OECD Report noted that while the principles which underlie the international norms that it has developed in the area of tax treaties and transfer pricing are capable of being applied to electronic commerce, there should be a clarification of how the OECD Model Tax Convention applies with respect to some aspects of electronic commerce.[14]

Consequently, the OECD came up with recommendations on the challenges e-commerce poses to the PE concept, which are now set out in paragraph 42 of the Commentary on article 5 of the OECD Model Tax Convention. The Commentary makes the following observation:[15]

> "An Internet web site, which is a combination of software and electronic data, does not in itself constitute tangible property. It therefore does not have a location that can constitute a "place of business" as there is no "facility such as premises or, in certain instances, machinery or equipment" … as far as the software and data constituting that web site is concerned. On the other hand, the server on which the web site is stored and through which it is accessible is a piece of equipment having a physical location and such location may thus constitute a "fixed place of business" of the enterprise that operates that server.
>
> The distinction between a web site and the server on which the web site is stored and used is important since the enterprise that operates the server may be different from the enterprise that carries on business through the web site. For example, it is common for the web site through which an enterprise carries on its business to be hosted on the server of an Internet Service Provider (ISP). Although the fees paid to the ISP under such arrangements may be based on the amount of disk space used to store the software and data required by the web site, these contracts typically do not result in the server and its location being at the disposal of the enterprise …, even if the enterprise has been able to determine that its web site should be hosted on a particular server at a particular location. In such a case, the enterprise does not even have a physical presence at that location since the web site is not tangible. In these cases, the enterprise cannot be considered to have acquired a place of business by virtue of that hosting arrangement. However, if the enterprise carrying on business through a web site has the server at its own disposal, for example it owns (or leases) and operates the server on which the web site is stored and used, the place where that server is located could constitute a permanent establishment of the enterprise if the other requirements of the Article are met."

In summary the OECD Commentary makes it clear that a server, as distinct from mere websites (which cannot fulfil the geographical situs condition) could constitute a PE where the equipment is fixed and the supplier has the server at its own disposal. The OECD acknowledges that no PE would be created if the e-commerce activities carried on via the server are restricted to preparatory or auxiliary functions which are excluded under paragraph 4 of Article 5. It mentions some examples of activities which would generally be regarded as preparatory or auxiliary:[16]

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14 OECD "Electronic Commerce: Taxation Framework Conditions" in para 11.

15 Para 42.2-42.3 of the Commentary on article 5 of the OECD Model Tax Convention.

16 Para 42.7 of the Commentary on article 5 of the OECD Model Tax Convention.

- providing a communications link – much like a telephone line – between suppliers and customers;
- advertising of goods or services;
- relaying information through a mirror server for security and efficiency purposes;
- gathering market data for the enterprise; and
- supplying information.

The OECD Commentary points out that:[17]

> "Where, however, such functions form in themselves an essential and significant part of the business activity of the enterprise as a whole, or where other core functions of the enterprise are carried on through the computer equipment, these would go beyond the activities covered by paragraph 4 and if the equipment constituted a fixed place of business of the enterprise .., there would be a permanent establishment."

3 CHALLENGES ENCOUNTERED IN APPLYING THE OECD GUIDELINES ON PES IN THE E-COMMERCE ERA

Generally servers are highly mobile and flexible in nature.[18] The location of a server can be easily moved (without affecting any underlying transaction) between different countries. Servers can transfer their programs almost instantaneously to a server in a different jurisdiction if necessary.[19] Servers can be shifted to a location outside a country where an e-commerce firm is based or where the software products are developed as well as outside of the source country where e-commerce goods and services are purchased.[20] Thus, even though a server could constitute a place of business of an enterprise, if it is not located in a place for at least a year, it cannot be considered a PE. In addition, for a server to constitute a place of business that qualifies as PE, it should be suitably equipped with on-site managerial and operational management and employees.

The other challenge is with respect to the OECD's view that the existence of a PE has to be determined using the traditional approach of the location of the server. This view is based on the assumption that an enterprise will utilise only one server. However, technology has since changed. Now an enterprise can have more than one server and e-commerce suppliers can utilise multiple servers in multiple jurisdictions. In theory, one transaction can be processed with multiple servers in multiple jurisdictions. Applying the current OECD principles to determine PE may

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17 Para 42.8 of the Commentary on article 5 of the OECD Model Tax Convention.

18 OECD "Dismantling the Barriers to Global Electronic Commerce" (Turku, Finland, November 1997). Available at http://www.oecd.org/LongAbstract/0,2546,en_2649_34223_2751231_1_1_1_1,00.html accessed on 4 June 2013.

19 A Cockfield "Transforming the Internet into a Taxable Forum: A Case Study in E-Commerce Taxation" (2001) 85 *Minnesota Law Review* (2001) at 1259.

20 Ibid.

result in multiple jurisdictions claiming there is a PE in their jurisdiction because a server is located in their jurisdiction.

Taxation challenges are also posed by large internet-based companies which are doing major business in countries but remitting very low amounts of corporate income tax in the countries they operate in. The argument is that the presence of such companies in any given country does not often amount to the level of creating a PE under existing tax treaty principles.[21] Digital Companies can collect user data in one country and use that data to sell targeted advertisements to advertisers in another country. Revenues collected from advertisements targeted to users in one country are then funnelled through subsidiaries in low tax jurisdictions, thus avoiding PE status in those countries in which the advertisements are collected.[22]

4 OECD BEPS ACTION ON THE DIGITAL ECONOMY

In its 2013 BEPS Action Plan, the OECD noted that

> "the spread of the digital economy poses challenges for international taxation. The digital economy is characterised by an unparalleled reliance on intangibles, the massive use of data (notably personal data), the widespread adoption of multi-sided business models capturing value from externalities generated by free products, and the difficulty of determining the jurisdiction in which value creation occurs. This raises fundamental questions as to how enterprises in the digital economy add value and make their profits, and how the digital economy relates to the concepts of source and residence or the characterisation of income for tax purposes. At the same time, the fact that new ways of doing business may result in a relocation of core business functions and, consequently, a different distribution of taxing rights which may lead to low taxation is not per se an indicator of defects in the existing system. The OECD noted that it is important to examine closely how enterprises of the digital economy add value and make their profits in order to determine whether and to what extent it may be necessary to adapt the current rules in order to take into account the specific features of that industry and to prevent BEPS."[23]

In the 2013 OECD report on Base Erosion and Profit Shifting (BEPS), Action 1 points out the challenges the digital economy poses to international taxation[24] and it called on countries:

- to develop rules to address the tax challenges of the digital economy; and
- to identify the main difficulties that the digital economy poses in the application of existing international tax rules and develop detailed options to address these difficulties.

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21 J Arora & LE Shepherd "Adjusting Jurisdictional Concepts for E-commerce Tax Analyst 8 October 2013. Available at http://services.taxanalysts.com/taxbase/tni3.nsf/(Number/2013+WTD+195-1?OpenDocument&Login accessed 29 October 2013.

22 SS Jonstone "News Analysis: Chasing Google -- The Global Struggle to Tax Ecommerce" 10 February 2014.

23 OECD/G20 2015 Final Report on Action 1 at 2.

24 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 14.

Action 1 required that a holistic approach be taken that considers both direct and indirect taxation of the digital economy. Examining in particular issues relating but 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 sources rules; and
- how to ensure the effective collection of VAT/GST with respect to cross-border supply of digital goods and services.

The work required a thorough analysis of the various business models in the digital economy.

The OECD acknowledges that work on Action 1 plan will be impacted by work on Action 7 (preventing the artificial avoidance of PE status) which covers the possibility of changes to the model treaty.

Revenue lost through the digital economy is a growing concern by governments internationally that lose substantial corporate tax revenue because of arrangements implemented by multinational enterprises which shift profits to low tax jurisdictions, thus eroding the taxable base. At their meeting in St. Petersburg on 5-6 September 2013, the G20 leaders fully endorsed the OECD BEPS Action Plan, noting that:[25]

> "In a context of severe fiscal consolidation and social hardship, in many countries ensuring that all taxpayers pay their fair share of taxes is more than ever a priority. Tax avoidance, harmful practices and aggressive tax planning have to be tackled. **The growth of the digital economy also poses challenges for international taxation.** We fully endorse the ambitious and comprehensive Action Plan – originated in the OECD – aimed at addressing base erosion and profit shifting with mechanism to enrich the Plan as appropriate. We welcome the establishment of the G20/OECD BEPS project and we encourage all interested countries to participate. **Profits should be taxed where economic activities deriving the profits are performed and where value is created**" **(Our emphasis).**

5 CONCERNS RAISED BY COMPANIES INVOLVED IN DIGITAL TRANSACTIONS

After the release of the 2013 BEPS report on the digital economy the OECD received several complaints from high-tech consortiums and other companies with significant digital income about the imposition of a separate standard of taxation on

[25] OECD "Public Discussion Draft: BEPS Action 1: Address the Challenges of the Digital Economy (March 2014). Available at http://www.oecd.org/ctp/tax-challenges-digital-economy-discussion-draft-march-2014.pdf accessed 6 May 2014.

mobile income.[26] On December 23, 2013, the Digital Economy Group, a lobbying group for high-tech companies, wrote a letter to the OECD arguing that:

> Enterprises that employ digital communications models operate in all sectors of the global economy. These enterprises constitute the digital economy. Accordingly, any options for addressing the digital economy should apply fairly and equally across all business lines. We believe that enterprises operating long-standing business models, subject to established international tax rules, should not become subject to altered rules on the basis that they have adopted more efficient means of operation. [27]

In response to these strongly worded comments, the OECD shifted its stance of referring to digital companies to reference to the digitalization of the economy.[28] In other words, the OECD changed its stance of defining digital goods or service providers differently from other multinational businesses using digital means to pursue commerce.[29]

6 APPROACHES ADOPTED BY SOME COUNTRIES ON THE TAXATION OF THE DIGITAL ECONOMY

The OECD Commentary on article 5 (discussed above) which deals on PE issues relating to websites and servers reflects the views of the majority of the OECD member States. It is, however, worth noting that several OECD Member States have expressed negative observations to the conclusions reached by the OECD Commentary on article 5, notably the United Kingdom (UK), Chile, Greece and Portugal.[30] This is because the current PE rules make it difficult for many countries to levy direct income taxes on e-commerce companies that transact with customers within their borders, some jurisdictions have become more aggressive about deeming that a PE exists or are seeking to levy indirect taxes on the transactions. [31]

6.1 UNITED KINGDOM

In relation to the Commentary on article 5, of the OECD Model Tax Convention, the UK takes the view that a server used by an e-tailer, either alone or together with web sites, could not as such constitute a PE. The UK tax authority (HMRC) has confirmed that this is the case regardless of whether the server is owned, rented or otherwise at the disposal of the business.[32] In March 2014, the UK Treasury (HM Treasury)

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26 M Herzfeld "News Analysis: Political Reality Catches Up With BEPS" *Tax Analysts* 3 February 2014.
27 Ibid.
28 Ibid.
29 L A Sheppard "News Analysis: OECD BEPS Hybrid Developments" Tax Analysts 29 January 2014.
30 Para 45.5 – 45.11 of the Commentary on art 5 of the OECD Model Convention.
31 J Arora & LE Shepherd "Adjusting Jurisdictional Concepts for E-commerce Tax Analyst 8 october 2013. Available at http://services.taxanalysts.com/taxbase/tni3.nsf/(Number/2013+WTD+195-1?OpenDocument&Login accessed 29 October 2013.
32 See HMRC International Manual INTM266100.

and the HMRC released a joint report entitled: "Tackling aggressive tax planning in the global economy: UK priorities for the G20-OECD project for countering Base Erosion and Profit Shifting (UK Report on BEPS)".[33] The Report observes that:[34]

> "…. it is not feasible to ring-fence the digital economy from the rest of the economy in order to apply entirely separate rules to it. Attempting to do so by creating artificial boundaries would cause unintended consequences, is unlikely to provide a long-term solution as the digital economy continues to evolve and could hamper prospects for growth in the UK. Instead, we think it is important for the OECD to analyse precisely how value is created in modern businesses which rely on digital technologies and complex systems, or where computing-related intangibles are central to revenue models, and consider how the existing rules can be updated to take this into account. Therefore, our view is that the key objective is to achieve consistent tax treatment of primarily digital companies and those where digital technologies are incorporated into their business models by focusing on comparable activities and seeking to ensure these receive consistent tax treatment within a jurisdiction."

The UK Report acknowledges that:[35]

> "Some characteristics of digitised business models exacerbate existing challenges in applying the international tax rules consistently to companies. These include, for instance, the ability of businesses to deliver products and services into a market without the need to physically locate there and thereby create a permanent establishment; the ability to fragment activities within a group to ensure that the threshold for creating a permanent establishment in relation to any particular group company operating in that country is not breached; the growth in proportional value of mobile intangible assets and increased reliance in a value chain on computing power and infrastructure which can more easily be located in low or no tax jurisdictions; and the ability of some market-leading businesses to quickly establish a significant market share through multi-sided business models and the impact of network effects."

The UK Report on BEPS concludes that there is a need to seriously consider revising the concept of a PE in order to take account of technological advances, including advances in functionality.[36] With respect to indirect taxes, the UK Report points out that the UK has been at the forefront of moves to modernise the EU VAT rules so that services are taxed by the Member State where these are used or consumed (the destination principle). It notes that the EU Ministers unanimously agreed to a series of changes to achieve that, with the final step being changes to be introduced across the EU on 1 January 2015.[37] This is a key step as the changes will ensure broadcasting, telecoms and e-services are taxed by the UK, when they are supplied to UK consumers from suppliers located elsewhere in the EU. This will bring the VAT treatment in line with the rules that already apply to suppliers located outside the EU.

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33 HM Treasury and the HMRC "Tackling aggressive tax planning in the global economy: UK priorities for the G20-OECD project for countering Base Erosion and Profit Shifting" (2014) (UK Report on BEPS).

34 UK Report on BEPS at 15 in para 2.4.

35 UK Report on BEPS in para 2.5.

36 UK Report on BEPS in para 2.6.

37 UK Report on BEPS in para 2.9.

6.2 AUSTRALIA

Following a request from National Government, the Australian Treasury released a scoping paper (Paper) in June 2013 which analysed the exposure to the Australian corporate tax system resulting from BEPS.[38] The Paper observes that global tax settings have failed to keep pace with changes in the global economy, which has led to growing concern around the world that some multinationals, while acting within the law, are taking advantage of outdated international tax laws to reduce the taxation contribution they make to the countries in which they operate.[39] The Paper notes the classical basis for the fiscal jurisdiction of a country, i.e. a country can assert the right to tax either on the basis of its sovereignty over its people (its citizens and residents) who derive benefits provided by the state (the benefits principle) or its sovereignty over the territory it claims authority over, i.e. based on the existence and extent of the economic relationships between the country and the income or person concerned (economic allegiance). Traditionally, the application of the economic allegiance and benefits doctrine, combined with the practical limits on countries' ability to assert sovereignty, gave rise to the two concepts that underpin the international framework for the taxation of cross-border income and capital: the residence (of individuals and entities) and the source (of income).[40] The Paper questions whether the concepts of source and residence continue to represent a reasonable proxy for the economic allegiance and benefit doctrines in the modern economy. In particular, it argues in relation to the digital economy and the broader knowledge economy that the concepts of source and residence may no longer adequately reflect the economic allegiance and benefits doctrine. It stresses that it is important not to lose sight of the fact that 'source', 'residence' and 'permanent establishment' are the tools for allocating taxing rights rather than the guiding conceptual frameworks.[41]

The Paper observes that the rise of the digital economy has meant that many transactions and functions that previously relied on a physical proximity with the market can now be undertaken more or less anywhere.[42] The Paper notes that the potential for developments in the digital economy to have an adverse impact on Australia's corporate tax base was identified in the Australian Tax Office's (ATO) 1997 report entitled: Tax and the Internet. The Paper points out that the nature and extent of those risks has shifted as the digital economy itself has evolved, and the international tax system has not adjusted sufficiently to reflect this.[43] The Paper

38 Australian Treasury "Scoping Paper on The Risks to the Sustainability of Australia's Corporate Tax Base" (July 2013). Available at http://www.treasury.gov.au/PublicationsAndMedia/Publications/2013/Aus-Corporate-Tax-Base-Sustainability accessed 5 May 2014.

39 Australian Treasury's Scoping Paper at 45.

40 Australian Treasury's Scoping Paper in para 19.

41 Australian Treasury's Scoping Paper in para 20.

42 Australian Treasury's Scoping Paper in para 54.

43 Australian Treasury's Scoping Paper in para 55.

observes that the PE rules date back to a time when the bulk of economic activity took place at a physical location. The rise of the digital economy, which essentially has no physical location, led to changes to the guidance material to: include examples of when electronic commerce (such as electronic equipment), facilities such as cables or pipelines or agents are treated as a PE; the exclusion of activities that were preparatory or auxiliary; and inclusion of alternative provisions that countries can use to allocate profits from the provision of services. The Paper expresses the view that although these modifications have been made to adjust to the changing international environment, the changes have sought to "shoehorn"' the developments to fit within the pre-existing concepts; the net effect is that it is 'possible to be heavily involved in the economic life of another country without having a taxable presence therein. [44]

The Paper concludes that to ensure an appropriate share of tax revenues between jurisdictions is achieved in the changing environment and to prevent the artificial avoidance of PE status, the rules need to be modified. It mentions one option to explore, i.e. whether a better balance can be achieved by changing the rules so they rely on the level of economic activity rather than on a physical presence.[45]

The Paper acknowledges that the underlying drivers of corporate tax base erosion are international in nature, and beyond the scope of any one country, acting alone, to resolve. Addressing the threat posed to the corporate tax bases of countries from BEPS will inevitably require effective multilateral action.[46]

6.3 FRANCE

France follows the OECD principles regarding e-commerce. Therefore, the existence of personnel in France operating a company's server, rather than the server itself would not constitute a PE. However; this would cause concern to tax authorities.[47] There is a growing disconnect between the theoretical French position on PE and the behaviour of the country's tax authorities, which have become quite aggressive. In recent times, tax officials, assisted by the police, have conducted highly publicised searches for documentation on the premises of Google and Amazon with the goal of finding information about business activity that would justify the determination of PEs in France. [48] If the French government decides that a company does have a PE and then determines that it was engaging in an undisclosed business, the company could be liable to heavy penalties on the tax that the undisclosed business is deemed to have avoided.[49] On 19 January 2013 the French Ministry for the Economy and Finance published the Colin-Collin report (predating the BEPS Report), in which it

44 Australian Treasury's Scoping Paper in paras 169 – 171.
45 Australian Treasury's Scoping Paper in para 172.
46 Australian Treasury's Scoping Paper in para 184.
47 Ibid.
48 Ibid.
49 Ibid.

proposed a new tax (commonly referred to as a Google tax) on database collection and the attribution of profits to a virtual PE based on the concept that data provided by Web users who search or shop on the Internet must be regarded as a source of revenue to digital companies. Basically, the proposed tax would impose a "link tax" to force companies like Google to pay French publishers for using snippets of their content in Google search engine results. The French government is contemplating redefining PE for the digital economy whereby PE would be defined as the provision of services in a country using data voluntarily uploaded by the consumer, and systematic monitoring of online users in that country. [50] French proposals to enact the Google tax were however stopped because of lobbying pressure. [51]

It is worth noting that in August 2012 Germany also tried to come up with a “link tax” in its proposed "ancillary copyright" legislation to compel Google and other search engines to pay for indexed links to copyrighted content. [52]

7 OECD BEPS PROJECT WORK ON THE DIGITAL ECONOMY

In September 2013, the OECD formed the Task Force on Digital Economy, a subsidiary body of the OECD Committee on Fiscal Affairs, with the aim of developing a report to identify issues raised by the digital economy and possible actions to address them by September 2014. On 24 March 2014, the OECD published a Discussion Draft entitled “BEPS Action 1: Address the Challenges of The Digital Economy”. [53] The matters addressed in this Discussion Draft culminated in September 2014 entitled “Address the Challenges of The Digital Economy”. The Final Report on the Digital economy was issued in October 2015, the gist of which is summarised below.

8 SUMMARY OF OECD 2015 FINAL REPORT ON ACTION 1 - TAX CHALLENGES OF THE DIGITAL ECONOMY

8.1 FUNDAMENTAL PRINCIPLES OF TAXATION TO APPLY TO THE DIGITAL ECONOMY

The OECD 2015 Final Report on the digital economy, affirmed the outcomes of the (above discussed) 1998 Ottawa Ministerial Conference on Electronic Commerce and 2001 OECD Report “Electronic Commerce: Taxation Framework Conditions” which set out the taxation principles that should apply to electronic commerce (neutrality; efficiency; certainty and simplicity; effectiveness and fairness; flexibility). The OECD notes that these principles are still relevant today and, supplemented as necessary,

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[50] Ibid.

[51] Ibid.

[52] SS Jonstone “News Analysis: Chasing Google -- The Global Struggle to Tax Ecommerce” 10 February 2014.

[53] The full report can be found at: http://www.oecd.org/ctp/tax-challenges-digital-economy-discussion-draft-march-2014.pdf

can constitute the basis to evaluate options to address the tax challenges of the digital economy.[54]

8.2 INFORMATION AND COMMUNICATION TECHNOLOGY AND ITS IMPACT ON THE ECONOMY

The OECD notes that 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.[55] Examples for such technological developments include:

- **Personal computing devices:** This covers innovative integrated packages of hardware and software, such as smartphones and tablets (and increasingly, connected wearable devices).[56]
- **Telecommunications networks:** This entails the development network component providers, infrastructure intermediaries, and Internet service providers (ISPs) that powered and operated the infrastructure of the telecommunications networks which have become central to the digital economy.[57]
- **Software:** The World Wide Web, initially made of websites and webpages, marked the emergence of Internet-powered software applications.[58]
- **Content:** Today, many major players in the digital economy are content providers. The definition of content in that regard is quite large: it includes both copyrighted content produced by professionals, enterprise-generated content, and non-copyrighted user-generated content (such as consumer reviews or comments in online forums).[59]
- **Use of data:** Users of applications provide businesses with access to substantial amounts of data, which are often personal and are used in a variety of ways that continue to be developed.[60]
- **Cloud-based processes:** These are processes whose resources can only be stored and executed in the cloud. As a result of the standardisation and commoditisation of different individual resources, such as hardware, network infrastructure, and software, some businesses have been able to combine those resources and make them available through the Internet as services.[61]

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54 OECD/G20 2015 Final Report on Action 1 at 2.
55 OECD/G20 2015 Final Report on Action 1 in para 64.
56 OECD/G20 2015 Final Report on Action 1 in para 67.
57 OECD/G20 2015 Final Report on Action 1 in para 69.
58 OECD/G20 2015 Final Report on Action 1 in para 72.
59 OECD/G20 2015 Final Report on Action 1 in para 75.
60 OECD/G20 2015 Final Report on Action 1 in para 77.
61 OECD/G20 2015 Final Report on Action 1 in para 78.

8.3 EMERGING AND POTENTIAL FUTURE DEVELOPMENTS OF THE DIGITAL ECONOMY

The rapid technological progress has led to a number of emerging trends and potential developments that may prove influential in the near future. These rapid changes make it difficult to predict future developments with any degree of reliability.[62] The developments include:

- **Internet of Things:** The ability to connect any smart device or object over time to a network of networks is enabling the "Internet of Things". The term refers to a series of components of equal importance including machine-to-machine communication, cloud computing, big data analysis, sensors and actuators, the combination of which leads to further developments in machine learning and remote control.[63]
- **Virtual currencies:** These are digital units of exchange that are not backed by government-issued legal tender. Some virtual currencies are specific to a single virtual economy, such as an online game, where they are used to purchase in-game assets and services. Other virtual currencies were developed primarily to allow the purchase of real goods and services. The most prominent example are "cryptocurrencies", which rely on cryptography and peer-to-peer verification to secure and verify transactions. For example, with bitcoins, transactions can be made on an entirely anonymous basis, since no personally identifying information is required to be provided to acquire or transact in bitcoins.[64]
- **Advanced robotics:** The development of new connected and smart robots is changing manufacturing profoundly. With the increased productivity of new automated factories some multinational enterprises that had previously moved manufacturing offshore to take advantage of lower labour costs are considering moving their manufacturing activities back to where most of their customers are.[65]
- **3D Printing:** Advances in 3D printing have resulted in manufacturing gradually moving away from mass production of standardized products to shorter product lifecycle. In the healthcare industry, 3D printing of custom health products such as hearing aid earpieces is already heavily used. 3D printing has the potential to reduce the number of steps involved in production, transportation, assembly, and distribution, and can reduce the amount of material wasted as well.[66]
- **The sharing economy and collaborative production:** This refers to peer-to-peer sharing of goods and services. Recent years have seen the emergence of numerous innovative sharing applications using different business models and focusing on one particular service or product, such as cars, spare rooms, food, clothes, and private jets.[67]

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[62] OECD/G20 2015 Final Report on Action 1 in para 83.
[63] OECD/G20 2015 Final Report on Action 1 in para 84.
[64] OECD/G20 2015 Final Report on Action 1 in para 87-88.
[65] OECD/G20 2015 Final Report on Action 1 in para 90.
[66] OECD/G20 2015 Final Report on Action 1 in para 93.
[67] OECD/G20 2015 Final Report on Action 1 in para 94.

- **Access to government data:** Governments are making progress at making machine-readable resources, notably data, publicly available in what has been alternatively labelled as open data policy, open government or government as a platform. The three main goals are to ensure accountability, better performance and participation of third parties in government business. [68]
- **Reinforced protection of personal data:** As individuals become more sensitive to the use of their personal data and expect their privacy to be protected, discussions are ongoing in a number of countries to strengthen applicable laws and regulate data collection and exploitation by organisations.[69]

8.4 THE DIGITAL ECONOMY AND ITS IMPACT ACROSS BUSINESS SECTORS

Many sectors of the economy have adopted ICT to enhance productivity, enlarge market reach, and reduce operational costs. [70]

- **Retail**: The digital economy has enabled retailers to allow customers to place online orders (often fulfilled from a local store) and has made it easier for retailers to gather and analyse data on customers, to provide personalised service and advertising; as well as to manage logistics and increase productivity.
- **Transport and Logistics**: This sector has been transformed by digital economy, which enables the tracking of both vehicles and cargo across continents, the provision of information to customers and facilitates the development of new operational processes such as "Just-In-Time" delivery in the manufacturing sector.
- **Financial Services**: Banks, insurance providers and other companies, including non-traditional payment service providers, increasingly enable customers to manage their finances, conduct transactions and access new products on line, although they still continue to support branch networks for operations. The digital economy has also made it easier to track indices and manage investment portfolios and has enabled specialist businesses such as high-frequency trading.
- **Manufacturing and Agriculture**: The digital economy has enhanced design and development, as well as the ability to monitor production processes in factories and control robots, which has enabled greater precision in design and development and ongoing product refinement. In the automobile industry, for example, it is estimated that 90% of new features in cars have a significant software component. On farms, systems can monitor crops and animals, and soil/environmental quality. Increasingly, routine processes and agricultural equipment can be managed through automated systems.

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68 OECD/G20 2015 Final Report on Action 1 in para 96.
69 OECD/G20 2015 Final Report on Action 1 in para 98.
70 OECD/G20 2015 Final Report on Action 1 in para at 109.

- **Education:** Universities, tutor services and other education service providers are able to provide courses remotely without the need for face to face interaction through technologies such as video conferencing and streaming and online collaboration portals, which enables them to tap into global demand and leverage brands in a way not previously possible.
- **Healthcare:** The digital economy is revolutionising the healthcare sector, from enabling remote diagnosis to enhancing system efficiencies and patient experience through electronic health records. It also allows opportunities for advertising, for example of drugs and other treatments.
- **Broadcasting and Media:** The digital economy has dramatically changed the broadcasting and media industry, with increasing broadband access in particular opening new avenues for delivery of content for traditional media players, while also enabling the participation in the news media of non-traditional news sources, and expanding user participation in media through user-generated content and social networking. The digital economy has also enhanced the ability of companies to collect and use information about the viewing habits and preferences of customers, to enable them to better target programming. [71]

As digital technology is adopted across the economy, segmenting the digital economy has become increasingly difficult. The digital economy is increasingly becoming the economy itself, it is increasingly impossible to ring-fence the digital economy from the rest of the economy. Attempting to isolate the digital economy as a separate sector would inevitably require arbitrary lines to be drawn between what is digital and what is not. As a result, the tax challenges and BEPS concerns raised by the digital economy are better identified and addressed by analyzing existing structures adopted by MNEs together with new business models and by focusing on the key features of the digital economy and determining which of those features raise or exacerbate tax challenges or BEPS concerns, and developing approaches to address those challenges or concerns. [72]

8.5 THE DIGITAL ECONOMY AND THE EMERGENCE OF NEW BUSINESS MODELS

The digital economy has given rise to a number of new business models. [73]

(a) Electronic commerce: Electronic commerce, or e-commerce, has been defined broadly by the OECD as “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 or services are ordered by those methods, but the payment and the ultimate delivery of the goods or service do not

[71] OECD/G20 2015 Final Report on Action 1 in para 114.
[72] OECD/G20 2015 Final Report on Action 1 in para 115.
[73] OECD/G20 2015 Final Report on Action 1 in para 116.

have to be conducted online. An e-commerce transaction can be between enterprises, households, individuals, governments, and other public or private organisations". [74] Although e-commerce covers a broad array of businesses, the more prominent types are:

- *Business-to-business models:* transactions in which a business sells products or services to another business (so-called business-to-business (B2B)
- *Business-to-consumer models: This* business model sells goods or services to individuals acting outside the scope of their profession.
- *Consumer-to-consumer models:* Businesses involved in C2C e-commerce play the role of intermediaries, helping individual consumers to sell or rent their assets (such as residential property, cars, motorcycles, etc.) by publishing their information on the website and facilitating transactions.

(b) Payment services: Online payment service providers provide a secure way to enable payments online without requiring the parties to the transaction to share financial information with each other. [75]

- Cash payment solutions: A customer buys online, and pays in cash with a barcode or payment code at participating shops or settlement agencies.
- E-wallets or cyber-wallets: These are often used for micropayments because the use of a credit card for frequent small payments is not economical.
- Mobile payment solutions: These encompass all types of technologies that enable payment using a mobile phone or smartphone. [76]
- Virtual currencies: These can be used to purchase goods and services from businesses that agree to accept them, acting as an alternative to payment services.

(c) App stores: Application stores, are a type of digital distribution platform for software, often provided as a component of an operating system. Application stores typically take the form of central retail platforms, accessible through the consumer's electronic device, through which the consumer can browse, view information and reviews, purchase and automatically download and install the application on his/her device. [77]

(d) Online advertising: This entails the using the Internet as a medium to target and deliver marketing messages to customers. Internet advertisers have developed sophisticated methods for segmenting consumers in order to allow more precise targeting of ads. Internet advertising publishers have also developed ways for clients to monitor performance of ads, tracking how users interact with their brands and learning what is of interest to current and prospective customers. [78]

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[74] OECD/G20 2015 Final Report on Action 1 in para 117.
[75] OECD/G20 2015 Final Report on Action 1 in para 126.
[76] OECD/G20 2015 Final Report on Action 1 in para 128.
[77] OECD/G20 2015 Final Report on Action 1 in para 130.
[78] OECD/G20 2015 Final Report on Action 1 in para 136.

(e) Cloud computing: Cloud computing is the provision of standardised, configurable, on-demand, online computer services, which can include computing, storage, software, and data management, using shared physical and virtual resources (including networks, servers, and applications). Since the service is provided online using the provider's hardware, users can access the service using their devices wherever they are located, provided they have a suitable Internet connection.[79]

(f) High frequency trading: High frequency trading uses sophisticated technology, including complex computer algorithms, to trade securities at high speed. Large numbers of orders which are typically fairly small in size are sent into the markets at high speed, on powerful computers that analyse huge volumes of market data and exploit small price movements or opportunities for market arbitrage that may occur for only milliseconds.[80]

(g) Participative networked platforms: A participative networked platform is an intermediary that enables users to collaborate and contribute to developing, extending, rating, commenting on and distributing user-created content (UCC) which comprises various forms of media and creative works (written, audio, visual, and combined) created by users. Examples of distribution platforms that have been created, including text-based collaboration formats such as blogs or wikis, group-based aggregation and social bookmarking sites, social networking sites, podcasting, and virtual worlds. The participative platform featuring the UCC, may monetise the UCC in a variety of ways, including through voluntary contributions, charging viewers for access on a per item or subscription basis, advertising-based models, licensing of content and technology to third parties, selling goods and services to the community, and selling user data to market research or other firms.[81]

8.6 KEY FEATURES OF THE DIGITAL ECONOMIES WHICH ARE RELEVANT FROM A TAX PERSPECTIVE

The key features of the digital economy which are increasingly potentially relevant from a tax perspective include the following:

(a) **Mobility**

- <u>Mobility of intangibles:</u> The investment in and development of intangibles is a core contributor to value creation and economic growth for companies in the digital economy. Digital companies often rely heavily on software, and will expend substantial resources on research and development to upgrade existing software or to develop new software products. Under existing tax rules, the rights to those

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79 OECD/G20 2015 Final Report on Action 1 in para 140.
80 OECD/G20 2015 Final Report on Action 1 in para 147.
81 OECD/G20 2015 Final Report on Action 1 in para 149-150.

intangibles can often be easily assigned and transferred among associated enterprises, with the result that the legal ownership of the assets may be separated from the activities that resulted in the development of those assets.[82]

- Mobility of users and customers: Users are increasingly able to carry on commercial activities remotely while traveling across borders. An individual can, for example, reside in one country, purchase an application while in a second country, and use the application from a third country. Consumers can use virtual personal networks or proxy servers, whether intentionally or unintentionally, to disguise the location at which the ultimate sale took place. The fact that many interactions on the internet remain anonymous may add to the difficulty of the identity and location of users.[83]
- Mobility of business functions: Businesses are increasingly able to manage their global operations on an integrated basis from a central location that may be removed geographically from both the locations in which the operations are carried out and the locations in which their suppliers or customers are located. This has increased the ability to provide those goods and services across borders.[84] Technological advances can make it possible for businesses to carry on economic activity with minimal need for personnel to be present (so-called "scale without mass").[85] Technological advances have also permitted greater integration of worldwide businesses, which has made it easier for business to adopt global business models that centralise functions at a regional or global level, rather than at a country-by-country level.[86]

(b) Reliance on data and user participation

The digital economy allows businesses to collect data about their customers, users, suppliers, and operations and to leverage and monetise such activities. In certain social networking focused business models, for instance, the active collaboration of their users is a key value-driver of the business.[87]

(c) Network effects

Networks effects refer to the fact that decisions of users may have a direct impact on the benefit received by other users. This is especially so with the "Internet of Things", in which companies deploy software in many devices and objects, and leverage this web off infrastructure to sell goods or services either to the owners of those devices or to advertisers. In this model, hardware and software infrastructure becomes a privileged channel to get in touch with end users and to create value by

[82] OECD/G20 2015 Final Report on Action 1 in para 152-153.
[83] OECD/G20 2015 Final Report on Action 1 in para 154.
[84] OECD/G20 2015 Final Report on Action 1 in para 155-156.
[85] OECD/G20 2015 Final Report on Action 1 in para 158.
[86] OECD/G20 2015 Final Report on Action 1 in para 159-160.
[87] OECD/G20 2015 Final Report on Action 1 in para 164.

monetising their attention (advertising-based business models), the data that flows from them, or the externalities generated through network effects, or through selling them goods or services. [88]

(d) Multi-sided business models

A multi-sided business model is one that is based on a market in which multiple distinct groups of persons interact through an intermediary or platform, and the decisions of each group of persons affects the outcome for the other groups of persons through a positive or negative externality. An example of a multi-sided business model involving positive externalities for different sides of the market is a payment card system, which will be more valuable to merchants if more consumers use the card, and more valuable to consumers if more merchants accept the card. [89]

(d) Tendency toward monopoly or oligopoly

In some markets, particularly where a company is the first actor to gain traction on an immature market, network effects combined with low incremental costs may enable the company to achieve a dominant position in a very short time. This ability to gain traction can be enhanced where a patent or other intellectual property right grants one competitor the exclusive power to exploit a particular innovation in a particular market. Ease of adoption of a new platform means that some players, as a result of customer choices compounded by network effects, have been able to rise to a dominant market position extremely quickly.[90]

(e) Volatility

Technological progress has led to progress in miniaturisation and a downward trend in the cost of computing power. This has increased performance reduced barriers to entry for new internet-based businesses which has fostered innovation and the constant development of new business models. As a result, in short periods of time, companies that appeared to control a substantial part of the market and enjoyed a dominant position have found themselves rapidly losing market share to challengers that manage to build their businesses on more powerful technology, a more attractive value proposal, or a more sustainable business model. The few companies that have managed long-term success typically have done so by investing substantial resources in research and development and in acquiring start-ups with innovative ideas, launching new features and new products, and continually evaluating and modifying business models in order to leverage their market position and maintain dominance in the market. [91]

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88 OECD/G20 2015 Final Report on Action 1 in para 169-172.
89 OECD/G20 2015 Final Report on Action 1 in para 173-174.
90 OECD/G20 2015 Final Report on Action 1 in para 178.
91 OECD/G20 2015 Final Report on Action 1 in para 179.

8.7 IDENTIFYING OPPORTUNITIES FOR BEPS IN THE DIGITAL ECONOMY

BEPS concerns in the digital economy are raised by:

- situations in which taxable income can be artificially segregated from the activities that generate it, or
- in the case of value-added tax (VAT), situations in which no or an inappropriately low amount of tax is collected on remote digital supplies to exempt businesses or multi-location enterprises (MLEs) that are engaged in exempt activities. [92]

Consequences:

- These situations undermine the integrity of the tax system and potentially increase the difficulty of reaching revenue goals.
- In addition, when certain taxpayers are able to shift taxable income away from the jurisdiction in which income producing activities are conducted, other taxpayers may ultimately bear a greater share of the burden.
- BEPS activities also distort competition, as corporations operating only in domestic markets or refraining from BEPS activities may face a competitive disadvantage relative to multinational enterprises (MNEs) that are able to avoid or reduce tax by shifting their profits across borders. [93]

In many cases, the nature of the strategies used to achieve BEPS in digital businesses is similar to the nature of strategies used to achieve BEPS in more traditional businesses. Some of the key characteristics of the digital economy may, however, exacerbate risks of BEPS in some circumstances, in the context of both direct and indirect taxation. [94]

8.8 BEPS IN THE CONTEXT OF DIRECT TAXATION

8.8.1 MINIMISATION OF TAXATION IN THE MARKET COUNTRY BY AVOIDING A TAXABLE PRESENCE EITHER BY SHIFTING GROSS PROFITS VIA TRADING STRUCTURES OR BY REDUCING NET PROFIT BY MAXIMISING DEDUCTIONS AT THE LEVEL OF THE PAYER

Minimising taxation by avoiding a taxable presence

In many digital economy business models, a non-resident company may interact with customers in a country remotely through a website or other digital means (e.g. an application on a mobile device) without maintaining a physical presence in the country. Increasing reliance on automated processes may further decrease reliance

[92] OECD/G20 2015 Final Report on Action 1 in para 180.
[93] OECD/G20 2015 Final Report on Action 1 in para 180.
[94] OECD/G20 2015 Final Report on Action 1 in para 181.

on local physical presence. However, the domestic laws of most countries require some degree of physical presence before business profits are subject to taxation. In addition, under Articles 5 and 7 of the OECD Model Tax Convention, a company is subject to tax on its business profits in a country of which it is a non-resident only if it has a PE in that country. Thus, such non-resident company may not be subject to tax in the country in which it has customers. [95]

- Companies in many industries have customers in a country without a PE in that country, and yet they can communicate with those customers via phone, mail, fax and through independent agents.
- The use of the digital economy to earn revenue from customers in a country without having a PE in that country coupled with strategies that eliminate taxation in the State of residence, results in such revenue not being taxed anywhere, BEPS concerns are raised. [96]
- In addition, under some circumstances, tax in a market jurisdiction can be artificially avoided by fragmenting operations among multiple group entities in order to qualify for the exceptions to PE status for preparatory and auxiliary activities, or by otherwise ensuring that each location through which business is conducted falls below the PE threshold.[97]

<u>Minimising the income allocable to functions, assets and risks in market jurisdictions</u>

Although MNEs do maintain a degree of presence in countries that represents significant markets for its products, in the context of the digital economy, an enterprise may establish a local subsidiary or a PE, with the local activities structured in a way that generates little taxable profit.

- MNEs can allocate functions, assets and risks in a way that minimises taxation by for example, contractually allocate them in a way that does not fully reflect the actual conduct of the parties, and that would not be chosen in the absence of tax considerations. For example, assets, in particular intangibles, and risks related to the activities carried out at the local level may be allocated via contractual arrangements to other group members operating in a low-tax environment in a way that minimises the overall tax burden of the MNE group.[98]
- Under these structures, the affiliate in the low-tax environment could to undervalue (typically at the time of the transfer) the transferred intangibles or other hard to-value income-producing assets, while claiming that it is entitled to have large portions of the MNE group's income allocated to it on the basis of its legal ownership of the undervalued intangibles, as well as on the basis of the risks assumed and the financing it provides. Operations in higher tax jurisdictions can then be contractually stripped of risk, and can avoid claiming

95 OECD/G20 2015 Final Report on Action 1 in para 184.
96 OECD/G20 2015 Final Report on Action 1 in para 185.
97 OECD/G20 2015 Final Report on Action 1 in para 185.
98 OECD/G20 2015 Final Report on Action 1 in para 186.

ownership of intangibles or other valuable assets or holding the capital that funds the core profit making activities of the group. Economic returns are thus reduced and income is shifted into low-tax environments. [99]

Examples of digital economy structures that can be used to minimise the tax burden in market jurisdictions through contractual allocation of assets and risks include:

- Using a subsidiary or PE to perform marketing or technical support, or to maintain a mirrored server to enable faster customer access to the digital products sold by the group, with a principal company contractually bearing the risks and claiming ownership of intangibles generated by these activities. A company may, for example, limit risk at the local company level by limiting capitalisation of that entity so that it is financially unable to bear risk.
- In the case of businesses selling tangible products online, a local subsidiary or PE may maintain a warehouse and assist in the fulfilment of orders. These subsidiaries or PEs will be taxable in their jurisdiction on the profits attributable to services they provide, but the amount they earn may be limited.
- Alternatively, functions allocated to local staff under contractual arrangements may not correspond with the substantive functions performed by the staff. For example, staff may not have formal authority to conclude contracts on behalf of a non-resident enterprise, but may perform functions that indicate effective authority to conclude those contracts. If the allocations of functions, assets, and risks do not correspond to actual allocations, or if less-than-arm's length compensation is provided for intangibles of a principal company, these structures may present BEPS concerns. [100]

Maximising deductions in market jurisdictions

Once a taxable presence in the market country has been established, another common technique to reduce taxable income in a source country is to maximise the amount of deductible payments made to affiliates other jurisdictions in the form of interest, royalties, service fees, etc. [101] For example, an affiliate in a low-tax jurisdiction may, due to a favourable credit rating, be able to borrow money at a low rate. It may then lend money to its subsidiaries in high-tax jurisdictions at a higher rate, thereby reducing the income of those subsidiaries by the amount of the deductible interest payments.

Alternatively, an affiliate may use hybrid instruments to create deductible payments for a subsidiary in a source country that result in no inclusion in the country of residence of the affiliate. Payments (including underpayments) for the use of intangibles held by low-tax group companies or for services rendered by other group companies can also be used to reduce taxable income in the market country. [102]

99 OECD/G20 2015 Final Report on Action 1 in para 187.
100 OECD/G20 2015 Final Report on Action 1 in para 188.
101 OECD/G20 2015 Final Report on Action 1 in para 189.
102 OECD/G20 2015 Final Report on Action 1 in para 189.

8.8.2 AVOIDING WITHHOLDING TAX

A company may be subject to withholding tax in a country in which it is not a resident if it receives certain payments, such as interest or royalties, from payers in that country. If allowed under a treaty between the jurisdictions of the payer and recipient, however, a company in the digital economy may be entitled to reduced withholding or exemption from withholding on payments of profits to a lower-tax jurisdiction in the form of royalties or interest. They may also make use of structures that involve treaty shopping by interposing shell companies located in countries with favourable treaty networks that contain insufficient protections against treaty abuse.[103]

8.8.3 ELIMINATING OR REDUCING TAX IN THE INTERMEDIATE COUNTRY

Eliminating or reducing tax in an intermediate country can be accomplished through the application of preferential domestic tax regimes, the use of hybrid mismatch arrangements, or through excessive deductible payments made to related entities in low or no-tax jurisdictions.

- Companies may locate functions, assets, or risks in low-tax jurisdictions or countries with preferential regimes, and thereby allocate income to those locations. [104]
- In the context of the digital economy, for example, the rights in intangibles and their related returns can be assigned and transferred among associated enterprises, and may be transferred, sometimes for a less-than-arm's length price, to an affiliate in a jurisdiction where income subsequently earned from those intangibles is subject to unduly low or no-tax due to the application of a preferential regime.[105]
- Companies may also reduce tax in an intermediate country by generating excessive deductible payments to related entities that are themselves located in low or no-tax jurisdictions or otherwise entitled to a low rate of taxation on the income from those payments. [106]
- Companies may also avoid taxes in an intermediate country by using hybrid mismatch arrangements to generate deductible payments with no corresponding inclusion in the country of the payee. Companies may also use arbitrage between the residence rules of the intermediate country and the ultimate residence country to create stateless income. [107]

103 OECD/G20 2015 Final Report on Action 1 in para 190.
104 OECD/G20 2015 Final Report on Action 1 in para 192.
105 OECD/G20 2015 Final Report on Action 1 in para 193.
106 OECD/G20 2015 Final Report on Action 1 in para 194.
107 OECD/G20 2015 Final Report on Action 1 in para 194.

8.8.4 ELIMINATING OR REDUCING TAX IN THE COUNTRY OF RESIDENCE OF THE ULTIMATE PARENT

The same techniques that are used to reduce taxation in the market country can also be used to reduce taxation in the country of the ultimate parent company of the group or where the headquarters are located.

This can involve contractually allocating risk and legal ownership of mobile assets like intangibles to group entities in low-tax jurisdictions, while group members in the jurisdiction of the headquarters are undercompensated for the important functions relating to these risks and intangibles that continue to be performed in the jurisdiction of the headquarters.[108]In addition, companies may avoid tax in the residence country of their ultimate parent if that country has an exemption or deferral system for foreign-source income and either does not have a controlled foreign company (CFC) regime that applies to income earned by controlled foreign corporations of the parent, or has a regime with inadequate coverage of certain categories of passive or highly mobile income, including in particular certain income with respect to intangibles. [109]

8.9 TACKLING BEPS IN THE DIGITAL ECONOMY

Many of the key features of the digital economy, particularly those related to mobility, generate BEPS concerns in relation to both direct and indirect taxes.

- For example, the importance of intangibles in the context of the digital economy, combined with the mobility of intangibles for tax purposes under existing tax rules, generates substantial BEPS opportunities in the area of direct taxes.
- The mobility of users creates substantial challenges and risks in the context of the imposition of VAT.
- The ability to centralise infrastructure at a distance from a market jurisdiction and conduct substantial sales into that market from a remote location, combined with increasing ability to conduct substantial activity with minimal use of personnel, generates potential opportunities to achieve BEPS by fragmenting physical operations to avoid taxation.

Work on the actions of the BEPS Action Plan (OECD, 2013) has taken into account these key features in order to ensure that the proposed solutions fully address BEPS in the digital economy.

[108] OECD/G20 2015 Final Report on Action 1 in para 195.
[109] OECD/G20 2015 Final Report on Action 1 in para 196.

8.10 TACKLING BEPS IN THE DIGITAL ECONOMY – DIRECT TAXES

8.10.1 RESTORING TAXATION ON STATELESS INCOME

Structures aimed at artificially shifting profits to locations where they are taxed at more favourable rates, or not taxed at all, will be addressed by the work carried out in the context of the BEPS Project. At the same time, the work on BEPS will increase transparency between taxpayers and tax administrations and among tax administrations themselves.

- Risk assessment processes at the level of the competent tax administration will be enhanced by measures such as the mandatory disclosure of aggressive tax planning arrangements and uniform transfer pricing documentation requirements, coupled with a template for country-by-country (CBC) reporting. [110]
- The comprehensiveness of the BEPS Action Plan will ensure that, once the different measures have been implemented in a co-ordinated manner, taxation is more aligned with the location in which economic activities take place. This will address BEPS issues at the level of both the market jurisdiction and the jurisdiction of the ultimate parent company, with the aim of putting an end to the phenomenon of so-called stateless income.
- BEPS issues in the market jurisdiction should be addressed by preventing treaty abuse (Action 6) and preventing the artificial avoidance of PE status (Action 7).
- BEPS issues in the ultimate residence jurisdiction should be addressed by strengthening controlled foreign company (CFC) rules (Action 3).
- Both market and residence BEPS issues should be addressed by neutralising the effects of hybrid mismatch arrangements (Action 2), by limiting the base erosion via interest deductions and other financial payments (Action 4), by countering harmful tax practices more effectively (Action 5), and by ensuring that transfer pricing outcomes are in line with value creation (Actions 8-10). [111]

Although all of the elements of the BEPS Action Plan will have an impact on BEPS in the digital economy; Actions 3 (strengthen CFC rules), 7 (prevent the artificial avoidance of PE status), and 8-10 (assure that transfer pricing outcomes are in line with value creation) were identified as particularly relevant to the digital economy. [112]

- In Action 3, it was noted that income from digital goods and services may be particularly mobile due to the importance of intangibles in the provision of such goods and services.[113]
- Action 7 considered that where activities that were previously considered preparatory or auxiliary for the purposes of these exceptions are increasingly

[110] OECD/G20 2015 Final Report on Action 1 in para 206.
[111] OECD/G20 2015 Final Report on Action 1 in para 207.
[112] OECD/G20 2015 Final Report on Action 1 in para 208.
[113] OECD/G20 2015 Final Report on Action 1 in para 209.

significant components of businesses in the digital economy, such activities may be considered core activities and subject to the PE rules.

  - The work on article 7 also considered how the definition of PE will be modified to address circumstances in which artificial arrangements relating to the sales of goods or services of one company in a multinational group effectively result in the conclusion of contracts, such that the sales should be treated as if they had been made by that company.[114]

- Under Actions 8-10, it was noted that companies in the digital economy rely heavily on intangibles in creating value and producing income, and that many BEPS structures adopted by participants in the digital economy involve the transfer of intangibles or rights in intangibles to tax-advantaged locations, coupled with the position that these contractual allocations, together with legal ownership of intangibles, justify large allocations of income to the entity allocated the risk even if it performs little or no business activity. BEPS work in the area of transfer pricing takes these issues in account as well as the implications of the increased integration of MNEs and the spread of global value chains in which various stages of production are spread across multiple countries. This work provides simpler and clearer guidance on the application of transfer pricing methods, including profit splits in the context of global value chains.[115]

8.10.2 MEASURES THAT WILL ADDRESS BEPS ISSUES IN THE MARKET JURISDICTION

A number of measures of the BEPS Action Plan will have the primary effect of restoring source taxation, in particular with respect to treaty abuse (Action 6) and artificial avoidance of PE status (Action 7).

<u>Prevent treaty abuse (Action 6):</u> The Report on Action 6 provides model rules to tackle the abuse of tax treaties.

- The denial of treaty benefits in cases that could otherwise inappropriately result in double non-taxation will ensure that the market country will be able to apply its domestic law unconstrained by treaty rules aimed at preventing double taxation. This is of relevance both in cases where the foreign company has claimed not to have a taxable presence in that country in the form of a PE or when there is indeed a taxable presence in the form of a PE or a group company, but the relevant taxable income is reduced by deductible payments. In cases where such deductible payments would be subject to a withholding tax under domestic law, the market country will be able to apply such a withholding tax without any treaty limitation.[116]

[114] OECD/G20 2015 Final Report on Action 1 in para 210.
[115] OECD/G20 2015 Final Report on Action 1 in para 211.
[116] OECD/G20 2015 Final Report on Action 1 in para 214.

<u>Prevent the artificial avoidance of PE status (Action 7):</u> The treaty definition of PE may limit the application of domestic law rules applicable to the taxation of the business profits of non-resident companies derived from sources in the market country.

- The work done with respect to Action 7 was aimed at preventing the artificial avoidance of the treaty threshold below which the market country may not tax.
- This work is a key area of focus in order to ensure that BEPS risks in the digital economy could be addressed. Work on Action 7 took into account the key features of the digital economy in developing changes to the definition of PE to ensure that artificial arrangements cannot be used to circumvent the threshold for exercising taxing rights. [117]
- The work involved modifying the definition of PE to address circumstances in which artificial arrangements relating to the sales of goods or services of one company in a multinational group effectively result in the conclusion of contracts, such that the sales should be treated as if they had been made by that company. For example, where the sales force of a local subsidiary of an online seller of tangible products or an online provider of advertising services habitually plays the principal role in the conclusion of contracts with prospective large clients for those products or services, and these contracts are routinely concluded without material modification by the parent company, it will result in a PE for the parent company even though the subsidiary does not formally conclude those contracts, and even though the contracts may be standard form contracts. Once the outcome of this work is implemented, such strategies will no longer be effective. [118]
- The work also ensures that where essential business activities of an enterprise are carried on at a given location in a country, the enterprise cannot benefit from the list of exceptions usually found in the definition of PE. It was therefore agreed to modify Article 5(4) of the OECD Model Tax Convention to ensure that each of the exceptions included therein is restricted to activities that are otherwise of a "preparatory or auxiliary" character.
- In addition, a new anti-fragmentation rule was introduced to ensure that it is not possible to benefit from the PE exceptions through the fragmentation of business activities among closely related enterprises. Where certain activities that were previously granted the benefit of these exceptions have become increasingly significant components of businesses in the digital economy, such that they are not preparatory or auxiliary in character, those activities will no longer be entitled to an exception from PE status. For example, the maintenance of a very large local warehouse in which a significant number of employees work for purposes of storing and delivering goods sold online to customers by an online seller of physical products (whose business model

[117] OECD/G20 2015 Final Report on Action 1 in para 216.
[118] OECD/G20 2015 Final Report on Action 1 in para 216.

relies on the proximity to customers and the need for quick delivery to clients) would constitute a PE for that seller.[119]

8.10.3 MEASURES THAT WILL ADDRESS BEPS ISSUES IN BOTH MARKET AND ULTIMATE PARENT JURISDICTIONS

<u>Neutralise the effects of hybrid mismatch arrangements (Action 2):</u> The BEPS Action Plan notes that hybrid mismatch arrangements can be used to achieve unintended double non-taxation or long-term tax deferral by, for example, creating two deductions for a single expense, generating deductions in one jurisdiction without corresponding income inclusions in another, or misusing foreign tax credit or participation exemption regimes.

- The 2015 Report on *Neutralising the Effects of Hybrid Mismatch Arrangements* (OECD, 2015) sets out recommendations regarding the design of domestic rules and the development of model treaty provisions to neutralise the effect of hybrid instruments and entities, and includes detailed commentary explaining how the recommendations are intended to operate in practice. [120]

<u>Limit base erosion via interest deductions and other financial payments (Action 4):</u> The innovation that is essential to success in the digital economy must be financed. Many large and well-established digital economy players are cash rich and they often finance new ventures, the acquisition of start-ups, or other assets with intra-group debt.

- It is often the case that taxpayers will establish and capitalise entities in low-tax environments that are then able to engage in transactions with associated enterprises that have the effect of eroding the tax base. For example, an affiliate in a low-tax environment might be established to lend to high-tax operating entities. Interest deductions on loans from such low-tax entities can present BEPS concerns in countries where business operations actually take place. [121]
- The work done with respect to Action 4 provides an agreed framework for best practices in the design of domestic rules, in order to reduce opportunities for BEPS via interest and other deductible financial payments. This work addresses BEPS in respect of interest paid to both related parties and third parties and addresses both inbound and outbound investment scenarios.
- The framework is based on a fixed ratio rule that limits an entity's net deductions for interest (and payments economically equivalent to interest) to a specified percentage of its earnings before interest, taxes, depreciation and

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119 OECD/G20 2015 Final Report on Action 1 in para 217.

120 OECD/G20 2015 Final Report on Action 1 in para 219.

121 OECD/G20 2015 Final Report on Action 1 in para 220.

amortization (EBITDA). To ensure that countries apply a fixed ratio that is low enough to tackle BEPS, while recognising that not all countries are in the same position, the recommended approach includes a corridor of possible ratios of between 10 and 30% along with factors that countries should take into account in setting their fixed ratio within this corridor.

- Recognising that some groups are highly leveraged with third party debt for non-tax reasons, the recommended approach allows the fixed ratio rule to be supplemented by a group ratio rule that allows an entity with net interest expense above a country's fixed ratio to deduct interest up to the level of the net interest/EBITDA ratio of its worldwide group.
- Alternatively the fixed ratio rule based on net interest/EBITDA can be supplemented by an "equity test", whereby the fixed ratio rule does not apply if an entity can show that its equity/total assets ratio is equal to or exceeds that of its group (within a small tolerance). The framework also recommends that countries introduce targeted rules to address specific risks.[122]

Counter harmful tax practices more effectively (Action 5): Digital economy companies heavily rely on intangibles to create value and produce income. Intangibles, and income arising from the exploitation of intangibles, are by definition geographically mobile. Over the last decade, a number of OECD and non-OECD countries have introduced regimes which provide for a preferential tax treatment for certain income arising from the exploitation of intellectual property (IP), generally through a 50% to 80 % deduction or exemption of qualified IP income. [123]

- The work undertaken under Action 5 has therefore included an examination of intangible regimes to determine whether they constitute harmful preferential tax regimes within the meaning of the OECD's 1998 Report "Harmful Tax Competition: An Emerging Global Issue".
- Action 5 of the BEPS Action Plan also requires there to be substantial activity for any preferential regime and as a result the existing substance factor has been elaborated and elevated in importance.
- In the context of IP regimes, agreement was reached on the "nexus approach" which uses expenditures as a proxy for substantial activity, ensuring that taxpayers can only benefit from IP regimes where they engaged in research and development and incurred actual expenditures on such activities.
- In the context of other preferential regimes, the same principle can be applied, so that such regimes would be found to meet the substantial activities requirement where the taxpayer undertook the core income generating activities required to produce the type of business income covered by the preferential regime.[124]

122 OECD/G20 2015 Final Report on Action 1 in para 222.
123 OECD/G20 2015 Final Report on Action 1 in para 223.
124 OECD/G20 2015 Final Report on Action 1 in para 224.

Assure that transfer pricing outcomes are in line with value creation (Actions 8-10): The BEPS work on transfer pricing addresses BEPS issues that commonly arise among companies active in the digital economy as well as other taxpayers. Taken together, the overall objective of the transfer pricing actions is to bring the allocation of income within a multinational group of companies more directly in line with the location of the economic activity that gives rise to that income (*Aligning Transfer Pricing Outcomes with Value Creation*, OECD, 2015). This objective is pursued by focusing on key transfer pricing issues including issues related to:

- the transfer and use of intangibles including hard-to-value intangibles, and cost contribution arrangements,
- delineating the actual transaction and business risks, and
- global value chains and transactional profit split methods. [125]

(i) The transfer and use of intangibles including hard-to-value intangibles, and cost contribution arrangements

A key feature of many BEPS structures adopted by participants in the digital economy involves the transfer of intangibles or rights in intangibles to tax advantaged locations. Digital economy companies rely heavily on intangibles in creating value and producing income. Depending on the local law, transfers of intangibles and rights in intangibles at non-arm's length prices can occur in connection with licensing arrangements, cost contribution arrangements or tax structures that separate deductions relevant to the development of the intangible from the income associated with it. [126] Transfers of intangibles at non-arm's length prices can occur *(i)* because of difficulties in valuing transferred intangibles at the time they are transferred; *(ii)* because of unequal access to information relating to value between taxpayers and tax administrations; and *(iii)* because some arrangements result in the transfer of hidden or unidentified intangibles without payment.

The BEPS work on intangibles addresses these issues by taking several steps.

- First, the work provides a broad but clear definition of intangibles for transfer pricing purposes, and makes clear that any intangible item for which unrelated parties would provide compensation upon transfer must be compensated in transfers between associated enterprises. This will help ensure that transfers of hidden intangibles are not used to shift income.
- Second, the work ensures that entities within an MNE group that contribute value to intangibles either by performing or managing development functions or by bearing and controlling risks are appropriately rewarded for doing so. Specifically, the revised guidance ensures that legal ownership alone does not entitle the owner to premium profits, but that the group companies

[125] OECD/G20 2015 Final Report on Action 1 in para 225.
[126] OECD/G20 2015 Final Report on Action 1 in para 226.

performing the important functions, contributing assets or assuming risks related to the development, enhancement, maintenance, protection and exploitation of intangibles will receive an appropriate return.

- The work also makes clear that valuation techniques can be used to determine arm's length transfer prices when comparable transfers of intangibles cannot be identified. In situations where hard-to-value intangibles are transferred, the work ensures that post transfer profitability of an intangible can be taken into account in the valuation in specified circumstances in order to balance the availability of information between taxpayers and tax administrations. [127]
- Revised guidance on cost contribution agreements (CCA) ensures that such arrangements are appropriately analysed and produce outcomes that are consistent with how and where value is created. Specifically, it ensures that the same guidance for valuing and pricing intangibles, including hard-to-value intangibles, is applicable to CCA as to other kinds of contractual arrangements. It ensures also that contributions made to CCA, with specific focus on intangibles, should not be measured at cost where this is unlikely to provide a reliable basis for determining the value of the relative contributions of participants, since this may lead to non-arm's length results. [128]

(ii) Delineating the actual transaction and allocating business risks

BEPS structures aimed at shifting income into low-tax environments often feature a contractual allocation of business risk into a low-tax affiliate. It then may be argued that these contractual risk allocations justify large allocations of income to the entity allocated the risk. The argument entails the assertion that other entities in the group are contractually insulated from risk so that a low-tax affiliate is entitled to substantial amounts of income after compensating other low risk group members for their functions.

- The revised guidance challenges such assertions by determining that risks contractually assumed by a party that cannot in fact exercise meaningful and specifically defined control over the risks, and does not have the financial capacity to assume the risks, will be allocated to the party that does exercise such control and have the financial capacity to assume the risk.
- This revision is part of the requirement to accurately delineate the actual transaction between the associated enterprises by supplementing, where necessary, the terms of any contract with the evidence of the actual conduct of the parties. In combination with the proper application of transfer pricing methods in a way that prevents the allocation of profits to locations where no contributions are made to these profits, this revised guidance will lead to the allocation of an appropriate return to group companies performing the

127 OECD/G20 2015 Final Report on Action 1 in para 228.
128 OECD/G20 2015 Final Report on Action 1 in para 229.

important functions, contributing important assets and controlling economically significant risks, as determined through the accurate delineation of the actual transaction. [129]

(iii) Global value chains and transactional profit split methods

When the arm's length principle was initially devised, it was common that each country in which an MNE group did business had its own subsidiary with full functionality and carrying out a broad range of activities reflecting the group's business as a whole. This structure was dictated by a number of factors, including slow communications, currency exchange rules, customs duties, and relatively high transportation costs that made integrated global supply chains difficult to operate. With the advent of improvements in information and communication technology (ICT), reductions in many currency and custom barriers, and the move to digital products and a service based economy, these barriers to integration broke down and MNE groups began to operate much more as single global firms.

Developments in ICT have thus accelerated and changed the spread of global value chains in which corporate legal structures and individual legal entities become less important and MNE groups move closer to the economist's conception of a single firm operating in a co-ordinated fashion to maximise opportunities in a global economy. Attention will therefore be devoted to the implications of this increased integration in MNEs and will evaluate the need for greater reliance on value chain analyses and transactional profit split methods. [130]

The consultation process on the transactional profit split method in the course of the BEPS Project confirmed that this method can be useful when properly applied to align profits with value creation in certain circumstances. The further work on the transactional profit split method will examine their application to highly integrated business operations and develop profit splitting factors that show strong correlation with value creation. This work should also address situations where comparables are not available because of the structures designed by taxpayers and could include revised guidance on the use of profit methods. This work will be carried out in 2016 and 2017 and may be relevant for highly integrated MNE groups in the digital economy. [131]

8.10.4 MEASURES THAT WILL ADDRESS BEPS ISSUES IN THE JURISDICTION OF THE ULTIMATE PARENT

The work on designing effective CFC rules may also contribute to restoring taxation in the jurisdiction of the ultimate parent company. As noted in the BEPS Action Plan,

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129 OECD/G20 2015 Final Report on Action 1 in para 230.
130 OECD/G20 2015 Final Report on Action 1 in para 232.
131 OECD/G20 2015 Final Report on Action 1 in para 233.

one source of BEPS concerns is the possibility of creating affiliated non-resident taxpayers and routing income of resident enterprises through that non-resident affiliate. Although CFC rules have been introduced in many countries to address this, there remain many jurisdictions that lack CFC rules. Where CFC rules do exist, they do not always address BEPS in a comprehensive manner. However, effective CFC rules can reduce the incentive to shift profits from a source country into a low-tax jurisdiction. The report on Action 3, *Designing Effective Controlled Foreign Company Rules* (OECD, 2015) provides recommendations in the form of six building blocks, including a definition of CFC income which sets out a non-exhaustive list of approaches or combination of approaches that CFC rules could use for such a definition. These approaches include categorical, substance, and excess profits analyses which could be applied on their own or combined with each other. The recommendations are designed to ensure that jurisdictions that choose to implement them will have effective CFC rules. [132]

To address BEPS issues within the digital economy, CFC rules must effectively address the taxation of mobile income typically earned in the digital economy. Although CFC rules vary significantly from jurisdiction to jurisdiction, income from digital goods and services provided remotely is frequently not subject to current taxation under CFC rules. Accordingly, a MNE in a digital business can earn income in a CFC in a low-tax jurisdiction by locating key intangibles there and using those intangibles to sell digital goods and services without that income being subject to current tax, even without the CFC itself performing significant activities in its jurisdiction. As a result, a digital economy company may pay little or no tax in the CFC jurisdiction while also avoiding tax in the source country and the country of ultimate residence. [133]

To address this situation, consideration was given to a number of approaches for CFC rules that could target income typically earned in the digital economy, such as IP income and income earned from the remote sale of digital goods and services. Such income may be particularly mobile due to the importance of intangibles in the provision of such goods and services and the relatively few people required to carry out online sales activities. Countries can implement these approaches to design CFC rules that would subject income that is typically earned in the digital economy to taxation in the jurisdiction of the ultimate parent company.

- For instance, countries could use the categorical analyses to define CFC income to include types of revenue typically generated in digital economy transactions such as license fees and certain types of income from sales of digital goods and services.

[132] OECD/G20 2015 Final Report on Action 1 in para 234.
[133] OECD/G20 2015 Final Report on Action 1 in para 236.

- If countries adopted the excess profits approach this could characterise any “excess profits” generated in low tax jurisdictions, which may include profits attributable to IP-related assets, as CFC income.
- This approach could potentially limit the use of offshore deferral structures popular with digital economy MNEs that indefinitely defer foreign income from taxation in the residence jurisdiction. Both approaches may be combined with a substance analysis aimed at verifying whether the CFC is engaged in substantial activities in order to accurately identify and quantify shifted income. [134]

8.11 BROADER DIRECT TAX CHALLENGES FOR POLICY MAKERS RAISED BY THE DIGITAL ECONOMY AND THE OPTIONS TO ADDRESS THEM

Although the spread of the digital economy brings about many benefits, for example in terms of growth, employment and well-being more generally, it gives rise to a number of challenges for policy makers. The development of digital technologies has the potential to enable economic actors to operate in ways that avoid, remove, or significantly reduce, their tax liability. This highlights the importance of designing corporate income and consumption tax systems that promote growth and investment, while reducing inequality and establishing a level playing field among economic actors.[135] In general terms, in the area of direct taxation, the main policy challenges raised by the digital economy fall into three broad categories:

- Nexus and the ability to have a significant presence without being liable to tax;
- Characterisation of income derived from new business models; and
- Data and the attribution of value created from the generation of marketable location-relevant data through the use of digital products and services.[136]

8.11.1 NEXUS AND THE ABILITY TO HAVE A SIGNIFICANT PRESENCE WITHOUT BEING LIABLE TO TAX

To generate income, businesses still need to source and acquire inputs, create or add value, and sell to customers. To support their sales activities, businesses have always needed to carry out activities such as market research, marketing and advertising, and customer support. Digital technology has, however, had significant impact on how these activities are carried out. Activities can for example be carried out remotely, increasing the speed at which information can be processed, analysed and utilized. Because distance forms less of a barrier to trade, it can be quite easy to expand the number of potential customers that can be targeted and reached. As a result, certain processes previously carried out by local personnel can now be performed cross-border by automated equipment, changing the nature and scope of activities to be performed by staff. Thus, the growth of a customer base in a country

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[134] OECD/G20 2015 Final Report on Action 1 in para 236.
[135] OECD/G20 2015 Final Report on Action 1 in para 244.
[136] OECD/G20 2015 Final Report on Action 1 in para 248.

does not always need the level of local infrastructure and personnel that would have been needed in a “pre-digital” age. [137]

This increases the flexibility of businesses to choose where substantial business activities take place, or to move existing functions to a new location, even if those locations may be removed both from the ultimate market jurisdiction and from the jurisdictions in which other related business functions may take place. As a result, it is increasingly possible for a business’s personnel, IT infrastructure (e.g. servers), and customers each to be spread among multiple jurisdictions, away from the market jurisdiction. Advances in computing power have also meant that certain functions, including decision-making capabilities, can now be carried out by increasingly sophisticated software programmes and algorithms. For example, contracts can in some cases be automatically accepted by software programmes, so that no intervention of local staff is necessary.[138] It is thus possible to generate a large quantity of sales without a taxable presence which raises questions about whether the current rules continue to be appropriate in the digital economy.[139]

These questions relate in particular to the definition of PE for treaty purposes, and the related profit attribution rules. The concept of PE refers not only to a substantial physical presence in the country concerned, but also to situations where the non-resident carried on business in the country concerned via a dependent agent. [140] Nowadays it is possible to be heavily involved in the economic life of another country without having a fixed place of business or a dependent agent therein. Concerns are raised regarding whether the existing definition of PE remains consistent with the underlying principles on which it was based. For example, the ability to conclude contracts remotely through technological means, with no involvement of individual employees or dependent agents, raises questions about whether the focus of the existing rules on conclusion of contracts by persons other than agents of an independent status remains appropriate in all cases. Another specific issue raised by the changing ways in which businesses are conducted is whether certain activities that were previously considered preparatory or auxiliary (and hence benefit from the exceptions to the definition of PE) may be increasingly significant components of businesses in the digital economy. [141]

8.11.2 DATA AND THE ATTRIBUTION OF VALUE CREATED FROM THE GENERATION OF MARKETABLE LOCATION-RELEVANT DATA THROUGH THE USE OF DIGITAL PRODUCTS AND SERVICES

Digital technologies enable the collection, storage and use of data, and also enable data to be gathered remotely and from a greater distance from the market than

137 OECD/G20 2015 Final Report on Action 1 in para 253.
138 OECD/G20 2015 Final Report on Action 1 in para 254.
139 OECD/G20 2015 Final Report on Action 1 in para 255.
140 OECD/G20 2015 Final Report on Action 1 in para 256.
141 OECD/G20 2015 Final Report on Action 1 in para 260.

previously. Data can be gathered directly from users, consumers or other sources of information, or indirectly via third parties. Data can also be gathered through a range of transactional relationships with users, or based on other explicit or implicit forms of agreement with users. Data gathered from various sources is often a primary input into the process of value creation in the digital economy. Leveraging data can create value for businesses in a variety of ways, including by allowing businesses to segment populations in order to tailor offerings, to improve the development of products and services, to better understand variability in performance, and to improve decision making.

The expanding role of data raises questions about whether current nexus rules continue to be appropriate or whether any profits attributable to the remote gathering of data by an enterprise should be taxable in the State from which the data is gathered, as well as questions about whether data is being appropriately characterised and valued for tax purposes. Although data collection is not new, the ability to collect and categorise data has increased exponentially in large part due to computing power and the growth of the internet. [142]

As with other user contributions, the value of data may be reflected in the value of the business itself, and may be monetised when the business is sold. Even where data itself is sold, the value of that data may vary widely depending on the capacity of the purchaser to analyse and make use of that data. The issue of valuing data as an asset is further complicated by existing legal questions about the ownership of personal data, and the ability of users to control whether businesses can access and utilise user data by using digital services anonymously, or by deleting data stored in local caches. Many jurisdictions have passed data protection and privacy legislation to ensure that the personal data of consumers is closely protected. [143]

The value of data, and the difficulties associated with determining that value, is also relevant for tax purposes in the cross-border context and triggers questions regarding whether:

- The remote collection of data should give rise to nexus for tax purposes even in the absence of a physical presence, and if so (or in the case of an existing taxable presence); and
- What impact this would have on the application of transfer pricing and profit attribution principles, which in turn require an analysis of the functions performed, assets used and risks assumed.

The fact that the value of data can impact tax results places pressure on the valuation of data. Further, the fact that the value of data can impact tax results if attributable to a PE or if held by a local subsidiary and sold to a foreign enterprise,

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[142] OECD/G20 2015 Final Report on Action 1 in para 262.
[143] OECD/G20 2015 Final Report on Action 1 in para 263.

but not if collected directly by a foreign enterprise with no PE, places pressure on the nexus issues and raises questions regarding the location of data collection.[144]

In addition, data, including location-specific data, may be collected from customers or devices in one country using technology developed in a second country. It may then be processed in the second country and used to improve product offerings or target advertisements to customers in the first country. Determining whether profit is attributable to each of these functions and the appropriate allocation of that profit between the first country and the second country raises tax challenges. These challenges may be exacerbated by the fact that in practice a range of data may be gathered from different sources and for different purposes by businesses and combined in various ways to create value, making tracing the source of data challenging. This data may be stored and processed using cloud computing, making the determination of the location where the processing takes place similarly challenging.[145]

8.11.3 CHARACTERISATION OF INCOME DERIVED FROM NEW BUSINESS MODELS

Products and services can be provided to customers in new ways through digital technology. This raises questions regarding both the rationale behind existing categorisations of income and consistency of treatment of similar types of transactions. New business models raise new questions about how to characterise certain transactions and payments for domestic and tax treaty law purposes. The question for tax treaty purposes is often whether such payments should be treated as royalties (particularly under treaties in which the definition of royalties includes payments for rentals of commercial, industrial, or scientific equipment), fees for technical services (under treaties that contain specific provisions in that respect), or business profits. More specifically, questions arise regarding whether infrastructure-as-a-service transactions should be treated as services (and hence payments characterised as business profits for treaty purposes), as rentals of space on the cloud service provider's servers by others (and hence be characterised as royalties for purposes of treaties that include in the definition of royalties payments for rentals of commercial, industrial, or scientific equipment), or as the provision of technical services.[146]

The development and increasing use of 3D printing may also raise character questions. For example, if direct manufacturing for delivery evolves into a license of designs for remote printing directly by purchasers, questions may arise as to whether and under what circumstances payments by purchasers may be classified as

[144] OECD/G20 2015 Final Report on Action 1 in para 264.
[145] OECD/G20 2015 Final Report on Action 1 in para 265.
[146] OECD/G20 2015 Final Report on Action 1 in para 269.

royalties rather than as business profits, or may be treated as fees for technical services.[147]

Under most tax treaties, business profits would be taxable in a country only if attributable to a PE located therein. In contrast, certain other types of income, such as royalties, may be subject to withholding tax in the country of the payer, depending on the terms of any applicable treaty. The characterisation of income arising from a transaction as business profits or as another type of income, can result in a different treatment for tax treaty purposes. There is therefore a need to clarify the application of existing rules to some new business models.[148]

At the same time, when considering questions regarding the characterisation of income derived from new business models, it may be necessary to examine the rationale behind existing rules, in order to determine whether those rules produce appropriate results in the digital economy and whether differences in treatment of substantially similar transactions are justified in policy terms. These developments imply that further clarity may be needed regarding the tax treaty characterisation of certain payments under new business models, especially cloud computing payments (including payments for infrastructure-as-a-service, software-as-a-service, and platform-as-a-service transactions).[149] In addition, issues of characterisation have broader implications for the allocation of taxing rights for direct tax purposes. For example, if a new type of business is able to interact extensively with customers in a market jurisdiction and generate business profits without physical presence that would rise to the level of a PE, and it were determined that the market jurisdiction should be able to tax such income on a net basis, modifying the PE threshold and associated profit attribution rules could permit such taxation. Source taxation could also be ensured by creating a new category of income that is subject to withholding tax. As a result, the issue of characterisation has significant implications for the issue of nexus.[150]

8.12 DEVELOPING OPTIONS TO ADDRESS THE BROADER DIRECT TAX CHALLENGES OF THE DIGITAL ECONOMY

The OECD discussed some options to address the broader direct tax challenges raised by the digital economy, as there is a substantial overlap between the challenges related to nexus, data, and characterisation, it was considered that rather than attempting to individually target them, any potential option should instead focus more generally on the ability of businesses in the digital economy to *(i)* derive sales income from a country without a physical presence, and *(ii)* use the contributions of users in the value chain (including through collection and monitoring of data), and

147 OECD/G20 2015 Final Report on Action 1 in para 270.
148 OECD/G20 2015 Final Report on Action 1 in para 271.
149 OECD/G20 2015 Final Report on Action 1 in para 272.
150 OECD/G20 2015 Final Report on Action 1 in para 272.

monetise these contributions by selling the data to third parties, by selling targeted ads, by selling the business itself, or in any other way.[151] The options analysed included:

- modifications to the exceptions from PE status;
- alternatives to the existing PE threshold;
- the imposition of a withholding tax on certain types of digital transactions; and
- the introduction of a tax on bandwidth use.[152]

8.12.1 MODIFICATIONS TO THE EXCEPTIONS FROM PE STATUS

With respect to the exceptions from PE status (contained in Article 5(4) of the OECD Model Tax Convention), work in the context of Action 7 of the BEPS Project will result in the modification of these exceptions to ensure that they are available only for activities that are of a preparatory or auxiliary nature.[153]

8.12.2 A NEW NEXUS BASED ON THE CONCEPT OF SIGNIFICANT ECONOMIC PRESENCE

This option would create a taxable presence in a country when a non-resident enterprise has a significant economic presence in a country on the basis of factors that evidence a purposeful and sustained interaction with the economy of that country via technology and other automated tools. These factors would ensure that only cases of significant economic presence are covered, limit compliance costs of the taxpayers, and provide certainty for cross-border activities.[154] The factors to be considered are:

- The revenue-based factor: Revenue that is generated on a sustained basis from a country could be considered to be one of the clearest potential indicators of the existence of a significant economic presence.[155]
- Digital factors: The test for significant economic presence in the digital economy could be determined through the ability to establish and maintain a purposeful and sustained interaction with users or customers in a specific country via an online presence depends on a range of digital factors, including: a local domain name, a local digital platform; and local payment options.[156]
- User-based factors: Given the importance of network effects in the digital economy, the user base and the associated data input may also be important indicators of a purposeful and sustained interaction with the economy of that another country. Examples of user based factors that reflect the level of

151 OECD/G20 2015 Final Report on Action 1 in para 273.
152 OECD/G20 2015 Final Report on Action 1 in para 274.
153 OECD/G20 2015 Final Report on Action 1 in para 275.
154 OECD/G20 2015 Final Report on Action 1 in para 277.
155 OECD/G20 2015 Final Report on Action 1 in para 278.
156 OECD/G20 2015 Final Report on Action 1 in para 279.

participation in the economic life of a country are: monthly active users, online contract conclusion and data collected. [157]

Determining the income attributable to the significant economic presence

Attribution of profits is a key consideration in developing a nexus based on significant economic presence in cases where an enterprise has no physical presence in the country concerned. If the significant economic presence is adopted, consideration must be given changing profit attribution rules while ensuring parity to the extent possible between enterprises that are subject to tax due to physical presence in the market country (i.e. local subsidiary or traditional PE) and those that would be taxable using the significant economic presence test.[158] Where significant economic presence nexus is adopted, the OECD has considered the following options for attributing profits to PE:[159]

- Methods based on fractional apportionment: The OECD considered the apportionment of the profits of the whole enterprise to the digital presence either on the basis of a predetermined formula, or on the basis of variable allocation factors determined on a case-by-case basis. However it found that in the context of a significant economic presence, effective implementation of a method based on fractional apportionment would require overcoming challenges of *(1)* the definition of the tax base to be divided, *(2)* the determination of the allocation keys to divide that tax base, and *(3)* the weighting of these allocation keys. Since domestic laws of most countries use profit attribution methods based on the separate accounts of the PE, rather than fractional apportionment (which would be a departure from current international standards), fractional apportionment methods were not pursued further. [160]
- Modified deemed profit methods: In the context of a nexus based on significant economic presence, one possible approach would be to regard the presence to be equivalent to a physical presence from which the non-resident enterprise is operating a commercial business and determine the deemed net income by applying a ratio of presumed expenses to the non-resident enterprise's revenue derived from transactions concluded with in-country customers. Determining an appropriate ratio would depend on a number of factors, including the industry concerned, the degree of integration of the particular enterprise, and the type of product and service provided. [161]

157 OECD/G20 2015 Final Report on Action 1 in para 280.
158 OECD/G20 2015 Final Report on Action 1 in para 284.
159 OECD/G20 2015 Final Report on Action 1 in para 285.
160 OECD/G20 2015 Final Report on Action 1 in para 287.
161 OECD/G20 2015 Final Report on Action 1 in para 290-291.

8.12.3 A WITHHOLDING TAX ON DIGITAL TRANSACTIONS

A withholding tax could be levied on payments by residents (and local PEs) of a country for goods and services purchased online from non-resident providers. This withholding tax could in theory be imposed as a standalone gross-basis final withholding tax on certain payments made to non-resident providers of goods and services ordered online or, alternatively, as a primary collection mechanism and enforcement tool to support the application of the nexus option described above, i.e. net-basis taxation.[162]

8.12.4 AN "EQUALISATION LEVY"

To avoid some of the difficulties arising from creating new profit attribution rules for purposes of a nexus based on significant economic presence, an "equalisation levy" could be considered as an alternative way to address the broader direct tax challenges of the digital economy. This approach has been used by some countries in order to ensure equal treatment of foreign and domestic suppliers. An equalisation levy would be intended to serve as a way to tax a non-resident enterprise's significant economic presence in a country. In order to provide clarity, certainty and equity to all stakeholders, and to avoid undue burden on small and medium-sized businesses, therefore, the equalisation levy would be applied only in cases where it is determined that a non-resident enterprise has a significant economic presence.[163]

NOTE: The above three options i.e., the new nexus based on the concept of significant economic presence, withholding tax on digital transactions and the equalisation levy; have been conceived in a way that allows them to be either combined into a single option or chosen individually. [164]

9 ADDRESSING THE DIRECT TAX CHALLENGES OF THE DIGITAL ECONOMY IN SOUTH AFRICA

In South Africa, the 1997 Katz Commission Report[165] recognised the need to protect South Africa's tax base, noting that e-commerce impacts on the basic methods of today's international taxation, making irrelevant the concept of physical presence in order to trade.[166] The Katz Commission noted that the manner in which goods and services can be contracted for, advertised and even delivered via electronic means, can lead to the erosion of South Africa's tax base. The Commission recommended that South Africa should not seek to pioneer a whole new tax regime to cope with the

162 OECD/G20 2015 Final Report on Action 1 in para 292.
163 OECD/G20 2015 Final Report on Action 1 in para 302.
164 OECD/G20 2015 Final Report on Action 1 in para 276.
165 Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa *The Fifth Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa* (1997) at 31 ("Katz Commission Report (1997)").
166 Ibid.

changes brought about by e-commerce, but that it should internationalise its laws affecting international trade and investment.[167]

In devising an e-commerce policy for South Africa, a green/white paper process was developed with the intention of coming up with legislation on e-commerce.[168] This culminated into the Green Paper on E-commerce released in 2000[169] which pointed out that the legal framework in South Africa was insufficient to deal with e-commerce issues. The legislation was tailored for paper-based commercial transactions. There was therefore a need to formulate a new legal framework that includes electronically concluded transactions to ensure that the e-commerce environment in South Africa is fair and equitable for all stakeholders. The Green Paper noted that since accurate identification of the party responsible for paying a particular tax should be a requirement of any taxation system,[170] attention should to be given to drafting a minimum standard of identification requirements of websites. This would require enterprises using a website to disclose information such as: the trading name of the business; the physical as well as the postal address of the business; an e-mail address; telephone number and the statutory registration number of the enterprise.

The Green Paper noted that many tax administrations consider such information as the only means of identifying businesses engaged in e-commerce.[171] With respect to the development of efficient tax collection mechanisms, the Green Paper noted that most tax collection mechanisms usually make use of a leverage point. A common example is PAYE where employers collect the taxes on behalf of SARS from the taxpayers. However, e-commerce tends to eliminate the “middle man”, so tax collection efficiency is reduced. To ensure efficient collection of taxes, the Green Paper suggested that a greater degree of international co-operation in revenue collection is required.[172] As a result of the green/white paper process that forged an e-commerce policy for South Africa,[173] in 2002, the Electronic Communications and Transactions Act[174] was enacted. This Act repealed the Computer Evidence Act of 1983.[175] The preamble to the Electronic Communications and Transactions Act[176] *inter alia* states that it was enacted to provide for the facilitation and regulation of electronic communications and transactions. This Act contains certain provisions which, if complied with and effectively enforced, may alleviate some of the

167 Ibid.
168 M Groenewald & D Lehlokoe “Towards an Electronic Commerce Policy for South Africa”. Available at >http://www.isoc.org/inet99/proceedings/1g/1g_4.htm< last accessed on 1 October 2009.
169 Department of Communications’ Green Paper on E-commerce *Making it your Business* (November 2000) at 10-14.
170 Ibid.
171 Ibid.
172 Ibid.
173 M Groenewald & D Lehlokoe “Towards an Electronic Commerce Policy for South Africa”. Available at http://www.isoc.org/inet99/proceedings/1g/1g_4.htm accessed on 1 October 2013.
174 Act 25 of 2002.
175 57 of 1983.
176 Act 25 of 2002.

identification problems posed by e-commerce.[177] On the whole, however, the Electronic Communications and Transactions Act does not provide for taxation issues in respect of e-commerce transactions.

In 2003, section 74(1) of the Income Tax Act (now repealed) was introduced in the Income Tax Act to allow for electronic record keeping.[178] Electronic recording keeping is now provided for in section 30(1)(b) of the Tax Administration Act. However, the TAA does not contain provisions that can be used to verify whether a particular electronic document or information is linked to a particular taxpayer. Thus electronic records can easily be altered without trace, or maybe encrypted, in order not to reveal transaction information.[179]

The drag in coming up with legislation on the taxation of the digital economy in South Africa can be explained from the fact that as a developing country, taxing the digital is has not been an urgent concern in South African as such measures would stifle the development of badly needed electronic advancements. Focusing on taxing the digital economy has also not been an urgent concern since the economy of South Africa has not reached the likes of US and European levels. Most digital companies in Africa are generally small and relatively unprofitable. South Africa is yet to see the rise of local e-commerce businesses from abroad (other than Amazon).[180]

9.1 DIRECT TAX: TAXING INCOME DERIVED FROM E-COMMERCE - THE CURRENT POSITION IN SOUTH AFRICA

As present there is very limited scope for South African residents to shift profits to offshore tax haven jurisdictions via e-commerce transactions. The application of the CFC rules under section 9D of the Income Tax Act in conjunction with the transfer pricing rules under section 31 make it difficult to shift profits to an offshore company unless significant substance is transferred to such CFC and a substantial physical base is established offshore, which is not feasible for most e-commerce businesses.

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177 Sec 23 of Electronic Communications and Transactions Act requires a disclosure of the time and place of communication, dispatch, and receipt of information. Se 24 deals with the expression of intent between the originator and the addressee. Sec 25 deals with the attribution of data messages to the originator. Sec 38 provides for the authentication of the products or services of service providers using an electronic signature. Sec 27 and 30 deal with cryptography to ensure the authenticity, integrity and reliability of Internet data. Sec 42 and 43 requires the supplier of electronic goods and services to display information on the website where the goods are offered. Sec 80 and 81 deals with the appointment of cyber inspectors. Sec 85 and 86 deal with the penalties of cybercrime.

178 S 67 of the Revenue Laws Amendment Act 45 of 2003 amended s 74(1) of the Income tax Act to provide that a “document” includes any printout of information generated, sent, received, stored, displayed or processed by electronic means. And that “information” includes electronic representations of information in any form.

179 Oguttu & Van der Merwe at 321; see also RL Doernberg, L Hinnekens & W Herrerstein W & J Li *Electronic Commerce and Multi-Jurisdictional Taxation* (2001) at 390; R Buys & F Cronje *Cyber law: The Law of the Internet in South Africa* 2 ed (2004 at 308.

180 SAIT: Comments on DTC First Interim BEPS Report (March 2015). Slide 14 of PowerPoint presentation.

Furthermore, the application of the effective management test to determine the residence of a company makes it impossible to manage such an offshore company from South Africa without becoming subject to worldwide tax in South Africa. It may however be necessary to make adjustments to the foreign tax credit rules and the CFC rules to cater more specifically for e-commerce, especially if the international developments succeed in allocating more taxing rights to source countries.

However, the situation is quite different with respect to e-commerce transactions conducted by non-residents with South African customers. Non-residents are only subject to tax in South Africa on any income derived from a source in South Africa. Thus the definition of gross income in Income Tax Act that deals with South African sourced income of non-residents can be applied to tax non-residents involved in electronic transactions in South Africa. The source basis of taxation for non-residents should be read with the double taxation agreements entered into by South Africa in terms of section 231 of the Constitution and section 108(2) of the Income Tax Act. In accordance with the source provisions under section 9 of the Income Tax Act, it is usually required that the non-resident must conduct some activity or operate via a some degree of physical local presence before business profits could be regarded as derived from a source in South Africa and thus be subject to taxation. However, the source rules in section 9 do not cover rules that deal specifically with electronic transactions. This implies that reference has to be given to common law principles.

The common law source rules rely on the principle of originating cause (which is essentially what the taxpayer does to earn the quid pro quo and its location). However the common law guidelines developed by the South African courts to determine whether or not the source of income may be located in South Africa do not also take into account the complexities of the digital economy. Therefore, currently there is no adequate legal basis for the expansion of the South African fiscal jurisdiction to allow for the taxation of income derived by a non-resident from e-commerce transactions with South African residents. Thus companies can avoid tax in South Africa because the originating cause of their income is not in South Africa. In terms of the above discussed OECD Guidelines on e-commerce implications for PEs,[181] the originating cause would be where the server is located.

In a treaty context, under Articles 5 and 7 of the typical South African DTA (mostly based on the OECD Model DTA), a company resident in the other Contracting State is only subject to tax on its business profits derived from South Africa if it has a PE in South Africa. To determine whether there is an e-commerce PE in South Africa, one has to first refer to section 1 of the Income Tax Act, which states that the meaning of a PE for South African purposes is as defined from time to time in Article 5 of the OECD Model Tax Convention. Therefore, South Africa also has the same difficulties

[181] Paragraph 42.1 to 42.10 of the Commentary on article 5 of the OECD MTC.

as outlined above relating to the restrictions which apply under the traditional definition of a PE, which does not cater adequately for the digital economy.

9.2 RECOMMENDATIONS ON DIRECT TAXES FOR THE DIGITAL ECONOMY IN SOUTH AFRICA

Since the challenges that South Africa faces with respect to taxation of the digital economy are of an international nature, it is recommended that South Africa adopts the OECD recommendations.

- The proposals by the OECD to change the definition of a PE in double tax treaties will help to address this matter. It is also important for South African legislators to note that technology is continuously changing, developing and evolving. In adopting any e-commerce legislation, it is crucial to understand the technology and ensure that South Africa does not implement taxing provisions which are attached to a particular type of technology because by the time the provision is promulgated the technology in question may be obsolete and redundant. To enable South Africa to impose tax on non-resident suppliers of goods and services via e-commerce to South African customers, new source rules that deal with the taxation of the digital economy need to be enacted.
- The current scope of the source rules under section 9 of the Income Tax Act needs to be expanded to include rules that cover proceeds derived from the supply of digital goods and services derived from a source in South Africa. The new rules should be based on payor principle (like a royalty). The rules could for instance provide that digital goods or services are sourced where the recipient who pays for the digital goods or services is based,[182] which would be where the South African tax-resident; physically present in South Africa, is at the time of supply. The rules should also aim to clarify the characterisation of the typical income flows from digital transactions. Enacting of such rules would create the basis from which South Africa can apply the OECD recommendations on the taxation of the digital economy.
- The recommended new source rules for non-resident suppliers of goods and services via e-commerce to South African customers should cover the situation where physical goods and services are delivered or rendered in South Africa and for which payment is made electronically to a non-resident (consider, for example, where payment is made to a non-resident, but where the service is rendered in South Africa, or the case where goods are delivered in South Africa, but payment is made to a non-resident). This would create the foundation for South Africa to tax non-residents on such goods and services, subject to the application of any tax treaty and the revised nexus rules contained therein, and provide for a level playing field between foreign and

182 SAIT: Comment on DTC First Interim BEPS Report (March 2015) Slide 14 of the Power Point Presentation.

domestic suppliers of similar goods and services. However any such services should be deemed to not be from a South Africa source where they do not meet the South Africa sourced rule. This is crucial in order to provide double tax relief to South African resident providers of such services and create a level playing field.[183]

- Apart from the gap in the source rules, there are also administrative concerns. Currently non-residents are required to submit tax returns for trade carried on through a South African PE. If SARS cannot assess whether a non-resident has a PE in South Africa, how will such non-residents be taxed? The lack of data in respect of inbound flows, as well as the lack of discernment between inbound and outbound flows, has resulted in little evidence indicating tax abuse as a result of the digital economy in South Africa. SARS doesn't keep a separate register for inbound foreign companies. There is a need to isolate and focus on foreign multi-nationals and get them to submit tax returns.
- The current rules that require non-resident companies with South African sourced income to submit income tax returns even if they do not have a PE in South Africa ensure that such non-residents are included in the tax system. To ensure that such non- residents register with SARS, a system should be created that imposes an obligation on a resident that transacts with a non-resident to withhold tax on any payment to a non-resident otherwise they would be penalised.
- To alleviate the compliance burden on non-residents having to submit comprehensive tax returns, notwithstanding that they may not be liable to tax in South Africa, an alternative measure would be for a non-resident to be able to apply for a ruling to the effect that it is not liable to tax in South Africa on its specific facts and circumstances and to be relieved of the obligation to submit tax returns for so long as there is no change in the circumstance (including the law).[184]
- South Africa's existing source rules need to be aligned to accounting mechanisms and should not rely too heavily on tax law to attempt to reconcile and determine tax liability. The use of a single IT14 return does not support the BEPS identification specifically with regard to separate disclosure of inbound investment flows. This information disclosure should be based on fact. There should, therefore, be variations of the IT14 return e.g. IT14F for inbound companies since a one-size-fits-all approach doesn't appear to be working. The IT14 also needs to be re-designed as it starts out with legal questions instead of factual (accounting) questions.
- From a policy perspective, it is also important to create a level playing field so that South African companies dealing with digital goods and services are able to compete with the likes of Google. This is what prompted the concerns of Kalahari's e-books complaints. It should be noted that it is not in the interest of

183 PWC "Comment on DTC BEPS First Interim Report" (30 March 2015) at 9.
184 PWC "Comment on DTC BEPS First Interim Report" (30 March 2015) at 9.

resident countries to allow the expansion of the PE concept to grant source states a wider scope to tax profits of digital businesses, since this would simply reduce the profits of the German or USA digital companies which may be taxed in the home state as the residence state would be required to give foreign tax credits in respect of such source tax.[185] In view of the strong presence of such digital companies in the highly developed OECD countries, it may be very difficult to obtain international consensus which is required before such major amendments could be made to DTAs.

10 ADMINISTRATIVE CHALLENGES IN THE DIGITAL ECONOMY

Regarding the tax administration challenges of the digital economy, it is worth noting that the BEPS Action 1 acknowledges that the borderless nature of digital economy produces specific administrative issues around identification of businesses, determination of the extent of activities, information collection and verification, and identification of customers.[186] In general, a remote supplier of goods or services via e-commerce to customers in the source country will not be required to register for tax purposes in the source country. This makes it very difficult to identify the seller or to ascertain the extent of the sales in the source country. To verify the local activities, the tax authorities of the source country may need to seek information from non-residents who have no operations in the source country.[187] This raises potential conflict relating to the excessive expansion of the fiscal jurisdiction of the source country. The OECD Report on Action 1 observes that while exchange of information can be a very useful tool where the proper legal basis in place, this is predicated on knowledge of where the offshore entity is tax resident and information retained or accessible by the reciprocating tax authority.[188] The OECD Convention on Mutual Administrative Assistance in Tax Matters aims to improve the exchange of such information:

> "The amended Convention facilitates international co-operation for a better operation of national tax laws, while respecting the fundamental rights of taxpayers. The amended Convention provides for all possible forms of administrative co-operation between states in the assessment and collection of taxes, in particular with a view to combating tax avoidance and evasion. This co-operation ranges from exchange of information, including automatic exchanges, to the recovery of foreign tax claims."[189]

185 R Pinkernell "Internationale Steuergestaltung im Electronic Commerce" 494 (2014) *Institut Finanzen und Steuern, Schrift* at 168.

186 OECD 2014 Discussion Draft Report on Action 1 at 61–62.

187 Such as the USA Foreign Account Tax Compliance Act (FATCA) provisions which require foreign financial institutions, such as banks, to enter into an agreement with the IRS to identify their U.S. account holders and to disclose the account holders' names.

188 OECD 2014 Discussion Draft Report on Action 1 at 62.

189 OECD "Convention on Mutual Administrative Assistance in Tax Matters" Available at http://www.oecd.org/tax/exchange-of-tax-information/conventiononmutualadministrativeassistanceintaxmatters.htm accessed 6 May 2014.

There is a pressing need to consider how investment in skills, technologies and data management can help tax administrations keep up with the ways in which technology is transforming business operations. The borderless nature of digital economy produces specific administrative issues around identification of businesses, determination of the extent of activities, information collection and verification, and identification of customers. These issues as explained in the OECD Final Report on the digital economy are outlined below:[190]

- **Identification:** While global business structures in the digital economy involve traditional identification challenges, these challenges are magnified in the digital economy. For example, the market jurisdiction may not require registration or other identification when overseas businesses sell remotely to customers in the jurisdiction, or may have issues with implementing registration requirements, as it is often difficult for tax authorities to know that activities are taking place, to identify remote sellers and to ensure compliance with domestic rules. Difficulties in identifying remote sellers may also make ultimate collection of tax difficult.
- **Determining the extent of activities:** Even if the identity and role of the parties involved can be determined, it may be impossible to ascertain the extent of sales or other activities without information from the offshore seller, as there may be no sales or other accounting records held in the local jurisdiction or otherwise accessible by the local revenue authority. It may be possible to obtain this information from third parties such as the customers or payment intermediaries, but this may be dependent on privacy or financial regulation laws.
- **Information collection and verification:** To verify local activity, the market jurisdiction's tax administration may need to seek information from parties that have no operations in the jurisdiction and are not subject to regulation therein. While exchange of information can be a very useful tool where the proper legal basis is in place, this is predicated on knowledge of where the offshore entity is tax resident and information retained or accessible by the reciprocating tax authority. This can create challenges for a market jurisdiction revenue authority seeking to independently verify any information provided by the offshore entity.
- **Identification of customers:** There are in principle a number of ways in which a business can identify the country of residence of its client and/or the country in which consumption occurs. These could include freight forwarders or other customs documentation or tracking of Internet Protocol (IP) and card billing addresses. However, this could be burdensome for the business and would not work where customers are able to disguise their location.

Most of these administrative challenges can be dealt with from the various recommends discussed in the Report above. The OECD is carrying out operational

190 OECD/G20 2015 Final Report on Action 1 per Box 7.1 at 105.

work within the Forum on Tax Administration to develop a strong voluntary compliance culture and expand the use of modern technology for self-service delivery purposes.[191]

10.1 RECOMMENDATIONS FOR SOUTH AFRICA REGARDING THE ADMINISTRATIVE CHALLENGES OF THE DIGITAL ECONOMY

- South Africa recently signed the OECD Mutual Administrative Assistance in Tax Matters Convention which aims for information sharing among signatories in matters of tax. SARS should actively utilise the procedures established under the Convention and similar provisions under applicable DTAs to ensure the frequent and efficient exchange of information and assistance with the enforcement of tax collection.
- Since most of the challenges that e-commerce poses to the legislation relate to difficulties of identifying the location of taxpayers and their business transaction, it is recommended that this Income Tax Act be amended to provide that the provisions of the Electronic Communications and Transactions Act be taken into account for detection and identification purposes, so as to ensure tax compliance for taxpayers involved in e-commerce. However the administrative and compliance costs with respect to enforcing and implementing taxing provisions must not outweigh the benefits received with respect to the taxation raised. The legislators should also be aware of implementing a system which, realistically, cannot be effectively enforced.
- SARS can also obtain information for purposes of identifying digital businesses carrying on activities in South Africa using the exchange of information tools provided for in treaties. While the major players such as Google and Amazon are well known, the nature of the digital economy is such that new players appear on a continuous basis. Other avenues of obtaining third party information from domestic sources in relation to digital transactions should be explored. In this regard, consultations should be held with the financial institutions to investigate the feasibility of providing information related to electronic transactions with non-residents and which could be provided to SARS through the IT3 mechanism. However, any such mechanism should not impose an excessive compliance burden on the financial institutions relative to the benefit to SARS.[192]

11 INDIRECT TAXES AND THE DIGITAL ECONOMY

191 OECD/G20 2015 Final Report on Action 1 per Box 7.1 at 105.
192 PWC Comments on “DTC BEPS First Interim Report” (30 March 2015) at 10.

Given the difficulties that countries face in asserting direct income taxes on e-commerce, assessing indirect taxes on the transactions has proven much easier.[193] The argument is that when companies scoop up local customer information and resell it to advertisers, the digital upload is a business-to-consumer transaction requiring no physical presence of the business (in terms of the permanent establishment principle). It doesn't matter what the business is selling - there is value creation wherever there is a customer base, regardless of data sharing. The presence of the immobile local consumer and the economic activity of the non-resident business should be the focus.[194]

In Spain for instance, a web presence, server and even inventory located in the country may not create a PE for income taxation. However, it is likely enough to find jurisdiction for VAT collection purposes.[195] In Canada the tax authorities are less concerned with PE and profit allocation than collecting customs duties and the goods and services tax (Canada's VAT analogue). The focus on a transaction tax, rather than a profit tax, in an e-commerce environment makes sense.[196] There is a case to be made that getting the VAT determinations correct "is more important than figuring out if a PE exists.[197]

11.1 PREVIOUS OECD WORK ON APPLYING INDIRECT TAXES TO THE DIGITAL ECONOMY

At the 1999 Ottawa Ministerial Conference on Electronic Commerce,[198] leaders from governments (29 OECD member countries and 11 non-member countries), heads of major international organisations, industry leaders, and representatives of consumer, labour and social interests discussed plans to promote the development of global electronic commerce. The leaders welcomed the 1998 OECD's Report "Electronic Commerce: Taxation Framework Conditions",[199] and endorsed the set of taxation principles which should apply to electronic commerce.[200] In the field of consumption

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193 J Arora & LE Shepherd "Adjusting Jurisdictional Concepts for E-commerce Tax Analyst 8 october 2013. Available at http://services.taxanalysts.com/taxbase/tni3.nsf/(Number/2013+WTD+195-1?OpenDocument&Login accessed 29 October 2013.

194 L Shepperd "What should the OECD do about Base Erosion?" Copenhagen precise of 2013 International Fiscal Association annual Congress" 9/9/2013.

195 J Arora & LE Shepherd "Adjusting Jurisdictional Concepts for E-commerce Tax Analyst 8 October 2013. Available at http://services.taxanalysts.com/taxbase/tni3.nsf/(Number/2013+WTD+195-1?OpenDocument&Login accessed 29 October 2013.

196 Ibid.

197 Ibid.

198 OECD "Forum Background: The Ottawa Conference" (October 1999). Available at http://www.oecd.org/sti/ieconomy/forumbackgroundtheottawaconference.htm accessed 5 May 2014.

199 OECD "Electronic Commerce: Taxation Framework Conditions" (1998). Available at http://www.biac.org/members/tax/BEPS/Ottawa_tax_Framework_923256.pdf accessed 5 May 2014.

200 OECD 2014 Discussion Draft Report on Action 1 in Annex 1.

taxes, the core elements of the Taxation Framework Conditions can be summarised as follows:[201]

- Rules for the consumption taxation of cross-border trade should result in taxation in the jurisdiction where consumption takes place and international consensus should be sought on the circumstances under which supplies are held to be consumed in a jurisdiction.
- For the purpose of consumption taxes, the supply of digitised products should not be treated as a supply of goods.
- Where business and other organisations within a country acquire services and intangibles from suppliers outside the country, countries should examine the use of reverse charge, self-assessment or other equivalent mechanisms where this would give immediate protection of their revenue base and of the competitiveness of domestic suppliers.

In 2003 the OECD Committee on Fiscal Affairs (CFA) released its E-commerce Guidelines. The CFA also released the Consumption Tax Guidance Series along with these Guidelines, consisting of three papers providing guidance on the implementation of the Guidelines in practice. These Guidelines and Guidance papers are summarised in the OECD Discussion Draft Report on Action 1 as follows:

> "Destination based taxation of cross-border e-business was the governing principle of the E-commerce Guidelines. Under the destination principle, tax is ultimately levied only on the final consumption within the jurisdiction where such consumption is deemed to occur. Exports are not subject to tax with refund of input taxes (that is, "free of VAT" or "zero-rated"), and imports are taxed on the same basis and at the same rates as domestic supplies. The E-commerce Guidelines provide that:
>
> - For business-to-business transactions, the place of consumption for cross-border supplies of services and intangibles that are capable of delivery from a remote location made to a non-resident business recipient should be the jurisdiction in which the recipient has located its business presence. This was referred to as the "main criterion". The Guidelines indicated that countries may, in certain circumstances, use a different criterion to determine the actual place of consumption, where the application of the main criterion "would lead to a distortion of competition or avoidance of tax." This was referred to as the "override criterion".
> - For business-to-consumer transactions, the place of consumption for cross-border supplies of services and intangibles that are capable of delivery from a remote location made to a non-resident private recipient should be the jurisdiction in which the recipient has its usual residence."[202]

These OECD Guidelines essentially provide that consumption taxes (such as VAT) should be levied in the jurisdiction where consumption takes place. This principle was again confirmed in the International VAT/GST Guidelines released by the OECD Global Forum on VAT.[203]

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201 OECD 2014 Discussion Draft Report on Action 1 in para 3.3 of Annex 1.

202 OECD 2014 Discussion Draft Report on Action 1 in para 242.

203 OECD "International VAT/GST Guidelines: Draft Consolidated Version" (February 2013) http://www.oecd.org/ctp/consumption/ConsolidatedGuidelines20130131.pdf accessed 6 May 2014.

The OECD notes that with increased cross-border transactions as a result of e-Commerce it is crucial that legislation is not adopted which will cause difficulties in imposing VAT on the supply or result in double taxation with another VAT jurisdiction. Despite the local objectives and the desire to protect the local tax base, e-commerce cannot be effectively taxed if principles are adopted which are in contradistinction with principles of a good tax system i.e. neutrality; efficiency; certainty and simplicity; effectiveness and fairness; and flexibility. The OECD recommends that countries adhere to the principles of a good tax system. Reference is made to promoting the use of “shared basic principles”, in developing VAT legislation for e-commerce in order to “prevent double taxation, involuntary non-taxation, tax evasion and distortion of competition”. [204] The OECD International VAT/GST Guidelines, Draft Consolidated Version 2013 in particular supports and reiterates this concept of neutrality, noting that:

> “The concept of tax neutrality in VAT has a number of dimensions, including the absence of discrimination in a tax environment that is unbiased and impartial and the elimination of undue tax burdens and disproportionate or inappropriate compliance costs for businesses. Neutrality is one of the principles that help to ensure the collection of the right amount of revenue by governments.” [205]

The OECD notes however that it may be appropriate for tax administrations to impose specific compliance requirements on different categories of business. This may apply, for example, to small enterprises and enterprises in specific sectors. It may also apply to foreign businesses. Indeed, dealing with foreign businesses with no “legal” presence in a jurisdiction inevitably brings an element of risk for tax administrations and they may need to take appropriate measures to protect against fraud or avoidance. Tax administrations should also seek to balance these appropriate measures with the need to prevent unjustified discrimination. In other words, specific rules applicable to foreign businesses should not result in a disguised form of discrimination. It is also important that such specific requirements are clear, consistent and accessible to foreign businesses.[206]

With respect to the principle of “efficiency” the OECD VAT guidelines require that compliance costs for taxpayers and administrative costs for the tax authorities should be minimized as far as possible.

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204 OECD Consumption Tax Trends, VAT / GST and Excise Rates, Trends and Administration Issues.

205 OECD “International VAT/GST Guidelines: Draft Consolidated Version” (February 2013) http://www.oecd.org/ctp/consumption/ConsolidatedGuidelines20130131.pdf accessed 6 May 2014.

206 OECD *International VAT / GST Guidelines, Draft Consolidated Version, Invitation for Comments (February 2013)* pgs 15, 18. Available at www.**oecd**.org/tax/consumption/**ConsolidatedGuidelines**20130131.pdf *[Accessed 26 August 013]*

The VAT registration threshold is supported by the OECD and applied by several VAT jurisdictions. The OECD notes that "the threshold model is fairly well established internationally". Furthermore, thresholds ensure that the compliance burden is eliminated where it would reduce or negate the incentive to carry on business activity. The OECD Working Party studied the advantages and disadvantages of registration thresholds for B2C (Business-to-Consumer) transactions on the basis of competitive equity between domestic and non-domestic suppliers, and the compliance burden imposed on private-sector stakeholders. It noted that thresholds can act to reduce the administrative burden, by permitting tax administrations to focus resources where the return is likely to be high.

The OECD guidelines with respect to "'registration"' as a tax collection mechanism provide that:

> "A registration system would oblige non-resident businesses to register in a jurisdiction and to charge, collect and remit the consumption tax to that country. From an administrative point of view, for the most part this option is feasible, effective and would promote neutrality. Difficulties arise in terms of identifying non-resident suppliers, as well as in imposing registration requirements and enforcing obligations on non-residents… registration would also impose significant compliance costs on non-resident suppliers, particularly for those making supplies in multiple jurisdictions with relatively few sales in each jurisdiction"

The Working Party studied the advantages and disadvantages of registration thresholds for B2C transactions on the basis of competitive equity between domestic and non-domestic suppliers, and the compliance burden imposed on private-sector stakeholders. It concluded that thresholds ensure that the compliance burden is eliminated where it would reduce or negate the incentive to carry on business activity. The principal disadvantage of registration thresholds, however, is the risk to neutrality/competitive equity between taxpayers below and above the threshold (although this is not a new problem for those revenue authorities that already operate a registration threshold for indirect taxation)

The OECD Working Party recognised that the threshold model is fairly well established internationally. It is likely that tax administrations will choose to take a similar approach to e-commerce. In light of this, the Working Party recommends that Member countries accept the principle that registration thresholds should apply in a non-discriminatory manner. The Taxation Framework Conditions recommend that revenue authorities should minimise compliance costs for taxpayers and administrative costs for revenue authorities as far as possible.[207]

12 INTERNATIONAL TRENDS ON INDIRECT TAXES AND THE DIGITAL ECONOMY

207 OECD *Taxation and Electronic Commerce, Implementing the Ottawa Taxation Framework Conditions* (2001) pgs 30 -31, 36.

12.1 THE EUROPEAN UNION (EU)

The EU VAT Directive[208] provides a very clear list of items and supplies which constitute electronically supplied services. The EU VAT Directive, furthermore, makes a distinction between electronically supplied services and "telecommunications services". Supplies made by electronic means are categorised as either, the supply of services, supply of intangible personal property or supply of telecommunication services (depending on what is being supplied).

Even though the OECD recommends the harmonization of VAT systems, and often the EU VAT system is looked at as demonstration of how harmonisation can be effectively applied, the EU has recently come up with a VAT Directive[209] that would not fit in the South African context and should not be followed. The previous EU VAT legislation required registration in the individual EU Member States subject to the registration requirements and thresholds applicable in each EU Member State. However the EU has amended its provisions relating to VAT administration and compliance in order to address administration and compliance of e-Commerce supplies by non-EU Member residents to EU residents as a whole and not on an individual EU Member State basis. In terms of the changes, a non-EU supplier will have to register for VAT in the EU with respect to e-commerce supplies made to EU Member residents, regardless of turnover, but will only have to register for VAT in one EU jurisdiction and account for all VAT imposed and collected for all supplies made to all EU Member States to the one EU Member State in which the non-EU supplier has registered. Thus, the administrative burden of requiring non-EU Member suppliers to register for VAT in multiple countries has been eliminated and the need to impose a VAT registration threshold to limit or reduce such administrative burden is no longer necessary. If the e-commerce supplies made to all EU Member states was examined as a whole, they would most likely be substantial thereby justifying the administrative burden of requiring registration.

South Africa differs from the EU in this regard and the administrative and compliance aspects of South Africa may be more closely associated with other non-EU VAT jurisdictions. South Africa should not follow the recent administrative changes made in the EU with respect to non-EU Member resident e-Commerce suppliers ("non-EU supplier") and the requirement to register for VAT in the EU regardless of turnover. South Africa should follow the OECD principle of neutrality and the OECD recommendations to apply a VAT registration threshold in such circumstances. To ensure VAT neutrality the VAT registration requirements which apply to South African e-commerce suppliers should also apply to non-resident e-commerce suppliers. The registration requirements which apply to local residents (the registration thresholds) should also apply to foreign e-commerce suppliers. (It should

[208] Directive 2006/112/EC.
[209] Directive 2013/42/EU and Directive 2013/43/EU.

be noted though that the compliance by the non-resident suppliers would still remain and issues and that this problem is not limited to e-commerce supplies).

12.2 CANADA

Like the EU, Canada has a definition of "telecommunication services" in its legislation; which is distinct from electronically supplied services. The term "telecommunication services" is defined as "the transmission of any information by means of a system for telecommunication or any part thereof and includes the making available of such a system or part for that use, whether or not it is so used."[210]

VAT registration is required in Canada if the non-resident supplier has a PE in Canada and is not a "small supplier"; or does not have a PE in Canada but make taxable supplies in Canada in the course of a business carried; on in Canada (subject to requirements).[211] The registration requirement may be summarised as follows:

> "Every non-resident person, other than a small supplier, who is carrying on business in Canada and is making taxable supplies in Canada, including supplies made by electronic means, is required to register for GST/HST purposes and to charge GST/HST on its taxable (other than zero-rated) supplies made in Canada. As well, a non-resident person who has a permanent establishment in Canada (which could include a server) is treated as a resident of Canada, and is subject to the same GST/HST obligations as a domestic supplier in respect of activities carried on through that permanent establishment."[212] [Emphasis added].

A "Small supplier" is effectively any supplier, other than a public service body, that has taxable supplies of CA $30,000 or less (CA $50,000 for a public service body). Thus, Canada also supports a VAT registration threshold for non-resident suppliers of electronic commerce.[213]

12.3 NEW ZEALAND

Like in the EU and in Canada, New Zealand has a definition of "telecommunication services" in its legislation. Subject to exceptions, a non-New Zealand supplier of telecommunications services (subject to different place of supply rules) is required to register for VAT in New Zealand as such services are treated as being supplied in New Zealand where the value of such supplies exceeds NZ $40,000 in a 12 month period. Electronically supplied services, which constitute 'content of telecommunication services' and subject to the general place of supply rules, are generally subject to VAT in terms of the reverse charge mechanism, but only with respect to Business-to-Business supplies. However, the reverse charge mechanism

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210 Canadian Revenue Authority "GST/HST Technical Information" Bulletin *GST / HST and Electronic Commerce* (July 2002) at 3
211 Ibid.
212 Ibid.
213 Ibid.

may require the recipient to register for VAT in New Zealand where the supplies received exceed NZ $60,000 in a 12 month period. While New Zealand applies slightly different rules with respect to imposing and collecting VAT on such supplies (i.e. the administrative aspect is different to that of the EU), VAT registration thresholds are nevertheless applied regardless of who must register and account for VAT on such supplies.

13 OECD BEPS ACTION ON THE DIGITAL ECONOMY: INDIRECT TAXES

In the 2013 OECD report on BEPS Action 1 points out the challenges the digital economy poses to international taxation.[214] With respect to indirect taxes, the OECD called on countries to ensure the effective collection of VAT/GST with respect to cross-border supply of digital goods and services. The 2015 Final Report on the digital economy exposes how the digital economy can be used to circumvent indirect taxes and it provides recommendations to curb base erosion

13.1 OPPORTUNITIES FOR BEPS IN THE DIGITAL ECONOMY WITH RESPECT TO INDIRECT TAXES

The OECD 2015 Final Report on the digital economy notes that if the OECD's "Guidelines on place of taxation for B2B supplies of services and intangibles" are not implemented, opportunities for tax planning by businesses and corresponding BEPS concerns for governments in relation to VAT may arise with respect to:

- remote digital supplies to exempt businesses, and
- remote digital supplies acquired by enterprises that have establishments (branches) in more than one jurisdiction (multiple location entities – MLE) that are engaged in exempt activities.[215]

13.1.1 REMOTE DIGITAL SUPPLIES TO EXEMPT BUSINESSES

VAT is generally not designed to be a tax on businesses as businesses are generally able to recover any tax they pay on their inputs. Many VAT jurisdictions using the destination principle for business-to-business (B2B) digital supplies will generally require a business customer in their jurisdiction to self-assess VAT on acquisitions of remotely delivered services and intangibles and then allow the business to claim a credit for this self-assessed VAT. The vast number of cross-border supplies made between businesses (other than businesses engaged in exempt activities) do not therefore, generally create BEPS concerns.[216]

BEPS concerns in a VAT context could arise however, with respect to offshore digital supplies made to exempt businesses (e.g. the financial services industry). Where a

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[214] OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 14.
[215] OECD/G20 2015 Final Report on Action 1 in para 197.
[216] OECD/G20 2015 Final Report on Action 1 in para 198.

business is engaged in VAT-exempt activities, no VAT is levied on the exempt supplies made by the business, while VAT incurred by the business on the associated inputs is not deductible. For example, a business acquiring a data processing service from a non-resident supplier would be required to self-assess VAT according to the rules of the jurisdiction in which it is located and could claim an off-setting credit for this self-assessed VAT (some jurisdictions may not require the business to self-assess tax as it is entitled to an offsetting credit). If the business customer is an exempt business, it is still required to self-assess VAT in these jurisdictions but would not be able to claim a credit for the self-assessed tax. The exempt business is then "input taxed" in its residence jurisdiction, where it is assumed to use the service for making exempt supplies. [217]

However, some jurisdictions currently do not require the exempt business to self-assess VAT on the services and intangibles acquired from abroad. In such case, no VAT is levied on the transaction.

BEPS concerns also arise if the data processing services would be subject to VAT in the jurisdiction where the supplier is resident (established, located). The VAT would then accrue to the jurisdiction in which the supplier is situated and not the jurisdiction of the exempt business. This is likely to raise concerns particularly where this jurisdiction has no VAT or a VAT rate lower than the rate in the jurisdiction of the exempt business customer. In these cases, the exempt business customer would pay no VAT or an inappropriately low amount of VAT.

The above cases illustrate how an exempt business could pay no or an inappropriately low amount of VAT when acquiring digital supplies from suppliers abroad. They also illustrate how domestic suppliers of competing services could face potential competitive pressures from non-resident suppliers. Domestic suppliers are required to collect and remit VAT on their supplies of services to domestic businesses while non-resident suppliers could structure their affairs so that they collect no or an inappropriately low amount of VAT. [218]

13.1.2 REMOTE DIGITAL SUPPLIES TO A MULTI-LOCATION ENTERPRISE

BEPS concerns could also arise in cases where a digital supply is acquired by an MNE. It is common practice for multinational businesses to arrange for a wide scope of services to be acquired centrally to realise economies of scale.

- Typically, the cost of acquiring such a service or intangible is initially borne by the establishment that has acquired it and, in line with normal business practice, is subsequently recharged to the establishments using the service or intangible. The establishments are charged for their share of the service or

217 OECD/G20 2015 Final Report on Action 1 in para 199.
218 OECD/G20 2015 Final Report on Action 1 in para 203.

intangible on the basis of the internal recharge arrangements, in accordance with corporate tax, accounting and other regulatory requirements.

- However, many VAT jurisdictions do not currently apply VAT to transactions that occur between establishments of one single legal entity.[219] This means that where an establishment of an MLE acquires a service, for instance data processing services, for use by other establishments in other jurisdictions, no additional VAT would apply on any internal cost allocations or recharges made within the MLE for the use of these services by other establishments.
- On the other hand, the establishment that acquired the service will be generally entitled to recover any input VAT on the acquisition of these services if it is a taxable business. In other words, the other establishments using the data processing services are able to acquire their portion of these services without incurring any VAT. This is generally not a great concern from a VAT perspective if all of the establishments of the MLE using the service are taxable businesses. This is because in this case they have a right to recover any input VAT. However, where the establishments using the data processing services are exempt businesses, they are not normally entitled to recover VAT paid on their inputs. [220]

13.2 ADDRESSING BEPS ISSUES IN THE AREA OF CONSUMPTION TAXES

The digitisation of the economy has greatly facilitated the ability of businesses to acquire a wide range of services and intangibles from suppliers in other jurisdictions around the world and to structure their operations in a truly global manner. These developments have allowed exempt businesses to avoid and minimise the amount of unrecoverable VAT they pay on their inputs. Such opportunities for tax planning by businesses and corresponding BEPS concerns for governments may arise to the extent that the OECD's Guidelines on place of taxation for business-to-business (B2B) supplies of services and intangibles are not implemented.

- The implementation of Guidelines 2 and 4 of the OECD's International VAT/GST Guidelines on place of taxation for business-to-business (B2B) supplies of services and intangibles will minimise BEPS opportunities for supplies of remotely delivered services and intangibles made to exempt businesses, including exempt entities that operate through establishments (branches) in multiple jurisdictions.[221]
- Guideline 2 recommends that the taxing rights on cross-border supplies of services and intangibles between businesses be allocated to the jurisdiction where the customer has located its business establishment and that business customers be required to self-assess VAT on remotely delivered services or

219 OECD/G20 2015 Final Report on Action 1 in para 201.
220 OECD/G20 2015 Final Report on Action 1 in para 201.
221 OECD/G20 2015 Final Report on Action 1 in para 238.

intangibles acquired from offshore suppliers according to the rules of the jurisdiction in which they are located.[222]

- Guideline 4 provides that when a supply is made to a business that is established in more than one jurisdiction, taxation should accrue to the jurisdiction where the customer's establishment (branch) using the service or intangible is located. These Guidelines set out the possible mechanisms for tax authorities to achieve the desired result in practice, which is allocation of the right to levy VAT on B2B services and intangibles to the jurisdiction where these services are used for business purposes irrespective of how the supply and acquisition of these services and intangibles were structured.[223]

13.3 BROADER INDIRECT TAX CHALLENGES RAISED BY THE DIGITAL ECONOMY AND THE OPTIONS TO ADDRESS THEM

13.3.1 CHALLENGES IN THE COLLECTION OF VAT IN THE DIGITAL ECONOMY

Cross-border trade in goods, services and intangibles (which include for VAT purposes digital downloads) create challenges for VAT systems, particularly where such products are acquired by private consumers from suppliers abroad. The digital economy magnifies these challenges, as the evolution of technology has dramatically increased the capability of private consumers to shop online and the capability of businesses to sell to consumers around the world without the need to be present physically or otherwise in the consumer's country. This often results in no or an inappropriately low amount of VAT being levied on these flows, with adverse effects on countries' VAT revenues and on the level playing field between resident and non-resident vendors.[224] The main tax challenges related to VAT in the digital economy relate to:

- imports of low value parcels from online sales which are treated as VAT-exempt in many jurisdictions, and
- the strong growth in the trade of services and intangibles, particularly sales to private consumers, on which often no or an inappropriately low amount of VAT is levied due to the complexity of enforcing VAT-payment on such supplies.[225]

(a) Exemptions for imports of low valued goods: The first challenge regarding collection of VAT arises from the growth that has occurred in e-commerce and in particular, online purchases of physical goods made by consumers from suppliers in another jurisdiction. Countries with VAT collect tax on imports of goods from the importer at the time the goods are imported using customs collection mechanisms. Many VAT jurisdictions apply an exemption from VAT for imports of low value goods

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222 OECD/G20 2015 Final Report on Action 1 in para 239.
223 OECD/G20 2015 Final Report on Action 1 in para 240.
224 OECD/G20 2015 Final Report on Action 1 in para 309.
225 OECD/G20 2015 Final Report on Action 1 in para 309.

as the administrative costs associated with collecting the VAT on the goods is likely to outweigh the VAT that would be collected on those goods. The value at which the exemption threshold is set varies considerably from country to country but regardless of the threshold value, many VAT countries have seen a significant growth in the volume of low value imports on which VAT is not collected.[226]

Challenges arise from the ability of businesses to deliberately structure their affairs to take advantage of a country's low value thresholds and sell goods to consumers without the payment of VAT. For example, a domestic business selling low value goods online to consumers in its jurisdiction would be required to collect and remit that jurisdiction's VAT on its sales. The business could restructure its affairs so that the low value goods are instead shipped to its consumers from an offshore jurisdiction and therefore qualify under that VAT jurisdiction's exemption for low value importations. Similarly, a business starting up could structure its operations to deliberately take advantage of the low value exemption and locate offshore rather than in the jurisdiction in which its customers are located. [227]

The exemption for low value imports results in decreased VAT revenues and the possibility of unfair competitive pressures on domestic retailers who are generally required, depending for instance on their size, to charge VAT on their sales to domestic consumers. As a consequence, the concern is not only this immediate loss of revenue and competitive pressures on domestic suppliers, but also the incentive that is created for domestic suppliers to locate or relocate to an offshore jurisdiction in order to sell their low value goods free of VAT. It should also be noted that such relocations by domestic businesses would have added negative impacts on domestic employment and direct tax revenues. [228]

The exemptions for low value imports have therefore become increasingly controversial in the context of the growing digital economy. The difficulty lies in finding the balance between the need for appropriate revenue protection and avoidance of distortions of competition, which tend to favour a lower threshold and the need to keep the cost of collection proportionate to the relatively small level of VAT collected, which favours a higher threshold. At the time when most current low value import reliefs were introduced, internet shopping did not exist and the level of imports benefitting from the relief was relatively small. Over recent years, many VAT countries have seen a significant and rapid growth in the volume of low value imports of physical goods on which VAT is not collected resulting in decreased VAT revenues and growing unfair competitive pressures on domestic retailers who are required to charge VAT on their sales to domestic consumers. [229]

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[226] OECD/G20 2015 Final Report on Action 1 in para 310.
[227] OECD/G20 2015 Final Report on Action 1 in para 311.
[228] OECD/G20 2015 Final Report on Action 1 in para 312.
[229] OECD/G20 2015 Final Report on Action 1 in para 313.

(b) Remote digital supplies to consumers: The second challenge regarding collection of VAT arises from the strong growth in cross-border business-to-consumer (B2C) supplies of remotely delivered services and intangibles. The digital economy has increasingly allowed the delivery of such products by businesses from a remote location to consumers around the world without any direct or indirect physical presence of the supplier in the consumer's jurisdiction. Such remote supplies of services and intangibles present challenges to VAT systems, as they often result in no or an inappropriately low amount of VAT being collected and create potential competitive pressures on domestic suppliers. [230]

Consider an example of an online supplier of streaming digital content such as movies and television shows. The supplies are made mainly to consumers who can access the digital content through their computers, mobile devices and televisions that are connected to the internet. If the supplier is resident in the same jurisdiction as its customers, it would be required to collect and remit that jurisdiction's VAT on the supplies. However, if the supplier is a non-resident in the consumer's jurisdiction, issues may arise. [231]

Broadly two approaches are used by countries for applying VAT to such cross-border supplies of services or intangibles:

- the first approach allocates the taxing rights to the jurisdiction where the supplier is resident; whereas
- the second approach allocates the taxing rights to the jurisdiction where the customer is resident. [232]

If the first approach is applied to the supply of digital content in the example, then this supply will be subject to VAT in the supplier's jurisdiction at the rate that is applicable in that jurisdiction. If the jurisdiction of the supplier of the digital content in the example applies no VAT or a VAT with a lower rate than that of the consumer's jurisdiction, then no or an inappropriately low amount of VAT would be collected on this supply and none of the VAT revenue would accrue to the jurisdiction where the final consumption takes place. [233]

The second approach that allocates the taxing rights to the jurisdiction where the customer is resident would, in principle, result in taxation in the jurisdiction of consumption. However, under this approach, it is challenging for the private consumers' jurisdictions to ensure an effective collection of the VAT on services and intangibles acquired by such consumers abroad. One option is to require the private consumer to remit, or "self-assess", the VAT in its jurisdiction at the rate applicable in this jurisdiction. However, such consumer self-assessment mechanism has proven

[230] OECD/G20 2015 Final Report on Action 1 in para 314.
[231] OECD/G20 2015 Final Report on Action 1 in para 315.
[232] OECD/G20 2015 Final Report on Action 1 in para 316.
[233] OECD/G20 2015 Final Report on Action 1 in para 316.

to be largely ineffective and as result, it is highly likely that no VAT would be paid by the consumer in this scenario.[234]

The OECD's E-commerce Guidelines of 2003 therefore recommend a mechanism that requires the non-resident supplier to register, collect and remit VAT according to the rules of the jurisdiction in which the consumer is resident. This results in the correct amount of VAT being paid in the jurisdiction of consumption. This approach, however, is dependent on the non-resident supplier complying with the requirement to register, collect and remit the VAT. In other words, if taxing rights are allocated to the jurisdiction of consumer residence without implementing a suitable mechanism to collect the tax in this jurisdiction, it is unlikely that VAT would be paid. [235]

- The example above illustrates how domestic suppliers of competing services could face potential competitive pressures from non-resident suppliers. Domestic suppliers are required to collect and remit VAT on their supplies of services and intangibles to their domestic consumers while the non-resident supplier, depending on the scenario, could structure its affairs so that it collects and remits no or an inappropriately low amount of tax.
- The example also illustrates how an incentive could arise for domestic suppliers to restructure their affairs so that their supplies of services and intangibles are made from an offshore location, which could allow them to make the supplies with no or an inappropriately low amount of VAT. This incentive could arise as a response to competition from non-resident suppliers who are collecting no or an inappropriately low amount of VAT or as part of a strategy to gain a potential competitive advantage over domestic suppliers who are charging VAT. Such relocations by domestic businesses are likely to have a negative impact on domestic employment and direct tax revenues. [236]

Against this background, jurisdictions are increasingly looking at ways to ensure the effective collection of VAT on services and intangibles acquired by resident consumers from suppliers abroad through a digital platform, in line with the destination principle, relying primarily on a requirement for non-resident suppliers to register and collect and remit the tax.

- Compliance with these requirements is essentially voluntary as the consumers' jurisdictions have limited means to enforce compliance by non-resident non-established suppliers.
- The experience in countries that have implemented such an approach suggests that a significant number of suppliers comply by either registering in the VAT jurisdiction and collecting and remitting tax on their remotely delivered services, or by choosing to establish a physical presence in the jurisdiction and effectively becoming a "domestic" supplier.

234 OECD/G20 2015 Final Report on Action 1 in para 317.
235 OECD/G20 2015 Final Report on Action 1 in para 317.
236 OECD/G20 2015 Final Report on Action 1 in para 318.

- It has been suggested that particularly the high-profile operators, which occupy a considerable part of the market, wish to be seen to be tax-compliant notably for reputational reasons.
- In the absence of a system that makes it easy for non-resident businesses to comply and without having well-functioning means of international co-operation between tax authorities, however, many non-resident suppliers are likely to fail to register and remit the VAT in the consumer's jurisdiction, without any real possibility for tax authorities to audit and sanction them. As a result, there is a loss of VAT revenue to these jurisdictions and potentially unfair competitive pressures on domestic suppliers. [237]

Some VAT regimes that allocate taxing rights to the jurisdiction of the residence or the actual location of the consumer, have not implemented a mechanism for collecting the VAT on services acquired by private consumers from non-resident suppliers. This has notably been based on the consideration that it would be overly burdensome on tax administrations to operate such a collection mechanism. As a result, no VAT is paid on digital supplies imported in these jurisdictions by private consumers. The strong growth of the digital economy, particularly the growing scale of B2C trade in digital products, may render this approach increasingly unsustainable. [238]

13.3.2 ADDRESSING THE BROADER INDIRECT TAX CHALLENGES OF THE DIGITAL ECONOMY

The OECD notes that collection of VAT on cross-border transactions concluded through digital media is a key issue that must be addressed urgently to level the playing field between foreign and domestic suppliers and to protect countries' VAT revenues.[239]

(a) The collection of VAT on imports of low value goods

When countries implement the VAT exemption thresholds for imports of low value goods, they generally attempt to find the appropriate balance between the administrative and compliance costs of taxing low value imports and the revenue loss and potential competitive distortions that the exemptions may create. However, these exemption thresholds were generally established before the advent and growth of the digital economy and a review may therefore be required to ensure that they are still appropriate. [240]

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[237] OECD/G20 2015 Final Report on Action 1 in para 319.
[238] OECD/G20 2015 Final Report on Action 1 in para 320.
[239] OECD/G20 2015 Final Report on Action 1 in para 321.
[240] OECD/G20 2015 Final Report on Action 1 in para 322.

If the efficiency of processing imports of low value goods and of collecting the VAT on such imports could be improved, governments may be in a position to lower these VAT exemption thresholds and address the issues associated with their operation. Against this background, the OECD came up with possible options or combinations of options for a more efficient collection of VAT on imports of low value goods, for governments to consider depending on their domestic situation and their exposure to imports of low value goods. [241]

The OECD Low Value Imports Report identifies four broad models for collecting VAT on low value imports and it assesses their likely performance. These models are:

- the traditional collection model
- the purchaser collection model
- the vendor collection model and
- the intermediary collection model.

The distinction between these collection models is essentially based on the person liable to account for the VAT. The traditional collection model is the model that is generally applied currently for the collection of duties and taxes at importation, and that is often combined with a VAT exemption for imports of low value goods. The other three models present possible alternative approaches for a more efficient collection of VAT on the importation of low value goods. The operation of these models and their likely performance are summarised below. [242]

<u>The traditional collection model:</u> The traditional collection model, where VAT is assessed at the border for each imported low value good individually, is generally found not to be an efficient model for collecting the VAT on imports of low value goods. This is certainly the case in the absence of electronic data transmission systems to replace the existing paper based and manual processes. The efficiency of the traditional collection model may improve over time, as and when electronic systems for pre-arrival declaration and electronic tax assessment and payment are implemented worldwide to replace paper based and manual verification processes. These new electronic processes are already prevalent in the express carrier environment where they have resulted in considerable efficiency gains. The consistent use of such electronic systems would improve the efficiency of the traditional collection model for both tax administrations and vendors. Their worldwide implementation might allow the removal of the current VAT exemption thresholds. The Low Value Import Report notes, however, that these systems are not yet available to process the import of the considerable numbers of low value goods that are moved by postal services. These electronic processes for the postal environment are still under development and may only be available in the medium term.[243]

241 OECD/G20 2015 Final Report on Action 1 in para 323.
242 OECD/G20 2015 Final Report on Action 1 in para 325.
243 OECD/G20 2015 Final Report on Action 1 in para 327.

The purchaser collection model: A model relying on the purchaser to self-assess and pay the VAT on its imports of low value goods is not likely to provide a sufficiently robust solution for an efficient collection of the tax. Although the purchaser collection model is likely to involve only limited compliance burden for vendors, the level of compliance by purchasers is expected to be low and this model would be highly complex and costly for customs and tax administrations to implement and operate. [244]

The vendor collection model: A model requiring the non-resident vendors to charge, collect and remit the VAT in the country of importation could improve the efficiency of the collection of VAT on low value imports and thus create opportunities for governments to remove or reduce import exemption thresholds if they wish to do so. While a vendor collection model would create additional burden for non-resident vendors, these can be mitigated by complementing this model with a simplified VAT registration and compliance regime similar to the one suggested in the context of the OECD International VAT/GST Guidelines on B2C supplies of services and intangibles (B2C Guidelines). When a vendor supplies both goods and services into a particular jurisdiction, the registration system applied under the B2C Guidelines could be used for both kinds of supplies. This would reduce the administrative and compliance costs of the vendor registration. Implementation of such a model is likely to involve considerable changes to existing customs and tax collection processes and systems, and that enhanced international and inter-agency (tax and customs administrations) co−operation would be required to help ensure compliance by non-resident vendors under this model. [245]

The intermediary collection model: A model where VAT on imports of low value goods would be collected and remitted by intermediaries on behalf of non-resident vendors could improve the efficiency of the collection of VAT on such imports and thus create opportunities for governments to remove or reduce import exemption thresholds, assuming that such intermediaries would have the required information to assess and remit the right amount of taxes in the country of importation. The VAT collection by intermediaries would involve minimal compliance burdens on vendors. It may, however, come at an additional cost that may be passed on to the purchaser. This model may be particularly effective when the VAT is collected by intermediaries that have a presence in the country of importation. Four main types of intermediaries are identified: postal operators; express carriers; transparent e-commerce platforms and financial intermediaries. [246]

[244] OECD/G20 2015 Final Report on Action 1 in para 328.
[245] OECD/G20 2015 Final Report on Action 1 in para 329.

[246] OECD/G20 2015 Final Report on Action 1 in para 330.

(b) The collection of VAT on cross-border business-to-consumer supplies of services and intangibles

The B2C Guidelines present a set of standards for determining the place of taxation for B2C supplies of services and intangibles, in accordance with the destination principle. They provide that the jurisdiction in which the customer has its usual residence has the right to collect VAT on remote supplies of services and intangibles, including digital supplies by offshore suppliers. This standard allows suppliers and tax administrations to predict with reasonable accuracy the place where the services or intangibles are likely to be consumed while taking into account practical constraints. The implementation of these standards aims at ensuring that VAT on such supplies in the market jurisdiction applies at the same rate as for domestic supplies. This ensures the even playing field between domestic and offshore suppliers, so that there is no tax advantage for foreign companies based in low or no tax jurisdictions selling to final consumers relative to domestic companies.[247]

Regarding the key issue of the collection of VAT in the destination country, the B2C Guidelines indicate that, at the present time, the most effective and efficient approach to ensure the appropriate collection of VAT on cross-border B2C supplies is to require the non-resident supplier to register and account for VAT in the jurisdiction of taxation. The B2C Guidelines recommend that jurisdictions consider establishing a simplified registration and compliance regime to facilitate compliance for non-resident suppliers. Appropriate simplification is particularly important to facilitate compliance for businesses faced with obligations in multiple jurisdictions. At the same time, in considering simplified registration for VAT purposes, it is important to underline that registration for VAT purposes is independent from the determination of whether there is a PE for income tax purposes. Recognising that a proper balance needs to be struck between simplification and the need of governments to safeguard the revenue, the B2C Guidelines indicate that it is necessary that jurisdictions take appropriate steps to strengthen international administrative co-operation, which is a key means to achieve the proper collection and remittance of the tax on cross-border supplies of services and intangibles by non-resident suppliers. [248]

Under the B2C Guidelines, the OECD recommends that:

- the jurisdiction of the usual residence of the customer will have the right to levy VAT on the supply of the digital content,
- the foreign seller will be required to register for VAT in that market jurisdiction under a simplified registration and compliance regime, and
- the foreign seller will be required to charge and collect the VAT in that jurisdiction at the same rate as for domestic supplies.

247 OECD/G20 2015 Final Report on Action 1 in para 336.
248 OECD/G20 2015 Final Report on Action 1 in para 337.

These Guidelines recognise explicitly that it is necessary to reinforce taxing authorities' enforcement capacity through enhanced international co-operation in tax administration in the field of indirect taxes. They recommend that such co-operation be enhanced through the development of a common standard for the exchange of information that is simple, minimises the costs for tax administrations and businesses by limiting the amount of data that is exchanged, and which can be implemented in a short timeframe.[249]

14 INDIRECT TAXATION AND THE DIGITAL ECONOMY IN SOUTH AFRICA

The principal deficiency in modern VAT systems is their inability to levy VAT on affected transactions through a simplified collection mechanism that does not overburden taxable entities charged with VAT collection, or is not inefficient from an economic point of view. VAT systems operate based on tax policy, tax administration, and the law. If any of these are inadequate, difficult technical issues will not be manageable. As a result, VAT systems that do not specifically provide for, or which have not been adapted to cope with, technology-driven advances, generally do not provide for the adequate levying and collection of VAT on cross-border digital trade. The South African VAT system is no exception.

Most VAT systems, including that of South Africa, are based on the principle of consumption. Consequently, the person who consumes the goods and services is the person who ultimately carries the burden of paying the tax due on them. Although the South African VAT system levies VAT on production, it is still the final consumer who carries the burden of tax as intermediaries (wholesalers, distributors, and retailers) receive tax credits on the VAT paid on input. In other words, VAT is levied on goods and services that are utilised and consumed within the borders of the Republic, irrespective of the taxpayer's residence status.

If VAT is not appropriately levied and recovered at each level of the production chain, it will no longer be a consumption tax.[250] Breaks in the tax chain can lead to the failure to collect VAT by revenue authorities. Breaks in the tax chain can also lead to the failure to recover VAT paid by intermediaries, which would ultimately lead to double taxation.[251] The following should *inter alia* be considered to determine the VAT treatment of online cross-border transactions:

- Is there a supply of goods or services?
- Where is the place of supply?
- Is it made in the course or furtherance of an enterprise?

249 OECD/G20 2015 Final Report on Action 1 in para 339.
250 Ebrill L, Keen M, Bodin JP, Summers V (2001) *The Modern VAT* at 18.
251 Ebrill L, Keen M, Bodin JP, Summers V (2001) *The Modern VAT* at 18; Cnossen S (1996) "VAT Treatment of Immovable Property" in Thuronyi (ed) (1996) *Tax Law Design and Drafting* vol 1 at 231-232.

- Should B2B (business-to-business) transactions be treated differently from B2C (business-to-consumer) transactions?
- How is VAT on the transaction collected?

Is there a Supply of goods or services?

In line with the OECD guidelines,[252] Treasury has resolved that digital goods should be treated as services for VAT purposes. To echo this view, section165(*d*) of the Taxation Laws Amendment Act 31 of 2013 introduced the definition of "electronic service" which is defined as: "[t]hose electronic services prescribed by the Minister by regulation in terms of this Act".

The Electronic Services Regulations (Government Gazette No. 37489),[253] which came into effect 1 June 2014, contain a list of definitions of different types of digital goods that are capable of being transferred/supplied over the internet. This list of electronic services is similar to the list of "electronically supplied services" in terms of Annexure 1 to the Council Regulation of 17 October 2005 in the EU. Further changes to the South African rules were effect in 2015.

As is the position in the EU, there is uncertainty with the scope of the services listed in the Electronic Services Regulations. For example, it is not clear what is meant by 'subscription service'. Where the ordinary dictionary meaning is applied, it could be construed to mean that payment must be made to access a certain service. Where, for example, a subscription fee is paid to enable the user to carry out transactions on a website, the service is subject to VAT. However, where no such subscription fee is payable but a service is fee is charged on individual transactions carried out on the website, the transaction would escape VAT. Similarly, the meaning of "web application", "web series", "webcast", and "webinar" under item 9 of the Regulations is uncertain. Should the ordinary dictionary meaning be applied? Furthermore, certain supplies of electronic services, for example computer software, are excluded from the Regulations despite the fact that the services are capable of being utilised and consumed by consumers other than VAT vendors. It is uncertain whether, if at all, computer software, cell phone software, or applications fall under "information system services" of item 5 of the Regulations or "software" under item 8(*e*) of the Regulations. The Regulations also do not provide for the supply of online advertising. It is uncertain whether, if at all, online advertising could resort under "images", "film", "music", or a combination thereof under item 8(*e*) of the Regulations.

The rules for the place of supply of services and electronic services differ (see below) and as a result, uncertainty exists as to the treatment of services that are capable of being delivered electronically but that are not specifically provided for in

252 OECD (2006) International VAT/GST Guidelines http://www.oecd.org/ctp/36177871.pdf
253 http://www.treasury.gov.za/public%20comments/E-services%20Regulation.pdf.

the Regulations. For example, there is no clear distinction between telecommunication services and electronic services. Some overlap is possible. Such a clear distinction between electronic services and telecommunication services, each with its own place-of-supply rules can be found in modern VAT systems such as Canada and New Zealand as well as established VAT systems in the EU.

- There is generally no place of supply rules in South Africa. Suppliers providing services to SA consumers are subject to the registration threshold. This has been extended to include services supplied electronically.
- It is recommended that "telecommunication services" should be specifically defined, and clear and specific place-of-supply rules for telecommunication services should be incorporated in the Act. These provisions should be in line with the OECD principles on the harmonisation of global VAT/GST rules.
- Regulations should be refined further in order to allow for a comprehensive understanding and appreciation of the ambit of thereof.

The EU guidelines, despite their extensive nature, are already obsolete in certain cases, and cannot be applied to correctly classify the type of service rendered.[254] As a result of the dynamic evolution of the internet and e-commerce, many transactions that should in principle be taxed, escape the application of VAT as a direct consequence of the unsatisfactory list of electronically supplied services. It has been suggested that further guidance in the form of definitions and classifications is required on a regular basis to guarantee clarity and certainty.[255] Whether this approach is desirable may be questioned given the fast pace at which e-commerce and technology evolve.[256] A less than definitive list in itself allows for alternative interpretation once e-commerce evolves beyond the scope it offers.[257] Greater certainty is not achieved through extensive legislation, but rather through explanatory guidelines.[258] These guidelines are not subject to the long and complex legislative process and can be amended with greater ease.

- While the list of services in the Regulations does not provide for adequate definitions, which causes some confusion, the definitions in the Regulations, as they stand may not necessarily require further amendments. However, further guidelines providing clarification should accompany the Regulations.

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254 Rendahl P (2007) "An Overview of Consumption Tax Implications on Sale of Digital Downloads in the European Union" *Journal of Media Business Studies* vol 4 no 2 at 71.

255 Fridensköld E (2004) "VAT and the Internet: The Application of Consumption Taxes to E-commerce Transactions" *Information & Communications Technology Law* vol 13 no 2 at 184-185.

256 Van Zyl SP (2013) The Collection of Value Added Tax on online cross-border trade in Digital Goods Unpublished LLD thesis (UNISA) at 142.

257 Bill S and Kerrigan A (2003) "Practical Application of European Value Added Tax to E-commerce" *Georgia Law Review* 38 no 1 at 76.

258 Bill S and Kerrigan A (2003) "Practical Application of European Value Added Tax to E-commerce" *Georgia Law Review* 38 no 1 at 76; also see Value Added Tax Committee, EC, VAT Information Sheet 04/03, *Electronically Supplied Services: A Guide to Interpretation* http://webarchive.nationalarchives.gov.uk/20120128212010/http:/customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageLibrary_PublicNoticesAndInfoSheets&propertyType=document&columns=1&id=HMCE_CL_000907.

These guidelines should be updated regularly to ensure that new technology cannot escape the VAT fold.

- It remains uncertain if the list of electronic services in the Regulations can be interpreted so as to include the supply of online advertising. It is recommended that the guidelines referred to above should clarify this issue.
- It is recommended that the Regulations be refined further to allow for a comprehensive understanding and appreciation of the ambit thereof.

Where is the place of supply?

As stated above, the VAT Act does not provide for specific place-of-supply rules. Where these rules have been incorporated in the Act, this has been couched in vague general terms not designed to meet the requirements of an electronic era. The definition of "enterprise", and the provisions in section 7(1) of the VAT Act, should be read in conjunction to determine the place of supply. It can generally be accepted that the place of supply is the place where the goods or services are utilised and consumed in the Republic. The reliance on the "utilised and consumed in the Republic" principle adds to confusion in determining the place of supply or consumption. This is particularly evident where intangible products or services have been physically delivered (in this case downloaded) outside of the Republic, but where the benefit of the service or product is experienced in the Republic.

Instead of providing for specific place-of-supply rules in the case of electronically supplied services, the National Treasury, in the Taxation Laws Amendment Act 31 of 2013, attempted to achieve the incorporation of deemed place-of-supply rules by the insertion of the definition of "electronic services" and the amendment of the definition of "enterprise". Although the place-of-supply proxies in the case of electronic services are not clearly set out in the amendments, it can be deduced with a certain amount of certainty by the reading together of the definition of "electronic services" and the definition of "enterprise."

Based on these definitions, a foreign supplier of e-commerce services to a recipient that is resident to South Africa, or where payment originates from a bank registered in South Africa, must register as VAT vendor under the VAT Act. However, this would only be the case where the taxable supplies, that is the supply of electronic services to South African residents, exceeds the annual threshold of R50 000 (for voluntary registration). In other words, the place of supply proxy is the Republic where-

- the recipient resides in South Africa; or
- payment was made from a South African Bank account.

This place-of-supply proxy is in line with the provisions in the Council Directive 2008/8/EC in the EU and the OECD *VAT/GST Guidelines*. It should be noted that the reverse-charge mechanism will remain as backstop to the new foreign VAT registration rules. However, it remains uncertain if the use and enjoyment principle will remain as backstop for the place-of-supply proxies in the case of electronic services. The OECD recommends that the use and enjoyment principle may be applied in cases where the special place-of-supply rules (applicable to electronically supplied services) lead to double or non-taxation, or market distortions. In other words, the use and enjoyment principle should only be applied in exceptional circumstances. A provision to this effect will come into operation in the EU on 1 January 2015.[259]

- While the reverse-charge mechanism applies as a backstop to the registration mechanism, it remains uncertain under what circumstances the reverse-charge mechanism will apply. It further remains uncertain under what circumstances the use-and-enjoyment principle will take precedence over the place-of-supply proxies in the case of the supply of electronic services. It is recommended that clarity should be given on whether the use-and enjoyment principle should apply as a backstop where the place-supply-proxies lead to double or non-taxation, or market distortions. It is recommended that the VAT Act be amended in line with the OECD proposals and Article 59a Council Directive 2008/8/EC.

As a result of the new place-of-supply rules, additional duties are imposed on foreign suppliers that supply electronic services to consumers who reside in South Africa or consumers who pay for these services from a South African bank account. These duties *inter alia* entail that the foreign supplier must identify and locate the consumer, register for VAT in South Africa, levy VAT on the transaction and remit VAT to SARS, and comply with the duties associated with VAT vendor registration status. These issues are discussed below.

Is the supply made in the course or furtherance of an enterprise?

The OECD recommends that B2B and B2C transactions should be treated differently. In terms of the OECD's principal rule, once the supplier has identified the customer as a business entity and has located the place of the customer's establishment in a foreign jurisdiction, the supplier is relieved from the VAT burden on the transaction.[260] The transaction will be taxed in the customer's country of jurisdiction in terms of the reverse-charge mechanism.[261] Put simply, the tax burden is shifted to the business customer who is deemed to be the taxable entity.[262]

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259 Article 59a of Council Directive 2008/8/EC

260 OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf.

261 OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf.

262 OECD (2010) OECD International VAT/GST Guidelines: International Trade in Service and Intangibles: Public Consultation for on Draft Guidelines for Consumer Location at 8 http://www.oecd.org/ctp/consumptiontax/44559751.pdf.

The OECD recommends that the burden of VAT should not lie on taxable businesses unless specifically provided for in legislation.[263] In other words, the business, as taxable entity, should be able to recover the taxes from its customers when it makes subsequent supplies for final home consumption. Where the business customer would be entitled to recover output VAT for which it must account on imports in terms of the reverse-charge mechanism, the OECD recommends that jurisdictions should consider dispensing with the self-assessment method.[264] Simply put, where the business customer applies the imported intangibles in the course and furtherance of an enterprise (in the making of taxable supplies), it should not be required to account for output VAT upon import, and simultaneously recover VAT as inputs. The supplier will only account for output VAT when it makes further taxable supplies to consumers (from whom VAT will be collected) or where the supplies acquired are not applied to make further taxable supplies. This position is also followed by the majority of the EU member states. The South African position is in line with the OECD proposal. In the case of imported services in terms of the use-and-consumption principle, the recipient vendor of imported services has to account only for VAT on the imported services that are not applied by it in the course and furtherance of an enterprise. However, some of the items listed in the Regulations are generally utilised by businesses in the making of taxable supplies. As a result, confusion arises as to whether the duty to levy VAT on B2B transactions for the services so listed would be shifted to the business recipient resident in South Africa when that business makes further taxable supplies.

- The differentiation between B2B and B2C transactions is, in principle, in line with the OECD recommendations. However, the existing rules do not make a clear distinction between B2B and B2C transactions. It is our understanding that the Regulations follows Treasury's intention that B2C transactions are captured by the special provisions and that B2B transactions will be captured by the 'imported services' provisions. For this purpose, the Regulations must accurately define what is included in the scope of 'electronic services' so as to clearly distinguish between B2B and B2C transactions.
- National Treasury is of the view that not having the distinction actually broadens the South African VAT net since the onus is now on the supplier to levy VAT. B2C transactions will lead to no input tax claim if the recipient is not registered for VAT purposes. B2B transactions are subject to the normal input tax provisions of the VAT Act.
- South African VAT legislation generally only deals with who the supplier is and what the supply is. The VAT implications usually flow from that rather than from who the recipient is (i.e. business or consumer).

It should, however, be noted that while this method reduces the risk of businesses carrying the burden of VAT, the reliance on the taxpayer's interpretation of what

263 OECD (2012) *OECD International VAT/GST Guidelines: Draft Commentary on the International VAT Neutrality Guidelines* at 4 http://www.oecd.org/ctp/consumptiontax/50667035_ENG.pdf.

264 OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf.

constitutes “in the furtherance of an enterprise” could increase the risk of VAT fraud or under-taxation. This was illustrated in *CSARS v De Beers Consolidated Mines Ltd*[265] and *Metropolitan Life Ltd v CSARS.*[266] In both these cases the taxpayer imported services and failed to account for VAT in terms of the reverse-charge mechanism because it believed the services were to be utilised in the making of taxable supplies. During an audit it was revealed that the services so imported were not utilised in the making of taxable supplies, but that it was utilised for purposes ancillary to the main business of the taxpayer. The self-assessment mechanism, therefore, relies on the integrity of the taxable entity to account for output VAT on the import of intangibles in so far as they are acquired to make exempt supplies or for final consumption. It would generally be difficult for revenue authorities to verify the accuracy of the taxpayer’s self-assessed tax return in the absence of practical evidence reflecting the actual use of the intangibles.

To eliminate VAT fraud, the European Commission proposed that in the case of cross-border trade, the reverse-charge mechanism as currently applied in the Netherlands, should find general application. Under this system, the recipient vendor of imported services must account for VAT on the supplies, irrespective of whether or not the supplies are applied in the furtherance of the enterprise. The supplier will immediately be entitled to an input VAT deduction. Under this model, the administrative burden on taxpayers to account for VAT and claim an input VAT deduction on imports is no different from the administrative burden of reporting domestic transactions.[267]

- In the case of B2B transactions, the recipient vendor can only account for VAT on the imported electronic services in so far as the services are not used in the making of taxable supplies (in other words, when the recipient vendor is the final consumer). This relies heavily on the vendor’s interpretation of what constitutes “in the making of taxable supplies”. It is recommended that, in the case of B2B transactions, the recipient vendor must, in terms of the reverse-charge mechanism, account for VAT on all imported services irrespective of it being applied in the making of taxable supplies. The recipient vendor should claim an input VAT deduction in cases where such a deduction is allowed.
- It is however acknowledged that the 2015 changes to the VAT Act that require the foreign supplier to register for VAT in SA eliminate this problem to a large extent. The supplier levies VAT on the supply and the recipient is subject to the normal input tax provisions of the VAT Act.

It should further be noted that the differentiation between B2C and B2B transactions create an additional administrative burden on foreign suppliers. The foreign supplier burdened with the duty to register, collect, and remit South African VAT on affected

265 (503/2011) [2012] ZASCA 103 (1 June 2012)
266 2009 (3) SA 484 (C).
267 Van Zyl SP (2013) The Collection of Value Added Tax on online cross-border trade in Digital Goods Unpublished LLD thesis (UNISA) at 166.

transactions must verify the VAT vendor status of the customer. This is virtually impossible. Verifying the customer's identity and VAT registration status requires costly technology which is not widely accessible and which most suppliers simply cannot afford to implement. In the EU, where the supplier cannot verify the VAT registration number because it has not been correctly supplied, or not supplied at all, and no other reasonable proof exists indicating the VAT registration status of the customer, the supplier may assume that the customer is a non-taxable person.[268] When the customer is established outside of the EU, the supplier may treat the customer as a business entity or VAT vendor if:

a) the customer has issued the supplier with a certificate issued by the tax authority in the country where the customer is established, in terms of which it can be deduced that the customer is entitled to obtain a VAT refund;[269]
b) the customer has provided any number that would identify it as a business for tax purposes, or any other proof evidencing its taxable status.[270]

- Foreign suppliers of electronic services are burdened with the task of identifying the recipient's VAT vendor status. No guidelines exist and foreign suppliers of electronic services run the risk of penalties being imposed on unintended non-taxation. It is recommended that guidelines similar to the EU guidelines must be drafted. However, provision must be made that where the foreign supplier is unable to determine the VAT status of the recipient, the supplier may deem the recipient a non-vendor. Furthermore, where the foreign supplier has followed the guidelines, no penalty should be imposed where the supplier incorrectly identified the recipient's VAT status.

VAT collection mechanisms

The OECD recognises four essential VAT collection mechanisms: registration; collection through a reverse charge mechanism; taxing at source and remittance; and collection by collecting agents.[271] Since registration and the reverse charge mechanism are commonly applied in most jurisdictions, the OECD recommends that as an *interim* approach, it should be adapted (where required) and applied as the collection mechanism of choice in the case of cross-border trade in intangibles.[272] Despite the rise of modern technology that can be applied to develop collection

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268 Article 18(2) of Council Implementing Regulation (EU) 282/2011 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:077:0001:0022:EN:PDF.

269 Article 18(3)a) of Council Implementing Regulation (EU) 282/2011 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:077:0001:0022:EN:PDF.

270 Article 18(3)b) of Council Implementing Regulation (EU) 282/2011 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:077:0001:0022:EN:PDF.

271 OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf [accessed on 24 August 2012]; OECD (2000) *Report by the Consumption Tax Technical Advisory Group* at 5 http://www.oecd.org/tax/consumptiontax/1923240.pdf.

272 OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf; Schenk A and Oldman O (2007) *Value Added Tax: A Comparative Approach* at 217.

mechanisms, OECD member countries are of the opinion that the traditional collection mechanisms remain the most effective.[273]

As the lack in the current VAT rules to levy and collect VAT on imported digital goods adequately negatively affects domestic suppliers of digital products, the new registration rules for foreign suppliers of electronic services are aimed, not only at raising revenue, but also to protect the domestic market. However, it remains uncertain whether registration as a VAT collection mechanism would serve this purpose without overburdening taxable entities charged with VAT collection, or is not inefficient from an economic point of view. The administrative and cost burden to suppliers could be significant. In many cases, the cost of compliance in the case of nominal value supplies would outweigh the benefit of international establishment. The OECD recommends that where registration of non-resident vendors is required, the burden on these vendors should be minimised. Discrimination created by specific rules applicable to foreign vendors should therefore not be disguised as compliance with these specific rules. This can be achieved by developing a simplified registration regime for foreign vendors which includes electronic registration and declaration procedures.

Thresholds

The effectiveness of a registration system is greatly affected by the design and application of a threshold system. The OECD recommends that, to further minimise the burden on small and micro businesses, thresholds that apply to resident vendors should be applied equally to non-resident suppliers.[274] In other words, the simplified registration dispensation should not create alternative registration thresholds for non-resident suppliers. This is not the case under the new rules. Domestic suppliers must register for VAT when their taxable supplies exceeds or is likely to exceed R1 million. However, foreign suppliers of electronic services must register as VAT vendors when their supply of electronic services “imported” to South Africa exceeds R50 000. This differentiation is justified by SARS in that is aimed at levelling the playing field between domestic and foreign suppliers of electronic services.

- The differentiation in thresholds that applies to domestic vendors and foreign suppliers of electronic services raises concerns. Although the differentiation can be justified in that it is aimed at the protection of domestic markets, further research is necessary to determine whether the differentiation, in fact, balances out the assumed market distortions. In the interim, it is recommended that the VAT registration threshold for foreign suppliers of electronic services should be reconsidered to give effect to tax neutrality.

273 OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf.
274 OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf.

Simplified registration process

The OECD recommends that the simplified registration regime for the cross-border supply of intangibles should not require the supplier to have a physical presence or fixed establishment in the country of supply.[275] Applicants should be allowed to complete an online registration application form that is accessible from the revenue authority's home page.[276] The application form should further be available in the official language of the applicable country's major trading partners.[277] In addition, the form should be standardised and the information requested should be limited to:

i) the registered name of the business and trading name;
ii) name and contact details of the person responsible for tax administration;
iii) postal/registered address of the business and name of contact person;
iv) telephone number of contact person;
v) electronic address of contact person;
vi) website URL of business; and
vii) the national tax number in the jurisdiction of establishment.[278]

Confirmation of receipt of the application, and the final registration number should be communicated to the supplier by electronic means.[279]

The South African VAT registration system does not provide for a simplified registration process for suppliers of cross-border intangibles. Vendors must, amongst other requirements, have a fixed establishment with a physical presence in the Republic. The current vendor registration regime is inconsistent with the simplified registration proposal. It is trite that the strict VAT registration regime in South Africa serves as a tax administration tool to combat VAT fraud and false VAT registrations. However, certain concessions were made in respect of foreign suppliers of electronic services. In terms of the VAT Registration Guide for Foreign Suppliers of Electronic Services,[280] the following concessions were made:

- The foreign supplier of electronic services is not required to have a physical presence in the Republic;
- The foreign supplier of electronic services is not required to have a South African ban account;

275 OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 12 http://www.oecd.org/ctp/consumptiontax/17851117.pdf .

276 OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 12 http://www.oecd.org/ctp/consumptiontax/17851117.pdf.

277 OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 12 http://www.oecd.org/ctp/consumptiontax/17851117.pdf.

278 OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 13 http://www.oecd.org/ctp/consumptiontax/17851117.pdf.

279 OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 13 http://www.oecd.org/ctp/consumptiontax/17851117.pdf.

280 SARS (2014) *VAT Registration Guide for Foreign Suppliers of Electronic Services* http://www.sars.gov.za/AllDocs/OpsDocs/Guides/VAT-REG-01-G02%20-%20VAT%20Registration%20Guide%20for%20Foreign%20Suppliers%20of%20Electronic%20Services%20-%20External%20Guide.pdf

- The foreign supplier of electronic services is not required to appoint a representative vendor;
- The foreign supplier of electronic services will be registered on the payment basis; and
- Registration can be completed online.
- The concessions made by SARS to streamline the VAT registration of foreign suppliers of electronic services is in line with the OECD guidelines as well as similar provisions in the EU that will come into operation on 1 January 2015. The registration process should be closely monitored and reviewed on a regular basis to ensure that the process remains compliant with the OECD simple registration guidelines. Despite the simplified registration process afforded by SARS, many foreign suppliers are still unaware of their obligations in terms of the Act.

Assessment / invoicing

In addition to a simplified registration process, a simplified electronic self-assessment procedure should be available to non-resident suppliers of cross-border intangibles.[281] The OECD recommends that a standardised international declaration form and process should be developed for vendors who are registered under the simplified registration regime.[282] The VAT declaration form should strike a balance between the need for simplicity, and the need for tax authorities to verify whether the tax obligations have been fulfilled.[283] The OECD suggests that further guidance should be given on the frequency of tax returns.[284] It is arguable whether the concession to register foreign suppliers of electronic services on the payment basis provides for a simplified assessment procedure. While the VAT201 form can be submitted electronically on the e-file system, the difficulty and administrative burden associated therewith is not diminished. It must be noted that National Treasury has come up with concessions to reduce compliance costs for foreign businesses to prevent these business from withdrawing from South Africa.

- With regards to foreign suppliers, SARS has issued guidelines for completing the VAT 201. SARS reports that to date 96 foreign taxpayers have registered with SARS. VAT returns are being submitted monthly and that the compliance rate of submitted returns is approximately 87%. To encourage increases registrations and to increase the rate of compliance, it is recommended that measures should be taken to lessen the administrative burdens of completing VAT 201. As foreign suppliers of electronic services are not eligible for a VAT

281 OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 13 http://www.oecd.org/ctp/consumptiontax/17851117.pdf .

282 OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 13 http://www.oecd.org/ctp/consumptiontax/17851117.pdf.

283 OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 13 http://www.oecd.org/ctp/consumptiontax/17851117.pdf.

284 OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 13 http://www.oecd.org/ctp/consumptiontax/17851117.pdf.

refund, it is recommended that an abridged VAT 201 should be developed specifically for foreign suppliers of electronic services.

- The option of payment or collection agents (whether acting as agents or third party services providers) to be appointed and registered as VAT vendors for and on behalf of foreign businesses must be considered.

If the non-resident supplier operates from a jurisdiction that applies strict exchange control measures, the transfer of funds could result in a long process. This could further result in late payments and additional penalties or interest being levied on the late payment.

A non-resident supplier of electronic services would face various compliance challenges, *inter alia*, costly once-off changes in its invoicing system is required to ensure that invoices reflect a) the term 'tax invoice'; b) the name, address and VAT registration number of the supplier; c) an individual serialized number and date on which the invoice is issued; d) a description of the services supplied; and e) the consideration of the supply and the amount of VAT expressed as 14 per cent of the value of the supply. Some concessions have been announced. The foreign supplier of 'electronic services' is allowed to submit an abridged invoice (the details of the recipient is not required. However, the invoice must still be issued in South African currency (the ZAR). In most instances the cost and payment of the 'electronic services' is made in foreign currency. The supplier is, accordingly, required to calculate and express the amount in ZAR. In terms of the Binding General Ruling on electronic services, the ZAR amount must be calculated in accordance with the Bloomberg or European Central Bank rate on the day that the tax invoice is issued. This can result in accounting differences where the supplier's system has a set exchange rate or where the system operates on monthly averages.

- The foreign supplier of electronic services is required to issue an invoice compliant with the invoice requirements in the VAT Act. Although this SA requirement is in line with the EU VAT Directive, this requirement would require other non-EU suppliers to change their invoicing system. The requirement to issue an invoice, based on the requirements of an invoice in terms of the VAT Act, should be re-considered.
- The foreign supplier of electronic services is required to display (on their website or online shopping portal) prices in ZAR and the price so displayed must include VAT at 14 per cent. This would require the supplier to change its accounting and invoicing system. It is recommended that the requirement to display prices (on the website or shopping portal) in ZAR inclusive of VAT should be reconsidered.
- Clause 103 of the TLAB 2014 and the Explanatory memorandum is addresses this matter.
- Foreign suppliers of 'electronic services' must account for VAT on the payment basis. This creates accounting problems where the supplier's accounting system is set up to account on the invoice basis.

Record keeping

The OECD proposes that an international standard for record keeping in the case of cross-border traders should be developed.[285] In developing record keeping guidelines that can ensure reliable and verifiable records that can be trusted to contain a full and accurate account of the electronic transaction concerned, cognisance should be taken of existing acceptable business practices.[286] In terms of the OECD guidelines, record keeping in jurisdictions other than the jurisdiction in which the documents are created, should not pose an adverse risk to tax authorities if a standardised record keeping format (as is required in the jurisdiction of establishment) is maintained and can be guaranteed.[287] Record keeping in a place other than South Africa is generally prohibited unless strict requirements are adhered to. In contrast, the EU Directive allows for record keeping in the cloud, provided that online access can be guaranteed.

Another impractical administrative concern relates to VAT branch registration and the requirement to maintain a separate independent accounting system. To expect foreign suppliers of electronic services to maintain a separate independent accounting system with respect to supplies falling within the South African VAT net, so as to ensure that supplies occurring outside of South Africa do not fall within the South Africa VAT net, is not practical. This is an extremely burdensome requirement.

- ➢ It is recommended that legislation around VAT branch registration and the requirement to maintain a separate independent accounting system should be revised. Foreign suppliers of electronic services should be entitled to register a VAT branch but should not be required to maintain a separate independent accounting system. A proviso should be added to this requirement to apply to foreign suppliers of electronic services, whereby, instead of maintaining an independent accounting system, the foreign supplier or electronic services should merely be required to produce financial accounts which reflect the supplies made to residents in South Africa or where payment was made from a South African bank account.

Enforceability of compliance / administrative burden

Enforceability of registration remains the chief challenge. In the absence of definitive rules and international cooperation, tax collection from non-compliant offshore suppliers would be difficult to enforce. In addition, transparency in cases where

285 OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 14 http://www.oecd.org/ctp/consumptiontax/17851117.pdf.

286 OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 14 http://www.oecd.org/ctp/consumptiontax/17851117.pdf; OECD *Record Keeping Guidance* at 17 http://www.oecd.org/tax/taxadministration/31663114.pdf.

287 OECD *Record Keeping Guidance* at 14 http://www.oecd.org/tax/taxadministration/31663114.pdf.

registration can be enforced would be difficult to achieve. For example, it is not clear whether SARS has extra-territorial powers to conduct audits on non-resident suppliers to ensure the accuracy of tax returns. Furthermore, it is not clear whether SARS is able to enforce penalties, interest, or other punitive measures against non-compliance in foreign jurisdictions.

- In the absence of international cooperation, the collection of VAT and enforcing the registration mechanism would be impossible. The negotiation of multilateral treaties, as opposed to bilateral treaties, must be undertaken to ensure greater international and regional cooperation.

Determining the place of supply

The levying and collection of VAT by non-resident suppliers of electronic supplies under both a proxy system and a system based on the "used and consumed" principle presupposes that the supplier can identify the customer's location. Place-of-supply proxies are founded on the premise that the supplier is able to determine the place where the consumer is established, has a fixed address, or resides. In the case of tangible goods, the address of delivery is fairly indicative of the place of consumption. In the absence of guidelines, determining the place of supply or consumption for digital deliveries is cumbersome. The following various methods of locating the customer's place of residence can be applied:

i) **Customer self-declaration:** This relies on the integrity of the customer. Taxpayers are known to manipulate information to best suit their taxing needs.

ii) **Billing information as supplied by the customer:** As the services are capable of electronic delivery, the customer can submit false billing information to escape VAT.

iii) **Tracking/Geo-location software:** This software is expensive and can be circumvented by anonymising software. Furthermore, accuracy levels are low.

iv) **IP address of the device on which the purchases are made:** Multiple devices can share the same IP address. The IP address can be hidden by use of anonymising software.

v) **Tracing the payment path:** Due to privacy protocol, financial institutions no longer reveal customer information to suppliers. Furthermore, credit card numbers can no longer be used to verify the country of issue with accuracy.

vi) **Digital certificates:** Very few countries issue taxpayers with individual digital tax certificates.

It would generally be onerous, if not impossible, to determine the actual place of consumption for tax purposes in the absence of a close relationship between the supplier and the non-taxable customer. Verification tests should not irritate customers, or significantly slow down the transaction process. It should, however, be noted that it has never been a priority to put the burden of identification of the recipient on the supplier. Transactions not covered by the 'electronic services' provisions will be taxed under the reverse-charge mechanism. The approach has been to keep the VAT system simple and easy to administer for all VAT vendors.

- The OECD recommends that the registration model should be applied as an interim measure to balance-out market distortions. In contrast, SARS is of the view that the registration model is the final/optimum solution. It is recommended that the registration model should be applied as an interim measure aimed at balancing out existing market distortions. Alternative VAT collection models should be explored. This, however, goes to the basic design of the VAT system and the impact of the extent to which the principles of the OECD VAT/GST Guidelines can be achieved.

Alternative VAT collection models[288]

Existing VAT collection mechanisms are in dire need of modernisation, in that they are inefficient and increasingly burdensome on revenue authorities and suppliers.[289] Some observers have proposed the use of financial institutions as VAT collectors and the use of technology to facilitate their task. The OECD's conclusion that VAT collection by financial institutions is not a viable option is based on resistance and objections from financial institutions coupled with the general international perception of the banker-customer relationship in respect of customer privacy prevailing when the proposal was considered.[290] Recent technological advances and a shift in VAT collection trends at local level warrant further research on the viability of VAT collection by financial institutions in the case of cross-border digital trade.

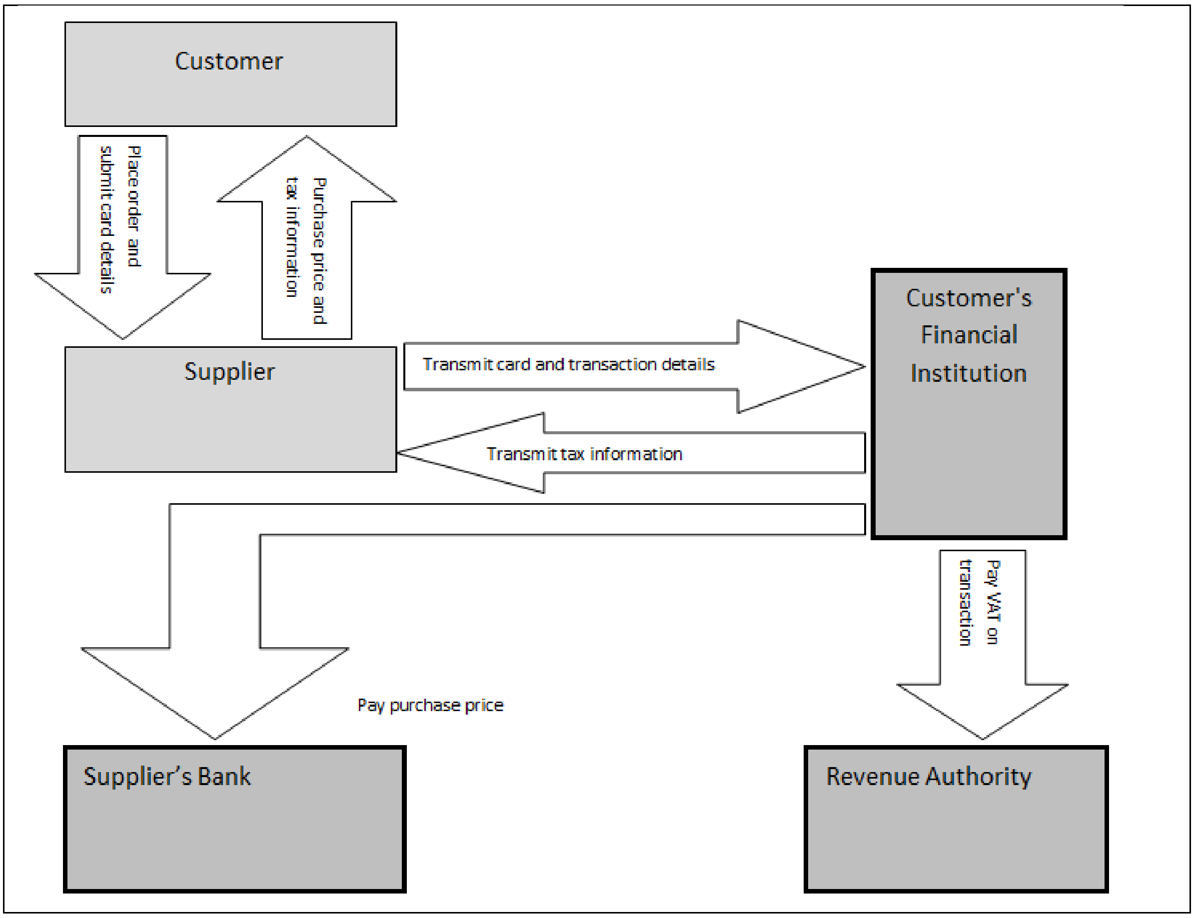
The basis of this model is to collect VAT on each transaction at the point at which it is traded through an electronic payment system – for example, a credit card system - based on the location of the customer and the VAT rules applicable in that jurisdiction. In other words, the customer is immediately assessed when the transaction is entered into, and the VAT payable is transferred to the relevant revenue authority without delay. This is typically achieved when the supplier submits the customer's credit card or other payment details to the customer's bank or credit card company, which then identifies and locates the customer's place of residence or establishment. Details of the transaction, i.e. the purchase price and type of supply, are transmitted to the financial institution to enable it to correctly assess the transaction based on the VAT rules applicable in the customer's jurisdiction where he resides, is established, or has a permanent address. The amount payable by the

288 This section is a summary of Chapter 7 of Van Zyl SP (2013) *The Collection of Value Added Tax on online cross-border trade in Digital Goods* Unpublished LLD thesis (UNISA).

289 Van Zyl SP (2013) The Collection of Value Added Tax on online cross-border trade in Digital Goods Unpublished LLD thesis (UNISA) at 303.

290 Van Zyl SP (2013) The Collection of Value Added Tax on online cross-border trade in Digital Goods Unpublished LLD thesis (UNISA) at 303.

customer is the final amount inclusive of VAT. A split-payment system separates the payment in two: the purchase price is transferred into the supplier's bank account; while VAT is transferred to the relevant revenue authority. This can be seen in the schematic explanation below adopted from Van Zyl's doctoral thesis.[291]



Neither the supplier nor the customer is required to register with the relevant revenue authority. Currently, two models exist: a Blocked VAT Account system and a Real-time VAT system.

Blocked VAT Account system

The Blocked VAT Account system was developed by PricewaterhouseCoopers. A Blocked VAT Account system is essentially a split payment system in terms of which the financial institution that executes the payment, levies VAT on the transaction, and then pays it into a blocked VAT account. The blocked VAT account can be used for no purpose other than incoming and outgoing VAT payments, and for VAT settlements at the end of a VAT reporting period. The financial institution merely acts as an intermediary burdened with the task of splitting the payment. Since the VAT

291 Van Zyl SP (2013) The Collection of Value Added Tax on online cross-border trade in Digital Goods Unpublished LLD thesis (UNISA) at 305.

collected from the customer is not deposited into the supplier's private bank account, the risk of disappearing vendors is eliminated. The supplier is still burdened with filing tax returns at the end of a VAT reporting period. However, the supplier will receive a partially completed assessment form from the financial institution reflecting all the transactions effected by it for which VAT was paid into the blocked account. VAT payments and refunds will be effected from and to the blocked account. Despite the fact that VAT is collected in real-time, settlement with tax authorities is delayed until the supplier submits an assessment at the end of a reporting period. This system remains to be tested.

Real-time VAT

Real-time VAT (RT-VAT) collection is most consistent with the tax collection model by financial institutions outlined in the schematic model above. RT-VAT was put forward by Chris Williams, chairman of the RTpay® executive committee, a non-profit organisation the main aim of which is to promote RT-VAT as an alternative assessment method to the current registration and reverse-charge mechanisms. RT-VAT is a real-time VAT collection system that operates on the existing card and payment platforms. Once the supplier has submitted the customer's card details, purchase price, and transaction details to the financial institution, the financial institution will identify and locate the customer from its database and levy VAT on the transaction based on the VAT rate applicable in the customer's jurisdiction of residence. Payment is made directly from the customer's bank account and split into two separate payments. The purchase price is paid into the supplier's bank account, and VAT is paid to the relevant revenue authority. Payment of VAT is effected once every 24 hours, as opposed to the delayed payment system under the post-transaction assessment model. A dedicated server system (Tax Authority Settlement System (TASS)) tracks every transaction to ensure that allowable input VAT claims in the case of B2B transactions are paid automatically. The RT-VAT system remains to be tested.

International trends show that tax collection by third party intermediaries is increasingly being introduced in countries where cross-border trade and employment are on the rise.[292] This is particularly evident in Latin American countries which increasingly apply withholding tax mechanisms as a VAT collection tool.[293] The implementation of withholding tax mechanisms in terms of which a third party (financial institution) is burdened with the withholding duty is a common modern

[292] Ainsworth RT and Madzharova B (2012) "Real-Time Collection of Value Added Tax: Some Business and Legal Implications" *Boston Univ School of Law Working Paper no 12-51* at 11 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2166316.

[293] Ainsworth RT and Madzharova B (2012) "Real-Time Collection of Value Added Tax: Some Business and Legal Implications" *Boston Univ School of Law Working Paper no 12-51* at 11 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2166316.

taxing trend among developing countries. Similar trends have recently been introduced in South Africa.[294]

Cross-border digital trade is a fully fledged electronic trading, and often automated, phenomenon. The execution of these transactions requires no or minimal human intervention. It therefore follows that the taxation of cross-border digital transactions should preferably be done electronically and with minimal human intervention. A withholding tax mechanism by financial institutions through the implementation of an RT-VAT system, offers this possibility.

- The reverse-charge mechanism is an ineffective tool to levy and collect VAT on cross-border trade in digital goods. The registration model, in theory, provides for a better VAT collection model. However, the registration model overly burdens the supplier and its remains problematic. Although in terms of SARS records about 96 foreign supplies have registered to date, this number and the collected revenue could be increased if an alternative model is considered. The implementation of the RT-VAT system should be considered as an alternative VAT collection mechanism where the registration and reverse-charge mechanisms are found to be ineffective tax collection models. As the model remains to be tested, extensive further research into the viability of the RT-VAT system should be undertaken.

There are for instance concerns from the Financial Institutions that:

- Financial institutions would have to make significant investments in IT/software systems that are capable of being integrated with the IT systems of suppliers in order to enable suppliers to submit customer credit or other payment details to the relevant financial institution I.e. the customer's bank or credit card provider
- The additional requirement for financial institutions to make split-payments (i.e. Payments of purchase price to the foreign supplier's bank account and the VAT payment to the relevant Revenue Authority) will place a further burden on the financial institutions' IT systems.
- Financial institutions would be required to perform additional tasks as identify verification and location identification of the related customers' place of residence or establishment, which may result in the transmission of information and efficiency in processing these digital transactions being compromised and/or slowed down.
- Financial institutions would have to correctly assess each customer's digital transactions and apply the relevant VAT legislation. The responsibility to levy

[294] In terms of section 37I of the Income Tax Act 58 of 1962 any person who pays interest to or for the benefit of a foreign person must withhold the tax from that payment except in circumstances where the interest or the foreign person is exempted from tax. Section 37I will come into operation on 1 July 2013. Similarly, in terms of section 49E, any person making payment of any royalty to or for the benefit of a foreign person must withhold 15% tax from that payment. Section 49E will come into operation on 1 July 2013.

and collect the correct amount of VAT therefore rests solely with the financial institutions.

- The sharing of customer information with suppliers and also the related sharing of supplier information with various revenue authorities, may compromise the privacy of customer and supplier information.
- Financial institutions would bear the burden of completing and sharing partial assessments to each of the suppliers for which VAT was paid into the relevant VAT blocked account.
- The additional costs to financial institutions completing these various allocation tasks would need to be recovered and will in all likelihood be passed onto customers by way of increased service fees.[295]

It is therefore recommended that before the RT-VAT system is implemented, a Steering Committee should be formed to determine its viability since it has not been tested anywhere in the world. The said Steering Committee should include relevant stakeholders such as representatives of Financial Institutions, legal, accounting and IT and payment systems professionals.

Further recommendations

- ➢ In its design of VAT legislation dealing with e-commerce, South Africa should ensure its laws are in line with international developments. It should not reinvent the wheel and draft provisions that are not internationally aligned.
- ➢ It is important that South Africa monitors the OECD recommendations and international developments and that it amends its legislation accordingly to ensure it is internationally aligned.
- ➢ There are concerns that the VAT amendments with respect to e-commerce do not comply with the principle of neutrality which requires that taxation should seek to be neutral and equitable between forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations, carrying out similar transactions, should be subject to similar levels of taxation.
- ➢ It is recommended that the administrative burden on foreign suppliers of electronic services, who do not otherwise have a presence in South Africa but who satisfy the compulsory requirements to register for VAT, need to be reviewed and reconsidered to ensure that the amendments addressing electronically supplied services are effectively and efficiently imposed and enforced. The administrative burden imposed on foreign suppliers of electronic services should minimise the administrative costs for both the taxpayer and SARS as far as possible.

[295] Comments submitted to the DTC by the Banking Association South Africa (BASA) on the “DTC First Interim Report on BEPS Action Plan 1” (25 March 2015) at 2.

- In a volatile economy, new tax rules should not be drafted so as to negatively impact on international trade or create additional market distortions. While we recommend that new tax rules should be in line with the OECD principles and international best practice, new tax rules should not merely slave-follow international trends in developed countries. Extensive research on the economic impact of new tax rules on the economy of developing countries should be undertaken and considered before these new rules are implemented.

15 DEVELOPMENTS IN THE DIGITAL ECONOMY: VIRTUAL CURRENCIES

OECD 2015 Final Report on Action 1 identifies the recent developments of "virtual currencies", which are digital units of exchange that are not backed by government-issued legal tender.[296] Some virtual currencies are specific to a single virtual economy, such as an online game, where they are used to purchase in-game assets and services. In some cases, these economy-specific virtual currencies can be exchanged for real currencies or used to purchase real goods and services, through exchanges which may be operated by the creators of the game or by third parties.[297] According to the OECD Discussion Draft Report on Action 1, virtual currencies have been developed to also allow the purchase of real goods and services. The most prominent are the various "cryptocurrencies", in particular so-called "Bitcoins".

"Bitcoin is a peer-to-peer payment system and digital currency introduced as open source software in 2009. It is a crypto currency, so-called because it uses cryptography to control the creation and transfer of money….. Bitcoins are created by a process called mining, in which participants verify and record payments into a public ledger in exchange for transaction fees and newly minted Bitcoins. Users send and receive Bitcoins using wallet software on a personal computer, mobile device, or a web application. Bitcoins can be obtained by mining or in exchange for products, services, or other currencies."[298]

The OECD Discussion Draft Report on Action 1 expresses concern about the development of Bitcoins, in particular because transactions can be undertaken on an anonymous basis since no personally identifying information is required to acquire or transact Bitcoins.[299]

The only 3 countries that appear to have taken action in respect of the taxation of Bitcoin are Canada, the UK and the USA.

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296 OECD 2014 Discussion Draft Report on Action 1 at 15.
297 Ibid.
298 See "Bitcoin" https://en.bitcoin.it/wiki/Bitcoin; "Public Key cryptography" http://en.wikipedia.org/wiki/Public-key_cryptography. Accessed 2 October 2013.
299 The OECD 2014 Discussion Draft Report on Action 1 at 15 in para 34.

15.1 BITCOIN TAXATION IN CANADA

The Canadian government has taken the position that Bitcoin is not legal tender[300]. The Canada Revenue Agency has stated that, when addressing the Canadian tax treatment of Bitcoin, taxpayers must look to the rules surrounding barter transactions [301] and must consider whether income or capital treatment arises on Bitcoin trading (*i.e.*, speculating on the changes in the value of Bitcoins**).**

15.2 BITCOIN TAXATION IN THE USA

In Notice 2014-21 (March 25, 2014),[302] the IRS states that Bitcoin is property and not currency for tax purposes. According to the Notice, "general tax principles applicable to property transactions apply to transactions using virtual currency." Some of the U.S. tax implications of Bitcoin include the following: (1) taxpayers receiving Bitcoins as payment for goods or services must include in their gross income the fair market value of the Bitcoins; (2) taxpayers will have a gain or loss upon the exchange of Bitcoins for other property; and (3) taxpayers who "mine" Bitcoins must include the fair market value of the Bitcoins in their gross incomes. The IRS also confirmed in its statement that employment wages paid in Bitcoins are taxable.

15.3 BITCOIN TAXATION IN THE UK

In the UK, Bitcoin is treated as a "money voucher" and attracts VAT. HMRC is considering changing its status to "private money". HMRC would tax any capital gain subject to an exemption for holding them for over a year.[303]

15.4 SOUTH AFRICA: RECOMMENDATIONS ON BITCOINS AND OTHER CRYPTO-CURRENCIES

- Whilst the use of virtual currencies such as Bitcoins is not yet widespread in South Africa, it is growing. South African legislators would be wise to consider the potential impact of virtual currencies on tax compliance and to monitor international developments to determine the most suitable approach for preventing abuse in South Africa.
- Exchange controls seem at least in the short term - a major defence against BEPS in relation to e-commerce, digital products, virtual currencies, virtual currencies (e.g. Bitcoin), IP royalty payments and other forms of intangible related transfer functions. However statutory provisions will be needed in the long run.

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300 http://www.canadiantaxlitigation.com/wp-content/uploads/2014/01/2013-0514701I7.txt.
301 http://www.cra-arc.gc.ca/E/pub/tp/it490/it490-e.html.
302 http://www.irs.gov/uac/Newsroom/IRS-Virtual-Currency-Guidance.
303 Forbes, 17 Jan 2014.

ANNEXURE 2

DAVIS TAX COMMITTEE: SECOND INTERIM REPORT ON BASE EROSION AND PROFIT SHIFTING (BEPS) IN SOUTH AFRICA

SUMMARY OF REPORT ON ACTION 2: NEUTRALISE THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS

Action 2 of the BEPS Action Plan focuses on neutralizing the tax benefits of hybrid mismatch arrangements. For this purpose, OECD recommends that countries adopt co-ordination rules under their domestic law. Hybrid mismatch arrangements exploit differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term deferral. These types of arrangements are widespread and result in a substantial erosion of the taxable bases of the countries concerned. They have an overall negative impact on competition, efficiency, transparency and fairness.

Part I

Part I of the report sets out recommendations in respect of payments made under a hybrid financial instrument or payments made to or by a hybrid entity. It also recommends rules to address indirect mismatches that arise when the effects of a hybrid mismatch arrangement are imported into a third jurisdiction. The recommendations take the form of linking rules that align the tax treatment of an instrument or entity with the tax treatment in the counterparty jurisdiction but otherwise do not disturb the commercial outcomes. The rules apply automatically and there is a rule order in the form of a primary rule and a secondary or defensive rule. This prevents more than one country applying the rule to the same arrangement and also avoids double taxation.

The recommended primary rule is that countries deny the taxpayer's deduction for a payment to the extent that it is not included in the taxable income of the recipient in the counterparty jurisdiction or it is also deductible in the counterparty jurisdiction. If the primary rule is not applied, then the counterparty jurisdiction can generally apply a defensive rule, requiring the deductible payment to be included in income or denying the duplicate deduction depending on the nature of the mismatch.

The report recognises the importance of co-ordination in the implementation and application of the hybrid mismatch rules to ensure that the rules are effective and to minimise compliance and administration costs for taxpayers and tax administrations. To this end, it sets out a common set of design principles and defined terms intended to ensure consistency in the application of the rules.

Part II

Work on Action 6 also addresses BEPS concerns related dual resident entities. The OECD recommends that cases of dual residence under a tax treaty would be solved on a case-by-case basis rather than on the basis of the current rule based on the place of effective management of entities.

- This change, however, will not address all BEPS concerns related to dual resident entities, domestic law changes are needed to address other avoidance strategies involving dual residence.
- The Commentary to the OECD MTC will also be revised that treaty benefits are not granted where neither State treats, under its domestic law, the income of such an entity as the income of one of its residents.

Recommendations on hybrid entity mismatches for South Africa

The provisions in the Income Tax Act that deal with "foreign partnerships" (for instance the definition of the same in section 1, the reference to foreign partnerships in s 24H) ensure that the tax treatment of hybrid entities in South African in line with international practice. Nevertheless, South Africa's legislation on hybrid entities is still behind the G20 and there is need for further reform of the provisions to ensure that any tax planning schemes that entail hybrid entities as a mechanism for double non-taxation (as well as potentially giving rise to double taxation) are curtailed. Thus will require:

- Further refinement of domestic rules related to treatment of hybrid entities;
- There is need for specific double tax treaty anti-avoidance clauses.

In light of the OECD 2015 Report on hybrid mismatches, South Africa should make appropriate domestic law amendments. Similarly South Africa should adopt the OECD tax treaty recommendations with regard to hybrid entity mismatches and adopt appropriate anti-avoidance treaty provisions.

Recommendations on hybrid instrument mismatches for South Africa

Although South Africa has various provisions (discussed in the main report on Action 2) that deal with hybrid instruments, the pertinent issue is the lack of local and international matching of a deduction in one country to the taxability in another, especially as this relates to the participation exemption (section 10B of Income Tax Act).

- ➢ South Africa's interventions to hybrid mismatches lead to mismatches of their own and could result in double taxation or double non-taxation. The approach has been rather piecemeal, which has resulted in a plethora of provisions as is evident from the extent of those listed in the report. As part of the reform process to deal with hybrid mismatches, this plethora of instruments should be consolidated into a clear and concise approach and any unnecessary anti-avoidance provisions eliminated.[1]

- The legislators should consider introducing or revising specific and targeted rules denying benefits in the case of certain hybrid mismatch arrangements. In doing so, the legislators should ensure that the rules must be simplified to deal with legal principles rather than specific transactions. The new rules should be aligned with the OECD recommendations and introduced as necessary and appropriate for South Africa with due regard to resource constraints and unnecessary legislative complexity.[2]
- SARS should introduce or the revise disclosure initiatives targeted at certain hybrid mismatch arrangements. To ensure the success of such disclosure rules, it is important that the rules are clear, free of loopholes, carry sufficient penalty for non-compliance and are adequately enforced. Such rules can be effective, either insofar as reporting is concerned or as a deterrent to aggressive tax planning. To address the compliance burden on taxpayers it is important that the rules should be targeted precisely at arrangements that are of concern and not formulated so broadly that they result in arrangements that present little or no risk to the tax base having to be reported and overwhelming both taxpayers and SARS.[3]
- It should be noted however that disclosure programs are never successful and are overly burdensome from a compliance perspective.
- The hybrid debt and interest rules require attention as they are not linked to the tax treatment in the hands of the counterparty and may themselves lead to mismatches and double taxation. A rule needs to be put in place that links the hybrid rules to the treatment in foreign counties. This would prevent tax abuse in cases where there is a denial of deduction in South Africa but not in other countries.
- The rules governing the deductibility of interest need to be developed holistically and without a proliferation of too many sections within the Act. The focus should be based on a principle rule and one should not have to apply many different sections to a transaction when assessing whether or not interest is deductible. The key policy requirement is an emphasis on mismatch rather than merely attacking a particular type of instrument.

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1 PWC "Comments on DTC BEPS First Interim Report (30 March 2015) at 17.

2 PWC "Comments on DTC BEPS First Interim Report (30 March 2015) at 17.

3 PWC "Comments on DTC BEPS First Interim Report (30 March 2015) at 17.

- From the analysis of the international jurisdictions, it is clear that OECD rules and in particular, the UK rules, focus on a deductibility mismatch or other clear tax leakage. This is, it is submitted, correct and is a different approach from what was adopted in sections 8E to 8FA of the Act (discussed in the main report on Action 2) which look purely at substance over form, without enquiring whether mischief exists. In other words, it makes no sense to alter the tax treatment of an instrument where no obvious leakage arises – such as in circumstances where a deduction is matched by a taxable receipt, or a non-deductible payment is exempt.
- NT contends that the rules do not concern themselves with specific tax structures but rather look to those terms of an instrument and/or arrangement that would not ordinarily be found in either an equity instrument or debt instrument. Nevertheless, there is need to ensure that sections 8E to 8FA do not overly place emphasis on the type of mischief being controlled rather than on the substance of the instrument in question. NT further contends that sections 8E to 8FA are structured to capture the "low-hanging" fruit. Hurdles for the application of these provisions range from the presence of guarantees and assurances that are only necessary in debt arrangements (8EA) to unreasonably long repayment periods for debt (8F) and the non-payment of obligations or increases in payment obligations (8FA) when the debtor attains financial stability. However these provisions are quite complex and unclear.
- Section 23M (discussed in the main report on Action 2) is a mismatch measure as contemplated in the OECD requirements. However, in its structure it also operates as a matching measure for interest deductions. In other words, an interest deduction is limited (and not denied) until that point in time that the corresponding interest income is subject to South African tax in the hands of the recipient of the interest. However the provision is quite complex and its workings unclear.
- It is strongly recommended that South Africa moves away from anti-avoidance sections aimed at particular transactions and establish anti-avoidance principles which can be applied to a broad range of transactions without undue technicality; even if there is a risk that one or two transactions fall through the cracks, a principal approach to drafting legislation is significantly preferential to a transaction-by-a-transaction approach which we currently appear to have. An example of this as explained in the sub-heading on ss 8F and 8FA, is that ss 8F and 8FA unintentionally provide a solution to the problems encountered in 8E and 8EA. This is type of unintentional tax effect arises due to overly complex tax legislation.
- The inconsistencies between hybrid debt and hybrid equity rules should be addressed. For instance there should be alignment with respect to security for equity as is the case for debt.

- There is need for specific double tax treaty anti-avoidance clauses. It is however important that the rules are in line with international best practices otherwise they would result in double taxation or double non-taxation of income.
- South Africa needs to monitor OECD recommendations on hybrid mismatches and adapt domestic provisions as appropriate. There is a danger of moving too quickly and undertaking unilateral changes no matter how small, considering the potential knock-on impact for foreign investment.

General recommendations on hybrid mismatches

It is apparent that South Africa has anticipated several of the recommendations in the OECD 2015 Reports on Hybrid Mismatch Arrangements, as it has incorporated provisions into the Act which achieve or are designed to achieve the objectives of OECD with regard to BEPS Action 2. Therefore, there is no immediate need for drastic legislative changes in this regard.

- As a port of last call to combat base erosion and profit shifting as envisaged in BEPS Action 2, South Africa may resort to the GAAR, which is designed to capture tax avoidance that is not caught by the specific anti-avoidance provisions of the Act.
- South Africa should be cautious around the complicated hybrid equity provisions which may operate in a contradictory fashion vis-á-vis the hybrid debt provisions and create the risk of potential abuse.
- If South Africa hopes to attract foreign direct investment and be competitive on the African continent, it must not hamper trade unnecessarily. Therefore South Africa should be cautious about unduly restrictive and complicated rules and must view with circumspection the Public Notice issued by SARS listing transactions [4] that constitute reportable arrangements for purposes of section 35(2) of the Tax Administration Act;
- Further, as regards balancing the BEPS risk and attracting foreign direct investment, South Africa should aim to increase its pull on and compete for a larger stake in the investments flowing into its BRIC counterparts.
- Since it remains essential to achieve equilibrium between nurturing cross-border trade and investment while simultaneously narrowing the scope of tax avoidance, some guidance may be gleaned from the UK's recent approach to "manufactured payments" where it removed the anti-avoidance legislation and instead focussed on applying the matching principle. This approach is preferable for revenue authorities and taxpayers alike.
- For South African purposes, focus should be honed on mismatches that

[4] GN 608 in GG 39650.

erode the South African tax base within the DTA context.

DTC REPORT ON ACTION 2: NEUTRALISE THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS

Table of Contents

1 INTRODUCTION

The OECD 2013 BEPS report[1] notes that international mismatches in the characterisation of hybrid entities and hybrid instrument arrangements can result in tax arbitrage. The OECD defines a hybrid mismatch arrangement as "an arrangement that exploits a difference in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to produce a mismatch in tax outcomes where that mismatch has the effect of lowering the aggregate tax burden of the parties to the arrangement.[2] Hybrid mismatch arrangements can be used to achieve unintended double non-taxation or long-term tax deferral. The OECD notes that it may be difficult to determine which country has in fact lost tax revenue, because multinational enterprises (MNE) will ensure that the laws of each country involved have been followed, but the result would be a reduction of the overall tax paid by all parties involved as a whole.[3]

2 EXAMPLES OF HYBRID MISMATCH ARRANGEMENTS

Hybrid arrangements generally use one or more of the following elements:

1) hybrid entities, that are treated as transparent for tax purposes in one country and as non-transparent in another country;
2) dual residence entities, that are resident in two different countries for tax purposes;
3) hybrid instruments, that are treated differently for tax purposes in the countries involved, for example as debt in one country and as equity in another.
4) hybrid transfers are arrangements that are treated as transfer of ownership of an asset in one country, but as a collateralised loan in another.[4]

2.1 HYBRID ENTITIES

A "hybrid entity" refers to a legal relationship that is treated as a corporation in one jurisdiction and as a transparent (non-taxable) entity in another.[5] The entity is transparent in that in the other country the profits or losses of the entity are taxed/deducted at the level of the members. The divergent treatment of the hybrid entity as between jurisdictions precipitates different characterisation of payments made in relation to such hybrid entity under the laws of different jurisdictions. The hybridity of an entity is generally a function of its transparency or opacity for tax

1 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 15.
2 OECD/G20 Base Erosion and Profit Shifting Project Neutralise the Effects of Hybrid Mismatch Arrangements: Action 2: 2014 Deliverable (2014) at 29 (OECD/G20 2014 Deliverable on Action 2).
3 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 15.
4 OECD "Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues" (March 2012) at 7.
5 B Arnold & M McIntyre *International Tax Primer* (2002) at 144; L Olivier & M Honiball *International Tax: A South African Perspective* (2011) at 554.

purposes; and consequently how its tax treatment in a particular jurisdiction impacts a particular payment. Since hybrid entities are treated as tax transparent in one jurisdiction and non-transparent or opaque in another, hybrid mismatch arrangements exploit the transparency or opacity of the entity for tax purposes to the extent that the discrepant tax treatment of the hybrid entity as between jurisdictions impacts a particular payment.

When a particular entity is afforded varying tax treatment in different jurisdictions, either double taxation or double non-taxation may arise. The varying tax status of entities arises because most countries adopt their own domestic entity classification approach when determining the tax status of foreign entities.[6] The hybrid mismatch arrangements in the case of hybrid entities involve the exploitation of cross-jurisdictional differences in the treatment of hybrid entities to produce duplicate deductions or deduction/no inclusion outcomes in respect of payments made by such entities. The most common hybrids involve partnerships and trusts. A multinational company subject to corporate income tax in one jurisdiction that qualifies for tax transparent treatment in another may be able to achieve significant tax savings. Typically this is accomplished when a company is organized as a partnership in one jurisdiction and as a corporation in another.

In the country where the entity is classified as a partnership for tax purposes the members or partners are taxable on their share of the entity's income. In the country where the entity is classified as a legal person, the entity itself is subject to tax on its income. Thus the different treatment of the entity in the two countries creates many tax planning opportunities.[7] For example, when an entity is classified as a corporation, the taxation of income may be deferred if the company does not distribute dividends to its shareholders. The deferral of taxes can however be prevented when a country has controlled foreign company (CFC) legislation. Where the foreign entity is classified as a partnership, CFC legislation may not be applied to the entity. Instead, the partners are taxed on their share of the profits of the partnership, generally at the time that the income is earned by the partnership, thus neutralising the deferral effect.[8]

The result of these arrangements is "stateless income" as tax authorities cannot determine which country has in fact lost tax revenue, even though the laws of each country involved have been followed, and there is a subsequent reduction of the overall tax paid by all parties involved. The double non-taxation, double deduction, and long-term deferral problems created by such arrangements can be boiled down

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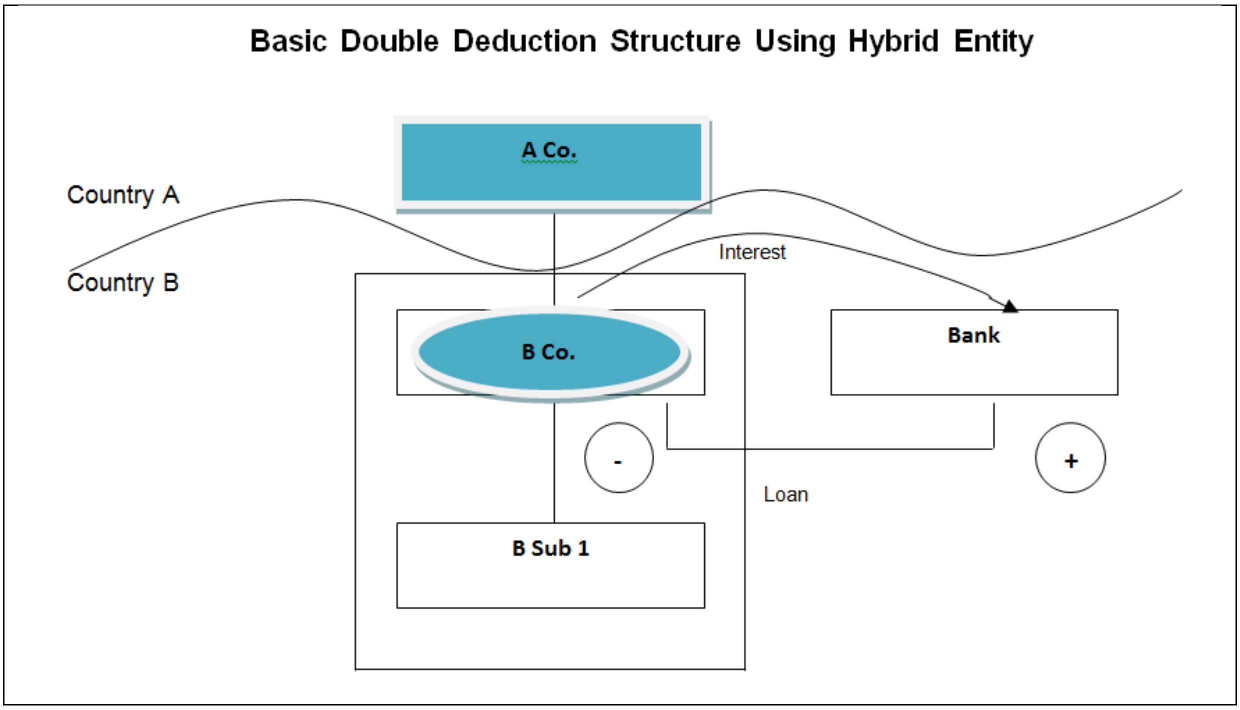
6 C Elliffe and A Yin "Hybrid Entity Double Taxation: A Case Study on the Taxation of Trans-Tasman Limited Partnerships" (2011) 21 No1 *Revenue Law Journal*.

7 Arnold & Mclyntre at 144.

8 AW Oguttu "The Challenges of Taxing Investments in Offshore Hybrid Entities: A South African Perspective" (2009) 21 No 1 *SA Mercantile Law Journal* 58.

to actions that neutralize the effect of an arrangement that consists of a deduction on one side and no income, or insufficient income, on the other side.

A double deduction technique frequently employed involves the use of a hybrid entity as a subsidiary of an investor where the hybrid subsidiary is treated as transparent under the tax regime governing the investor's jurisdiction but non-transparent in terms of the laws of its jurisdiction of establishment or operation. The differing tax treatment of the hybrid subsidiary across jurisdictions may result in the same payment being tax deductible in both the investor's and the subsidiary's jurisdiction. The example below[9] illustrates the use of a hybrid entity to achieve a double deduction outcome:



In this example, A Co holds all the shares of a foreign subsidiary (B Co). B Co is disregarded (i.e. treated as transparent) for Country A tax purposes. B Co borrows from a bank and pays interest on the loan. B Co derives no other income. Because B Co is disregarded in Country A, A Co is treated as the borrower under the loan for the purposes of Country A's tax laws and allowed a deduction. At the same time Country B considers that BCo has incurred interest expenditure which is deductible in terms of the tax laws of Country B. The arrangement therefore gives rise to an interest deduction under the laws of both Country A and Country B.

B Co is consolidated, for tax purposes, with its operating subsidiary B Sub 1 which allows it to surrender the tax benefit of the interest deduction to B Sub 1. The ability to "surrender" the tax benefit through the consolidation regime allows the two

9 Adopted from OECD/G20 2014 Deliverable on Action 2 at 52.

deductions for the interest expense to be set-off against separate income arising in Country A and Country B. The creation of a permanent establishment in the payer jurisdiction, that is eligible to consolidate with other taxpayers in the same jurisdiction, can be used to achieve similar DD outcomes. [10]

2.2 DUAL RESIDENT ENTITIES

Hybrid mismatch arrangements can also result when dual resident companies create double deductions, namely, in both the jurisdiction of incorporation and the jurisdiction of effective management.[11] Conflicts in the treatment of the hybrid entity generally involve a conflict between the transparency or opacity of the entity for tax purposes in relation to a particular payment.[12] An example of a scheme that was used to avoid taxes in this regard is the Double Irish and Dutch Sandwich scheme, discussed in the Report on Action 8.

When a company is regarded as tax resident in two jurisdictions, the tiebreaker rules in article 4 of the OECD Model Tax Convention can determine that for treaty purposes, the company is resident in only one of the two jurisdictions. In many tax treaties, that is the jurisdiction in which the company is effectively managed. The tiebreaker test applies only for purposes of the tax treaty, but most jurisdictions adopt the treaty residence status in their national tax laws so that it applies for all domestic tax legislation. In these circumstances, a double deduction cannot arise since the company is singly resident from the viewpoint of both jurisdictions. This process therefore predates what is envisaged by the BEPS Action 2. Following publicity about the Double Irish and Dutch Sandwich and publication of the OECD Action Plan, Ireland's Finance (No. 2) Bill 2013 now provides that a company incorporated in Ireland is to be treated as resident in Ireland for tax purposes. In treaties in which dual residence is settled instead by the mutual agreement procedure (all U.S. treaties and an increasing number of newer treaties, such as that of the Netherlands and the UK.) Action 14 aims to address current obstacles that tend to make these procedures time-consuming.

The determination of whether a hybrid entity constitutes a resident person is critical not only from a domestic tax perspective, but also within the international domain for purposes of establishing whether a hybrid entity qualifies for DTA protection as a person resident in one of the Contracting States to the DTA. Within a DTA context and by virtue of the inconsistent classification of hybrid entities cross-jurisdictionally, a hybrid entity may be deemed liable to tax in both Contracting States. This would be the case if the hybrid entity constituted a person resident in both Contracting States.

10 OECD/G20 2014 Deliverable on Action 2 at 52.

11 A Cinnamon "How the BEPS Action Plan Could Affect Existing Group Structures" Tax Analyst (12 Nov 2013).

12 OECD/G20 2014 Deliverable on Action 2 at 30.

Once the hybrid entity qualifies as a person[13] for purposes of Article 3(1)(a) and (b) of the OECD Model Tax Convention, liability to tax in both Contracting States may arise in consequence of the hybrid entity constituting a person resident in one Contracting State where residence is established with reference to incorporation and registration; while the other State bases residence on the place of effective management of a person.[14] Article 4(3) of the OECD MTC provides that "where by reason of the provisions of paragraph 1[15] a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated." Place of effective management has been adopted as the preferred criterion for persons other than individuals for MTC purposes;[16] a concept which in itself is problematic from an interpretation point of view, both domestically and internationally.

Where the hybrid entity is treated as opaque and subject to tax in one Contracting State, and as transparent in the other State, it will qualify for DTA protection as a person[17] resident[18] in the first-mentioned Contracting State. Where the hybrid entity is classified as transparent in both Contracting States and accordingly not liable to tax in either, the hybrid entity would not qualify as a person resident in either one of the Contracting States, and it would not be entitled to any DTA protection or relief.

From a hybrid entity classification perspective, it is important to consider the breadth of meaning accorded the term "person" for treaty purposes. In addition to individuals, the definition explicitly references companies and other bodies of persons.[19] The meaning ascribed to "company"[20] encompasses any entity which, although not a body of persons itself, is treated as a body corporate for tax purposes. This potentially brings a range of internationally employed transparent entities within scope. Examples include:

- The *fonds commun de placement* (FCP) (established in terms of the Luxembourg Law on Specialized Investment Funds, in terms of which an FCP must be managed by a management company established under Luxembourg law.

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13 Article 1 of the OECD Model Tax Convention, defines the term "person" as including an individual, a company and any other body of persons; b) the term “company” means anybody corporate or any entity that is treated as a body corporate for tax purposes."

14 K Vogel Vogel on Double Taxation Conventions (1997) at 93.

15 Paragraph 1 of Article 4 of the MC reads as follows: "For the purposes of this Convention, the term “resident of a Contracting State” means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein."

16 Vogel at 259.

17 Article 3(1)(a) and (b) of the OECD MTC.

18 Article 4(1) of the OECD MTC.

19 Article 3(1)(a) of the OECD MTC.

20 Article 3(1)(b) of the OECD MTC.

- The US Limited Liability Company (LLC) and generally the US ‘check the box’ rules;
- The UK Limited Liability Partnership (LLP);
- The *Société d'investissement à capital variable* (SICAV) which is an open-ended collective investment scheme common in Western Europe (especially Luxembourg, Switzerland, Italy, Spain, Belgium, Malta, France and Czech Republic) to mention a few.
- The UK, the open-ended investment company (OEIC) or investment company with variable capital (ICVC) which is a type of open-ended collective investment formed as a corporation under the Open-Ended Investment Company Regulations 2001. In the UK the incorporated OEIC is the preferred legal form of new open-ended investment over the older unit trust.

Another popular hybrid entity encountered in the international arena is the Dutch cooperative association (COOP) popular due to the favourable Dutch tax treatment it receives and its structural flexibility from a Dutch legal perspective. The COOP[21] has a legal personality but it does not have shares and instead of shareholders, it has members. This fact notwithstanding; its distributions are deemed to be dividends. The COOP is subject to Dutch corporate income tax and is regarded as a tax resident under Dutch DTAs. As such, the COOP has access to reduced withholding tax rates and DTA relief. Structurally a COOP is usually interposed between a pooled investment fund (e.g. a limited partnership) and a target company. From a tax perspective an investor in a COOP is not subject to Dutch corporate income tax and profit distributions by a COOP are not subject to Dutch dividend withholding tax, except in abusive situations.[22] Generally, the target company distributes dividends free of withholding tax to the COOP. These dividends are received tax free as they fall under the participation exemption. The COOP can distribute its profits to its ultimate investors free of dividend withholding tax. Advance tax rulings[23] can be obtained from the Dutch tax authorities for active target companies provided there is active involvement from the fund owning the COOP. If the interests in a COOP form part of the business assets of an active company;[24] the investor will not be subject to Dutch corporate income tax and distributions will be exempt from Dutch dividend withholding tax.

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21 The COOP is an association incorporated by at least two members by way of a notarial deed. The liability of the members of the COOP can be excluded in the deed of incorporation.

22 Abusive situations only arise if a COOP has no “real function” within the chain of ownership. Whether a COOP can be regarded as having a real function can be determined in advance with the Dutch tax authorities.

23 Minimal substance is required to obtain an advance tax ruling. However, the source jurisdiction may demand more substance before DTA access, and consequently reduced withholding tax rates will be granted. This regime is causing investment funds to increasingly relocate skilled personnel to the Netherlands to set up office. If certain conditions are met, personnel are entitled to apply for the 30% ruling, which allows them to receive 30% of their remuneration tax-free. Combined with the entitlement to deduct mortgage interest in respect of their primary residence and a full tax exemption for investment income, the Netherlands is a decidedly attractive option for skilled personnel.

24 Advance tax rulings are not required in such circumstances.

From the South African perspective, SARS issued Binding Private Ruling 149,[25] which provides that if the profit to be distributed by the COOP that was party to the transaction would be treated as a dividend or like payment for Dutch tax law purposes; the interest in the COOP would qualify as a "share" and an "equity share"[26] as defined in the Act. The COOP therefore constitutes a "company" and a "foreign company" within the meaning of the Income Tax Act; and a "foreign dividend" would be received pursuant to declaration made by the COOP.

Since partnerships have always created transparency issues because of the cross-jurisdictional differences in their treatment, in some jurisdictions, South Africa amongst them, partnerships are treated as transparent i.e. they have no separate legal identity. The individual partners are taxed on their respective shares of partnership income. Other jurisdictions treat partnerships as opaque, taxable as separate entities (on occasion as companies). The divergent treatment of partnerships impacts the application of DTA terms, particularly if one or more of the partners are not residents of the State where the partnership was established or created.

As a departure point, one must ask whether a partnership would be entitled to DTA protection or relief. In terms of the OECD MTC, the partnership would have to constitute a person resident in one of the Contracting States to invoke the relevant DTA provisions. In the absence of specific DTA provisions dealing with partnerships, it would seem that if a partnership is not considered opaque in one of the jurisdictions party to the DTA, it would be denied DTA relief.[27]

This conundrum is exacerbated by the spectrum of OECD MTC provisions available to deal with income derived by a partner from a partnership. If a partnership is treated as a company in a Contracting State, the distribution of partnership profits will in all likelihood be treated as dividends in terms of article 10(3) of the OECD MTC.[28] However, in certain jurisdictions, partnership profits, whether distributed or not, may be considered to be business profits of the partners in terms of article 7 of the OECD MTC. Depending on the jurisdiction, business profits in turn may incorporate other specific types of income and article 7(4) provides that "where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article." Alternatively the taxing jurisdiction may not treat

25 Dated 24 July 2013 dealing with the disposal of an asset that constitutes an equity share in a foreign company.

26 For purposes of the Income Tax Act an "equity share" "means any share in a company, excluding any share that, neither as respects dividends nor as respects returns of capital, carries any right to participate beyond a specific amount in a distribution."

27 Vogel at 86.

28 Article 10(3) of the MC states that "the term "dividends"…means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident".

partnership profits as business profits at all, and they may fall to be taxed as income from immovable property,[29] interest,[30] royalties,[31] independent[32] or dependent[33] personal services.

Similarly divergent treatment may result from the investment of capital in a partnership or the disposal by a partner of its partnership interest. Depending on the approach adopted by a taxing jurisdiction applying DTA provisions akin to those of the OECD MTC; capital may either be taxed in terms of Articles 22(2)[34] and 13(2)[35] as the capital attributable to a PE; or in terms of Articles 22(4)[36] or 13(4)[37] with regard to all other movable property.

The complexity arising by virtue of the domestic disconformity in tax treatment of partnerships within the realm of DTAs and the spectrum of provisions available to deal with income derived by a partner from a partnership is clearly evident in the Australian case of *Commissioner of Taxation v Resource Capital Fund III LP.*[38] In brief the case dealt with the interplay of certain Australian domestic legislation,[39] in particular, the Australian Income Tax Assessment Act 1997 and the DTA between Australia (the source jurisdiction) and the USA (the jurisdiction of residence of the partners of Resource Capital Fund III LP (RCF) which was a limited partnership, resident and formed in the Cayman Islands). RCF made a taxable capital gain on the sale of shares[40] it had held in an Australian mining company, St Barbara Mines Ltd (SBM). Australia treats corporate limited partnerships such as RCF as opaque and taxes them as companies. The US however, the jurisdiction of residence of the partners of RCF, treats limited partnerships as fiscally transparent and disregards them for US tax purposes while taxing the partners on their respective shares in the Australian sourced gain derived by RCF from the sale of the SBM shares.

Since in Australia RCF is a foreign limited partnership, Australia is only entitled to tax

29 Article 6 of the OECD MTC.
30 Article 11 of the OECD MTC.
31 Article 12 of the OECD MTC.
32 Article 14 of the OECD MTC.
33 Article 15 of the OECD MTC.
34 This article deals with "*capital represented by movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State may be taxed in that other State.*"
35 This article deals with "*gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise), may be taxed in that other State.*"
36 This article deals with "*all other elements of capital of a resident of a Contracting State shall be taxable only in that State.*"
37 This article deals with "*gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50 per cent of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State.*"
38 [2014] FCAFC 37 on appeal from Resource Capital Fund III *LP v Commissioner of Taxation* [2013] FCA 363.
39 Including the International Tax Agreements Act 1953 and the Taxation Administration Act 1953.
40 In Australia "real property" includes shares in a company, the assets of which consist wholly or principally of real property situated in Australia.

the capital gain it derived from the sale of the SBM shares if they constituted "taxable Australian real property." The Commissioner sought to tax RCF on the capital gain it derived from the sale of its SBM shares. RCF challenged such taxation. The issue raised was how the DTA should be applied if the gain was derived by RCF for Australian tax law purposes yet simultaneously treated as having been derived by the partners of RCF in terms of the US tax regime. The court *a quo* found in favour of RCF on the basis that, since the gain had been derived by the US partners of RCF and not RCF,[41] the provisions of the Australian Income Tax Assessment Act, which imposed the liability to tax the gain on RCF as the relevant taxable entity, were inconsistent with the provisions of the Australia/US DTA which treated the gain as having been derived not by RCF but by the partners of RCF. As such the court *a quo* found that the Commissioner was precluded from assessing RCF to tax on the gain.[42]

The Commissioner appealed the decision of the court *a quo* and argued that he was not precluded from taxing RCF on the gain in terms of Article 13 (Capital Gains) because the provisions of the Australia/ US DTA only applied to RCF if RCF were a resident of the US. In that case, Article 13(1) of the Australia/US DTA, which states that "*income or gains derived by a resident of one of the Contracting States from the alienation or disposition of real property*[43] *situated in the other Contracting State may be taxed in that other State*;" granted Australia the right to tax RCF on the gain. As fiscally transparent, RCF did not constitute a US resident. The Commissioner argued that the "essential error" made by the primary judge in the court *a quo* was by construing Article 13 as containing the negative inference that if a partnership was treated as fiscally transparent in the Resident State (US), the Source State (Australia) is prohibited from taxing such partnership and may only tax the partners. The Commissioner averred that it was irrelevant whether or not RCF was a US resident, as irrespective thereof, there existed no inconsistency between Article 13 of the Australia/US DTA and the application of the Australian Income Tax Assessment Act *vis-á-vis* the tax treatment of RCF as the entity taxable in Australia on the gain.

RCF argued that the gain on the sale of the SBM shares had been derived by the US partners of RCF and not by RCF. Accordingly RCF refuted the imposition of tax on it in terms of the Australian Income Tax Assessment Act on the basis that such

41 The primary judge substantiated his treatment of the gain as having been derived by the US partners of RCF rather than RCF on the strength of OECD Commentary on Article 1, paragraph 6.4, which comments that "(t)*his interpretation avoids denying the benefits of tax Conventions to a partnership's income on the basis that neither the partnership, because it is not resident, nor the partners, because the income is not directly...derived by them, can claim the benefits of the Convention with respect to that income...*(T)*he conditions that the income be...derived by a resident should be considered to be satisfied even where, as a matter of the domestic law of the State of source* (Australia*), the partnership would not be regarded as transparent for tax purposes, provided that the partnership is not actually considered as a resident of the State of source.*"

42 In terms of section 4(2) of the International Tax Agreements Act 1953.

43 This discussion assumes that the SBM shares sold constituted "real property" for Australian tax purposes.

taxation was inconsistent with the application of the Australia/US DTA by reason of Article 7 (Business Profits) thereof, which applied to the "business profits" of the US partners in terms of US tax law. As such RCF contended that Australia was precluded from taxing the gain in terms of Article 7(6) which provides that "where business profits include items of income which are dealt with separately in other Articles of (the Australia/US DTA), then the provisions of those Articles shall not be affected by this Article." RCF argued that while Article 13 operated as an exception to Article 7, it only entitled Australia to tax "*gains derived by a* (US) *resident*" and since RCF was not a US resident by virtue of its fiscal transparency for US tax purposes, alternatively because it was a resident of the Cayman Islands; Article 13(1) did not entitle Australia to tax RCF on the gain.

The Commissioner contended further on appeal that Article 7 was not applicable to the gain in the hands of RCF although he acknowledged that the partners of RCF were entitled to the benefits bestowed by Article 7 subject to Article 7(6).

On appeal, the court disagreed with the conclusions of the court *a quo*, and found that the inconsistencies arose not by virtue of the Australia/US DTA, but in consequence of the differing domestic tax treatment of partnerships as between Australia and the US. Because Australia regards certain limited partnerships as taxable entities, while the US treats partnerships as transparent non-taxable entities; the application of the DTA in Australia (the source jurisdiction) differs from its application in the US (the residence jurisdiction).

According to the court the departure point was to determine RCF's tax status for Australian tax purposes. As a foreign corporate limited partnership, Australia may assess it to tax as a company on its capital gains from the disposal of "taxable Australian real property." Since RCF is not a US resident nor an Australian resident, it follows that the Australia/US DTA can have no application[44] to the gain derived by FCP.

The court held that RCF is an independent taxable entity liable to tax in Australia on Australian sourced income. The provisions of Australia/US DTA cannot refute RCF's liability to Australian tax in these circumstances. There is no inconsistency between the Australia/US DTA and the provisions of the Australian Income Tax Assessment Act as regards the taxation of the gain in RCF's hands. The inconsistency pertains to the imposition of the liability for tax on the gain, resulting in the Australia/US DTA provisions applying differently between Australia as the source jurisdiction and the US as the jurisdiction of residence of the RCF partners.

The court noted that there may be an argument for the US resident RCF partners to seek Australia/US DTA benefits based upon the Australian sourced "business profits" received by them in consequence of the gain derived from the sale of

[44] See article 1 of the Australia/US DTA.

“taxable Australian real property” but the court did not consider this possibility further. As such the court found that the Commissioner was not precluded from assessing RCF to tax on the gain.

2.3 HYBRID INSTRUMENTS

Investors involved in international transactions often consider an appropriate funding method for their offshore investments as there are tax consequences that flow from both the structure and the funding method selected for investment.[45] Traditionally there are two main financial instruments that have been used to finance offshore investments: debt and equity.[46] In most jurisdictions interest on a loan is normally regarded as an expense incurred in earning profits, so it is deductible by the payer of the interest in computing its taxable income (unless there are special rules to the contrary).[47] In equity investment, dividends paid to shareholders are generally not deductible when calculating a taxpayer’s taxable income.[48] The past few decades have however seen the development of “hybrid financial instruments”; are neither debt nor equity, but possess characteristics of both debt and equity.[49] The economic and legal form of hybrid instruments allows them to be treated or classified differently for tax purposes (and even for non-tax purposes such as in corporate law or for accounting purposes).[50]

A hybrid financial instrument may be described as a financial instrument possessed of economic characteristics which are partially or wholly inconsistent with the classification of its legal form.[51] Indeed hybrid financial instruments may have characteristics which are consistent with more than one tax classification in more than one jurisdiction; or are not obviously consistent with any tax classification. As such, the term hybrid instrument is used to encompass a vast range of financial instruments which have both debt and equity features.[52] Thus a hybrid instrument may be treated as debt in one country and yet be regarded as equity in another country.[53]

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45 L Oliver & M Honiball International Tax: A South African Perspective at 216.

46 Equity investment involves the contribution of capital in return for shares. As a result, the investor has no assurance of any return. Debt involves the relending of money to the company, which is often evidenced by the issuing of debentures to the creditor in exchange for interest or some other form of fixed return. Boltar 253-255; HS Cilliers, ML Benade, JJ Henning, JJ Du Plessis, PA Delport, L De Koker L & JT Pretorius JT *Corporate Law* 3rd ed (2001) chapter 14.

47 K Huxham & P Haupt *Notes on South African Income Tax* (2014) at 80.

48 Ibid.

49 Oliver & Honiball at 240; K Keller & C McKenna “International Taxation of Derivatives” in Swan at 73; Arnold & Mclyntre at 144.

50 R Rohatgi *Basic International Taxation* (2002) at 562.

51 Duncan, General Reporter on Subject I: Tax treatment of hybrid financial instruments in cross-border transactions, *Cahiers de droit fiscal international*, Vol.85a (2000) at 21 (54th Congress of the International Fiscal Association, Munich, 2000).

52 Committee of European Banking Supervisors ("**CEBS**"), Report on quantitative analysis of the characteristics of hybrids in the European Economic Area ("**EEA**") (2007) at 6.

53 Rohatgi at 562.

In the 2014 OECD Report on Hybrid Mismatches,[54] a hybrid financial instrument is described as "any financing arrangement that is subject to a different tax characterisation under the law of two or more jurisdictions such that a payment under that instrument gives rise to a mismatch in tax outcomes".

Assume that a company in Country A buys financial instruments issued by a company in Country B. Under Country A's tax laws, the instrument is treated as equity, whereas for Country B's tax purposes the instrument is regarded as a debt instrument. Payments under the instrument are considered to be deductible interest expenses for the company under Country B tax law while the corresponding receipts are treated as dividends for Country A tax purposes and therefore exempt therein. Hybrid mismatch arrangements can be used to achieve unintended double non-taxation or long-term tax deferral, for instance, by creating two deductions for one borrowing, generating deductions without corresponding income inclusions, or misusing foreign tax credit and participation exemption regimes.[55]

Other financial transactions including those involving captive insurance or derivatives can give rise to similar outcomes of payments being deductible in one country, but not being taxed in another country.[56] Derivatives are financial instruments in which the rights and obligations under the instrument are derived from the value of another underlying instrument but they are not themselves the primary instruments.[57] The underlying instrument could be in the form of financial variables such as share indexes, interest rates, foreign exchange rates, stock market indexes, commodity prices, corporate stock or bonds; which could be linked to precious metals, agricultural products, property or contract rights.[58] Internationally, no accepted norm exists for classifying instruments as hybrid instruments. Generally the classification rules do not take cognisance of the classification of the instrument in other jurisdictions.[59]

This difference in characterisation often results in a payment of deductible interest by the issuer being treated as a dividend which is exempted from the charge to tax in the holder's jurisdiction or subject to some other form of equivalent tax relief.[60]

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54 OECD "Discussion Draft: Neutralise The Effects of Hybrid Mismatch Arrangements" (2014) at 19

55 A Cinnamon "How the BEPS Action Plan Could Affect Existing Group Structures" *Tax Analyst* (12 November 2013).

56 OECD "Base Erosion and Profit Shifting" (2013) at 40-41.

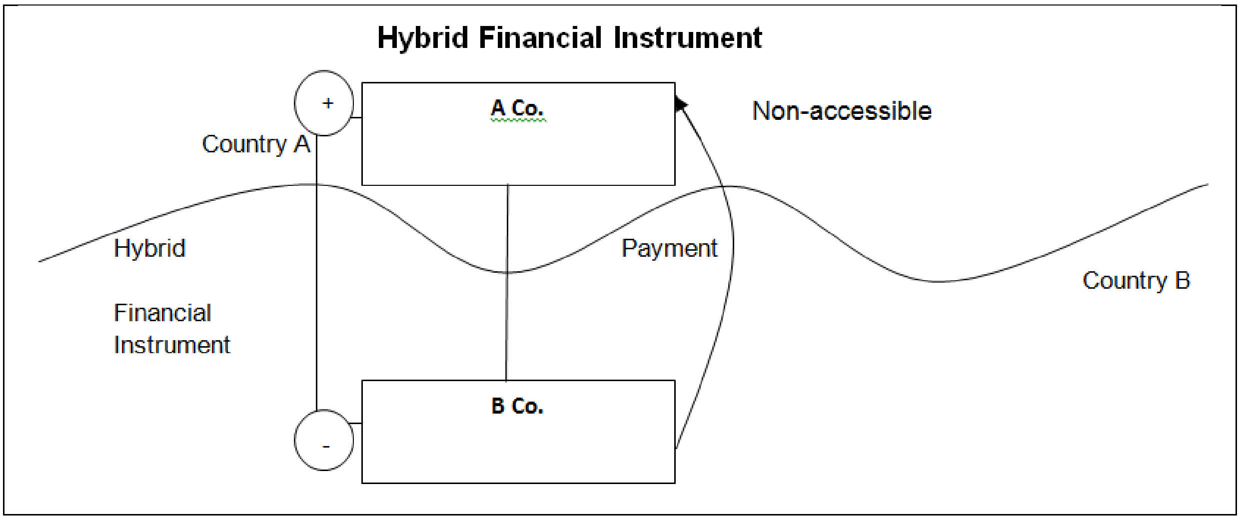
57 AW Oguttu "Challenges In Taxing Derivative Financial Instruments: International Views And South Africa's Approach" *(2012) 24 South African Mercantile law Journal at* 387*;* Oliver & Honiball at 252.

58 Oguttu at 387-388; JB Darby "International Tax Aspects of Derivative Instruments" in D Campbell *Globalisation of Capital Markets* (1996) at 379.

59 Duncan at 29.

60 OECD/G20 2014 Deliverable on Action 2 at 30.

The example below illustrates a basic mismatch arrangement using a hybrid financial instrument to achieve a tax mismatch: [61]



In this example B Co (an entity resident in Country B) issues a hybrid financial instrument to A Co (an entity resident in Country A). The instrument is treated as debt for the purposes of Country B law and Country B grants a deduction for interest payments made under the instrument while Country A law does not tax the payment or grants some form of tax relief (an exemption, exclusion, indirect tax credit, etc.) in relation to the interest payments received under that instrument. [62]

This mismatch can be due to a number of reasons. Most commonly the financial instrument is treated by the issuer as *debt* and by the holder as *equity*. This difference in characterisation often results in a payment of deductible interest by the issuer being treated as a dividend which is exempted from the charge to tax in the holder's jurisdiction or subject to some other form of equivalent tax relief. In other cases the mismatch in tax outcomes may not be attributable to a general difference in the characterisation of an instrument for tax purposes but rather to a specific difference in the tax treatment of a particular payment made under the instrument. For example the hybrid financial instrument might be an optional convertible note where B Co is entitled to a deduction for the value of the embedded option while A Co ignores the value of the option component or gives it a lower value than the B Co. This difference in tax treatment may result in a portion of the payment under the instrument being deductible under the laws of Country B but not included in ordinary income under the laws of Country A. [63]

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61 Adopted from OECD/G20 2014 Deliverable on Action 2 at 33.
62 Adopted from OECD/G20 2014 Deliverable on Action 2 at 34.
63 Adopted from OECD/G20 2014 Deliverable on Action 2 at 34.

2.4 HYBRID TRANSFERS

Hybrid transfers are a type of hybrid instrument. Hybrid transfers are arrangements pertaining to an asset where taxpayers in two jurisdictions assume mutually incompatible stances relative to the ownership of such asset, e.g. the transfer qualifies as a transfer of ownership of the asset in one jurisdiction for tax purposes but as a collateralised loan in the other jurisdiction e.g. the transfer qualifies as a transfer of ownership of the asset in one jurisdiction for tax purposes but as a collateralised loan in the other jurisdiction.[64]

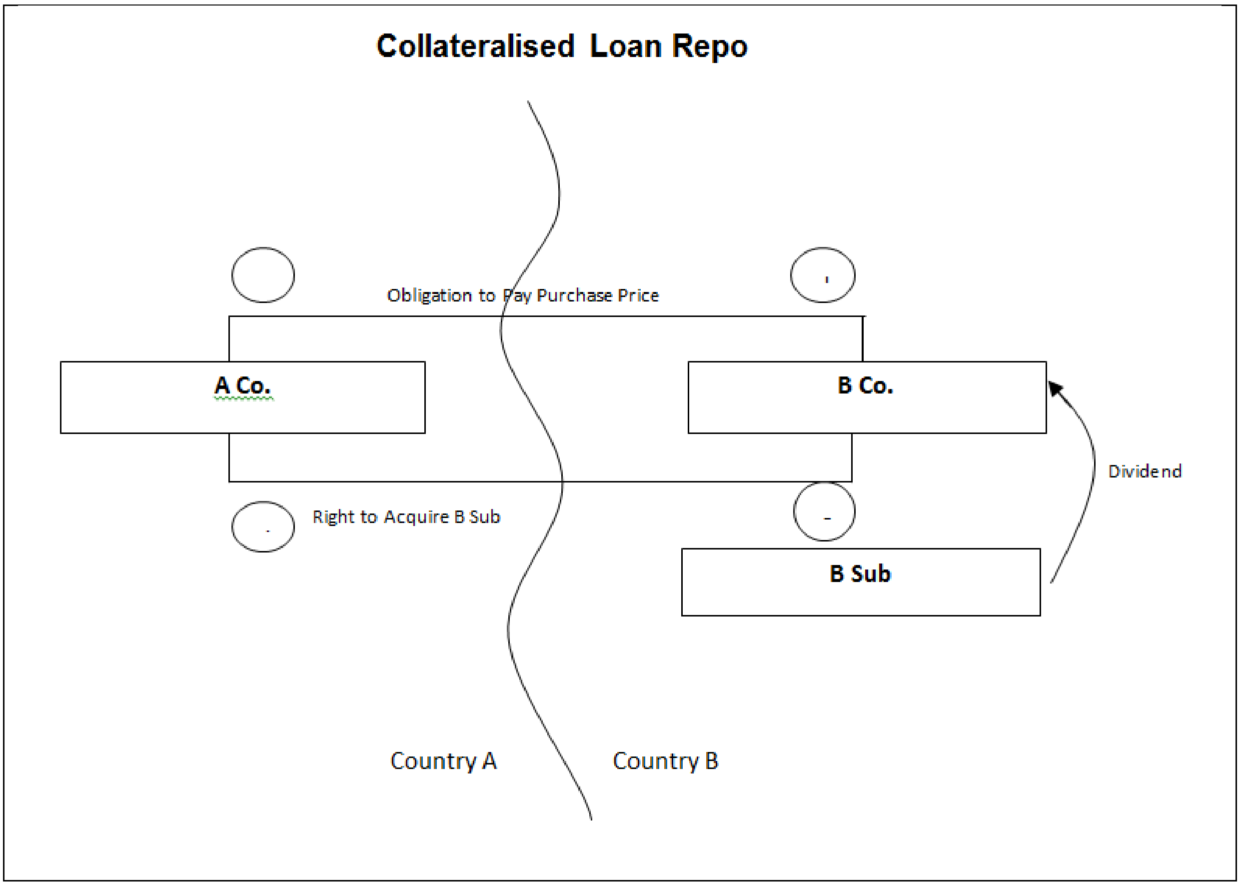
Thus hybrid transfers are typically collateralised loans or derivative transactions in terms of which both parties to the self-same arrangement in different jurisdictions consider themselves to be the owner of the loan collateral or subject matter of the derivative. The differences in the characterisation of the arrangement may cause payments made in terms of the arrangement to generate deduction/no inclusion outcomes.

The most common transaction used to achieve a tax mismatch under a hybrid transfer is a sale and repurchase arrangement (colloquially termed a "repo") of an asset where the repo terms result in the arrangement constituting the economic equivalent of a collateralised loan. The legal mechanism used to structure the repo generally results in one jurisdiction treating the arrangement as a sale and repurchase in accordance with its form; while the other jurisdiction classifies the arrangement according to its economic substance – as a loan secured by an asset. In most instances the collateral for such arrangements comprises shares of controlled entities but the repo mechanism can also be used with any asset that generates an exempt yield or some other tax benefit under the law of both jurisdictions.

Example 3 below illustrates a hybrid transfer structure and is taken from the OECD Report.[65] The structure illustrated below involves a company in Country A (A Co) which owns a subsidiary (B Sub). A sells the shares of B Sub to B Co under an arrangement that A Co (or an affiliate) will acquire those shares at a future date for an agreed price. Between sale and repurchase, B Sub makes distributions on the shares to B Co. The net cost of the repo to A Co is treated as a deductible financing cost. A Co's cost includes the B Sub dividends that are paid to and retained by B Co. Country B will typically grant a credit, exclusion, exemption or some other tax relief to B Co on the dividends received. B Co also treats the transfer of the shares back to A Co as a genuine sale of shares and may exempt any gain on disposal under an equity participation exemption or a general exclusion for capital gains. The combined effect of the repo transaction is, therefore, to generate a deduction for A Co in

64 OECD/G20 2014 Deliverable on Action 2 at 34.
65 OECD/G20 2014 Deliverable on Action 2 at 30.

respect of the aggregate payments made under the repo with no corresponding inclusion for B Co. [66]



3 TAX POLICY ISSUES THAT ARISE FROM HYBRID MISMATCHES

Hybrid mismatch arrangements generally aim to achieve the following results:

- double deduction schemes, where a deduction related to the same contractual obligation is claimed in two different countries;
- deduction or no inclusion schemes, that create a deduction in one country, but avoid the corresponding income inclusion in another country;
- foreign tax credit "generator", arrangements that generate foreign tax credits that would otherwise not be available, or available to the same extent.[67]
- prolonged tax deferral, which over time equates economically to double non-taxation.

Key tax issues that arise from hybrid mismatches:

- T<u>ax revenue</u>: It is often difficult to determine which of the countries has lost tax revenue, but it is clear that the countries concerned collectively lose tax revenue. [68]

66 OECD/G20 2014 Deliverable on Action 2 at 35.
67 OECD "Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues" (March 2012) at 7.

- Tax policy concerns: The particular difficulty encountered with these arrangements is that they are ostensibly compliant with the letter of the law in both affected tax jurisdictions yet they achieve a result unintended in either jurisdiction. The concern around this type of tax arbitrage hinges upon relief granted in respect of the same tax loss in multiple jurisdictions in consequence of differences in tax treatment between jurisdictions. The tax policy concern is that either due to the lacuna between different tax systems, or the application of certain bilateral tax treaties, income from cross-border transactions may escape tax altogether, alternatively be taxed at unduly low rates. [69]
- Competition: Businesses that use mismatch opportunities have competitive advantages over businesses that cannot use mismatch opportunities. [70]
- Economic efficiency: Where a hybrid mismatch is available, a cross-border investment will often be more attractive than an equivalent domestic investment. Hybrid mismatch arrangements may also contribute to increases in leverage from tax-favoured borrowing. [71]
- Transparency: The adoption of tax-driven structures leads to a lack of transparency. The public will be generally unaware that the effective tax regime is quite different for those taxpayers that use mismatch opportunities.
- Fairness: Fairness relates to the fact that mismatch opportunities are more readily available for taxpayers with income from capital, rather than labour.[72]

4 EARLIER WORK BY THE OECD ON HYBRID MISMATCHES

The role played by hybrid mismatch arrangements in aggressive tax planning has been discussed in a number of earlier OECD reports:

(i) The 1999 report entitled: "The Application of the OECD Model Tax Convention to Partnerships"[73]

This report contains an extensive analysis of the application of treaty provisions to partnerships, including in situations where there is a mismatch in the tax treatment of the partnership. The Partnership Report, however, did not consider the application of the tax transparency rules to entities other than partnerships (i.e. hybrid entities that do not constitute partnerships under the law of the contracting jurisdictions but are nevertheless treated as fiscally transparent for tax purposes) and did not consider payments made under hybrid instruments.

(ii) The 2010 OECD Report entitled: "Addressing Tax Risks Involving Bank Losses"[74]

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68 OECD "Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues" (March 2012) at 11-12.
69 Ibid.
70 Ibid.
71 Ibid.
72 Ibid.
73 OECD "The Application of the OECD Model Tax Convention to Partnerships" (1999).
74 OECD *"Addressing Tax Risks Involving Bank Losses" (*2010).

This report highlighted the use of hybrid mismatches in the context of international banking and recommended that revenue bodies "bring to the attention of their government tax policy officials those situations which may potentially raise policy issues, and, in particular, those where the same tax loss is relieved in more than one country as a result of differences in tax treatment between jurisdictions, in order to determine whether steps should be taken to eliminate that arbitrage/mismatch opportunity".

(iii) The 2011 OECD Report entitled: "Corporate Loss Utilisation through Aggressive Tax Planning"[75]

This report recommended that countries "consider introducing restrictions on the multiple use of the same loss to the extent they are concerned with these results".

(iv) The 2012 OECD Report entitled: "Hybrid Mismatch Arrangements"

In 2012, the OECD undertook a review with a number of interested member countries to identify examples of tax planning schemes involving hybrid mismatch arrangements and to assess the effectiveness of response strategies adopted by those countries. The review culminated in the 2012 OECD report on "*Hybrid Mismatch Arrangements*".[76] The 2012 Hybrids Report concludes that the collective tax base of countries is put at risk through the operation of hybrid mismatch arrangements even though it is often difficult to determine unequivocally which individual country has lost tax revenue under the arrangement. Apart from impacting on tax revenues, the report also concluded that hybrid mismatch arrangements have a negative impact on competition, efficiency, transparency and fairness. The 2012 Hybrids Report sets out a number of policy options to address hybrid mismatch arrangements:

a) On General anti-avoidance rules: The 2012 report noted that general anti-avoidance rules (including judicial doctrines such as "abuse of law", "economic substance", "fiscal nullity", "business purpose" or "step transactions") could be an effective tool in addressing some hybrid mismatch arrangements, particularly those with circular flows, contrivance or other artificial features, however the terms of general anti-avoidance rules and the frequent need to show a direct link between the transactions and the avoidance of that particular jurisdiction's tax tended to make the application of general anti-avoidance rules difficult in many cases involving hybrid mismatch arrangements. As a consequence, although general anti-avoidance rules are an effective tool, they do not always provide a comprehensive response to cases of unintended double non-taxation through the use of hybrid mismatch arrangements. [77]

c) On Specific anti-avoidance rules: The report noted that a number of countries have introduced specific anti-avoidance rules that had an indirect impact on hybrid mismatch arrangements. For example, certain countries have introduced rules that in certain cases deny the deduction of payments

75 OECD "Corporate Loss Utilisation through Aggressive Tax Planning" (2011).
76 OECD "Hybrid Mismatch Arrangements: Policy and Compliance Issues" (2012).
77 OECD 2014 Report on Action 2 in para 4.

where they are not subject to a minimum level of taxation in the country of the recipient. Similarly, other countries deny companies a deduction for a finance expense where the main purpose of the arrangement is gaining a tax advantage under local law. While these provisions are not specifically aimed at deductions with no corresponding inclusion for tax purposes, they may impact on those structures by denying the deduction at the level of the payer.[78]

d) On rules specifically addressing hybrid mismatch arrangements: The report considered rules which specifically targeted hybrid mismatch arrangements. Under these rules, the domestic tax treatment of an entity, instrument or transfer involving a foreign country is linked to the tax treatment in the foreign country, thus eliminating the possibility for mismatches. The report concluded that domestic law rules which link the tax treatment of an entity, instrument or transfer to the tax treatment in another country had significant potential as a tool to address hybrid mismatch arrangements. Although such "linking rules" make the application of domestic law more complicated, the report noted that such rules are not a novelty as, in principle, foreign tax credit rules, subject to tax clauses, and CFC rules often do exactly that.[79]

5 OECD 2013 BEPS ACTION ON HYBRID MISMATCHES

Action 2 of the 2013 OECD Report on "Base Erosion and Profits Shifting (BEPS)[80] recommends that countries should develop tax treaty rules regarding the design of domestic rules to neutralise the effects of (e.g. double non-taxation, double deduction, and long-term deferral) of hybrid instruments and entities.

- On the domestic front, the OECD recommends that countries come up with domestic laws that:
  - prevent exemption or non-recognition for payments that are deductible by the payor;
  - deny a deduction for a payment that is not includible in income by the recipient (and is not subject to taxation under controlled foreign company (CFC) or similar rules);
  - deny a deduction for a payment that is also deductible in another jurisdiction;
  - provide guidance on co‑ordination or tie-breaker rules if more than one country seeks to apply such rules to a transaction or structure.
- On the international front, the OECD undertakes to come up with changes to the OECD Model Tax Convention that will ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly.

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78 OECD 2014 Report on Action 2 in para 5.
79 OECD 2014 Report on Action 2 in para 6.
80 OECD Action Plan on Base Erosion and Profit Shifting (2013) at 15.

- OECD's work will be co-ordinated with the work on CFC rules, and the work on treaty shopping.[81]

Following the OECD 2013 BEPS Report, in 2014, the OECD issued a Discussion Draft document entitled "Neutralise the effects of Hybrid mismatches" which sets out draft recommendations for domestic rules designed to neutralise the effect of hybrid financial instruments and for payments made by and to hybrid entities.[82] After comment from various stakeholders, in September 2014 the OECD issued a Report on hybrid mismatches.[83]

6 OECD 2015 FINAL REPORT ON HYBRID MISMATCHES

In 2015, the OECD issued its Final Report on Action 2[84] which supersedes the 2014 report. The 2015 Final Report calls for the development of model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effects of hybrid instruments and entities. The Action Item states that this may include:

(a) Changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly;
(b) Domestic law provisions that prevent exemption or non-recognition for payments that are deductible by the payer;
(c) Domestic law provisions that deny a deduction for a payment that is not includible in income by the recipient (and is not subject to taxation under CFC or similar rules);
(d) Domestic law provisions that deny a deduction for a payment that is also deductible in another jurisdiction; and
(e) Where necessary, guidance on co-ordination or tie-breaker rules if more than one country seeks to apply such rules to a transaction or structure.

Part I of the Final Report sets out the recommendations for the design of the domestic law rules called for under Action 2. It recommends specific improvements to domestic law, designed to achieve a better alignment between those laws and their intended tax policy outcomes (specific recommendations) and the introduction of linking rules that neutralise the mismatch in tax outcomes under a hybrid mismatch arrangement without disturbing any of the other tax, commercial or regulatory consequences (hybrid mismatch rules).[85]

81 Ibid.
82 OECD 2014 Report on Action 2 at 4.
83 OECD "Neutralise The Effects of Hybrid Mismatch Arrangements" (2014) (OECD 2014 Report on Action 2).
84 OECD/G20 2015 Final Report on Action 2.
85 OECD/G20 2015 Final Report on Action 2 at 16.

Part II deals with tax treaty BEPS concerns related dual resident entities. The OECD recommends that cases of dual residence under a tax treaty would be solved on a case-by-case basis rather than on the basis of the current rule based on the place of effective management of entities.

7 PART I: OECD 2015 FINAL REPORT ON HYBRID MISMATCHES - RECOMMENDED DOMESTIC RULES

The Final Report recommends improvements to domestic law rules that:[86]

(a) Deny a dividend exemption, or equivalent relief from economic double taxation, in respect of deductible payments made under financial instruments.
(b) Introduce measures to prevent hybrid transfers being used to duplicate credits for taxes withheld at source.
(c) Alter the effect of CFC and other offshore investment regimes to bring the income of hybrid entities within the charge to taxation under the laws of the investor jurisdiction.
(d) Encourage countries to adopt appropriate information reporting and filing requirements in respect of tax transparent entities established within their jurisdiction.
(e) Restrict the tax transparency of reverse hybrids that are members of a control group.

In addition to these specific recommendations, Part I also sets out recommendations for hybrid mismatch rules that adjust the tax outcomes under a hybrid mismatch arrangement in one jurisdiction in order to align them with the tax outcomes in the other jurisdiction [87] These recommendations target payments under a hybrid mismatch arrangement that give rise to one of the three following outcomes:

(a) *Payments that give rise to a deduction / no inclusion outcome* (D/NI outcome), i.e. payments that are deductible under the rules of the payer jurisdiction and are not included in the ordinary income of the payee. Both payments made under hybrid financial instruments and payments made by and to hybrid entities can give rise to D/NI outcomes.
(b) *Payments that give rise to a double deduction outcome* (DD outcome), i.e. payments that give rise to two deductions in respect of the same payment. As well as producing D/NI outcomes, payments made by hybrid entities can, in certain circumstances, also give rise to DD outcomes.
(c) *Payments that give rise to an indirect D/NI outcome*, i.e. payments that are deductible under the rules of the payer jurisdiction and that are set-off by the payee against a deduction under a hybrid mismatch arrangement. Once taxpayers have entered into a hybrid mismatch arrangement between two jurisdictions without effective hybrid mismatch rules, it is a relatively simple

[86] Ibid.
[87] OECD/G20 2015 Final Report on Action 2 at 16.

matter for the effect of that mismatch to be shifted into a third jurisdiction (through the use of an ordinary loan, for example).

The report identifies the two main areas of concern that give rise to the need of the recommendations made in this regard, viz, the mismatch and the hybrid elements.

Mismatch

The Final Report determines the extent of a mismatch by comparing the tax treatment of the payment under the laws of each jurisdiction where the mismatch arises. A D/NI mismatch generally occurs when a payment or part of a payment that is treated as deductible under the laws of one jurisdiction is not included in ordinary income by any other jurisdiction. A DD mismatch arises to the extent that all or part of the payment that is deductible under the laws of another jurisdiction is set-off against non-dual inclusion income.[88]

The hybrid mismatch rules contained in the Final Report focus on payments and whether the nature of that payment gives rise to a deduction for the payer and ordinary income for the payee. Rules that entitle taxpayers to a unilateral tax deduction for invested equity without requiring the taxpayer to make a payment are economically closer to a tax exemption or similar taxpayer specific concessions and do not produce a mismatch in tax outcomes in the sense contemplated by this Action. Such rules, and rules having similar effect are considered separately in the context of the implementation of these recommendations.[89]

Hybrid element

Cross-border mismatches arise in other contexts such as the payment of deductible interest to a tax exempt entity. However, the only types of mismatches targeted by this report are those that rely on a hybrid element to produce such outcomes. Some arrangements exploit differences between the transparency or opacity of an entity for tax purposes (hybrid entities) and others involve the use of hybrid instruments, which generally involve a conflict in the characterisation of the instrument (and hence the tax treatment of the payments made under it). Hybrid instruments and entities can also be embedded in a wider arrangement or group structure to produce indirect D/NI outcomes.[90]

The 2015 Final Report on Action 2 notes that in most cases the causal connection between the hybrid element and the mismatch will be obvious. There are some challenges, however, in identifying the hybrid element in the context of hybrid financial instruments. Because of the wide variety of financial instruments and the

88 OECD/G20 2015 Final Report on Action 2 at 17.
89 Ibid.
90 OECD/G20 2015 Final Report on Action 2 at 18.

different ways jurisdictions tax them, it has proven impossible, in practice, for the Final Report to comprehensively identify and accurately define all those situations where cross-border conflicts in the characterisation of a payment under a financing instrument may lead to a mismatch in tax treatment. Rather than targeting these technical differences, the focus of the Final Report is to align the treatment of cross-border payments under a financial instrument so that amounts that are treated as a financing expense by the issuer's jurisdiction are treated as ordinary income in the holder's jurisdiction.[91]

Structure regarding order of the rules

In order to avoid the risk of double taxation, the Final Report also calls for "guidance on the co-ordination or tie-breaker rules where more than one country seeks to apply such rules to a transaction or structure." For this reason the rules recommended in Action 2 of the Final Report are organised in a hierarchy so that a jurisdiction does not need to apply the hybrid mismatch rule where there is another rule operating in the counterparty jurisdiction that is sufficient to neutralise the mismatch.[92]

The report recommends that every jurisdiction introduce all the recommended rules so that the effects of hybrid mismatch arrangements are neutralised even if the counterparty jurisdiction does not have effective hybrid mismatch rules. Overly broad hybrid mismatch rules may be difficult to apply and administer. Accordingly, each hybrid mismatch rule has its own defined scope, which is designed to achieve an overall balance between a rule that is comprehensive, targeted and administrable.[93]

7.1 RECOMMENDED DOMESTIC RULES REGARDING HYBRID MISMATCHES

7.1.1 Recommendation 1: Neutralise the mismatch to the extent the payment gives rise to a D/NI outcome

This recommendation is intended to prevent a taxpayer from entering into structured arrangements or arrangements with a related party that exploit differences in the tax treatment of a financial instrument to produce a D/NI outcome. [94]

Where a payment under a financial instrument results in a hybrid mismatch and to a substitute payment under an arrangement to transfer a financial instrument, the OECD recommends this rule to Neutralise the mismatch to the extent the payment gives rise to a D/NI outcome

(a) The payer jurisdiction should deny a deduction for such payment to the extent it gives rise to a D/NI outcome.

91 Ibid.
92 OECD/G20 2015 Final Report on Action 2 at 18.
93 Ibid.
94 OECD/G20 2015 Final Report on Action 2 in para 18.

(b) If the payer jurisdiction does not neutralise the mismatch then the payee jurisdiction will require such payment to be included in ordinary income to the extent the payment gives rise to a D/NI outcome.
(c) Differences in the timing of the recognition of payments will not be treated as giving rise to a D/NI outcome for a payment made under a financial instrument, provided the taxpayer can establish to the satisfaction of a tax authority that the payment will be included as ordinary income within a reasonable period of time.[95]

The rule aligns the tax treatment of payments under a financial instrument by adjusting the amount of deductions allowed under the laws of the payer jurisdiction, or the amount of income to be included in the payee jurisdiction, as appropriate, in order to eliminate the mismatch in tax outcomes.[96] The recommendation applies to three different types of financing arrangements:

(a) Financial instruments: These are defined in the OECD Final Report on Action 2 to mean "any arrangement that is taxed under the rules for taxing debt, equity or derivatives under the laws of both the payee and payer jurisdictions and includes a hybrid transfer".[97]
(b) Hybrid transfers: These are defined in the OECD Final Report on Action 2 as including any arrangement to transfer a financial instrument entered into by a taxpayer with another person where:
   (i) the taxpayer is the owner of the transferred asset and the rights of the counterparty in respect of that asset are treated as obligations of the taxpayer; and
   (ii) under the laws of the counterparty jurisdiction, the counterparty is the owner of the transferred asset and the rights of the taxpayer in respect of that asset are treated as obligations of the counterparty.

   Ownership of an asset for these purposes includes any rules that result in the taxpayer being taxed as the owner of the corresponding cash-flows from the asset.[98]
(c) Substitute payments: These are defined in the OECD Final Report on Action as "any payment, made under an arrangement to transfer a financial instrument, to the extent it includes, or is payment of an amount representing, a financing or equity return on the underlying financial instrument where the payment or return would:
   (i) not have been included in ordinary income of the payer;
   (ii) have been included in ordinary income of the payee; or
   (iii) have given rise to hybrid mismatch;

   if it had been made directly under the financial instrument"[99]

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[95] OECD/G20 2015 Final Report on Action 2 at 23.
[96] OECD/G20 2015 Final Report on Action 2 in para 18.
[97] OECD/G20 2015 Final Report on Action 2 at 23.
[98] OECD/G20 2015 Final Report on Action 2 at 23.
[99] OECD/G20 2015 Final Report on Action 2 at 23.

The OECD further recommends that a jurisdiction should treat any arrangement where one person provides money to another in consideration for a financing or equity return as a financial instrument to the extent of such financing or equity return. Furthermore, that any payment under an arrangement that is not treated as a financial instrument under the laws of the counterparty jurisdiction shall be treated as giving rise to a mismatch only to the extent the payment constitutes a financing or equity return.[100]

The OECD noted that the rule only applies to a payment under a financial instrument that results in a hybrid mismatch. A payment under a financial instrument results in a hybrid mismatch where the mismatch can be attributed to the terms of the instrument. A payment cannot be attributed to the terms of the instrument where the mismatch is solely attributable to the status of the taxpayer or the circumstances in which the instrument is held. Furthermore, this rule only applies if the parties to the mismatch are in the same control group or where the payment is made under a structured arrangement and the taxpayer is a party to that structured arrangement.[101]

7.1.2 Recommendation 2: Specific recommendations for the tax treatment of financial instruments

The OECD provides two specific recommendations for changes to the tax treatment cross-border financial instruments:

(a) Denial of dividend exemption for deductible payments

In order to prevent D/NI outcomes from arising under a financial instrument, a dividend exemption that is provided for relief against economic double taxation should not be granted under domestic law to the extent the dividend payment is deductible by the payer. Equally, jurisdictions should consider adopting similar restrictions for other types of dividend relief granted to relieve economic double taxation on underlying profits.

(b) Restriction of foreign tax credits under a hybrid transfer

In order to prevent duplication of tax credits under a hybrid transfer, any jurisdiction that grants relief for tax withheld at source on a payment made under a hybrid transfer should restrict the benefit of such relief in proportion to the net taxable income of the taxpayer under the arrangement.[102]

The purpose of these recommendations is to bring the treatment of these instruments into line with the tax policy outcomes that will generally apply to the same instruments in the wholly-domestic context.[103]

100 OECD/G20 2015 Final Report on Action 2 at 23.
101 OECD/G20 2015 Final Report on Action 2 at 23.
102 OECD/G20 2015 Final Report on Action 2 at 45.
103 OECD/G20 2015 Final Report on Action 2 at 45.

7.1.3 Recommendation 3: Disregarded hybrid payments rule

A deductible payment can give rise to a D/NI outcome where the payment is made by a hybrid entity that is disregarded under the laws of the payee jurisdiction. Such disregarded payments can give rise to tax policy concerns where that deduction is available to be set-off against an amount that is not treated as income under the laws of the payee jurisdiction (i.e. against income that is not "dual inclusion income"). The purpose of the disregarded hybrid payments rule is to prevent a taxpayer from entering into structured arrangements, or arrangements with members of the same control group, that exploit differences in the tax treatment of payer to achieve such outcomes.[104]

To neutralise the mismatch to the extent the payment gives rise to a D/NI outcome, the OECD recommends that the following rule should apply to a disregarded payment made by a hybrid payer that results in a hybrid mismatch:

(a) The payer jurisdiction should deny a deduction for such payment to the extent it gives rise to a D/NI outcome.
(b) If the payer jurisdiction does not neutralise the mismatch then the payee jurisdiction will require such payment to be included in ordinary income to the extent the payment gives rise to a D/NI outcome.
(c) No mismatch will arise to the extent that the deduction in the payer jurisdiction is set-off against income that is included in income under the laws of both the payee and the payer jurisdiction (i.e. dual inclusion income).
(d) Any deduction that exceeds the amount of dual inclusion income (the excess deduction) may be eligible to be set-off against dual inclusion income in another period.[105]

The OECD defines a disregarded payment as a payment that is deductible under the laws of the payer jurisdiction and is not recognised under the laws of the payee jurisdiction. In this regards, a person will be a hybrid payer where the tax treatment of the payer under the laws of the payee jurisdiction causes the payment to be a disregarded payment.[106]

The rule only applies to payments that result in a hybrid mismatch. A disregarded payment made by a hybrid payer results in a hybrid mismatch if, under the laws of the payer jurisdiction, the deduction may be set-off against income that is not dual inclusion income.[107] This rule only applies if the parties to the mismatch are in the

[104] OECD/G20 2015 Final Report on Action 2 in para 115.
[105] OECD/G20 2015 Final Report on Action 2 at 49.
[106] OECD/G20 2015 Final Report on Action 2 at 49.
[107] OECD/G20 2015 Final Report on Action 2 at 49.

same control group or where the payment is made under a structured arrangement and the taxpayer is a party to that structured arrangement. [108]

The primary recommendation under the deductible hybrid payments rule is that the payer jurisdiction should restrict the amount of the deduction that can be claimed for a disregarded payment to the total amount of dual inclusion income. The defensive rule requires the payee jurisdiction to include an equivalent amount in ordinary income. [109]

7.1.4 Recommendation 4: Reverse hybrid rule

A deductible payment made to a reverse hybrid may give rise to a mismatch in tax outcomes where that payment is not included in ordinary income in the jurisdiction where the payee is established (the establishment jurisdiction) or in the jurisdiction of any investor in that payee (the investor jurisdiction). [110] A reverse hybrid is defined in the report as "any person that is treated as a separate entity by an investor and as transparent under the laws of the establishment jurisdiction". [111]

In this regard, the OECD recommends a rule to neutralise the mismatch to the extent the payment gives rise to D/NI outcome. Thus if a payment is made to a reverse hybrid that results in a hybrid mismatch the payer jurisdiction should apply a rule that will deny a deduction for such payment to the extent it gives rise to a D/NI outcome.[112]

The recommended rule neutralises those mismatches that arise under a reverse hybrid structure where the mismatch is a result of both the establishment jurisdiction and the investor jurisdiction treating the payment to the reverse hybrid as owned by a taxpayer in the other jurisdiction. This reverse hybrid rule can apply to a broad range of deductible payments (including interest, royalties, rents and payments for services). [113]

The rule only applies to payment made to a reverse hybrid. The rule also only applies to hybrid mismatches. In this regard, a payment results in a hybrid mismatch if a mismatch would not have arisen had the accrued income been paid directly to the investor. [114] The rule only applies where the investor, the reverse hybrid and the payer are members of the same control group or if the payment is made under a structured arrangement and the payer is party to that structured arrangement. [115]

108 OECD/G20 2015 Final Report on Action 2 at 49.
109 OECD/G20 2015 Final Report on Action 2 in para 116.
110 OECD/G20 2015 Final Report on Action 2 in para 139.
111 OECD/G20 2015 Final Report on Action 2 at 55.
112 OECD/G20 2015 Final Report on Action 2 at 55.
113 OECD/G20 2015 Final Report on Action 2 in para 139.
114 OECD/G20 2015 Final Report on Action 2 at 55.
115 OECD/G20 2015 Final Report on Action 2 at 55.

7.1.5 Recommendation 5: Specific recommendations for the tax treatment of reverse hybrids

The OECD provides three specific recommendations for the tax treatment of reverse hybrids. These recommendations cover the tax treatment of payments made to a reverse hybrid under the laws of the investor and establishment jurisdiction and recommendations on tax filing and information requirements in order to assist both taxpayers and tax administrations to make a proper determination of the payments that have been attributed to that non-resident investor. [116]

These specific recommendations are not hybrid mismatch rules. That is, they do not adjust the tax consequences of a payment because of differences in its tax treatment in another jurisdiction. Rather, the recommendations sets out improvements that jurisdictions could make to their domestic law that will reduce the frequency of hybrid mismatches by bringing the tax treatment of cross-border payments made to transparent entities into line with the tax policy outcomes that would generally be expected to apply to payments between domestic taxpayers. [117]

(a) Improvements to CFC and other offshore investment regimes

Jurisdictions should introduce, or make changes to, their offshore investment regimes in order to prevent D/NI outcomes from arising in respect of payments to a reverse hybrid. Equally jurisdictions should consider introducing or making changes to their offshore investment regimes in relation to imported mismatch arrangements.[118]

- Payments made through a reverse hybrid structure will not result in D/NI outcomes if the income is fully taxed under a CFC, foreign investment fund (FIF) or a similar anti-deferral rule in the investor jurisdiction that requires the investor to include its allocated share of any payment of ordinary income made to the intermediary on a current basis. [119]
- A jurisdiction may use one or a combination of measures that could include changes to residency rules, CFC rules and rules that tax a resident investor on changes in the market value of the investment. When considering changes to their offshore investment regime, jurisdictions should also take into account the effect of existing exemptions, safe harbours and thresholds that may reduce the effectiveness of those regimes in bringing into account income of a reverse hybrid.[120]

[116] OECD/G20 2015 Final Report on Action 2 in para 169.
[117] OECD/G20 2015 Final Report on Action 2 in para 170.
[118] OECD/G20 2015 Final Report on Action 2 at 63.
[119] OECD/G20 2015 Final Report on Action 2 in para 171.
[120] OECD/G20 2015 Final Report on Action 2 in para 172.

(b) Limiting the tax transparency for non-resident investors

A reverse hybrid should be treated as a resident taxpayer in the establishment jurisdiction if the income of the reverse hybrid is not brought within the charge to taxation under the laws of the establishment jurisdiction and the accrued income of a non-resident investor in the same control group as the reverse hybrid is not brought within the charge to taxation under the laws of the investor jurisdiction. [121]

- Tax transparency is an effective way for collective investment vehicles to ensure tax neutrality of outcomes for different investors that are subject to different marginal rates of taxation. Tax transparency proceeds on the assumption, however, that the income allocated to the investor will be taxable in the hands of the investor. In the cross-border context this is not always the case. Recommendation 5.2 is intended to prevent a non-resident taking advantage of a person's tax transparency in order to achieve a mismatch in tax outcomes. [122]
- This recommendation applies where a tax transparent person is controlled or otherwise owned by a non-resident investor and that investor is not required to take into account payments of ordinary income allocated to them by that person. The rule effectively encourages jurisdictions to turn off their transparency rules when those rules are primarily used to achieve hybrid mismatches. [123]

(c) Information reporting for intermediaries

Jurisdictions should introduce appropriate tax filing and information reporting requirements on persons established within their jurisdiction in order to assist both taxpayers and tax administrations to make a proper determination of the payments that have been attributed to that non-resident investor. [124]

- This rule is intended to encourage jurisdictions to maintain appropriate reporting and filing requirements for tax transparent entities that are established within that jurisdiction. This would involve the maintenance of accurate records of who their investors are, how much of an investment each investor holds in the entity and the amount of income and expenditure allocated to those investors. These records should be made available, on request, to both investors and to the tax administration in the establishment jurisdiction. [125]

121 OECD/G20 2015 Final Report on Action 2 at 63.
122 OECD/G20 2015 Final Report on Action 2 in para 174.
123 OECD/G20 2015 Final Report on Action 2 in para 175.
124 OECD/G20 2015 Final Report on Action 2 at 63.
125 OECD/G20 2015 Final Report on Action 2 in para 176.

7.1.6 Recommendation 6: Deductible hybrid payments rule

Where a taxpayer makes a payment through a cross-border structure, such as a dual resident, a foreign branch or a hybrid person, that payment may trigger a DD outcome where:

(a) the expenditure is required to be taken into account in calculating the taxpayer's net income under the laws of two or more jurisdictions; or

(b) in the case of a payment made by a hybrid person that is treated as transparent by one of its investors, the payment is also treated as deductible in calculating the net income of that investor. [126]

A DD outcome will give rise to tax policy concerns where the laws of both jurisdictions permit that deduction to be set-off against an amount that is not treated as income under the laws of the other jurisdiction (i.e. against income that is not "dual inclusion income"). The policy of the deductible hybrid payments rule is to limit a taxpayer's deduction to the amount of dual inclusion income in circumstances where the deduction that arises in the other jurisdiction is not subject to equivalent restrictions on deductibility. [127]

OECD recommends a rule to neutralise the mismatch to the extent the payment gives rise to a DD outcome, where a hybrid payer makes a payment that is deductible under the laws of the payer jurisdiction and that triggers a duplicate deduction in the parent jurisdiction that results in a hybrid mismatch.[128] The OECD recommends that:

(a) The parent jurisdiction should deny the duplicate deduction for such payment to the extent it gives rise to a DD outcome.

(b) If the parent jurisdiction does not neutralise the mismatch, the payer jurisdiction should deny the deduction for such payment to the extent it gives rise to a DD outcome.

(c) No mismatch will arise to the extent that a deduction is set-off against income that is included in income under the laws of both the parent and the payer jurisdictions (i.e. dual inclusion income).

(d) Any deduction that exceeds the amount of dual inclusion income (the excess deduction) may be eligible to be set-off against dual inclusion income in another period. In order to prevent stranded losses, the excess deduction may be allowed to the extent that the taxpayer can establish, to the satisfaction of the tax administration, that the excess deduction in the other jurisdiction cannot be set-off against any income of any person under the laws of the other jurisdiction that is not dual inclusion income.[129]

[126] OECD/G20 2015 Final Report on Action 2 in para 180.
[127] OECD/G20 2015 Final Report on Action 2 in para 181.
[128] OECD/G20 2015 Final Report on Action 2 at 67.
[129] OECD/G20 2015 Final Report on Action 2 at 67.

This rule only applies to deductible payments made by a hybrid payer. A person will be treated as a hybrid payer in respect of a payment that is deductible under the laws of the payer jurisdiction where:

(a) the payer is not a resident of the payer jurisdiction and the payment triggers a duplicate deduction for that payer (or a related person) under the laws of the jurisdiction where the payer is resident (the parent jurisdiction); or

(b) the payer is resident in the payer jurisdiction and the payment triggers a duplicate deduction for an investor in that payer (or a related person) under the laws of the other jurisdiction (the parent jurisdiction).[130]

This applies to DD outcomes in respect of expenditure incurred through a foreign branch or hybrid person.

The definition of "hybrid payer" means that the deductible hybrid payments rule only applies where a deductible payment in one jurisdiction (the payer jurisdiction) triggers a duplicate deduction in another jurisdiction (the parent jurisdiction) because:

(a) the payer is resident in the parent jurisdiction (i.e. the expenditure has been incurred through a branch); or

(b) an investor in the parent jurisdiction claims a deduction for the same payment (i.e. the expenditure has been incurred by a hybrid person that is treated as transparent under the laws of the parent jurisdiction). [131]

The primary recommendation under the deductible hybrid payments rule is that the parent jurisdiction should restrict the amount of duplicate deductions to the total amount of dual inclusion income. There is no limitation on the scope of the primary response. The defensive rule, which imposes the same type of restriction in the payer jurisdiction, will only apply in the event that the effect of mismatch is not neutralised in the parent jurisdiction and is limited to those cases where the parties to the mismatch are in the same control group or the taxpayer is party to a structured arrangement. [132]

7.1.7 Recommendation 7: Dual-resident payer rule

A payment made by a dual resident taxpayer will trigger a DD outcome where the payment is deductible under the laws of both jurisdictions where the taxpayer is resident. Such a DD outcome will give rise to tax policy concerns where one jurisdiction permits that deduction to be set-off against an amount that is not treated as income under the laws of the other jurisdiction (i.e. against income that is not "dual inclusion income"). [133]

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130 OECD/G20 2015 Final Report on Action 2 at 67.
131 OECD/G20 2015 Final Report on Action 2 in para 182.
132 OECD/G20 2015 Final Report on Action 2 in para 83.
133 OECD/G20 2015 Final Report on Action 2 in para 216.

To neutralise the mismatch to the extent the payment gives rise to a DD outcome, the Final Report recommends that the following rule should apply to a dual resident that makes a payment that is deductible under the laws of both jurisdictions where the payer is resident and that DD outcome results in a hybrid mismatch:[134]

(a) Each resident jurisdiction should deny a deduction for such payment to the extent it gives rise to a DD outcome.
(b) No mismatch will arise to the extent that the deduction is set-off against income that is included as income under the laws of both jurisdictions (i.e. dual inclusion income).
(c) Any deduction that exceeds the amount of dual inclusion income (the excess deduction) may be eligible to be set-off against dual inclusion income in another period. In order to prevent stranded losses, the excess deduction may be allowed to the extent that the taxpayer can establish, to the satisfaction of the tax administration, that the excess deduction cannot be set-off against any income under the laws of the other jurisdiction that is not dual inclusion income.

This rule should only apply to deductible payments made by a dual resident. A taxpayer will be a dual resident if it is resident for tax purposes under the laws of two or more jurisdictions. This rule should only apply to payments that result in a hybrid mismatch

Recommendation 6 applies to DD outcomes in respect of expenditure incurred through a foreign branch or hybrid person where it is possible to distinguish between the jurisdiction where the expenditure is actually incurred (the payer jurisdiction) and the jurisdiction where the duplicate deduction arises due to the resident status or the tax transparency of the payer (the parent jurisdiction). The distinction between the parent/payer jurisdictions is not possible in the context of dual resident taxpayers because it is not possible to reliably distinguish between where the payment is actually made and where the duplicate deduction has arisen. In this case, therefore, the dual resident payer rule provides that both jurisdictions should apply the primary rule to restrict the deduction to dual inclusion income. There is no limitation on the scope of the response under the dual resident payer rule as the deduction that arises in each jurisdiction is being claimed by the same taxpayer. [135]

7.1.8 Recommended 8: Imported mismatch rule

The OECD came up with a recommendation regarding an imported mismatch rule to prevent taxpayers from entering into structured arrangements or arrangements with

[134] OECD/G20 2015 Final Report on Action 2 at 77.
[135] OECD/G20 2015 Final Report on Action 2 in para 217.

group members that shift the effect of an offshore hybrid mismatch into the domestic jurisdiction through the use of a non-hybrid instrument such as an ordinary loan. [136]

The rule denies the deduction to the extent the payment gives rise to an indirect D/NI outcome The payer jurisdiction should deny a deduction for any imported mismatch payment to the extent the payee treats that payment as set-off against a hybrid deduction in the payee jurisdiction.[137]

For the purpose of this rules, hybrid deduction means a deduction resulting from:

(a) a payment under a financial instrument that results in a hybrid mismatch;
(b) a disregarded payment made by a hybrid payer that results in a hybrid mismatch;
(c) a payment made to a reverse hybrid that results in a hybrid mismatch; or
(d) a payment made by a hybrid payer or dual resident that triggers a duplicate deduction resulting in a hybrid mismatch; and includes a deduction resulting from a payment made to any other person to the extent that person treats the payment as set-off against another hybrid deduction. [138]

An imported mismatch payment is a deductible payment made to a payee that is not subject to hybrid mismatch rules. [139] The rule applies if the taxpayer is in the same control group as the parties to the imported mismatch arrangement or where the payment is made under a structured arrangement and the taxpayer is party to that structured arrangement. [140]

The imported mismatch rule disallows deductions for a broad range of payments (including interest, royalties, rents and payments for services) if the income from such payments is set-off, directly or indirectly, against a deduction that arises under a hybrid mismatch arrangement in an offshore jurisdiction (including arrangements that give rise to DD outcomes). The key objective of imported mismatch rule is to maintain the integrity of the other hybrid mismatch rules by arrangements. While these rules involve an unavoidable degree of co-ordination and complexity, they only apply to the extent a multinational group generates an intra-group hybrid deduction and will not apply to any payment that is made to a taxpayer in a jurisdiction that has implemented the full set of recommendations set out in the report. [141]

The imported mismatch rule applies to both structured and intra-group imported mismatch arrangements and can be applied to any payment that is directly or indirectly set-off against any type of hybrid deduction. This guidance sets out three

[136] OECD/G20 2015 Final Report on Action 2 in para 234.
[137] OECD/G20 2015 Final Report on Action 2 at 83.
[138] OECD/G20 2015 Final Report on Action 2 at 83.
[139] OECD/G20 2015 Final Report on Action 2 at 83.
[140] OECD/G20 2015 Final Report on Action 2 at 83.
[141] OECD/G20 2015 Final Report on Action 2 in para 234.

tracing and priority rules to be used by taxpayers and administrations to determine the extent to which a payment should be treated as set-off against a deduction under an imported mismatch arrangement. These rules start by identifying the payment that gives rise to a hybrid mismatch under one of the other chapters in this report (a "direct hybrid deduction") and then determine the extent to which the deductible payment made under that hybrid mismatch arrangement has been funded (either directly or indirectly) out of payments made by taxpayers that are subject to the imported mismatch rule ("imported mismatch payments"). The tracing and priority rules are summarised below, in the order in which they should be applied. [142]

7.1.9 Recommendation 9: Design principles

The hybrid mismatch rules have been designed to maximise the following outcomes:

(a) neutralise the mismatch rather than reverse the tax benefit that arises under the laws of the jurisdiction;
(b) be comprehensive;
(c) apply automatically;
(d) avoid double taxation through rule co-ordination;
(e) minimise the disruption to existing domestic law;
(f) be clear and transparent in their operation;
(g) provide sufficient flexibility for the rule to be incorporated into the laws of each jurisdiction;
(h) be workable for taxpayers and keep compliance costs to a minimum; and
(i) minimise the administrative burden on tax authorities.

Jurisdictions that implement these recommendations into domestic law should do so in a manner intended to preserve these design principles. [143]

The domestic law changes and hybrid mismatch rules recommended in Part I of the report are designed to be co-ordinated with those in other jurisdictions. Co-ordination of the rules is important because it ensures predictability of outcomes for taxpayers and avoids the risk of double taxation. Co-ordination can be achieved by ensuring that countries implement the recommendations set out in the report consistently and that tax administrations interpret and apply those rules in the same way. [144]

Jurisdictions should co-operate on measures to ensure these recommendations are implemented and applied consistently and effectively. These measures should include:

(a) the development of agreed guidance on the recommendations;
(b) co-ordination of the implementation of the recommendations (including timing);

[142] OECD/G20 2015 Final Report on Action 2 in para 235.
[143] OECD/G20 2015 Final Report on Action 2 at 93.
[144] OECD/G20 2015 Final Report on Action 2 in para 272.

(c) development of transitional rules (without any presumption as to grandfathering of existing arrangements);
(d) review of the effective and consistent implementation of the recommendations;
(e) exchange of information on the jurisdiction treatment of hybrid financial instruments and hybrid entities;
(f) endeavouring to make relevant information available to taxpayers (including reasonable endeavours by the OECD); and
(g) consideration of the interaction of the recommendations with other Actions under the BEPS Action Plan including Actions 3 and 4. [145]

7.1.10 Recommendation 10: Definition of structured arrangement

The hybrid mismatch rules apply to any person who is a party to a structured arrangement. [146]

The Report on Action 2 defines a structured arrangement as any arrangement where the hybrid mismatch is priced into the terms of the arrangement or the facts and circumstances (including the terms) of the arrangement indicate that it has been designed to produce a hybrid mismatch.[147]

The purpose of the structured arrangement definition is to capture those taxpayers who enter into arrangements that have been designed to produce a mismatch in tax outcomes while ensuring taxpayers will not be required to make adjustments under the rule in circumstances where the taxpayer is unaware of the mismatch and derives no benefit from it. [148]

Facts and circumstances that indicate that an arrangement has been designed to produce a hybrid mismatch include any of the following:

(a) an arrangement that is designed, or is part of a plan, to create a hybrid mismatch;
(b) an arrangement that incorporates a term, step or transaction used in order to create a hybrid mismatch;
(c) an arrangement that is marketed, in whole or in part, as a tax-advantaged product where some or all of the tax advantage derives from the hybrid mismatch;
(d) an arrangement that is primarily marketed to taxpayers in a jurisdiction where the hybrid mismatch arises;
(e) an arrangement that contains features that alter the terms under the arrangement, including the return, in the event that the hybrid mismatch is no longer available; or

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[145] OECD/G20 2015 Final Report on Action 2 at 93.
[146] OECD/G20 2015 Final Report on Action 2 at 93.
[147] OECD/G20 2015 Final Report on Action 2 in para 318.
[148] OECD/G20 2015 Final Report on Action 2 at 93.

(f) an arrangement that would produce a negative return absent the hybrid mismatch.

A taxpayer will not be treated as a party to a structured arrangement if neither the taxpayer nor any member of the same control group could reasonably have been expected to be aware of the hybrid mismatch and did not share in the value of the tax benefit resulting from the hybrid mismatch.

The test for whether an arrangement is structured is objective. It applies, regardless of the parties' intentions, whenever the facts and circumstances would indicate to an objective observer that the arrangement has been designed to produce a mismatch in tax outcomes. The structured arrangement rule asks whether the mismatch has been priced into the terms of the arrangement or whether the arrangement's design and the surrounding facts and circumstances indicate that the mismatch in tax outcomes was an intended feature of the arrangement. The test identifies a set of non-exhaustive factors that indicate when an arrangement should be treated as structured.[149]

The structured arrangement definition does not apply to a taxpayer who is not a party to the arrangement. A person will be a party to an arrangement when that person has sufficient involvement in the design of the arrangement to understand how it has been structured and what its tax effects might be. A person will not be a party to a structured arrangement, however, if that person (or any member of the control group) does not benefit from, and could not reasonably have been expected to be aware of, the mismatch arising under a structured arrangement.[150]

7.1.11 Recommendation 11: Definitions of related persons, control group and acting together

The report treats hybrid financial instruments and hybrid transfers between related parties as within the scope of the hybrid mismatch rules. Other hybrid mismatch arrangements are generally treated as within scope of the recommendations where the parties to the mismatch are members of the same control group.[151]

The Final Reports recommends the following definitions for the purposes of the aforementioned recommendations:[152]

(a) Two persons are related if they are in the same control group or the first person has a 25% or greater investment in the second person or there is a third person that holds a 25% or greater investment in both.

(b) Two persons are in the same control group if:

[149] OECD/G20 2015 Final Report on Action 2 in para 319.
[150] OECD/G20 2015 Final Report on Action 2 in para 320.
[151] OECD/G20 2015 Final Report on Action 2 in para 348.
[152] OECD/G20 2015 Final Report on Action 2 at 113.

- they are consolidated for accounting purposes;
- the first person has an investment that provides that person with effective control of the second person or there is a third person that holds investments which provides that person with effective control over both persons;
- the first person has a 50% or greater investment in the second person or there is a third person that holds a 50% or greater investment in both; or
- they can be regarded as associated enterprises under Article 9. [153]

(c) A person will be treated as holding a percentage investment in another person if that person holds directly or indirectly through an investment in other persons, a percentage of the voting rights of that person or of the value of any equity interest in that person. [154]

For the purposes of the related party rules a person who acts together with another person in respect of ownership or control of any voting rights or equity interests will be treated as owning or controlling all the voting rights and equity interests of that person. Two persons will be treated as acting together in respect of ownership or control of any voting rights or equity interests if:

(a) they are members of the same family;
(b) one person regularly acts in accordance with the wishes of the other person;
(c) they have entered into an arrangement that has material impact on the value or control of any such rights or interests; or
(d) the ownership or control of any such rights or interests are managed by the same person or group of persons. [155]

If a manager of a collective investment vehicle can establish to the satisfaction of the tax authority, from the terms of any investment mandate, the nature of the investment and the circumstances that the hybrid mismatch was entered into, that the two funds were not acting together in respect of the investment then the interest held by those funds should not be aggregated for the purposes of the acting together test. [156]

8 PART II: OECD 2015 FINAL REPORT ON HYBRID MISMATCHES - RECOMMENDED DOMESTIC RULES

8.1 RECOMMENDATIONS ON TREATY ISSUES

Part II of this report complements Part I and deals with the parts of Action 2 that indicate that the outputs of the work on that action item may include changes to the *OECD Model Tax Convention* (OECD, 2014) to ensure that hybrid instruments and

[153] OECD/G20 2015 Final Report on Action 2 at 113.
[154] OECD/G20 2015 Final Report on Action 2 at 113.
[155] OECD/G20 2015 Final Report on Action 2 at 113.
[156] OECD/G20 2015 Final Report on Action 2 at 113.

entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly" and that stress that special attention should be given to the interaction between possible changes to domestic law and the provisions of the *OECD Model Tax Convention*. [157]

A number of treaty provisions resulting from the work on Action 6 (Preventing Treaty Abuse) may play an important role in ensuring that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly. The following provisions included in the report on Action 6 may be of particular relevance:

(a) limitation-on-benefits rules;
(b) rule aimed at arrangements one of the principal purposes of which is to obtain treaty benefits;
(c) rule aimed at dividend transfer transactions (i.e. to subject the lower rate of tax provided by Art. 10(2)a) or by a treaty provision applicable to pension funds to a minimum shareholding period);
(d) rule concerning a Contracting State's right to tax its own residents;
(e) anti-abuse rule for permanent establishments situated in third States. [158]

8.2 DUAL-RESIDENT ENTITIES

Action 2 refers expressly to possible changes to the *OECD Model Tax Convention* (OECD, 2014) to ensure that dual resident entities are not used to obtain the benefits of treaties unduly.

The change to Art 4(3) of the *OECD Model Tax Convention* (OECD, 2014) that will result from the work on Action 6 will address some of the BEPS concerns related to the issue of dual resident entities by providing that cases of dual treaty residence would be solved on a case-by-case basis rather than on the basis of the current rule based on place of effective management of entities, which creates a potential for tax avoidance in some countries. [159]The new version of Art. 4(3) reads as follows:

> *Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States.*

157 OECD/G20 2015 Final Report on Action 2 in para 427.
158 OECD/G20 2015 Final Report on Action 2 in para 429.
159 OECD/G20 2015 Final Report on Action 2 in para 431.

This change, however, will not address all BEPS concerns related to dual resident entities. It will not, for instance, address avoidance strategies resulting from an entity being a resident of a given State under that State's domestic law whilst, at the same time, being a resident of another State under a tax treaty concluded by the first State, thereby allowing that entity to benefit from the advantages applicable to residents under domestic law without being subject to reciprocal obligations (*e.g*. being able to shift its foreign losses to another resident company under a domestic law group relief system while claiming treaty protection against taxation of its foreign profits). [160]

8.3 TREATY PROVISION ON TRANSPARENT ENTITIES

The 1999 OECD report on *The Application of the OECD Model Tax Convention to Partnerships* (the Partnership Report, OECD, 1999)1 contains an extensive analysis of the application of treaty provisions to partnerships, including in situations where there is a mismatch in the tax treatment of the partnership. The main conclusions of the Partnership Report, which have been included in the Commentary of the *OECD Model Tax Convention* (OECD, 2014), seek to ensure that the provisions of tax treaties produce appropriate results when applied to partnerships, in particular in the case of a partnership that constitutes a hybrid entity. [161]

The Partnership Report (OECD, 1999), however, did not expressly address the application of tax treaties to entities other than partnerships. In order to address that issue, as well as the fact that some countries have found it difficult to apply the conclusions of the Partnership Report, it was decided to include in the *OECD Model Tax Convention* (OECD, 2014), the change the Commentary on article 1, which will ensure that income of transparent entities is treated, for the purposes of the Convention, in accordance with the principles of the Partnership report. This will ensure not only that the benefits of tax treaties are granted in appropriate cases but also that these benefits are not granted where neither Contracting State treats, under its domestic law, the income of an entity as the income of one of its residents.[162]

8.4 INTERACTION BETWEEN PART I AND TAX TREATIES

Part I of this report includes various recommendations for the domestic law treatment of hybrid financial instruments and hybrid entity payments. Since Action 2 provides that special attention should be given to the interaction between possible changes to domestic law and the provisions of the *OECD Model Tax Convention*, it is necessary to examine treaty issues that may arise from these recommendations. [163]

[160] OECD/G20 2015 Final Report on Action 2 in para 432.
[161] OECD/G20 2015 Final Report on Action 2 in para 434.
[162] OECD/G20 2015 Final Report on Action 2 in para 435.
[163] OECD/G20 2015 Final Report on Action 2 in para 436.

9 INTERNATIONAL TRENDS ON THE TAXATION OF HYBRID ENTITIES

Before the BEPS Action Plan, the advantages of hybrid entity structures have already been attacked as follows by some countries.[164] Set out below are existing international legislative provisions that combat duplicate deductions in respect of the same payment or expense within the context of hybrid entities or dual resident entities. Countries that have rules denying the deduction of a payment or expense on the basis of its deductibility in another jurisdiction include Denmark, Germany, the UK and the US.

UK: There are specific provisions aimed at eliminating double tax deductions for the same expense. The rule against double deductions in section 244 of the Taxation (International and Other Provisions) Act 2010 stipulates that no amount is allowable as a deduction for purposes of the UK Corporation Tax Acts "*so far as an amount is otherwise deductible or allowable in relation to the expense in question…An amount is otherwise deductible or allowable if it may be otherwise deducted or allowed in calculating the income, profits or losses of any person for the purposes of any tax.*" The deduction rules apply only where a scheme involving a hybrid entity or hybrid instrument increases a UK tax deduction or deductions to more than they would otherwise have been in the absence of the scheme.[165] The legislation effectively limits tax deductions to the extent necessary to cancel the increase in UK tax deductions attributable to the scheme. The deductions rules are designed to disallow UK tax deductions in circumstances where there is another deduction allowed for the same item of expenditure where the UK tax deduction is not matched by a taxable receipt.

- Further, UK companies and UK PEs of foreign entities are prohibited from surrendering losses to other group companies where such losses relate to amounts that are for foreign tax purposes, deductible or otherwise allowable against the foreign profits of any person.[166]
- Section 106 of the UK Corporation Tax Act 2010 applies to UK resident companies and eliminates from group relief certain amounts that are attributable to foreign PEs. In most cases the profits of a foreign PE are taxed in the country where the PE is located and operates. The profits remain subject to UK tax but credit is granted for foreign tax on the profits. If the PE is not profitable, relief may be available for the loss in the foreign jurisdiction. This section prevents relief being granted for the same loss both in the foreign

[164] A Cinnamon "How the BEPS Action Plan Could Affect Existing Group Structures" Tax Analyst (12 Nov 2013).
[165] HMRC Manual INTM594500.
[166] This UK provision is concerned with foreign group relief, thus any potential circularity (e.g. simultaneous denial of foreign group relief) is resolved by giving relief where the company is resident (i.e. in the UK). However there is an exception to this rule if the company is also resident in the country where the PE is. In that case, UK relief is denied.

jurisdiction and in the UK.[167]

- Section 107 of the UK Corporation Tax Act 2010 applies to foreign companies conducting trade in the UK through a PE. It eliminates from group relief amounts that arise from activities that are not within the UK tax net, or are relieved elsewhere. If a DTA exempts the income of the PE from UK tax, it will be prohibited from surrendering its losses in terms of the UK group relief provisions.
- Section 109 of the UK Corporation Tax Act 2010 extends the prohibition on double deductions to dual resident investment companies. A company that is resident both in the UK and in a foreign jurisdiction is prohibited from surrendering losses in terms of the UK group relief provisions. The provision is limited in application to investment companies that do not carry on a trade.

<u>USA:</u> Internationally, concerns have been raised about how the USA Check the box rules which are too flexible in the international context that they play a major role in the tax mismatch of hybrid arrangements. The problem arises when a USA-based multinational company with subsidiary companies in other countries elects to use the check-the-box rules (Reg. section 301.7701-3) so that it is not exposed to USA CFC rules (subpart F rules). Essentially the multinational company's income can be moved through its subsidiary companies without any subpart F exposure (since all of those transactions are disregarded). For example, if one subsidiary company is located in Germany and the other in Bermuda (as a finance company), the German company can borrow from the Bermuda finance company and the taxation of interest income can be deferred, but the income is also no longer subject to the higher German tax rate because all of the profits have been stripped out of Germany and put into a zero-tax jurisdiction. The concern therefore is that the USA subpart F rules encourage the stripping of income in other countries through the use of check-the-box rules.[168] As a result of the check the box rules, the multinational company's income disappears for tax purposes in the USA and the company is also able to avoid the application of the CFC rules in other countries.[169]

The USA tax entity terminology and classification differ significantly from South African terminology. Accordingly, what follows is an attempt to use neutral, commonly understood tax and entity terminology and classification in summarising the USA rules prohibiting the multiple deduction of a single expense.

- In the USA, a dual resident company, which is defined as a US resident company subject to tax in a foreign jurisdiction on its worldwide income (i.e. on a residence basis of taxation); is prohibited from deducting an expense or loss, in the first instance, against income subject to USA tax but not subject to

[167] UK National Archives: Corporation Tax Act 2010 – Explanatory Notes.

[168] DL Glene "U.S. Check-the-Box Rules Largely to Blame for Hybrid Tax Mismatches, Practitioner Says" *Tax Analyst* 4 February 2014.

[169] DL Glene "U.S. Check-the-Box Rules Largely to Blame for Hybrid Tax Mismatches, Practitioner Says" *Tax Analyst* 4 February 2014.

foreign tax; and secondly, from deducting such expense or loss against income subject to foreign tax but not US tax. These provisions apply to a foreign branch or PE of a US resident company in the event that the relevant foreign group relief provisions extend to such branch or PE of the US resident company. The type of expense or loss under consideration here is a "dual consolidated loss,"[170] which refers to either the net operating loss of a dual resident company, or the net loss attributable to a foreign branch or PE of a USA resident company.

- The deduction for USA group relief purposes (i.e. "domestic use") of a "dual consolidated loss" is generally prohibited. The primary exception to the blanket prohibition occurs when the taxpayer makes an election to apply the loss for US group relief purposes, subject to an undertaking that the taxpayer will refrain from using any portion of the "dual consolidated loss" for foreign group relief purposes for a five year period.

<u>Denmark:</u> A Danish resident taxpayer is denied the deduction of an expense that is tax deductible under foreign tax provisions against income that is not included for Danish tax purposes. A deduction is also denied in circumstances where the expense incurred by the Danish resident taxpayer is deductible under foreign tax rules against the income of affiliated companies which is not subject to Danish tax. These dual consolidated loss rules disallow a deduction for expenses in Denmark if the expenses are also deductible in a foreign country, colloquially termed a “double dip”. The rules apply, *inter alia*, when an expense may be deducted by a foreign affiliated company and their scope of application encompasses situations where the affiliation is caused by unrelated taxpayers acting in concert or through a transparent entity.[171] Similar rules operate to ring-fence the losses of PEs, denying set-off of the PE’s loss against the income of other group members if such loss is included in the calculation of the taxable income of the company in its jurisdiction of residence. The loss is carried forward and may only be claimed against future income of the PE.

Denmark [172] also has rules addressing the deduction of payments without commensurate inclusion in the taxable income of the recipient (deduction/no inclusion) within the domain of hybrid entities. A Danish resident company or a foreign company with a PE in Denmark is treated as transparent for Danish tax purposes: if such company is treated as transparent for tax purposes in a foreign jurisdiction; the income of the transparent entity is included in the foreign taxable income of one or more foreign affiliated companies located in the foreign jurisdiction that disregards the transparent entity; the foreign affiliated companies control the transparent entity; and the foreign jurisdiction forms part of the EU or the EEA. In such cases, the transparent entity will be denied a deduction for payments made to

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170 The US Internal Revenue Service and Treasury Department's final regulations issued under the Dual Consolidated Loss Regulations, I.R.C. §1503(d), 2007.

171 Section 5G of the Danish Tax Assessment Act.

172 OECD “Neutralise the effects of Hybrid Mismatch Arrangements” (2014) paras 0, 0.0o and 0.

the foreign affiliated controlling company on the basis that the transparent entity and the foreign controlling recipient of the payments from a single legal entity.[173]

- The ambit of the above prohibition is extended, in the case of attempted circumvention, to treat affiliated companies in other jurisdictions as transparent for Danish tax purposes if such affiliated companies are considered transparent in the jurisdiction of residence of the company that controls both the Danish company and the other affiliated companies. Consequently, the Danish company would be denied the deduction of payments made to such affiliated companies as such payments would similarly be treated as being made within a single legal entity. The rule is not applicable if the affiliated company is resident in an EU, EEA or treaty country other than the country of residence of the controlling company; although it does apply if such affiliated company is not the beneficial owner of the payment.
- Further specific Danish law provisions[174] have been introduced to address deduction/no inclusion cases involving hybrid entities which are treated as tax transparent in Denmark but as taxable non-transparent entities in foreign jurisdictions.[175] The provisions apply to partnerships organised in Denmark,[176] Danish registered branches of foreign entities, and transparent entities registered, organised or effectively managed in Denmark, in respect of which one or more foreign persons directly hold more than 50% of the capital or voting rights in such entity, which is treated as a non-transparent, separate entity for tax purposes in the foreign jurisdiction; or the foreign jurisdiction does not exchange information with the Danish tax authorities under a tax treaty or other international convention or agreement. In these circumstances, the otherwise transparent entity will be treated as a Danish resident company for tax purposes. The participants would be deemed to have disposed of all assets and liabilities at fair market value at the time the entity is classified as a non-transparent entity. In the normal course the entity would be deemed to have acquired all assets and liabilities at fair market value at the time of its reclassification and a distribution to the participants would be deemed to constitute a dividend distribution, possibly triggering withholding tax.

[173] Section 2A of the Danish Corporate Tax Act.
[174] Section 2C of the Danish Corporate Tax Act.
[175] Deloitte Touche Tohmatsu *Danish Tax Alert* (2008).
[176] The provisions were enacted to target US investors establishing Danish partnerships. Typically the US investors would transfer intangibles (intellectual property) to the transparent Danish partnership, which would facilitate contract product manufacture (using the intellectual property) by a Danish or foreign subsidiary, with yet another Danish or foreign subsidiary distributing the finished products. As such the profits generated through the use of the intellectual property escaped both Danish and US taxation provided the partnership did not constitute a PE in Denmark.

Germany: A parent company's loss is denied for purposes of the group taxation regime if it has been permitted in a foreign jurisdiction in a manner similar to the application of tax to the parent company under the German tax regime.[177] This provision prohibits dual-resident companies from deducting the same loss in both Germany and another jurisdiction.

- In some jurisdictions, preferred shares take on a hybrid character in that dividend payments are treated as a tax-deductible financing expense. In the recipient jurisdiction, a participation exemption can often apply to the preferred dividend. However, an increasing number of countries disqualify the participation exemption when the dividend has been deducted in the payer's jurisdiction. Several European countries already have laws that deny the participation exemption when the payee has deducted the payment. For example German domestic law disallows a dividend exemption when the payer was allowed to deduct the payment in its country of residence.[178] Other countries that disqualifying participation exemption include Austria, Italy, New Zealand, South Africa, and the UK
- Profit participating interest, or interest on hybrid convertible debt, may be denied by treating the interest payment as a dividend. This applies, for example, in Australia and the UK.
- Interest incurred by a hybrid entity, such as a U.S. check-the-box foreign holding company used for inbound investment, can be denied tax consolidation in the home or host country. Denmark and the UK are examples of jurisdictions already applying these anti-hybrid rules.
- A treaty may disqualify interest paid on hybrid instruments from reduced withholding rates, typically through a subject-to-tax condition. Subject-to-tax conditions are included in most of Germany's treaties. Another anti-hybrid treaty mechanism is article 1.6 of the US model treaty restricting treaty benefits for fiscally transparent entities to income that is taxed to a resident in the treaty partner's state. Also, a few countries deny treaty reductions through specific domestic override legislation, which could thereby impose full withholding taxes on outbound hybrid interest. Germany, Switzerland, and the US are examples.

10 HYBRID ENTITY MISMATCHES IN SOUTH AFRICA

In South Africa, the typical transactions involving hybrid entities result:

- In the claiming of foreign tax credits by South African entities in circumstances where the foreign tax suffered is effectively neutralised in the foreign jurisdiction.
- Alternatively such arrangements result in the South African entities claiming exemption from South African tax in respect of foreign sourced income by virtue of an appropriate DTA.

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177 Section 14.1.5 of the German Corporation Tax Act.

178 L A Sheppard "News Analysis: OECD BEPS Hybrid Developments" *Tax Analysts* 29 January 2014.

The most common transaction entered into by South African residents in respect of hybrid entity arrangements has been the United States (US) repurchase transactions. There are several variations of these transactions, but the key mechanics are essentially the same. In essence:

- A US partnership is set up by various companies within a US (banking) group;
- A South African investor acquires an "interest" in the US partnership in terms of a repurchase agreement. The South African investor may borrow money to acquire this "interest";
- The US partnership uses its capital to invest in a loan and earns interest;
- The South African investor is, in terms of South African law, entitled to its share of the partnership income derived in accordance with the partnership agreement.

From the US tax perspective the US partnership is viewed as a separate entity and is liable to US tax. The US partnership therefore pays tax in the USA and the South African investor claims a credit for the US tax suffered in respect of its partnership distributions.

- In terms of the OECD Commentary on conflict of qualification issues, the South African investor is entitled to a credit for the US tax paid by the partnership.
- The South African investor also claims a deduction for any funding costs.
- The US partnership distributes a post-tax return to the South African Investor. Using simplified numbers and mechanics, the South African investor borrows R100 from the market on which it pays interest of R10. It uses the R100 to acquire the "partnership interest" (essentially an undivided share in the underlying assets of the US partnership) in terms of a repurchase agreement from the repurchase counterparty.
- The US partnership invests in loans of R100 and earns interest of R10.
- The US partnership pays tax in the USA of, say, 3.5 and distributes 6.5 to the SA investor.
- The South African investor enters into a swap arrangement with its repurchase counterparty in terms of which it pays "manufactured interest" of 10 and receives "manufactured interest" of, say, 12.
- The South African investor then pays interest of 10 on its loan funding from the market.
- The South African investor then claims a tax credit in South Africa of 3.5 against other income. The reason it receives a high swap payment is because its repurchase counterparty claims a credit in respect of the amount of tax paid by the US partnership on the basis that it forms part of the same group as the US partnership. The US tax paid is therefore "neutralised" since, on a group basis, no US tax is suffered.
- In addition in terms of US tax law the repurchase agreement is not viewed as a transfer of ownership, but rather as a collateralised loan. Therefore, from a

US tax perspective, the "partnership interest" remains in the tax group of the US repurchase counterparty. However, from a South African tax perspective the South African investor is viewed as having acquired an undivided share in the assets of the partnership.

10.1 LEGISLATION ON HYBRID ENTITY MISMATCHES IN SOUTH AFRICA

Until the 2010 Taxation Laws Amendment Act 7 of 2010, South Africa did not have legislation to deal with the taxation of hybrid entities. Uncertainty about the tax treatment of foreign hybrid entities existed for a long time even though there had been growing use of these entities by South Africans investing offshore and foreigners investing in South Africa.[179] Examples are the UK LLP which is a body corporate (with legal personality separate from that if its members). It combines the organisational flexibility and taxation treatment of a partnership but with limited liability for its members.[180] For purposes of taxation, the UK LLP is not treated as a corporation but as a partnership.[181] The other example is the United States' (LLC) which is recognised as a corporate entity in the United States but it is treated as partnerships for tax purposes.[182] This tax treatment implies that the taxable income of the LLC passes through to its owners, thereby avoiding corporate tax.[183]

The main concern had been the company status of these entities which perpetuated uncertainty in the tax treatment of these entities.[184] In South Africa, partnerships have their origin in common law and are as such mainly regulated by common law principles. Sundry pieces of legislation do however regulate certain aspects of partnerships. South African case law[185] has also developed and clarified the legal principles relating to partnerships. As a result, a partnership is not regarded as a "person" as defined in section 1 of the Act for tax purposes and is therefore not separately taxable.[186] Rather, the individual partners are taxed on their share of the partnership income in their personal capacity, making partnerships tax transparent. This is so irrespective of whether a partner's liability to creditors of the partnership is limited. Section 24H(5) of the Income Tax Act provides that the income of the partnership is taxed in the hands of the individual partners at the time it accrues to or

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179 See AW Oguttu **"**The Challenges of Taxing Investments in Offshore Hybrid Entities: A South African Perspective" (2009) 21 No 1 *SA Mercantile Law Journal* 51-73.

180 D Armour Tolley's Limited Liability Partnerships: The New Legislation (Reed Elsevier, UK 2001) at 295.

181 Section 10 of the LLPA 2000 which inserts section 118ZA to 118ZD in the Income and Corporations Act 1988 (ICTA) and sections 59A and 156A in the Taxation of Capital Gains Act 1992 (TCGA), provides that an LLP is treated as if it were a partnership for purposes of these two Acts.

182 Whittenburg G, & Altus-Buller M, *Income Tax Fundamentals* (Thomson West Eagan, Minnesota USA 2007) in par 10.8.

183 Ibid.

184 Explanatory Memorandum Para 5.7 in part II.

185 In the case of *Sachs v CIR* 13 SATC 343 it was specifically held that a partnership is not a separate legal person and does not have an existence separate from its members.

186 *R v Levy* 1929 AD 312; *Muller en Andere v Pienaar* 1968 (3) SA 195 (A).

is received by the partnership. Section 24H of was introduced into the Act with the aim of:

- deeming each partner (including limited partners) to be carrying on the trade or business of the partnership;
- regulating the timing of accruals of income [187] and the incurral of expenditure[188] in respect of persons conducting business in a partnership; and
- regulating deductions and allowances claimable by partners whose liability to creditors of the partnership are limited.

Generally in South Africa where by some rule of law, a legal entity is established that is legally separate from the members comprising that entity, it is taxed in its own right as a "person." Where no separate legal personality is conferred, the members are taxed individually (as is the case with partnerships). Problems arise where hybrid entities are involved in cross-border transactions, such as where they are employed as either inbound or outbound investment vehicles.

The Income Tax Act has always recognised entities incorporated in foreign jurisdictions. Specifically, the definition of "company" in section 1 of the Act includes "any association, corporation or company incorporated under the law of any country other than the Republic or anybody corporate formed or established under such law."[189] In addition the Act provides specific definitions for "foreign company";[190] "foreign dividend"; and the "foreign return of capital". The latter means:

> "any amount that is paid or payable by a foreign company in respect of any share in that foreign company where that amount is treated as a distribution or similar payment (other than an amount that constitutes a foreign dividend) by that foreign company for the purposes of the laws relating to -(a) tax on income on companies of the country in which that foreign company has its place of effective management; or (b) companies of the country in which that foreign company is incorporated, formed or established, where that country in which that foreign company has its place of effective management does not have any applicable laws relating to tax on income, but does not include any amount so paid or payable to the extent that the amount so paid or payable — (i) is deductible by that foreign company in the determination of any tax on income of companies of the country in which that foreign company has its place of effective management; or (ii) constitutes shares in that foreign company."

Thus if a South African resident and a United Kingdom resident decided to incorporate an LLP in the United Kingdom, one of the issues that arose was whether the South African CFC rules could be applied to tax the South African shareholder. Since the previous section 1(b) of the definition of "company" in section 1 of the Income Tax Act included foreign companies, CFC rules could potentially not apply to the LLP. The other issue is that since a UK LLP or a USA LLC was considered a

187 Section 24H(5)(*a*) of the Income Tax Act.
188 Section 24H(5)(*b*) of the Act.
189 Paragraph (*b*) of the definition of "company".
190 That is any company that is not a resident.

company in South Africa law, it was also not clear whether LLP or LLC could be considered a South African resident if it is effectively managed in South Africa.[191]

In a similar vein, if a transparent entity (such as the Luxembourg *fonds commun de placement* (FCP), the S*ociété d'investissement à capital variable* (SICAV) that is utilised in Western Europe or the UK open-ended investment company (OEIC)) constitutes a paragraph (*e*)(ii) company as defined in section 1 of the Income Tax Act, it may fall within the definition of a CFC in section 9D of the Act. Paragraph e(ii) defines a company to include:

> "any portfolio comprised in any investment scheme carried on outside the Republic that is comparable to a portfolio of a collective investment scheme in participation bonds or a portfolio of a collective investment scheme in securities in pursuance of any arrangement in terms of which members of the public (as defined in section 1 of the Collective Investment Schemes Control Act)[192] are invited or permitted to contribute to and hold participatory interests in that portfolio through shares, units or any other form of participatory interest;"

In brief, a paragraph (*e*)(ii) company or a foreign company[193] would constitute a CFC if; after having discounted all South African resident investors who hold less than 5% of the participation rights in such company, and may not exercise at least 5% of its voting rights; the remaining South African investors were found to hold, either directly or indirectly, more than 50% of the participation rights in the company, or more than 50% of the voting rights in such company were directly or indirectly exercisable by such remaining South African investors. If this were the case, all South African resident investors holding more than 10% of the participation rights in the company constituting a CFC would be required to attribute and include deemed income proportionate to their participation in the CFC in their income for the relevant year of assessment; notwithstanding that the CFC may not have distributed any income or declared a dividend. Further, the participation exemption embodied in section 10B(2) of the Act for shareholders who hold more than 10% of the total equity shares and voting rights in a foreign company is denied to investors earning foreign dividends by virtue of holding such percentage in a paragraph (*e*)(ii) company.

In order to alleviate the concerns regarding hybrid entities, and to ensure that their tax treatment in South Africa corresponds with their tax treatment in foreign jurisdictions, the Act was amended to ensure the consistent treatment of all hybrid entities. The Taxation Laws Amendment Act 7 of 2010, inserted the definition of a "foreign partnership" in section 1 of the Income Tax Act which inter alia means a partnership, association, [or] body of persons or entity formed or established under the laws of any country other than the Republic if it is not liable for or subject to any

191 Olivier & Honiball at 434.

192 The paragraph will come into operation as cited on 1 January 2015, but the amendment from the current wording pertains only to the removal of the Collective Investment Schemes Control Act's number and year.

193 That is, a company that is not a South African resident.

tax on income in that country. The definition of a “foreign partnership” in section 1 of the Act means:

> "any partnership, association, body of persons or entity formed or established under the laws of any country other than the Republic if:
>
> (a) for the purposes of the laws relating to tax on income of the country in which that partnership, association, body of persons or entity is formed or established –
>
> (i) each member of the partnership, association, body of persons or entity is required to take into account the member’s interest in any amount received by or accrued to that partnership, association, body of persons or entity when that amount is received by or accrued to the partnership, association, body of persons or entity; and
>
> (ii) the partnership, association, body of persons or entity is not liable for or subject to any tax on income in that country; or
>
> (b) where the country in which that partnership, association, body of persons or entity is formed or established does not have any applicable laws relating to tax on income –
>
> (i) any amount –
>
> (aa) that is received by or accrues to; or
>
> (bb) of expenditure that is incurred by, the partnership, association, body of persons or entity is allocated concurrently with the receipt, accrual or incurral to the members of that partnership, association, body of persons or entity in terms of an agreement between those members; and
>
> (ii) no amount distributed to a member of a partnership, association, body of persons or entity may exceed the allocation contemplated in subparagraph (i) after taking into account any prior distributions made by the partnership, association, body of persons or entity."

- Provisos were added to the definitions of “person” and “company” in section 1 of the Act. The term "person" is defined in section 1 of the Act as including "(a) an insolvent estate; (b) the estate of a deceased person; (c) any trust; and (d) any portfolio of a collective investment scheme, but does not include a foreign partnership."
- The provisions of section 24H of the Act have also been amended to ensure that “foreign partnerships” (i.e. hybrid entities) are treated in the same manner as ordinary partnerships are treated for South African tax law purposes.
- The definitions of “permanent establishment” and “qualifying investor” were also amended to specifically provide for a “foreign partnership.” In consequence of these amendments:–
    - the Income Tax Act mirrors the tax treatment in foreign legislation whereby hybrid entities are taxed on a conduit basis, i.e. a foreign partnership will not be subject to tax in South Africa, but the members or partners may be subject to tax;
    - foreign partnerships will not be regarded as companies;[194]
    - foreign partnerships will not be regarded as persons;[195]and

[194] Thus the provisions relating to CFCs in section 9D of the Act will not apply to foreign partnerships.

[195] This implies that foreign partnerships will probably not constitute employers for employees’ tax purposes.

- foreign partnerships may be used as investment vehicles without many of the previous uncertainties and complications.

- Sec 24H of the Income Tax Act was also amended to provide that a "limited partner" means:

  > "Any member of a partnership *en commandite*, an anonymous partnership [or], any similar partnership or a foreign partnership, if such member's liability towards a creditor of the partnership is limited to the amount which the member has contributed or undertaken to contribute to the partnership or is in any other way limited.''

From the above changes, since LLP/LLCs and similar hybrid entities have been included in the definition of a "foreign partnership" this synchronises the South African tax treatment with foreign tax practice. Since foreign partnerships are no longer defined as companies for purposes of the Income Tax Act, they are not CFCs for purposes of section 9D of the Income Tax Act.

It should however be appreciated that to the extent that a "partnership, association, body of persons or entity" is subject to tax in its own right in a foreign jurisdiction, it will fall outside of the definition of "foreign partnership" and will in all likelihood be subject to tax as a "person" or "company" in South Africa.

The following is how the South African provisions could be applicable to Example 1 involving a bank loan. Assume South Africa is Country A, the investor jurisdiction. A Co holds all the shares in a foreign subsidiary, B Co. B Co is a hybrid entity that initially appears to be tax transparent for South African tax purposes. B Co borrows funds from a bank and pays interest on the loan. B Co derives no other income. If B Co were to constitute a "foreign partnership" as defined in section 1 of the Act, A Co would qualify as the borrower under the loan. However since B Co is opaque in terms of the laws of Country B and liable to tax in its own right in terms of Country B's tax regime, it will fall outside the definition of "foreign partnership" and its tax deductible interest payment will not be available for deduction by A Co, thus eliminating the base erosion risk in South Africa.

Let's consider how a deduction/no inclusion outcome would be alleviated in Example 1 where B Co borrows funds from A Co instead of the bank. The treatment of B Co under the tax laws of Country B will result in B Co falling outside the definition of "foreign partnership": While B Co may be entitled to deduct the interest payment it makes to A Co in terms of the loan, the payment will not be disregarded for South African tax purposes. To the extent that Country B imposes withholding tax at full or reduced rate, should a DTA apply, A Co will be entitled to claim a section 6*quat* rebate against such foreign tax withheld. The deduction/no inclusion outcome is effectively resolved by applying the definition of "foreign partnership" in determining the transparency or opacity of B Co with reference to its treatment in Country B.

10.2 RECOMMENDATIONS ON HYBRID ENTITY MISMATCHES IN SOUTH AFRICA

With the above changes in the legislation, that brought the tax treatment of hybrid entities in line with international practice, one could say that hybrid mismatches are not of a major concern in the South Africa for now. Nevertheless, South Africa's legislation on hybrid entities is still behind the G20 and there is need for further reform of the provisions to ensure that any tax planning schemes that entail hybrid entities as a mechanism for double non-taxation (as well as potentially giving rise to double taxation) are curtailed. Thus will require:

- Further refinement of domestic rules related to treatment of hybrid entities;
- There is need for specific double tax treaty anti-avoidance clauses.

In light of the OECD 2015 Report on hybrid mismatches, South Africa should make appropriate domestic law amendments. Similarly South Africa should adopt the OECD tax treaty recommendations with regard to hybrid entity mismatches and adopt appropriate anti-avoidance treaty provisions.

11 INTERNATIONAL DEVELOPMENTS ON CURBING HYBRID INSTRUMENT MISMATCHES

Set out below are existing international legislative provisions that deny the deduction of payments that are not matched by the commensurate taxation of payments in the payee's jurisdiction.

<u>United Kingdom:</u> Specific provisions are in place to disallow UK tax deductions which are not matched by a taxable receipt. These provisions are grouped with provisions that eliminate double tax deductions for the same expense. The rule against double deductions in section 244 of the Taxation (International and Other Provisions) Act 2010 stipulates that no amount is allowable as a deduction for purposes of the UK Corporation Tax Acts "so far as an amount is otherwise deductible or allowable in relation to the expense in question...An amount is otherwise deductible or allowable if it may be otherwise deducted or allowed in calculating the income, profits or losses of any person for the purposes of any tax." The deductions rules apply only where a scheme involving a hybrid entity or hybrid instrument increases a UK tax deduction or deductions to more than they would otherwise have been in the absence of the scheme.[196] The legislation does not apply in a case where, although there is such a scheme, it has no effect on UK taxation. Where the legislation does apply, it effectively limits tax deductions to the extent necessary to cancel the increase in UK tax deductions attributable to the scheme. The deductions rules are designed to disallow UK tax deductions which are not matched by a taxable receipt; or in circumstances where there is another deduction allowed for the same item of expenditure.

[196] HMRC Manual INTM594500.

- The rules only apply if HM Revenue and Customs ("HMRC") issue a notice directing a company to make or amend its self-assessment taking into account the deductions rules (i.e. disallowing the tax deduction for UK corporation tax purposes).[197]
- As stated above the UK has specific legislation that targets situations where a payment may be deducted for UK tax purposes in the absence of a corresponding inclusion of such payment as taxable income. There is a carve-out for payments received that are not taxable because the recipient is not liable to tax under the tax legislation of the foreign jurisdiction, or the payment is not subject to tax because it is exempt in terms of the tax law of the foreign jurisdiction. Should the provision apply, HMRC will issue a notice advising the company that the tax deduction will be disallowed for UK corporation tax purposes.

Denmark: A tax policy was adopted to align the domestic tax treatment of certain transactions with their tax treatment in foreign jurisdictions.[198] Section 2B of the Danish Corporate Tax Act is a specific anti-arbitrage provision targeting tax arbitrage structures using hybrid financial instruments. The provision applies if:

- A fully taxable Danish company, or a foreign company with a Danish permanent establishment or immovable property situate in Denmark, is "indebted or similarly obligated" to a foreign individual or foreign company;
- The foreign individual or foreign company has "decisive influence"[199] over the Danish debtor company; or the foreign individual or foreign company and the Danish debtor company form a "group of companies,"[200] which is broadly defined as a group of legal persons in which the same circle of participants is in control; or where there is common management among the shareholding entities;[201]
- The hybrid financial instrument in question constitutes debt as defined in Danish Tax law; and the hybrid financial instrument is treated as equity/paid-up capital under the tax legislation of the creditor's/investor's jurisdiction of residence.

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197 HMRC operate a voluntary clearance process in terms of which they may issue clearance in circumstances when they are of the opinion that the rule does not apply. Such clearances are binding upon HMRC.

198 Bundgaard at 33.

199 Section 2(2) of the Danish Tax Assessment Act defines "decisive influence" as ownership of, or the right to dispose of, voting rights by foreign individuals or corporations that directly or indirectly own or dispose of more than 50% of the share capital or voting rights of a Danish company. The reference to foreign individuals and foreign companies as controlling shareholders has been interpreted by the Danish Minister of Finance as including transparent entities, which has led to certain interpretational issues regarding the interchangeability of the terms "company" and "legal person," and further whether the term "company" can be defined expansively to include both taxable and non-taxable (i.e. transparent) entities.

200 In 2006 Danish tax law introduced a concept of "group of companies" specifically for purposes of transfer pricing and thin capitalisation legislation, withholding tax on interest payments and capital gains on claims and the like.

201 Bundgaard at 37.

- o If all the above requirements are satisfied, the hybrid financial instrument will be construed as equity for Danish tax calculation purposes. The reclassification will result in any interest payments and capital losses being treated as dividend payments made by the Danish debtor company. As such they will not be deductible for Danish tax computation purposes. In addition, the withholding tax rate applicable to such reclassified dividend payments would differ from the rate applicable to interest and capital gains.[202]

Several jurisdictions, including Austria, Denmark, Germany and the UK have introduced legislation that prohibits the exemption of income which is tax deductible in another jurisdiction; an approach which has been endorsed by the European Union ("EU") Code of Conduct Group (Business Taxation) as appropriate to counter the arbitrage achieved through the use of hybrid instruments. The Group acknowledged that problems arose when the jurisdiction of a debtor company permitted a deduction for an interest payment (thereby reducing its tax base) to a corporate recipient resident in a jurisdiction that treated such receipt as a tax exempt dividend. Accordingly the Group proposed that in so far as payments made in terms of hybrid loan arrangements were tax deductible for the debtor/payer, EU Member States ought to deny the exemption of such payments as profit distributions/dividends under the participation exemption.[203]

- o Austria: Income derived from hybrid instruments that constitute equity investments in terms of Austrian tax legislation, will only qualify for tax exemption under the Austrian participation exemption regime if it does not entitle the payer to a tax deductible expense.
- o Denmark: Dividends received by a Danish parent company will not be granted exemption from tax if the subsidiary payer is entitled to claim a tax deductible expense in respect of such dividends.[204] This prohibition also applies if a deduction has been permitted in a lower tier subsidiary and the dividend has been granted exemption in an intermediary subsidiary sandwiched between the lower tier subsidiary claiming the deduction and the Danish parent company. The rule does not apply if the dividends fall within the ambit of the European Commission (EC) Parent-Subsidiary Directive.[205]
- o Germany: Dividend distributions are generally exempt from tax for the recipient shareholder. In terms of the EC Parent-Subsidiary Directive, domestic dividend withholding tax will be reduced to zero if dividends are

202 Bundgaard at 39.

203 Report of the Code of Conduct Group (Business Taxation) to the ECOFIN Council of 8 June 2010, No. 1033/10.

204 Section 13 of the Danish Corporate Tax Act.

205 The EC Parent-Subsidiary Directive was designed to eliminate tax obstacles in the domain of profit distributions between groups of companies in the EU by abolishing withholding tax on dividends between associated companies (minimum participation threshold of 10%) within different Member States; preventing double taxation of parent companies on the profits of their subsidiaries; and eliminating double taxation of subsidiaries of subsidiary companies.

distributed to a qualifying EU shareholder that holds a minimum of 10% of the subsidiary. Such exemption does not apply to constructive dividends[206] in circumstances where such dividends were tax deductible for the payer thereof.

- The UK: There is legislation capable of taxing certain receipts, which in normal circumstances would not be subject to UK corporation tax. HMRC may issue a "receipt notice"[207] disallowing the exemption of the offending receipt for UK corporation tax purposes in circumstances where:[208]
  - There is a scheme that makes or imposes a provision as between the company and another person (the paying party/payer)[209] by means of a transaction or series of transactions;
  - The provision entails the paying party making, by means of a transaction or series of transactions, a "qualifying payment" (i.e. a contribution to the capital of the company) in relation to the company;
  - When embarking upon the scheme the company and the paying party expected that a benefit would arise because at least part of the qualifying payment would be exempt from UK corporation tax; and
  - There is an amount in relation to the qualifying payment that is a deductible amount, and it is not set against any scheme income arising to the paying party for income tax purposes or corporation tax purposes.

  As is clear from the foregoing, the receipts rules apply in relatively narrow circumstances where an amount that represents a contribution to capital is received by a UK resident company in a non-taxable form while it creates a tax deduction for the payer.

It should also be noted that in 2013, Mexico came up with Tax Reforms that would reduce deductions on payments to related companies if the income received by the related party would be subject to little or no taxation. To be deductible, the income would have to be subject to an effective tax rate of at least 75 percent of the rate that would be applied to the income in Mexico. Mexico’s tax reform plan is a "first effort at legislating what may come out of the BEPS report."[210]

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206 A constructive dividend is a taxable benefit derived by a shareholder from the company even though the benefit is not designated a dividend. For German tax law purposes, any transaction concluded between a company and its shareholders other than on an arm's length basis could potentially give rise to a constructive dividend (*verdeckte Gewinnausschüttungen*).

207 Issued in terms of section 249 of the UK Taxation (International and Other Provisions) Act 2010

208 Section 250 of the UK Taxation (International and Other Provisions) Act 2010.

209 There are exceptions for certain paying parties e.g. dealers.

210 DD Stewart “Mexico's Tax Reform Reflects BEPS Action Plan, Practitioner Says” Tax Analyst 10 October 2013. Available at http://services.taxanalysts.com/taxbase/tni3.nsf/(Number/2013+WTD+197-1?OpenDocument&Login accessed 28 October 2013.

12 HYBRID INSTRUMENT MISMATCHES IN SOUTH AFRICA

Hybrid instruments allow for tax neutrality in a foreign jurisdiction and non-taxation in South Africa. However the risk for South Africa regarding tax avoidance involving hybrid instrument mismatches is limited as these are really only used in "niche" transactions.

- Typical examples in this regard often involve transactions entered into by a South African resident company, incorporated in South Africa for exchange control reasons. However the company is also tax resident in a jurisdiction that has a DTA with South Africa, for example, The Netherlands;
- The company does not qualify as a "resident" as defined in section 1 of the Act since it is treated as a resident of The Netherlands in terms of the tie-breaker test in that DTA;
- The company issues redeemable preference shares and invests in debt instruments in South Africa;
- From a South African tax perspective the company earns South African sourced income which is not taxed in South Africa due to the provisions of the DTA;
- The company pays out "foreign dividends" which are not subject to dividend withholding tax and are exempt from normal tax in the hands of non-resident investors. South African resident investors will, however, be taxed on these foreign dividends since they do not qualify for exemption in terms of the provisions of section 10B of the Act.
  - From a Dutch tax perspective, the interest received by the company is taxable. However the redeemable preference shares are re-characterised as debt for tax purposes and therefore a deduction is granted for the dividends paid on these shares. The company is therefore only taxed on its spread in The Netherlands.
  - This is an example of both a dual resident company and a hybrid instrument mismatch.

Many such transactions were entered into, in particular, by financial institutions between 2002 and 2009.

12.1 SARS INVESTIGATIONS INTO HYBRID INSTRUMENT MISMATCHES

SARS investigations show that most cross border hybrid instruments arrangements involve major financial institutions dealing in the artificial generation of local foreign tax credits (FTC) and exemptions give effect to permanent tax benefits to both local and offshore taxpayers and contribute to the erosion of the hosting country's tax base.[211] Although there are variations of these transactions, the tax benefits generally flow from the fact that the tax relief claimed is in excess of any economic

[211] Adapted from SARS Media Release dated 05 October 2010.

double taxation that has occurred on interest income or post-tax dividends. The tax benefits are normally shared between the financial institution and its foreign counterparty through the pricing of the transactions. The transactions would typically lead to a financial loss for the institution in the absence of the tax benefits. It is understood that these transactions have had a substantial effect on tax bases of a number of countries and have been challenged internationally. In a notable success, the New Zealand Inland Revenue Department ("NZIR") succeeded in its litigation against two major financial institutions in the High Court and finally settled those disputes, together with similar disputes with two other financial institutions, for a combined amount exceeding NZ$2.2 billion. The total value that SARS derived from those settlements was in excess of R3 billion. In addition to the recovery of a substantial sum of tax and the respective financial institutions' co-operation in ensuring that the tax effects of these transactions were to be immediately terminated, SARS also obtained their undertaking not to enter into similar or substantially the same transactions in future. The financial institutions concerned advised SARS that they acted in good faith when they entered into the transactions in light of independent legal advice furnished to them at the time. SARS, however, regarded and still regards these transactions as constituting unacceptable tax avoidance that, *inter alia*, erodes the South African tax base.

The transactions identified in South Africa by and large operate on the basis of exploiting the double taxation relief mechanisms contained in either domestic tax law or double taxation treaties between South Africa and other countries. Artificial tax credits and exemptions were generated in South Africa, without which the transaction would not have been economically viable for the local financial institution. In fact the transactions actually generated an economic loss had it not been for the tax credit or exemption. It is only when the tax credit or exemption is brought into the equation that the transaction produces a "profit".

It should be noted that in respect of foreign tax credit transactions there are essentially two aspects.

- Firstly, the South African investor claims foreign tax credits. This essentially results in the income on which the foreign tax credits is claimed being protected from South African tax.
- Secondly such foreign tax credit transactions may be debt funded. In these circumstances the South African investor only makes a spread representing the difference between the income earned from the foreign tax credit transaction and its funding costs. The ability to claim a foreign tax credit in respect of the <u>gross</u> amount of income received from the foreign tax credit transaction, essentially shelters other income earned by the South African taxpayer from South African tax.

An example of a version of a FTC generator investigated by SARS involved a limited liability partnership ("LLP") established in Delaware in the United States of America

("U.S."). It is noted that the use of a LLP is just one method in achieving the same benefit that could have been obtained through the use of a company, in different circumstances. The structure in issue involved a foreign multinational bank in the U.S. ("Bank 1") that sought to take advantage of the tax arbitrage opportunities available in the U.S. / South Africa double taxation treaty. It approached a South African banking group ("Bank 2") to participate in the transaction and share in the tax benefit. The LLP was set up by Bank 1 as a special purpose vehicle to facilitate the transaction. The general partner rights ("GP rights") associated with the LLP were then sold to Bank 2 in terms of a repurchase agreement in terms of which Bank 2 would contribute the economic amount necessary for the LLP to acquire fixed interest bearing instruments. In return, Bank 2 would be entitled to receive distributions from the LLP and the capital back after a predetermined term. As Bank 2 required a floating return, it swapped the fixed return received from the LLP for a floating return (Libor plus a margin) with Bank 1 in terms of an interest rate swap agreement. In order to create the tax benefit in the form of a FTC in South Africa, the LLP elected to "check the box" and be regarded for Federal Income Tax purposes as a stand-alone entity and subject to Federal Income tax. The consequence of this election was two-fold: firstly, it enabled Bank 2, which was in a neutral tax position, to claim a credit from SARS to the extent of the taxes paid by the LLP, secondly, it enabled Bank 1 to treat the entire transaction as a "secured lending arrangement" and claim the distribution to Bank 2 as a deemed interest deduction against the swap receipt from Bank 2. Economically, prior to any sharing of the tax benefit generated in Bank 2, Bank 1 and Bank 2 were both pre and post-tax neutral. However as a result of the tax benefit being priced into the fixed leg of the interest rate swap (based on a profit sharing formula) Bank 1 became profitable both pre and post-tax and Bank 2 made a pre-tax loss but a post-tax profit.

The effect of these transactions is that both the international and local financial institutions that were party to these transactions were enriched at a cost to the South African fiscus. Furthermore, to the extent that international financial institutions were being enriched, the South African tax base was being eroded. The portion of the tax benefit kept by the South African financial institutions served as compensation (lucrative) for participating in the transaction. Table 1 below gives examples of a few countries where these arrangements have been effected. The approximate amounts involved show that the taxes lost with regard to these transactions are significant.

Table 1: Extent of FTC generator nationally and internationally

Country	No. of t/a's	Tax benefit
South Africa	7	ZAR2.8bn
United States of America	11	US$3.5bn
Canada	17	CDN$850m
New Zealand	6	NZD$2.2bn

The transactions identified in South Africa relate only to two major South African financial institutions.

At the time of SARS' investigation into these transactions, the New Zealand Revenue authority (NZIR) was the only tax authority that had any degree of success internationally. SARS followed the NZIR approach in challenging these transactions together with the assistance from the Canadian Revenue Agency which proved to be of significant value. On 23 December 2009 NZIR announced that it had satisfactorily reached a settlement with four Australian-owned banks. The settlement followed an audit and litigation process of approximately eight years where each of the banks concerned challenged assessments brought by NZIR for tax avoidance using FTC generator type structured finance transactions. Prior to the settlement it was expected that the appeals would work their way to the New Zealand Supreme Court. Earlier in 2009 the New Zealand High Court had decided against BNZ and Westpac, both of whom were appealing the decisions. In the end the approach NZIR took was to tackle all the transactions together under the same assessment for each of the banks concerned. They were able to do this due to the nature of the grounds used to support the assessments issued. NZIR applied their general anti-avoidance legislation and focused more on the purpose of the arrangements rather than the purpose of the parties concerned. The Commissioner's argument was essentially that the purpose of all the arrangements was the same, namely to solely to avoid tax. It was held that while taxpayers are free to structure their affairs in the most tax effective way and to take post-tax consequences into account when deciding whether to proceed with a transaction, it is still premised on the assumption that the transaction has an independently justifiable commercial rationale. The arrangements in issue were however not cases of a taxpayer choosing between "two means of carrying out an economically rational transaction, one of which would result in less tax being payable than the other".

SARS noted from the Australian and New Zealand cases that the judgements were lengthy and reflected the amount of evidence adduced. It is perhaps also indicative of the intensity of resource and time required to execute such an approach. As many as twelve experts in different fields were used (and five Counsels employed).

12.2 CURTAILING HYBRID MISMATCHES INVOLVING DUAL RESIDENT ENTITIES AND HYBRID INSTRUMENTS

There are currently far less of the above transactions being entered into. Some of the reasons for this are as follows:

- SARS' Interpretation Note on section *6quat* of the Act as well as DTA's had an impact these transactions. This Note, although only draft and not binding in law, argued that foreign tax credits would not be granted on a "gross" basis, but instead after the deduction by the South African entities of their funding costs. This significantly reduces the benefit arising from such transactions.

- Pressure was excreted on the group tax department/financial directors of various banks/institutions/corporates by SARS and National Treasury. These "extra-judicial" meetings are very effective particularly in a small market like South Africa. The pressure helped to ensure that such transactions are not overdone and commoditised. In particular they were being offered by numerous foreign banks in various jurisdictions including South Africa.
- Various New Zealand cases dealt with foreign tax credits and disallowed such credits in the hands of the New Zealand entities. Although only of persuasive influence in South Africa, the New Zealand courts held that the foreign tax credits could not be claimed and, in particular, set out detailed reasoning in this regard. They "laid bare" the mechanics of such transactions and, in particular, the fact that the foreign taxes suffered in the other jurisdiction were effectively neutralised.

Recommendations

From the above, it is clear that the reason why foreign tax credit/exemption transactions are not currently being entered into is not as a result of legislative amendments, but rather for the reasons set out above.

- The problem is therefore that, as long as the law is not being amended, such transactions may still be concluded. Tax credit may be claimed on a gross basis in respect of various DTAs entered into by South Africa with other jurisdictions.
- There should be a focus on re-negotiating relevant DTA's to the language contained in the modern DTA's where the foreign tax credit granted cannot exceed that claimable under domestic law (i.e. on a net basis).
- With respect to the granting of credit, there is no policy/principle issue with the fact that a credit is granted in circumstances where the foreign tax is effectively neutralised from an economic perspective by a foreign group entity claiming a credit or through the application of group relief provisions. It is submitted that to place an onus on a South African taxpayer to prove that the foreign tax was not economically neutralised in some manner is too high a burden.
- In terms of current law, both section 6*quat* of the Act as well as the provisions relating to the elimination of double taxation in DTA's, require that <u>tax is paid</u> in the foreign jurisdiction and that this represents a <u>final tax</u> by the relevant entity. This should be sufficient for a South African taxpayer to claim a credit in respect of foreign taxes.
- It is also submitted that no further amendments to domestic law are required to deal with the position where taxes paid by, for example, a foreign partnership in circumstances where South Africa does not recognise the partnership as a separate taxpayer. This is adequately dealt with by the OECD Commentary.

12.3 LEGISLATION ON HYBRID FINANCIAL INSTRUMENTS IN SOUTH AFRICA

Section 24J

Using Example 2 as the point of departure, assume Country B is South Africa. Assume South African tax resident B Co, issues a hybrid financial instrument to A Co, an entity tax resident in Country A. No entity hybridity exists in respect of B Co or A Co – both entities are non-transparent corporate entities liable to tax in their respective jurisdictions. Assume further that the instrument has sufficient debt characteristics from a South African tax law perspective for the payment made by B Co to constitute interest as defined in section 24J of the Income Tax Act, No 58 of 1962.

In order for the interest payment to be deductible in the determination of B Co's taxable income, the interest expense must have been incurred in the production of income in the course of B Co's trade as required in terms of section 24J(2) of the Act.

Interest withholding tax:

As part of South Africa's uniform withholding tax regime,[212] which is hopped to be instrumental in eliminating base erosion, an interest withholding tax at the rate of 15% will apply to South African sourced interest paid to a non-resident with effect from 1 January 2015.[213] With regard to the expel above, in terms of the interest withholding tax, A Co will be exempt from normal tax[214] on the interest unless the debt claim in respect of which the interest is paid is effectively connected to a PE of A Co in South Africa. This exemption aligns with the treatment of interest in terms of South Africa's DTA network which generally exempts non-residents from tax on South African sourced interest unless the interest is attributable to a South African PE of the non-resident. This exemption is designed to attract foreign debt capital to the domestic market.

Section 23M

National Treasury has placed considerable emphasis on limiting cross-border interest[215] deductibility in circumstances where a controlling relationship[216] exists

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212 The regime includes interest withholding tax; dividend withholding tax, withholding tax on royalties; withholding tax on foreign entertainers and sportspersons; withholding tax on the disposal of immovable property by non-residents; and withholding tax on service fees. For a detailed discussion of South Africa's withholding tax regime please refer to: AW Oguttu "*An Overview of South Africa's Withholding Tax Regime*" Tax Talk (March/April 2014).

213 Section 50A - H of the Act.

214 Section 10(1)(*h*) of the Act.

215 Interest as defined in section 24J of the Act.

216 A controlling relationship exists if the payer/debtor and payee/creditor are "connected persons" as defined in section 1 of the Act. The interest deduction limitation will also apply in the absence of a controlling relationship between debtor and creditor if the creditor facilitated the funding for

between the payer/debtor and payee/creditor and the latter is not subject to tax. This is dealt with under section 23M in Chapter II, *Part I* of the Income Tax Act.[217] The reason for Treasury's preoccupation with placing a limitation on interest deductibility is that, notwithstanding the importance of debt capital as an investment mechanism, it has the potential to erode the South African tax base. The particular issue that section 23M of the Act has been designed to address is the perceived risk to the *fiscus* of a deduction/no inclusion outcome due to deductible interest being paid to non-resident and other exempt persons.[218] That noted, Treasury has acknowledged that a balance must be struck between attracting foreign direct investment and protecting the South African tax base from erosion. The limitation on interest deductibility is formula driven[219] and the section is scheduled to come into operation with effect from 1 January 2015.

Section 23M may operate to redress a deduction/no inclusion outcome such as that envisaged in Example 2, if B Co - a South African resident, and A Co are in a controlling relationship; and A Co, as the person to whom the interest accrues, is not subject to tax thereon. As such, with effect from 1 January 2015, section 23M will operate in a manner akin to the primary rule of the OECD hybrid financial instrument rule, provided there is a controlling relationship between the payer and the payee. In such circumstances, section 23M will impose a formula-driven limitation on the tax deductibility of the interest payment by the payer if the payee is not subject to tax under Chapter II, *Part I* of the Act.

Treasury is of the view that when the payer/debtor and payee/creditor are connected persons, the terms of the hybrid financial instrument are often flexible and subject to

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the debt through a connected person in relation to the debtor; or the debt is guaranteed by a connected person in relation to the debtor.

217 Section 23M will not apply to limit interest deductibility if such interest is included in the net income of a CFC in terms of section 9D of the Act in the foreign tax year commencing or ending in the year of assessment in which the interest deduction is claimed by the debtor. Further, section 23M does not apply to interest incurred by a debtor where the creditor funded the debt advanced to the debtor with funding granted by a lending institution (i.e. a foreign bank comparable to a bank contemplated in the Banks Act) that is not in a controlling relationship with the debtor and the interest rate does not exceed the South African repurchase (repo) rate plus 200 basis points. In addition, the section will not limit the deduction of interest incurred on linked units (comprising a share and debenture) in a company where the linked unit is held by a long-term insurer, a pension fund, a provident fund, a Real Estate Investment Trust ("**REIT**"), or a short-term insurer; if such holder holds at least 20% of the linked units in the company; the units were acquired before 1 January 2013; and at the end of the previous year of assessment at least 80% of the asset value of the company was directly or indirectly attributable to immovable property.

218 Treasury is also concerned with over-gearing to achieve tax benefits but further discussion of that issue falls beyond the scope of this report.

219 The annual deduction is limited to the amount of interest received by or accrued to the debtor plus 40% of the debtor's adjusted taxable income as defined, less any amount of interest incurred by the debtor in respect of debt other than that contemplated in section 23M (i.e. between a debtor and creditor in a controlling relationship where the creditor is not subject to tax under Chapter II, *Part I* of the Act). Should the average repo rate exceed 10% in any year of assessment, the percentage of adjusted taxable income of the debtor (40%) will be increased proportionately.

change by the parties in service of the objectives of the group as a whole. As such instruments are sometimes categorised as debt for tax purposes, when in fact they more closely resemble capital to be repaid only once the debtor is profitable.[220]

Section 23N

While not entirely apposite to Example 2, it is relevant to mention the limitation imposed on interest deductibility in terms of section 23N of the Act. Section 23N was specifically enacted to limit the use of excessive debt financing to achieve tax savings in reorganisation and "acquisition transactions."[221]

Sections 8F and 8FA

The domestic concern with hybrid debt instruments and interest deductibility is apparent in sections 8F and 8FA of the Act. Treasury is of the view that since tax law generally follows the form of a particular instrument, this affords taxpayers an opportunity to select a label for an instrument with the consequent tax benefits without due regard to its economic substance. Of particular concern to the *fiscus* is the use of hybrid financial instruments to achieve deduction/no inclusion outcomes. The stated provisions operate to deny a deduction in respect of any amount paid or payable in terms of a hybrid debt instrument, while leaving the debt characterisation of the instrument intact for all other purposes of the Act. This aligns with the treatment of hybrid financial instruments in the OECD September 2014 Report on hybrid mismatches.

In a manner similar to that in the above mentioned OECD Report section 23M of the Act recognises the hybrid regulatory capital held by the financial sector. Thus certain forms of regulatory capital issued by regulated intermediaries are excluded[222] from the ambit of the anti-avoidance provisions. These exceptions should simplify administration to some extent and ensure that South Africa is not rendered

220 National Treasury Republic of South Africa, Explanatory Memorandum on the Taxation Laws Amendment Bill, 2013, 24 October 2013 [W.P. – '13].

221 An "acquisition transaction" is defined as "any transaction - (a) in terms of which an acquiring company acquires an equity share in an acquired company that is an operating company as defined in section 24O; and (b) as a result of which that acquiring company, as at the close of the day of that transaction, becomes a controlling group company in relation to that operating company." Section 24O applies to "acquisition transactions" concluded on or after 1 January 2013 and in certain circumstances allows for the deduction of interest on funding for equity share acquisitions. Previously, under section 23K of the Act, the Commissioner's approval had to be obtained to deduct such interest. Section 23K has been repealed with effect from 1 April 2014, and section 23N operates in its stead effective from the same date.

222 Section 8F does not apply to any instrument that constitutes a tier 1 or tier 2 capital instrument (section 90 of the Banks Act) issued by a bank or controlling company in relation to a bank; any instrument subject to approval by the Registrar as defined in the Short-term Insurance Act or the Long-term Insurance Act where an amount is owed in terms of such instrument by a long-term or short-term insurer as defined in the relevant Act; or any instrument that constitutes a linked unit in a company where the linked unit is held by a long-term insurer, a pension fund, a provident fund, a REIT; or a short-term insurer, if such holder holds at least 20% of the linked units in the company; the units were acquired before 1 January 2013; and at the end of the previous year of assessment at least 80% of the asset value of the company was directly or indirectly attributable to immovable property.

uncompetitive as an emerging jurisdiction for investment purposes.

Section 8F has been amended, and section 8FA was introduced with effect from 1 April 2014, to deny the deduction of interest incurred or accrued under a hybrid debt instrument; or the deduction of hybrid interest incurred or accrued on or after the above date. The two-pronged approach applicable to domestic corporate debt issuers is designed to reduce the potential for artificially disguising equity as debt so as to generate interest deductions when equity features are clearly evident in the debt instrument. Section 8F deals with the *corpus* of the hybrid debt instrument while section 8FA focuses on the nature of the yield.

Section 8F defines a "hybrid debt instrument" as:

> "any instrument in respect of which a company owes an amount during a year of assessment if in terms of any arrangement as defined in section 80L[223] — (a) that company is in that year of assessment entitled or obliged to — (i) convert that instrument (or any part thereof) in any year of assessment to; or (ii) exchange that instrument (or any part thereof) in any year of assessment for, shares unless the market value of those shares is equal to the amount owed in terms of the instrument at the time of conversion or exchange; (b) the obligation to pay an amount in respect of that instrument is conditional upon the market value of the assets of that company not being less than the market value of the liabilities of that company; or (c) that company owes the amount to a connected person in relation to that company and is not obliged to redeem the instrument, excluding any instrument payable on demand, within 30 years — (i) from the date of issue of the instrument; or (ii) from the end of that year of assessment:
>
>> Provided that, for the purposes of this paragraph, where the company has the right to — (aa) convert that instrument to; or (bb) exchange that instrument for, a financial instrument other than a share — (A) that conversion or exchange must be deemed to be an arrangement in respect of that instrument; and (B) that instrument and that financial instrument must be deemed to be one and the same instrument for the purposes of determining the period within which the company is obliged to redeem that instrument."

As is apparent from the above definition, the provision targets hybrid debt instruments that have features that facilitate a conversion to shares; where the market value of which is less than the amount of the outstanding debt; if it has a yield determined with reference to the solvency of the debtor/issuer; or in respect of which redemption seems unlikely within a reasonable period.[224]

As regards the yield from a debt instrument, section 8FA defines "hybrid interest" in relation to any debt owed by a company in terms of an instrument, to mean

> "(a) any interest where the amount of that interest is — (i) not determined with reference to a specified rate of interest; or (ii) not determined with reference to the time value of money; or (b) if the rate of interest has in terms of that instrument been raised by reason of an increase in the profits of the company, so much of the amount of interest as has been determined with

223 For purposes of the General Anti-Avoidance Rule in section 80A-80L of the Income Tax Act an arrangement is defined as "any transaction, operation, scheme, agreement or understanding (whether enforceable or not), including all steps therein or parts thereof, and includes any of the foregoing involving the alienation of property."

224 The existence of such features must be investigated on an ongoing basis.

> reference to the raised rate of interest as exceeds the amount of interest that would have been determined with reference to the lowest rate of interest in terms of that instrument during the current year of assessment and the previous five years of assessment."

To avoid the application of section 8FA, the yield must be based on the time value of money and it must not fluctuate in accordance with the profits of the debtor/issuer.

As stated above, should a debt instrument constitutes a "hybrid debt instrument" as defined, the instrument will remain within the debt paradigm, but the interest thereon will be deemed to be a dividend *in specie* for both the payer and payee for the duration of the instrument's classification as a hybrid debt instrument. The payer will be denied an interest deduction and the dividend *in specie* may be subject to dividends tax. In addition, the section 24J interest incurral provisions will no longer be of application to the instrument.

Should the yield rather than the *corpus* of the debt instrument be under scrutiny, on the assumption that the particular yield[225] under consideration constitutes "hybrid interest" as defined in section 8FA, it will be deemed to be a dividend *in specie* for both payer and payee and the same consequences as those detailed above will ensue.

<u>Applying section 8F to Example 2:</u> Assuming Country B is South Africa and B Co issues a hybrid financial instrument to A Co, which instrument falls within the definition of "hybrid debt instrument" in section 8F; B Co will be denied a deduction in respect of the payment to A Co, which will be deemed to be a dividend *in specie* for both B Co and A Co. B Co will be required to withhold dividends tax at the rate of 15% in terms of section 64FA of the Act unless A Co, as beneficial owner of the deemed dividend *in specie*, qualifies for and submits a declaration to B Co confirming its entitlement to exemption from dividends tax[226] in terms of the Act; or reduction in the rate thereof in terms of DTA relief, as appropriate. Since A Co is a non-resident, it will not qualify for exemption in terms of section 64F(*a*) of the Act.

<u>Applying section 8FA to Example 2</u>: While the hybrid financial instrument issued by B Co may not constitute a hybrid debt instrument for purposes of section 8F, if the yield has equity characteristics that result in it being caught within the definition of "hybrid interest". B Co will be denied a deduction in respect of the payment to A Co which will be deemed a dividend *in specie* for both parties subject to dividends tax at 15% unless A Co qualifies for exemption under the Act or relief by way of a reduction in the rate of dividends tax in terms of a DTA.

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225 As opposed to any other yields from the instrument which may not bear equity characteristics and accordingly will not be deemed to be dividends *in specie.*

226 A Co would have to establish that if the dividend *in specie* had not constituted a distribution of an asset *in specie*, it would have qualified for exemption as a dividend other than a dividend *in specie* under section 64F of the Act.

It warrants mention that the hybrid debt provisions (sections 8F and 8FA) and the hybrid equity provisions (sections 8E and 8EA) are to some extent operationally contradictory and there is the risk of potential abuse with reference to sections 8F and 8FA. A taxpayer may intentionally structure an arrangement to fall within the ambit of section 8F, thereby circumventing the need to comply with the complicated provisions of section 8E or section 8EA.

Continuing with Example 2 as the point of departure, now assume conversely that Country A is South Africa. South African tax resident A Co is the holder/payee of a hybrid financial instrument issued by B Co, an entity tax resident in Country B. No entity hybridity exists in respect of A Co or B Co – both entities are non-transparent corporate entities liable to tax in their respective jurisdictions. Assume further that the instrument has adequate equity characteristics from a South African tax law perspective for the payment made to A Co to constitute a dividend. The term "dividend"[227] is defined in section 1 of the Act as "any amount transferred or applied by a company that is a resident for the benefit or on behalf of any person in respect of any share in that company…". Since B Co is not a South African resident, we must consider whether the payment received by A Co constitutes a "foreign dividend" which is defined in section 1 of the Act as follows:

> "any amount that is paid or payable by a foreign company[228] in respect of a share in that foreign company where that amount is treated as a dividend or similar payment by that foreign company for the purposes of the laws relating to — (a) tax on income on companies of the country in which that foreign company has its place of effective management; or (b) companies of the country in which that foreign company is incorporated, formed or established, where the country in which that foreign company has its place of effective management does not have any applicable laws relating to tax on income, but does not include any amount so paid or payable that — (i) constitutes a redemption of a participatory interest in an arrangement or scheme contemplated in paragraph (e)(ii)[229] of the definition of "company"; or…(iii) constitutes a share in that foreign company."

It would appear that the payment received by A Co from B Co would not qualify as a

227 Dividends are included in gross income in terms of paragraph (*k*) of the "gross income" definition in section 1 of the Act and then exempted from normal tax under section 10(*k*)(*i*) subject to certain exceptions to which the exemption does not apply, namely: dividends received by a South African resident from a REIT or an International Financial Reporting Standards ("**IFRS**")-defined subsidiary of a REIT (a "controlled company" in terms of section 25BB of the Act); dividends received by a company in consequence of a cession of the right to such dividends or the exercise of discretion by a trustee of a trust; dividends received in respect of shares borrowed by the recipient; the aggregate amount of manufactured dividends incurred by a person reduced by the aggregate of manufactured dividends received by such person; dividends received by a person (excluding manufactured dividends) to the extent that such dividends will be applied in meeting deductible expenditure which is wholly or partly determined with reference to such dividends; and dividends received by a person in respect of services rendered or to be rendered or by virtue of employment or holding office, other than a dividend in respect of a section 8C restricted equity instrument.

228 Any company which is not a South African resident.

229 That is: a portfolio comprised of any investment scheme conducted outside South Africa that is comparable to a collective investment scheme (CIS) in bonds or securities available to the public at large.

"foreign dividend" in terms of the Act since B Co considers the hybrid instrument it issued to A Co to be debt in character and the payment, interest. If Country B does not treat the payment as a dividend or similar payment in terms of its income tax regime, it will not qualify as a foreign dividend for South African tax purposes. This provision which links the domestic treatment of the payment with its tax or corporate law treatment in the foreign jurisdiction aligns with the OECD hybrid financial instrument secondary rule by compelling inclusion of the payment in A Co's ordinary income and denying any exemption or equivalent relief to which A Co would be entitled if the payment had constituted a foreign dividend. Accordingly, since South African residents are taxed on their worldwide income, the payment would fall into A Co's gross income and be subject to corporate income tax at the rate of 28%. Had the payment to A Co constituted a "foreign dividend" as defined, it would have fallen into A Co's gross income in terms of paragraph (*k*) of the definition of "gross income" in section 1 of the Act being "any amount received by or accrued by way of a dividend or foreign dividend".

<u>Section 10B</u>

Section 10B of the Income Tax Act operates to wholly[230] exempt foreign dividends from normal tax or subject them to tax at a reduced rate. The section 10B(3)[231] formula-driven exemption for foreign dividends results in the effective rate of tax applicable to so much of the foreign dividends as does not qualify for exemption, being 15% - the dividends tax rate.[232]

Neither the participation exemption nor the exemption available to foreign corporate dividend recipients resident in the same jurisdiction as the foreign company that declared or paid the foreign dividend, may be availed of if the foreign dividend payer is permitted a tax deduction in determining its liability to any tax on companies in the jurisdiction in which it has its place of effective management.

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230 In terms of section 10B(2), the foreign dividend will be exempt from normal tax if the recipient of the foreign dividend holds (alone or together with any other company forming part of the same group of companies as the recipient) at least 10% of the total equity shares and voting rights (the participation exemption) in the company declaring the dividend and the foreign dividend is received in respect of an equity share (as opposed to a non-equity share); if the recipient is a foreign company resident in the same jurisdiction as the foreign company that declared or paid the foreign dividend; if the dividend is paid out of profits that have been taxed in terms of section 9D (CFC provisions) of the Act; to the extent the foreign dividend, other than a foreign dividend *in specie*, arises from a listed share; or if the foreign dividend is an *in specie* dividend in respect of a listed share and the recipient is a South African resident company.

231 For any corporate foreign dividend recipient, the amount of the foreign dividend to be exempted from normal tax for the relevant year of assessment is calculated by multiplying the aggregate of foreign dividends received during such year that do not qualify from exemption in terms of section 10B(2) by the ratio of 13 to 28. The balance of the foreign dividend not exempted in terms of the formula is subject to tax at the 28% normal corporate rate of income tax.

232 While the recipient of the foreign dividend may be liable to tax to the extent that the foreign dividend does not qualify for exemption, section 23(*q*) of the Act denies "*any expenditure incurred in the production of income in the form of foreign dividends*" as a deduction in the determination of taxable income.

Applying the above to A Co, any exemption for which the “foreign dividend” from B Co may have qualified in terms of the participation exemption, would have been denied on the assumption that B Co was entitled to a tax deduction in Country B in respect of the payment to A Co. As such only the formula-driven exemption would apply to the foreign dividend A Co received from B Co resulting in the foreign dividend being subject to tax at the effective rate of 15%.

Section 10B(4) of the ITA presents a significant problem for legitimate commercial transactions as it denies the participation exemption in certain instances where deductible payments are funnelled back to South Africa as foreign dividends which would otherwise be exempt. It applies where:

- any amount of a foreign dividend is determined directly or indirectly with reference to or arises from any amount paid or payable by a person;
- the amount paid or payable by the person is deductible; and
- is not subject to SA income tax in the hands of the recipient or in terms of the CFC provisions.

The only circumstance in which the provision does not apply is where the amount paid relates to the purchase of trading stock.

Unfortunately, the provision catches purely commercial transactions where no mischief is involved. Take for example the following scenario. A SA telecommunications company (Company A) has a customer who makes a phone call to a customer of Company B in country B. Company B is a subsidiary of Company C, a SA resident company, neither of which are related to Company A. Company A charges the customer for the call. In terms of a standard call termination agreement, Company A must pay a call termination fee to Company B for which it is entitled to a deduction and which is taxable in Country B. Company B pays a dividend to Company C, partly out of the profits arising from the above transaction. The dividend does not qualify for the participation exemption and is taxable in the hands of Company C. the result is double taxation

The inequity of such treatment and the resultant distortions are obvious. There is no mischief involved in such a scenario, yet Company C would be obliged to account for the foreign dividend as taxable, notwithstanding that only a tiny portion of the dividend may have been derived from the deductible payment. In practice, it would be all but impossible for this provision to be applied to such third party transactions as in many instances the company would have no idea that the dividend arose out of payments that were deductible for SA tax purposes. There is a need to refine this provision to apply only in circumstances where there is mischief involved.[233]

Sections 10(1)(k)(i)(ee), (ff), (gg) and (hh)

233 PWC “Comments on DTC BEPS First Interim Report” (30 March 2015) at 17.

There are also anti-dividends scheme rules contained in sections 10(1)(k)(i)(ee), (ff), (gg) and (hh). These counter mismatches achieved through the creation of a deduction (e.g. a deductible manufactured dividend) in respect of exempt dividends income. Under these provisions, a dividend exemption is denied.

Section 64EB

While dealing with dividends, the anti-avoidance provisions of section 64EB[234] of the Income Tax Act require mention. The section was introduced to prohibit the transfer of dividend income from entities that are subject to dividends tax, to entities that are exempt from dividends tax. The cession of the right to a dividend ceded after the announcement or declaration of such dividend is disregarded for purposes of section 64EB(1) and the cedent of such dividend is deemed to be the beneficial owner thereof. This is not the case if a share is ceded *cum dividend* to a cessionary that holds the full bundle of rights attaching to such share post cession. The anti-avoidance provision operates to prohibit for example, a non-resident shareholder, either ceding its right to dividends or selling its shares *cum dividend* and repurchasing them *ex dividend* from an entity exempt from dividends tax (e.g. a South African company). By ignoring the cession or the "resale agreement",[235] as appropriate, the cedent or seller is denied the exemption from dividends, although if such cedent or seller is resident in a jurisdiction which has a DTA with South Africa, it may qualify for a reduction in the dividends tax rate. These deeming provisions also apply to securities lending arrangements where listed shares are borrowed temporarily after the announcement or declaration of dividends. Because legal title is transferred to the borrower in terms of these arrangements, the borrower becomes beneficial owner of the listed shares, entitled to all dividends in respect of the borrowed shares. Typically the dividends are transferred back to the lender by way of "manufactured dividends". In terms of section 64EB(2), the dividends in respect of borrowed shares are deemed to have been paid by the borrower to the lender and the lender is deemed to have received a dividend equal to the amount so paid.

Irrespective of the characterisation of the payment received by A Co from B Co, A Co would qualify for a rebate against its South African tax liability in respect of foreign taxes paid on such payment in terms of section 6*quat* of the Act.[236] Section 6*quat* of the Act grants relief to South African tax residents for foreign tax paid on foreign source income (i.e. A Co would be entitled to section 6*quat* relief against its

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[234] Operative from 1 September 2012 in respect of transactions entered into on or after that date, and amounts paid on or after 1 October 2012 in respect of transactions entered into before 1 September 2012.

[235] A "resale agreement" for purposes of section 64EB is "the acquisition of a share by any person subject to an agreement in terms of which that person undertakes to dispose of that share or any other share of the same kind and of the same or equivalent quality at a future date."

[236] Many DTAs that South Africa has concluded with other countries have articles eliminating double taxation of amounts subject to tax in the foreign jurisdiction with which South Africa has concluded the relevant DTA. Unless the DTA stipulates that the foreign tax paid (duly converted to South African currency (ZAR)) must be credited against any South African tax liability in accordance with South African tax law (i.e. section 6*quat* of the Act); the taxpayer may choose whether to use section 6*quat* or claim a tax credit under the DTA.

South African tax liability if the payment it received from B Co was subject to tax in Country B).

Section 8E and 8EA

The discussion above has dealt with the provisions that deem interest in respect of hybrid debt instruments (debt instruments bearing certain equity features) or hybrid interest to be dividends *in specie.* It is also important to consider whether the instrument issued by B Co to A Co would constitute a “hybrid equity instrument” or a “third-party backed share” in terms of either section 8E or section 8EA of the Act and what the tax implications of such characterisation would be.

The provisions that deal with hybrid equity instruments[237] seeks to align the tax treatment of financial instruments with their economic substance. If the financial instrument giving rise to the dividends or foreign dividends constitutes a “hybrid equity instrument” as defined in section 8E, or a section 8EA “third-party backed share”, the relevant provision will operate to deem the dividends earned on such instruments to be income taxable in the hands of the payee/holder, leaving the dividend nature intact vis-á-vis the payer/issuer. As such, the payer/issuer will be denied any deduction in the determination of its taxable income in consequence of the payment of such dividends. No dividends tax will be due in respect of such deemed income on which the payee/holder will be subject to normal tax.

A hybrid financial instrument which combines expected time value returns as well as exposure to changes in the value of a company (unexpected gain or loss attributable to a risk element) poses problems in determining whether the instrument should be characterised as debt or equity. These mixed features are designed to obtain the best of both worlds so that the economic substance of the instrument often differs from its tax characterisation.

Although section 8E applies to both domestic and foreign shares, the original provision[238] was amended in 2003 to prevent foreign round-tripping schemes designed to generate South African source interest deductions along with tax-free foreign dividends. The purpose of the section was to counter tax avoidance by ensuring that debt was not disguised as short-term redeemable preference shares.
The ambit of section 8E[239] has been extended over time such that in its current form section 8E(2) provides that:

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[237] Sections 8E and 8EA of the Act.

[238] Inserted into the Act in 1989 in terms of which dividends on certain types of shares were deemed to be interest.

[239] The amended section 8E of the Act applies in respect of years of assessment commencing on or after 1 January 2013. An additional anti-avoidance provision applies to dividends or foreign dividends accrued in respect of hybrid equity instruments on or after 1 April 2012 but received three months or more after the accrual. If such dividends or foreign dividends are received in a year of assessment commencing on or after 1 April 2013, then the amended section 8E will apply to deem such dividends to be income (as opposed to interest) subject to tax for the recipient.

"any dividend or foreign dividend received by or accrued to a person during any year of assessment in respect of a share must be deemed in relation to that person to be an amount of income accrued to that person if that share constitutes a hybrid equity instrument at any time during that year of assessment."

A "hybrid equity instrument" is defined in section 8E(1) as:

> "(a) any share, other than an equity share, if – (i) the issuer of that share is obliged to redeem that share in whole or in part; or (ii) that share may at the option of the holder be redeemed in whole or in part, within a period of three years from the date of issue of that share; (b) any share, other than a share contemplated in paragraph (a), if – (i)(aa) the issuer of that share is obliged to redeem that share in whole or in part within a period of three years from the date of issue of that share; (bb) that share may at the option of the holder be redeemed in whole or in part within a period of three years from the date of issue of that share; or (cc) at any time on the date of issue of that share, the existence of the company issuing that share – (A) is to be terminated within a period of three years; or (B) is likely to be terminated within a period of three years upon a reasonable consideration of all the facts at that time; and (ii)(aa) that share does not rank pari passu as regards its participation in dividends or foreign dividends with all other ordinary shares in the capital of the relevant company or, where the ordinary shares in such company are divided into two or more classes, with the shares of at least of one such classes; or (bb) any dividend or foreign dividend payable on such share is to be calculated directly or indirectly with reference to any specified rate of interest or time value of money;[240] or (c) any preference share[241] if that share is – (i) secured by a financial instrument;[242] or (ii) subject to an arrangement in terms of which a financial instrument may be disposed of, unless that share was issued for a qualifying purpose."

In addition, section 8EA[243] of the Act applies to equity that resembles debt by virtue of the provision of security, where the dividend yield in respect of shares is secured or guaranteed by third party balance sheet. The provision operates by defining a "third-party backed share" as "any preference share in respect of which an

240 Paragraph (*b*)(ii)(*bb*) may apply to the payment received by A Co from B Co, since B Co considers the instrument to be debt, so the payment thereon would ordinarily be calculated directly or indirectly with reference to a specified rate of interest or the time value of money.

241 A "preference share" is defined in section 8EA of the Act as "any share – (a) other than an equity share; or (b) that is an equity share, if an amount of any dividend or foreign dividend in respect of that share is based on or determined with reference to a specified rate of interest or the time value of money."

242 A "financial instrument" is defined for purposes of section 8E as an interest-bearing arrangement or a financial arrangement based on or determined with reference to a specified rate of interest or the time value of money. In section 1 of the Act, a "financial instrument" is defined as including "(a) a loan, advance, debt, bond, debenture, bill, share, promissory note, banker's acceptance, negotiable certificate of deposit, deposit with a financial institution, a participatory interest in a portfolio of collective investment scheme, or a similar instrument; (b) any repurchase or resale agreement, forward purchase agreement, forward sale agreement, futures contract, option contract or swap contract; (c) any other contractual right or obligation the value of which is determined directly or indirectly with reference to – (i) a debt security or equity; (ii) any commodity as quoted on an exchange; or (iii) a rate index or a specified index; (d) any interest-bearing arrangement; and (e) any financial arrangement based on or determined with reference to the time value of money or cash flow or the exchange or transfer of an asset."

243 The concern of SARS and National Treasury is that preference shares (and other similar shares) guaranteed by third parties have debt-like features and should be taxed accordingly.

enforcement right[244] is exercisable by the holder of that preference share or an enforcement obligation[245] is enforceable as a result of any amount of any specified dividend, foreign dividend, return of capital or foreign return of capital attributable to that share not being received by or accruing to any person entitled thereto." The provision targets funding structures where the issuer/payer does not require a tax deduction in respect of the cost of borrowing in the form of interest, and the sole reason for using a third-party backed share as opposed to debt funding is to return interest to the holder/payee as exempt dividends. If the hybrid equity instrument in question constitutes a third-party backed share, the dividends received by the holder/payee of such share will be deemed to be income subject to tax in its hands. The corresponding deduction will be denied to the issuer/payer, the income deeming applying only to the dividends vis-á-vis the holder/payee.

Notwithstanding the hybrid financial instrument constituting a "hybrid equity instrument" in terms of section 8E or a "third-party backed share" as defined in section 8EA of the Act, the income deeming provisions will not apply if the instrument is issued for a "qualifying purpose" in terms of section 8EA. Should the issue proceeds be applied for a qualifying purpose, then it is permissible for the holder of the preference shares to secure the dividend yield through an enforcement right against or enforcement obligation from certain stipulated persons without the preference share constituting a "hybrid equity instrument"[246] or a "third-party backed share" and triggering adverse tax consequences.

A share which would otherwise constitute a "hybrid equity instrument" or a "third-party backed share" will not constitute such a share if the preference shareholder is entitled to an enforcement right against or enforcement obligation from one or more of the persons detailed in section 8EA(3)(*b*)[247] of the Act and the subscription

244 An "enforcement right" means any fixed or contingent right of the holder of a share or a connected person vis-á-vis such holder to require any person other than the issuer of the share to acquire it from the holder; make payment in respect of that share in respect of a guarantee, indemnity or similar arrangement; or procure such acquisition or payment.

245 An "enforcement obligation" means any fixed or contingent obligation upon any person other than the issuer of the share to acquire it from the holder; make payment in respect of that share in respect of a guarantee, indemnity or similar arrangement; or procure such acquisition or payment.

246 Paragraph (*c*) of the definition of "hybrid equity instrument" in section 8E of the Act.

247 That is: "(i) the operating company to which the qualifying purpose relates; (ii) any issuer of a preference share if that preference share was issued for the purpose of the direct or indirect acquisition by any person of an equity share in an operating company to which that qualifying purpose relates; (iii) any other person that directly or indirectly holds at least 20% of the equity shares in - (aa) the operating company contemplated in subparagraph (i); or (bb) the issuer contemplated in subparagraph (ii); (iv) any company that forms part of the same group of companies as – (aa) the operating company contemplated in subparagraph (i); (bb) the issuer contemplated in subparagraph (ii); or (cc) the other person that directly or indirectly holds at least 20% of the equity shares in the operating company contemplated in subparagraph (i) or the issuer contemplated in subparagraph (ii); (v) any natural person; or (vi) any organisation – (aa) which is – (A) a non-profit company as defined in section 1 of the Companies Act; or (B) a trust or association of persons; and (bb) if – (A) all the activities of that organisation are carried on in a non-profit manner; and (B) none of the activities of that organisation are intended to

proceeds are used for a “qualifying purpose”. A “qualifying purpose” in relation to the funds derived from the issue of a preference share means:

“(a) (t)he direct or indirect acquisition of an equity share by any person in an operating company,[248] other than a direct or indirect acquisition of an equity share from a company that, immediately before that acquisition, formed part of the same group of companies as the person acquiring that equity share;

(b) the partial or full settlement by any person of any –

(i) debt incurred for one or more of the following purposes:

(aa) The direct or indirect acquisition of any equity share by any person in an operating company, other than a direct or indirect acquisition of an equity share from a company that, immediately before that acquisition, formed part of the same group of companies as the person acquiring that equity share;

(bb) a direct or indirect acquisition or a redemption contemplated in paragraph (c);

(cc) the payment of any dividend or foreign dividend as contemplated in paragraph (d); or

(dd) the partial or full settlement, directly or indirectly, of any debt incurred as contemplated in item (aa), (bb) or (cc); or

(ii) interest accrued on any debt contemplated in subparagraph (i);

(c) the direct or indirect acquisition by any person or a redemption by any person of any other preference share if –:

(i) that other preference share was issued for any purpose contemplated in this definition; and

(ii) the amount received by or accrued to the issuer of that preference share as consideration for the issue of that preference share does not exceed the amount outstanding in respect of that other preference share being acquired or redeemed, being the sum of –

(aa) that amount; and

(bb) any amount of dividends, foreign dividends or interest accrued in respect of that other preference share; or

(d) the payment by any person of any dividend or foreign dividend in respect of the other preference share contemplated in paragraph (c).”[249]

The complexity of these provisions is perhaps attributable to their evolution. While it appears that they were originally conceived using the “bottom-up” approach by defining what fell within their scope; they have evolved over time in a convoluted manner which has sought to capture an ever-increasing variety of hybrid financial

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directly or indirectly promote the economic self-interest of any fiduciary or employee of that organisation, otherwise than by way of reasonable remuneration payable to that fiduciary or employee.”

248 An “operating company” is defined in section 8EA as “(a) any company that carries on business continuously, and the course or furtherance of that business provides goods or services for consideration; (b) any company that is a controlling group company (defined in section 1 of the Act as a company which holds shares in at least one other company provided inter alia that the controlling group company holds at least 70% of the equity shares in the other company) in relation to a company contemplated in paragraph (a); or (c) any company that is a listed company.”

249 The stated definition of “qualifying purpose” applies in respect of dividends or foreign dividends received in a year of assessment commencing on or after 1 April 2013, and to dividends or foreign dividends accrued on or after 1 April 2012 but received three months or more after the accrual. If such dividends or foreign dividends are received in a year of assessment commencing on or after 1 April 2013, then such dividends will be deemed to be income subject to tax for the recipient.

instruments so that they now appear to have been crafted in terms of the "top-down" approach. This has created a complicated carve-out or an escape hatch, excluding from their application "hybrid equity shares" or "third-party backed shares" the issue proceeds from which are used to acquire equity shares in an operating company; to repay bridging finance used to acquire equity shares in an operating company; or the refinancing (other than in the case of third-party backed shares) of finance originally used for a qualifying purpose. The escape hatch underwent considerable legislative refinement in 2013, the objective being to ensure that third-party backed shares used to facilitate Black Broad Based Economic Empowerment (BBBEE) activities were placed beyond the ambit of the provision. As such the section 8EA escape hatch may be availed of in circumstances where the third-party backed share subscription proceeds are used for a "qualifying purpose" as defined.

Notwithstanding the 2013 refinements, the provisions of section 8EA of the Act have continued to adversely affect the implementation of commercial transactions and taxpayers have been struggling with their practical application. A welcome announcement was made in the 2014 Budget Speech[250] in terms of which it is proposed that the escape hatch be broadened to allow for the refinancing of third-party backed shares, originally used to finance the acquisition of equity shares in an operating company; and for the limited provision of security to the funder (equity shares held by the acquiring company equity shareholders directly or indirectly in the underlying operating company).

The lesson the OECD may glean from this process is perhaps to give due consideration to the approach it adopts in framing the hybrid financial instrument rule because changing course *en route* leads to undue legislative complexity. In addition, the South African hybrid equity tax regime illustrates how legislating from the "bottom-up" enables taxpayers to structure around the defined scope of the legislation by exploiting gaps in the definitions and operative terms of the provisions. In addition, the hybrid equity provisions of section 8E and hybrid debt provisions of section 8F may operate in a contradictory manner. The more complicated the legislation, the greater the scope for ambiguity and interpretational discrepancies and consequently, the more time and resources expended by revenue authorities and taxpayers on respectively enforcing and circumventing such legislation.

Applying the complex hybrid equity tax regime to the facts of Example 2: If South African tax resident A Co is the holder/payee of a section 8E "hybrid equity instrument" or a section 8EA "third-party backed share" issued by B Co, the subscription proceeds which are not used for a "qualifying purpose" as defined; the dividends received by A Co will be deemed to be income subject to tax in its hands at the normal corporate income tax rate of 28%. The corresponding deduction will be denied to B Co from a South African tax perspective, the income deeming applying

[250] Annexure C (miscellaneous tax amendments).

only to the dividends vis-á-vis A Co.

12.4 RECOMMENDATIONS ON HYBRID INSTRUMENT MISMATCHES FOR SOUTH AFRICA

The pertinent question for South Africa with regard to hybrid mismatches is the lack of local and international matching of a deduction in one country to the taxability in another, especially as this relates to the participation exemption (section 10B of Income Tax Act) and the potential for a new interpretation by the OECD. The likelihood of re-negotiating treaties is slim and this thus brings into question whether existing treaties are sustainable.

- South Africa's interventions to hybrid mismatches lead to mismatches of their own and could result in double taxation or double non-taxation. The approach has been rather piecemeal, which has resulted in a plethora of provisions as is evident from the extent of those listed in the report. As part of the reform process to deal with hybrid mismatches, this plethora of instruments should be consolidated into a clear and concise approach and any unnecessary anti-avoidance provisions eliminated.[251]
- The legislators should consider introducing or revising specific and targeted rules denying benefits in the case of certain hybrid mismatch arrangements. In doing so, the legislators should ensure that the rules must be simplified to deal with legal principles rather than specific transactions. The new rules should be aligned with the OECD recommendations and introduced as necessary and appropriate for South Africa with due regard to resource constraints and unnecessary legislative complexity. [252]
- SARS should introduce or the revise disclosure initiatives targeted at certain hybrid mismatch arrangements. To ensure the success of such disclosure rules, it is important that the rules are clear, free of loopholes, carry sufficient penalty for non-compliance and are adequately enforced. Such rules can be effective, either insofar as reporting is concerned or as a deterrent to aggressive tax planning. To address the compliance burden on taxpayers it is important that the rules should be targeted precisely at arrangements that are of concern and not formulated so broadly that they result in arrangements that present little or no risk to the tax base having to be reported and overwhelming both taxpayers and SARS. [253]
- It should be noted however that disclosure programs are never successful and are overly burdensome from a compliance perspective.
- The hybrid debt and interest rules require attention as they are not linked to the tax treatment in the hands of the counterparty and may themselves lead to mismatches and double taxation. A rule needs to be put in place

251 PWC "Comments on DTC BEPS First Interim Report (30 March 2015) at 17.
252 PWC "Comments on DTC BEPS First Interim Report (30 March 2015) at 17.
253 PWC "Comments on DTC BEPS First Interim Report (30 March 2015) at 17.

that links the hybrid rules to the treatment in foreign counties. This would prevent tax abuse in cases where there is a denial of deduction in South Africa but not in other countries.

- The rules governing the deductibility of interest need to be developed holistically and without a proliferation of too many sections within the Act. The focus should be based on a principle rule and one should not have to apply too many different sections to a transaction when assessing whether or not interest is deductible. The key policy requirement is an emphasis on mismatch rather than merely attacking a particular type of instrument.
- From the analysis of the international jurisdictions, it is clear that OECD rules and in particular, the UK rules, focus on a deductibility mismatch or other clear tax leakage. This is, it is submitted, correct and is a different approach from what was adopted in sections 8E to 8FA of the Act which looks purely at substance over form, without enquiring whether mischief exists. In other words, it makes no sense to alter the tax treatment of an instrument where no obvious leakage arises – such as in circumstances where a deduction is matched by a taxable receipt, or a non-deductible payment is exempt.
- NT contends that the rules do not concern themselves with specific tax structures but rather look to those terms of an instrument and/or arrangement that would not be ordinarily be found in either an equity instrument or debt instrument. Nevertheless, there is need to ensure that sections 8E to 8FA do not overly place emphasis on the type of mischief being controlled rather than on the substance of the instrument in question. NT further contends that sections 8E-8FA are structured to capture the “low-hanging” fruit. Hurdles for the application of these provisions range from the presence of guarantees and assurances that are only necessary in debt arrangements (8EA) to unreasonably long repayment periods for debt (8F) and the non-payment of obligations or increases in payment obligations (8FA) when the debtor attains financial stability. However these provisions are quite very complex and unclear.
- Section 23M is a mismatch measure as contemplated in the OECD requirements. However, in its structure it also operates as a matching measure for interest deductions. In other words, an interest deduction is limited (and not denied) until that point in time that the corresponding interest income is subject to South African tax in the hands of the recipient of the interest. However the provision is quite complex and its workings unclear.
- It is strongly recommended that South Africa moves away from anti-avoidance sections aimed at particular transactions and establish anti-avoidance principles which can be applied to a broad range of transactions without undue technicality; even if there is a risk that one or two transactions fall through the cracks, a principle approach to drafting

legislation is significantly preferential to a transaction-by-a-transaction approach which we currently appear to have. An example of this as explained in the sub-heading on ss 8F and 8FA, is that ss 8F and 8FA unintentionally provide a solution to the problems encountered in 8E and 8EA. This is type of unintentional tax effect only arises due to overly complex and poorly thought out tax legislation.

- The inconsistencies between hybrid debt and hybrid equity rules should be addressed. For instance there should be alignment with respect to security for equity as is the case for debt.
- There is need for specific double tax treaty anti-avoidance clauses. It is however import that the rules are in line with international best practices otherwise they would result in double taxation or double non-taxation of income.
- South Africa needs to monitor OECD recommendations on hybrid mismatches and adapt domestic provisions as appropriate. There is a danger of moving too quickly and undertaking unilateral changes no matter how small, considering the potential knock-on impact for foreign investment.

13 PROVISIONS IN SOUTH AFRICA THAT DEAL WITH HYBRID TRANSFERS

<u>Section 24J</u>

For South African tax purposes, section 24J[254] of the Income Tax Act is relevant. An "instrument" is defined in section 24J as including, *inter alia*,

> "(e) any repurchase agreement or resale agreement,...but excluding any lease agreement (other than a sale and leaseback arrangement as contemplated in section 23G)"[255]

A "repurchase agreement" as defined in section 24J:

> "means the obtaining of money (which money shall for the purposes of this section be deemed to have been so obtained by way of a loan) through the disposal of an asset by any person (seller) to any other person (purchaser) subject to an agreement in terms of which such person (seller) undertakes to acquire from such other person (purchaser) at a future date the asset so disposed of or any other asset issued by the issuer of, and which has been so issued subject to the same conditions regarding term, interest rate and price as, the asset so disposed of."

[254] Section 24J deals with the incurral and accrual of interest.

[255] Section 23G is an anti-avoidance provision which effectively treats sale and leaseback arrangements involving payments to lessors or lessees that do not constitute income in their hands under the Act, as financing arrangements and denies any capital allowances that would otherwise be available in respect of the asset sold and leased back.

A “resale agreement” is similarly defined in section 24J to mean:

> “the provision of money (which money shall for the purposes of this section be deemed to have been so provided in the form of a loan) through the acquisition of an asset by any person (purchaser) from any other person (seller) subject to an agreement in terms of which such person (purchaser) undertakes to dispose of to such other person (seller) at a future date the asset so acquired or any other asset issued by the issuer of, and which has been so issued subject to the same conditions regarding term, interest rate and price as, the asset so acquired.”

While the above definitions have given rise to some interpretational anomalies, the vagaries of which exceed the scope of this report, they however have potential application to hybrid transfers. Should a hybrid transfer constitute either a repurchase or resale agreement as defined in section 24J, it will fall within the definition of an "instrument" (i.e. an "income instrument" for corporate persons) and as such all amounts payable and receivable thereunder will be deemed to be interest[256] accruing to the holder and incurred by the issuer on a day-to-day basis. As such, for purposes of section 24J the repurchase or resale agreement will be treated as a loan secured by an asset, the sale and repurchase[257] of which will be ignored.

Section 23G

Section 23G of the Income Tax Act is an anti-avoidance provision that deals with sale and leaseback arrangements. The provision effectively treats the "sale and leaseback arrangement"[258] in respect of an "asset"[259] as a financial arrangement where:

> "the receipts or accruals of…a lessee or sublessee in relation to a sale and leaseback arrangement, do not for the purposes of (the) Act constitute income of such person", in which

256 "Interest" as defined in section 24J "includes the — (a) gross amount of any interest or related finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement; (b) amount (or portion thereof) payable by a borrower to the lender in terms of any lending arrangement as represents compensation for any amount to which the lender would, but for such lending arrangement, have been entitled; and (c) absolute value of the difference between all amounts receivable and payable by a person in terms of a sale and leaseback arrangement as contemplated in section 23G throughout the full term of such arrangement, to which such person is a party, irrespective of whether such amount is — (i) calculated with reference to a fixed rate of interest or a variable rate of interest; or (ii) payable or receivable as a lump sum or in unequal instalments during the term of the financial arrangement."

257 Any difference between the purchase price and sale price will in all likelihood be deemed to be interest although it is not specifically included in the definition of "interest," and as such the purchaser will be prohibited from claiming an allowance based on any increased purchase price of the asset. See TE Brincker “Taxation Principles of Interest and Other Financing Transactions” Issue 9 May (2011) *Derivatives.*

258 Defined in the section as "Any arrangement whereby - (a) any person disposes of any asset (whether directly or indirectly) to any other person; and (b) such person or any connected person in relation to such person leases (whether directly or indirectly) such asset from such other person."

259 Defined for purposes of section 23G as "any asset, whether movable or immovable, or corporeal or incorporeal".

case "any amount which is received by or accrues to any lessor in relation to such sale and leaseback arrangement, shall be limited to an amount which constitutes interest as contemplated in section 24J; and such lessor shall, notwithstanding the provisions of (the) Act, not be entitled to any deduction in terms of section 11(e), (f) or (gA), (gC), 12B, 12C, 12DA, 13 or 13quin in respect of an asset which is the subject matter of such sale and leaseback arrangement"; and where "the receipts or accruals of…a lessor in relation to a sale and leaseback arrangement, arising from such arrangement do not for the purposes of (the) Act constitute income of such person, any deduction to which a lessee or sublessee in relation to such sale and leaseback arrangement is entitled under the provisions of (the) Act shall, subject to the provisions of section 11(f), be limited to an amount which constitutes interest as contemplated in section 24J." "Interest" for purposes of section 23G is defined in section 24J the "absolute value of the difference between all amounts receivable and payable by a person in terms of a sale and leaseback arrangement as contemplated in section 23G throughout the full term of such arrangement, to which such person is a party, irrespective of whether such amount is – (i) calculated with reference to a fixed…or a variable rate of interest; or (ii) payable or receivable as a lump sum or in unequal instalments during the term of the financial arrangement."

Effectively the sale of the asset is disregarded and where the lessee or sublessee is not subject to tax under the Act (e.g. a non-resident); the accruals and receipts of the lessor under the arrangement are limited to section 24J "interest" and the lessor is prohibited from claiming any tax allowances in terms of the Act. Conversely, if the lessor is not subject to tax under the Act (e.g. as a non-resident); the deductions available to the lessee or sublessee are limited to section 24J "interest" as defined for purposes of section 23G.

Applying the provisions of the South African tax regime to Example 2: Assume South Africa is Country A. A Co, resident in South Africa, owns a subsidiary, B Sub; tax resident in Country B. A sells its shares in B Sub to B Co in terms of an arrangement that entitles A Co to acquire those shares at a future date for an agreed price.

How would South Africa treat the hybrid transfer? A Co has obtained money through the disposal of the B Sub shares to B Co subject to an agreement in terms of which A Co is entitled to acquire from B Co the B Sub shares originally disposed of at a future date for a predetermined price. It appears that the hybrid transfer would constitute a "repurchase agreement" as defined in section 24J and be treated as the obtaining of money by way of a loan secured by the B Sub shares. As such it will fall within the definition of an "instrument" which is interest-bearing by virtue of the payments A Co is required to make to B Co for the duration of the repo. We are not advised whether or not the agreed repurchase price will carry a premium on the original price paid by B Co.

Since B Sub is a foreign company, one may assume that the yield on the shares A Co holds in B Sub will resemble foreign dividends. As such the payment will fall into A Co's gross income in terms of paragraph (*k*) of the definition of "gross income" in section 1 of the Act being an "*amount received by or accrued by way of a...foreign* *dividend*". Section 10B of the Act would then operate to either exempt the payment in its entirety (e.g. by virtue of the participation exemption) or in terms of the formula-driven exemption for foreign dividends, resulting in the effective rate of tax applicable to so much of the foreign dividend payment as does not qualify for exemption, being 15% - the dividends tax rate.[260]

A Co would not qualify for the participation exemption in respect of the foreign dividend received from B Sub if B Sub is permitted a tax deduction in determining its liability to any tax on companies in Country B where it is resident and presumably has its place of effective management.

If the payments due by A Co to B Co on the obtaining of money from B Co by way of a loan have been incurred in the production of A Co's income from carrying on its trade, they will be tax deductible and their incurral will be determined in accordance with the provisions of section 24J.

As regards such payments in respect of the instrument to B Co, interest withholding tax at the rate of 15% will apply to South African sourced interest paid to a non-resident with effect from 1 January 2015. B Co will be exempt from normal tax on the interest payment unless the loan in respect of which the interest is paid is effectively connected to a PE of B Co in South Africa. B Co may in any event qualify for exemption from tax on the South African sourced interest if a DTA exists between South Africa and Country B unless the interest is attributable to a South African PE of B Co.

If a controlling relationship exists between A Co and B Co, since B Co is in all likelihood not subject to tax under Chapter II, *Part I* of the Act, section 23M will impose a formula-driven limitation[261] on A Co's entitlement to deduct the interest payments to B Co with effect from 1 January 2015.

<u>Now transpose South Africa as Country B in Example 2.</u> What are the tax implications? If it can be said that the agreement between B Co and A Co constitutes the provision of money through the acquisition of B Sub shares by B Co from A Co subject to an agreement in terms of which B Co is obliged to resell to A Co at a future date the B Sub shares it originally acquired; one could reasonably conclude that such agreement constitutes a "resale agreement" within the meaning

260 While the recipient of the foreign dividend may be liable to tax to the extent that the foreign dividend does not qualify for exemption, section 23(*q*) of the Act denies "*any expenditure incurred in the production of income in the form of foreign dividends*" as a deduction in the determination of taxable income.

261 The annual deduction will be limited to the amount of interest received by or accrued to A Co plus 40% of A Co's adjusted taxable income as defined, less any amount of interest incurred by A Co in respect of debt other than that contemplated in section 23M (i.e. between A Co and a creditor in a controlling relationship where the creditor is not subject to tax under Chapter II, Part I of the Act). Should the average repo rate exceed 10% in any year of assessment, the percentage of adjusted taxable income of A Co (40%) will be increased proportionately.

of section 24J. As such it will fall within the definition of an "instrument" which is interest-bearing by virtue of the payments A Co is required to make to B Co for the duration of the repo.

The sale of the B Sub shares to B Co will be ignored for purposes of section 24J and all payments made to B Co in terms of the provision of money to A Co by way of a loan will be deemed to be interest subject to tax as such in B Co's hands. Since South Africa taxes on a residence basis, the fact that the payment from A Co is foreign sourced will be of no consequence. If a DTA exists between South Africa and Country A, which operates to withhold tax on the interest payment due by A Co to B Co, B Co may qualify either for DTA relief or a rebate against or deduction in its South African tax liability in respect of foreign taxes paid on such payment in terms of section 6*quat* of the Act.[262]

<u>Other potentially relevant provisions</u>
Other provisions that can be applied to hybrid transfer include section 64EB of the ITA relating to dividends tax and those related to securities lending arrangements. The exclusions from the dividend exemption in section 10(1)(*k*) of the ITA are also relevant in this regard.

14 CONCLUSION AND RECOMMENDATIONS

From the above, it is apparent that South Africa has anticipated several of the recommendations in the OECD 2015 Report on Hybrid Mismatch Arrangements, as it has incorporated provisions into the Act which achieve or are designed to achieve the objectives of OECD with regard to BEPS Action 2.

- However, legislative simplicity is critical in this complex area of tax. Thus while South Africa may be considered at the forefront in achieving OECD objectives with regard to BEPS Action 2, caution should be exercised around the complicated hybrid equity provisions (sections 8E and 8EA) of the Act, which may operate in a contradictory fashion vis-á-vis the hybrid debt provisions (sections 8F and 8FA) and create the risk of potential abuse with reference to section 8F.
- As regards the commerciality of sections 23M and 23N of the Act, there is a concern that the limitation on interest deductibility embodied in these sections may unduly impede business transactions to the potential detriment of the economy. If South Africa hopes to attract foreign direct investment and be competitive on the African continent, it must not hamper trade unnecessarily. In this regard one must view with circumspection the Draft Public Notice

262 Many DTAs that South Africa has concluded with other countries have articles eliminating double taxation of amounts subject to tax in the foreign jurisdiction with which South Africa has concluded the relevant DTA. Unless the DTA stipulates that the foreign tax paid (duly converted to ZAR) must be credited against any South African tax liability in accordance with South African tax law (i.e. section 6*quat* of the Act); the taxpayer may choose whether to use section 6*quat* or claim a tax credit under the DTA.

recently issued by SARS listing transactions[263] that constitute reportable arrangements for purposes of section 35(2) of the Tax Administration Act;[264] which once finalised is intended to be supplementary to any previous notices issued in this regard, and extends the existing listed reportable arrangements, which include certain hybrid equity and debt instruments in terms of sections 8E and 8F of the Act.

- Further, as regards balancing the BEPS risk and attracting foreign direct investment, South Africa should aim to increase its pull on and compete for a larger stake in the investments flowing into its BRIC counterparts.
- Since it remains essential to achieve equilibrium between nurturing cross-border trade and investment while simultaneously narrowing the scope of tax avoidance, some guidance may be gleaned from the UK's recent approach to "manufactured payments" where it removed the anti-avoidance legislation and instead focussed on applying the matching principle. This approach is preferable for revenue authorities and taxpayers alike.
- It is noted that to date emphasis has been predominantly on interest deductibility and the receipt of interest and/or dividends, with minimal focus on other forms of income and/or deductions. As a port of last call to combat base erosion and profit shifting as envisaged in BEPS Action 2, South Africa may resort to the GAAR,[265] which is designed to capture tax avoidance that is not caught by the specific anti-avoidance provisions of the Act. The Commissioner's discretion in determining the tax consequences of any impermissible avoidance arrangement is virtually unfettered, which one hopes will be limited by the courts in practice. Reference may also be had to the body of case law dealing with simulated or disguised transactions - the substance over form debate and the requirement that a transaction is required to be underpinned by a commercial purpose.[266]

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263 The Draft Notice lists several reportable arrangements including share buy-backs for an aggregate amount of at least ZAR10 million, if the company issued any shares within 12 months of entering into the buy-back agreement; any arrangement that is expected to or has given rise to a foreign tax credit exceeding an aggregate amount of ZAR10 million; an arrangement in which a resident contributes to or acquires a beneficial interest in a non-resident trust, where the value of contributions or payments to the trust exceed ZAR10 million, with certain exclusions; an arrangement where one or more persons acquire a controlling interest in a company that has or expects to carry forward an assessed loss exceeding ZAR20 million from the preceding year of assessment or expects an assessed loss exceeding ZAR20 million in the year of assessment in which the relevant shares are bought; and an arrangement involving payments by a resident to an insurer exceeding ZAR1 million, if any amounts payable to any beneficiary, are determined with reference to the value of particular assets or categories of assets held by or on behalf of the insurer or another person.

264 No 28 of 2011.

265 Section 80A – L of the Act, which must be read in conjunction with the reportable arrangements provisions in the Tax Administration Act.

266 *Roschcon (Pty) Ltd v Anchor Auto Body Builders CC* (49/13) [2014] ZASCA 40 (31 March 2014) in which the court held that in determining whether a transaction was simulated or disguised, it was necessary to "establish whether the parties to the transaction actually intended the agreement that they had entered into should have effect in accordance with its terms; whether the parties to the contract intended to give effect to it according to its tenor." It commented obiter that one of the most common forms of tax avoidance is where the parties to a contract

- It is submitted for South African purposes, that focus should be honed on mismatches that erode the South African tax base within the DTA context.

attempt to disguise its true nature in order to qualify for a tax benefit that would not have been available if the true contract between them were revealed. Shongwe JA, citing Zandberg v Van Zyl 1919 AD 302 at 309, stated that "(o)ur courts require no statutory powers to ignore pretence of this kind, and the law will always give effect to the real transaction between the parties".

ANNEXURE 3

ADDRESSING BASE EROSION AND PROFIT SHIFTING IN SOUTH AFRICA DAVIS TAX COMMITTEE INTERIM REPORT*

SUMMARY OF DTC REPORT ON OECD ACTION 3: STRENGTHENING CONTROLLED FOREIGN COMPANY[1] RULES

The main purpose of controlled foreign company ("CFC") rules is to combat base erosion and profit shifting (BEPS) by targeting foreign investments made by residents, via foreign entities, in an attempt to shift income from the local residence country tax base to low-tax countries.

This is generally achieved through identifying the relevant companies by determining a specified level of shareholding/voting rights held by the residents (in South Africa, where there has been some form of controlled foreign company legislation since 1997, this is currently more than 50% of the participation rights i.e. rights to participate in the income), and where there is insufficient real activity taking place in that company, the income of the company is attributed to the resident shareholders.

OECD Principles and Relevant Recommendations

The OECD provides "common approaches and best practice" in its Action 3 recommendations on CFCs. It advises that a number of policy considerations (some relating to all jurisdictions and some which follow different policy objectives, linked to the overall domestic systems of individual jurisdictions) need to be addressed when designing CFC rules. These considerations consist of shared considerations and specific jurisdictional considerations:[2]
Shared considerations[3]:

- The role of the CFC rules as a deterrent measure;
- How the CFC rules complement transfer pricing rules;
- The need to balance effectiveness with reducing administrative and compliance burdens; and
- The need to balance effectiveness with preventing or eliminating double taxation.

These considerations are prioritised differently by different jurisdictions depending on whether they have a worldwide or territorial system.

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1 Prepared with the assistance of the South African Institute of Tax Practitioners.

2 OECD/G20 2015 Final Report on Action 3 at 11.

3 OECD/G20 2015 Final Report on Action 3 at 11.

Specific Jurisdictional considerations:
- How to strike a balance between taxing income and maintaining competiveness; and
- Preventing base stripping[4].

The OECD identifies six constituent elements (termed by it as “building blocks”, numbered 1-6) required for the design of effective CFC rules, which should be considered by countries with existing CFC rules, and addressed by those which currently do not:
1. Rules for defining a CFC (including a definition of control);
2. CFC exemption and threshold requirements;
3. Definition of CFC income;
4. Rules for computing income;
5. Rules for attributing income; and
6. Rules to prevent or eliminate double taxation.[5]

The OECD advises that the success of the Action 3 proposals on strengthening CFC legislation will depend on the willingness of the larger OECD member countries to adopt the proposals.

One particular structure of continuing and imminent concern to tax authorities is the existence of a group of companies that indirectly “control” further foreign subsidiaries via an offshore discretionary trust (or foundation). This trust, and the subsidiary shares owned by the trust, are economically part of the same group and are even consolidated under internationally accepted accounting principles (International Financial Reporting Standards (‘‘IFRS’’) 10)[6], but often fall outside of the CFC regime. It is contended that these lower-tier foreign subsidiaries should be brought into the CFC net.[7]

The OECD Action 3 report[8] recommends that the foreign companies which are consolidated in terms of IFRS, should be treated as CFC’s, despite true control lying with an intermediary trust.

The BEPS Action 3 Report also sets out considerations with respect to CFC exemptions and threshold requirements i.e. (i) *de minimis* amount below which the CFC rules would not apply; (ii) an anti-avoidance requirement which would focus CFC rules on situations where there was a tax avoidance motivation or purpose; and (iii) a tax rate exemption, where CFC rules would only apply to CFC’s resident in

4 OECD/G20 2015 Final Report on Action 3 at 15 and 16.
5 OECD/G20 2015 Final Report on Action 3 at 11.
6 Based on various determinants of “control”, as defined for accounting purposes.
7 OECD/G20 2015 Final Report on Action 3 at 24.
8 OECD/G20 2015 Final Report on Action 3 at 24.

countries with a lower tax rate than the country[9] (this could be combined with a list such as a white list.[10]).

Complementary to this, the BEPS Action 3 report provides a number of options for testing substance.[11] These are as follows:

- One option would be a threshold test which looks at facts and circumstances to determine whether the employees can factually demonstrate a "substantial contribution" to the CFC income earning activity.
- A second option would look at all the significant functions performed by entities within the group to determine whether the CFC is the entity that would be most likely to own particular assets and / or undertake particular risks, if the entities were independent. Either all the income would be imputed if the CFC fell below the threshold test or only assets and risks that would not otherwise be owned by an independent foreign entity would result in imputation.
- A third option would look to determine if the CFC has sufficient business premises and *nexus* to the country of residence and whether enough skills are being employed to undertake the CFC's core functions. Again, the income could be attributed on and all or partial basis.
- A fourth option would be a variation on the third and would use the *nexus* approach (used in Action 5) to ensure that preferential IP regimes require substantial activity. Income would be attributed to the extent that it could not be shown that the CFC met the requirements of the *nexus* approach.

A further option- the excess profits approach, which attempts to determine what profit levels a third party business would achieve in similar circumstances to the CFC, and imputes the excess to the resident shareholder thereof is not currently a feature of any existing CFC rules.

South African CFC rules and recommendations

The DTC Report on Action 3 evaluates each of these policy and design considerations, together with the proposals made in relation thereto, against South Africa's prevailing CFC legislation, and makes certain recommendations:

- CFC rules are the subject of much international debate and the prospects of major change on the international front. South Africa should adopt the position of protecting its own interests. It should follow and not lead or set the trend. South Africa's CFC legislation is also very sophisticated and comparable to other G20 countries; there is thus no need to strengthen this legislation at this stage. In summary, since South Africa already has robust CFC legislation, the

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9 OECD/G20 2015 Final Report on Action 3 in para 52.
10 OECD/G20 2015 Final Report on Action 3 in para 51.
11 OECD/G20 2015 Final Report on Action 3 at 48.

DTC recommends that it should not be significantly changed until it is clear what other countries intend to do.

The recommendations, set out below, thus only deal with further recommendations where action is recommended in relation to a specific aspect, and not where the recommendation in the detailed DTC Report on Action 3 is to leave the legislation as is:

- In the past, South Africa treated trusts as controlled foreign entities for purposes of legislation relating to controlled foreign companies. However, given the inability to neatly establish a legal connection in terms of the CFC legislation's imputation methodology, despite the *de facto* control, the legislation, which included foreign trusts as controlled foreign entities, was removed soon after its insertion.[12] Given that certain companies held by foreign trusts are consolidated for accounting purposes under IFRS, it is recommended that consideration be given to imputing the income of these companies to the 'parent' South African company, based on the IFRS methodology for consolidation (i.e. in terms of a defined method of imputation). However, prior to implementing this recommendation, reference should be had to the Final DTC Estate Duty report[13] for its recommendations, in order to ensure that any such recommendations are consistent.
- The South African CFC regime currently applies both a tax rate threshold - the 75 per cent comparable South African tax exception, which applies to all forms of CFC income-and a *de minimis* form of relief.[14] The current *de minimis* relief is largely limited to alleviating otherwise tainted passive income from triggering section 9D imputation, when it likely relates to working capital attendant on an operating business (activities of a foreign business establishment, as defined). More specifically, this exception applies only to remove section 9D imputation in the case of financial instrument income not exceeding five per cent of a CFC's total receipts and accruals excluding passive type income.[15] It is thus considered that the current South African regime covers this aspect satisfactorily, and follows the recommendation of BEPS Action 3, through adopting the combined *de minimus* approach and low effective tax rate rules, and should be maintained. It is recommended,

12 'The initial CFC legislation in 2001 referred to "controlled foreign entities" (CFEs) as opposed to CFCs, since it included foreign trusts as entities, whose income required attribution. The definition was changed to refer to CFC in 2002 and, thus, trusts were removed from the section, which then referred to companies. The first version of the 2011 Tax Laws Amendment Bill once again attempted to include trusts in the CFC regime, but the wording was poor and it was removed prior to promulgation'(p668: International Fiscal Association *Cahiers de droit fiscal international* Volume 98a-The taxation of foreign passive income for group companies-South Africa Branch Reporter: Deborah Tickle.

13 See First DTC Estate Duty Report (accessed 10 April 2016) at http://www.taxcom.org.za/docs/20150723%20DTC%20First%20Interim%20Report%20on%20Estate%20Duty%20-%20For%20public%20comment%20by%2030%20September%202015.pdf. Final Report to be accessed on this site, once released.

14 Section 9D(9A)(a)(iii).

15 Section 9D(9A)(a)(iii).

however, that consideration be given to the method adopted by South Africa for determining the effective tax rate, as set out in the final Action 3 Report. Furthermore, consideration needs to be given to whether the exemption provided when the actual tax paid by the CFC in its country of residence exceeds 75% of the South African tax that would have been paid applying South African tax principles to the CFC's income, is appropriate given the global trend of reducing tax rates, for example, the UK plans to reduce the statutory tax rate to 16% by 2020, and the average rate of corporate tax in 2015 for Europe was 20.24% e.g. Ireland 12.5%, Hungary19%, and Asia 21.91% e.g. Singapore 17%,and Thailand 20%,[16] unless the South African tax rate is likewise reduced.

(It should also be noted that, should South Africa significantly lower its corporate tax rate to compete with other lower tax jurisdictions, the risk of diversionary profits is, in any event, reduced).

- At a mechanical level, the question is whether the current South African CFC regime requires enough substance under the foreign business establishment test to meet the policy objective of having meaningful CFC local activity. At a technical level, the "foreign business establishment" test generally requires the business: (i) to be conducted through a physical structure, (ii) to be suitably staffed with on-site managerial and operational employees, (iii) to be suitably equipped to conduct primary operations, (iv) to have suitable facilities, and (v) that the business be located outside South Africa for a purpose other than the avoidance of South African tax.[17] Although the numerical size of these tests can sound intimidating, more aggressive taxpayers may appear to satisfy the test with as little as one managerial employee, one operational employee, a small fixed office (which may even be shared) and a modest amount of office equipment. It is therefore recommended that a review of the substance requirement may be appropriate. It is further recommended, in this regard, that a further inquiry of the tax base risks associated with outsourcing needs to be explored before some form of automatic tainting could be legislatively imposed to this practice.
- A side issue involving intellectual property may be the artificial labelling of certain portions of intellectual property income as ancillary services in order to avoid CFC imputation. This form of artificial labelling works best when the local countries involved treat services preferentially vis-à-vis royalties, but in some cases local royalties may be preferred. Given the flexible characterisation of these amounts as ancillary services or royalties, it is recommended that ancillary services should be classified as royalties under the South African tax provisions relating to CFCs (section 9D) (or at least if the amounts are characterised as royalties for local country tax purposes).

16 KPMG Corporate Tax Rate Survey.
17 See section 9D(1) definition of "foreign business establishment".

CLOSING REMARKS/RECOMMENDATIONS

- As indicated above, the South African CFC regime is largely in line with CFC systems used by many developed countries in Europe, North America, East Asia and the Pacific. Like all CFC systems, the regime is trying to protect the tax base without unduly interfering with the global competitiveness of South Africa's global listed multinationals. This balance is a core reason for the regime's complexity. Although the regime can be theoretically tightened, competitive constraints have been a very limiting factor.
  Many European systems have softened their CFC systems since 2000. Countries such as the UK and Netherlands (major competitors in the region) have fairly light CFC regimes. Given South Africa's limited status on the global stage, South African cannot afford to be a leader in this field but must follow the practice set by others.
  Consideration could be given to adopting a regime similar to that of the UK or Netherlands in order to improve South Africa's tax competitiveness in the long term. This step or approach should, however, be taken with caution, as simplification at this late stage of a long protracted period of development of CFC legislation may open loopholes in the regime that could compromise the fiscus.
- South Africa's CFC rules are very stringent, particularly in respect of anti-diversionary rules which create practical anomalies especially with respect to the limitation relating to foreign dividend participation. This make rules difficult to enforce practically. Care should be taken to ensure that the CFC rules are not made so onerous that they pose excessive compliance burden to South African based companies.
- Care should also be taken to ensure that the rules are not so rigid that they hinder legitimate business establishments. This is particularly so with regard to service income anti-diversionary rules for the foreign business exemption. The legislators should therefore consider refining the anti-diversionary rules as necessary.
- South African CFC rules are some of the most sophisticated and complicated within the G20. A trend that needs to be curtailed is the fact that over the last few years the legislators have resorted to explaining the working of complex legislation in Explanatory Memoranda that have no legal effect, but the law is not clear. Efforts should be made to ensure that the legislation itself is clear. Consideration should be given to simplifying the legislation so as to reduce the cost of administration for business.

It should, however, be borne in mind that policy considerations other than tax (e.g. political stability, labour laws, immigration rules, access to electricity, investment security, etc.) need to be dealt with in order to improve South Africa as a country *to* which companies wish to migrate rather than *from* which they wish to migrate. Thus, the considerations set out above merely ensure that the legislation serves its purpose as an anti-avoidance measure and a deterrent for diverting income in line with the recommendations set out in the OECD Action 3 report and go no further than this.

Should South Africa seriously wish to embark upon a programme of attracting foreign direct investment as one of the means of fulfilling its goals, as set out under the National Development Plan, to create employment and improve the opportunities for the poor to be uplifted, these other policy matters need first to be addressed. The tax regime will then, in its current form, naturally provide increased taxes for other social spending. In line with this overall objective, though, and once the other policies have been attended to, a more competitive tax rate and CFC regime (similar to that in the UK or Netherlands) might well support such initiatives.

DTA REPORT ON ACTION 3: STRENGTHENING CONTROLLED FOREIGN COMPANY RULES*

Table of Contents

1 RELEVANCE OF CONTROLLED FOREIGN COMPANY RULES

1.1 INTRODUCTION

The main purpose of the controlled foreign company ("CFC") rules is to combat base erosion and profit shifting by targeting foreign investments made by residents, via foreign entities, in an attempt to shift income from the local residence country tax base to low-tax countries.

This is generally achieved through identifying the relevant companies through determining a specified level of shareholding/voting rights held by the residents (in South Africa this is currently more than 50% of the participation rights i.e. rights to participate in the income), and where there is insufficient real activity taking place in that company, the income of the company is attributed to the resident shareholders.
Many countries identify a 'white list' of countries in which the CFC can be located, such that attribution is not required, where the tax rate is such that the likelihood of profit diversion is low. In South Africa such countries are identified through a determination of the tax that would be payable if the CFC's tax were calculated using South African tax rules, and measuring this against the tax that is actually payable in the CFC country of residence. If the latter is equal to or exceeds 75% of the former, attribution will not apply.[1]

2 INITIAL OECD THEORECTICAL CONSIDERATIONS

2.1 BEPS CONSIDERATIONS FOR ADOPTING CFC RULES AS STATED BY THE OECD

The OECD advises that a number of policy considerations (some relating to all jurisdictions, and some which follow different policy objectives, linked to the overall domestic systems of individual jurisdictions) need to be addressed when designing controlled foreign company ("CFC") rules. These considerations consist of shared considerations and specific jurisdictional considerations:[2]

Shared considerations:
- The role of the CFC rules as a deterrent measure;
- How the CFC rules complement transfer pricing rules;
- The need to balance effectiveness with reducing administrative and compliance burdens; and
- The need to balance effectiveness with preventing or eliminating double taxation.[3]

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1 More detail on the South African legislation is set out in part 3 of this document.
2 OECD/G20 2015 Final Report on Action 3 at 11.
3 OECD/G20 2015 Final Report on Action 3 at 11.

These considerations are prioritised differently by different jurisdictions depending on whether they have a worldwide or territorial system.

Specific Jurisdictional considerations:

- How to strike a balance between taxing income and maintaining competiveness; and
- Preventing base stripping[4].

The OECD identifies six constituent elements (termed by it as “building blocks”, numbered 1-6) required for the design of effective CFC rules, which should be considered by countries with existing CFC rules, and addressed by those which currently do not:

1. Rules for defining a CFC (including a definition of control);
2. CFC exemption and threshold requirements;
3. Definition of CFC income;
4. Rules for computing income;
5. Rules for attributing income; and
6. Rules to prevent or eliminate double taxation.[5]

These policy considerations and building blocks are each looked at below,[6] in light of the Action 3 considerations. The OECD, however, further emphasises, that these considerations need to be evaluated together with certain of the other Actions.[7] Equally, certain of the other Davis Tax Committee (“DTC”) reports need to be aligned with the recommendations below, for example the Report on Estate Duty, as it pertains to the tax treatment of offshore trusts.

Firstly, the policy considerations raised are evaluated, as they pertain to the South African CFC rules and policy objectives.

2.2 THE OVERALL BALANCE BETWEEN TAX NEUTRALITY AND COMPETIVENESS

In designing CFC rules a balance must be struck between taxing foreign income, and global competitiveness.[8] In the absence of harmonised global tax systems, this balance must achieve both capital export neutrality[9] and capital import neutrality.[10]

4 OECD/G20 2015 Final Report on Action 3 at 15 and 16.

5 OECD/G20 2015 Final Report on Action 3 at 11.

6 See 2.4 onwards.

7 Actions 1, 2, 4, 5, 8-10, 11, 14 and 15. See OECD/G20 2015 Final Report on Action 3 at 12.

8 OECD/G20 2015 Final Report on Action 3 in para 14.

9 Residents are taxed equally regardless of whether they invest in South Africa or another country.

10 Income earned from investments in a particular country is taxed at the same rate regardless of the investor’s residence.

In seeking this balance, poorly designed CFC rules run the risk of distortions. Weak systems may result in artificial outflows while over-zealous systems may leave resident country multinationals at a competitive disadvantage. The latter disadvantage arises, for example, if a global multinational operates an active business operation, through a CFC, in a low-taxed foreign country, with the multinational being subject to higher-taxes in its country of residence via CFC imputation. This competition comes from both low-taxed local foreign persons, as well as competitor global participants that similarly enjoy local low-tax country rates without CFC imputation in their home countries.

To address these competitiveness concerns, the current paradigm for global CFC systems exempts active income linked to real economic activity in the foreign subsidiary, as long as that income is perceived not to be an artificial shift of income from elsewhere. At issue is whether this relief goes too far, so as to be ineffective at combating BEPs. To address this the OECD advises that more countries need to adopt similar CFC systems.[11]

Of particular concern is the United States (USA) CFC (subpart F) rules,[12] which are commonly circumvented through the 'check the box' Regulations of 1996. However, the EU is also of concern since it regulated that EU-member tax havens and low tax countries cannot be blacklisted as tax havens. This undermines the principle of preventing companies from 'fobbing off' mobile passive income to tax havens. Other countries, such as the UK have recently[13] adopted rules which are far less aggressive than South Africa's.

Thus, the success of the Action 3 proposals on strengthening CFC legislation will depend on the willingness of the larger OECD member countries to adopt the proposals.

- It is thus recommended that South Africa should not significantly change its already robust CFC legislation until it is clear what other countries intend to do. The principles of the Action 3 proposals are nevertheless reviewed below.

An additional consideration is the risk of double taxation, which can equally erode competitiveness. However, this is generally dealt with through implementing low tax rate threshold rules as well as ensuring the availability of foreign tax credits.[14] Both are currently present in the South African legislation (see 1.1 above).

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11 OECD/G20 2015 Final Report on Action 3 in para 16.

12 The purpose of the Subpart F provisions is to eliminate deferral of USA tax on some categories of foreign income by taxing certain USA persons currently on their pro rata share of such income earned by their controlled foreign corporations (CFCs). See further on Subpart F https://www.irs.gov/pub/int_practice_units/DPLCUV_2_01.PDF accessed on 25 January 2016.

13 The revised CFC legislation was promulgated in the UK in 2012.

14 OECD/G20 2015 Final Report on Action 3 in para 11.

2.3 ADMINISTRATION

Effective CFC regimes should not be unduly burdensome in terms of tax enforcement and tax compliance. CFC regimes must strike a balance between the need for reduced complexity inherent in mechanical rules and the effectiveness of more subjective rules, for example, in the rules that define income. Mechanical rules are simple but prone to distortions. Subjective rules are more theoretically accurate, but can be harder to enforce and create more uncertainty in terms of compliance. A combined approach appears to find favour.[15]

As indicated above, we now look at the policy considerations set out by the OECD in its final Action 3 BEPS report in more detail.

2.4 CFC RULES AS A DETERRENT MEASURE

CFC rules admittedly raise some revenue, but their main focus is to protect the domestic tax base from artificial erosion i.e. to act as a deterrent for tax avoidance.[16] The goal is to keep taxable profits onshore, in line with domestic economic profits, so as to sustain the local corporate tax base. As a result, the benefit of revenue streams raised by CFC regimes cannot be measured by looking solely to taxable CFC revenue.

2.5 SCOPE OF BASE STRIPPING

According to the OECD, CFC rules should be designed to protect both the resident country's tax base as well as the tax base of other countries[17] (i.e. also to cover 'foreign-to-foreign stripping').[18] In effect, the CFC regime of one country may effectively protect the source country taxation of another. Indeed, much of the debate in the first world is the European implicit request for the USA to increase the strength of its CFC regime so as to protect the tax base of various European countries against base erosion caused by USA multinationals[19].

It should be noted that one of the early draft versions of the South African CFC regime sought to adopt a "worldwide tax police" approach that triggered section 9D

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15 OECD/G20 2015 Final Report on Action 3 in para 10.

16 OECD/G20 2015 Final Report on Action 3 in para 7.

17 OECD/G20 2015 Final Report on Action 3 in para17.

18 This covers income that has been in any jurisdiction as well as the CFC jurisdiction.

19 Since enacting section 954(c)(6) in 2005 with an original expiration date of 2009, the US Congress has acted several times to extend the benefits of the provision to US multinationals, which significantly diminishes the effect of its CFC rules by allowing many cross-border interest and dividend payments to fall outside the scope of its subpart F rules. Also, the IRS has contributed to the diminished effect of the subpart F rules by expanding the scope of some regulatory exceptions to the rules. At the same time, lawmakers have proposed various tax reforms, a number of which would significantly expand the scope of the CFC rules by imposing immediate US income tax on a much broader category of foreign earned income.

imputation when both the South African base and the tax base of other countries were at risk of base erosion. This version, however, was roundly (but unofficially) rejected given that most global CFCs systems do not go this far in practice. It was believed that a South Africa "worldwide tax police" role would place South African multinationals at a strong competitive disadvantage vis-à-vis other global competitor CFC regimes (almost all of which take a more parochial approach).[20]

2.6 CFC RULES AND TRANSFER PRICING

Transfer pricing rules are meant to restore the taxing rights of all jurisdictions. While the CFC rules can act as a partial supplement (often termed as "backstops"[21]) only a pure capital export neutrality system could achieve significant protection (i.e. full imputation of CFC income without competitive offsets).[22] However, even this full inclusion system would not capture all transfer pricing arbitrage. The CFC rules can only capture transfers between the parent company and its lower-tier subsidiaries. Countries receiving in-bound investments must still rely on transfer pricing as their core method of protecting their local tax base (e.g. in addition to withholding taxes).[23] Thus, CFC rules can be said to complement transfer pricing rules and *vice versa*.

3 BASIC SOUTH AFRICAN CONSIDERATIONS

3.1 SOUTH AFRICAN POLICY THRUST

South Africa introduced the full CFC regime in 2000 with the core provision being section 9D of the Income Tax Act, 58 of 1962.[24] This regime was introduced along with residency (i.e. worldwide) taxation of South African residents. Without this regime, South Africans could effectively avoid the breadth of worldwide tax by placing foreign income generating assets into a foreign company, while indirectly retaining South African control and the economic benefit of those foreign-placed assets. Like other countries that have adopted CFC regimes, South African taxation of foreign sourced income of foreign companies can only occur by way of imputation to the South African shareholders, because South Africa does not have any direct taxing jurisdiction over a foreign company in terms of residence or source.

Like many European countries, which introduced CFC regimes in the 1980's, the overall changes to South Africa's cross-border tax system came into effect roughly in tandem with the steady relaxation of the exchange control rules that began to emerge in the late 1990s. [25]

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20 SAIT submission to DTC (23 August 2015).
21 OECD/G20 2015 Final Report on Action 3 in para 8.
22 SAIT submission to DTC (23 August 2015).
23 SAIT submission to DTC (23 August 2015).
24 South Africa had had a version of CFC legislation that covered only specific passive income since 1997.
25 SARS Explanatory Memorandum (1997:3).

The South African CFC regime (like all CFC regimes) is complex because the CFC regime is intended to balance the need for protecting the South African tax base against the need for international competitiveness. Although many academics have justified this complexity on the basis that the key global businesses involved are sufficiently sophisticated to handle this capacity, it must be borne in mind that this legislation has been introduced by countries with more advanced tax systems like the United Kingdom and the United States of America.[26]

At present, South Africa is the only Southern African Development Community (SADC) State and also the only African country which has introduced CFC legislation.[27] Expatriates from developed countries were called in assist in drafting this legislation. Thus the legislation was largely tailored around the way it worked in these developed countries and minimal consideration was given to the peculiar conditions South Africa was going through.[28] It is reasoned that since CFC rules are largely prophylactic in nature, taxpayers are generally better off arranging their affairs in order to avoid the application of the legislation rather than risk an assessment under it.[29] The complexity of this legislation, however, also hinders foreign direct investment

3.2 MECHANICAL FRAMEWORK

The South African CFC rules as set out in section 9D of the Income Tax Act, require the following three analytical parts:

- Determining whether a foreign entity, as well as South Africa resident control of that foreign entity (referred to as the entity and control tests), falls within the ambit of the CFC regime;[30]
- Determining whether certain foreign income of a CFC is viewed as "tainted" so as to create section 9D imputed income;[31] and
- Computing and imputing "tainted" CFC income to South African shareholders, reduced by foreign tax credits to prevent double taxation.[32]

In terms of the entity and control tests, the South African CFC regime applies solely to companies – not to other organisations such as partnerships and trusts (the latter of which have their own forms of imputation (e.g. conduit or specific attribution treatment)). In order for a foreign company to qualify as a CFC, South African

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26 AW Oguttu *Curbing Offshore Tax Avoidance: The Case of South African Companies and Trust* (UNIDA LLD Thesis, 2007) at 196.
27 Olivier & Honiball at 560.
28 Oguttu at 196.
29 Sandler at 54. (Sandler D: Tax Treaties and Controlled Foreign Company Legislation- Pushing the Boundaries- Second Edition.)
30 Building blocks 1, 2 and 3 as set out in the Action 3 draft Report.
31 Building block 4 as set out in the Action 3 draft Report.
32 Building blocks 4, 5 and 6 as set out in the Action 3 draft Report.

residents must directly or indirectly hold more than 50 per cent of the rights to participate in the share capital/profit of the foreign company or, in certain circumstances, more than 50 per cent of the voting rights in that foreign company. It should be noted that South African residents do not need to be connected to one another (or even be aware of one another's participation) for the more than 50 per cent participation test to be satisfied.[33][34]

If a foreign company qualifies as a CFC, the 'tainted'[35] income of that CFC is imputed back to South African participation rights holders, where they hold at least 10% of the participation rights (alone or together with connected persons, as defined). Tainted income falls roughly into two categories:

(i) mobile income, that mainly includes passive income, such as interest, dividends, royalties, rentals, annuities, exchange differences, insurance premiums, similar income and associated capital gains; and

(ii) certain income from active sources, such as sales and services that have little economic connection to the CFC's country of residence and that involve a South African connected participant that acquires from, or sells to, the CFC (often referred to as South African diversionary transactions).

If specific CFC income is viewed as tainted, section 9D requires calculation of the CFC 'net income'[36] to determine the amount required to be imputed.

4 OECD ACTION PLAN 3 RECOMMENDATIONS

4.1 RULES FOR DEFINING A CFC

The final OECD Action 3 BEPS report seeks to define entities that are to be within the CFC scope and raises the question whether the CFC regime should also apply to partnerships, trusts and permanent establishments ("PE") (where the latter are either owned by CFC's or treated as separate to their owners).[37]

In the main, however, the overall BEPS reports are concerned about hybrid entities (e.g. limited liability companies treated as separate taxable companies for one country and as a conduit for another) i.e. it also seeks to include a modified hybrid mismatch rule. While this form of arbitrage could potentially pose a problem in

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33 See Jooste "The Imputation of Income of Controlled Foreign Entities" *South African Law Journal* (2001) 475-476. It should, however, be noted that where a resident (together with connected persons) hold less than 5% of the participation rights in a listed offshore company, that holding is not taken into account to determine whether the 50% threshold has been exceeded.

34 Headquarter companies are, however, specifically excluded from the attribution regime of section 9D (section 9D(2)).

35 Income falling within the section 9D regime without any of the exemptions applying is often termed 'tainted income'.

36 Determined using South African tax rules.

37 OECD/G20 2015 Final Report on Action 3 in paras 26 and 28.

theory, the factual evidence for this concern is unknown.[38] The OECD indicates that a possible approach to prevent arbitrage would be to take an intergroup payment into account if the payment is not included in CFC income and it would have been included if the parent jurisdiction had classified the entities and arrangements in the same way as the payer or payee jurisdiction.[39]

4.1.1 THE SOUTH AFRICAN POSITION

The South African CFC regime, currently, only requires attribution of income only from foreign companies (as defined) as opposed to partnerships, trusts and other conduit entities.[40]

It should also be noted that in terms of the definition of “foreign partnership” in section 1 of the Income Tax Act, foreign partnerships, associations and similar bodies are treated as conduits under South African tax law if those bodies are treated as conduits for foreign tax purposes in their country of formation/establishment. In essence, South African conduit treatment follows foreign conduit treatment in order to prevent the arbitrage raised by BEPs. This rule also applies to single member bodies treated as a branch.[41]

A more immediate issue within the South African context is the taxation of offshore trusts. The CFC regime initially included foreign trusts (then known as the “controlled foreign entity” regime). However, offshore trusts were removed in the early 2000’s because section 9D imputation is based on ownership, and the discretionary trust model does not neatly fit that model. The preferred route was to solve the offshore trust problem under section 7(8) of the Income Tax Act which provides that where there has been a donation, settlement of other disposition (which includes an interest free loan) made by a South African resident to a foreign trust, the income received by or accrued to that trust will be taxed in the hands of the South African resident ‘donor’. Section 7(8) still appears to need improvement and requires an independent analysis, as indicated in the Davis Committee report on the Estate Duty.[42]

One trust structure of continuing and imminent concern, under section 9D, is the existence of a group of companies that indirectly “control” further foreign subsidiaries via an offshore discretionary trust (or foundation). This trust, and the subsidiary shares owned by the trust, are economically part of the same group and are even consolidated under internationally accepted accounting principles (International

[38] Refer to discussion on hybrid mismatches dealt with in the DTC Report dealing with BEPS Action 2.

[39] OECD/G20 2015 Final Report on Action 3 in para 30.

[40] Section 9D requires a foreign *company.* See also National Treasury Detailed Explanation to section 9D. June 2002.

[41] I.e. under the worldwide taxation system branches of South African companies are taxed in South Africa as part of the main company.

[42] Davis Tax Committee 1st Interim Report, 2015:45.

Financial Reporting Standards (''IFRS'') 10)[43], but often fall outside of the CFC regime e.g. in South Africa. It is contended that these lower-tier foreign subsidiaries should be brought into the CFC net[44].

However, as is noted above, prior attempts to bring such structures into the CFC net failed, given the inability to neatly establish a legal connection in terms of section 9D imputation despite the *de facto* control, and, as indicated above, the legislation including foreign trusts as controlled foreign entities was thus removed soon after its insertion.[45]

The OECD Action 3 report[46] recommends that the foreign companies which are consolidated in terms of IFRS, should be treated as CFC's, despite true control lying with an intermediary trust.

- Consideration could be given to imputing the income of these additional CFCs to the parent South African company in terms of a defined method of imputation. However, reference should be had to the Final DTC Estate Duty report[47] for its recommendations in order to ensure that any such recommendations are consistent.

The OECD discusses 'control' in chapter 2[48] and this is discussed in more detail below (Part C) and it is recommended that South Africa considers these options in order to be in line with international norms. This is critical in order to honour the principle that as many countries should adopt CFC rules and such rules should follow similar building blocks.

It is recommended, however, that South Africa does not adopt any of these suggestions until it has evaluated the level of adoption by other countries in order to ensure that it does not become uncompetitive.

4.2 CFC EXEMPTIONS AND THRESHOLD REQUIREMENTS

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43 Based on various determinants of "control", as defined for accounting purposes.

44 OECD/G20 2015 Final Report on Action 3 at 24.

45 'The initial CFC legislation in 2001 referred to "controlled foreign entities" (CFEs) as opposed to CFCs, since it included foreign trusts as entities, whose income required attribution. The definition was changed to refer to CFC in 2002 and, thus, trusts were removed from the section, which then referred to companies. The first version of the 2011 Tax Laws Amendment Bill once again attempted to include trusts in the CFC regime, but the wording was poor and it was removed prior to promulgation'(p668: International Fiscal Association *Cahiers de droit fiscal international* Volume 98a-The taxation of foreign passive income for group companies-South Africa Branch Reporter: Deborah Tickle.

46 OECD/G20 2015 Final Report on Action 3 at 24.

47 See DTC Estate Duty Report (accessed 10 April 2016) at http://www.taxcom.org.za/docs/20150723%20DTC%20First%20Interim%20Report%20on%20Estate%20Duty%20-%20For%20public%20comment%20by%2030%20September%202015.pdf.

48 OECD/G20 2015 Final Report on Action 3 in paras 34-46.

4.2.1 BEPS ACTION BREAKDOWN

The BEPS CFC Report has an action break-down for possible consideration with respect to CFC exemptions and threshold requirements: (i) *de minimis* amount below which the CFC rules would not apply; (ii) an anti-avoidance requirement which would focus CFC rules on situations where there was a tax avoidance motivation or purpose; and (iii) a tax rate exemption, where CFC rules would only apply to CFC's resident in countries with a lower tax rate than the country[49] (this could be combined with a list such as a white list.[50]).

- *De minimis* threshold: Under the *de minimis* relief category, small levels of otherwise tainted income are ignored due to the administrative burden of imputing such small amounts. The danger in this mechanism is the fragmentation, or re-adjustment, of CFC group income to artificially enhance this form of *de minimis* relief. Passive income can also be used to maximise the caps. Thus, no general recommendation is made for or against this proposal, but if jurisdictions adopt it best practice would be to combine it with an anti-fragmentation rule.[51]

- Anti-avoidance requirement: Some CFC regimes provide full relief for CFCs based on a good business purpose or motive – the old United Kingdom rules being most notable in this regard: Under the United Kingdom rule (section 747(1) of the Income and Corporation Taxes Act 1988), a resident company satisfied the "motive test" by establishing the following: (i) the main purpose of the transactions of the accounting period in question was not a reduction in United Kingdom tax; and (ii) the main reason for the CFC's existence was not a reduction in United Kingdom tax by means of a diversion of profits (i.e. a situation where, in the absence of the CFC, the receipts would have been taxable in the hands of a United Kingdom resident). These rules now fall largely under the Diversionary Profits Tax legislation in the UK as the UK substantially relaxed its CFC rules in 2013 in order to increase competitiveness. The OECD advises that such a rule should not be necessary if the rules defining income within the scope of the regime are properly targeted, and thus do not deal with it further. However, it is stated that this does not mean that rules can never play a role.[52]

- Tax rate exemption: Given that low-taxed countries pose the greatest risk to the tax base, relief often exists when the CFC foreign tax rate is higher or only slightly lower than the tax rate of the resident shareholders of the CFC. This relief should simplify the CFC computation. This relief can be based on statutory or effective rates, or even on a country list. This form of relief eliminates tainted

[49] OECD/G20 2015 Final Report on Action 3 in para 52.
[50] OECD/G20 2015 Final Report on Action 3 in para 51.
[51] OECD/G20 2015 Final Report on Action 3 in para 59.
[52] OECD/G20 2015 Final Report on Action 3 in para 60.

income for the entire CFC. The OECD discusses the possibility of calculating the exemption based on a company by company approach and a country by country approach (which may reduce administrative complexity but increase the complexity of the calculation). No specific recommendation is made.

4.2.2 SOUTH AFRICAN PARADIGM

The South African CFC regime currently applies both a tax rate threshold - the 75 per cent comparable South African tax exception, which applies to all forms of CFC income-and a *de minimis* form of relief.[53]

The current *de minimis* relief is largely limited to alleviating otherwise tainted passive income from triggering section 9D imputation, when it likely relates to working capital attendant on an operating business (activities of a foreign business establishment, as defined). More specifically, this exception applies only to remove section 9D imputation in the case of financial instrument income not exceeding five per cent of a CFC's total receipts and accruals excluding passive type income.[54]

Although the OECD is not opposed to this type of relief, it suggests that this test may be manipulated by dividing up entities as stated above. However, the division of entities solely for this purpose is considered to be unlikely when looking at the current South African regime, given the small percentage involved and the fact that there must be genuine trading income against which the passive income is measured. Dividing foreign entities solely to expand this five per cent tax threshold would be much harder to engineer in practice than in theory.

The first set of relief, for CFCs subject to comparable tax rates, is far more significant. Under this relief mechanism, South Africa disregards all section 9D imputation in respect of a CFC, if the CFC is subject to an overall foreign effective tax rate of at least 75 per cent of the tax that would have been computed had South African tax rules been applied (proviso to section 9D(2)). Stated differently, if the tax rules in both countries were the same, CFC income subject to a 21 per cent foreign effective tax rate would be entirely free from section 9D imputation. Although most taxpayers welcome this exception, the 75 per cent calculation is said to be overly complex because the calculation requires a hypothetical South Africa tax calculation (including a determination of exemptions and deductions which may not be the same in the CFC country). In order to resolve this problem, two solutions have been recommended:

- Many taxpayers have requested relief if a CFC is subject to 21 per cent foreign statutory tax rate (versus an effective rate determination) on the basis of compliance simplicity. These requests have repeatedly been rejected

[53] Section 9D(9A)(a)(iii).
[54] Section 9D(9A)(a)(iii).

because a simple statutory approach may deviate significantly from the effective rate, due to a variety of unique foreign statutory provisions (e.g. local tax incentives) and other issues relating to local enforcement.[55]

- The use of a "good country"/"bad country" list of countries to simplify enforcement, which existed when the CFC regime was initially adopted in South Africa[56], and is also cited as an option by the OECD,[57] was ultimately repealed (despite this method's seeming simplicity) because of international politics. A good/bad country list approach is bound to offend certain countries, with adjustments eventually being made on the basis of political grounds as opposed to sound tax principles.

Notwithstanding the above, a reasonable case can be made for placing all countries on a "good" list if they are, for example, located on the African mainland. Most countries on the African continent tend to impose tax at rates at or above the South African corporate rate of 28 per cent rate, and tend to place significant enforcement emphasis on multinationals.[58] While many of these countries do indeed have incentive regimes, these regimes are almost entirely limited to mining, manufacturing and other "brick and mortar" businesses likely to fall outside section 9D, in any event, due to them being attributable to a "business establishment".[59] A relief mechanism of this nature would possibly assist South Africa's intention of being a gateway to the region, outside the headquarter regime (which excludes the CFC rules, in any event). One issue may be the existence of financial centre regimes, such as the Botswana International Financial Services Centre[60] or Mauritius Global Business Company regime,[61] which seek to provide special incentives for regional treasury operations and international companies, respectively. In cases such as these, National Treasury should be given the regulatory authority to exclude/include CFCs utilising regimes of this nature, as considered appropriate.

As for the anti-avoidance requirement, South Africa has consistently rejected this escape hatch because the CFC rules are designed to be objective, not discretionary.

55 Submissions by SAICA to SARS and Treasury on recommended Annexure C inclusions (Annual Budget Review suggestions called for in the preceding November).

56 'Between 1997 and 2001 the controlled foreign entity legislation did not apply where the foreign tax actually paid or (without any right of recovery) was more than 85 per cent of the normal tax payable in the Republic and in 2000 this exemption was changed to refer to the receipts, accruals and capital gains of a CFC where 'such receipts and accruals have been or will be subjected to tax in a designated country at a statutory rate of at least 27%' (13.5% for capital gains). A list of designated countries was compiled for this purpose and included in a Government Gazette. The designated countries (non-low-tax jurisdictions) exemption prevailed in various forms until 2004, when the exclusion was removed completely' (p674: International Fiscal Association *Cahiers de droit fiscal international* Volume 98a-The taxation of foreign passive income for group companies-South Africa Branch Reporter: Deborah Tickle.

57 The Banking Association of South Africa favours this method for its simplicity.

58 SAIT submission (August 2015).

59 CFC income satisfying the requirements under this heading falls outside the attribution regime.

60 Refer www.gov.bw/en/News/IFSC-BOTSWANA-MAKES-STRIDES-TO-IMPROVE-GLOBAL-COMPETITIVENESS for details.

61 Refer www.fscmauritius.org.

Anti-avoidance rules like the motive/business purpose tests are easy to assert and hard to maintain as an administrative matter because the focus eventually shifts the debate onto the matter of international competition, as opposed to sound tax principles. That said, the United Kingdom's motive/purpose[62] escape hatch creates a gateway competition issue for South Africa because the resulting CFC regime is so light that most global multinationals would prefer to work through that regime in terms of a regional gateway, than working through the more objective and income-by-income analysis of the South African CFC regime.

4.2.3 LOW TAX ALTERNATIVE

An alternative approach, to the complexities of distinguishing between foreign business establishment income and other income, is to simply determine section 9D imputation based on the local foreign tax rate (effective or statutory). Under this approach, all CFCs with a rate falling below a set percentage (e.g. 10 or 15 per cent) would be subject to section 9D without regard to any other facts and circumstances. The obvious benefit of this approach is simplicity.

At first blush, it could be argued that a simple flat threshold as a trigger for section 9D imputation would be unfair because all low-taxed active and passive income would be targeted. However, from a South African perspective, all of the countries of concern with low rates seemingly have little or no sizable active operating businesses from an aggregate South African country perspective. A dual effective and statutory tax rate threshold would mean that "subtle" and explicit low-taxed jurisdictions would be subject to section 9D imputation.

The most probable contrary argument would be one of international competitiveness because this method may be more effective in triggering imputation than most other CFCs regimes (meaning that South African multinationals would be in a less competitive position than their international competitors). For instance, this approach would require section 9D imputation even for subsidiary manufacturing operations operating in an African tax holiday zone, when the manufacturing subsidiaries of other competitor country multinationals would fall outside CFC imputation (the latter being excluded due to the active nature of the business involved).

- It is thus recommended that the current regime covers this aspect satisfactorily, and follows the recommendation of BEPS Action 3, through adopting the combined *de minimus* approach and low effective tax rate rules, and should be maintained.
- It is recommended, however, that consideration be given to the method adopted by South Africa for determining the effective tax rate, as set out in the final Action 3 Report. Furthermore, consideration needs to be given to

62 Refer UK 2012 CFC legislation.

whether the exemption provided when the actual tax paid by the CFC in its country of residence exceeds 75% of the South African tax that would have been paid applying South African tax principles to the CFC's income, is appropriate given the global trend of reducing tax rates, for example, the UK plans to reduce the statutory tax rate to 16% by 2020, and the average rate of corporate tax in 2015 for Europe was 20.24% e.g. Ireland 12.5%, Hungary19%, and Asia 21.91% e.g. Singapore 17%,and Thailand 20%,[63] unless the South African tax rate is likewise reduced.

(It should also be noted that, should South Africa significantly lower its corporate tax rate to compete with other lower tax jurisdictions, the risk of diversionary profits is, in any event, reduced).

4.3 DEFINITION OF CONTROL

According to the BEPS action report, there are two determinations for control: (i) the type of control; and (ii) the level of control.[64]

Types of control can be determined in various ways: – legal control,[65] economic control[66] (currently most jurisdictions use a combination of these two), *de facto* control[67] and control based on consolidation.[68] The OECD recommends that legal and economic control rules potentially be supplemented with *de facto* or consolidation types rules.[69]

Once a CFC regime has established what actually confers control the next question is how much (the level) control is enough for the CFC rules to apply.[70] The most common threshold is the more than 50% level (although 50% may also be used). However, the question of whether minority shareholders are acting together is always a concern. To address this concern, three methods may be adopted: The "acting in concert" test (not often used); a test which looks at the relationship of the parties; or a "concentrated ownership" test.
The South African system is fairly standard in this regard. Foreign companies are viewed as CFCs only if more than 50 per cent of the participation rights[71] or voting

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63 KPMG Corporate Tax Rate Survey.
64 OECD/G20 2015 Final Report on Action 3 in para 34.
65 Holding of share capital to determine percentage of voting rights.
66 Focuses on rights to profits, capital and assets of the company.
67 Based on who takes the top level decisions or who has the ability to influence or direct its day to day activities.
68 Based on whether the company is consolidated based on accounting principles. See OECD OECD/G20 2015 Final Report on Action 3 in para 35.
69 OECD/G20 2015 Final Report on Action 3 in para 36.
70 OECD/G20 2015 Final Report on Action 3 in para 37.
71 Broadly defined as the right to participate directly or indirectly in the benefits attaching to a share.

rights are directly or indirectly[72] held by South African residents (excluding certain categories as indicated above).

At this stage, there do not appear to be significant issues in this regard despite the BEPS theoretical concern about artificial structures designed to separate "the more than 50 per cent" trigger from economic or *de facto* control. The company governance challenges in achieving this split probably make this option non-viable for larger foreign subsidiaries indirectly held by listed entities or a group of truly independent investors.

- It is therefore recommended that more evidence of a factual problem should be pursued before complex adjustments are made to the CFC regime in this regard.

One ongoing technical issue is the determination of CFC status (and section 9D imputation) when a CFC has multiple classes of shares. In this circumstance, the question of what are the relative weights of participation rights – a concept established at a time before the Company Act (Act No. 71 of 2008) i.e. a time when distributions from shares were based on concepts such as share premium, share capital and profit reserves came into question.

- It is recommended that a cleaner approach would be to shift the focus from "participation rights" to one of economic value (being the whole bundle of dividend, liquidation, voting and selling rights).
- Alternatively, the concept of accounting consolidation could be added (or used in the alternative) using the predefined rules set out in IFRS 10 (see above). Such a change would ensure the inclusion of companies held through trust structures which are consolidated into the South African group, but bearing in mind the DTC Estate Duty report recommendations.
- It is, thus, recommended that the current South African definitions for control be retained, subject to any significant moves from other global players towards widening the definition based on the principle of consolidation, using IFRS 10 as the guideline.

4.4 DEFINITION OF CFC INCOME

4.4.1 BEPS ACTION REPORT ANALYSIS

There are various contrasting options for defining CFC income.[73] At one end, options can target complete or near worldwide/full inclusion. Various partial inclusion regimes can occur in the middle. For instance, the CFC regime could be limited to situations where the CFC has developed intangible property that the CFC exploits (e.g. through sales and services), dividends derived solely from related CFCs, and

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72 As recommended by OECD/G20 2015 Final Report on Action 3 in para 25.

73 Chapter 4 of OECD/G20 2015 Final Report on Action 3.

passive income.[74] A light touch approach, on the other hand, would solely target passive income, including business income not tied to substantive business operations.

The categorical analysis[75] (addressing specific categories of income, income earned from related parties and/or source of income), the full inclusion system (in terms of which all the CFC income is included) and the excess profits (which recognises and attributes profits in excess of a normal return) approaches are the approaches as explained by the OECD, that jurisdictions could use in defining which CFC income should be attributed, with none representing a consensus view.

Further, the BEPS Action 3 report provides a number of options for testing substance.[76] These options are as follows:

- One option would be a threshold test which looks at facts and circumstances to determine whether the employees can factually demonstrate a "substantial contribution" to the CFC income earning activity.
- A second option would look at all the significant functions performed by entities within the group to determine whether the CFC is the entity that would be most likely to own particular assets and / or undertake particular risks, if the entities were independent. Either all the income would be imputed if the CFC fell below the threshold test or only assets and risks that would not otherwise be owned by an independent foreign entity would result in imputation.
- A third option would look to determine if the CFC has sufficient business premises and nexus to the country of residence and whether enough skills are being employed to undertake the CFC's core functions. Again, the income could be attributed on and all or partial basis.
- A fourth option would be a variation on the third and would use the nexus approach (used in Action 5) to ensure that preferential IP regimes require substantial activity. Income would be attributed to the extent that it could not be shown that the CFC met the requirements of the nexus approach.

The excess profits approach is not a feature of any existing CFC rules.

4.4.2 SOUTH AFRICAN CONTEXT: FOREIGN BUSINESS ESTABLISHMENT THRESHOLD

The South African CFC regime broadly targets two sets of activities for deemed inclusion: (i) mobile income that mainly includes income of a passive nature (even if indirectly arising from or associated with a business operation); and (ii) diversionary income (income activities susceptible to transfer pricing). Mobile (passive) income includes dividends, interest and other financial instrument income, certain rental,

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[74] The so-called "form-based approach".
[75] OECD/G20 2015 Final Report on Action 3 in para 76.
[76] OECD/G20 2015 Final Report on Action 3 at 48.

insurance, as well as intellectual property income. In terms of the diversionary rules, South Africa seeks to target greater forms of active income (e.g. sales and services) but only when these activities lack any meaningful economic nexus to the local country of residency.

The starting point for determining whether CFC income is tainted (i.e. requires section 9D imputation) is the existence (or lack) of a foreign business establishment. The objective of the test is to determine whether real activity (and, thereby, value creation) is occurring in the CFC country. If not, section 9D imputation is required.

South Africa has chosen an option that is similar to the BEPS option of distinguishing between imputed and non-imputed income, although it does recognise aspects of the substance approach in defining this. While arguably less accurate, the mechanical business establishment test is far easier for SARS to audit and enforce (and for taxpayers to satisfy compliance) than the facts and circumstances nature of the looking at the substantial contribution and the independent entity analysis. Mechanical tests are more in sync with most current global CFC systems in existence (with the other methods apparently representing a shift in a new direction). At a mechanical level, the policy issue is whether the current CFC regime requires enough substance under the foreign business establishment test to meet the policy objective of having meaningful CFC local activity. At a technical level, the "business establishment" test generally requires the business: (i) to be conducted through a physical structure, (ii) to be suitably staffed with on-site managerial and operational employees, (iii) to be suitably equipped to conduct primary operations, (iv) to have suitable facilities, and (v) that the business be located outside South Africa for a purpose other than the avoidance of South African tax.[77] Although the numerical size of these tests can sound intimidating, more aggressive taxpayers may appear to satisfy the test with as little as one managerial employee, one operational employee, a small fixed office (which may even be shared) and a modest amount of office equipment.

- ➢ It is therefore recommended that a review of the substance requirement may be appropriate.

At a business establishment level, two common fact patterns appear to be of repeating concern. First is the use of CFCs to conduct marginal non-stand-alone activities; the second is the creation of mobile businesses that can easily shift from one country to the other.

- Non-viable stand-alone businesses: Certain CFCs are solely conducting "auxiliary and preparatory" activities that could never survive on their own.[78] All (or almost all) inputs and outputs involve domestic and foreign affiliates. These activities may be substantial in size with multiple employees and/or structures but

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77 See section 9D(1) definition of "foreign business establishment".

78 SAIT Submission to DTC (August 2015).

amount to nothing more than an internal set of centralised activities. Some of these may even involve purchases and sales so as to constitute an intermediate step in the production process. Suitable transfer pricing in these circumstances may also be difficult because no actual specific comparables of an independent nature may exist for proper comparison.

- Mobile businesses: Certain CFC's have a few core administrative and supervisory employees. Much of the value in many of these CFCs stems from outsourced employment contracts with these outsourced employees conducting the bulk of the work, with the CFC claiming the value-added profit in respect of this employee outsourcing.[79] Many of these businesses have little or no nexus to the CFC country of residence other than nominal office space with small local staffing.

According to the OECD, a true employee establishment approach requires the local CFC to directly conduct its core functions with limited outsourcing. Management and oversight by themselves should be insufficient. The current test, however, does not appear to exclude outsourcing, and an outright exclusion of outsourcing may not be indicative of something that is artificial in a modern economy. Outsourcing to connected persons would indeed seem suspect, but genuine businesses do indeed outsource activities for a variety of non-tax reasons (e.g. risk, employee versus contractor cost, and flexibility) and outsourcing may indeed increase legitimate profitability of performance.

- ➢ It is therefore recommended that a further inquiry of the tax base risks associated with outsourcing needs to be explored before some form of automatic tainting could be legislatively imposed.

In summary, many of the above businesses would exist for reasons other than tax even though these operations satisfy the mechanical business establishment threshold. Given the widespread nature of these activities within the South African CFC and other countries' CFC systems, any Government crackdown could be argued as anti-competitive unless a fair number of countries similarly follow suit.

However, it should be noted that the mere existence of a foreign business establishment is not sufficient to free a CFC of having tainted income. The income at issue must be (economically) "attributable to" that establishment. Therefore, proof that income is attributable to a business establishment becomes much more difficult for taxpayers to prove as a practical matter if the business establishment has little factual substance. Given that little guidance exists in this regard, it is hard to say whether the "attributable to" test can be said to be successful.

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79 SAIT Submission to DTC (August 2015).

4.4.3 ANTI-BASE STRIPPING (I.E. ANTI-DIVERSIONARY) RULES

The OECD takes note of "anti-base stripping"[80] rules requiring imputation when CFCs engage in goods and service transactions with connected persons (either as inputs or outputs). The purpose of these rules is to trigger imputation for transactions that typically give rise to base erosion - a drain from the tax base in terms of transfer pricing. The mechanical nature of the CFC is such that a complex fair market transfer pricing analysis can be avoided.

South Africa falls in line with this approach by targeting CFC connected person transactions with South African residents. These targeted transactions include imported goods, exported goods and imported services. All of these activities are tainted unless some meaningful factual nexus to the CFC country of residence exists (i.e. mere invoice companies to connected parties will fail even if the minimum foreign business establishment standard is satisfied). This nexus can come in a variety of forms pertaining to inputs (e.g. production) and outputs (e.g. clientele). The benefit of these mechanical tests is to avoid the complex factual inquiry of transfer pricing as stated above; the down-side is that the mechanical nexus may be under-inclusive or over-inclusive.

It should be noted that the diversionary rules only target connected relationships with South African residents and CFCs – not CFCs vis-à-vis other CFCs. This limitation exists because the South African CFC system is designed solely to protect the South African tax base – not the tax base of other countries. On the other hand, intermediary CFCs can be used to hide the South African company and CFC diversionary relationship. The question is how to attack these indirect diversionary relationships without becoming a global tax police system (a CFC approach that few countries adopt in theory or in practice).

4.4.4 PASSIVE INCOME-CATEGORICAL ASPECTS

The South African CFC regime targets passive income pursuant to the traditional "categorical approach" in which listed passive forms are viewed as tainted but for specific mechanical exceptions. More specifically:

- Dividends are largely viewed as tainted unless previously taxed or eligible for the participation exemption (under section 10B of the Income tax Act for shareholdings of at least 10 per cent (common to most European CFC systems).
- Income from other financial instruments (e.g. interest, insurance, certain rental, currency gains and losses) are tainted unless they are part of certain active banking, financial service provider and similar businesses. As an exception to the exception, financial instrument income from treasury operations and captive

80 OECD/G20 2015 Final Report on Action 3 in para 80.

insurers never fall within the relief for banks and financial service providers / similar businesses.

The above income may also fall outside tainted treatment if part of the 5 per cent working capital exemption (as discussed above).

The overall categories have generally raised little controversy but for isolated issues. The biggest issue seemingly relates to the denial of relief for treasury operations and captive insurers. The goal is to ensure that the active banking and financial service provider or similar business exception is utilised for business activities with outside independent parties. Treasury operations and captive insurers are essentially a larger form of savings vehicle for the benefit of a listed group. The principle is that if individuals and small businesses are not given exemption for placing their passive investments offshore, why should large corporates be effectively allowed to do the same?

The BEPS Action 3 report expresses a fair level of concern regarding intellectual property (a strong European concern). Under the South African CFC system, licensing income from intellectual property is tainted unless the CFC is regularly engaged in creating, developing or substantially upgrading intellectual property.[81] A similar system of tainting exists for capital gains arising from the disposal of intellectual property.[82] The BEPS Action 3 report raises concerns that the disposal of intellectual property is a problem in some jurisdictions because licensing income can easily be disguised as part disposals of intellectual property.[83] This concern presumably does not exist in the South African CFC system because both licensing and sales income are treated similarly. However, there may be an inadvertent escape hatch for the disposal of intellectual property qualifying as trading stock (where the CFC is not regularly engaged in the creation, development or substantial upgrading of intellectual property).

A side issue involving intellectual property may be the artificial labelling of certain portions of intellectual property income as ancillary services in order to avoid CFC imputation. This form of artificial labelling works best when the local countries involved treat services preferentially vis-à-vis royalties, but in some cases local royalties may be preferred.

- Given the flexible characterisation of these amounts as ancillary services or royalties, it is recommended that ancillary services should be classified as royalties under section 9D (or at least if the amounts are characterised as royalties for local country tax purposes).

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81 Section 9D(9A)(v).
82 Section 9D(9A)(vi).
83 OECD/G20 2015 Final Report on Action 3 at 45.

4.4.5 OECD EXCESS PROFIT ALTERNATIVE

The OECD Action Report raises an alternative option to the above tainting of categories used by South Africa and most other CFC regimes. Under this alternative, all CFCs with "excess profits" would trigger CFC imputation in terms of the proposed "excess". [84] This approach is a form of "risk engine" approach with "excess profits" being viewed as a statistical outlier that is suggestive of deviant economic activity or tax avoidance.

The problem with this approach is the determination of the "excess", which presumably requires an industry-by-industry comparative analysis. An analysis of this kind would require significant data, and essentially amounts to a different form of transfer pricing analysis (the type of analysis that CFC regimes are designed to avoid). At an economic level, the "excess" test seems to be targeting more successful businesses on the (probably false) assumption that tax avoidance is the cause. In effect, this approach could wrongfully target certain CFCs with "excess" profits that are simply operating in a more efficient way.

- ➢ As this approach is not currently used anywhere else in the world it is recommended that it not be considered at this stage.

4.4.6 THE SOUTH AFRICAN INTRA-GROUP CFC EXCEPTION

A seemingly unique aspect of the South African CFC regime is the intra-group relief mechanism of section 9D(9)(*f*A). Under this relief mechanism, interest, royalties, rentals, insurance premiums and income of a similar nature falls outside section 9D imputation despite their passive nature, if received or accrued from another CFC within the same group of companies. The price of this relief is the loss of any imputed deductions for the payer.

This mechanism essentially operates as a form of intra-group relief to nullify events between the same economic group, especially because both sides of the transactions will be attributed to the same taxpayers. This dual imputation should therefore create a neutralised tax result at the South African taxpayer level.

One issue could be the use of this s9D(9)(*f*A) exemption as a means to facilitate base stripping in respect of the tax systems of other countries. However, this theoretical point again falls outside the policy scope of the current South African CFC regime because the South African CFC regime is designed solely to protect the South African tax base – not to operate as a global tax police force. It should also be noted that this area is a sensitive one because intra-group payments will often simply shift funds between otherwise exempt amounts of CFC business establishments.

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84 OECD/G20 2015 Final Report on Action 3 at 49.

- It is thus, recommended, that more factual analysis is required in respect of the intra-group relief mechanism before any concrete action can be taken.

Transactional (categorical approach) versus entity analysis

A final note in terms of CFC imputation is the difference between a transactional approach and an entity (all-or-nothing) approach. South Africa applies a transactional approach. This approach is consistent with the categorical system of identifying tainted sources of CFC income. An entity (all-or-nothing) approach has the burden of being under-inclusive or over-inclusive.
Thus, the South African rules currently appropriately follow the recommended route, and it is considered that they are therefore adequate.

- It is therefore recommended that, other than to clarify or simplify the rules the South African rules need no amendment on this front.

4.5 COMPUTATION OF SECTION 9D IMPUTATION

South African CFC imputation is based solely on South African tax principles. While this hypothetical calculation in regards to CFC income adds another compliance calculation, this hypothetical calculation is the most consistent method from a policy standpoint.[85] The purpose of the South African CFC regime is to ensure that certain forms of foreign income are taxed at the same level as amounts wholly within the domestic South African income.

Given that section 9D is only a partial imputation system, one must arguably impute only CFC deductions or allowances associated with tainted CFC income. In other words, the rules of section 9D are designed to take into account tainted CFC activities regardless of whether the tainted CFC activities produce net income or net loss. Under section 9D, net tainted CFC losses can only offset income within the same CFC. While some argue that section 9D operates similar to a partnership model, the CFC regime creates only a limited partial inclusion system (meaning that deductions should similarly be limited). Direct excess foreign losses are somewhat limited under section 20 (which deals with assessed losses and the carry forward thereof) under the notion that the worldwide tax systems should always be an addition to the South African tax base (i.e. foreign net losses should not be subsidised by the South African tax system).

- In this regard, the South African rules comply with the recommendation in the OECD Action 3 report and do not, therefore require any amendment, in principle.

[85] SAIT submission (August 2015).

4.6 RULES FOR ATTRIBUTING INCOME

4.6.1 SOUTH AFRICAN TAXPAYERS SUBJECT TO IMPUTATION

According to the OECD, most CFC rules tie imputation to control or to a concentrated ownership in the CFC.[86] Best practice for imputation relies on either voting or *de* facto control, or economic influence over a CFC. The South African formulation of CFC income imputation is fairly standard. South African residents that own at least 10 per cent of the CFC's participation rights or voting rights will be subject to imputation (taking into account connected persons). This imputation includes indirect ownership through lower-tier CFCs.[87]

4.6.2 SOUTH AFRICAN ALLOCATION AND TIMING OF IMPUTATION

CFC rules attribute income in proportion to each taxpayer's participation rights, as defined. This allocation is generally straight-forward except where multiple classes of shares are involved (as discussed above) – an issue of little consequence for most offshore structures (except possibly for consortium groups such as private equity).

A more complicated issue is one of timing i.e. when the ownership of a CFC changes during the course of the year. South Africa (like many countries) typically looks at ownership of a CFC as of the close of the CFC's year.[88] While not ideal as a matter of purity, this year-end approach is a common method given its simplicity. Special allocation rules exist when a foreign company obtains or terminates CFC status during the tax year.[89]

Should control be determined on the consolidation basis (i.e. in terms of IFRS 10) the method for determining attribution will need to be made clear. The current legislation does not cater for this eventuality.

- It is recommended that reference be had to the DTC Estate Duty report for the treatment of offshore foreign trusts. Should separate specific rules, however, be required for offshore trusts falling within the CFC regime, it is recommended that the imputation be made to the company consolidating the income of the underlying companies in the 'group', in its annual financial statements.

4.6.3 NATURE OF IMPUTATION

Imputation has two general forms. Section 9D imputation of CFC income can be treated as deemed dividends or as foreign income directly earned by the allocable

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86 OECD/G20 2015 Final Report on Action 3 at 62.
87 Proviso to section 9D(2).
88 Section 9D(2)(a)(i).
89 Section 9D(2)(a)(ii).

owner. South Africa takes a direct income imputation approach. Under this approach, the net tainted income of the CFC is deemed to have been directly earned by the 10 per cent or greater participation rights holder in the CFC. The underlying income effectively retains its nature.

4.6.4 TAX RATE APPLICABLE TO CFC INCOME

Given the direct imputation system, applicable participation rights simply add CFC income to overall taxable income of the resident. No special rate calculation is required. The policy rationale for different rates, raised by the OECD report is not considered appropriate for South Africa as the administrative complexity of a different system of rates is hard to justify in terms of compliance.

4.7 CFC RULES ADDRESSING DOUBLE TAXATION

4.7.1 RELIEF FOR FOREIGN CORPORATE TAXES

South Africa has a foreign tax credit (rebate) system under section 6*quat* of the Income Tax Act, which that provides credits to prevent double taxation as suggested by the OECD.[90] This credit system allows a South African resident to directly reduce South African taxes otherwise owing in respect of foreign taxes, proved to be payable by the CFC in respect of imputed CFC income. Double tax relief is widely accepted international tax practice. The only issue of recurring controversy is the concept of "proved to be payable"[91] due to practices associated with foreign taxes imposed by certain African revenue authorities[92] (an issue outside the scope of this report).

A bigger issue for CFC systems is how to deal with dividends from CFCs in respect of amounts not previously subject to imputation. These dividends (not representing previously imputed income) also represent amounts subject to foreign taxes. Many countries provide offsets by way of indirect tax credits.[93] Nonetheless, this method of indirect credits is extremely complicated and was abandoned when the participation exemption was adopted as a more viable alternative.[94]

- It is therefore considered that the South African foreign tax credit regime adequately deals with this aspect and no further changes are recommended.

4.7.2 OFFSETS IN THE CASE OF CFCs SUBJECT TO MULTIPLE IMPUTATION CLAIMS

90 Article 23 of the OECD Model Tax Convention.
91 Section 6quat (1A).
92 Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011 page 100, para 4.3 II.
93 SAIT Submission (August 2015).
94 See below at 4.7.3(a)

In a world of growing CFC systems, it is possible that a single subsidiary can be subject to multiple country CFC imputation claims giving rise to possible multiple taxation of the same CFC income. For example, assume a USA company owns all of the shares South African company, and that South African company owns all the shares of offshore African subsidiaries. In this scenario, both the USA and South African CFC regimes would apply to the offshore African subsidiaries. This dual set of CFC regimes is extremely cumbersome, and is often a deterrent from using a country with a CFC regime as a regional gateway.

In theory, some form of offset will be required so that one CFC system provides a tax credit against the other. In the case of the scenario above, the country with the ultimate ownership should provide the credits against the lower-tier CFC system (i.e. the USA should provide credits against the South African taxes paid as a consequence of the South African CFC imputation in the above scenario). In the current global climate, precise rules dealing with this circumstance are either rare or non-existent. However, this issue will ultimately have to be addressed if more countries adopt CFC systems in line with the implicit mandate of the OECD.

South Africa has created the headquarter company regime (section 9I) which is exempt from CFC rules, deal with this circumstance. Under this approach, certain South African companies, controlled by foreign shareholders, can operate free of the CFC system. The goal is to eliminate the dual CFC regime problem where South African companies are used as a regional gateway by foreign multinationals.

4.7.3 RELIEF FOR SUBSEQUENT DIVIDENDS AND CAPITAL GAINS

Like many European countries, South Africa utilises a participation exemption in the case of dividends and capital gains.

a) Exempt dividends

Under the participation exemption system,[95] foreign dividends distributed by foreign companies are exempt from tax if a South African tax resident directly or indirectly owns at least 10 per cent of the equity shares and voting rights of the foreign company (which, in such instances, most often is a CFC). The purpose of this rule was to exempt these foreign dividends so that the South African tax system does not discourage the repatriation of funds back to South Africa. The 10 per cent threshold exists because only larger shareholders have an influence over the dividend decision. The participation exemption has the added advantage of eliminating the need for providing indirect tax credits for foreign taxes paid in respect of the underlying foreign profits – a system that is hard to track and highly complex.

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[95] Section 10B(2).

The only concern associated with the participation exemption is the opportunity for abuse via round-tripping schemes. In these schemes, South African taxpayers make deductible payments offshore with essentially the same funds routed back to South African in the form of tax-free dividends (via the participation exemption[96]). These schemes should be closed via the general anti-avoidance rule of Part IIA of the Income Tax Act and by substance-over-form principles of judicial case law, together with the prevailing Exchange Control prohibition against such practices. However, section 10B does have some objective rules that seek to prevent this practice as well. Section 10B(2) is limited to equity shares because round-tripping most easily occurs via foreign debt-like instruments such as preference shares.

In addition, the exemption does not apply if funded via South African deductible payments.[97] In terms of this latter anti-round tripping rule for deductible payments, there is some concern by revenue enforcement about the ability to track deductible payment proceeds in relation to foreign dividends (especially when a dividend may have only incidentally and partially been funded by *de minimis* ordinary deductible amounts).

b) Exempt capital gains

South African residents disposing of foreign equity shares are similarly exempt from capital gains tax if the South African holds 10 per cent or more of the equity shares and voting rights in the company before the disposal.[98] This exemption exists as a matter of theoretical parity. Capital gains arguably stem from accrued profits normally associated with future dividends. Therefore, if foreign dividends are exempt, it is argued that comparable capital gains should be exempt. This approach is fairly standard for other systems, especially European, with participation exemptions.

The impact of the participation exemption is part of a different debate. Most taxpayers view the participation exemption as an important planning device available to multinationals of most global systems. The problem has been the misuse of the exemption to facilitate indirect corporate migrations.[99]

5 CLOSING REMARKS/RECOMMENDATIONS

- The South African CFC regime is largely in line with CFC systems used by many developed countries in Europe, North America, East Asia and the Pacific. Like all CFC systems, the regime is trying to protect the tax base without unduly interfering with the global competitiveness of South Africa's global listed multinationals. This balance is a core reason for the regime's

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96 Section 10B(2).
97 Section 10B(4).
98 Paragraph 64B of the Eighth Schedule.
99 The participation exemption is dealt with in the DTC Report dealing with BEPS Action 4.

complexity. Although the regime can be theoretically tightened, competitive constraints have been a very limiting factor.

CFC rules are, thus, the subject of much international debate and the prospects of major change on the international front. Many European systems have softened their CFC systems since 2000. Countries such as the UK and Netherlands (major competitors in the region) have fairly light CFC regimes. Given South Africa's limited status on the global stage, South African cannot afford to be a leader in this field but must follow the practice set by others.

Consideration could be given to adopting a regime similar to that of the UK or Netherlands in order to improve South Africa's tax competitiveness in the long term. This step or approach should, however, be taken with caution, as simplification at this late stage of a long protracted period of development of CFC legislation may open holes in the regime that could compromise the fiscus.

- CFC rules are the subject of much international debate and the prospects of major change on the international front. South Africa should adopt the position of protecting its own interests. It should follow and not lead or set the trend.

- South Africa's CFC legislation is very sophisticated and comparable to other G20 countries; there is no need to strengthen this legislation at this stage.

- South Africa's CFC rules are very stringent, particularly in respect of anti-diversionary rules which create practical anomalies especially with respect to the limitation relating to foreign dividend participation. This make rules difficult to enforce practically.

- Care should be taken to ensure that the CFC rules are not made so onerous that they pose excessive compliance burden to South African based companies.

- Care should also be taken to ensure that the rules are not so rigid that they hinder legitimate business establishments. This is particularly so with regard to service income anti-diversionary rules for the foreign business exemption. The legislators should therefore consider refining the anti-diversionary rules as necessary.

- South African CFC rules are some of the most sophisticated and complicated within the G20. A trend that needs to be curtailed is the fact that over the last few years the legislators have resorted to explaining the working of complex legislation in Explanatory Memoranda that have no legal effect, but the law is not clear. Efforts should be made to ensure that the legislation itself is clear.

Consideration should be given to simplifying the legislation so as to reduce the cost of administration for business.

- South Africa should monitor the OECD recommendations and reform the CFC rules as necessary.

It should, however, be borne in mind that policy considerations other than tax (e.g. political stability, labour laws, immigration rules, access to electricity, investment security, etc.) need to be dealt with in order to improve South Africa as a country *to* which companies wish to migrate rather than *from* which they wish to migrate. Thus, the considerations set out above merely ensure that the legislation serves its purpose as an anti-avoidance measure and a deterrent for diverting income in line with the recommendations set out in the OECD Action 3 report and go no further than this.

Should South Africa seriously wish to embark upon a programme of attracting foreign direct investment as one of the means of fulfilling its goals, as set out under the National Development Plan, to create employment and improve the opportunities for the poor to be uplifted, these other policy matters need first to be addressed. The tax regime will then, in its current form, naturally provide increased taxes for other social spending. In line with this overall objective, though, and once the other policies have been attended to, a more competitive tax rate and CFC regime (similar to that in the UK or Netherlands) might well support such initiatives.

ANNEXURE 4

DAVIS TAX COMMITTEE: SECOND INTERIM REPORT ON BASE EROSION AND PROFIT SHIFTING (BEPS) IN SOUTH AFRICA

SUMMARY OF DTC REPORT ON ACTION 4: LIMIT BASE EROSION VIA INTEREST DEDUCTIONS AND OTHER FINANCIAL PAYMENTS

This report is based on the OECD's report on Action 11 that seeks to limit base erosion via interest deductions and other financial payments. Due to the mobility and fungibility of money, multinational groups are able to achievable tax results by adjusting the amount of debt in a group entity. Financing a company with debt, at a commercial interest rate, which is a deductible expense, is more effective in reducing source country tax than financing with equity where a distribution of dividends is not deductible. In the 2013 BEPS Draft Report the OECD notes that the deductibility of interest can give rise to double non-taxation in both inbound and outbound investment scenarios.

Limiting BEPS due to interest deductions is a high priority for South Africa due to the potential risk of loss to the fiscus due to such avoidance strategies by multinationals. South Africa employs various provisions to curb the avoidance of tax using interest and similar instruments, including transfer pricing and thin capitalisation provisions, and various recharacterisation and provisions that limit the deductibility of interest. Such provisions are also used in other jurisdictions. The OECD however, considers that these provisions are not adequate due to the developing financial structures currently used by multinationals.

The 2015 BEPS Report On Limiting BEPS Involving Interest And Other Financial Payments[1] lists the following three scenarios as the basic avenues that pose BEPS risks, namely:

- Groups placing higher levels of third party debt in high tax countries;
- Groups using intragroup loans to generate interest deductions in excess of the group's actual third party interest expense; and
- Groups using third party or intragroup financing to fund the generation of tax exempt income.

The Report recommends a best practice approach that involves the use of the fixed ration rule (which limits an entity's net interest deductions to a fixed percentage of its profit, measured using earnings before interest, taxes, depreciation and amortisation based on tax numbers). This rule is supplemented by the group ratio rule in terms of

1 OECD. (2015), *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project. (OECD/G20 2015 Final Report on Action 4).

which if an entity exceeds the benchmark fixed ratio, it will be allowed to deduct the net interest expense up to its group's net third party interest expense or the earnings before interest, taxes, depreciation and amortisation ratio, if the latter is higher. The Report recommends that where necessary, the special provisions could be introduced that restrict interest deductions on payments made under specific transactions or arrangements. Specific rules are suggested for the banking and insurance sectors as well as transitional measures.

Having considered the above, the DTC makes the following recommendations for South Africa:

Recommendations on the effectiveness of arm's length principle in preventing BEPS due to excessive interest deductions

The OECD recommended that the arm's length test should only apply to the pricing of the debt i.e. the interest rate. It may be preferable in the South African context to retain the approach of evaluating the extent of debt (i.e. thin capitalization) and the debt pricing (i.e. the interest rate) separately. In doing so, exchange control requirements should be borne in mind.

- The Draft Interpretation Note on Thin Capitalisation creates uncertainties with taxpayers due to the fact that it has remained a draft since its release in March 2013. This has created concern for foreign investors as reliance on a draft of this nature is problematic.

The DTC recommends that the Guidance from SARS should be changed to be in line with that of the OECD and international thinking as a matter of urgency, and be finalised to avoid uncertainty of its application. It is important that the use of thin capitalisation rules to prevent BEPS resulting from excessive interest deductions is in line with what is recommended by the OECD, as different rules between different countries could lead to double taxation. In finalising or redrafting this draft, the DTC recommends that SARS considers the following:

- Simplification of rules;
- Consistency with the OECD recommendations and international precedent on the Final Report;
- Transfer pricing rules for interest rate should take into account outcome of the GE and Chevron cases on relevance of parent credit ratings;
- Introducing ways of reducing the administrative burden for taxpayers with a low risk of BEPS through interest deductions. These could be one or all of the below:
    - Introduction of a safe harbour; and
    - Threshold based upon loan value or another measure whereby taxpayers falling below such a threshold would not have to comply with the rules.

- How to treat start-up operations where loan funding is required;
- Compliance cost for investors.

It is recommended that a “safe harbour” with a fixed ratio be introduced in section 31 or the Interpretation Note to provide non-residents that are funding local entities with guidance as to reasonable levels of debt versus equity.
It is further recommended that legislation and Interpretation Notes be released together, first in draft and then in final form.

Recommendations on exchange controls

It is recommended that the interest cap between SARB and SARS should be aligned. Interest rates allowable from a SARB perspective are potential indicators of risk from a South African transfer pricing perspective.

The DTC’s recommendation is further that a taxpayer should determine what interest rate would be acceptable from a Transfer Pricing perspective. If acceptable, then it should be allowed by SARB. Alternatively SARS should indicate what interest rates it would allow, and then those should be allowed from an exchange control perspective.

Recommendation on withholding tax on interest

Although the OECD rejected the use of withholding taxes on interest as not suitable for preventing BEPS relating to excessive interest deductions unless the rates are aligned with the corporate tax rate. Nevertheless, the withholding tax on interest became effective in South Africa with effect 1 March 2015. Although OECD countries reject withholding taxes, they are used by source countries to ensure allocation of taxing rights to the source jurisdiction. As such, despite the OECD’s rejection of withholding taxes as a measure of preventing BEPS, it is considered that the withholding tax serves an important role in the South African tax system, that being protecting the South African tax base by ensuring its ability to tax interest sourced in South Africa.

- To that end, from a treaty context, it is recommended that the treaties with zero or low interest withholding tax rates be renegotiated to afford South Africa a full taxing right to such interest. It is noted, however, that renegotiation of tax treaties is a time consuming process, and should perhaps be done in a holistic manner where the objective is to achieve more than just one objective.

Recommendation on interest deductibility

Recognising the complexities and uncertainties for potential investors as to what level of interest deductibility they would be entitled to in any particular year it is recommended that a proper analysis be made to determine whether reliance on deduction limitation rules is appropriate.

Recommendation on incurral and accrual of interest

Section 24J was originally introduced into the Income Tax Act principally to regulate the incurral and accrual of interest in respect of "instruments". The provisos to rules relates to the definition of "yield to maturity". However as explained in the detailed report below, the wording of the provisos is wider than their intended ambit as expressed in the Explanatory Memorandum. It is recommended that:

- The rules relating to incurral and accrual of interest in section 24J be reconsidered, without widening the definition of interest, to ensure that the rules do not adversely apply to transactions where there is no tax avoidance purpose.
- The appropriate mechanism to remedy this problem is to add a requirement that, for example, there must be a purpose of avoiding tax before the provisos apply, or to include some other explicit reference to the tax avoidance mischief identified in the Explanatory Memorandum.
- The definition of interest is apposite. There should not be any amendment to the definition of interest for the purpose of interest withholding tax that could broaden the definition further than the current definition that includes the definition in para (a) and (b) of the definition of interest in section 24J(1).
- It is also not recommended that a further withholding tax on derivative payments should be imposed. This would constitute an unusual withholding tax from an international perspective and could adversely impact on foreign direct investment.

Recommendations on hybrid interest and debt instruments

Both section 8F and section 8FA of the Income Tax Act re-characterise interest as dividends in both the paying and receiving entities in certain circumstances. These provisions are effective in preventing excessive interest deductions in respect of inbound transactions, but not outbound transactions. In respect of outbound transactions these provisions mean that a South African resident, instead of receiving taxable interest, receives a tax exempt dividend.

- The re-characterisation in respect of outbound debt instruments falling within the provisions of section 8F or section 8FA of the Income Tax Act should be changed to refer to "foreign dividends". Such foreign dividends would therefore only be exempt if they qualify for the more onerous exemption criteria set out in section 10B of the Income Tax Act.
- In addition in all circumstances these transactions should be subject to the provisions of section 8EA of the Income Tax Act. There has been much time spent on section 8EA of the Income Tax Act, but these rules can now be

circumvented by taking security over a hybrid debt instrument falling into the provisions of section 8F or section 8FA of the Income Tax Act.

These recommendations are intended to improve and enhance the South African tax system's ability to curb tax avoidance using interest and similar payments.

DTC REPORT ON ACTION 4: LIMIT BASE EROSION VIA INTEREST DEDUCTIONS AND OTHER FINANCIAL PAYMENTS

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1 INTRODUCTION

There are essentially two ways in which a company may be financed; debt (loan capital) or equity capital.[1] The tax treatment of a company and its financers differs fundamentally depending on whether it is financed by loan or equity capital.[2] In an international context, the difference between debt and equity may be a significant concern to the tax authorities[3] since multinational companies often manipulate group company financing to minimize their global tax exposure.[4]

If capital is loaned by a parent company to its subsidiary in another jurisdiction, the subsidiary company will have to pay interest to the parent company, which in most jurisdictions is regarded as an expense incurred in earning profits, and is deductible by the payer of the interest in computing its taxable income (unless there are special rules to the contrary).[5] However, withholding tax may be payable by the payer of the interest on behalf of the recipient. If there is an applicable double tax treaty, interest paid to the parent company is usually subject to a lower withholding tax.[6] If the parent company were to subscribe for shares in its subsidiary in another jurisdiction, dividends would be distributed by the subsidiary to the parent company. In most jurisdictions the dividends would not be deductible when calculating the subsidiary's taxable income since these are distributions of profits that have already been taxed.[7]

From the above it is clear that financing a company with debt, at a commercial interest rate, which is a deductible expense, is more effective in reducing source country tax than financing with equity where a distribution of dividends is not deductible.[8] Thin capitalisation often entails cases where a company is financed with

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1 AW Oguttu "Curbing Thin Capitalisation: A Comparative Overview With Specific Reference To South Africa's Approach - Challenges Posed By The Amended Section 31 of The Income Tax Act" (2013) Vol 67 Issue No 6 *Bulletin for International Taxation* at 312; RA Sommerhalder 'Approaches to Thin Capitalisation' *Bulletin for International Fiscal Documentation* (March 1996) at 446.

2 Sommerhanlder at 82.

3 B Lawrence 'Government Restrictions on International Corporate Finance (Thin Capitalization)' *Bulletin for international Fiscal documentation (March* 1990) at 118.

4 HM Revenue & Customs "INTM542005 - The Main Thin Capitalisation Legislation: Overview". Available at http://www.hmrc.gov.uk/manuals/intmanual/intm542005.htm accessed 18 September 2015.

5 K Huxham & P Haupt *Notes on South African Income Tax* (2013) at 80.

6 United Nations Ad Hoc Group of Experts on International Cooperation in Tax Matters at 18; Sommerhalder at 82.

7 Sommerhalder at 82.

8 BJ Arnold & MJ McIntyre *International Tax Primer* (2002) at 72-73; L Olivier & M Honiball *International Tax: A South African Perspective* (2011) at 649.

more debt than it could have borrowed based on its own balance sheet and, thus, financial strength, because it is borrowing either from, or with the support of, connected persons.[9]

The deductibility of interest can give rise to double non-taxation in both inbound and outbound investment scenarios. With inbound investment, the concern is mostly with loans from a related entity in a low-tax regime. This creates interest deductions for the borrower without a corresponding tax on the interest income for the lender. For outbound investment, a company may use debt to finance the production of exempt or deferred income, claiming a deduction for interest expense while deferring or exempting the related income.[10]

Domestic tax authorities often introduce rules that place a limit on the amount of interest that can be deducted in calculating the measure of a company's profit for tax purposes. From a policy perspective, failure to tackle excessive interest payments to associated enterprises gives multinational enterprises an advantage over purely domestic businesses that are unable to gain such tax advantages.[11]

The problem of excessive use of deductible payments is not limited to loans and debt. Other forms of financial transfers can give rise to similar base erosion processes: intra-group insurance and guarantees on commercial and credit default risk and internal derivatives used in intra-bank dealings. Excessive deductions can also involve royalties and management costs at headquarters level.

The 2013 OECD BEPS report[12] notes that:

> "The deductibility of interest expenses can give rise to double non-taxation in both the inbound and outbound investment scenarios. From an inbound perspective, the concern regarding interest expense deduction is primarily with lending from a related entity that benefits from a low-tax regime, to create excessive interest deductions for the issuer without a corresponding interest income inclusion by the holder. The result is that the interest payments are deducted against the taxable profits of the operating companies while the interest income is taxed favourably or not at all at the level of the recipient, and sometimes the group as a whole may have little or no external debt. From an outbound perspective, a company may use debt to finance the production of exempt or deferred income (e.g. participation exemptions), thereby claiming a current deduction for interest expense while deferring or exempting the related income. Rules regarding the deductibility of interest expense should therefore take into account that the related interest income may not be fully taxed or that the underlying debt may be used to inappropriately reduce the earnings base of the issuer or finance deferred or exempt income. Related concerns are raised by deductible payments for other financial transactions, such as financial and performance guarantees, derivatives, and captive and other insurance arrangements, particularly in the context of transfer pricing."

9 G Richardson, D Hanlon & L Nethercott "Thin Capitalization: An Anglo-American Comparison" *The International Tax Journal Spring* 1998 Vol 24 Iss 2 at 36.

10 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 16.

11 OECD "Thin Capitalisation Legislation: A Background Paper for Country Tax Administrators" August 2012 (draft) at 7.

12 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 16-17.

The OECD notes that BEPS using interest can arise from arrangements using third party debt (for example where one entity or country bears an excessive proportion of the group's net third party interest expense) as well as intragroup debt (for example where a group uses intragroup interest expense to shift taxable income from high to low tax countries). [13]

2 INTERNATIONAL TRENDS IN PREVENTING EXCESSIVE INTEREST DEDUCTIONS

A large number of intra-group debt techniques exist for which countries have considerable restrictions even before the BEPS Action Plan. Such include:[14]

2.1 THIN CAPITALISATION PROVISIONS

One approach to curbing the financing of subsidiary companies with higher levels of debt than equity capital is the use of the arm's length principle[15] (which is applied in curbing transfer pricing[16]) to determine whether the size of the loan would have been made in an arm's length transaction,[17] whether the rate of the interest is at an arm's length rate and whether a prima facie loan can be regarded as a loan or some other kind of payment.[18] Thus, if the loan exceeds what would have been lent in an arm's length situation, then the lender must be taken to have an interest in the profitability of the enterprise and so the loan, or interest rate that exceeds the arm's length amount, must be taken to be effectively designed to procure a share in the profits.[19] A high debt to equity ratio would thus be considered as one of the factors in determining whether the loan is non-arm's length and thus treating the interest as a distribution of dividends for tax purposes.[20]

13 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 19.

14 A Cinammon "How the BEPS Action Plan Could Affect Existing Group Structures" Tax Analyst 12 Nov 2013.

15 The arm's length principle as set out in article 9 (1) of the OECD MTC provides that when conditions are made or imposed between two associated enterprises in their commercial or financial relations which differ from those which would have been made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

16 Transfer pricing is a term that describes the process by which related entities set prices at which they transfer goods or services between each other. It entails the systematic manipulation of prices in order to reduce profits or increase profits artificially or cause losses and avoid taxes in a specific country. See Arnold & McIntyre at 53.

17 In an arm's length transaction, each party strives to get the utmost possible benefit from the transaction. See Article 9 of the OECD *Model Tax Convention on Income and on Capital* (2010 condensed version).

18 OECD Issues in International Taxation No.2 *Thin Capitalisation: Taxation of Entertainers, Artists and Sportsmen* (1987) in in para 48.

19 OECD Issues in International Taxation No.2 at 15 in para 25(i); see also OECD/G20 BEPS Project 'Limiting Base Erosion Involving Interest Deductions and Other Financial Payments' (2015 Final Report) para 12.

20 OECD Issues in International Taxation No.2 at 15 in para 25(i).

The OECD's views on thin capitalisation were first presented in its 1979 Report on "Transfer Pricing and Multinational Enterprises".[21] In 1987, the OECD issued a Report on Thin Capitalisation[22] which examined the ways in which various OECD countries dealt with thin capitalisation. In this Report the OECD noted that countries often make use of the arm's length approach or the fixed ratio approach or a combination of the two, in order to reduce the benefits attached to thin capitalisation practices.[23]

The United Kingdom for instance, relies on the arm's length approach to prevent thin capitalisation.[24] The United States' thin capitalisation rules are commonly referred to as "earnings stripping" rules.[25] These rules are designed to prevent United States corporations from deducting interest payments in respect of outstanding debts payable to related parties who are exempt from United States tax. The US also applies the arm's length principle in order to curb thin capitalisation. According to the United States' Treasury Regulations 1.482-2(a) loans between related parties must be at an arm's length interest rate.

Research conducted on the impact of thin capitalisation rules[26] that limit the tax deductibility of interest on the capital structure of the foreign affiliates, found that these rules affect multinational firm capital structure in a significant way. The research shows that restrictions on borrowing from the parent company reduce the affiliate's debt to assets ratios. This shows that rules targeting internal leverage have an indirect effect on the overall indebtedness of affiliate firms. The impact of capitalisation rules on affiliate leverage is higher if their application is automatic rather than discretionary.[27]

The OECD notes that one advantage of an arm's length approach is it recognises that entities may have different levels of interest expense depending on their circumstances. However, since each entity is considered separately after arrangements are entered into, the outcomes of applying the arm's length principle can be uncertain.[28] The OECD noted that some countries that applied this approach concerns about its effectiveness in preventing BEPS. This is particularly so in cases of groups structuring intragroup debt with equity-like features to justify interest payments that are in excess of those the group actually incurs on its third party debt.

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21 OECD "Transfer Pricing and Multinational Enterprises" (1979) paras 183-191.
22 OECD Issues in International Taxation No.2 in para 20.
23 OECD Issues in International Taxation No.2 para 25.
24 HJ Ault & BJ Arnold *Comparative Income Taxation: A Structural Analysis* 2nd edition (2003) at 413; AK Rowland "Thin Capitalization in the United Kingdom" (1995) *Bulletin for International Fiscal Documentation* at 554.
25 Ault & Arnold at 412.
26 J Blouin, H Huizinga & L Laeven, G Nicodème "Thin Capitalization Rules and Multinational Firm Capital Structure" (15 January 2014).
27 Ibid.
28 OECD/G20 2015 Final Report on Action 4 in para 12.

The OECD also notes that arm's length test does not prevent an entity from claiming a deduction for interest expense which is used to fund investments in non-taxable assets or exempt income.[29] The other concern is that internationally there are no clear guidelines for determining the parameters within which the arm's length principle is to apply in the context of thin capitalisation. Consequently, internationally countries tend not to only rely on the arm's length principle to curbing thin capitalisation but they often apply this principle alongside fixed debt/equity ratios which can be used as 'safe harbours' in setting the parameters within which this principle applies. Sometimes fixed debt/equity are applied exclusively since they are considered relatively easier for tax administrations to administer as countries can easily link the level of the interest expense to a measure of an entity's economic activity.[30]

2.2 FIXED RATIO RULES

In terms of fixed ratio rules, the interest relating to the debt above the fixed ratio is not taxed deductible. However the OECD cautions that the fixed ratios can be relatively inflexible if the same ratio is applied to entities in all sectors. The other concern is that in some countries the rates at which these ratios are set are too high to be an effective tool in addressing BEPS or too low such that they can lead to double taxation risks. A rule which limits the amount of debt in an entity still allows significant flexibility in terms of the rate of interest that an entity may pay on that debt. interest expense, which makes it relatively easy for a group to manipulate the outcome of a test by increasing the level of equity in a particular entity. Due to these disadvantages, the OECD concludes that although the fixed ratio approach can play a role within the overall tax policy to limit interest deductions, in general it is not a best a best practice approach to tackle BEPS.[31]

2.3 WITHHOLDING TAXES ON INTEREST

Some countries levy withholding taxes on interest as a means of preventing the erosion of their tax bases. A withholding tax is used as a mechanism to enable the collection of taxes from non-residents, by appointing a resident as the non-resident's agent and imposing an obligation on the resident agent to withhold a certain percentage of tax from payments made to the non-resident. If the resident agent does not comply with this duty or if he/she withholds an incorrect amount of tax, personal liability can be imposed on the resident agent.[32] Where there is a double tax treaty in place, withholding tax rates will be reduced to 10% for treaties based on article 11 of the OECD MTC. Any double taxation that arises is usually addressed in terms of article 23A of the OECD MTC by giving credit in the country where the

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[29] OECD/G20 2015 Final Report on Action 4 in para 12.

[30] OECD/G20 2015 Final Report on Action 4 in para 17.

[31] OECD/G20 2015 Final Report on Action 4 in para 17.

[32] L Olivier & M Honiball *International Tax: A South African Perspective* (2011) at 362-363.

interest payment is received. The OECD notes unless the withholding tax is applied at the same rate as corporate tax, opportunities for base erosion and profit shifting would remain. In fact, in some cases withholding taxes can drive BEPS behaviour, where groups enter into structured arrangements to avoid imposition of a tax or generate additional tax benefits (such as multiple entities claiming credit with respect to tax withheld). For the above reasons, the OECD advises that countries should apply withholding taxes alongside other best practices as discussed below.[33]

2.4 DEBT/EBITDA RATIOS

A debt/EBITDA ratio is a metric measure of a company's ability to pay off its short term incurred debt by giving an investor the approximate amount of time that would be needed to pay off all debt. The metric ratio is calculated as debt divided by earnings, before factors such as interest, taxes, depreciation and amortization are taken into account. A high debt/EBITDA ratio suggests that a company may not be able to service their debt in an appropriate manner and can result in a lowered credit rating. Conversely, a low ratio can suggest that the firm may want take on more debt if needed and it often warrants a relatively high credit rating.[34] Although debt/EBITDA ratios may be useful, the fact that they do not include the effects of the company's expenditures on its finances requires that they should be used with caution when evaluating a company, as not all of the company's risk is accounted for in the ratio.[35]

2.5 GROUP RATIO TESTS

Some countries apply group ratio tests which compare the level of debt in an entity by reference to the corporate groups' overall position. These group ratio tests typically operate by reference to debt/equity ratios. However in many cases the amount of equity in an entity may at best only be an indirect measure of its level of activity and can be subject to manipulation.[36]

2.6 TARGETED ANTI-AVOIDANCE RULES

Some countries apply targeted anti-avoidance rules which disallow interest expense on specific transactions. However, as new BEPS are exploited, further targeted rules may be required and so there is a tendency over time for more rules to be

33 OECD/G20 2015 Final Report on Action 4 in para 13.

34 Investopedia Available at http://www.investopedia.com/terms/d/debt_edbitda.asp#axzz2AxUfUVka accessed 31 October 2012; see also E Novinson 'Explanation of Debt to EBITDA Ratio' eHow.com http://www.ehow.com/info_7856136_explanation-debt-ebitda-ratio.html#ixzz2AxWymT1e accessed 31 October 2012.

35 The Free Dictionary 'Debt/EBITDA ratio'. Available at http://financial-dictionary.thefreedictionary.com/Debt%2FEBITDA+ratio accessed 31 October 2012.

36 OECD/G20 2015 Final Report on Action 4 at 19.

introduced, resulting in a complex system and increased administration and compliance costs.[37]

2.7 SPECIFIC COUNTRY EXAMPLES

An example of a specific provision applied in some countries to deny excessive interest deductions is the participation exemption provision. In other countries, interest deductions are denied to the extent that the paying company benefits from the receipt of tax-free dividends and gains. The following are examples of provisions applied in some countries:

2.7.1 UNITED KINGDOM

The UK uses the worldwide debt cap which treats inbound loans as dividends. It is not a straightforward comparison of each member's debt-equity ratio to the group's total debt-equity ratio.[38] The worldwide debt cap prevents British interest deductions from exceeding the group's worldwide interest expense. It applies to purely domestic groups with intra-group debt, which are allowed to exclude the income represented by disallowed interest. The tested amount is the total intra-group interest expense in the United Kingdom, excluding British external interest expense, and the cap is the worldwide group's net external interest expense. HM Revenue & Customs must determine the subject company's debt capacity - that is, how much it would be able to borrow, as an independent company, from an outside lender. Debt capacity is then compared to the subject's actual borrowing from related companies, or under a related party guarantee, to determine whether it is thinly capitalised. Outside loans are considered when the proceeds are on-lent around the group.[39] However the debt cap still focuses on the location of the borrower. The location of an interest deduction can be arbitrary. Even for a group without outside borrowing, the interest deduction is likely to be in the parent's home country or in a high-tax country with developed capital markets. Since money is fungible, and borrowing benefits the whole group, the allowable interest deductions should be allocated in the group in a rational manner.[40]

2.7.2 UNITED STATES

In terms of the branch profits tax under section 882(c) of the US Internal Revenue Code, Treasury regulation 1.882-5 allocates interest between foreign banks and their US branches based on the fair market value of its US assets relative to its worldwide assets for purposes of determining the branch's separate US interest deduction. The

37 OECD/G20 2015 Final Report on Action 4 at 20.
38 Ibid.
39 Ibid.
40 Ibid.

regulation treats money as fungible, and the branch as having a call on its parent's assets. This regulation is formulary apportionment in all but in name. [41]

2.7.3 GERMANY

Germany applies a limitation of interest deductions which is to 30 percent of EBITDA (section 8A of the *Abgabenordnung*). This percentage is becoming the standard for Europe. However, EBITDA ratios have their shortcomings, particularly in the fat capitalisation situation, in which a multinational with no debt uses internal interest deductions to strip income from operating affiliates. [42]

3 OECD BEPS REPORT RECOMMENDATIONS

On the domestic front the 2013 OECD BEPS Report[43] recommended that:

- Countries should come up with provisions that limit base erosion via interest deductions and other financial payments.
- Countries should 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 payments that are economically equivalent to interest payments.

On the international front the OECD recommended that addressing this concern would require considering how the OECD transfer pricing guidelines would work with regard to:

- the pricing of related party financial transactions,
- financial and performance guarantees,
- derivatives, and
- captives and other insurance arrangements.

The OECD's work in this regard was to be co-ordinated with the work on hybrids and CFC rules.

4 SUMMARY OF OECD DISCUSSION DRAFT ON ACTION 4: INTEREST DEDUCTIONS AND OTHER FINANCIAL PAYMENTS

On 18 December 2014 the OECD Issued a Discussion draft on Action 4 ("the Discussion Draft").[44] The Discussion Draft noted in the Introduction that "the use of

41 Ibid.

42 L Shepperd "What should the OECD do about Base Erosion?" Copenhagen precise of 2013 International Fiscal Association annual Congress" 9/9/2013.

43 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 17.

interest, in particular related party interest is perhaps one of the most simple of the profit-shifting techniques available in international tax planning.” The Discussion Draft listed the following concerns regarding BEPS using interest deductions:

- The interest deducted by a group in total may be higher than its actual third party interest expense;
- Parent companies are typically able to claim relief for their interest expense, while the return on equity holdings is taxed on a preferential basis, benefiting from a participation exemption, preferential tax rate or taxation only on distribution;
- Subsidiary entities may be heavily debt financed, bearing a disproportionate share of the group’s total third party interest cost and incurring interest deductions which are used to shelter local profits from tax;
- Taking the above combined, these potentially create competitive distortions between groups operating internationally and those operating in the domestic market. This in turn has a negative impact on capital ownership neutrality, creating a tax preference for assets to be held by overseas groups rather than domestic groups;
- Another form of BEPS could be the use of interest deductions to fund income which is exempt or deferred for tax purposes, and obtaining relief for interest deductions greater than the actual net interest expense of the group;

MNE’s have achieved this through various ways including:

- the use of intragroup loans to generate deductible interest expense in high tax jurisdictions and taxable interest income in low tax jurisdictions;
- development of hybrid instruments which give rise to deductible interest expense but no corresponding taxable income;
- the use of hybrid entities or dual resident entities to claim more than one tax deduction for the same interest expense; and
- the use of loans to invest in structured assets which give rise to a return that is not taxed as ordinary income.

The Discussion Draft noted that the use of a specific approach to restrict interest deductions in a single country could adversely impact the attractiveness of the country to international business and the ability of domestic groups to compete globally. It is therefore necessary for a consistent approach utilising international best practices, if concerns regarding BEPS on interest are to be addressed. A consistent approach should remove distortions, reduce the risk of unintended double taxation, remove opportunities for BEPS and, as a result, increase fairness and equality between groups.

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[44] Public discussion draft, BEPS Action 4: Interest Deductions and other financial payments, 18 December 2014 to 6 February 2015 – www.oecd.org/ctp/agressive/discussion-draft-action-4-interest-deductions.pdf

The Discussion Draft focused on options for designing statutory limitations on the deductibility of payments that truly represent interest, rather than how to set the prices for financial transactions. In general the OECD recommends that groups should be able to obtain tax relief for an amount equivalent to their actual third party interest cost.

The OECD considered the rules (discussed in paragraph 2 above) that are currently applied by countries to prevent base erosion through excessive interest deductions, and categorized these into 6 broad groups, with some countries (such as South Africa) applying more than one of these rules concurrently. These were:

- rules which limit the level of interest expense or debt in an entity with reference to a fixed ration including debt-equity ratios, interest to EBITDA ratios and interest to asset ratios;
- rules which compare the level of debt in an entity by reference to the corporate groups' overall position;
- targeted anti-avoidance rules which disallow the interest expense on specific transactions;
- arm's length tests which compare the level of interest or debt in an entity or person that would have existed had that entity being dealing entirely with third parties;
- withholding tax on interest payments, which are used to allocate taxing rights to a source jurisdiction; and
- rules which disallow a percentage of interest expense of an entity in respect of the nature of the payment or to who it is made.[45]

Of these methods, the OECD Discussion Draft rejected 3 methods as not being effective in in preventing BEPS. These are:

- arm's length tests,
- withholding taxes
- rules to disallow a percentage of interest, irrespective of the facts and circumstances.

In the Discussion Draft, many countries expressed the view that it is difficult to find the right solution to address BEPS with regards to interest payments. Countries felt that existing approaches may have had limited success in fully addressing BEPS issues involving interest deductions. There is a general view that international groups are still able to claim total interest deductions significantly in excess of the group's actual third party interest expense. It was agreed that in order for an approach to work, it will be necessary for countries to agree upon the definitions and scope of terms such as interest, groups, etc.

[45] OECD Discussion Draft on Action 4 at 12.

5 THE OECD'S 2015 FINAL REPORT ON ACTION 4

5.1 INTRODUCTION

On 5 October 2015 the OECD released an OECD/G20 Base Erosion and Profit Shifting Project: *Limiting Base Erosion Involving Interest and Other Financial Payments* – Action 4:2015 Final Report ("the Final Report"). The Final Report builds on the concerns and suggestions made in the Discussion Draft. At the outset the Final Report acknowledges that it is an empirical matter of fact that money is mobile and fungible. This factor allows multinational groups to achieve favourable tax results by adjusting the amount of debt in a group entity. "Financial instruments can also be used to make payments which are economically equivalent to interest but have a different legal form, therefore escaping restrictions on the deductibility of interest."[46] The report lists the following three scenarios as the basic avenues that pose Base Erosion and Profit Shifting (BEPS) risks, namely:

- Groups placing higher levels of third party debt in high tax countries;
- Groups using intragroup loans to generate interest deductions in excess of the group's actual third party interest expense; and
- Groups using third party or intragroup financing to fund the generation of tax exempt income.[47]

These are the risks against which Action 4 of the OECD BEPS Action Plan 2013 called for recommendations for best practice to curb BEPS using interest and payments economically equivalent to interest. The Final Report analyses several best practices and recommends an approach which directly addresses the risks outlined above. The recommended best practice includes the implementation of a fixed ratio rule and a group ratio rule which may be supplemented by targeted rules to prevent the circumvention of the former rules. The approach also allows the fixed ratio rule and the group ratio rule to be supplemented with other provisions, to reduce the impact of the rules on entities or situations which pose less BEPS risk, such as the *de minimis* rule, an exclusion for interest paid to third party lenders on loans used to fund public benefit projects and the carry forward/back of disallowed interest expense and unused interest capacity for use in future/prior years to cater for industries that incur interest before generating income.

5.2 FIXED RATIO RULE

According to the Final Report the best practice approach is based around a fixed ratio rule which limits an entity's net interest deductions to a fixed percentage of its profit, measured using earnings before interest, taxes, depreciation and amortisation (EBITDA) based on tax numbers. This is a straightforward rule to apply and ensures

46 OECD/G20 2015 Final Report on Action 4 at 11.
47 OECD/G20 2015 Final Report on Action 4 at 11.

that an entity's interest deductions are directly linked to its economic activity.[48] This approach is also favoured because it directly links the deductions to an entity's taxable income, which makes the rule reasonably robust against planning.[49]

The key advantage of a fixed ratio rule is that it is relatively simple for companies to apply and tax administrations to administer. The main disadvantage, on the other hand, is that it does not take into account the fact that groups operating in different sectors may require different amounts of leverage, and even within a sector groups may adopt different funding strategies for non-tax reasons.[50]

Although a fixed ratio rule provides a country with a level of protection against base erosion and profit shifting, it is said to be a blunt tool which does not take into account the fact that groups operating in different sectors may require different amounts of leverage, and even within a sector some groups are more highly leveraged for non-tax reasons. If a benchmark fixed ratio is set at a level appropriate to tackle BEPS, it could lead to double taxation for groups which are leveraged above this level.[51]

It is recommended that countries set their benchmark fixed ratio within the corridor of 10% to 30% or EBITDA. However, because of different legal frameworks and economic circumstances countries are encouraged to take into account a number of factors in setting benchmark fixed ratios, including the following:

- Applying a higher benchmark fixed ratio if it operates a fixed ratio rule in isolation, rather than operating it in combination with a group ratio rule;
- Applying a higher benchmark fixed ratio if it does not permit the carry forward of unused interest capacity or carry back of disallowed interest expense;
- Applying a higher benchmark fixed ratio if it applies other targeted rules that specifically address the base erosion and profit shifting risks to be dealt with under Action 4;
- Applying a higher benchmark fixed ratio if it has high interest rates compared with those of other countries;
- Applying a higher benchmark fixed ratio where, for constitutional or other legal reasons (e.g. EU law requirements), it has to apply the same treatment to different types of entities which are viewed as legally comparable, even if these entities pose different levels of risk; and
- Applying different fixed ratios depending upon the size of an entity's group.[52]

Due to the fact that the recommended benchmark ratios are set low, the Final Report recommends that countries adopt a group ratio rule to offer relief to companies in

48 OECD/G20 2015 Final Report on Action 4 at 25.
49 OECD/G20 2015 Final Report on Action 4 at 26.
50 OECD/G20 2015 Final Report on Action 4 at 47.
51 OECD/G20 2015 Final Report on Action 4 at 26.
52 OECD/G20 2015 Final Report on Action 4 at 50.

groups that are more highly leveraged for reasons other than tax. This rule allows an entity to deduct more interest expense in certain circumstances. A group ratio rule is introduced in addition to the fixed ratio rule and or as a separate provision from the fixed ratio rule.

5.3 GROUP RATIO RULE

In terms of this rule, if an entity exceeds the benchmark fixed ratio, it will be allowed to deduct the net interest expense up to its group's net third party interest expense or the EBITDA ratio, if the latter is higher. The net interest expense that exceeds both the benchmark fixed ratio and the ratio of the group should be disallowed. In calculating the group's ratio, a country may also apply an uplift of up to 10% to the group's net third party interest expense (i.e. its third party interest expense after deducting third party interest income).[53]

Determining the amount of net interest expense deductible under a group ratio rule involves a two stage test. The first step is to determine the group's net third party interest or EBITDA ratio. The second step is to apply the group's ratio to an entity's EBITDA.

The Final Report acknowledges two scenarios where the presence of loss making entities may require the limitation of the general approach. The first is where a group which has a positive EBITDA includes the results of a loss-making entity. In this case countries may apply a general principle that places an upper limit on the interest capacity of any entity applying the group ratio rule, equal to the net third party interest expense of the entire group.[54]

The second scenario concerns groups which have negative EBITDA at a consolidated level, but which include some profitable entities. In this situation, it is not possible to calculate a meaningful net third party interest/EBITDA for the group, as the ratio will be negative. In this case, under the best practice approach an entity with positive EBITDA which is part of a loss-making group could receive interest capacity equal to the lower of the entity's actual net interest expense and the net third party interest expense of the group.[55] An alternative approach to these solutions, according to the Final Report would be to exclude loss-making entities from the calculation of a group's EBITDA. This would remove the risk that any entity would receive an excessive amount of interest capacity.

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53 OECD/G20 2015 Final Report on Action 4 at 67-68.
54 OECD/G20 2015 Final Report on Action 4 at 65.
55 *Ibid*.

5.4 ENTITIES THAT THE BEST PRACTICE APPROACH APPLIES TO

For the purposes of considering which entities these rules should apply to, the Final Report has categorised entities into three types:

a) entities which are part of a multinational group;
b) entities which are part of a domestic group; and
c) standalone entities which are not part of a group.

The OECD recommends that, as a minimum, the best practice approach in this report should apply to all entities that are part of a multinational group. Countries may also apply the best practice approach more broadly to include entities in a domestic group and/or standalone entities which are not part of a group.[56] For the purposes of applying a group ratio rule, a group includes a parent company and all entities which are fully consolidated on a line-by-line basis in the parent's consolidated financial statements.[57]

5.5 THE INSTRUMENTS TO WHICH A BEST PRACTICE APPROACH APPLIES

A best practice rule to address base erosion and profit shifting using interest expense should therefore apply to:

a) interest on all forms of debt;
b) payments economically equivalent to interest; and
c) expenses incurred in connection with the raising of finance.[58]

These should include, but not be restricted to, the following:

- payments under profit participating loans;
- imputed interest on instruments such as convertible bonds and zero coupon bonds;
- amounts under alternative financing arrangements, such as Islamic finance;
- the finance cost element of finance lease payments;
- capitalised interest included in the balance sheet value of a related asset, or the amortisation of capitalised interest;
- amounts measured by reference to a funding return under transfer pricing rules, where applicable;
- notional interest amounts under derivative instruments or hedging arrangements related to an entity's borrowings;
- certain foreign exchange gains and losses on borrowings and instruments connected with the raising of finance;
- guarantee fees with respect to financing arrangements; and

56 OECD/G20 2015 Final Report on Action 4 at 33.
57 OECD/G20 2015 Final Report on Action 4 at 59.
58 OECD/G20 2015 Final Report on Action 4 at 29-30.

- arrangement fees and similar costs related to the borrowing of funds.[59]

The best practice approach does not apply to payments which are not interest, economically equivalent to interest or incurred in connection with the raising of finance, such as:

- foreign exchange gains and losses on monetary items which are not connected with the raising of finance;
- amounts under derivative instruments or hedging arrangements which are not related to borrowings, for example commodity derivatives;
- discounts on provisions not related to borrowings;
- operating lease payments;
- royalties; and
- accrued interest with respect to a defined benefit pension plan.[60]

5.6 VOLATILITY AND DOUBLE TAXATION

Where volatility in earnings, or mismatches in the timing of interest expense and EBITDA impacts an entity's ability to deduct interest expense, the group ratio rule may provide a solution by allowing the entity to deduct net interest expense up to the group's net third party interest/EBITDA ratio where this is higher. The Final Report recommends that, alternatively, these issues may be addressed to an extent by using average EBITDA over a number of years or by permitting an entity to carry disallowed interest expense and unused interest capacity for use against the fixed rule ratio or group rule ratio in earlier or later periods.

Permitting long term carry forward or carry back may be viewed as incentivising BEPS practices and the Final Report thus suggests that limits in terms of time or value may be worthy of consideration.[61]

5.7 TARGETED RULES

Targeted interest limitation rules include any provisions which apply to restrict interest deductions on payments made under specific transactions or arrangements. These may be contrasted with general interest limitation rules, such as the fixed ratio rule and group ratio rule, which impose an overall limit on an entity's interest deductions.[62]

The Final Report recommends that a fixed ratio rule (and group ratio rule where applied) should be supported by targeted rules to counteract planning undertaken by

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59 OECD/G20 2015 Final Report on Action 4 at 30.
60 OECD/G20 2015 Final Report on Action 4 at 30.
61 OECD/G20 2015 Final Report on Action 4 at 67-70.
62 OECD/G20 2015 Final Report on Action 4 at 71.

groups to reduce the impact of these rules. To achieve this, it is recommended that countries also introduce targeted rules to address the following risks:

- An entity with net interest expense enters into an arrangement to reduce the net interest expense subject to the fixed ratio rule (e.g. by converting interest expense into a different form of deductible expense, or by converting other taxable income into a form which is economically equivalent to interest);
- An entity which is part of a group enters into an arrangement with a related party or third party in order to increase the level of net third party interest expense under the group ratio rule (e.g. by making a payment to a related party or to a third party under a structured arrangement, or by converting interest income into a different form); and
- A group is restructured to place an unincorporated holding entity at the top of the structure, to create two groups. This may be to prevent a fixed ratio rule applying (e.g. in a country where the rule does not apply to standalone entities) or to separate the original group into two parts for group ratio rule purposes.

Although the fixed ratio rule and group ratio rule, described in this report, provide an effective solution to tackle BEPS involving interest and payments economically equivalent to interest, a country may restrict application of the fixed ratio rule and group ratio rule to entities in multinational groups. Therefore, targeted rules may be required to address BEPS risks posed by entities which are not subject to the general interest limitation rules. Even where the fixed ratio rule and group ratio rule apply, a number of specific base erosion and profit shifting risks remain. Therefore, it is recommended that countries consider introducing rules to address those risks.[63]

In addressing the risks the Final Report recommends that the definitions of 'related parties' are clear in order to address the risks set out. In addition 'structured arrangements' need to be dealt with e.g. those incorporating a third party e.g. 'back to back' arrangements, often using non- interest payments in one leg of the structure.[64]

5.8 PROVISIONS THAT REDUCE THE IMPACT OF THE RULES ON ENTITIES

The recommended approach also allows countries to supplement the fixed ratio rule and group ratio rule with other provisions that reduce the impact of the rules on entities or situations which pose less BEPS risk. These are:[65]

- A *de minimis* threshold which carves-out entities which have a low level of net interest expense. Where a group has more than one entity in a country, it is recommended that the threshold be applied to the total net interest expense of the local group.

63 OECD/G20 2015 Final Report on Action 4 at 72.
64 OECD/G20 2015 Final Report on Action 4 at 74.
65 OECD/G20 2015 Final Report on Action 4 at 12.

- An exclusion for interest paid to third party lenders on loans used to fund public-benefit projects, subject to conditions. In these circumstances, an entity may be highly leveraged but, due to the nature of the projects and the close link to the public sector, the BEPS risk is reduced.
- The carry forward of disallowed interest expense and/or unused interest capacity (where an entity's actual net interest deductions are below the maximum permitted) for use in future years. This will reduce the impact of earnings volatility on the ability of an entity to deduct interest expense. The carry forward of disallowed interest expense will also help entities which incur interest expenses on long-term investments that are expected to generate taxable income only in later years, and will allow entities with losses to claim interest deductions when they return to profit.

5.9 BANKING AND INSURANCE GROUPS

Due to the special features of the banking and insurance sectors, such as the role that interest plays in these sectors, the fact that they hold financial assets and liabilities as an integral part of their main business activities, and that they are subject to strict regulations in most countries, the Final Report considers that a different approach from the general approach should be taken when addressing BEPS using interest in these sectors.[66]

According to the Final Report, BEPS by banking and insurance groups could potentially take a number of forms. These include: regulated entities holding a regulatory capital buffer (including a debt component) above the level required to support existing business; routing regulatory capital and ordinary debt issued within a group through intermediate entities in low tax countries, placing excessive interest deductions in branches, which do not need to be separately capitalised for regulatory purposes, and in non-regulated entities; using deductible interest expense to fund assets which are tax exempt or taxed on a preferential basis; and the use of hybrid financial instruments and hybrid entities.[67]

Banks and insurance companies typically hold buffers of regulatory capital above the minimum level required which provides some opportunities for BEPS. The Final Reports states that the recommended fixed ratio rule and group ratio are unlikely to be effective in addressing these BEPS risks for a number of reasons, including and in particular that banking and insurance groups are important sources of debt funding for groups in other sectors and as such many are net lenders by a significant margin.[68]

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66 OECD/G20 2015 Final Report on Action 4 at 75.
67 OECD/G20 2015 Final Report on Action 4 at 75.
68 OECD/G20 2015 Final Report on Action 4 at 75-76.

The Final Report recommends that banks and insurance companies are not to be exempted from best practice, but a best practice approach that includes rules which are capable of addressing risks posed by different entities is to be developed. To that end, further work will be conducted, to be completed in 2016, to identify best practice rules to deal with the potential BEPS risks posed by banks and insurance companies, taking into account the particular features of these sectors. This will include work on regulated banking and insurance activities within non-financial groups (such as groups operating in the manufacturing or retail sector).[69]

5.10 IMPLEMENTATION AND TRANSITIONAL MEASURES

Countries are encouraged to give entities reasonable time to restructure existing financing arrangements before the rules come into effect. As a transitional measure, countries may decide whether to exclude pre-ruler existing loans from the best practice or not.[70]

The Final Report suggests that countries applying separate entity taxation systems, like South Africa, may apply the fixed ratio rule and group ration rule in the following three ways:

- The fixed ratio rule and group ratio rule may be applied separately to each entity based on its EBITDA;
- The country may treat entities within a tax group as a single entity for the purposes of applying the fixed ratio rule and group ratio rule; or
- The country may treat all entities in the country which are part of the same financial reporting group as a single entity for the purposes of applying the fixed ratio rule and group ratio rule.[71]

Countries may treat the entities within the consolidated tax group or which are part of the same financial reporting group as a single entity for purposes of applying the fixed ratio rule and group ratio rule.

5.11 INTERACTION WITH OTHER ACTIONS

Action 2 - hybrid mismatch rules: the application of the fixed ratio rule reduces, but does not eliminate, the BEPS risk posed by hybrid mismatch arrangements. The Final Report recommends that the rules to address hybrid mismatch arrangements should be applied by an entity before the fixed ratio rule and group ratio rule to determine an entity's total net interest expense. Once this total net interest expense figure has been determined, the fixed ratio rule and group ratio rule should be applied to establish whether the full amount may be deducted, or to what extent net interest expense should be disallowed. Further work should be done on the

69 OECD/G20 2015 Final Report on Action 4 at 76.
70 OECD/G20 2015 Final Report on Action 4 at 79.
71 OECD/G20 2015 Final Report on Action 4 at 80.

treatment of interest and payments economically equivalent to interest in a separate OECD work.[72]

<u>Action 3 – CFCs:</u> Countries may introduce the fixed ratio rule and the group ratio rule as well as the CFC rules. The Final Report demonstrates that the interaction of these two types of rules needs to be carefully crafted so as to ensure that neither the taxpayer, nor the relevant fiscus in the country where the interest is deducted and simultaneously imputed, are prejudiced or advantaged. The best practice approach should reduce the pressure on a country's CFC rules, by encouraging groups to spread net interest expense between group entities so that there is a greater link to taxable economic activity.

<u>Withholding taxes:</u> Where a country applies withholding tax to payments of interest, this should in no way be impacted by the application of the fixed ratio rule, group ratio rule or targeted rules described in this report. Withholding taxes would continue to apply.[73]

<u>Other interest limitation rules:</u> A country may also apply other general interest limitation rules, such as arm's length rules, rules to disallow a percentage of all interest expense and thin capitalisation rules. It is suggested that in most cases, these targeted and general interest limitation rules should be applied before the fixed ratio rule and group ratio rule.[74]

6 BASE EROSION VIA INTEREST DEDUCTIONS AND OTHER FINANCIAL PAYMENTS FROM SOUTH AFRICA

Cross-border interest and similar financial flows have a long track record, in South Africa, as a BEPS risk, and are, thus of great concern to the country. The Explanatory Memorandum to the Taxation Laws Amendment Bill 2013 noted that while debt capital is an important tool for investment, debt capital can also create opportunities for base erosion. A balance is required between attracting debt capital and the protection of the tax base against base erosion. In line with international concerns the South African tax base could potentially be at risk of allowing interest deductions in excess of what is actually incurred overall by a group. This is mitigated to a large extent through the following existing measures in place in South Africa:

- **Exchange control**: The interest rate payable on loan financing obtained from a non-resident is capped and subject to pre-approval by the South African Reserve Bank ("SARB"). The SARB places a cap on the interest rate payable on these loans.

72 OECD/G20 2015 Final Report on Action 4 at 81.
73 OECD/G20 2015 Final Report on Action 4 at 82.
74 *Ibid.*

- **Transfer pricing**: Section 31 and the SARS Draft Interpretation Note on Thin Capitalisation requires taxpayers to not only price the interest rate at arm's length, but also to determine whether it is thinly capitalised on an arm's length basis. Ratios applied through submission of the annual tax return are designed to alert the tax authorities to potential transfer pricing risk pertaining to interest.
- **Income tax**: Sections 8F, 8FA, 23N and 23M restrict interest deductions.
- **WHT on interest**: With effect 1 March 2015, a 15% WHT is imposed on South African sourced interest paid to non-resident persons, subject to DTA reductions.

All of the above measures should prevent excessive interest deductions provided taxpayers comply with these rules and measures. Provided these requirements are correctly applied, it is therefore unlikely that South Africa is significantly at risk of BEPS through excessive interest deductions. Of concern, is the capacity of the South African Revenue Service to audit adequately to ensure compliance with the requirements, and it is essential that such capacity be put in place and maintained.
However, the current legislative environment is complex and unclear. Having several differing sections all serving to limit interest deductions is cumbersome and needs to be addressed. The lack of clarity on the application is also a concern with no final guidance having been provided on the thin capitalization measures since the incorporation of these into the broader transfer pricing rules in 2012. Taxpayers need certainty and simplification to be compliant. From a broader regulatory point of view, it is also preferable that tax and exchange control rules applicable to inbound debts be aligned as far as possible.

The table below[75] considers each of the methods considered by the OECD that countries apply currently to prevent excessive interest deductions, their advantages and disadvantages. The ones applied in South Africa are pointed out in the table and a full discussion of how they apply follows immediately below.

OECD Rule	Advantages of rule	Disadvantages of rule	Effectiveness of the rule in Final Report	South Africa
1. **Fixed Rules to limit the level of interest expense or debt with reference to a fixed ratio.** Examples of fixed ratios include debt to equity, interest to EBITDA, interest to asset ratios	• Easy to apply • Links the level of interest expense to a measure of an entity's economic activity	• Same ratio is applied to all entities in all sectors • Becomes inflexible • Current rates applied by countries using this too high to prevent BEPS	To consider further in some respects	Sections 23M and N currently apply a fixed ratio interest deduction limitation under prescribed circumstances. In addition Debt : EBITDA over 3:1 is currently used as an indication of risk in relation to thin capitalization for

[75] Graph adopted and adapted from Technical Report submitted to the TDC by Deloitte (Billy Joubert and Team) to apply to current legislation and findings of the Final Report.

				transfer pricing purposes
2. **Rules which compare the level of debt in an entity by reference to the group's overall position** (often Debt : Equity ratios)	• Easy to apply • Provides reasonable certainty to groups in planning financing	• Equity not a good measure of level of activity • Equity levels can be subject to manipulation	To consider further in some respects	Not currently used~~.~~
3. Anti-avoidance rules which disallow interest expense on certain transactions	• Many countries have these in place and seems to be effective	• As new BEPS opportunities are exploited new targeted rules may be required • Could lead to complex rules • May be costly to administer and comply with	To consider further	South Africa has rules in place in respect of hybrids (sections 8F and FA) which reclassify income to dividends while the underlying transaction remains debt
4. **Arm's length tests** which compare the level of interest or debt in an entity with the position that would have existed had the entity been dealing entirely with third parties	• Good test as it provides an arm's length result • Recognises that entities may have different levels of interest expenses depending on the circumstances	• Time consuming • Burdensome • Expensive	Not considered to be best practice in tackling BEPS.	Section 31 and the Draft IN rely on the arm's length test
5. **WHT on Interest payments** used to allocate taxing rights to a source jurisdiction	• Mechanical tool • Easy to apply and administer	• Difficult for EU members to apply	Rejected as not suitable for preventing BEPS	Introduced with effect 1 March 2015
6. Rules which disallow a percentage of the interest expense of an entity, irrespective of the nature of the payment or who it is made to	• Easy to apply	• Not aimed at addressing BEPS	Rejected as not suitable for preventing BEPS	Section 23M disallows a percentage of interest expense paid to a recipient which is not subject to SA tax on the interest income. This disallowance is based upon a formula~~.~~ No fixed percentage disallowance in South Africa

From the above it is clear that South Africa is applying a form of the fixed rule method, whilst also applying two of the other three methods rejected by the OECD as not being effective in preventing BEPS with regards to interest payments (these are: arm's length tests and withholding taxes). The effectiveness of the methods applied in South Africa is discussed below.

6.1 THE TREATMENT OF INBOUND FINANCIAL ASSISTANCE - THIN CAPITALISATION: THE ARM'S LENGTH PRINCIPLE

One of the provisions that South Africa has applied over the years to prevent excessive deduction of interest is the use of thin capitalisation rules to prevent the funding of entities by disproportionate degree of debt to equity capital. Thin capitalisation rules were introduced in South Africa in 1995, based on a combination of an arm's length approach (in the then section 31(3) of the Income Tax Act – now repealed) and a shareholder 3:1 debt/equity safe harbour ratio that was used to determine excessive interest (based on the now scrapped SARS Practice Note 2). The previous section 31(3) gave the Commissioner the power to re-characterise debt as equity, with the result that interest incurred thereon was not deductible for income tax purposes.[76] Section 31(3) applied where a non-resident investor granted financial assistance whether directly or indirectly to a resident connected person in whom there was an interest.

The then thin capitalisation rules were however found to be narrow because they only applied to financial assistance granted by a foreign resident investor to certain residents and not to financial assistance by a foreign resident to another foreign resident, even if the latter had a South African permanent establishment. As a result, some taxpayers sought to exploit this loophole by having a foreign company utilise a wholly owned foreign subsidiary with most or all of its operations conducted in South Africa through a branch (permanent establishment). The foreign company would then capitalise the foreign subsidiary with excessive debt, thereby using the interest deductions associated with the excessive debt to offset income attributable to the South African permanent establishment.[77]

It was thus necessary to amend and broaden the rules so as to close this loophole. The legislators also reasoned that the previous thin capitalisation rules paralleled the transfer pricing rules and that they were not in line with international practice under the OECD and UN Model Tax Conventions which deal with thin capitalisation as part of the transfer pricing rules.[78] Consequently in terms of the Taxation Laws Amendment Act 24 of 2011, the thin capitalisation rules have now been merged with the transfer pricing rules (effective from years of assessment commencing on or after 1 April 2012).[79] Basically, the focus of the new provision is on cross-border transactions, operations, schemes, agreements or understandings that have been effected between, or undertaken for the benefit of, connected persons.

If the terms or conditions made or imposed by the connected persons differ from the terms and conditions that would have existed between independent persons acting

76 Olivier & Honiball at 651.
77 Explanatory Memorandum on the Taxation Laws Amendment Bill of 2010 in para 5.3 Part II(C).
78 Article 9 of the OECD Model Tax Convention.
79 Explanatory Memorandum on the Taxation Laws Amendment Bill of 2010 in para 5.3 Part II(C).

at arm's length, and the difference confers a South African tax benefit on one of the parties, the taxable income of the parties must be calculated as if the terms and conditions had been at arm's length. In terms of the current rules the arm's length principle is applied to deny deductions for interest that would not have existed had the South African entity not been able to procure the debt based on its balance sheet.

Section 31(1) defines financial assistance as including any loan, advance or debt or any security or guarantee. Thus, any borrowing (i.e. foreign financial assistance) from a foreign person to a foreign person with a South African business establishment is subject to the rules.[80] The practical effect of the provision is that the taxpayer must determine what amount it would have been able to borrow had the transaction been concluded in the open market. The taxpayer has to determine its lending capacity by taking into account terms and conditions which would have been applicable between independent parties.

Should the Commissioner be of the opinion that the financial transaction is not at arm's length, he is entitled make a primary adjustment to ensure an arm's length result. The legislation also provides for a secondary adjustment under section 31(3) on the basis that any "adjustment amount" (i.e. the difference between the tax payable calculated in accordance with the provisions of section 31(2) and otherwise) will be deemed to be a dividend paid by the South African taxpayer to the non-resident connected person on which dividends tax must be paid.

To provide some guidance as to how excessive interest will be determined, SARS published a Draft Interpretation Note on thin capitalisation which was open for public comment until the end of June 2013.[81] The Explanatory Note to the draft interpretation note states that the Draft Note provides taxpayers with guidance on the application of the arm's length basis in the context of determining whether a taxpayer is thinly capitalised under section 31 and, if so, calculating taxable income without claiming a deduction for the expenditure incurred on the excessive portion of finance. The guidance and examples provided are not an exhaustive discussion of every thin capitalisation issue that might arise. Each case will be decided on its own merits, taking into account its specific facts and circumstances. SARS explains that it is not enough for the taxpayer to demonstrate that it could have secured the loan at arm's length terms. The taxpayer must, in addition to proving that the loan or financial assistance was at arm's length, demonstrate a business need for the loan.[82]

In order to consider what is an appropriate amount of debt for thin capitalisation purposes and in applying the arm's length principle to funding arrangements, a

80 Explanatory Memorandum on the Taxation Laws Amendment Bill of 2010 in para 5.3 Part III (B).
81 SARS Draft Interpretation Note "Determination of the Taxable Income of Certain Persons from International Transactions: Thin Capitalisation" (2013) at 3.
82 SARS Draft Interpretation Note at 3.

taxpayer should consider the transaction from both the lender's perspective and the borrower's perspective. That is, from the lender's perspective, a taxpayer should consider whether the amount borrowed *could* have been borrowed at arm's length (that is, what a lender would have been prepared to lend and therefore what a borrower could have borrowed) and from the borrower's perspective, whether the amount *would* have been borrowed at arm's length (that is, what a borrower acting in the best interests of its business would have borrowed).

In analysing a funding transaction on this basis, SARS proposes that a taxpayer perform a functional analysis to support the appropriateness of its arm's length debt assessment. SARS has indicated that, in performing such a functional analysis of the transaction, the following types of factors and information could be relevant in support of a taxpayer's funding arrangements:

- The funding structure which has been or is in the process of being put in place, including, *inter alia*, the dates of transactions, the source of the funds, reasons for obtaining the funds, the purpose of the funding, the repayment and other terms and conditions;
- The business of the taxpayer, including details of the industry in which it operates;
- The financial and business strategies of the business;
- Details of the principal cash flows and the sources for repayment of the debt;
- The taxpayer's current and projected financial position for an appropriate period of time, including the assumptions underlying the projections and cash flows;
- Appropriate financial ratios (current and projected), for example:
  - debt: EBITDA ratio;
  - interest cover ratio;
  - debt: equity ratio; and
- Other indicators of the creditworthiness of the taxpayer, including, if available, any ratings by independent ratings agencies.

SARS has provided what it considers to be indicators of risk (paragraph 7 of the draft Interpretation Note), acknowledging that the risk indicator may not constitute an arm's length position for a particular taxpayer or industry. SARS may make use of a "risk based" audit approach as a risk identifier.[83] In this regard, debt/EBITDA ratios[84] would be applied as a potential risk identifier for a particular taxpayer or industry but not as indication of what constitutes an arm's length position.[85] SARS may consider transactions in which the debt/EBITDA ratio of the South African taxpayer exceeds 3:1 to be of greater risk. There is however no guarantee that a ratio which does not exceed 3:1 may not be considered as a risk by SARS. It can therefore be inferred that transactions below the 3:1 ratio may also be investigated if they are risky to

[83] SARS Draft Interpretation Note at 7.
[84] SARS Draft Interpretation Note at 2.
[85] Idem at 11.

SARS. Unfortunately, by the time of writing of this Report the Draft Interpretation Note had not yet been finalised. Thus, taxpayers are left with little formal guidance, other than the OECD guidelines.

Recommendation on the effectiveness of arm's length principle in preventing BEPS due to excessive interest deductions

It is worth noting, as explained above, that the OECD indicated in its Discussion Draft and in the Final Report that the use of the arm's length test, although a very good test, is not to be considered further as the best method for preventing BEPS in the context of Action 4 and the quantum of debt, due to the fact that it can be time consuming, burdensome and very expensive for taxpayers to comply with. The approach recommended by the OECD is that the arm's length test should only apply to the pricing of the debt i.e. the interest rate. This makes sense as the pricing is directly reflective of the quantum of the debt and associated risk, therefore applying a two-tier test to both the quantum and the price is counter intuitive and to some degree pointless. Higher levels of debt will inevitably attract higher risk and higher rates.

Thus, it may well be considered preferable in the South African context to retain the approach of evaluating the extent of debt (i.e. thin capitalization) and the debt pricing (i.e. the interest rate) separately. It is suggested that, in considering which approach to follow, exchange control requirements be borne in mind. This could mean that the current guidance (draft) available to South African taxpayers in determining its thin capitalization position may change completely if the OECD recommendations are to be followed. The DTC recommends that the Guidance from SARS should be changed to be in line with that of the OECD and international thinking as a matter of urgency.

- The Draft Interpretation Note on Thin Capitalisation creates uncertainties with taxpayers due to the fact that it has remained a draft since its release in March 2013. This has created concern for foreign investors as reliance on a draft of this nature is problematic.
- It is important that the use of thin capitalisation rules to prevent BEPS resulting from excessive interest deductions is in line with what is recommended by the OECD, as different rules between different countries could lead to double taxation.

Other recommendations on the thin capitalisation rules

There is uncertainty as to how excessive interest is going to be determined. No definitive guidance has been provided by SARS in this regard. This uncertainty is detrimental to inbound investment. Investors are often less concerned about the actual rules than about having certainty about what they have to comply with. The

Draft Interpretation Note needs to be finalised, urgently, so that South African taxpayers have certainty on thin capitalisation rules.

In finalising or redrafting this draft, the DTC recommends that SARS considers the following:

- Simplification of rules;
- Consistency with the OECD recommendations and international precedent on the Final Report;
- Transfer pricing rules for interest rate should take into account outcome of the GE and Chevron cases on relevance of parent credit ratings;
- Introducing ways of reducing the administrative burden for taxpayers with a low risk of BEPS through interest deductions. These could be one or all of the below:
    - Introduction of a safe harbour (e.g. Debt to Equity of 2:1); and
    - Threshold based upon loan value or another measure whereby taxpayers falling below such a threshold would not have to comply with the rules (see recommendations on Actions 8-10 and 13);
- How to treat start-up operations where loan funding is required;
- Investors often feel that, due to the potential risk associated with a transfer pricing adjustments in respect of interest, they have no choice but to undertake costly debt pricing exercises – notwithstanding certain ratios being indicated in the Draft Interpretation Note as indicating lower risk to SARS (e.g. a Debt:EBITDA ratio not exceeding 3:1).

It is recommended that a “safe harbour” with a fixed ratio be introduced in section 31 or the Interpretation Note to provide non-residents that are funding local entities with guidance as to reasonable levels of debt versus equity. Investors need clarity as to how they can structure their investment without running the risk of any costly and time intensive enquiries from the revenue authorities. It should be kept in mind that ascertaining what qualifies as an arms-length debt:equity ratio is extremely difficult as the appropriate comparative information is very costly to source or justify given the uniqueness of each group’s circumstances.

It is further recommended that legislation and Interpretation Notes be released together, first in draft and then in final form. This is in order to avoid the current situation that prevails around the thin capitalisation rules. In addition, transfer pricing rules should be amended to apply to cell captive insurers as was done for CFCs. Payments by a South African company to an offshore cell captive need to be addressed as this is not caught by current transfer pricing legislation because the cell captives are not connected persons in terms of the definition of connected person in section 1 of the Income Tax Act.

6.2 EXCHANGE CONTROLS

Although not governed through the Income Tax Act, it is relevant to note the importance of exchange control in relation to interest. Approvals have to be obtained for the acceptance of foreign loans prior to the receipt of the loan funds. This approval process includes not only the approval of the loan funds, but also the allowable interest rate that is capped depending on the relationship with the lender and the currency of the loan funding.

Exchange control is a very effective mechanism with which to prevent BEPS with regards to the interest rate payable, as such payment is subject to pre-approval. It will be even more effective if there is consistency between the rates allowable from a SARB and transfer pricing perspective. As a recommendation: if an interest rate is allowable from a SARS transfer pricing perspective, it should also be allowed by SARB. The SARB and SARS acceptance or otherwise, of the interest charged on a loan should be aligned.

It is also important to note that an excessive interest deduction is also limited to an extent as a result of an interest rate that is too high due to the caps in place from an exchange control perspective. However, the cap on interest rates from an exchange control perspective is in some instances higher than those viewed by SARS in the Draft Interpretation Note on Thin Capitalisation as an indication of risk from a transfer pricing perspective. This creates uncertainty for taxpayers. Exchange control can be very effective if the cap on interest rates is in line with what would be allowable from a SARS transfer pricing perspective. If this can be achieved, the risk of BEPS through excessive interest deductions (as a result of an interest rate that is too high) should be relatively limited from a South African perspective.

Recommendations

It is recommended that the interest cap between SARB and SARS should be aligned. Interest rates allowable from a SARB perspective are potential indicators of risk from a South African transfer pricing perspective. Currently the interest rate is firstly approved from a SARB perspective, but that may not be acceptable from a SARS transfer pricing perspective.

The DTC's recommendation is further that a taxpayer should determine what interest rate would be acceptable from a Transfer Pricing perspective. If acceptable, then it should be allowed by SARB. Alternatively SARS should indicate what interest rates it would allow, and then those should be allowed from an exchange control perspective.

The table below[86] illustrates the current discrepancies:

Loan obtained from	SARB	SARS Draft IN on Thin Cap (indicative interest rates only)	Comment
Shareholder loan, foreign currency denominated	Prime or base rate of the country of denomination	Weighted average of the base rate of the country of denomination plus 2%	Current interest rate cap from SARB should prevent non-arm's length interest rates
Non-shareholder loan, foreign currency denominated	Prime or base rate of the country of denomination + 2%	Same as above	Same as above
Shareholder loan, ZAR denominated	SA prime	JIBAR plus 2%	SARS considers interest exceeding JIBAR plus 2% to be of higher risk. JIBAR plus 2% is higher than SA prime. A taxpayer could therefore have an interest rate approved by SARB that is not viewed as arm's length from a TP perspective. This is not helpful.
Non-shareholder loan, ZAR denominated	SA prime + 3%	JIBAR plus 2%	Same as above, except that the gap between what SARB allows and SARS views as high risk is greater

6.3 DEBT PUSHDOWN TRANSACTIONS AND PROVISIONS TO PREVENT SUCH TRANSACTIONS

The so-called "debt pushdown" transactions have been a common feature of merger and acquisition transactions in South Africa. There are several variations of these transactions. The common feature is that they result in an interest deduction and often the receipt of a tax-exempt dividend.

6.3.1 ACTIONS TAKEN BY NATIONAL TREASURY TO ADDRESS DEBT-PUSH DOWN STRUCTURES

(a) Media Statements

A Media Statement was issued on 20 February 2009 which dealt with "Funnel Finance Schemes". This Media Statement was issued as a supplement to the Media Statement issued on 20 March 2008 titled "Avoidance Closure Alert: Funnel Financing Masquerades". The Media Statement, issued in 2009, included two methods of funnel finance schemes: transactions involving "split incorporation-effective management" and transactions involving "hybrid tax entities".

86 Graph adopted from Technical Report submitted to the DTC by Deloitte (Billy Joubert and Team).

However, many transactions did not fall into either of the described methods. Often the transactions involve entities which are not incorporated in South Africa and their place of effective management may be located in a foreign tax haven treaty country.

The 2009 Media Statement provided that the SARB would identify all South African incorporated entities which have their tax residence located outside of South Africa and share the information regarding these entities with the SARS. This applied in circumstances where exchange control applications were required to be submitted to the SARB in respect of such entities. However, many transactions did not require any such applications to be submitted. Mere notification was sufficient for exchange control purposes.

Generally the remedies proposed in the Media Statement were inappropriate. To deal with the above matter, one proposal related to the re-negotiation of South Africa's double tax treaties that are based on "effective management". However, the concept of "effective management" is fundamental to South African tax law. This re-negotiation process would therefore require fundamental changes to the South African tax system.

(b) Legislative provisions dealing with debt-push down structures

It is noted at the outset, that while some of these provisions may be of application only to local entities and local transactions, they form part of an investor's considerations in due diligence for investment in South Africa.

(i) Section 45 of the Income Tax Act

Excessive debt transactions using debt pushdown structures can be dealt with under section 45 of the Income Tax Act, which deals with "intra-group transactions". Section 45(3A) of the Income Tax Act states that various funders of transferee companies will be deemed to have a base cost of nil in preference shares and loans advanced to such transferee companies. This would thus result in a capital gain tax imposition on the full value of the shares upon disposal thereof.

(ii) Section 23N – limitations of deductibility of interest

For years of assessment ending 1 April 2014, section 23K of the Income Tax Act requires that a ruling be obtained in respect of the deductibility of interest in respect of debt arising from a re-organisation transaction. From 1 April 2014, section 23N was introduced in the Income Tax Act to replace section 23K's discretionary ruling system with a codified formula which provides for a maximum deduction in the context of re-organisation transactions.

Section 23N limits the deduction of an interest expense incurred by a company on a loan or debt raised to acquire assets or shares in reorganisations and acquisition transactions. It imposes a limitation on the deductibility of interest in the case of leveraged asset acquisitions in respect of reorganisations and acquisition transactions in particular, those undertaken relying upon any of an intra-group transaction or liquidation distribution contemplated in sections 45 and 47 of the Income Tax Act respectively, as well as acquisition transactions governed in terms of section 24O of the Income Tax Act.

(iii) Section 23M of the Income Tax Act - limitations of deductibility of interest

Section 23M came into effect on 1 January 2015. It imposes a limitation on the deductibility of interest on debt owed to persons (borrower) in a controlling relationship. Essentially the section applies to interest paid to certain entities that are not subject to tax in South Africa connected to the debtor and in this regard it has been criticised for potentially being discriminatory. The rationale for introducing the legislation was because the legislators had noted that excessive interest deductions pose a recurring risk if the creditor and debtor form part of the same economic unit. The terms of the funding instrument are often irrelevant because both parties can freely change the terms to serve the overall interest of the group. As a result, the debt label for these instruments is often driven by tax and other regulatory factors; whereas, loan capital frequently represents equity capital to be repaid only once the debtor is profitable.

Of particular concern to the legislators was the fact that the methods to limit excessive interest owed to exempt persons were largely incomplete. Interest is generally deductible if arising from trade, incurred in the production of income and not of a capital nature. This deduction applies even if the creditor is wholly exempt in respect of the interest received or accrued. Notable parties eligible to receive exempt interest are pensions and foreign persons. In the case of a foreign person, interest from South African sources is generally exempt unless that foreign person has a South African permanent establishment. This exemption is roughly matched within the South African tax treaty network, which often exempts foreign residents from taxation in respect of South African sourced interest unless that interest is attributable to a South African permanent establishment. The purpose of this cross-border exemption is to attract foreign debt capital to the domestic market. Deductible interest paid to foreign (and other exempt) persons represents a risk to the fiscus because of the deduction/exemption mismatch. This mismatch leads certain parties to over-leverage because of the overall tax benefits.

Consequently, provisions were enacted to ensure that the aggregate deductions for interest that is not subject to tax in the hands of the person to whom the interest accrues be subject to a limitation if a “controlling relationship” exists between the debtor and the creditor. However, this limitation does not apply if the interest is included in the net income of a controlled foreign company ("CFC") as contemplated in section 9D in the foreign tax year commencing or ending in the year of assessment in which the interest deduction is claimed by the debtor.

Section 23M which was introduced into the Income Tax Act by the Taxation Laws Amendment Act 2013, effective from 01 January 2015 limits interest expenditure incurred on or after that date. Section 23M limits interest deductions incurred by a borrower:

- where the recipient of the interest is not subject to tax in South Africa on the interest accrual; and
- if the creditor holds a specified percentage of the share capital of the borrower.

The interest limitation rule will apply if either the debtor or creditor is in a controlling relationship. This would frequently apply to international groups which have invested in South Africa. For purposes of section 23M, a controlling relationship exists if the creditor and the debtor are connected persons, as contemplated in section 1, in relation to each other.

This interest limitation rule also applies to debt owed to persons who are not in a controlling relationship if:

➢ that person obtained the funding of the debt from a person with a controlling relationship in relation to the debtor; or
➢ the debt is guaranteed by a person with a controlling relationship with the debtor.

The deductible interest limitation is based on a formula calculation, in terms of which the aggregate deductions for interest paid or incurred (not being subject to tax in South Africa in the hands of the beneficial owner) in respect of debt owed to persons in a controlling relationship with the debtor will be limited to:

a) the total interest received or accrued to the debtor; and
b) 40% of adjusted taxable income.

With effect from 1 January 2017, section 23M would not apply to so much of interest incurred by a debtor in respect of a debt owed to a creditor if the creditor funded the debt amount with funding granted by a lending institution that is not in a controlling relationship with the debtor and the interest rate charged does not exceed the official rate of interest plus 1%.[87]

[87] Paragraph 1 of the Seventh Schedule to the Income Tax Act defines "official rate of interest" as (*a*) in the case of a debt which is denominated in the currency of the Republic, a rate of interest equal to the South African repurchase rate plus 100 basis points; or (*b*) in the case of a debt which is denominated in any other currency, a rate of interest that is the equivalent of the South African repurchase rate applicable in that currency plus 100 basis points.

Recommendations on the effectiveness of sections 23N and 23M in preventing BEPS relating to excessive interest deductions:

It should be noted, as explained above, that the OECD Discussion Draft rejected, as not suitable for preventing BEPS, rules which disallow a percentage of the interest expense of an entity, irrespective of the nature of the payment or who the payment is made to. Section 23M disallows an amount of interest determined in terms of a formula paid to a person that is not subject to tax in South Africa. Section 23M does not take account of whether or not the foreign creditor is subject to tax in their home jurisdiction on the interest they receive, but merely whether or not they are subject to South African tax. The limitation of interests deductions in this context may well be misplaced given that there may well not be any tax avoidance related to the funding advances, unless the creditor is, for example exempt from tax in their home country or subject to a lower tax rate. In light of the OECD recommendations, the legislators should re-consider the relevance of section 23M in preventing BEPS relating to excessive interest deductions.

Other concerns about section 23M

Section 23M, which sets out rules to limit interest deductions in relation to acquisition transactions and untaxed connected party debt, also creates uncertainties, especially with regard to the 40% of adjusted taxable income. The section may potentially impact on commercially driven arrangements, resulting in uncertainties, especially for start-ups and cyclical businesses (e.g. mining), and may lead to double taxation.

It is recommended that in order to bring about clarity on the details and application of section 23M of the Income Tax Act and the interaction between section 23M and section 31 of the Income Tax Act, the SARS should clarify the application of, or publish an interpretation note on, section 23M of the Income Tax Act. Furthermore, the limitation on interest deductions needs to be extended to incorporate other finance charges and payments e.g. finance lease payments and derivative payments.

It is also not entirely clear whether this provision will apply to payments of interest to foreign persons – since such persons will, subject to possible DTA relief, become subject to withholding tax on interest which came into effect from 1 January 2015. It is undesirable to have the same amount of income subjected to multiple levels of taxation.

Comments on the calculation applied to limit the interest deductibility

In the calculation set out in sections 23M(3) and 23N(4), the limitation calculation applied to limit the interest deductibility in both is similar. The upper threshold of the interest which may be deducted is calculated with reference to the repo rate at that point in time. The percentage figure generated in terms of this calculation is then multiplied by the amount of "adjusted taxable income" for that entity.

Because the calculation of a company's "adjusted taxable income" begins with its taxable income as the key determinant of the amount of interest which is deductible, the definition of adjusted taxable income prejudices certain entities. In this regard, a number of papers providing commentary to the OECD analysis warn that, in general, the use of a percentage ratio can be arbitrary and discourage economic activity.[88] This is a general concern but we believe that this criticism is enhanced in the current legislation due to the reliance on taxable income as the key factor for calculation the limitation amount.

The result of this formulation is that borrowers who pay more tax generally will be less impacted by the limitation on the amount of interest which they can deduct in the relevant scenarios when compared with similar borrowers with lower taxable income. The rationale for linking the limitation to the tax paid appears cogent at first glance: entities paying more tax are less likely to be eroding profits or shifting their tax base. On greater scrutiny though, and as can be seen from the OECD analysis, there are a range of alternative factors that can be taken into account: these include the group's gearing, the asset base of the borrower, the finances of the borrower, etc. These factors, while potentially arbitrary in their own rights, are more rational in our view than preventing taxpayers that do not pay a lot of tax from deducting interest expenditure without interrogating the reasons behind the amount of tax paid by the entity.

There is significant commentary in the OECD analysis to the effect that the use of a fixed ratio does not take account of different industry needs and can deter investment. For example, on page 3 of Part 1 of the commentary, included in the comments submitted by the 100 Group Taxation Committee. The submission notes "… capital intensive industries will be disproportionally impacted by the proposed recommendations compared to other industries". We believe this is correct. South Africa is in a slow-to-no growth phase and is seeking to attract foreign investment; encourage development and projects aimed at improving the country's infrastructure and stimulate job creation. Including overly-complex tax rules which negatively impact on how projects in capital intensive sectors are funded is counterproductive and discouraging of these sorts of initiatives. Further, limiting capital-intensive industries by regulating their funding is of concern.

Moreover, many start-up businesses pay very little tax, and require significant funding before profitability is attained. It is exactly these types of entities that are

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88 See for example the comments on page 649 of paper 2 of the comments submitted by the Irish Tax Institute.

going to be prejudiced by making tax paid the key reference point of the calculation. Where a group seeks to achieve tax efficiency through its debt model, the current rules will only lead to more complex tax planning being implemented. Funding will intentionally, and perhaps artificially, be routed through companies that have a high taxable income or alternative finance structures is merely utilised. In our view, these types of focused anti-avoidance rules rarely achieve their desired outcome; they simply add to complexity in the system as those taxpayers that need to raise finance will always do so. If a taxpayer has the means, they will ensure they plan sufficiently so that they are not affected by the rules in question. A fixed ratio rule should be considered to supplement a single entity calculation.

(iv) Section 24O of the Income Tax Act

In terms of section 24O of the Income Tax Act, where debt is issued or used by a company for the purpose of financing the acquisition by that company of equity shares in an operating company in terms of an acquisition transaction, any interest incurred by that company in terms of that debt must be deemed to have been incurred in the production of its income and expended for the purposes of trade. This provision therefore allows the deduction of interest in respect of share acquisitions. The deduction of the interest is limited, however, since the acquiring company must obtain a controlling stake (i.e. at least 70% of the equity shares) in the target company. In addition the target company must constitute an operating company as defined in section 24O(1) of the Income Tax Act. The deductibility of the interest ceases when the controlling group company ceases to be a controlling group company, an operating company ceases to be an operating company or any company in the transaction ceases to form part of the group of companies.[89]

(v) Interest withholding tax

The Taxation Laws Amendment Act 31 of 2013 amended the Income Tax Act by the insertion of Part IVB in Chapter II of Act 58 of 1962, to introduce a withholding tax on interest. Section 50B provides for the levying a final withholding tax on interest, at a rate of 15% on the amount of any interest paid by any person to or for the benefit of any foreign person to the extent that the amount is regarded as having been received or accrued from a source within the Republic in terms of section 9(2)*(b)*. The interest withholding tax, which is subject to certain exemptions set out in section 50 of the Income Tax Act, came into operation on 1 March 2015.

In the original version, the withholding tax provisions did not contain a specific definition of interest, and thus interest was understood in the ordinary meaning of the word. The definition of interest for purposes of the withholding tax on interest has been included by section 70 of the Taxation Laws Amendment Bill 2015 to include

[89] Section 23(4)(a) of the Income Tax Act.

interest as defined in para (a) and (b) of the definition of interest in section 24J. This includes in the definition of interest the following items: (a) gross amount of interest or related finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement; or (b) amount, or portion thereof payable by a borrower to the lender in terms of any lending arrangement as represents compensation for any amount to which the lender would, but for such lending arrangement, have been entitled.

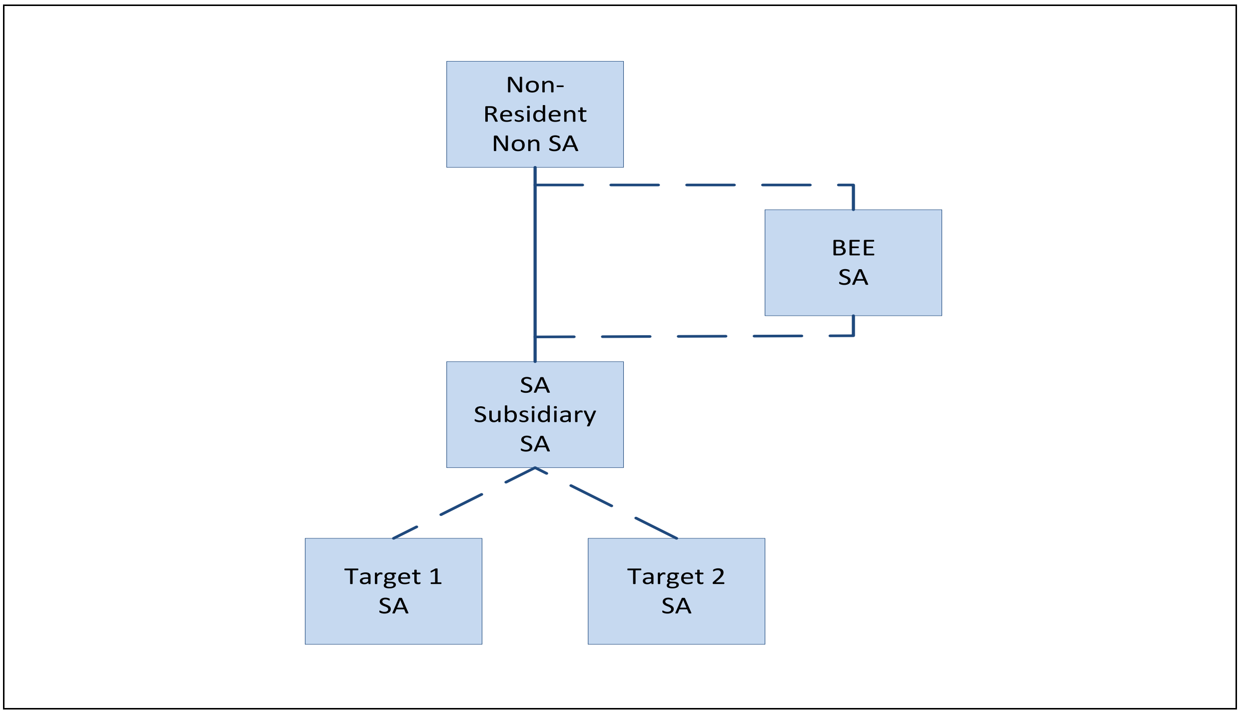
The withholding tax is reduced to zero under most South African tax treaties since most of South Africa's double tax treaties have not been re-negotiated to provide for better rates. This provides an opportunity for foreign lenders to make their loan funding from an appropriate jurisdiction which has a zero withholding tax rate in respect of interest advanced to South Africa, provided that they are able to demonstrate that the recipient has beneficial ownership thereof.

Recommendation:

It should be noted, as discussed above, that the OECD in the Discussion Draft and the Final Report specifically rejected the use of withholding taxes on interest as not suitable for preventing BEPS relating to excessive interest deductions unless the rates are aligned with the corporate tax rate. Nevertheless, the withholding tax on interest became effective in South Africa with effect 1 March 2015. Although OECD countries reject withholding taxes, they are used by source countries to ensure allocation of taxing rights to the source jurisdiction. As such, despite the OECD's rejection of withholding taxes as a measure of preventing BEPS, it is considered that the withholding tax serves an important role in the South African tax system, that being protecting the South African tax base by ensuring its ability to tax interest sourced in South Africa. To that end, from a treaty context, it is recommended that the treaties with zero or low interest withholding tax rates be renegotiated to afford South Africa a full taxing right to such interest. It is noted, however, that renegotiation of tax treaties is a time consuming process, and should perhaps be done in a holistic manner where the objective is to achieve more than just one objective.

Comments on the complexity posed by all the provisions and the challenges these pose to foreign investment

The complexities attaching to cross-border debt seems to be at odds with the steps one would intuitively suggest that a jurisdiction, which is trying to encourage foreign investment, should be taking. It is important to ensure a balance between the limiting base erosion and stimulating economic growth. The example below illustrates the complexities facing non-resident investors.



In the scenario above:

- a foreign group wishes to expand its operations by way of making acquisitions in South Africa;
- it forms a local holding company and seeks to fund that company appropriately to make a series of acquisitions in the region;
- it can choose to use debt funding and/or equity funding subject to the transfer pricing rules;
- the acquisitions which the subsidiary may make could well involve restructurings utilising the provisions of section 45 and/or section 47 of the Income Tax Act.

In such a situation, the foreign group must take the following factors into account:

- They must understand the exchange control regime and its obligations in respect of the funding provided to the local holding company;
- Any funding introduced into the company must meet the requirements of the Income Tax Act:
  - section 11(a) i.e. be in the production of income;
  - sections 8F and 8FA relating to hybrid interest and hybrid debt; and
  - section 31 of the Income Tax Act; i.e. comply with the transfer pricing rules;
- If the parent company is tax resident in a treaty country and the treaty imposes withholding tax at a rate of 0% on interest accruing to that entity, the provisions of section 23M would apply. The entity has to factor in, based on its future performance, whether it will be entitled to deduct any funding provided by its offshore shareholders;

- If any of the local funding is used for any acquisition transactions (using any of sections 45, 47 or 24O of the Income Tax Act), the provisions of section 23N may also need to be taken into account. Section 23N *and* 23M may apply where any funding received from the offshore parent are used for any acquisition transactions;
- The parent company must understand the interest withholding tax rules and if it is entitled to any treaty benefits it must make sure that all requisite declarations required by section 50E are properly and timeously submitted.
- The parent company must also consider the home country tax implications, thus whether the interest receipt would be subject to tax, qualify for a unilateral or bilateral foreign tax relief, etc.

While the above analysis may be sensible in a number of more developed jurisdictions, it poses complexities and uncertainties for parties as to what level of interest deductibility they will be entitled to in any particular year. The rules can also be overwhelming for groups which do not have sophisticated in-house tax skills or a large foreign network which has introduced them to these types of rules previously. It is therefore important that regulatory certainty is maintained for foreign investors, who have to take such matters into account when deciding where their funds are best placed. It is recommended that a proper analysis be made to determine whether reliance on deduction limitation rules is relevant or if it just amounts to overkill in the circumstances.

From the above it is clear that taxpayers may be subject to multiple layers of taxation. This can be demonstrated as follows: if a South African taxpayer has excessive interest from a transfer pricing perspective:

- Income tax payable by the South African borrower is adjusted for the excessive interest portion; and
- Interest income subject to non-South African tax in the hands of the recipient (albeit possibly subject to credit for South African withholding tax on interest)

This result is in line with a conventional double taxation scenario. However, under current law, the MNE is also potentially subject to two types of other tax on interest, more specifically:

- South African withholding tax on interest in the hands of the entity receiving the interest income (on the full interest expense); and
- Secondary adjustment imposed in South African on the borrower

This seems like an unduly punitive result. This result could be mitigated by amending the WHT rules to state that any withholding tax on interest paid by the South African borrower can be claimed as a credit against any tax on interest payable as a result of a secondary adjustment.

7 INTEREST: DIVIDEND SWAPS

Interest: dividend swap transactions raise similar issues to the debt pushdown arrangements. However, a difference is that interest:dividend swaps are not necessarily linked to a group re-organisation. Instead a South African resident investor invests in, say, preference shares issued by a foreign entity which, in turn, invests in debt instruments in South Africa. The interest payable on the debt is deductible for the borrower, no tax is suffered in the non-resident entity and tax exempt dividends are declared to the South African investors in respect of the redeemable preference shares. Various mechanisms have been put in place to prevent these transactions. These include the following:

7.1 SECTION 10B ROUND-TRIPPING PROVISIONS

Section 10B of the Income Tax Act contains round-tripping provisions. In particular a foreign dividend will not be exempt from tax if any amount of the foreign dividend is determined directly or indirectly with reference to an amount paid by a South African resident entity to a non-resident entity in circumstances where the South African resident entity obtains a tax deduction for the payment and the payment is not subject to tax in the hands of the non-resident entity.[90]

In addition, the provisions in section 10B require an investment in equity shares in order to qualify for the participation exemption on foreign dividends. The round-tripping provisions of section 10B have been very effective in ending many transactions previously entered into in this regard.

7.2 SECTION 8E

Section 8E can be applied to deem a dividend declared by a company on a hybrid equity instrument as interest. The aim of the provision is to turn non-taxable dividends into taxable interest.

7.3 SECTION 8EA

Section 8EA applies in respect of preference shares where investors have security over such shares and therefore do not take “equity risk”.

7.4 TAX TREATIES: DOUBLE NON-TAXATION OF INTEREST

Double non-taxation of interest and other financial payments arise in South Africa when foreign direct investment in South Africa is routed through a jurisdiction which does not tax interest/financial payments. For example, a foreign investor may invest in, say, a Luxembourg company or Mauritian company which on-invests in the South

[90] Section 10B(4) of the Income Tax Act.

African target. The South African target would obtain a deduction in respect of interest paid to the Luxembourg/Mauritian entity. In addition, due to the application of applicable DTAs, the interest may only suffer a reduced (to as little as zero) amount of withholding tax from the introduction of the withholding tax on interest in March 2015. If the investment is routed through a jurisdiction that has a double tax treaty with South Africa but the jurisdiction levies zero withholding tax on interest, no or limited tax would then be suffered in the intermediate jurisdiction. Depending on the CFC rules in the jurisdiction of the ultimate investor, the interest may then never be taxed in the hands of the investor. The policy issue arises whether this is a problem for South Africa as the source jurisdiction. If so, consideration could be given to amendment of our domestic tax law in circumstances where no or limited tax is suffered on interest payments in the recipient jurisdiction.

7.5 BASE EROSION VIA OTHER FINANCIAL PAYMENTS

Base erosion can also arise from excessive interest deductions arising from derivative financial instruments. Derivatives are financial instruments in which the rights and obligations under the instrument are derived from the value of another underlying instrument but they are not themselves the primary instruments.[91] In most countries, the income taxation of financial instruments is based on the distinction between debt and equity. But derivatives cause an outright fragmentation of the distinction between debt and equity.[92]

Amounts derived from derivatives may not fall into the definition of interest and will therefore not be subject to the interest withholding tax when introduced. An example is “manufactured interest” payments in respect of share lending agreements. Another example is amounts payable on forward exchange contracts and cross currency swap contracts where there are no initial exchanges. This economically represents interest, but does not fall into the definition of interest. Set-off mechanisms can also be used, in terms of which there is no physical payment of interest between parties which would give rise to interest withholding tax. However such amounts give rise to a tax deductible payment for the payor since the relevant amount is “actually incurred” by it, although it is not paid due to the set-off mechanism.

7.6 SECTION 24J

Section 24J was originally introduced into the Income Tax Act principally to regulate the incurral and accrual of interest in respect of “instruments”. The section prescribes *inter alia* that interest accrues on a day-to-day basis using a yield-to-maturity methodology (unless an alternative method has been used and approved), and applies to all instruments.

91 L Oliver & M Honiball *International Tax: A South African Perspective* 5 ed (2011) at 252.

92 AW Oguttu “Challenges in Taxing Derivative Financial Instruments: International Views And South Africa’s Approach” *(2012) 24 South African Mercantile law Journal* at 390.

The provisions of section 24J of the Income Tax Act therefore require the existence of an “instrument”. An “instrument” includes any “interest bearing arrangement” or debt. Section 24J(2)(*a*) of the Income Tax Act provides that the issuer of an “instrument” is deemed to have incurred an amount of interest during a year of assessment equal to the sum of all “accrual amounts” in relation to all accrual periods falling, whether in whole or in part, within such year of assessment in respect of such instrument.

In calculating the “accrual amount” of an instrument, the “yield to maturity” is applied to the “adjusted initial amount”. The proviso to paragraph (*b*) of the definition of “adjusted initial amount” provides, in relation to the issuer of any instrument, that where such instrument forms part of a transaction, operation or scheme:

> *“any payments made by the issuer to any other person pursuant to that transaction, operation or scheme with a purpose or with the probable effect of making payment directly or indirectly to the holder or a connected person in relation to the holder, must be deducted for purposes of this paragraph; and*
>
> *in the case where any party to that transaction, operation or scheme is a connected person in relation to that issuer, any payments made by that connected person to any other person pursuant to that transaction, operation or scheme with a purpose or with the probable effect of making payment directly or indirectly to the holder or a connected person in relation to the holder, must be deducted for purposes of this paragraph”.*

The “yield to maturity” is defined as, *inter alia*, the rate of compound interest per accrual period at which the present value of all amounts payable or receivable in terms of any instrument in relation to a holder or an issuer, as the case may be, of such instrument during the term of such instrument equals the initial amount in relation to such holder or issuer of such instrument. The proviso to the definition of “yield to maturity" is similar to the proviso to paragraph (*b*) of the definition of “adjusted initial amount” set out above.

<u>Problem statement</u>

The above provisos were inserted into the Income Tax Act by the Revenue Laws Amendment Act, 32 of 2004. The Explanatory Memorandum issued by SARS in conjunction therewith states the following in relation to the insertion of the provisos:

> *“A number of structured finance schemes which are based on convertible loans have been identified. The schemes under investigation were entered into between members of groups of companies (large and smaller companies) and are as a general rule facilitated by financial institutions.*
>
> *Common characteristics of the structures are the use of compulsory convertible debt, the circular flow of funds through a number of related and unrelated companies, and the borrowing of an inflated amount by the party claiming interest for tax purposes. The tax benefit for the group of companies entering into the scheme is the deduction of interest on the principal amount of a loan on an accrual basis and the creation of a deferred capital gain which in essence results in the deduction of interest and capital of the actual financing needs of the borrower.*

In order to address the tax avoidance element of schemes which are based on the circular flow of funds to which more than one company in a group of companies are party it is proposed that the interest claimed by a group company be limited to the net amount borrowed in terms of the scheme by the group of companies. It will be required that payments made by the borrower in respect of a financial arrangement or scheme as well as payments made by any connected person in relation to the issuer in respect of a financial arrangement or scheme should be taken into account. A circular flow of funds would then reduce the amount of interest claimed by a group company.
The definitions of "adjusted initial amount" and "yield to maturity" in section 24J(1) are to be amended to provide that where an instrument forms part of any transaction, operation or scheme and, any payments made by the issuer or connected person must be taken into account if made with a purpose or the probable effect of making payment directly or indirectly to the holder (or a connected person to the holder)".

Issue

The wording of the provisos is wider than their intended ambit as expressed in the Explanatory Memorandum. Consider a hypothetical situation where Company A, Company B and Company C form part of a group of companies, Company A advances an interest-bearing loan to Company B which, in turn, advances an interest-bearing loan to Company C as part of a single arrangement. Company A is a connected person in relation to Company C. Payments are made by Company A to any other person (Company B) with both the purpose and probable effect of making payment to the holder (Company B).

In these circumstances Company C's "adjusted initial amount" is reduced by the value of the entire loan advanced to it by Company B. In addition, these amounts reduce Company C's yield to maturity. The effect of this is that Company C obtains no tax deduction for the interest it incurs on its loan from Company B, while Company B is taxed on the full amount of such interest.

Recommendations:

- The appropriate mechanism to remedy this problem is to add a requirement that, for example, there must be a purpose of avoiding tax before the provisos apply, or to include some other explicit reference to the tax avoidance mischief identified in the Explanatory Memorandum.
- The definition of interest is apposite. There should not be any amendment to the definition of interest for the purpose of interest withholding tax that could broaden the definition further than the current definition that includes the definition in para (a) and (b) of the definition of interest in section 24J(1).
- It is also not recommended that a further withholding tax on derivative payments should be imposed. This would constitute an unusual withholding tax from an international perspective and could adversely impact on foreign direct investment.

7.7 SECTION 8F AND SECTION 8FA

From 1 April 2014 section 8F of the Income Tax Act deems interest on a hybrid debt instrument to be a dividend *in specie* for both the company paying the interest and the person receiving the interest. As a result, no deduction is allowed of the interest paid by the issuer on the instrument. Section 8F(2) of the Income Tax Act disallows the deduction of interest incurred on a hybrid debt instrument that is considered debt in its legal form but is actually equity in economic substance.

Section 8FA of the Income Tax Act, introduced from 1 April 2014 and deems hybrid interest paid by a company to be a dividend in specie for both the company paying the interest and the person receiving the interest.

Both section 8F and section 8FA of the Income Tax Act re-characterise interest as dividends in both the paying and receiving entities in certain circumstances. These provisions are effective in preventing excessive interest deductions in respect of inbound transactions, but not outbound transactions. In respect of outbound transactions these provisions mean that a South African resident, instead of receiving taxable interest, receives a tax exempt dividend.

<u>Recommendations:</u>

- The re-characterisation in respect of outbound debt instruments falling within the provisions of section 8F or section 8FA of the Income Tax Act should be changed to refer to "foreign dividends". Such foreign dividends would therefore only be exempt if they qualify for the more onerous exemption criteria set out in section 10B of the Income Tax Act.
- In addition in all circumstances these transactions should be subject to the provisions of section 8EA of the Income Tax Act. There has been much time spent on section 8EA of the Income Tax Act, but these rules can now be circumvented by taking security over a hybrid debt instrument falling into the provisions of section 8F or section 8FA of the Income Tax Act.

7.8 THE SECTION 80A-80L GENERAL ANTI-AVOIDANCE PROVISIONS

The general anti-avoidance provisions under sections 80A to 80L of the Income Tax Act can also be applied to prevent excessive interest deductions. A question that arises is whether a "tax benefit" in terms of section 80G(1) of the Income Tax Act, exists as a consequence of the transaction, operation, scheme, agreement or understanding entered into (s 80L of the Income Tax Act).

In the context of the definition of a "tax benefit" in terms of section 1 of the Income Tax Act, and based on case law (*Hicklin v SIR*[93] and *Smith v CIR*[94]), the liability for the payment of any tax, levy or duty that a taxpayer must seek to avoid, postpone or reduce is not an accrued or existing liability, but an anticipated liability. In *Smith v CIR*,[95] it was held that to avoid liability in this sense is "to get out of the way of, escape or prevent an anticipated liability".

In *ITC 1625*,[96] Wunsh J held that the test to be applied in determining whether a transaction had the effect of avoiding tax was to ask whether "the taxpayer would have suffered tax but for the transaction." The court stated that "if the transaction in issue had not been entered into, the taxpayer would not have acquired the property, it would not have earned the income and it would not have incurred the interest expenditure" and thus the court could find "no basis on which it can successfully be argued that by incurring expenditure on interest in order to earn the income on which it has to pay tax the taxpayer avoided tax or reduced tax."

If there is a "tax benefit", the second requirement for the application of the anti-tax-avoidance provisions in terms of section 80A of the Income Tax Act is that the "sole or main purpose" of the avoidance arrangement is to obtain such tax benefit. Therefore, provided the taxpayer does not comply with this requirement, the arrangement will not constitute an impermissible tax avoidance arrangement and so the provisions would not apply.

Section 80G of the Income Tax Act provides that an avoidance arrangement is presumed to have been entered into or carried out for the sole or main purpose of obtaining a tax benefit, unless and until that party proves that, reasonably considered in light of the relevant facts and circumstances, obtaining a tax benefit was not the sole or main purpose of the avoidance arrangement. The purpose of a step in or part of an avoidance arrangement may be different from the purpose attributable to the avoidance arrangement as a whole and may itself be subject to the anti-avoidance provisions.

If a non-resident enters into a derivative arrangement instead of advancing a loan to a South African resident, this may have the effect of avoiding an anticipated tax liability in respect of interest withholding tax for the non-resident entity. A tax benefit will therefore arise for the non-resident. The non-resident then bears the onus of proving that its sole or main purpose was not to achieve the tax benefit.

[93] 1980(1) SA 481(A); 4 SATC 179.
[94] 1964 (1) SA 324(A).
[95] 1964 (1) SA 324(A).
[96] (1966) 59 SATC 383.

7.9 SUBSTANCE OVER FORM

The common law doctrine of substance over form can also be applied to interest transactions where the substance of the transaction is not the same as the form in which the transaction is presented. The recent court decisions in *Commissioner for the South African Revenue Service v NWK Ltd*[97], *Roshcon (Pty) Ltd v Anchor Auto Body Builders CC*[98] and *CSARS v Bosch*[99] demonstrated that the substance over form doctrine can be widely applied in a wide range of legal matters.

7.10 CFC – DOUBLE NON-TAXATION OF FOREIGN INTEREST

The CFC-CFC exemption contained in section 9D(9)(fA) of the Income Tax Act implies that it is possible to have a situation where a CFC (CFC 1) which qualifies for the "foreign business establishment exemption", pays interest to another CFC which does not have a foreign business establishment (CFC 2). CFC 2 may then on-declare such interest as an exempt foreign dividend back to its South African shareholder.

This type of mechanism can extract passive income (including interest) from CFC 1 into CFC 2, which, if situated in a low tax jurisdiction, can avoid tax both in the source jurisdiction of CFC 1 and in South Africa. Consider this hypothetical example:

- CFC 1 obtains a tax deduction in its jurisdiction;
- There is no allocation of an amount equal to the net income of CFC 1 to the South African residents who hold participation rights in CFC 1 due to the foreign business establishment exemption;
- The interest is not taxed or is taxed at a low rate in the jurisdiction of CFC 2;
- When CFC 2 declares a dividend back to the South African shareholder, the dividend qualifies for exemption in terms of section 10B of the Income Tax Act.

The question that arises is whether the fact that such amounts are not taxable in the source jurisdiction of CFC 1 should be an issue from a South African tax perspective. It is submitted that this should not be of concern to South Africa. Instead South Africa should concern itself with its own tax base, as the example above does not result in tax loss in South Africa.

8 GENERAL RECOMMENDATION

From the above, it is clear that many of the schemes associated with financial flows have been heavily targeted already and, as a consequence, may provide a disincentive for foreign persons to invest in South Africa. The question is whether these efforts are complete (and whether the taxes associated with cross-border

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97 2011 (2) SA 67 (SCA).
98 2014 ZASCA 40.
99 2014 ZASCA 171.

financial flows have to be re-examined in light of Government's growing need for external finance).

Nevertheless, as mentioned above, the plethora of legislation dealing with the incurral of interest is creating considerable uncertainty for investors into South Africa. It is strongly recommended that the current position in relation to inbound debt be considered holistically. The following points should be considered as part of this process:

- Should taxpayers really be required to do expensive debt pricing exercises? Are safe harbours not a viable option – particularly in view of the excessive debt rules and the interest withholding tax?
- How should the excessive debt rules and the thin capitalisation rules interact with each other? For example, might it not make sense to align these rules so that the test in the excessive debt rules (40% of "adjustable taxable income") automatically apply for thin capitalisation purposes. This would avoid the need for multiple tests of the same transaction.
- There will be significant potential for economic double taxation – or even triple taxation – for groups. This would apply for example, if a transfer pricing adjustment is made in South Africa in respect of an interest payment, while the recipient is subject to South African withholding tax (possibly at a reduced rate) and income tax in their own country.
- Should thin capitalisation rules and exchange control rules applicable to inbound debt not be aligned?

The benefits of including complex provisions against BEPS, as recommended by the Final Report must always be weighed against the necessity of having legislation which is easy to interpret, accessible to taxpayers and not unnecessarily voluminous. A good tax system is one in which, *inter alia*, taxpayers have certainty regarding their obligations to the fiscus. It should also be kept in mind that in order to encourage foreign investment, there is a need for a regulatory framework which is not unnecessarily onerous or which is too complex that it will discourage investors who can easily invest their funds in less regulated environs for a similar return.[100]

At present, it appears that the tax rules regulating finance and funding of entities, and in particular, the deduction limitations rules, constitute over-regulation of this field. As a result, the balance between base protection on the one hand, and certainty for taxpayers on the other, is out of sync in favour of impractical base-protection rules. Even if some deduction limitation rules are necessary:

- the current approach based on the tax EBITDA of borrowers creates distortions and prejudices certain borrowers. This may ultimately negatively impact the economy by discouraging investment by start-ups and in certain

[100] Andrew Wellsted (Norton Rose Fulbright) Technical Report to the DTC on Action 4.

industries. A group ratio rule as canvassed in the OECD Action 4 should be considered in this regard.

- the economy desperately requires regulatory certainty and simplicity in order to stimulate growth and foreign investment. Numerous and overlapping tax rules which limit the ability to leverage undermines this goal. Only transfer pricing and interest withholding tax should be used to regulate group cross-border financing. The addition of the deduction limitation rules adds complexity which discourages foreign investment and is the benefit is disproportionate to the harm done; and
- as regards financing decisions of taxpayers in relation to a leveraged acquisition, taxpayers need to be able to freely choose which transaction they enter into and how they are funded, to the extent that such transactions do not result in BEPS. It is beyond the realms of fiscal legislation to limit taxpayer's ability to freely transact in a capitalist economy seeking to grow.

These recent provisions have focused strongly on anti-avoidance – and it is acknowledged that excessive debt has proved to be a method often used in practice for profit stripping by multi-national enterprises (MNE's). However, has this really been a big issue in South Africa (given the fact that inbound loans require exchange control approval – and the debt to equity levels of the South African borrower are taken into account).

It is suggested that, in evaluating these rules holistically, the considerations of anti-avoidance be carefully balanced against trying to make them as investor friendly as possible. This applies particularly to the compliance burden placed on MNE's.

The issuing of a final Interpretation Note on Thin Capitalisation should probably be deferred until such a holistic evaluation of all these rules has been performed. South Africa should monitor OECD recommendations on domestic rules to limit excessive interest deductions and ensure that the domestic legislation is aligned with those recommendations.

South Africa should seriously consider the costs by both local and foreign investors of complying with the required tax legislation in relation to its benefits and the impact that it has on the ease of doing business in South Africa. The Discussion Draft and the Final Report acknowledged that compliance with some of the best practice recommendations may be high. In order to reduce the compliance cost and administrative burden for entities with very low leverage and which pose a low risk of BEPS, it was suggested that a country could include a monetary threshold which sets a *de minimis* level of net interest expense below which an entity will not be required to apply the general interest limitation rule. This threshold should be set at an adequate low level to apply only to those that do not pose a risk.

It is, for instance, argued that although the thin capitalisation rules are flexible in that they apply to different industries, it is not practical for taxpayers with a low risk of BEPS to comply with the rules. Thus in the redraft of the Draft Interpretation Note, SARS could consider introducing a threshold, either at the level of the funding, or at the level of the net interest expense.

9 SUMMARY OF RECOMMENDATIONS

(i) Recommendations on the effectiveness of arm's length principle in preventing BEPS due to excessive interest deductions

The OECD recommended that the arm's length test should only apply to the pricing of the debt i.e. the interest rate. It may be preferable in the South African context to retain the approach of evaluating the extent of debt (i.e. thin capitalization) and the debt pricing (i.e. the interest rate) separately. In doing so, exchange control requirements should be borne in mind. The DTC recommends that the Guidance from SARS should be changed to be in line with that of the OECD and international thinking as a matter of urgency, and be finalised to avoid uncertainty of its application. It is important that the use of thin capitalisation rules to prevent BEPS resulting from excessive interest deductions is in line with what is recommended by the OECD, as different rules between different countries could lead to double taxation.

In finalising or redrafting this draft, the DTC recommends that SARS considers the following:

- Simplification of rules;
- Consistency with the OECD recommendations and international precedent on the Final Report;
- Transfer pricing rules for interest rate should take into account outcome of the GE and Chevron cases on relevance of parent credit ratings;
- Introducing ways of reducing the administrative burden for taxpayers with a low risk of BEPS through interest deductions. These could be one or all of the below:
  - Introduction of a safe harbour; and
  - Threshold based upon loan value or another measure whereby taxpayers falling below such a threshold would not have to comply with the rules.
- How to treat start-up operations where loan funding is required;
- Compliance cost for investors.

It is recommended that a "safe harbour" with a fixed ratio be introduced in section 31 or the Interpretation Note to provide non-residents that are funding local entities with guidance as to reasonable levels of debt versus equity.

It is further recommended that legislation and Interpretation Notes be released together, first in draft and then in final form.

(ii) Recommendations on exchange controls

It is recommended that the interest cap between SARB and SARS should be aligned. Interest rates allowable from a SARB perspective are potential indicators of risk from a South African transfer pricing perspective.

The DTC's recommendation is further that a taxpayer should determine what interest rate would be acceptable from a Transfer Pricing perspective. If acceptable, then it should be allowed by SARB. Alternatively SARS should indicate what interest rates it would allow, and then those should be allowed from an exchange control perspective.

(iii) Recommendation on withholding tax on interest

It is recommended that South Africa reconsiders the effectiveness of the withholding tax on interest to ensure that its source right to tax is protected. This would include, but is not limited to, the renegotiation of zero rate treaties.

(iv) Recommendation on interest deductibility

Recognising the complexities and uncertainties for potential investors as to what level of interest deductibility they would be entitled to in any particular year it is recommended that a proper analysis be made to determine whether reliance on deduction limitation rules is appropriate.

(v) Recommendation on incurral and accrual of interest

It is recommended that the rules relating to incurral and accrual of interest in section 24J be reconsidered, without widening the definition of interest, to ensure that the rules do not adversely apply to transactions where there is no tax avoidance purpose.

(vi) Recommendations on hybrid interest and debt instruments

The re-characterisation in respect of outbound debt instruments falling within the provisions on hybrid interest and hybrid debt instruments should be changed to apply to "foreign dividends" and these transactions be subject to the provisions dealing with third party backed shares.

ANNEXURE 5

DAVIS TAX COMMITTEE: SECOND INTERIM REPORT ON BASE EROSION AND PROFIT SHIFTING (BEPS) IN SOUTH AFRICA*

SUMMARY OF DTC REPORT ON ACTION 5: COUNTER HARMFUL TAX PRACTICES MORE EFFECTIVELY, TAKING INTO ACCOUNT TRANSPARENCY AND SUBSTANCE

In 1998 the OECD issued a Report entitled *Harmful Tax Competition: An Emerging Global Issue.* This Report pointed out that tax haven jurisdictions and harmful preferential tax regimes distort financial and investment flows among countries.[1] Further that the harmful tax practices of both tax haven and harmful preferential tax regimes undermine the integrity and fairness of tax structures; they discourage compliance by all taxpayers; they cause undesirable shifts of part of the tax burden to less mobile tax bases such as labour, property and consumption; and they increase the administrative costs and compliance burdens on tax authorities and taxpayers respectively.

In the 1998 Report the OECD described a tax haven as a jurisdiction with no or nominal taxation, actively making itself available for the avoidance of tax that would have been paid in high-tax countries.[2] The OECD noted that tax-haven jurisdictions are characterised *inter alia* by:

- high levels of secrecy in the banking and commercial sectors.
- lack of transparency and effective exchange of information with other governments concerning the benefits taxpayers receive from the tax haven.[3]

Progress Reports were issued in 2000 (listing 35 tax haven jurisdictions); 2001 (which reiterated that a jurisdiction would not be considered uncooperative if it committed to transparency and effective exchange of information.)[4]; 2002 (which gave rise to the principles (standards) set out in the 2002 OECD "Model Agreement on Exchange of Information on Tax Matters"); and annual progress reports thereafter on implementation of the standards. Due to countries having implemented or agreed

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1 OECD "Harmful Tax Practices (1998) in par 75; Spitz & Clarke at OECD/3.

2 OECD Issues in International Taxation No 1 *International Tax Avoidance and Evasion* (1987) at 20; A Ginsberg *International Tax Havens* 2 ed (1997) at 5-6; P Roper & J Ware *Offshore Pitfalls* (2000) at 5.

3 OECD 1998 Report in par 79.

4 M Herzfeld "News Analysis: Political Reality Catches Up With BEPS" Tax Analysts 3 February 2014.

to implement the tax standard on exchange of information, by May 2009 no countries remained on the “tax haven list”.

The 1998 Report also described preferential regimes, which could exist even in jurisdictions with high tax rates:

(i) The regime imposes no or low effective tax rates on income from geographically mobile financial and other service activities.
(ii) The regime is ring-fenced from the domestic economy. [5]
(iii) The regime lacks transparency (for example, the details of the regime or its application are not apparent, or there is inadequate regulatory supervision or financial disclosure).
(iv) There is no effective exchange of information with respect to the regime. [6]

The eight factors determining whether such regimes are harmful are:

(i) An artificial definition of the tax base.
(ii) Failure to adhere to international transfer pricing principles.
(iii) Foreign source income exempt from residence country taxation.
(iv) Negotiable tax rate or tax base.
(v) Existence of secrecy provisions.
(vi) Access to a wide network of tax treaties.
(vii) The regime is promoted as a tax minimisation vehicle.
(viii) The regime encourages operations or arrangements that are purely tax-driven and involve no substantial activities. [7]

A regime that is identified as being potentially harmful based on the above factor analysis may be considered not to be actually harmful if it does not appear to have created harmful economic effects. The following three questions can be helpful in making this assessment:

- Does the tax regime shift activity from one country to the country providing the preferential tax regime, rather than generate significant new activity?
- Is the presence and level of activities in the host country commensurate with the amount of investment or income?
- Is the preferential regime the primary motivation for the location of an activity?[8]

Although the OECD's 1998 initiative was successful in promoting a programme of transparency and exchange of information by tax haven jurisdictions, it generally failed to accomplish what it set out to do, which is addressing harmful tax

5 The term “ring-fencing” refers to the artificial demarcation or limitation of profits or losses for tax purposes, ignoring the corporate form of the taxable or restricting the application of particular provisions to transactions inside the ring fence. See L Olivier & M Honiball *International Tax: A South African Perspective* 4 ed (2011) at 849.

6 OECD/G20 2015 Final Report on Action 5 at 20.

7 OECD/G20 2015 Final Report on Action 5 at 20.

8 OECD/G20 2015 Final Report on Action 5 at 21.

competition.[9] In fact, many of the OECD member countries have since enacted such regimes, especially with regard to mobile income.[10]

The OECD 2013 Report on BEPS stated, in its commentary on Action 5, that the underlying policy concerns expressed in the 1998 Report as regards harmful tax practices (often termed the "race to the bottom") are as relevant today as they were when the 1998 report on harmful tax completion was issued. However, nowadays it often takes less of the form of traditional ring fencing and now entails:

- artificial demarcations or limitation of profits or losses for tax purposes;
- ignoring the corporate form of the taxable entities;
- restricting the application of particular provisions to transactions inside the ring fence;
- across the board corporate tax rate reductions on particular types of income (such as income from financial activities or from the provision of intangibles).

The 2013 Report thus recommended that this area should be revisited both domestically and internationally. The OECD's previous failed attempt to shame countries into changing local laws, however, causes one to have tempered expectations for the BEPS initiative.[11]

The 2015 Final Report on Action 5 (issued on October 2015) observes that combating harmful tax practices is an interest common to OECD and non-OECD member countries alike. However there are obvious limitations to the effectiveness of unilateral actions against such practices. Thus, the need for countries to agree on a set of common criteria to promote a co-operative framework that supports the effective fiscal sovereignty of countries over the design of their tax systems; and to enhance the ability of countries to react against the harmful tax practices of others.

The OECD notes that its work on harmful tax practices is not intended to promote the harmonisation of income taxes or tax structures generally within or outside the OECD, nor is it about dictating to any country what should be the appropriate level of tax rates. Rather, the work is about reducing the distortionary influence of taxation on the location of mobile financial and service activities, thereby encouraging an environment in which free and fair tax competition can take place. This is essential in moving towards a "level playing field" and a continued expansion of global economic growth.[12]

In Action 5, the OECD has, therefore, placed priority on:

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9 M Herzfeld "News Analysis: Political Reality Catches Up With BEPS" Tax Analysts 3 February 2014.

10 Ibid.

11 M Herzfeld "News Analysis: Political Reality Catches Up With BEPS" Tax Analysts 3 February 2014.

12 OECD/G20 2015 Final Report on Action 5 at 11-12.

1) Requiring substantial activity for any preferential regime.
2) Improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes,

In addition to the above matters relating to revamping work on harmful tax practices:

3) OECD planned to take a holistic approach to evaluate preferential tax regimes in the BEPS context. The OECD also planned to engage with non-OECD members on the basis of the existing framework and consider revisions or additions to the existing framework.

The OECD's work on substantial activity has focused in the first instance on regimes which provide a preferential tax treatment for certain income arising from qualifying Intellectual Property ("intangible regimes" or "IP regimes"). This is in line with the statements in the BEPS Action 5 that current concerns in the area of harmful tax practices may be less about traditional ring-fencing and instead relate to corporate tax rate reductions on particular types of income, such as income from the provision of intangibles. Thus all intangible regimes in OECD member countries are being reviewed. Under Action 5, the substantial activity requirement also applies to all preferential other than IP regimes. [13]

For the substantial activity requirement in the context of IP regimes the "nexus approach" was supported by OECD member countries and the G20. This approach allows a regime to provide for a preferential rate on IP-related income to the extent it was generated by qualifying expenditures. This is achieved by applying a formula to ensure that only qualifying expenditures relating to income from an IP asset will result in defining the income receiving tax benefits. Where the amount of income receiving benefits under an IP regime does not exceed the amount determined by the nexus approach, the regime has met the substantial activities requirement. [14]

For the substantial activity requirement in the context of non-IP regimes to be satisfied the tax benefits may only granted to taxpayers that undertake core income generating activities that produce the type of business income covered by the preferential regime.[15]

In addressing the second priority under Action 5 i.e. improving transparency, the report deals with 3 steps: firstly, develop a framework for compulsory spontaneous information exchange; then, consideration of whether transparency with regards to rulings (for preferential regimes and other matters) can be improved in relation to the rulings regimes in the associated countries – this concluded that the requirement to undertake compulsory spontaneous information exchange should generally cover all instances in which the absence of exchange of a ruling may give rise to BEPS

[13] OECD/G20 2015 Final Report on Action 5 at 23-24.
[14] OECD/G20 2015 Final Report on Action 5 at 25.
[15] OECD/G20 2015 Final Report on Action 5 at 37.

concerns, thus taking away the need for a jurisdiction to determine if a particular regime is preferential; and thirdly, develop a general best practice framework for design and operation of rulings regimes.

It is important to note that the Report requires that the obligation to spontaneously exchange rulings applies not only to future rulings, but also to past rulings i.e. those issued after 1 January 2010 and still in effect from 1 January 2014 must be exchanged. For future rulings i.e. after 1 April 2016, countries are expected to ensure they have the relevant information required, on hand.[16] The report makes it clear that taxpayers have a legal right to expect that information exchanged remains confidential.

In relation to the third priority, whereby the OECD is evaluating preferential tax regimes in the BEPS context, the OECD commenced its review of member countries in late 2010. By the time of the issue of the Final Report on Action 5, forty three (43) preferential regimes had been reviewed. A list of these is provided and reflects, for South Africa, the headquarter company regime, but it notes that this is considered to be potentially harmful but not actually harmful; and the exemption of income for ships used in international shipping, with is indicated as being not harmful.[17]

Further work is to be carried out on these regimes, especially in the context of substantial activities.

South Africa is an associate country to the OECD BEPS project. Thus, the requirement for “substantial activity” needs to be examined in South Africa, for instance, with respect to the country’s headquarter company regime. The important thing for South Africa is, however, to ensure it continues to balance its international obligations to prevent harmful tax competition, and also to ensure it preserves the competitiveness of the economy.

From the angle of preserving the competitiveness of the economy, the headquarter company regime has, however, not been very successful. South Africa has been reluctant to participate in international tax competition and this has hindered its ability to fully establish itself as the gateway to Africa. There are also other factors which might affect the decision of foreign investors when deciding whether to choose South Africa as a regional headquarter location, most notably exchange controls, labour law policy, availability of guaranteed power sources, and immigration requirements (specifically the obtaining of work permits).[18]

While South Africa should be concerned about preventing harmful tax competition, it should move cautiously to protect its competitiveness since many major countries

[16] OECD/G20 2015 Final Report on Action 5 at 53-54.
[17] OECD/G20 2015 Final Report on Action 5 at 64.
[18] PWC “Comment on DTC BEPS First Interim Report (30 March 2015) at 19.

are not willing to give up their special tax regimes, such as corporate rate reductions and patent boxes (identified in Action 5 as harmful), which are designed to attract investment so as to remain competitive. For example, the United Kingdom has reduced its corporate rate to 20% and is continuing a phased reduction.[19] South Africa must, thus, take care not to be a "first mover" in terms of the BEPS reform associated with harmful tax practices.

South Africa already has regimes that are designed to encourage investment into the country in the form of urban and industrial development zones, as well as the proposed special economic zones. It would appear, however, that these will fall within the categories of low risk "disadvantaged areas",[20] which are discussed in the Final Report on Action 5. Furthermore, these are physical investments rather than mobile activities which are the concern of the OECD Report.[21] Care should be taken to ensure that this remains the case and that the necessary disclosure is made to the FHTP and, if considered necessary, potentially, spontaneous exchange of information is made.

Thus, to the extent that certain tax preferences exist (with economic benefits outweighing the tax loss), these preferences should not be automatically repealed in the expectation that the OECD will follow up on them.

Of importance will be South Africa's continued transparency with regards to its laws and rulings.

The DTC makes the following recommendations for South Africa:

- It is important that South Africa balances its international obligations not to engage in harmful tax practices with the need to preserve the competiveness of the economy. More so, as the National Development Plan provides that South Africa should aspire to be a gateway for investment in Africa. There is potential for substantial job creation and tax revenue to the Government in the form of VAT and employees' tax from which South Africa would benefit, as long as it ensures that it complies with the OECD's substance requirements. The bottom line is that BEPS is both a risk and an opportunity for South Africa.
- From a tax perspective, consideration should be given to instituting a reduced corporate income tax rate for headquarter companies which meet minimum substance requirements. (It may, however, be necessary to align this rate for all companies in order for such rate not to be viewed as a harmful tax practice. However, this would need to be evaluated in terms of the DTC Reports as a whole).

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19 L Shepperd "What should the OECD do about Base Erosion?" Copenhagen precise of 2013 International Fiscal Association annual Congress" 9/9/2013.

20 OECD/G20 2015 Final Report on Action 5 at 65.

21 PWC "Comment on DTC BEPS First Interim Report "(30 March 2015) at 19.

This would make South Africa more attractive as a destination for regional headquarters. While this may result in the perception that there will be a notional cost related to corporate income tax foregone, the direct and indirect spin-offs of an increased number of such companies (that would otherwise go elsewhere) which would result in increased tax revenues, as well as from increased employment taxes, consumption taxes and profit taxes of suppliers should outweigh such perceived forgone taxes.

It is, however, important that any revised headquarter regime be bundled with a package of measures to address all of the impediments and externalities associated with the choice of South Africa as a location for regional headquarters, including with respect to exchange control (although there is relief for headquarter companies, better alignment with the tax regime is required), labour law policy, availability of power and immigration.[22]

- To ensure the headquarter regime is in line with Action 5, reforms to the provisions should be considered, that incorporate minimum levels of substance as required by the OECD, so that it does not slip into the area of a harmful tax practice. It is therefore important that South Africa considers revising its criteria of for headquarter companies in line with the OECD recommendations.

With respect to tax rulings in South Africa, Chapter 7 of the Tax Administration Act 28 of 2011 (TAA), sets out provisions dealing with “advance rulings”. Basically these categories of advance rulings allow taxpayers to obtain clarity and certainty on the Commissioner’s interpretation and application of the tax laws on proposed transactions. The OECD’s framework covers only spontaneous exchange of information on taxpayer specific rulings. In the South African context these would include binding private rulings.

- It is thus recommended that, in line with the OECD Recommendations on exchange of information regarding tax rulings, SARS notifies other tax authorities, on a timely and spontaneous basis, of the existence of a binding private ruling relating to the headquarter company regime, and any other regime that could be viewed as a harmful tax practice based on the filters provided, or where there is uncertainty, where SARS is aware that it affects residents in another country. This is especially so where such a ruling provides for a downward adjustment that would not be directly reflected in the company's financial accounts.
- It is further recommended that South Africa’s tax authorities ensure that they do not sanction tax rulings relating e.g. to the headquarter company regime that foster harmful practices and hamper transparency. This could cover secret rulings that enable taxpayers to get tax haven results even if the country may have a tax system with an acceptable tax rate.

[22] PWC “Comment on DTC BEPS First Interim Report" (30 March 2015) at 19.

- Although not currently available in South Africa, the DTC recommends that the resources be sought to put an APA option in place, for purposes of enhancing its transfer pricing regime (in particular to provide taxpayers with certainty- see DTC reports on Actions 8-10) and thus consideration needs to be given to the practices that would need to also be put in place so as not to contravene the harmful tax practices principles set out in the OECD Action 5 Report.
- The DTC furthermore recommends that SARS' capacity be increased to enable it to satisfy the requirements of the spontaneous exchange of information whenever this should be required in terms of the conclusions reached by the forum for harmful tax practices of the OECD.

The Action 5 Report calls for confidentiality of any information exchanged. It recommends that provisions must be in place in the receiving country to protect the confidentiality of the information that is exchanged.

- In the case of South Africa, Chapter 6 of the TAA provides detailed provisions relating to "confidentiality of information". These provisions must be applied to ensure confidentiality with respect to exchange of information on tax rulings in South Africa.
- South Africa and other African countries could consider extending the automatic exchange of information arrangements currently reached to ensure a level playing field amongst them. This could be facilitated through the Africa Tax Administration Forum.

DTC REPORT ON ACTION 5: COUNTER HARMFUL TAX PRACTICES MORE EFFECTIVELY, TAKING INTO ACCOUNT TRANSPARENCY AND SUBSTANCE

Table of Contents

1 INTRODUCTION

In 1998 the OECD issued a Report entitled *Harmful Tax Competition: An Emerging Global Issue.* This 1998 report is the foundation for the OECD's work in the area of harmful tax practices. The 1998 report was published in response to a request by Ministers of Finance of the 29 OECD member countries at the time (1996), to develop measures to counter harmful tax practices with respect to geographically mobile activities, such as financial and other service activities, including the provision of intangibles. This request was endorsed by the Ministers of Finance of the G7 countries, later in 1996.[1] The nature of these types of activities makes it very easy to shift them from one country to another. Globalisation and technological innovation have further enhanced that mobility. [2] The 1998 Report divided the work on harmful tax practices into the following areas:

(i) tax havens;

(ii) preferential tax regimes in OECD member countries, and in non-OECD economies.

The 1998 Report pointed out that tax haven jurisdictions and harmful preferential tax regimes distort financial and investment flows among countries.[3] Further that the harmful tax practices of both tax haven and harmful preferential tax regimes undermine the integrity and fairness of tax structures; they discourage compliance by all taxpayers; they cause undesirable shifts of part of the tax burden to less mobile tax bases such as labour, property and consumption; and they increase the administrative costs and compliance burdens on tax authorities and taxpayers respectively. In order to counter those harmful tax practices, the OECD came up with certain recommendations for countries to adopt in order to enhance the effectiveness of their domestic legislation in curbing harmful tax practices.[4]

1.1 CRITERIA FOR IDENTIFYING TAX-HAVEN JURISDICTIONS IN THE OECD 1998 REPORT

The OECD described a tax haven as a jurisdiction with no or nominal taxation, actively making itself available for the avoidance of tax that would have been paid in

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1 OECD Report on Harmful Tax Competition An Emerging Issue (1998) at 7.

2 OECD/G20 Base Erosion and Profit Shifting Project Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance: Action 5: 2014 Deliverable (2014) at 13 (OECD/G20 2014 Report on Action 5).

3 OECD "Harmful Tax Practices (1998) in par 75; Spitz & Clarke at OECD/3.

4 OECD 1998 Report at pages 67-71. See also AW Oguttu "A Critique on the OECD Campaign against Tax Havens: Has it been Successful? A South African Perspective" (2010) 21 No 1 *Stellenbosch Law Review* 176-177.

high-tax countries.[5] The OECD noted that tax-haven jurisdictions are characterised *inter alia* by:

- high levels of secrecy in the banking and commercial sectors.
- the lack of transparency and effective exchange of information with other governments concerning the benefits taxpayers receive from the tax haven.[6]

1.1.1 PROGRESS ON TAX HAVENS AFTER THE OECD 1998 REPORT

In June 2000, the OECD issued its first progress report,[7] after the 1998 Report on Harmful Tax Competition. With regards to tax havens, the June 2000 Report listed 35 jurisdictions found to have met the tax haven criteria (in addition to the 6 jurisdictions meeting the criteria that had made advance commitments to eliminate harmful tax practices). The listed jurisdictions were called upon to commit themselves to the principles of transparency and effective exchange of information or they would be regarded as uncooperative tax havens that presented a threat not only to the tax systems of developed and developing countries but also to the integrity of international financial systems.[8]

In 2001, the OECD issued another progress report entitled: "The OECD's Project on Harmful Tax Practices”. This report showed a shift from harmful tax competition in its 1998 report to harmful tax practices. The 2001 Progress Report also showed a shift in focus from preferential regimes to tax havens. With respect to tax havens, the OECD focussed on transparency and exchange of information as the criteria for defining an uncooperative tax haven. Thus, a jurisdiction would not be considered uncooperative if it committed to transparency and effective exchange of information.[9]

In 2002, Jurisdictions that made a commitment to reform[10] worked alongside the OECD in developing international standards of transparency and information exchange on tax matters under the direction of OECD’s “Global Forum on Taxation”.[11] The standards of transparency and exchange of information on tax matters that were formulated by the Global Forum require:

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5 OECD Issues in International Taxation No 1 *International Tax Avoidance and Evasion* (1987) at 20; A Ginsberg *International Tax Havens* 2 ed (1997) at 5-6; P Roper & J Ware *Offshore Pitfalls* (2000) at 5.

6 OECD 1998 OECD Report in para 79.

7 OECD: *Towards Global Tax Co-operation: Report of the 2000 Ministerial Council Meeting and Recommendations by the Committee on Fiscal Affairs: Progress in Identifying and Eliminating Harmful Tax Practices* (2000) in par 8. The list appears in para 11.

8 B Arnold & MJ McIntyre *International Tax Primer* 2 ed (2002) at 122-123.

9 M Herzfeld “News Analysis: Political Reality Catches Up With BEPS” Tax Analysts 3 February 2014.

10 OECD “Agreement on Exchange of Information on Tax Matters” para 2 of the Introduction.

11 OECD “Overview of the OECD’s Work on Countering International Tax Evasion” in para 9, available at http://www.ecovis.com/fileadmin/user_upload/international/news/global/oecd-releases-overview.pdf accessed 30 May 2013; OECD “Implementing the Tax Transparency Standards” at 9.

- Exchange of information on request where it is "foreseeably relevant" to the administration and enforcement of the domestic laws of a treaty partner;
- No restrictions on exchange of information because of banking secrecy or other domestic tax interest requirements;
- Respect for taxpayer rights;
- Strict confidential information exchange.

These standards are now embodied in the 2002 OECD "Model Agreement on Exchange of Information on Tax Matters" and its commentary, which serves as a basis for several "Tax Information Exchange Agreements" (commonly referred to as TIEAs) entered into between countries.[12] The standards are also embedded in article 26 of the OECD Model Tax Convention[13] and article 26 of the United Nations Model Double Taxation Convention.[14] Successive OECD Global Forum reports[15] show that a number of countries originally qualifying as 'tax-havens' made commitments to implement the OECD's standards of transparency and exchange of information for tax purposes. Some of these jurisdictions also signed exchange of information agreements with various OECD and non-OECD Member countries.[16]

The OECD is of the view that transparency and exchange of information among countries will be helpful in preventing harmful tax practices. In 2005 the Global Forum agreed on standards on transparency relating to availability and reliability of information. Since 2006, the Global Forum has published annual assessments of progress in implementing the standards. In September 2009, the Global Forum was renamed the Global Forum on Transparency and Exchange of Information for Tax Purposes, and was restructured to expand its membership and its mandate and to improve its governance.[17]

By May 2009 no countries remained on the Tax Haven list, since all had either implemented, or agreed to implement within a reasonable timeframe, the internationally agreed tax standard on exchange of information[18].

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12 OECD "The OECD's Project on Harmful Tax Practices: The 2004 Progress Report" in para 24 Available at http://www.oecd.org/dataoecd/60/33/30901115.pdf last accessed on 5 May 2014.

13 OECD Model Tax Convention on Income and on Capital 2010 Condensed Version.

14 United Nations "Model Tax Convention Between Developed and Developing Countries", 2011 Version.

15 OECD "Tax Co-operation Towards a Level Playing Field: 2007 Assessment by the Global Forum on Taxation". Available at www.oecd.org/document/29/0,3343,fr_2649_201185_39473821_1_1_1_1,00.html - 27k accessed 9 April 2014.

16 OECD "Overview of the OECD's Work on Countering International Tax Evasion" (21 April 2009). Available at >http://www.oecd.org/dataoecd/32/45/42356522.pdf<, last accessed 5 May2014.

17 OECD/G20 2014 Report on Action 5 at 18.

18 OECD "Countering Offshore Tax Evasion: Some Questions and Answers" (28 September 2009) at 12.

1.2 CRITERIA FOR IDENTIFYING PREFERENTIAL TAX REGIMES IN THE 1998 REPORT

The OECD 1998 Report on Harmful Tax Competition points out that, in contrast to tax havens, harmful preferential tax regimes, can occur in both tax-haven and high-tax jurisdictions. The framework under the 1998 Report for determining whether a regime is a harmful preferential regime involves three stages:

a) Consideration of whether a regime is preferential;
b) Consideration of the four key criteria/factors and eight other factors set out in the 1998 Report to determine whether a preferential regime is potentially harmful; and
c) Consideration of the economic effects of a regime to determine whether a potentially harmful regime is actually harmful. [19]

a) Consideration of whether a regime is preferential

To be within the scope of the 1998 Report, the regime must:

(i) Firstly, apply to income from geographically mobile activities, such as financial and other service activities, including the provision of intangibles. Preferential regimes designed to attract investment in plant, building and equipment are outside the scope of the 1998 Report.
(ii) Secondly, the regime must relate to the taxation of the relevant income from geographically mobile activities. Hence, the Report is mainly concerned with business taxation. Consumption taxes are explicitly excluded. [20]

Preferential tax treatment: In order for a regime to be considered preferential, it must offer some form of tax preference in comparison with the general principles of taxation in the relevant country. A preference offered by a regime may take a wide range of forms, including a reduction in the tax rate or tax base or preferential terms for the payment or repayment of taxes. Even a small amount of preference is sufficient for the regime to be considered preferential. The key point is that the regime must be preferential *in comparison with the general principles of taxation in the relevant country*, and not in comparison with principles applied in other countries.[21]

b) Consideration of the four key factors and eight other factors set out in the 1998 Report to determine whether a preferential regime is potentially harmful

In terms of the 1998 OECD Report, four factors are used to determine whether a preferential regime is potentially harmful are:

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[19] OECD/G20 Base Erosion and Profit Shifting Project Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance: Action 5: 2015 issued 5 October 2015 at p19 ('OECD/G20 2015 Final Report on Action 5').

[20] OECD/G20 2015 Final Report on Action 5 at 19.

[21] OECD/G20 2015 Final Report on Action 5 at 19-20.

(i) The regime imposes no or low effective tax rates on income from geographically mobile financial and other service activities.
(ii) The regime is ring-fenced from the domestic economy.[22]
(iii) The regime lacks transparency (for example, the details of the regime or its application are not apparent, or there is inadequate regulatory supervision or financial disclosure).
(iv) There is no effective exchange of information with respect to the regime.[23]

The eight other factors are:
(i) An artificial definition of the tax base.
(ii) Failure to adhere to international transfer pricing principles.
(iii) Foreign source income exempt from residence country taxation.
(iv) Negotiable tax rate or tax base.
(v) Existence of secrecy provisions.
(vi) Access to a wide network of tax treaties.
(vii) The regime is promoted as a tax minimisation vehicle.
(viii) The regime encourages operations or arrangements that are purely tax-driven and involve no substantial activities.[24]

In order for a regime to be considered potentially harmful, in terms of the 1998 Report, the first key factor, "no or low effective tax rate", must apply. This is a gateway criterion. Where a regime meets the no or low effective tax rate factor, an evaluation of whether that regime is potentially harmful should be based on an overall assessment of each of the other three 'key factors' and, where relevant, the other eight 'other factors'. Where low or zero effective taxation and one or more of the remaining factors apply, a regime will be characterised as potentially harmful.[25]

c) Consideration of the economic effects of a regime to determine whether a potentially harmful regime is actually harmful

A regime that is identified as being potentially harmful based on the above factor analysis may be considered not to be actually harmful if it does not appear to have created harmful economic effects. The following three questions can be helpful in making this assessment:

- Does the tax regime shift activity from one country to the country providing the preferential tax regime, rather than generate significant new activity?
- Is the presence and level of activities in the host country commensurate with the amount of investment or income?

22 The term "ring-fencing" refers to the artificial demarcation or limitation of profits or losses for tax purposes, ignoring the corporate form of the taxable or restricting the application of particular provisions to transactions inside the ring fence. See L Olivier & M Honiball *International Tax: A South African Perspective* 4 ed (2011) at 849.
23 OECD/G20 2015 Final Report on Action 5 at 20.
24 OECD/G20 2015 Final Report on Action 5 at 20.
25 OECD/G20 2015 Final Report on Action 5 at 21.

- Is the preferential regime the primary motivation for the location of an activity?[26]

Following consideration of its economic effects, a regime that created harmful effects would be categorised as a harmful preferential regime. The 1998 Report recommended that where a preferential regime is found to be actually harmful, the relevant country should be given the opportunity to abolish the regime or remove the features that create the harmful effect. Other countries may take defensive measures to counter the effects of the harmful regime, while at the same time continuing to encourage the country applying the regime to modify or remove it.[27]

1.3 COMMENTS ON THE OECD WORK ON TAX HAVENS AND PREFERENCE TAX REGIMES AFTER THE 1998 REPORT

Although the OECD's 1998 initiative was successful in promoting a programme of transparency and exchange of information by tax haven jurisdictions, it generally failed to accomplish what it set out to do, which is addressing harmful tax competition.[28] The OECD's initiative did not lead to the elimination of harmful preferential tax regimes and many of the OECD member countries have since enacted such regimes, especially with regard to mobile income.[29]

2 OECD 2013 BEPS REPORT: ACTION 5

In the 2013, the OECD issued a Report on Base Erosion and Profits Shifting (BEPS). Its Action 5, which deals with countering Harmful Tax Practices, reiterated the concerns expressed in the 1998 Harmful Tax Competition Report recognising that a "race to the bottom" would ultimately drive applicable tax rates on certain mobile sources of income to zero for all countries, whether or not this was the tax policy a country wished to pursue.[30] The OECD 2013 BEPS Report on Action 5 notes that the underlying policy concerns expressed in the 1998 Report as regards the "race to the bottom" on the mobile income tax base are as relevant today as they were 15 years ago, when the 1998 report on harmful tax completion was issued. However, the "race to the bottom" nowadays often takes less of the form of traditional ring fencing and now entails:

- artificial demarcations or limitation of profits or losses for tax purposes;
- ignoring the corporate form of the taxable entities;
- restricting the application of particular provisions to transactions inside the ring fence;

26 OECD/G20 2015 Final Report on Action 5 at 21.
27 OECD/G20 2015 Final Report on Action 5 at 21.
28 M Herzfeld "News Analysis: Political Reality Catches Up With BEPS" Tax Analysts 3 February 2014.
29 Ibid.
30 OECD/G20 2015 Final Report on Action 5 at 23.

- across the board corporate tax rate reductions on particular types of income (such as income from financial activities or from the provision of intangibles).

To counter these harmful tax practices, the OECD 2013 Action 5 recommended that

- National Countries should 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.

On the International Front:

- OECD planned to take a holistic approach to evaluate preferential tax regimes in the BEPS context.
- OECD Planned to engage with non-OECD members on the basis of the existing framework and consider revisions or additions to the existing framework.

It should be noted that work under Action 5 focuses on preferential tax regimes and on defensive measures in respect of such regimes (other than any such measures related to a lack of exchange of information or transparency). In Action 5, the OECD is reviving its attack on harmful tax competition that it dropped over a decade ago. However, the OECD's failed attempt, over a decade ago, to shame countries into adopting changes to local law that would require a significant rethinking of substantive tax rules causes one to have tempered expectations for the BEPS initiative.[31]

3 OECD 2015 REPORT ON ACTION 5

Following its 2013 BEPS Report, in September 2014 the OECD issued its findings on Action 5, and in October 2015 the Final Report was issued. The 2015 Final Report observes that combating harmful tax practices is an interest common to OECD and non-OECD member countries alike. However there are obvious limitations to the effectiveness of unilateral actions against such practices. Thus the need for countries to agree on a set of common criteria to promote a co-operative framework that supports the effective fiscal sovereignty of countries over the design of their tax systems; and to enhance the ability of countries to react against the harmful tax practices of others.

The OECD notes that its work on harmful tax practices is not intended to promote the harmonisation of income taxes or tax structures generally within or outside the OECD, nor is it about dictating to any country what should be the appropriate level of tax rates. Rather, the work is about reducing the distortionary influence of taxation on

31 M Herzfeld "News Analysis: Political Reality Catches Up With BEPS" Tax Analysts 3 February 2014.

the location of mobile financial and service activities, thereby encouraging an environment in which free and fair tax competition can take place. This is essential in moving towards a "level playing field" and a continued expansion of global economic growth.[32]

In response to Action 5 which recommends that National Countries should revamp the work on harmful tax practices, the OECD has placed priority on:

- Requiring substantial activity for any preferential regime.
- Improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes,

In addition to the above matters relating to revamping work on harmful tax practices:

- OECD planned to take a holistic approach to evaluate preferential tax regimes in the BEPS context. The OECD also planned to engage with non-OECD members on the basis of the existing framework and consider revisions or additions to the existing framework.

The recommendations of the OECD on each of these matters in its Final 2015 Report on Action 5 are set out below.

3.1 REQUIRING "SUBSTANTIAL ACTIVITY" FOR ANY PREFERENTIAL REGIME

As noted in the analysis of the criteria for identifying preferential tax regimes in the 1998 Report, a reference to "substantial activity" is already included in the eight others factors for determining whether a regime is potentially harmful. So this is not a new concept. However the 1998 Report contains limited guidance on how to apply this factor. The substantial activity factor has been elevated in importance under Action 5, in that it has to be considered along with the first four key factors when determining whether a preferential regime is potentially harmful. [33]

This factor requires substantial activity for any preferential regime. This requirement contributes to the second pillar of the Base Erosion and Profit Shifting (BEPS) project, which is to align taxation with substance by ensuring that taxable profits can no longer be artificially shifted away from the countries where value is created. This factor looks at whether a regime "encourages purely tax-driven operations or arrangements" and states that "many harmful preferential tax regimes are designed in a way that allows taxpayers to derive benefits from the regime while engaging in operations that are purely tax-driven and involve no substantial activities". [34]

[32] OECD/G20 2015 Final Report on Action 5 at 11-12.
[33] OECD/G20 2015 Final Report on Action 5 at 23.
[34] OECD/G20 2015 Final Report on Action 5 at 23.

The OECD's work on substantial activity has focused in the first instance on regimes which provide a preferential tax treatment for certain income arising from qualifying Intellectual Property ("intangible regimes" or "IP regimes"). Thus all intangible regimes in OECD member countries are being reviewed. Under Action 5, the substantial activity requirement also applies to all preferential other than IP regimes. [35]

3.1.1 SUBSTANTIAL ACTIVITY REQUIREMENT IN THE CONTEXT OF IP REGIMES

The OECD recognises that IP-intensive industries are a key driver of growth and employment and that countries are free to provide tax incentives for Research and Development (R&D) activities, provided that they are granted according to the principles agreed by the OECD. [36]

Three potential approaches were explored by the Forum for Harmful Tax Practices (FHTP) division of the OECD, but little support was given by countries to the first two-the value creation approach and the transfer pricing approach. Countries, however, supported the use of the third, "nexus approach", to require substantial activities in an IP regime. This approach was furthermore endorsed by the G20. This approach looks to whether an IP regime makes its benefits conditional on the extent of R&D activities of taxpayers receiving benefits. The approach seeks to build on the basic principle underlying R&D credits and similar "front-end" tax regimes that apply to expenditures incurred in the creation of IP.

The nexus approach extends this principle to apply to "back-end" tax regimes, that apply to the income earned after the creation and exploitation of the IP. In essence then the nexus approach allows a regime to provide for a preferential rate on IP-related income to the extent it was generated by qualifying expenditures. This is achieved by applying a formula to ensure that only qualifying expenditures relating to income from an IP asset will result in defining the income receiving tax benefits. Where the amount of income receiving benefits under an IP regime does not exceed the amount determined by the nexus approach, the regime has met the substantial activities requirement. [37]

IP regimes are generally designed to encourage research and development (R+D) activities and contribute to growth and employment, thus the principle underlying the substantial activity requirement, in this context, is to only permit taxpayers that engaged in such activities, and incurred expenditure thereon, to benefit from the regimes.[38]

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35 OECD/G20 2015 Final Report on Action 5 at 23-24.
36 OECD/G20 2015 Final Report on Action 5 at 24.
37 OECD/G20 2015 Final Report on Action 5 at 25.
38 OECD/G20 2015 Final Report on Action 5 at 37.

The Final Report thus sets out a formula for determining the "nexus ratio" for IP assets. The formula multiplies overall income from the IP asset by the ratio of qualifying expenditures incurred to develop the IP asset to the overall expenditures to develop it[39].

In applying the formula it is necessary to determine who the "qualifying taxpayer" is, and what the "qualifying" and "overall expenditures" are. Qualifying taxpayers include resident companies, domestic permanent establishments ("PE's") of foreign companies that are subject to tax in the jurisdiction providing benefits. However, the expenditure incurred by a PE cannot qualify income earned by the head office as qualifying income if the PE did not exist at the time the income was earned.[40]

The only IP assets which, under the "nexus approach", would qualify for tax benefits under an IP regime would be patents (in a broad sense) and other IP assets that are functionally equivalent to patents and are legally protected (subject to similar approval and registration processes). Examples are copyrighted software.[41] Market-related IP assets like trademarks can never qualify under the IP regime.[42]

The FHTP indicates that only taxpayers with less than EUR 50mn in global group wide turnover, and that do not themselves earn more than EUR 7.5mn per year (or the nearest equivalent in local currency) in gross revenues, from all IP assets may qualify for the IP tax benefits.[43]

Other IP assets that are non-obvious, useful and novel may also qualify but jurisdictions that provide benefits to this category must advise the FHTP, with details thereof and the taxpayers concerned and volunteer such information, under the exchange of information framework set out in the Action. Such assets are to be evaluated by the FHTP and reported on by 2020.[44]

"Qualifying expenditures" relate to expenditure incurred by the qualifying taxpayer directly in connection with the IP asset (and would apply in the year they are incurred). They would not, however, include interest payments, building costs or acquisition costs. The FHTP indicates an approved uplift of 30% for qualifying expenditures in terms of domestic tax rules.[45]

The "overall expenditure" definition is designed to ensure that if the taxpayer incurred all the relevant expenses itself, it would qualify for a 100% of the income from the IP

39 OECD/G20 2015 Final Report on Action 5 at 25.
40 OECD/G20 2015 Final Report on Action 5 at 25.
41 OECD/G20 2015 Final Report on Action 5 at 26.
42 OECD/G20 2015 Final Report on Action 5 at 27.
43 OECD/G20 2015 Final Report on Action 5 at 26.
44 OECD/G20 2015 Final Report on Action 5 at 26-27.
45 OECD/G20 2015 Final Report on Action 5 at 27.

asset to benefit from the preferential regime. Thus, only expenditure that is the type that would qualify as qualifying expenditure may fall into the definition of overall expenditure (e.g. it would exclude interest etc.). However, it adds related party outsourcing and acquisition costs to the overall expenditure definition.[46]

Finally, “overall income” must be defined in terms of the domestic rules of the country after applying transfer pricing rules, but requiring that IP expenditures allocable to IP income and incurred in the year must be subtracted from gross IP income earned in the year. IP income would include royalties, capital gains and other income from the sale of an IP asset, and may include embedded income from the sale of products or use of processes directly related to the IP asset, provided this is clearly defined.[47]

As can be seen from the formula set out, for a significant portion of the IP income to qualify from a preferential regime, a significant portion of the actual IP activities must have been undertaken by the qualifying taxpayer itself, or unrelated parties (based on the nature of IP development the FHTP views the risk of the outsourcing of significant portions to unrelated parties as being small).[48]

As indicated above, where IP is acquired the FHTP considers that only costs incurred, after acquisition, for the purposes of improving the IP, should qualify as qualifying expenditure, and not the acquisition costs themselves. Acquisition costs would fall into overall expenditures.[49]

In order to determine the relevant components of the formula, the FHTP indicates that taxpayers would need to track income and expenditure per IP asset or on a particular product on an aggregated basis (the “product-based approach”).[50]

Implementation of the regime is advised by the FHTP such that no new entrants will be permitted to enter into an existing regime not consistent with the nexus approach after 30 June 2016. Existing regimes are to be phased out by 30 June 2012.[51]

3.1.2 SUBSTANTIAL ACTIVITY REQUIREMENT IN THE CONTEXT OF NON-IP REGIMES

Action 5 requires the substantial activity regime not only for IP regimes, but for all preferential regimes. As with IP regimes, the objective is to ensure that jurisdictions only permit taxpayers to benefit from a preferential regime that fulfils the objectives

46 OECD/G20 2015 Final Report on Action 5 at 28.
47 OECD/G20 2015 Final Report on Action 5 at 29.
48 OECD/G20 2015 Final Report on Action 5 at 30.
49 OECD/G20 2015 Final Report on Action 5 at 30.
50 OECD/G20 2015 Final Report on Action 5 at 31.
51 OECD/G20 2015 Final Report on Action 5 at 35.

of growth and employment in the relevant jurisdiction. Thus, the substantial activities requirement is only satisfied if the benefits are only granted to taxpayers that undertake core income generating activities that produce the type of business income covered by the preferential regime.[52]

The determination of what constitutes core activities necessary to earn income depends on the type of regime, and the Final Report on Action 5 sets out some preferential regimes for guidance.

Headquarter regimes grant preference to taxpayers that provide e.g. managing, co-ordinating and controlling business activities for a group or those companies in a particular geographic are. The core income- generating activities could include key activities giving rise to specific types of service income.[53]

Distribution and service centre regimes provide purchase and re-sell services from/to other group companies with a small percentage profit. Their core income generating activities could include transporting and storage of goods; managing stocks and taking orders; and providing consulting or other administrative services.[54]

Financing and leasing regimes provide preferential treatment that raise concerns regarding ring-fencing and artificial definition of the tax base. The core income-generating activities could include agreeing funding terms. Identifying and acquiring assets to the lease, monitoring and revising any agreements and managing risks.[55]

Fund management regimes grant preferential regimes to income earned by fund managers for management of funds. The concerns lie with transparency, which can be partly dealt with through compulsory spontaneous exchange of rulings. The substantial activity to the income- generating activities of a fund manager could include taking decisions on holding or selling investments; calculating risks and reserves; taking decisions on currency and interest fluctuations and hedging positions; and preparing relevant regulatory or other reports for government authorities and investors.[56]

Banking and insurance regimes raise concerns regarding the benefits that are provided to income from foreign activities. Substance should already be regulated by the regulatory environment ensuring that the business is capable of bearing risks and undertaking activities. Insurance, however, does not necessarily have these safeguards, due to the ability to reinsure. The core income-generating activities for banking depend on the type of banking undertaken, but could include raising of

52 OECD/G20 2015 Final Report on Action 5 at 37.
53 OECD/G20 2015 Final Report on Action 5 at 37.
54 OECD/G20 2015 Final Report on Action 5 at 38.
55 OECD/G20 2015 Final Report on Action 5 at 38.
56 OECD/G20 2015 Final Report on Action 5 at 38.

funds; managing risk, including credit, interest and currency risk, taking hedging positions and other financial services to customers; managing regulatory capital and preparing regulatory reports and returns. For insurance companies: predicting and calculating risk, insuring or re-insuring against risk and providing client services.[57]

Shipping regimes raise concerns where they permit the separation of shipping income from the core activities that generate it. The core income-generating activities include managing the crew, hauling and maintaining the ships, overseeing and tracking deliveries and organising and overseeing voyages.[58]

Holding company regimes comprise those that hold a variety of assets and thus earn different types of income (e.g. interest, rents and royalties) and those that apply only to equity holding companies earning only dividends and capital gains. In the former case the substantial activity requirement looks to the activities that generate the relevant type of income. In the latter case, where little activity is required, concerns revolve around transparency and beneficial ownership, treaty shopping and whether ring-fencing should apply. These concerns are addressed under other BEPS actions through exchange of information; prevention of treaty abuse (Action 6); Neutralising hybrid arrangements (Action 2); Controlled foreign companies (Action 3); Ring fencing. The substantial activity requirement would also require that these companies have sufficient activity to manage their investments and satisfy local regulatory requirements (people and premises) that should avoid letter box and brass plate companies from benefiting from these regimes.[59]

3.2 REVAMP OF THE WORK ON HARMFUL TAX PRACTICES: FRAMEWORK FOR IMPROVING TRANSPARENCY IN RELATION TO RULINGS

The second priority under Action 5 for revamping the work on harmful tax practices is to improve transparency, including compulsory spontaneous exchange of information on certain rulings. Seen in the wider context of the work on BEPS, this requirement contributes to the third pillar of the BEPS project, which is to ensure transparency while promoting increased certainty and predictability.[60] The Final Report on Action 5 deals with this in three steps:[61]

- (i) Develop a framework for compulsory spontaneous information exchange.
- (ii) Consideration of whether transparency with regards to rulings (for preferential regimes and other matters) can be improved in relation to the rulings regimes in the associated countries – this concluded that the requirement to undertake compulsory spontaneous information exchange

57 OECD/G20 2015 Final Report on Action 5 at 39.
58 OECD/G20 2015 Final Report on Action 5 at 39.
59 OECD/G20 2015 Final Report on Action 5 at 39-40.
60 OECD/G20 2015 Final Report on Action 5 at 45.
61 OECD/G20 2015 Final Report on Action 5 at 45-46.

should generally cover all instances in which the absence of exchange of a ruling may give rise to BEPS concerns, thus taking away the need for a jurisdiction to determine if a particular regime is preferential.(This step recognises the work already done in the context of transfer pricing in Action 13, which requires that APA's and advance tax rulings be disclosed in the master and local files).

(iii) Develop general best practice framework for design and operation of rulings regimes.

The OECD combines the first two steps and sets out six categories of taxpayer specific-rulings which, in the absence of compulsory spontaneous exchange of information could give rise to BEPS concerns

(i) rulings relating to preferential regimes;
(ii) unilateral APA's or other cross border unilateral rulings in respect of transfer pricing;
(iii) cross border rulings providing for a downward adjustment of taxable profits;
(iv) permanent establishment (PE) rulings;
(v) related party conduit rulings;
(vi) any other type of ruling agreed by the OECD that in the absence of spontaneous exchange of information gives rise to BEPS concerns.[62]

In this context the OECD focuses on specific instances where the absence of exchanges can give rise to BEPS concerns rather than suggesting that in all instances the country providing the ruling operates a preferential regime.[63]

Extensive guidance on transparency with respect to rulings is set out in the OECD, 2004 Report entitled "Consolidated Application Note: Guidance in Applying the 1998 Report to Preferential Tax Regimes" (CAN Report), which makes it clear that transparency is often relevant in connection with rulings, including unilateral Advance Pricing Agreements (APAs)[64] and certain administrative practices.[65]

The purpose of this disclosure is to ensure that countries have the necessary information to identify BEPS risk areas, without imposing an unduly high administrative burden on the disclosing country.

The Final Report on Action 5 addresses:

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62 OECD/G20 2015 Final Report on Action 5 at 46.

63 OECD/G20 2015 Final Report on Action 5 at 45.

64 An APA is a binding written contract between a taxpayer and the revenue authority. In an APA the parties agree on the best transfer-pricing method for determining the arm's length price. See AW Oguttu "Resolving Transfer Pricing Disputes: Are Advance Pricing Agreements the Way Forward for South Africa?" (2006) 18 *SA Mercantile Law Journal* 460-485; C Rolfe & A Casley 'Towards Reconciliation in Transfer Pricing' (1996) *Corporate Finance* 37.

65 OECD/G20 2015 Final Report on Action 5 at 46.

(i) Which rulings are covered?
(ii) Which countries information needs to be exchanged with;
(iii) Application of the framework to past and future rulings;
(iv) Information subject to the exchange;
(v) Practical implementation issues;
(vi) Reciprocal approach to exchange of information (EOI);
(vii) Confidentiality of information exchanged;
(viii) Recommendations of best practices in respect of rulings.[66]

Addressing these individually:

(i) <u>Which rulings are covered</u>:

Rulings are defined as "any advice, information or undertaking provided by a tax authority to a specific group of taxpayers concerning their tax situation and on which they are entitled to rely".[67] Rulings are generally specific to a set of facts and the framework is designed only to apply to *taxpayer- specific rulings* i.e. that only the specific taxpayer may rely on. It does not include agreements reached as a consequence of tax audits conducted after the filing of the tax return.[68]

- *Advanced tax rulings* provide the determination of the tax consequences of a proposed transaction that has not yet taken place.
- *Advanced pricing agreements* refer to agreements for the determination of the pricing of goods or services for transfer pricing purposes over a fixed period of time. Automatic exchange of information on APA's is required, not necessarily because they are preferential, but because in the absence of transparency they can create distortions and mismatches that give rise to BEPS concerns. Furthermore, due to materiality required in transfer pricing documentation (set out in Action 13), not all APA's will be reflected in the Master File or Local File.[69]
- *General rulings* apply to groups or types of taxpayers in relation to a specified set of circumstances. These are excluded from the framework but the best practises nevertheless apply.
- For *taxpayer specific rulings* Action 5 states that the FHTP has already agreed to a framework, described in the 2014 Progress Report on Harmful Tax Practices, for the compulsory exchange of information on rulings related to preferential regimes, and which sets out the filter approach to determine when there will be an obligation for spontaneous exchange of information.[70]

The filter approach seeks to reduce the level of discretion that would otherwise have to be used by a tax administration to make the determination of when a ruling needs

[66] OECD/G20 2015 Final Report on Action 5 at 47.
[67] OECD/G20 2015 Final Report on Action 5 at 47.
[68] OECD/G20 2015 Final Report on Action 5 at 47.
[69] OECD/G20 2015 Final Report on Action 5 at 49-50.
[70] OECD/G20 2015 Final Report on Action 5 at 48.

to be exchanged, and instead uses more mechanical filters. The first three filters limit the obligation to spontaneously exchange information to rulings related to

a) A preferential regime itself or certain aspects of it, and more broadly, rulings that concern matters that have an impact on the application of a preferential regime.
b) Regimes that firstly, relate to income from geographically mobile activities, such as financial and other service activities, including the provision of intangibles; and secondly regimes that relate to the taxation of the relevant income from geographically mobile activities
c) regimes that meet the no or low effective tax rate because the tax rate itself is very low or because of the way in which a country defines the tax base to which the rate is applied

If a ruling passes all of these three filters, additional filters apply to further target the obligation to spontaneously exchange information on rulings that are likely to be relevant to other jurisdictions. Under the filter approach, as contemplated, only a ruling that passes through all of the filters will be subject to compulsory spontaneous information exchange.[71]

The additional filters referred to are:

- *Is there a taxpayer-specific ruling related to a regime that meets the first three filters?*[72]
- *Is the taxpayer-specific ruling a ruling in the area of transfer pricing or another ruling?*[73]
- *For transfer pricing rulings – Is the ruling a unilateral transfer pricing ruling or a bilateral or multilateral APA?*
- *For rulings other than transfer pricing rulings – Does the ruling cover (i) inbound investment into the country in which the taxpayer has obtained the ruling, (ii) outbound investment from that country or (iii) transactions or a situation involving other countries?*[74]

For rulings other than transfer pricing rulings, a further filter is considered necessary to make sure that the information exchanged is relevant and that the obligation to spontaneously exchange information on rulings does not impose an unnecessary administrative burden on either the country exchanging the information or the country receiving it.

The Final Report on Action 5, however, makes it clear that the obligation to simultaneously exchange information arises for cross border taxpayer specific rulings that are (i) in the scope of the work of the FHTP; (ii) are preferential; (iii) meet

[71] OECD/G20 2014 Report on Action 5 at 39-40.
[72] OECD/G20 2014 Report on Action 5 at 41.
[73] OECD/G20 2014 Report on Action 5 at 43.
[74] OECD/G20 2014 Report on Action 5 at 44.

the low or no effective tax rate factor. Thus, any such preferential regimes that will apply need not have been reviewed or identified by the FHTP, but will need to be determined by the country concerned, and in that case, or in the case of doubt, the information spontaneously exchanged immediately. Thereafter the regime can be referred to the FHTP for review.[75]

Cross border unilateral APA's and any other cross border unilateral tax rulings (such as ATRs) covering transfer pricing or the application of transfer pricing principles. Unilateral APAs are APAs established between a tax administration of one country and a taxpayer of another. Other cross border unilateral tax rulings covering transfer pricing or the application of transfer pricing principles cover, for example, ATRs on transfer pricing issues that fall short of an APA, for instance because the ruling is limited to addressing questions of a legal nature based on facts presented by the taxpayer (as against an APA, which deals with factual issues) or is binding for a specific transaction (unlike APA's which often deal with several transactions).[76]

Transparency is required for unilateral APAs and other unilateral tax rulings not because they are preferential, but because in the absence of transparency they can create distortions and mismatches that give rise to BEPS concerns and either directly or indirectly impact the tax position in another country. Furthermore, due to materiality required in transfer pricing documentation (set out in Action 13), not all APA's will be reflected in the Master File or Local File. In addition, the combined disclosure of rulings and Action 13 documentation permits tax authorities to cross-check information reported by taxpayers. [77]

Cross border rulings providing for a unilateral downward adjustment to a taxpayer's taxable profits that is not directly reflected in the taxpayers financial/ commercial accounts include, for example informal capital or similar rulings, and potentially provide the incentive to shift profits. Such rulings tend to recognise the contribution of capital or an asset by a related party and e.g. deem there to be an interest deduction, which reduces the company's taxable profits to reflect an arm's length position without a corresponding inclusion in the related party's hands. Thus, this information is required by the corresponding tax authority.[78]

Information concerning *Permanent establishment (PE) rulings concerning the attribution of profits to be attributed to a PE* requires exchange with the head office country.[79]

[75] OECD/G20 2015 Final Report on Action 5 at 49.
[76] OECD/G20 2015 Final Report on Action 5 at 49.
[77] OECD/G20 2015 Final Report on Action 5 at 49-50.
[78] OECD/G20 2015 Final Report on Action 5 at 51.
[79] OECD/G20 2015 Final Report on Action 5 at 51.

Related party conduit rulings include rulings covering arrangements involving cross border flows of funds or income through an entity in the country giving the ruling, where the funds or income flow to another country directly or indirectly. The effect is often a deduction in one jurisdiction without a corresponding income in the other.[80]

Finally, the reference to *any other types of rulings that in the absence of spontaneous information exchange gives rise to BEPS concerns* leaves the FHTP the ability to add additional types of rulings under this heading.[81]

(ii) Which countries information needs to be exchanged with: This requires that exchange of information on rulings for the six categories need to take place with:

a) The country of residence if all related parties with which a taxpayer enters into a transaction for which a ruling is granted or gives rise to income as a consequence (The related party threshold is set at 25%, but the FHTP will keep this under review);
b) The residence country of the ultimate parent company and immediate parent company (or head office for a PE as well; for conduits thee country of the paying entity and the beneficial owner are also added).[82]

(iii) Application of the framework to past and future rulings: The obligation to spontaneously exchange applies not only to future rulings but also to past rulings i.e. those issued after 1 January 2010 and still in effect from 1 January 2014 must be exchanged. Thus, countries will need to be able to identify immediate and ultimate parent companies as well as related parties to a transaction. Where such information is not readily available countries are expected to use their "best efforts" to use whatever information they can find without contacting the taxpayer. For future rulings i.e. after 1 April 2016 countries are expected to ensure they have the relevant information required, on hand.[83]

(iv) Information subject to the exchange: The FHTP recognises the need to balance greater transparency with the need to ensure that too great an administrative burden is not placed on tax administrations. Thus a two-step approach was developed. Firstly, a summary and basic information on the ruling is required (a template is provided which enables tax administrations to determine whether the ruling is covered by the framework and with which country it should be exchanged). The recipient tax administration can then determine whether to ask for more detail of the ruling, as the second step.[84]

80 OECD/G20 2015 Final Report on Action 5 at 51.
81 OECD/G20 2015 Final Report on Action 5 at 52.
82 OECD/G20 2015 Final Report on Action 5 at 52.
83 OECD/G20 2015 Final Report on Action 5 at 53-54.
84 OECD/G20 2015 Final Report on Action 5 at 54.

(v) Practical implementation issues: It was originally anticipated (in the 2014 Interim Report on Action 5) that the framework would apply following the FHTP's 2014 autumn meeting. However, this had not (by October 2015) begun, due to the fact that the increase in the categories had substantially increased the volume of rulings that need to be exchanged. This, thus, required more consideration for past rulings (the three month requirement for future rulings remains, subject to any legal impediment that may cause delay). As a consequence, the time period for exchange of past rulings has been extended to the end of 2016. [85]

(vi) Reciprocal approach to EOI: A country that has issued a ruling that is subject to obligation of spontaneous exchange of information may not use the excuse of lack of reciprocity as an argument for not exchanging that information with a country that does not grant, and therefore cannot exchange, rulings that are subject to such an obligation.[86]

(vii) Confidentiality of information exchanged: Both the country exchanging information and its taxpayers have a legal right to expect that information exchanged pursuant to the framework remains confidential. The receiving country must therefore have the legal framework necessary to protect information exchanged.

All treaties and exchange of information instruments contain provisions regarding tax confidentiality and the obligation to keep information exchanged confidential. Under these provisions information may only be used for specified purposes disclosed to specified persons. Information exchange partners may suspend or limit the scope of information exchange if appropriate safeguards for confidentiality are not put in place, or there has been a breach that has not adequately been resolved.

Domestic laws must be in place in the receiving country to protect confidentiality of tax information, including information exchanged. Effective penalties must apply for unauthorised disclosures of confidential information exchanged. Information exchanged pursuant to this framework may be used only for tax purposes or other purposes permitted by the relevant information exchange instrument. If domestic law allows for a broader use of the information than the applicable information exchange instrument, it is expected that international provisions and instruments will prevail over provisions of domestic law. [87]

(xiii) Recommendations of best practices in respect of rulings: The Final Report to Action 5 sets out a set of best practices pertaining to"

a) the process for granting a ruling (i.e. official rules and administrative practices for rulings should be identified in advance and published; they should be retained within the limits of the domestic tax laws; they should

[85] OECD/G20 2015 Final Report on Action 5 at 54-55.
[86] OECD/G20 2015 Final Report on Action 5 at 55.
[87] OECD/G20 2015 Final Report on Action 5 at 55-56.

respect tax treaties; they should be in writing and only issued by a competent government office or approved thereby under a prescribed procedure; they should be binding on the tax authority; be applied for an issued in writing, based on facts agreed with the taxpayer, with relevant reference numbers and details of the taxpayer).

b) the terms of the ruling and audit /checking procedure (i.e. APAs should be for a limited time period, but subject to review or extension; taxpayers should be obliged to notify of any changes in facts; procedures should be in place to periodically verify the facts and assumptions; and if facts change the ruling should be subject to revocation)

c) publication and exchange of information (i.e. general rulings should be published timeously and specific rulings should be exchanged with the relevant tax authority within the framework for compulsory spontaneous exchange of information).

These practices are designed to reinforce the transparency advancements made in the OECD Framework for compulsory spontaneous exchange of information on rulings and relate to specific and general rulings. [88]

3.3 REVIEW OF OECD AND ASSOCIATE COUNTRY REGIMES

The OECD's review of its member country regimes commenced in late 2010 with the preparation of a preliminary survey of preferential tax regimes in member countries, based on publicly available information and without any judgment as to the potential harmfulness of any of the regimes included. Further regimes were subsequently added to the review process based on member countries' self-referrals and referrals by other member countries. [89]

As all the intangible regimes of member countries were considered together, they were being considered not only in light of the factors as previously applied but also in light of the elaborated substantial activity factor. As intangible regimes are just a subset of preferential regimes, the OECD also needed to discuss and subsequently apply the substantial activity requirement to other preferential regimes; this included preferential regimes already reviewed provided that they were still in force and not abolished. [90]

By the time of the issue of the Final Report on Action 5, forty three (43) preferential regimes had been reviewed. A list of these is provided and reflects, for South Africa, the headquarter company regime, but it notes that this is considered to be potentially

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88 OECD/G20 2015 Final Report on Action 5 at 56-58.
89 OECD/G20 2015 Final Report on Action 5 at 61.
90 OECD/G20 2015 Final Report on Action 5 at 61.

harmful but not actually harmful; and the exemption of income for ships used in international shipping, which is indicated as being not harmful.[91]

The FHTP will carry out further work on these regimes, particularly in the context of the substantial activities, which have now been more clearly determined in the context of non-IP regimes.

The Final Report on Action 5 also makes clear the position where disadvantaged areas have preferential regimes to stimulate the economy there, and indicates that these are not considered to pose a high risk to BEPS provided that:

- The preferential tax treatment is only applicable to a small area (in terms of surface or population) selected for low level structural, economic and social development in the region relative to the country as a whole;
- The regime is mainly designed to create new jobs and attract tangible investments;
- An entity has to meet certain substance requirements to qualify for the regime;
- The country must retain relevant data relating to beneficiaries of the regime.[92]

3.4 FURTHER WORK OF THE FHTP

The Final Report defines what the next steps in the work of the FHTP, being (i) ongoing work, including the monitoring of preferential regimes and the application of the agreed transparency framework, (ii) further development of a strategy to expand participation to third countries, and (iii) considerations of revisions or additions to the existing FHTP criteria.[93]

Under the last step reference is made to the need to look at identifying harmful tax regimes that have “an artificial definition of the tax base” (i.e. where the tax base is narrowed so as to reduce the tax on income (e.g. by exempting income) rather than offering a low tax rate), and the application of the ring-fencing factor i.e. where a regime excludes residents from qualifying for the benefits, or a beneficiary of the regime may not operate in the domestic market.[94]

4 ADDRESSING ACTION 5 IN SOUTH AFRICA

As noted above, OECD Action 5 requires countries to revamp the work on harmful tax practices with a priority on:

- Requiring substantial activity for any preferential regime.
- Improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes,

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91 OECD/G20 2015 Final Report on Action 5 at 64.
92 OECD/G20 2015 Final Report on Action 5 at 65.
93 OECD/G20 2015 Final Report on Action 5 at 67.
94 OECD/G20 2015 Final Report on Action 5 at 68-69.

- An evaluation of preferential tax regimes in OECD members and in associate counties.

These factors are considered below from a South African perspective. It should be noted that South Africa is an associate country to the OECD BEPS project.

4.1 REQUIRING SUBSTANTIAL ACTIVITY FOR PREFERENTIAL REGIMES: SOUTH AFRICA

The requirement for "substantial activity" needs to be examined in South Africa, for instance, with respect to the country's headquarter company regime. As indicated in the Final Report to Action 5 South Africa's headquarter company regime[95] potentially constitutes a harmful tax practice but is not actually harmful.[96] This is in line with the OECD 2000 Report "Towards Global Tax Cooperation",[97] which investigated the tax practices of holding company regimes and similar preferential tax regimes, noting that they do not constitute harmful tax practices, although such regimes may constitute harmful tax competition.

South Africa's headquarter company regime is intended to enable the country to become a gateway for foreign investment into Africa. Consequently certain anti-avoidance rules, such as CFC rules and transfer pricing, have been relaxed with regard to headquarter companies.[98] The headquarter regime is actually a holding company regime which enables MNEs to use South Africa as a conduit for passive income flows. The important thing for South Africa is to ensure it continues to balance its international obligations to prevent harmful tax competition, and also to ensure it preserves the competitiveness of the economy.

From the angle of preserving the competitiveness of the economy, the headquarter company regime has, however, not been very successful. South Africa has been reluctant to participate in international tax competition and this has hindered its ability to fully establish itself as the gateway to Africa. On the African continent, Botswana, Ghana and Mauritius have tax regimes that make them better bases for investment into Africa, especially with respect to their tax rates.[99] There are also other factors

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95 In terms of section 1 of the Income tax Act, as amended by the Taxation Laws Amendment Act 24 of 2011, a 'headquarter company' is defined as any company which has made an election in terms of section 9I.

96 OECD/G20 2015 Final Report on Action 5 at 64.

97 OECD Towards Global Tax Cooperation – Report on the 2000 Ministerial Council Meeting and Recommendations by the Committee on Fiscal Affairs: progress in Identifying and Eliminating Harmful Tax Practices (2000) in para 12.

98 Oguttu "Developing South Africa As A Gateway For Foreign Investment In Africa" 61; P Surtees "Transfer Pricing Amendments Would Aid South African Companies Funding Offshore Expansion" *Tax Analyst* 4 November 2013.

99 AW Oguttu "Developing South Africa As A Gateway For Foreign Investment In Africa: A Critique Of South Africa's Headquarter Company Regime" (2011) 36 *South African Year Book of International Law* 68-71.

which might affect the decision of foreign investors when deciding whether to choose South Africa as a regional headquarter location, most notably exchange controls, labour law policy, availability of guaranteed power sources, and immigration requirements (specifically the obtaining of work permits).[100]

While South Africa should be concerned about preventing harmful tax competition, it should move cautiously to protect its competitiveness since many major countries are not willing to give up their special tax regimes, such as corporate rate reductions and patent boxes (identified in Action 5 as harmful), which are designed to attract investment so as to remain competitive. For example, the United Kingdom has reduced its corporate rate to 20% and is continuing a phased reduction.[101] South Africa must, thus, take care not to be a "first mover" in terms of the BEPS reform associated with harmful tax practices.

South Africa already has regimes that are designed to encourage investment into the country in the form of urban and industrial development zones, as well as the proposed special economic zones. It would appear that these will fall within the categories of low risk "disadvantaged areas",[102] discussed in the Final Report on Action 5. Furthermore, these are physical investments rather than mobile activities which are the concern of the OECD Report.[103] Care should be taken to ensure that this remains the case and that the necessary disclosure is made to the FHTP and, if considered necessary, potentially, spontaneous exchange of information is made.

Thus, to the extent that certain tax preferences exist (with economic benefits outweighing the tax loss), these preferences should not be automatically repealed in the expectation that the OECD will follow up on them. Many countries within the OECD continue to operate tax preferences that serve as base eroding platforms. These platforms have previously survived, despite public statements to the contrary. Undoubtedly, many of these platforms will continue even after the BEPS reform is complete.[104]

Of importance will be South Africa's continued transparency with regards to its laws and rulings.

4.1.1 RECOMMENDATIONS

- It is important that South Africa balances its international obligations not to engage in harmful tax practices with the need to preserve the competiveness

100 PWC "Comment on DTC BEPS First Interim Report (30 March 2015) at 19.
101 L Shepperd "What should the OECD do about Base Erosion?" Copenhagen precise of 2013 International Fiscal Association annual Congress" 9/9/2013.
102 OECD/G20 2015 Final Report on Action 5 at 65.
103 PWC "Comment on DTC BEPS First Interim Report "(30 March 2015) at 19.
104 SAIT: Comments on DTC First Interim BEPS Report (March 2015) at 4.

of the economy. More so, as the National Development Plan provides that South Africa should aspire to be a gateway for investment in Africa. There is potential for substantial job creation and tax revenue to the Government in the form of VAT and employees' tax from which South Africa would benefit, as long as it ensures that it complies with the OECD's substance requirements. The bottom line is that BEPS is both a risk and an opportunity for South Africa.

- From a tax perspective, consideration should be given to instituting a reduced corporate income tax rate for headquarter companies which meet minimum substance requirements. (It may, however, be necessary to align this rate for all companies in order for such rate not to be viewed as a HTP. However, this would need to be evaluated in terms of the DTC Reports as a whole).

  This would make South Africa more attractive as a destination for regional headquarters. While this may result in the perception that there will be a notional cost related to corporate income tax foregone, the direct and indirect spin-offs of an increased number of such companies (that would otherwise go elsewhere) which would result in increased tax revenues, as well as from increased employment taxes, consumption taxes and profit taxes of suppliers should outweigh such perceived forgone taxes.

  It is, however, important that any revised headquarter regime be bundled with a package of measures to address all of the impediments and externalities associated with the choice of South Africa as a location for regional headquarters, including with respect to exchange control (although there is relief for headquarter companies, better alignment with the tax regime is required), labour law policy, availability of power and immigration.[105]
- To ensure the headquarter regime is in line with Action 5, reforms to the provisions should be made that incorporate minimum levels of substance as required by the OECD, so that it does not slip into the area of a harmful tax practice. It is therefore important that South Africa considers revising its criteria of for headquarter companies in line with the OECD recommendations.

4.2 IMPROVING TRANSPARENCY, INCLUDING COMPULSORY SPONTANEOUS EXCHANGE ON RULINGS RELATED TO PREFERENTIAL REGIMES: RECOMMENDATIONS FOR SOUTH AFRICA

With respect to tax rulings in South Africa, Chapter 7 of the Tax Administration Act 28 of 2011 (TAA), sets out provisions dealing with "advance rulings". Section 75 of the TAA defines an advance ruling to mean 'a binding general ruling, a binding private ruling or a binding class ruling'. In terms of s 75 of the Tax Administration

[105] PWC "Comment on DTC BEPS First Interim Report" (30 March 2015) at 19.

Act, a “binding general ruling” is defined as a written statement issued by SARS regarding the application of a tax Act to a specific ‘class’ of persons in respect of a “proposed transaction”. A “binding private ruling” means as a written statement issued by SARS regarding the application of a tax Act a specific ‘class’ of persons in respect of a ‘proposed transaction’. Basically these categories of advance rulings allow taxpayers to obtain clarity and certainty on the Commissioner’s interpretation and application of the tax laws on proposed transactions.

They are intended to promote clarity, consistency and certainty regarding the interpretation and application of a tax Act on proposed transactions by creating a framework for issuance of the advance rulings.[106] The OECD’s framework covers only spontaneous exchange of information on taxpayer specific rulings. In the South African context these would include binding private rulings.

- It is recommended that, in line with the OECD Recommendations on exchange of information regarding tax rulings, SARS notifies other tax authorities, on a timely and spontaneous basis, of the existence of a binding private ruling relating to the headquarter company regime, and any other regime that could be viewed as a HTP based on the filters where SARS is aware that it affects residents in another country. This is especially so where such a ruling provides for a downward adjustment that would not be directly reflected in the company's financial accounts.
- It is further recommended that South Africa’s tax authorities ensure that they do not sanction tax rulings relating e.g. to the headquarter company regime that foster harmful practices and hamper transparency. This could cover secret rulings that enable taxpayers to get tax haven results even if the country may have a tax system with an acceptable tax rate.

It should however be noted that section 80(1)*(a)*(iii) of the TAA provides that:

> ‘SARS may reject an application for an advance ruling if the application requires or requests the rendering of an opinion, conclusion or determination regarding the pricing of goods or services supplied by or rendered to a connected person in relation to the applicant or a class member’

This implies that transfer-pricing transactions are potentially excluded from South Africa’s advance rulings system.[107] In this regard, APAs which are normally entered into by taxpayers with tax authorities in order to resolve transfer-pricing disputes are currently not in use in South Africa and, although the DTC recommendations contained in the discussions on Actions 8-10 and 13 recommend that SARS administrative capacity be increased to facilitate this, SARS has declared that APAs

106 Section 76 of Tax Administration Act. See also SARS ‘Comprehensive Guide to Advance Tax Rulings’ at 6.

107 AW Oguttu ‘Resolving Transfer-pricing Disputes: Are ‘Advance Pricing Agreements’ the Way Forward for South Africa?’ 2006) 18 *SA Mercantile Law Journal* 147.

will not be made available to South African taxpayers in the foreseeable future.[108] However, the use of the word ‘may’ in s 80(1)*(a)*(iii) implies that the Commissioner has the discretion to reject or approve the granting of an advance ruling relating to transfer pricing. To date the Commissioner has not exercised discretion in this regard. It is regrettable that South Africa is lagging behind international trends with regards to introducing APAs.

- As mentioned above, the DTC does, however, recommend that the resources be sought to put such an APA option in place, for purposes of enhancing its transfer pricing regime (in particular to provide taxpayers with certainty- see DTC reports on Actions 8-10) and thus consideration needs to be given to the practices that would need to also be put in place so as not to contravene the Harmful Tax Practices principles set out in the OECD Action 5 Report.
- The DTC furthermore recommends that SARS capacity be increased to enable it to satisfy the requirements of the spontaneous exchange of information whenever this should be required in terms of the conclusions reached by the FHTP.

To ensure spontaneous exchange of information on tax rulings relating to preferential regimes, the OECD recommended that its member and associate countries that do not (yet) have the necessary legal framework in place to spontaneously exchange information, as required by Action 5, were to be given an adjustment period of up to end of 2016 to initiate steps to put in place that legal framework to enable spontaneously exchange information.

- In line with the above OECD recommendation, South Africa has inserted provisions into the Tax Administration Act that provide for the legal framework to ensure spontaneous exchange of information regarding tax rulings that relate to *inter alia* the headquarter company with other countries’ tax authorities[109].

The other forum that can be used in South Africa to ensure spontaneous exchange of information on rulings relating to e.g. its headquarter company regime, is double tax treaties, since they also ensure transparency and exchange of information in tax matters, specifically under article 26 of treaties based on the OECD Model Tax Convention. The standard of exchange of information under double tax treaties provides for information exchange to the widest possible extent. This includes: upon request, automatically, spontaneously, and by using other techniques such as simultaneous examinations, tax examinations abroad and industry-wide exchange of information.

[108] SARS *Practice Note 7* in para 6.2; see also D Clegg *Income Tax in South Africa* (May 2005) in para 24.12.1; Olivier & Honiball *International* at 501.

[109] See section 1 definition of International Reporting Standard read with Section 3, as amended by the 2015 Administration Laws Amendment Act.

Although South Africa has signed Tax Information Exchange Agreements (TIEAs) with some countries (especially tax haven jurisdictions that do not normally have a double tax treaty in place),[110] currently the standard of exchange of information in the TIEAS is not spontaneous; it is only "upon request".[111] The effectiveness of exchange of information upon request is hampered by the fact that the requesting states' taxation procedures must first be exhausted before a request for information is made to the other state. Due to the inherent restriction of this approach, intentional exchanges of information upon request are relatively small and are based on reciprocity.[112] The OECD has recommended that the standard for exchange of information in TIEAs should be automatic. The Common Reporting Standard for automatically exchanging information pertaining to South African bank accounts owned by residents of other countries is an example of this.

The Action 5 Report, calls for confidentiality of the information exchanged. It recommends that provisions must be in place in the receiving country to protect the confidentiality of the information that is exchanged.

- In the case of South Africa, Chapter 6 of the TAA provides detailed provisions relating to "confidentiality of information". These provisions must be applied to ensure confidentiality with respect to exchange of information on tax rulings in South Africa.
- South Africa and other African countries could consider extending the automatic exchange of information arrangements currently reached to ensure a level playing field amongst them. This could be facilitated through the Africa Tax Administration Forum.

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110 This is because most tax havens do not levy income tax taxes, so they often do not sign double tax treaties. See M Keen & JE Ligthart "Information Sharing and International Taxation: A Primer" 13 (2006) *International Tax and Public Finance* at 92. In 2010, South Africa signed Tax Information Exchange Agreements, in line with the OECD standards, with the Bahamas, Bermuda, Cayman Islands, Guernsey, Jersey and San Marino. See SARS "International Treaties - Tax Information Exchange Agreements." Available at http://www.sars.gov.za/home.asp?pid=53079 accessed 10 August 2010.

111 M Stewart "Transnational Tax Information Exchange Networks: Steps Towards a Globalised, Legitimate Tax Administration" (June 2010) *World Tax Journal* at 162.

112 Keen and Ligthart at 95; Oguttu "A Critique on the Effectiveness of 'Exchange of Information on Tax Matters" at 11.

DAVIS TAX COMMITTEE: SECOND INTERIM REPORT ON BASE EROSION AND PROFIT SHIFTING (BEPS) IN SOUTH AFRICA*

SUMMARY OF DTC REPORT ON ACTION 6: PREVENTING THE GRANTING OF TREATY BENEFITS IN INAPPROPRIATE CIRCUMSTANCES

Treaty abuse rules entails the use of treaty shopping schemes, which involve strategies through which a person who is not a resident of a State attempts to obtain benefits that a tax treaty concluded by that State grants to residents of that State, for example by establishing a letterbox company in that State. The OECD/G20 2015 Final Report covers various recommendations to curtail treaty abuse.

Currently, the main specific treaty provision that is applied in South Africa's treaties to curb conduit company treaty shopping is the "beneficial ownership" provision as set out in article 10, which deals with dividends, article 11 which deals with interest and article 12 which deals with royalties. However the effectiveness of the beneficial ownership provision in curbing treaty shopping is now questionable in light of certain international cases such as the decisions in Canadian cases of of *Velcro Canada Inc. v The Queen*[1] *and Prevost Car Inc. v Her Majesty the Queen*[2]*.* Paragraph 12.5 of the Commentary on Article 10 provides that: "whilst the concept of "beneficial ownership" deals with some forms of tax avoidance (*i.e.* those involving the interposition of a recipient who is obliged to pass on the dividend to someone else), it does not deal with other cases of treaty shopping and must not, therefore, be considered as restricting in any way the application of other approaches to addressing such cases" (such as those explained below). Nevertheless, the OECD does not recommend that the beneficial ownership provision should be completely done away with. The provision can still be applied with respect to income in articles 10, 11 and 12 but it cannot be relied on as the main provision to curb treaty shopping.

- Where that is the case, in the South African context, it is important that SARS should address the practical application or implementation of the tax treaty by coming up with measures of how a beneficial owner is to be determined. This could be achieved by introducing measures such as:

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* DTC BEPS Sub-committee: Prof Annet Wanyana Oguttu, Chair DTC BEPS Subcommittee (University of South Africa - LLD in Tax Law; LLM with Specialisation in Tax Law, LLB, H Dip in International Tax Law); Prof Thabo Legwaila, DTC BEPS Sub-Committee member (University of Johannesburg - LLD,) and Ms Deborah Tickle, DTC BEPS Sub-Committee member (Director International and Corporate Tax Managing Partner KPMG).

1 2012 TCC 57.

2 2008 TCC 231.

- Beneficial Ownership Certificate;
- Tax Registration Form;
- Permanent Establishment Confirmation Form.
- A definition of beneficial ownership in section 1 of the Income Tax Act, which is in line with the treaty definition as set out in the OECD MTC.

(1) OECD Recommendations for the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances

To prevent the granting of treaty benefits in inappropriate circumstances, the OECD notes that a distinction has to be made between:

a) Cases where a person tries to circumvent the provisions of domestic tax law to gain treaty benefits. In these cases, treaty shopping must be addressed through domestic anti-abuse rules.[3]

b) For cases where a person tries to circumvent limitations provided by the treaty itself, the OECD recommends treaty anti-abuse rules, using a three-pronged approach:

   (i) The title and preamble of treaties should clearly state that the treaty is not intended to create opportunities for non-taxation or reduced taxation through treaty shopping.[4]

   (ii) The inclusion of a specific limitation-of-benefits provisions (LOB rule), which is normally included in treaties concluded by the United States and a few other countries

   (iii) To address other forms of treaty abuse, not being covered by the LOB rule (such as certain conduit financing arrangements), tax treaties should include a more general anti-abuse rule based the principal purposes (PTT) rule.

The OECD acknowledges that each rule has strengths and weaknesses and may not be appropriate for all countries.[5] Nevertheless, the OECD recommends that at a minimum level, to protect against treaty abuse, countries should include in their tax treaties an express statement that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements.[6] This intention should be implemented through either:

- using the combined LOB and PPT approach described above; or
- the inclusion of the PPT rule or;

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3 OECD/G20 Base Erosion and Profit Shifting Project “Preventing the Granting of Treaty Benefits in Inappropriate Circumstances Action 6: 2015 Final Report (2015) in para 15.

4 OECD/G20 2015 Final Report on Action 6 in para 19.

5 OECD/G20 2015 Final Report on Action 6 in para 21

6 OECD/G20 2015 Final Report on Action 6 in para 22.

- the inclusion of LOB rule supplemented by a mechanism (such as a restricted PPT rule applicable to conduit financing arrangements or domestic anti-abuse rules or judicial doctrines that would achieve a similar result) that would deal with conduit arrangements not already dealt with in tax treaties. [7]

Recommendations for South Africa regarding the above measures

Where taxpayers circumvent the provisions of domestic tax law to gain treaty benefits, treaty shopping must be addressed through domestic anti-abuse rules

- However to prevent treaty override disputes the OECD recommends that the onus is on countries to preserve the application of these rules in their treaties.
- South Africa should ensure it preserves the use of the application of domestic ant- avoidance provisions in its tax treaties.

<u>On the common intention of tax treaties:</u>

- It is recommend that in line with this recommendation, South Africa ensures that all its treaties refer to the common intention that its treaties are intended to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements. The costs and challenges of re-negotiating all treaties will be alleviated by signing the multilateral instrument that is recommended under Action 15 which will act as a simultaneous renegotiation of all tax treaties.

<u>Feasibility of applying the LOB provision in South Africa</u>

- The proposed LOB is modelled after the US LOB provision. Essentially, the LOB provision requires that treaty benefits (such as reduced withholding rates) are available only to companies that meet specific tests of having some genuine presence in the treaty country. However such an LOB provision has not been applied in many DTAs other than those signed by the USA, and even then, the provisions vary from treaty to treaty. South Africa for instance has an LOB provision in article 22 of its 1997 DTA with the USA.[8] The structure of the LOB provision as was set out in the September 2014 the OECD Report[9] on Action 6 was however criticised for its complexity. Even in the US, application of the LOB has given rise to considerable difficulties in practice and is continuously being

[7] OECD/G20 2015 Final Report on Action 6 at 21.
[8] Published in Government Gazette No. 185553 of 15/12/1997.
[9] OECD/G20 Base Erosion and Profit Shifting Project "Preventing the Granting of Treaty Benefits in Inappropriate Circumstances Action 6: 2014 Deliverable" (2014).

reviewed and refined.[10] In its 2015 Final Report, the OECD considered some simplified versions of LOB provisions to be finalised in 2016.[11]

- If the simplified versions of the LOB provision are found feasible when complete, South Africa should consider adopting the same.

Feasibility of applying the PPT test in South Africa

- The PPT rule requires tax authorities to make a factual determination as to whether the principle purpose (main purpose) of certain creations or assignments of income or property, or of the establishment of the person who is the beneficial owner of the income, was to access the benefits of a particular tax treaty.
- As alluded to above, the factual determination required under the "principle purpose test" is similar to that required to make an "avoidance transaction" determination under the GAAR in section 80A-80L of the Income Tax Act – in particular, whether the primary purpose of a transaction (or series of transactions of which the transaction was a part) was to achieve a tax benefit, broadly defined. Since the two serve a similar purpose, the GAAR can be applied to prevent the abuse of treaties. Based on that one could argue that there is no need for South Africa to amend its treaties to include a PPT test since the GAAR could serve a similar purpose. Nevertheless, much as the OECD Final Report clearly explains that domestic law provisions can be applied to prevent treaty abuse, there could be concerns of treaty override if South Africa applies it GAAR in a treaty context. Besides South Africa's GAAR may not be exactly worded like a similar provision with its treaty partner. It is thus recommended that South Africa inserts a PPT test in its tax treaties. Required re-negotiation of treaties can be effected by signing the Multilateral Instrument that could have a standard PPT test as is recommended in Action 15 of the OECD's BEPS Project.

(2) OECD Recommendations regarding other situations where a person seeks to circumvent treaty limitations

The OECD recommends targeted specific treaty anti-abuse rules fully discussed in paragraph 4.2 of the report below.

- It is also recommended that South Africa ensures its tax treaties also cover the targeted specific treaty anti-abuse rules in specific articles of its tax treaties (as pointed out in the OECD Report discussed in the attached) to prevent treaty abuse where a person seeks to circumvent treaty limitations. For example:

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10 PWC "Comment on DTC BEPS First Interim Report (30 March 2015) at 20.

11 OECD/G20 2015 Final Report on Action 6 in para 25.

(3) OECD recommendations in cases where a person tries to abuse the provisions of domestic tax law using treaty benefits

The OECD notes that many tax avoidance risks that threaten the tax base are not caused by tax treaties but may be facilitated by treaties. In these cases, it is not sufficient to address the treaty issues: changes to domestic law are also required (see discussion in paragraph 4.3 of the Report below).

- The OECD notes that its work on other aspects of the Action Plan, in particular Action 2 (Neutralise the effects of hybrid mismatch arrangements), Action 3 (Strengthen CFC rules), Action 4 (Limit base erosion via interest deductions and other financial payments) and Actions 8, 9 and 10 dealing with Transfer Pricing has addressed many of these transactions. [12]
- The DTC recommendations in respect to each of these Action Points is covered in the DTC Reports that deal with the same.

(4) OECD recommendations on tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country or to terminate one

- ➢ South Africa should also take heed of the OECD recommendations on tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country or to terminate one. These are discussed in paragraph 4.5 of the Report below.

OTHER RECOMMENDATIONS ON TREATY SHOPPING FOR SOUTH AFRICA

Treaty shopping and tax sparing provisions

South Africa's treaties with tax sparing also encourages "treaty shopping".[13] Generous tax sparing credits in a particular treaty can encourage residents of third countries to establish conduit entities in the country granting the tax incentive.[14]

- ➢ It is acknowledged that tax treaties are not generally negotiated on tax considerations alone and often countries' treaty policies take into account their political, social and other economic needs.[15] Nevertheless,

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12 OECD/G20 2015 Final Report on Action 6 in para 54.

13 H Becker & FJ Wurm *Treaty Shopping: An Emerging Tax Issue and its Present Status in Various Countries* (1988) 1; S Van Weeghel *The Improper Use of Tax Treaties with Particular Reference to the Netherlands and The United States* (1998) 119.

14 B Arnold & MJ McIntyre *International Tax Primer* (2002) at 53.

15 Weeghel at 257-260.

care should be taken to adhere to international recommendations when designing tax sparing provisions, so as to prevent tax abuse. The OECD recommends that such designs should follow the form set out in its 1998 Report on Tax Sparing.

- The problem in the older treaties may be resolved by renegotiation of the treaty or through a protocol. The protocol should, for instance, ensure that the relevant tax sparing provision refers to a particular tax incentive and should contain a sunset clause or expiry date to ensure that it is not open to abuse.[16]
- As the process of removing or modifying existing tax sparing provisions to prevent such abuses is often slow and cumbersome,[17] South Africa's legislators should ensure that future tax sparing provisions are drafted circumspectly.
- It is thus desirable for South Africa to adhere to the OECD's recommendations and best practices in drafting tax sparing provisions.
- All the obsolete tax sparing provisions should be brought up to date with the current laws if they are still considered necessary.

Low withholding tax rates in tax treaties encourage treaty shopping

A number of withholding taxes have been introduced in South Africa.[18] It is hoped that these will be instrumental in eliminating base erosion. Treaties with low tax jurisdictions with zero or very low withholding tax rates have been a major treaty shopping concern for South Africa. However measures are underway to adopt South Africa's its tax treaty negotiation policy to cater for the new policy on withholding taxes. Currently, all tax treaties with zero rates are under renegotiation so that they are not used for treaty shopping purposes.

- It is recommended that when re-negotiating the new limits for treaty withholding tax rates, caution is exercised since high withholding taxes can be a disincentive to foreign investment. Equilibrium must be achieved between encouraging foreign investment and protecting South Africa's tax base from erosion.

Treaty Shopping: Accessing capital gains benefits

A resident of a country which has no DTA or a less beneficial DTA with South Africa could make an investment in a property holding company in South Africa via a country, such as the Netherlands, in order to protect the eventual capital

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16 RJ Vann & RW Parsons "The Foreign Tax Credit and Reform of International Taxation" (1986) 3(2) *Australian Tax Forum* 217.

17 Para 76 of the OECD commentary on art 23A & 23B.

18 The interest withholding tax; dividend withholding tax; withholding tax on royalties; withholding tax on foreign entertainers and sportspersons; withholding tax on the disposal of immovable property by non-resident sellers. See AW Oguttu "*An Overview of South Africa's Withholding Tax Regime*" TaxTalk (March/April 2014).

gains realized on the sale of the shares from South African capital gains tax. Treaties based on the OECD MTC provide in article 13(4) that the Contracting State in which immovable property is situated may tax capital gains realised by a resident of the other State on shares of companies that derive more than 50 per cent of their value from such immovable property.[19] However in Article 13(4) of the Dutch/South African DTA, only the Netherlands may impose tax on the gains realized from the sale of shares in a South African company. In the Netherlands, the gain on the sale of the shares should enjoy the protection under the Dutch participation exemption, and it is possible to extract the gain from the Dutch intermediate company without incurring withholding tax. The OECD Final Report on Action 6 (see discussion in paragraph 4.2 of the Report below) recommends that countries should ensure that there treaties have the anti-abuse provision in article 13(4) of the OECD Model Convention.[20] Paragraph 28.5 of the Commentary on Article 13 provides that States may want to consider extending the provision to cover not only gains from shares but also gains from the alienation of interests in other entities, such as partnerships or trusts, which would address one form of abuse.

- The OECD noted that Article 13(4) will be amended to include such wording.[21]
- In cases where assets are contributed to an entity shortly before the sale of the shares or other interests in that entity in order to dilute the proportion of the value of these shares or interests that is derived from immovable property situated in one Contracting State. The OECD noted that Article 13(4) also will be amended to refer to situations where shares or similar interests derive their value primarily from immovable property at any time during a certain period as opposed to at the time of the alienation only.[22]
- These anti-abuse provisions can be adopted by South Africa if it signs the envisaged multilateral instrument under Action 15, which will alleviate the need to renegotiate all its double tax treaties to cover these changes.

Treaty shopping and dual resident entities

The concept of "dual residence" could be used to avoid the dividends withholding tax (DWT) in South Africa. In terms of the current article 4(3) of the OECD model convention, a dual resident entity is deemed to be resident where its place of effective management (POEM) is located. If a company incorporated in South Africa is effectively managed in the United Kingdom (UK), it will be deemed to be a resident of the UK for purposes of the DTA between South Africa and the UK. A UK resident parent company can thus avoid South

19 OECD/G20 2015 Final Report on Action 6 in para 41.
20 OECD/G20 2015 Final Report on Action 6 in para 41.
21 OECD/G20 2015 Final Report on Action 6 in para 42.
22 OECD/G20 2015 Final Report on Action 6 in para 43.

African DWT on dividends derived from its South African subsidiary by transferring the effective management of the subsidiary to the UK. The subsidiary will then be treated as a UK tax resident which is not subject to DWT in terms of section 64C of the ITA.

- It should be noted though that the subsidiary will incur a CGT exit tax in South Africa in terms of section 9H of the ITA and paragraph 12(2)*(a)* of the Eighth Schedule to the ITA. The provision would for instance apply if a company moves its place of effective management out of South Africa.
- The OECD Final Report on Action 6 (see paragraph 4.3 of the Report below) notes that the OECD will make changes to the OECD MTC to the effect that treaties do not prevent the application of domestic "exit taxes".[23]
- It should also be noted that the OECD recommends that the current POEM rule in article 4(3) will be replaced with a case-by-case solution of these cases.[24] The competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its POEM the place where it is incorporated and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any treaty benefits. [25]
- South Africa can adopt this change in its tax treaties if it signs the multilateral instrument envisaged under Action 15, which will alleviate the need to renegotiate all double tax treaties.

Treaty shopping and permanent establishment concept

The permanent establishment concept (as set out in article 5) of most South African DTAs does not include a building site or construction or assembly project if the project does not exist for more than twelve months (in some DTAs, e.g. the DTA with Israel, the period is limited to six months). A resident of those contracting States will, therefore, not be subject to South African tax on building or construction activities if the specific project does not last longer than twelve months (six months for residents of Israel). A resident of the other contracting state could split up the project into different parts, which are performed by different legal entities, thus allowing the fuller project to be performed in South Africa without incurring a tax liability in South Africa.

- It should be noted that treaty abuse through splitting-up of contracts to take advantage article 5 of the OECD Model Convention[26] will be curtailed by the OECD recommendation that the Principle Purpose Test rule that will be added to the model convention in terms of the OECD Report on

23 OECD/G20 2015 Final Report on Action 6 in para 65-66.
24 OECD/G20 2015 Final Report on Action 6 in para 47.
25 OECD/G20 2015 Final Report on Action 6 in para 48.
26 OECD/G20 2015 Final Report on Action 6 in para 29.

Action 7 (*Preventing the Artificial Avoidance of Permanent Establishment Status*, 2015).[27]

- Concerns about renegotiating all its tax treaties will be alleviated if South Africa signs the envisaged multilateral instrument under Action 15.

Treaty shopping involving dividend transfer transactions

Taxpayers can get involved in dividend transfer transactions, whereby a taxpayer entitled to the 15 per cent portfolio rate of Article 10(2)(b) may seek to obtain the 5 per cent direct dividend rate of Article 10(2)(a) or the 0 per cent rate that some bilateral conventions provide for dividends paid to pension funds.[28] The concern is that Article 10(2)(a) does not require that the company receiving the dividends to have owned at least 25 per cent of the capital for a relatively long time before the date of the distribution. This may encourage abuse of this provision, for example, where a company with a holding of less than 25 per cent has, shortly before the dividends become payable, increased its holding primarily for the purpose of securing the benefits of the provision, or where the qualifying holding was arranged primarily in order to obtain the reduction.[29]

- The OECD concluded that in order to deal with such transactions, a minimum shareholding period before the distribution of the profits will be included in Article 10(2)(a).
- Additional anti-abuse rules will also be included in Article 10 to deal with cases where certain intermediary entities established in the State of source are used to take advantage of the treaty provisions that lower the source taxation of dividends.[30]
- These anti-abuse provisions can be adopted by South Africa if it signs the envisaged multilateral instrument under Action 15, which will alleviate the need to renegotiate all its double tax treaties to cover these changes.

Issues Pertaining to migration of Companies

In the case of *CSARS v Tradehold Ltd,*[31] *a* South African company was "migrated" to Luxembourg from a tax perspective. This had the effect of capital gains which had accumulated in the company during the period that it was a resident of South Africa being taxable only in Luxembourg. Luxembourg then did not exercise its domestic tax law to tax any such gain. As a result of the

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27 OECD/G20 2015 Final Report on Action 6 in para 30.

28 See paragraph 69 of the Commentary on Article 18 and also OECD/G20 2015 Final Report on Action 6 in para 34.

29 OECD/G20 2015 Final Report on Action 6 in para 35.

30 OECD/G20 2015 Final Report on Action 6 in para 37.

31 (132/11) [2012] ZASCA 61.

decision in this case, South Africa's domestic law was amended in order to prevent such arrangements. Specifically, section 9H of the Income Tax Act states that, *inter alia*, where a company that is a resident ceases to be a resident, or a controlled foreign company ceases to be a controlled foreign company, the company or controlled foreign company must be treated as having disposed of its assets on the date immediately before the day on which that company so ceased to be a resident or a controlled foreign company, for an amount equal to the market value of its assets.

- It is worth noting that the OECD Final Report on Action 6, the OECD intends to make changes to the OECD MTC to the effect that treaties do not prevent the application of domestic "exit taxes". [32]

Issues pertaining to dividend cessions

Shortly after the introduction of dividends tax in section 64D of the Income Tax Act, various transactions were entered into by non-resident shareholders of South African shares in order to mitigate the tax. In particular, non-resident shareholders of listed South African shares in respect of which dividends were to be declared transferred their shares to South African resident corporate entities. The dividends were therefore declared and paid to the South African resident corporate entities which claimed exemption from dividends tax on the basis that, as set out in section 64F(1) of the Income Tax Act, the entities constituted companies which were residents of South Africa.

- The provisions of section 64EB of the Act were therefore introduced in August 2012 which adequately deal with such transactions since, *inter alia*; they deem the "manufactured dividend" payments to constitute dividends which are liable for dividends tax.

Base erosion resulting from exemption from tax for employment outside the Republic

Section 10(1)(o)(ii) of the Income Tax Act, exempts from tax any remuneration received or accrued by an employee by way of any salary, leave pay, wage, overtime pay, bonus, gratuity, commission, fee, emolument, including an amount referred to in paragraph(i) of the definition of gross income (fringe benefits) subject to certain conditions. Section 10(1)(o) was implemented along with the residence basis of taxation in 2001. It was supposed to be reviewed after 3 years. More than ten years have passed without a review. The concern about the provision is that there are many South Africans working abroad but whose home is still South Africa, so the exemption takes away the right for South Africa to tax on a residence basis.–Because of the section 10(1)(o) exemption, an SA resident individual working in a foreign tax free country will

[32] OECD/G20 2015 Final Report on Action 6 in para 65-66.

not pay tax anywhere in the world on his/her remuneration for services rendered if he/she meets the 183 day (broken) and 60 day (continuous) outside SA requirements per tax year. At present it is not clear as to how many taxpayers are taking advantage of the exemption. SARS does not have reliable statistics on this matter. In a double tax treaty context, article 15 of treaties based on the OECD MTC deals with income from employment. It is recommended that either:

- The exemption should be withdrawn and a foreign tax rebate granted if foreign tax is imposed on the basis that the ongoing income stream should be taxable in RSA, even if the capital is invested abroad, or the exemption is amended to only apply where the employee will be taxed at a reasonable rate in the other country.

Base erosion that resulted from South Africa giving away its tax base

Some foreign jurisdictions, especially in Africa, are incorrectly claiming source jurisdiction on services (especially management services) rendered abroad and yet those services should be considered to be from a South African source. These foreign jurisdictions are withholding taxes from amounts received by South African residents in respect of services rendered in South Africa. The withholding taxes are sometimes imposed even if a treaty that exists between South Africa and the foreign country specifies otherwise, in that the treaties do not have an article dealing with management fees or South African residents have no permanent establishments in these countries. This results in double taxation. In 2011, the section 6*quin* special foreign tax credit for service fees was introduced to operate to offer relief from double taxation on cross-border services for South African multinational companies that render services to their foreign subsidiaries. National Treasury noted that section 6*quin* was intended to be a temporal measure. However the section amounted to South Africa effectively eroded its own tax base as it was obliged to give credit for taxes levied in the paying country. In the 2015 Tax Laws Amendment Act the section 6*quin* special foreign tax credit was withdrawn with effect from 1 January 2016. National Treasury's reason for the change was that the special tax credit regime was a departure from international tax rules and tax treaty principles in that it indirectly subsidised countries that do not comply with the tax treaties. South Africa was the only country in the world that provided for this kind of tax concession. This provision effectively encouraged its treaty partners not to abide by the terms of the tax treaty and it resulted in a significant compliance burden on the South African Revenue Service. Some taxpayers also exploited this relief by claiming it even for other income such as royalties and interest that are not intended to be covered by this special tax credit.[33] Mutual Agreement Procedure (MAP) under tax treaties is the forum that ought to be used to solve

[33] Explanatory Memorandum to the Taxation Laws Amendment Bill, 2015.

such problems. There have been concerns that the withdrawal of section 6*quin* could undermine South Africa as a location for headquarters and could see banking, retail, IT and telecommunication companies relocating their service centers elsewhere. The tax credit under section 6quin was reasoned to be one of the reasons why such service companies based their headquarters in South Africa.[34] In order to mitigate against such concerns and any double taxation that could be faced by South African taxpayers doing business with the rest of Africa, section 6*quat*(1C) Income Tax Act has been amended to allow for a deduction in respect of foreign taxes which are paid or proved to be payable without taking into account the option of the mutual agreement procedure under tax treaties. All tax treaty disputes should be resolved by competent authorities through mutual agreement procedure available in the tax treaties. In terms of SARS Interpretation Note 18, the phrase "proved to be payable" should be interpreted as an "unconditional legal liability to pay the tax." The concern though is whether the deduction method will offer the required taxpayers relief. The word "paid" as used in the section could be interpreted as requiring an "unconditional legal liability to pay the tax". If so, there would be no relief in cases where tax is incorrectly withheld (e.g. contrary to treaty provisions).

- To avoid such a situation, it is recommended that the wording in the previous 6*quin*, should be reintroduced in section 6quat1(C) which gives access to the section if tax was "levied" or "imposed" by a foreign government.
- It is submitted that the rationale behind the introduction of section 6*quin* remains valid; in that it was intended to make South Africa an attractive as a headquarter location. However this does not detract from the fact that it resulted in the erosion of its own tax base.
- South Africa's need to develop a coherent policy in respect of treaty negotiation and interpretation, especially with respect to its response to Africa's needs. SARS is encouraged to actively engage with the African countries which are incorrectly applying the treaties with the objective of reaching agreement on the correct interpretation and application of the treaties. South African taxpayers should not be subjected to double taxation simply because SARS is not able to enforce binding international agreements with other countries.[35]
- South African has a model tax treaty which informs its treaty negotiations. This model treaty should be made publicly available and any treaties that provide for the provision of taxing rights on technical service fees should be renegotiated insofar as possible to bring them in line with the model in this regard.[36]

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34 BusinessDay "MTN Warns Against Removing African Tax Incentive". Available at http://www.bdlive.co.za/business/technology/2015/09/17/mtn-warns-against-removing-african-tax-incentive accessed 21 October 2015.

35 PWC "Comments on DTC BEPS First Interim Report" (30 March 2015) at 22.

36 PWC "Comments on DTC BEPS First Interim Report" (30 March 2015) at 22.

- As noted above, the Mutual Agreement Procedure (MAP) under tax treaties is the forum that ought to be used to solve problems arising from the improper application of the treaty, such as in this case, where treaty services rendered by South African residents in treaty countries ought to be taxed in South Africa but those countries still impose withholding taxes on services rendered in these countries despite the fact that the DTAs with these countries do not have an article dealing with management fees or South African residents have no permanent establishments in these countries. MAP has however not been effective in Africa.
- It is recommended that solving this problem, that is affecting intra-Africa trade, will require organisations such as ATAF to play a significant role.

Treaty shopping that could be encouraged by South Africa's Head quarter company regime

South Africa has a Head Quarter Company (HQC) regime under section 9I and of the ITA. The objective of the HQC regime is to promote the use of South Africa as the base for holding international investments. Thus headquarter companies are, for example, not subject to CFC rules, transfer pricing and thin capitalisation rules. Dividends declared by a HQC are exempt from dividends withholding tax. HQCs are exempt from the interest withholding tax. Royalties paid by a HQC are not subject to the withholding tax on royalties. A HQC must also disregard any capital gain or capital loss in respect of the disposal of any equity share in any foreign company, provided it held at least 10% of the equity shares and voting rights in that foreign company. The HQC will thus be subject to tax by virtue of its incorporation in South Africa, but the various exemptions from withholding taxes and the transfer pricing rules should have the impact that the HQC would not effectively be subject to any tax. Since the HQC will be "liable to tax by virtue of its incorporation", it will generally be entitled to the benefits of the South African DTA network,[37] it could encourage treaty shopping by non-residents.

- The question arises whether a court could conceivably condemn a treaty shopping scheme by a non-resident to access a DTA with South Africa if the South African Legislator has effectively sanctioned treaty shopping by non-residents to access South African DTAs with other countries.

[37] Article 1 of the UK/South Africa DTA, which is the typical requirement to qualify as a resident of South Africa for DTA purposes.

DTC REPORT ON ACTION 6: PREVENT TREATY ABUSE

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1 INTRODUCTION

In terms of Article 1 of the OECD Model Tax Convention (OECD MTC), the first requirement that must be met by a person who seeks to obtain benefits under a double tax treaty is that the person must be "a resident of a Contracting State", as defined in Article 4 of the OECD MTC. There are a number of treaty abuse arrangements through which a person who is not a resident of a Contracting State may attempt to obtain benefits that a tax treaty grants to residents of the contracting States. These arrangements are generally referred to as "treaty shopping"; a term that describes the use of double tax treaties by the residents of a non-treaty country in order to obtain treaty benefits that are not supposed to be available to them.[38] This is mainly done by interposing or organising a "conduit company"[39] in one of the contracting states so as to shift profits out of the non-treaty states.[40]

Similarly when a conduit company is set up in a third country, this can result in loss of revenue for the signatories to a treaty.[41]

Treaty shopping is undesirable because it frustrates the spirit of the treaty. When treaties are concluded, the assumption is that a certain amount of income will accrue to both countries involved in the treaty and would, without the treaty, be taxed in both countries. The anticipated capital flows are distorted if the treaty is used by third country residents. When unintended beneficiaries are free to choose the location of their businesses, then treaties designed to eliminate double taxation may end up being used to eliminate taxation altogether.[42] Treaty shopping can result in a bilateral treaty functioning largely

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38 H Becker & FJ Wurm *Treaty Shopping: An Emerging Tax Issue and its Present Status in Various Countries* (1988) at 1; S van Weeghel *The Improper Use of Tax Treaties with Particular Reference to the Netherlands and The United States* (1998) at 119.

39 Defined below.

40 After setting up the conduit company structure, other "stepping stone" strategies can also be applied to shift income from the contracting countries. This could be done by changing the nature of the income to appear as tax deductible expenses such as commission of service fees. See FJ Wurm *Treaty Shopping in the 1992 OECD Model Convention Intertax* (1992) at 658; S M Haug "The United States Policy of Stringent Anti-treaty shopping Provisions: A Comparative Analysis" (1996) 29 *Vanderbilt Journal of Trans-national law* at 196; E Tomsett *Tax planning for Multinational companies* (1989) at 149.

41 OECD Issues in International Taxation No. 1 *International Tax Avoidance and Evasion* (1987) at 20; A Ginsberg *International Tax Havens* 2nd ed (1997) at 5-6; P Roper & J Ware *Offshore Pitfalls* (2000)at 5.

42 Weeghel at 121 notes that treaty shopping results in international income being exempt from taxation altogether or being subject to inadequate taxation in a way unintended by the contracting states.

as a "treaty with the world", and this can often result in loss of revenue for the contracting states.[43]

2 PREVIOUS MEASURES RECOMMENDED IN THE OECD MODEL TAX COVENTION TO CURB TREATY SHOPPING

The 2014 version OECD MTC (yet to be revised in line with the OECD BEPS recommendations) provides for two main measures to prevent treaty abuse. These are: the use of domestic anti-avoidance provisions and the use of specific treaty provisions.

2.1 DOMESTIC ANTI-AVOIDANCE PROVISIONS

Paragraph 7.1 of the OECD Commentary on Article 1 of the OECD MTC Convention provides that where taxpayers are tempted to abuse the tax laws of a State by exploiting the differences between various countries' laws, such attempts may be countered by jurisprudential rules that are part of the domestic law of the state concerned. In other words, the onus is placed on countries to adopt domestic anti-avoidance legislation to prevent the exploitation of their tax base and then to preserve the application of these rules in their treaties. The current Commentary on Article 1 states in paragraph 22 that, when base companies[44] are used to abuse tax treaties, domestic anti-avoidance rules such as "substance over form",[45] "economic substance" and other general anti-avoidance rules can be used to prevent the abuse of tax treaties.[46]

2.2 SPECIFIC TREATY PROVISIONS

The Commentary on Article 1 of the OECD MTC also suggests the following examples of specific clauses that can be inserted in tax treaties to curb the different forms and cases of conduit company treaty shopping.

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43 R Rohatgi *Basic International Taxation* (2002) at 363; Haug at 218; Weeghel at 121.

44 A base company can be defined as a company that acts as a holder of the legal title that belongs to the parent company, which may be registered outside the country where the base company is registered. See AW Oguttu *International Tax Law: Offshore Tax Avoidance in South Africa* (2015) at 127.

45 Ware and Roper at 77 where the 'substance over form' doctrine is described as a doctrine which permits the tax authorities to ignore the legal form of a tax arrangement and look at the actual substance of the relevant transaction.

46 This position seems to be based on the 1987 OECD Report entitled 'Double Taxation Conventions and the Use of Base Companies' which states in par 38 that anti-abuse rules or rules on 'substance over form' can be used to conclude that a base company is not the beneficial owner of an item of income.

The "look through" approach: In terms of this approach treaty benefits should be disallowed for a company not owned, directly or indirectly, by residents of the State of which the company is a resident.[47]

The subject-to-tax provision: In terms of this approach, treaty benefits in the state of source can be granted only if the income in question is subject to tax in the state of residence.[48]

Exclusion provisions: This approach denies treaty benefits where specific types of companies enjoy tax privileges in their state of residence that facilitate conduit arrangements and harmful tax practices.[49]

Provisions that apply to subsequently enacted regimes: Paragraph 21.5 of the Commentary suggests a provision that can be inserted in treaties to protect a country against preferential regimes adopted by its treaty partner after the treaty has been signed. Such a provision would apply to both existing and subsequently enacted regimes.[50]

The "limitation of benefits" provision: This provision is aimed at preventing persons who are not residents of the contracting states from accessing the benefits of a treaty through the use of an entity that would qualify as a resident of one of the States.[51] The gist of such a provision is to the effect that residents of a contracting state who derive income from the other contracting state shall be entitled to all benefits of the treaty with respect to an item of income derived from the other state only if the resident is actively carrying on business in the first mentioned state, and the income derived from the other contracting state is derived in connection with, or is incidental to, that business, and that resident satisfies the other conditions of the treaty for access to such benefits.[52]

The "beneficial ownership" clause: Paragraph 10 of the Commentary suggests the use of a "beneficial ownership" clause as one of the anti-abuse provisions that can be used to deal with source taxation of specific types of income set out in articles 10, 11 and 12 of the OECD MTC. The concept of "beneficial owner" was introduced in the OECD MTC in 1977 in order to deal with simple treaty shopping situations where income is paid to an intermediary resident of a treaty country who is not treated as the owner of that income for tax purposes (such

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47 Para 13 of the commentary on Article 1 of the OECD Model Convention. See also AJM Jiménez 'Domestic Anti-Abuse Rules and Double Taxation Treaties: A Spanish Perspective – Part 1' (Nov. 2002) *Bulletin for International Fiscal Documentation* at 21.

48 Para 15 of the commentary on article 1 of the OECD Model.'

49 BJ Arnold *The Taxation of Controlled Foreign Corporations: An International Comparison* (1986) at 256.

50 Jiménez 'at 22.

51 Para 20 of the commentary on article 1 of the OECD Model Convention.

52 Ibid.

as an agent or nominee). This resulted in the addition of a section on "Improper Use of the Convention" to the Commentary on Article 1. This section was expanded in succeeding years, after the OECD released reports such as the 1986 report on *Double Taxation and the Use of Base companies* and the 1992 Report on *Double Taxation and the Use of Conduit Companies.*

The term "beneficial ownership" is, however, not defined in the OECD MTC or its Commentary.[53] Although article 3(2) of the OECD MTC permits countries to apply the domestic meaning of a term that is not fully defined in the OECD MTC, with regard to the beneficial ownership concept, the OECD recommends that the definition should carry an international meaning that would be understood and used by all countries that adopt the OECD MTC.[54] There is however no clear international meaning of the term, and many countries, including South Africa, do not have a definition in domestic legislation.

The OECD MTC does, however, provide some clues to the meaning of the term. In terms of the OECD MTC, a nominee or agent who is a treaty country resident may not claim benefits if the person who has all the economic interest in, and all the control over, property (the beneficial owner) is not also a resident. To further clarify the meaning of the term, in 2003 the OECD released a Report on *Restricting the Entitlement to Treaty Benefits* which lead to amendments in the OECD MTC to further clarify that a conduit company cannot be regarded as a beneficial owner if, through the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties (such as the shareholders of the conduit company).[55]

In October 2012,[56] the OECD issued revised proposals to amend the Commentaries on articles 10, 11 and 12 to provide that beneficial ownership has a treaty meaning independent of domestic law[57] and that it means "the right to use and enjoy" the amount "unconstrained by a contractual or legal obligation to pass on the payment received to another person." However the effectiveness of the beneficial ownership provision in curbing treaty shopping is now questionable in light of certain international cases such as the decisions in Canadian cases of of *Velcro Canada Inc. v The Queen*[58] *and Prevost Car Inc. v*

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53 International Fiscal Association *The OECD Model Convention – 1998 and Beyond; The Concept of Beneficial Ownership in Tax Treaties* (2000) at 15.

54 L Oliver & M Honiball *International Tax: A South African Perspective* (2011) at 46; The International Fiscal Association's 2000 Report on the OECD Concept of Beneficial Ownership in Tax Treaties at 20.

55 OECD "Report on the Use of Base Companies" (1987) in par 14(b).

56 OECD "Revised Proposals concerning the Meaning of "Beneficial Owner" in Articles 10, 11, and 12" (19 October (2012).

57 Proposed paragraph 12.1 of the Commentary on Article 10, paragraph 9.1 of the Commentary on Article 11, and paragraph 4 of the Commentary on Article 12.

58 2012 TCC 57.

Her Majesty the Queen[59] (discussed under the international approached below). As a result of cases such as the above additional work by the OECD, on the clarification of the "beneficial ownership" concept, resulted in changes to the Commentary on articles 10, 11 and 12 of the 2014 version of the OECD MTC, which acknowledged the limits of using that concept as a tool to address various treaty-shopping situations.[60]

Paragraph 12.5 of the Commentary on Article 10 provides that: "whilst the concept of "beneficial ownership" deals with some forms of tax avoidance (*i.e.* those involving the interposition of a recipient who is obliged to pass on the dividend to someone else), it does not deal with other cases of treaty shopping and must not, therefore, be considered as restricting in any way the application of other approaches to addressing such cases."

3 INTERNATIONAL APPROACHES

3.1 THE CANADIAN APPROACH

The Canadian tax authorities have three distinct measures available to combat tax avoidance, which include specific legislative anti-avoidance provisions, a general legislative anti-avoidance rule (the GAAR), and judicial anti-avoidance doctrines, i.e. the sham doctrine, the doctrine of legally ineffective transactions and the substance versus form doctrine.[61] In the Canadian Federal Court of Appeal *case of Paul Antle and Renee Marquis-Antle Spousal Trust v The Queen*,[62] the Minister of National Revenue relied on specific legislative anti-avoidance provisions, the judicial doctrines of sham and legally ineffective transactions, as well as on the GAAR, to challenge the tax treatment claimed by a taxpayer with respect to certain international transactions.

Before the amendment of the Canadian GAAR in 2005 (retroactively to the date of inception in 1988), there was uncertainty whether the GAAR could apply to transactions that resulted in a misuse or abuse of a DTA. The Canadian government ended any uncertainty by amending the GAAR to include in the definition of "tax benefit" those benefits derived from a DTA, and by providing that the GAAR applied to transactions that misuse or abuse a DTA.[63]

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59 2008 TCC 231.

60 OECD "Tax Conventions and Related Questions: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances" (17-18 September 2013) para 8.

61 Canadian Country Report in the 2010 IFA Report, Volume 1 at 172.

62 2009 TCC 465 (TCC), appeal filed to the Federal Court of Appeal (FCA), A-428-09.

63 IFA Report at 175.

The Supreme Court of Canada established the methodology to be followed to determine whether the GAAR can be applied to deny a tax benefit.[64] The following three requirements must be established: (a) a tax benefit; (b) an avoidance transaction; and (c) abusive tax avoidance. The burden is on the taxpayer to prove that there was no tax benefit or no avoidance transaction whilst the Canadian tax authorities must show that there was abusive tax avoidance. The abuse analysis is conducted in two stages. Under the first stage, the court must conduct a unified textual, contextual and purposive (TCP) analysis of the provisions conferring the benefit, in order to determine why these provisions were put in place and why the benefit was conferred. With respect to DTAs, this means that the Court should look at (a) the text of the provisions; (b) their context, which is likely to include other DTA provisions, the preamble, the annexes, other treaties and the OECD Commentary on the OECD Model DTA; and (c) the purpose of the provisions as well as the purpose of the treaty. Under the second stage of the abuse analysis, the court should determine whether the avoidance transactions respect or defeat the object, spirit or purpose of the provisions in issue.

The approach, by the courts in Canada, was analysed by Nathalie Goyette in her thesis[65] and also in her subsequent paper in the Canadian Jaw Journal.[66] She considers whether the Canadian general anti-abuse rules could be applied to counter DTA abuse. Her 1999 thesis concluded that the preamble to Canadian treaties, which stipulates that the purpose of the DTA is to prevent tax evasion, does not constitute a general anti-abuse rule applicable to DTAs for three reasons. First, tax evasion is not synonymous with tax avoidance, and in cases of abuse, the issue is avoidance. Second, although the preamble refers to the prevention of tax evasion, DTAs generally do not include provisions to deal with evasion. Finally, the "domestic tax benefit provision" contained in most Canadian DTAs (according to which the provisions of the DTA do not restrict in any way the deductions, credits, exemptions, exclusions, or other allowances available under domestic tax law), coupled with the principle that DTAs do not levy taxes, supports the argument that the preamble to DTAs does not include a general anti-abuse rule.[67]

However, she points out that in some French-speaking countries, the word "évasion" extends to avoidance transactions, i.e. the word "évasion" found in paragraph 7 of the OECD Commentary on article 1 of the OECD Model DTA probably extends to "évitement" ("avoidance"), as is confirmed by the English

64 *Canada Trustco Mortgage Co. v. Canada*, [2005] 2 S.C.R. 601, 2005 SCC 54, in paras 17 and 66; *Mathew v Canada* [2005] 2 SCR 643 in para 31.

65 Nathalie Goyette "Countering Tax Treaty Abuses: A Canadian Perspective on an International Issue: The Tax Professional Series" (Toronto: Canadian Tax Foundation, 1999).

66 Goyette at 766.

67 Ibid.

version. Therefore, she concludes that there are now grounds to argue that one of the purposes of DTAs is the prevention of avoidance.[68]

She refers to the decision of the Supreme Court of Canada in *Crown Forest Industries v Canada,*[69] where the Court was asked to determine whether a corporation incorporated in the Bahamas, Norsk, was resident in the United States for the purposes of the application of the Canada-US treaty. If such were the case, Norsk could benefit from a reduced rate of withholding tax in respect of rental income that it earned in Canada. Iacobucci J made the following comments in the course of his analysis:[70]

> "It seems to me that both Norsk and the respondent are seeking to minimize their tax liability by picking and choosing the international tax regimes most immediately beneficial to them. Although there is nothing improper with such behaviour, I certainly believe that it is not to be encouraged or promoted by judicial interpretation of existing agreements."

Iacobucci J went on to state that:

> "adopting the interpretation of the word "resident" proposed by Norsk would mean that a corporation that was not subject to any US tax could nonetheless benefit from the reduction in Canadian withholding tax provided for in the Canada-US treaty."

This observation led him to comment:[71]

> "Treaty shopping" might be encouraged in which enterprises could route their income through particular states in order to avail themselves of benefits that were designed to be given only to residents of the contracting states. This result would be patently contrary to the basis on which Canada ceded its jurisdiction to tax as the source country, namely that the US as the resident country would tax the income".

Goyette points out that the numerous other decisions that have referred to the modern and broad interpretive rule for DTAs proposed by the Supreme Court in *Crown Forest* seem to confirm that the latter judgment has had a distinct impact on the manner in which the courts approach Canadian DTA.[72] Furthermore, she notes that recent literature indicates that the presumption against treaty shopping articulated in *Crown Forest* may be a more useful weapon for Canadian tax authorities than GAAR. She observes that the question that remains is the appropriate scope of the anti-treaty-shopping presumption set out in *Crown Forest*. She points out that the Supreme Court stated that to allow treaty shopping would be contrary to the basis on which Canada ceded its jurisdiction to tax as the source country—namely, that the United States, as the country of residence, would tax the income.

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68 Ibid at 793.
69 [1995] 2 SCR 802.
70 Goyette at 773.
71 Ibid.
72 Ibid at 774.

However, even if a state is allocated a right to tax under a DTA, nothing requires it to exercise that right. Consequently, one might question the soundness of the Supreme Court's reasoning. She expressed the view that it seems preferable to interpret the Court's pronouncement as simply stating that treaty shopping is contrary to the basis on which Canada agreed to restrict its jurisdiction to tax, namely, that the taxpayer who receives the income in question is a resident of the United States. Since Norsk was not a US resident, there was no reason for Canada to limit its taxing power.[73]

Goyette observes[74] that, since 1999, the Federal Court Trial Division has rendered a decision in *Chua v. Minister of National Revenue*.[75] In that decision, the court stated that DTAs have two primary objectives: to avoid double taxation and to permit governments to collect amounts due to them by dividing these amounts between them and by combating tax *avoidance* and evasion.[76] She points out that this is the second time that the Federal Court has declared that one of the purposes of DTAs is to combat tax avoidance, which may be the beginning of a trend toward clear interpretation in this regard. She concludes that if the courts were to uphold this trend, they could find it easier to rule that the interpretation of DTAs on the basis of their object or purpose authorizes the application of a domestic anti-abuse rule such as GAAR in cases of DTA abuse; moreover, it is possible that the recent revisions to the OECD Commentary may persuade the courts to consider that one purpose of DTAs is to prevent tax avoidance.[77]

Goyette considers a "borderline" case is in fact a variation of the classic situation of "treaty shopping" through which a Dutch company is interposed in order to benefit from the DTA between Canada and the Netherlands[78]. In this example, a Bahamian company wanted to loan money to a Canadian company, but a direct loan would have given rise to part XIII tax of 25 percent on the interest. Consequently, the Bahamian company incorporated a company in the Netherlands (Dutchco), which loaned money to the Canadian company. The transaction was structured so that very little tax would be paid in the Netherlands and withholding tax would be avoided when the money was returned to the Bahamas.

In her 1999 thesis, Goyette concluded that the search for concordance meant that GAAR could not be invoked in this situation.[79] Her conclusion was based primarily on the following factors:

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73 Ibid at 774.
74 Ibid at 793.
75 [2000] 4 CTC 159 (FCTD).
76 Ibid at 179.
77 Goyette at 793.
78 Ibid at 802.
79 Ibid.

- the Netherlands considers that Dutchco is resident in that country and is entitled to the benefits of the treaty with Canada;
- the Netherlands treats the amounts received by Dutchco as taxable interest, and thus Canada also must consider that the Canadian company paid interest to Dutchco; and
- the objective intention of the contracting states is that domestic anti-abuse rules are not applicable to abuses of the Canada-Netherlands treaty.

Goyette points out[80] that a re-examination of this scenario, or a more flexible and objective application of the search for symmetry of treatment, calls for a different conclusion. First, it should be noted that in a number of situations similar to that of Dutchco, an argument can be made that a company like Dutchco is not the beneficial owner of the interest; and, on the basis of the facts, this argument could satisfy a court that there is no ground for granting the reduction in withholding tax provided for by the DTA. Article 11(2) of the Canada-Netherlands DTA provides for a reduction in the rate of withholding tax imposed by the source state (in this case Canada), but only to the extent that the person who claims this reduced rate is the "beneficial owner" of the interest.

Goyette observes[81] that the revised OECD Commentary on articles 10, 11, and 12 of the OECD Model DTA points out that the term "beneficial owner" is not to be used in a narrow technical sense, rather it should be understood in its context and in light of the object and purposes of the Model DTA, including avoiding double taxation and the prevention of fiscal evasion and avoidance. She points out[82] that the revised OECD Commentary adds that it would be contrary to the purpose and the object of the DTA for the source state (such as Canada in the Dutchco example) to grant a reduction of tax to a resident of a contracting state who acts as an agent, a nominee, or a simple intermediary for another person who, in fact, receives the benefit of the income in question. It follows that if the facts demonstrate that Dutchco is merely an agent or conduit, or that it cannot profit freely from the interest paid by the Canadian company, a court will likely conclude that Dutchco is not the beneficial owner of the interest and is therefore not entitled to the reduced rate of withholding tax provided for by the Canada-Netherlands DTA.

The Canadian Federal Court of Appeal considered the "beneficial ownership" requirement in the 2006 case reported as *Prévost Car Inc v Her Majesty the Queen.*[83] In this case, a Swedish resident and a UK resident held their shares in Prévost Car Inc, a Canadian company, via a Dutch holding company

80 Goyette at 793.
81 Goyette at 803.
82 Ibid.
83 2006 DTL 330.

(HoldCo). Under the applicable DTAs, a 10% withholding tax is imposed on dividends paid to a Swedish shareholder and 15% on dividends paid to a shareholder in the UK, whilst the Netherlands-Canada DTA reduces the dividend withholding tax to 5%. The Court had to decide whether, for purposes of claiming treaty relief, the Dutch holding company (as opposed to its shareholders) was the beneficial owner of dividends received from its wholly owned subsidiary. The court, in finding that the Dutch holding company (DutchCo) was the beneficial owner of the dividends, held that:

> "The beneficial owner of the dividends is the person who receives the dividends for his or her own use and enjoyment and assumes the risk and control of the dividend he or she received."
>
> "When corporate entities are concerned, one does not pierce the corporate veil unless the corporation is a conduit for another person and has absolutely no discretion as to the use or application of funds put through it as conduit or has agreed to act on someone else's behalf pursuant to that person's instructions without any right to do other than what that person instructs it, for example, a stockbroker who is the registered owner of the shares it holds for clients."

In *Velcro Canada Inc v Her Majesty The Queen* (judgment delivered on 24 February 2012) [84] the Court again considered the beneficial ownership requirement for DTA relief. In this case, Velcro Industries BV (VIBV), a Dutch company which migrated to the Netherlands Antilles during 1995, owned certain intellectual property. At the time, VIBV made the intellectual property available to Velcro Canada Inc ("VCI") in terms of a licence agreement. Two days after its migration to the Netherlands Antilles, VIBV assigned the licence agreement to Velcro Holdings BV ("VHBV"), a company resident in the Netherlands. In terms of the assignment agreement, the ownership of the intellectual property remained with VIBV and VHBV:

- was assigned the right to grant licences for VIBV's intellectual property to VCI and to collect royalty payments from VCI as payment for the licences;
- was obliged to enforce the terms of the licence agreement and to take any steps necessary should VCI breach the terms of the contract; and
- was obliged to pay 90%[85] of the royalties so received to VIBV within 30 days of receiving royalty payments from VCI.

In terms of Canadian law, a withholding tax of 25% applies to royalties paid to non-residents. However, until 1999, the rate was reduced to 10% in terms of the Netherlands-Canada DTA, whereafter it was reduced even further to 0%.

[84] 2012 TCC 57.
[85] This secured the arm's length margin required by the Dutch tax authorities.

The Court followed the approach of the Court in the Prévost-case by holding that, when considering the beneficial owner of income, "one must determine who has received the payments for his/her own use and enjoyment and assumed the risk and control of the payment he/she received." The Court held that the attributes of beneficial ownership are "possession", "use", "risk" and "control". The Court considered the dictionary meaning of each of these concepts (as defined in Black's Law Dictionary) and applied it to the facts. It held that:

- VHBV had possession of the royalties as it had exclusive possession of the funds upon receipt, the funds were comingled with VHBV's "general funds" and there was no automatic flow-through of royalties to VIBV;
- VHBV used the funds for its own benefit as there were no restrictions on the use of the funds. The fact that it was contractually obliged to pay an amount equal to 90% of the royalties to VIBV, did not impact on the fact that it had the use of the funds received from VCI;
- The royalties received were the assets of VHBV and available to creditors of VHBV, with no priority given to VIBV. The risk thus remained with VHBV;
- VHBV did have control over the funds as it received it for its own account, comingled the funds with its other funds, etc.

On behalf of the Canadian tax authority, it was argued that VHBV was a mere agent for VIBV, or acted as nominee or conduit. However, the Court held that it would only "take the draconian step of piercing the corporate veil" should the recipient of the funds have "absolutely no discretion" regarding the use and application of the funds. The Court found that even though VHBV's discretion may be limited, it still had a discretion. The Court thus concluded that VHBV was the beneficial owner of the royalties and accordingly entitled to the benefit of the Netherlands-Canada DTA.

3.2 THE UK APPROACH

The UK country report (UK IFA Report) in the IFA Report 2010[86] surmises that DTAs may well stand in conflict with UK domestic anti-avoidance provisions, including in ways which have not yet been fully tested before the courts. The UK IFA Report expresses the view that the conflict may be countered through further domestic provisions intended to re-establish the domestic law position, some involving a more overt DTA override than others. (Very occasionally, however, the DTA will itself contain an anti-avoidance provision which would not otherwise be reflected in UK domestic law and the domestic law provides that no better result may be obtained.)

[86] IFA Report at 805.

Judicial approaches to tax avoidance have been more restrained in construing DTAs than in construing domestic legislation, given in part the need for uniform construction of DTAs. This has further fuelled the difficult relationship between domestic anti-avoidance provisions and DTAs. The UK IFA Report concludes that the statement at paragraph 22(1) of the OECD Commentary on article 1, to the effect that there will be no conflict between anti-avoidance provisions and DTAs, is therefore too bald a statement as far as UK law and practice is concerned[87].

The UK IFA Report observes[88] that the title of most of the UK DTAs refers to the avoidance of double taxation and the prevention of fiscal evasion, but not to the prevention of avoidance. Although the French version of the OECD Model carries equal weight, in the UK domestic context evasion means taking unlawful steps to escape a tax liability whereas avoidance means taking lawful but sometimes ineffective steps to escape a liability, where the effectiveness will depend on the application and interpretation of the relevant taxing provisions. Originally the emphasis was clearly on addressing juridical double taxation[89] as well as the prevention of evasion by providing for the exchange of information. However, as avoidance became more of a concern specific provisions have been introduced incrementally in line with international practice.

In the absence of a GAAR in the UK Tax Act, the UK IFA Report outlined the application of specific anti-tax avoidance provisions of the UK Tax Act to counter DTA abuse.[90] Of particular interest was the application of the UK CFC rules in cases where a UK resident set up a foreign intermediary company in a country which has a DTA with the UK, which protects the income of such intermediary from UK tax.

This scenario was considered by the UK Court of Appeal in *Bricom Holdings Ltd v. CIR.*[91] The case dealt with the application of the UK prevailing CFC rules in respect of UK source interest received by a Netherlands subsidiary of a UK parent. The interest received by its Netherlands subsidiary was apportioned under the UK's CFC rules to the UK parent. The Court had to consider whether the CFC rules could apply in the context of article 7 of the UK/Netherlands DTA,

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87 Ibid.

88 Ibid at 818.

89 The term "juridical double taxation" refers to the imposition of comparable taxes in two (or more) countries on the same taxpayer in respect of the same subject matter and for identical periods. "Economic double taxation" arises when the same economic transaction, item, or income is taxed in two or more jurisdictions during the same period, but in the hands of different taxpayers. See AW Oguttu *International Tax Law: Offshore Tax Avoidance in South Africa* (2015) at 159.

90 Ibid at 807.

91 [1997] EWCA Civ 2193.

which prohibited the UK from taxing income derived by a Netherlands company unless the company operated in the UK through a permanent establishment and such interest was attributable to such a base.

The Court held that the CFC rules did not function to tax the interest income of the Netherlands subsidiary, but an amount equal to the net income of the CFC which is allocated to the resident of the UK, i.e. the Court found that there is no conflict between the CFC rules and the DTA provisions. The amount calculated under the CFC rules is merely a notional profit amount and is no longer interest income as contemplated in the DTA.[92] However, the Court appeared to acknowledge that the UK would have otherwise contravened its DTA obligations.

In *Indofood International Finance Ltd v J P Morgan Chase Bank*[93], a case heard by the Court of Appeal in the UK during 2006, the Court considered the situation where an Indonesian company wished to raise funding by issuing loan notes on the international market. However, should the Indonesian company have raised the funding directly, interest payable to note holders would have been subject to a 20% Indonesian withholding tax on interest. The Indonesian company thus incorporated a Mauritian company ("the Issuer") which issued loan notes to note holders. The Issuer and the Indonesian company ("the Parent Guarantor") then entered into a loan agreement which complied with the relevant terms of the DTA between Mauritius and Indonesia, which reduced the Indonesian withholding tax on the interest from 20% to 10%.

When it became known that the DTA would be renegotiated and that the interest withholding rate would not be reduced in terms of the renegotiated DTA, it was suggested that a Dutch company ("Newco") should be interposed between the Issuer and the Parent Guarantor. Newco would have no role other than to receive the interest from the Parent Guarantor and to pay it to a paying agent ("the Principal Paying Agent") for the benefit of the note holders. In fact, Newco would be obliged, in terms of the respective loan agreements, to on-pay funds received from the Parent Guarantor to the Principal Paying Agent, and would be precluded from *"finding the money from any other source".*

In terms of the Netherlands-Indonesia DTA, should Newco be the beneficial owner of the interest, the interest withholding rate would have been reduced to 10% or less. The Court of Appeal applied a substance over form approach and decided that Newco would not be the beneficial owner of the interest:

92 It is interesting to note that section 9D of the South African ITA was amended shortly after the decision in the Bricom case to add the words "amounts equal to the net income" of the CFC, which could imply that the legislator was concerned that the direct attribution of the income may contravene DTA obligations.

93 [2006] STC 1195.

> "But the meaning to be given to the phrase "beneficial owner" is plainly not to be limited by so technical and legal an approach. Regard is to be had to the substance of the matter. In both commercial and practical terms the Issuer is, and Newco would be, bound to pay on to the Principal Paying Agent that which it receives from the Parent Guarantor.
> …
> [the role of Newco in the structure] can hardly be described as the "full privilege" needed to qualify as the beneficial owner, rather the position of the Issuer and Newco equates to that of an "administrator of income"].

The Court concluded:

> "that the term 'beneficial owner' is to be given an international fiscal meaning not derived from the domestic law of contracting states. As shown by those commentaries and observations, the concept of beneficial ownership is incompatible with that of the formal owner who does not have 'the full privilege to directly benefit from the income'."

The UK IFA Report points out that the Court relied on both the 1986 OECD Conduit Company Report and the 2003 OECD Commentary on the OECD Model DTA to arrive at the "international fiscal meaning" which is distinguished from the narrower "UK technical meaning of the Beneficial ownership" concept which applies under English law.[94]

3.3 THE GERMAN APPROACH

The general anti-avoidance provision under German tax law applies to domestic as well as international transactions, and allows taxes to be levied on the "adequate" substance of a transaction rather than on the "inadequate" legal form, in order to prevent tax avoidance through abusive transactions. The application of this provision in a DTA context is seen as the determination of the "right" rather than the "alleged" facts and, thus, as not being in conflict with the DTA.[95] This general substance-over-form rule is backed up by a wide range of special anti-avoidance provisions in German international tax law. Where these rules are in conflict with DTAs, they are applied nonetheless as DTA overrides have been accepted by the tax courts in Germany.[96]

To prevent the abuse of a DTA through conduit company structures, essentially to reduce German withholding taxes, Germany introduced a special anti-treaty abuse provision into its domestic law[97]. Under the provision, a foreign entity is not entitled to DTA benefits if its shareholders would not be entitled to these benefits had they received the payments directly, and

- there are no commercial or other relevant non-tax reasons for the interposition of the foreign entity; or

94 UK IFA Report at823.
95 German IFA Report in the IFA 2010 Report at 333.
96 Ibid at 341; see also A Linn Generalthemal *Steuerumgehung und Abkommensrecht IStR* (2010) 542 at 543.
97 § 50d Abs. 3 Satz 1 EStG; see the German IFA Report at 336 – 337.

- the foreign company earns no more than 10% of its gross earnings from a business activity of its own; or
- the foreign company is not adequately equipped to take part in business operations given its purpose.

The German courts have upheld the application of these specific anti-abuse provisions in the context of a DTA[98], but the German Constitutional Court (Bundesverfassungsgericht (BVerfG)) gave two judgments in 2004 which may have the impact to limit the scope for treaty override.[99]

Whilst the scope of the specific anti-avoidance rules are reasonably clear, there is an intense debate about the scope of the general anti-avoidance provisions, in particular to what extent "aggressive tax planning" may exceed the realms of legitimate planning and should be treated as "abuse".[100] This uncertainty is a serious problem in Germany in view of the decisions by the German tax courts that a director of a company or a tax advisor has the obligation to utilize or advise of the most efficient tax structures otherwise they could become liable to damages.[101]

The German tax courts have confirmed that the specific anti-treaty abuse provisions override the general anti-tax avoidance provisions of AO 42.[102]

3.4 THE US APPROACH

The US does not currently have a general statutory anti-avoidance rule, but the tax courts have developed anti-abuse doctrines that may be used by the Internal Revenue Service (IRS) to challenge a transaction.[103] These doctrines include the business purpose, economic substance, step transaction, substance over form and sham transaction doctrines.[104] These anti-abuse doctrines may be applied in the international context, including when DTAs are involved.[105] In addition to these anti-abuse doctrines, the US tax rules (the Internal Revenue Code) contain several specific international anti-avoidance rules[106].

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98 German IFA Report at 341, which refers to the decision in BFH, I R 120/93, BStBl. II 1995, 129 as support.

99 German IFA Report at 341.

100 Wolfgang Blumers, Aggressive Steuerplanung, – Vielleicht legal, aber jedenfalls verwerflich, Beriebs Berater, 2013, Beck-online at 2785.

101 Blumers at 2785; also Pinkernell at 9.

102 R Klein, AO § 42 Missbrauch von rechtlichen Gestaltungsmöglichkeiten, Becks online, at 143.

103 USA IFA Report, in the 2010 IFA Report in para 1.1 at 827.

104 Ibid.

105 Ibid.

106 Ibid.

A transaction may be disregarded if the court finds it to be a "sham", devoid of genuine substance.[107] Thus, if the form employed for the transaction is unreal it can be ignored and effect can be given to the actual transaction performed.[108] More often however, the "substance over form" test is applied.[109] In such cases the taxpayer intends that effect should be given to the actual transaction performed. Since the form used is not covered by the literal provision of the statute, the taxpayer manages to escape taxation. In substance, however, he has achieved the economic result which the statute aims to cover. A court may, under certain circumstances, ignore the form of the transaction and consider its substance, e.g. a loan to an associated company may be treated as, in substance, a contribution to equity capital.[110]

The US IFA Report confirms that the substance over form principle has been used to disregard intermediate entities as mere "conduits" or "shams" where they are used to obtain DTA benefits.[111]

Tax avoidance schemes often rely upon the separate fiscal identity of a corporation. Although the IRS has often argued that the corporate identity of an interposed corporation in a treaty shopping scheme should be ignored since it is a mere sham, the courts have not readily accepted this argument. The test to determine whether a corporation should be recognised as an independent fiscal entity was established in the *Moline Properties Inc v CIR*.[112] As long as there was a valid business purpose for the existence of the corporation or it carried out substantive business activities, its separate fiscal entity should be respected.[113] If a tax avoidance scheme consists of several separate steps, the various stages may be amalgamated and treated as one transaction if the steps are interdependent and are directed at a particular end result (the so-called "step-transaction" doctrine).[114]

A test which has been applied frequently to counter treaty shopping schemes is the "conduit test". The classical case in which the test was so applied is *Aiken*

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107 *Higgins v Smith* 40-1 USTC 9160; *Moline Properties Inc v CIR*, 43-1 USTC 9464 esp at 391; also the comments in the US Report on "Tax Avoidance/Tax Evasion" in Cahiers De Droit Fiscal International, Vol XXXVII, 1983, page 333 esp at 335.

108 US IFA Report in para 1.2.2 at 829, where it concludes that the Gregory case is viewed as a precedent for the disregard of the transfer of an asset without a business purpose but solely to reduce a tax liability.

109 *Gregory v Helvering* 35-1 USTC, 9043, esp at 420; also the comments in the US IFA Report in para 1.2.1 at 829.

110 US Report, Cahiers De Droit Fiscal International, Vol La, 1970 at 301; also *Knetch v United States* 60-2 USTC 9785.

111 US IFA Report in para 1.2.1 at 829 which refers to the decision in *Teong-Chan Gaw v Commissioner, T.C. Memo*, 1995-531, 70 T.C.M. 1196.

112 43-1 USTC 9464 esp at 391.

113 US IFA Report at 829.

114 US IFA Report in para 1.2.3 at 832.

Industries Inc v CIR[115]. In accordance with this test the entity is regarded as a conduit since it is not in substance the beneficial owner of the income received from the source State. It merely passes the income on to the ultimate beneficiary. Therefore, it is not entitled to treaty benefits. The most significant cases on treaty "abuse" are analysed below to illustrate the attitude of the US courts.

In the case of *Maximov v US*[116], the petitioner was a private trust (represented by Maximov) which had been created in the US by a resident and citizen of the U.K. The grantor, his wife and their children were the beneficiaries (all residents of the U.K.). The trust which was administered in the US, realized capital gains income upon the sale of certain of its assets during 1954 and 1955. The petitioner claimed exemption from a liability for US income tax on its realized and retained capital gains. As support for this claim he relied on article XIV of the DTA between the U.S and the U.K. which provides:

> "A resident of the United Kingdom not engaged in trade or business in the United States shall be exempt from United States tax on gains from the sale, or exchange of capital assets."

The petitioner argued that, since the real burden of the tax fell upon the beneficiaries of the trust all of whom were residents of the UK, the DTA should have been read as exempting the trust from the tax asserted by the US, i.e. the trust should not have been regarded as a taxable entity. The court could find no support in the plain language of the DTA for petitioner's argument in favour of disregarding the trust entity. It pointed out that the exemption provided for by article XIV applies only to a resident of the UK. Article 11(i)(g) defines a UK resident as "any person (other than a citizen of the United States or a United States corporation) who is a resident in the UK for the purposes of UK tax and not resident in the United States for purposes of United States tax. The word "person" is not defined in the DTA and therefore recourse must be had to the domestic tax law of the State applying the DTA, i.e. the US, to determine its meaning (in accordance with article 11(3) of the DTA). Under US law "person" includes a "trust". Therefore the trust was regarded as a taxable entity, distinct from its beneficiaries and was held to be a resident of the US for purposes of US tax.

Petitioner's claim was, however, supported by a second argument. He argued that equality of tax treatment was an objective for the conclusion of the DTA and that a court had to further this objective. In the petitioner's view the court was compelled to adopt the theory that exemption had to be granted whenever the burden of the tax diminished such equality. The UK imposed no tax on capital gains and therefore, the petitioner claimed, no similar tax could be

115 56 T. C. 925 (1971) – see analysis of the case below.
116 63-1 USTC 9438.

imposed by the US. The court considered the purpose of the DTA and concluded that the general purpose is not to ensure complete and strict equality of tax treatment but rather to facilitate commercial exchange through the elimination of double taxation; an additional purpose is the prevention of fiscal evasion. Neither of these purposes required relief in the situation presented as the beneficiaries did not pay tax on the US income of the trust in the UK and fiscal evasion was not involved. The court thus refused to read the DTA in such a way as to accord unintended benefits, inconsistent with its words and not compellingly indicated by its purpose.

A fine example of "treaty shopping" is the case of *Ingemar Johannson v US.*[117] Johannson, a citizen of Sweden, fought Patterson for the heavyweight boxing championship of the world in three consecutive fights during 1960 and 1961. Johannson formed a service (base) corporation in Switzerland to obtain certain treaty benefits of the US - Switzerland double taxation agreement, i.e. the exemption from US source tax provided for by article X(1) of the treaty. To obtain this benefit Johannson had to prove that he was a resident of Switzerland and that he received the income as an employee of, or under contract with, a Swiss corporation.

The court first examined whether US tax law provides for the taxation of Johannson's income. Section 871(C) of the Internal Revenue Code, 1954, provided at the time that a non-resident alien individual engaged in trade or business within the US shall be taxable there. The term "engaged in trade or business within the US" includes the performance of personal services within the US at any time within the taxable year. The court then enquired whether a DTA required a contrary result. It found no contrary provision in the US DTA with Sweden. As Johannson, however, relied on the US - Switzerland DTA the court proceeded to examine its provisions. The term “resident" is nowhere defined in the DTA. In accordance with article II(2) the contracting State, applying the DTA, should revert to its own national law definition, if the DTA does not define a term.[(291)] As the criteria applied to determine the meaning are the same in both States the court regarded article II(2) as unimportant.

On the evidence before it, the court concluded that Johannson was not a resident of Switzerland as his social and economic ties, during the relevant time, remained predominantly with Sweden. The court also considered the second condition which had to be fulfilled before DTA benefits could be claimed, i.e. that the recipient must have received the income as an employee of, or under contract with, a Swiss corporation.

117 64-2 USTC 9743.

The court established that the corporation had no legitimate business purpose and therefore held it to be a device used by Johannson to divert his US income so as to escape US taxes. The fact that Johannson was motivated in his actions by the desire to minimize his tax burden was, however, not the reason why the exemption, to which he was entitled in accordance with the DTA provision, was refused. The court stressed that the specific words of a DTA should be given a meaning consistent with the genuine shared expectations of the contracting parties, and to do this was necessary to examine not only the language (i.e. the literal text), but the entire context of the DTA.

In the court's opinion the main objective of the DTA with Switzerland was the elimination of the impediments to international commerce resulting from double taxation. As a general rule, applied in DTAs, the income from services is taxable where the services are rendered. Exceptions to this rule are made to avoid taxation of an enterprise in every country where it is active or of agents and employees of such firms. Where the circumstances do not warrant an exception, the general rule must be applied. Thus the court held that Johannson had failed to establish any substantial reasons for deviating from the DTA's basic rule (income from services is taxable where the services are rendered) in spite of the fact that he had brought himself within the words of the DTA. The court concluded that international trade would not be seriously encumbered by its refusal to give special tax treatment to one only marginally, if at all, Swiss resident who was only technically, if at all, employed by a paper Swiss corporation.

In *Perry Bass v. Commissioner of Internal Revenue*[118] the taxpayer successfully used the US - Switzerland DTA to avoid US taxes. The petitioners (Perry and Nancy Lee Bass) were citizens and residents of the US. Perry Bass organised a Swiss corporation, Stantus AG, and acquired, for cash, all the stock except three shares, which were held by the directors for the benefit of the petitioner. He then transferred, to the corporation, a substantial share of his interest in certain oil producing properties in the US. The corporation thereafter signed working agreements, collected royalties, made investments and carried out other business activities. Stantus AG reported the income from these interests on its US and Swiss tax returns, but claimed exemption from US taxes under the DTA between the US and Switzerland.

The sole issue, in the court's view, was whether Stantus AC could be disregarded for tax purposes so that the income and losses of the corporation would constitute the income and losses of the petitioner. The court stressed that a taxpayer may adopt any form he desires for the conduct of his business, and that the chosen form cannot be ignored merely because it results in tax

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118 50 T.C. 595 (1968).

saving. To be afforded recognition, however, the form the taxpayer chooses must be a viable business entity, i.e. it must have been formed for a substantial business purpose or actually engage in substantive business activity.

After considering the facts, the court concluded that Stantus AG was a viable business corporation. It was duly organised in accordance with Swiss law, and also carried out activities which a viable corporation normally carries out. The fact that an owner of a corporation (the petitioner in this case) retains direction of its affairs down to the minutest details affords no ground for disregarding it as a separate corporate entity. The court acknowledged that the corporation was formed with the aim to reduce US taxes but, in its opinion, the test is not the personal purpose of the taxpayer in creating a corporation, but rather whether he intends to reduce US taxes by using a corporation which carries out substantive business functions. The corporation was thus regarded as a separate tax entity which implied that it was taxable in Switzerland in accordance with the US - Switzerland DTA.

It should be noted that Bass had requested a tax ruling from the US IRS as to the validity of the proposed scheme. The ruling confirmed that Stantus AG would be exempt from US tax under the US Switzerland tax DTA.

Another example of unsuccessful "treaty shopping" is the *Aiken Industries* case (see reference above). Aiken Industries Inc., a US corporation, borrowed money from its parent corporation situated in the Bahamas. To avoid US withholding (source) taxes on interest payments by Aiken Industries to its parent corporation, the parent corporation created a corporation in Honduras and assigned its rights and interest in the promissory note (issued by Aiken Industries) to this corporation. The US - Honduras DTA provided that interest received by a resident or corporation of a contracting State, from sources within the other State, would be exempt from source taxation in the other State if the receiver of the interest had no permanent establishment there.

In support of its claim for exemption under the DTA, the petitioner argued that the Honduran corporation conformed to the definition of a corporation provided for in article II(1)(g) of the DTA. The court pointed out that DTAs are the supreme law of the land and superior to domestic tax laws. Consequently the courts and tax authorities must apply the definitions expressly set forth in the DTA. Therefore, when the formal requirements of a definition in a DTA are met the benefits flowing from the DTA, as a result of conforming to such formal requirements, cannot be denied by an enquiry behind those formal requirements. The Honduran corporation did fulfill the definitional requirements of the DTA and therefore, the court had to recognize it as a taxable entity for purposes of the DTA.

This fact alone was, according to the court, not sufficient to qualify the interest in question for the exemption from tax granted by article IX of the DTA. A further condition required by article IX was that the interest payments had to be "received by" the corporation in the other contracting State. The meaning of "received by" had to be established by the court. Under article II(2) of the DTA, terms not otherwise defined had to carry the meaning which they normally had under the laws of the State which applied the DTA unless the context required otherwise. In order to give the specific words of a DTA a meaning consistent with the genuine shared expectations of the contracting States, it is necessary to examine not only the language but the entire context of the DTA.

The court applied these principles and found that the interest payments were not "received by" a corporation of a contracting State within the meaning of article IX. "Received by" was interpreted to mean not merely the obtaining of physical possession of such interest on a temporary basis, but to contemplate dominium and control over the funds. The petitioner could not prove that a substantive indebtedness existed between the US corporation and the Honduran corporation.

The assignment of the debt between the Bahamian corporation and the Honduran corporation had no valid business purpose. A tax avoidance motive is generally not regarded as fatal to a transaction, but such a motive, standing by itself is not a business purpose which is sufficient to support a transaction for tax purposes. The Honduran corporation was thus held to be a mere conduit which had no actual beneficial interest in the interest payments it "received" and thus, in substance, the US corporation was paying the interest to the Bahamian corporation, which received it within the meaning of article IX of the US — Honduran DTA.

In *Compagnie Financiere De Suez et de L'Union Parisienne v US*[119] the taxpayer attempted to use a double taxation agreement to avoid US source tax. The "Compagnie Financiere de Suez et de L'Union Parisienne" was the corporation that built and operated the Suez Canal until it was nationalized on July 26, 1956. The corporation entered into a trust agreement with J.P. Morgan and Co. Inc. of New York, on January 17 1949. A revocable trust was created. The corporation designated JP Morgan and Co. Inc. as trustee of a trust fund for the purpose of enabling the corporation to fund, or otherwise secure, its pension obligations. Current trust income, exclusive of capital gains was to be paid over to the corporation as of 1 December each year. The trustee had to withhold the US source tax on interest and dividend payments which the trust made to foreigners, in accordance with the US Internal Revenue Code. The corporation identified itself, on all the tax returns it filed, as an Egyptian

119 74-1 USTC 9254.

corporation. It received the dividends and interest paid by the trust. At no time during the years from 1952 — 1956 did the corporation have a permanent establishment in the US. On January 14 1959 it filed refund claims for the withholding tax levied in the US.

The basis for the plaintiff's claim was that it was a French corporation for the purposes of article 6(A) of the DTA between France and the US as its administrative domicile was in Paris (according to article 3, of the articles of incorporation). Furthermore all the corporation's major administrative functions, performed during its operating history, were done through its general administrative office in Paris. All the officers and all the agents of the corporation, resident in Egypt, with one exception, were French citizens. The corporation was subject to French jurisdiction for purposes of handling its securities (but the securities were treated as foreign for tax purposes).

Countervailing factors were that the corporation had its designated head office, its primary place of business and its basic source of income in Egypt. After considering the history of the corporation the court concluded that it was an Egyptian corporation from 1952 to 1956. It was, therefore, not entitled to the reduced tax rate on US interest and dividend payments, as provided in the DTA between the US and France and it was thus not entitled to refunds.

The corporation was created under Egyptian law, and Egypt exercised sovereign power over it. Its head office was in Egypt and all its profit-making business was carried on outside of France. Moreover, it was not subject to French tax. As support for this finding, based on facts, the court relied on a US Treasury Regulation (1961) which was an attempt to define the concept "French enterprise" or "French corporation or other entity" for purposes of the tax DTA with France. According to the Regulation an enterprise carried on wholly outside France, by a French corporation, is not a French enterprise within the meaning of the DTA. The court expressed the opinion that the Regulation was an attempt to prevent corporations that were incorporated in France, but which conducted all their profit-making business outside France in order to avoid French tax, to claim tax benefits of DTAs to which France was a signatory. Therefore, even if the corporation had been created in France under French law, it would not have qualified for DTA benefits.

To further justify the decision, the court considered the purpose of the tax DTA. It concluded that the main purpose was to avoid double taxation and, as the corporation paid no taxes in France, there was no such burden. Thus, there was no need for the DTA to be applied.

The US tax courts have also applied the "step transaction doctrine" to counter DTA abuse.[120] The USA IFA Report points out that the step transaction doctrine may be viewed as another variation of the "substance over form" principle: In determining whether steps should be integrated under the step transaction doctrine, courts and the IRS typically have applied three alternative tests. In the strictest test, the "binding commitment" test, a series of transactions will be "stepped together" only if, at the time the first step occurs, there is a binding commitment to undertake the subsequent steps. In the "mutual interdependence" test, a series of transactions will be stepped together if the steps were "so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series". Under the "end result" test, a series of transactions will be stepped together if the parties' intent, at the commencement of the transactions, was to achieve the particular result and the steps were all entered into to achieve that result."[121]

In *Del Commercial Properties Inc v Commissioner*,[122] Delcom Financial Ltd (Financial), a Canadian corporation obtained an $18 million loan from a third-party bank. Delcom Financial then loaned $14 million of the loan to its wholly owned Canadian subsidiary, which then contributed $14 million to its wholly owned Cayman subsidiary, which contributed the $14 million to its wholly owned Netherlands-Antilles subsidiary, which contributed the $14 million to its wholly owned Netherlands subsidiary. The Netherlands subsidiary then loaned the $14 million to Delcom Commercial in the US. Initially, the taxpayer made its payments under the loan to the Netherlands subsidiary, but later it made payments directly to Delcom Financial, ignoring the intermediate parties. The IRS argued that the real loan was made by Delcom Financial to Delcom Commercial and that interest payments were subject to 15 per cent withholding under the 1985 USA–Canada DTA. The taxpayer argued that the loan from the Netherlands subsidiary to Delcom Commercial should be respected and that the interest payments were not subject to withholding under the US Netherlands DTA.

The court denied the DTA relief on the basis of the step transaction doctrine, stating that a step in a series of transactions would be ignored if the step does "not appreciably affect [the taxpayer's] beneficial interest except to reduce his tax".[123] The court referred to two Revenue Rulings from the IRS, which provide that "if the sole purpose of the transaction with a foreign country is to dodge US taxes, the treaty cannot shield the taxpayer from the fatality of the step-

120 USA IFA Report in para 1.2.3 at 832.
121 Ibid.
122 251 F.3rd 505, 512 (DC Cir. 2000).
123 USA IFA Report at.833.

transaction doctrine. For the taxpayer to enjoy the treaty's tax benefits, the transaction must have a sufficient business or economic purpose."[124]

The US IFA Report concludes that the court's decision appears to be grounded more in the substance over form and conduit principles, since Delcom Commercial could not show that BV had "any business or economic purpose sufficient to overcome the conduit nature of the transaction". [125]

In general, the US courts have applied the domestic anti-abuse rules to counter DTA abuse, i.e. they have not viewed the application of such rules as inconsistent with the DTAs.[126] In terms of the US Constitution, federal domestic law and DTAs are on an equal footing; whilst a court will attempt to give effect to both, if there is a clear conflict, the later in time will prevail.[127] Several specific anti-avoidance rules directly limit the application of DTA provisions and may possibly be regarded as in conflict with US DTA obligations.[128]

The US has introduced many specific and general anti-avoidance provisions in its DTAs. [129] The most prominent is the US Limitation of Benefits (LOB) provision in Article 21 of the US Model DTA.[130] The LOB provision in US DTAs has been criticized for its inflexibility. For example, if a South African Group should hold its international investments via a Netherlands holding company (Holdco), which is typically established for many other reasons apart from tax benefits, that Holdco will not be entitled to the benefits of the Netherlands/US DTA, even though the South African parent company is entitled to virtually the same benefits under the US/South Africa DTA. The test is applied very rigidly, without consideration of the wider circumstances.

4 THE OECD BEPS PROJECT

When the OECD issued its 2013 Report on base erosion and profit shifting (BEPS),[131] it noted, in Action 6, that although current rules to prevent treaty abuse work well in many cases, they need to be adapted to prevent BEPS that results from the interactions among more than two countries, and to fully account for global value chains. The OECD recommends that:
Existing domestic and international tax rules should be modified in order to more closely align the allocation of income with the economic activity that generates that income.

124 Ibid.
125 Ibid.
126 Ibid, par 1.4 at.837.
127 Ibid, par 1.4.2 at.838.
128 Ibid, par 1.4.3 at. 839.
129 Ibid, par 2 at 840.
130 Article 22 of the US/South Africa DTA.
131 OECD *Action Plan on Base Erosion and Profit Shifting* (2013) at 19.

To address treaty abuse, the OECD embarked on work to:
Develop changes to model treaty provisions and provide recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances.

Clarify that tax treaties are not intended to be used to generate double non-taxation.

Identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country.

In September 2014 the OECD issued a Report[132] on Action 6 and a Final report was issued in 2015,[133] a summary of its recommendations is set out below:

4.1 OECD RECOMMENDATIONS REGARDING THE DESIGN OF DOMESTIC RULES TO PREVENT THE GRANTING OF TREATY BENEFITS IN INAPPROPRIATE CIRCUMSTANCES

The September 2015 Final Report on Action 6, sets out recommendations intended to prevent the granting of treaty benefits in inappropriate circumstances. The OECD noted that a distinction has to be made between:

c) Cases where a person tries to circumvent the provisions of domestic tax law to gain treaty benefits. In these cases, treaty shopping must be addressed through domestic anti-abuse rules (as discussed above).[134]
d) For cases where a person tries to circumvent limitations provided by the treaty itself, the OECD recommends treaty anti-abuse rules, using a three-pronged approach:
    (iv) The title and preamble of treaties should clearly state that the treaty is not intended to create opportunities for non-taxation or reduced taxation through treaty shopping.[135] Such a provision augments the treaty interpretation approach of preventing treaty abuse in article 31 of the Vienna Convention on the Law of Treaties which provides that treaties are to be interpreted in good faith and in the light of the object and purpose of the treaty.[136]

132 OECD/G20 Base Erosion and Profit Shifting Project “Preventing the Granting of Treaty Benefits in Inappropriate Circumstances Action 6: 2014 Deliverable” (2014). (OECD/G20 September 2014 Report on Action 6).
133 OECD/G20 Base Erosion and Profit Shifting Project “Preventing the Granting of Treaty Benefits in Inappropriate Circumstances” (2015 Final Report))
134 OECD/G20 2015 Final Report on Action 6 in para 15.
135 OECD/G20 2015 Final Report on Action 6 in para 19.
136 Vienna Convention on the Law of Treaties of 23 May 1969

(v) The inclusion of a specific limitation-of-benefits provisions (LOB rule), which is normally included in treaties concluded by the United States and a few other countries: The OECD is of the view that 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. [137]

(vi) To address other forms of treaty abuse, not being covered by the LOB rule (such as certain conduit financing arrangements), tax treaties should include a more general anti-abuse rule based the principal purposes (PTT) rule. This rule is intended to provide a clear statement that the Contracting States intend to deny the application of the provisions of their treaties when transactions or arrangements are entered into in order to obtain the benefits of these provisions in inappropriate circumstances. [138]

The OECD acknowledges that each rule has strengths and weaknesses and may not be appropriate for all countries.[139] It thus advises that the rules may be adapted to the specificities of individual States and the circumstances of the negotiation of DTAs. For example, some countries may have constitutional or certain legal restrictions that prevent them from adopting the recommendation. Some countries may have domestic anti-abuse rules or interpretative tools developed by their courts that prevent some of the treaty abuses. In other cases, the administrative capacity of some countries (a major issue in African countries) may prevent them from applying certain detailed anti-abuse rules and require them to adopt more general anti-abuse provisions (for example the PPT rule).[140] Nevertheless, the OECD recommends that at a minimum level, to protect against treaty abuse, countries should include in their tax treaties an express statement that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements.[141] This intention should be implemented through either:

- using the combined LOB and PPT approach described above; or
- the inclusion of the PPT rule or;
- the inclusion of LOB rule supplemented by a mechanism (such as a restricted PPT rule applicable to conduit financing arrangements or domestic anti-abuse rules or judicial doctrines that would achieve a

137 OECD/G20 2015 Final Report on Action 6 in para 19.
138 Ibid.
139 OECD/G20 2015 Final Report on Action 6 in para 21
140 OECD/G20 2015 Final Report on Action 6 in para 21.
141 OECD/G20 2015 Final Report on Action 6 in para 22.

similar result) that would deal with conduit arrangements not already dealt with in tax treaties. [142]

4.2 OECD RECOMMENDATIONS REGARDING OTHER SITUATIONS WHERE A PERSON SEEKS TO CIRCUMVENT TREATY LIMITATIONS

The OECD noted that although the general anti-abuse rule will be useful in addressing treaty abuse situations, it is also important to have targeted specific treaty anti-abuse rules which generally provide greater certainty for both taxpayers and tax administrations. Such rules are already found in some Articles of the Model Tax Convention; for example: Articles 13(4) and 17(2)). [143] In addition, the OECD provides the following examples of situations with respect to which specific treaty anti-abuse rules may be helpful, and makes proposals for changes intended to address some of these situations. [144]

<u>Splitting-up of contracts:</u> The OECD notes that paragraph 18 of the Commentary on Article 5 indicates that "[t]he twelve-month threshold [*of Article 5(3)*] has given rise to abuses; it has sometimes been found that enterprises (mainly contractors or subcontractors working on the continental shelf, or engaged in activities connected with the exploration and exploitation of the continental shelf) divided their contracts up into several parts, each covering a period less than twelve months and attributed to a different company which was, however, owned by the same group." [145]

- To address these issues the PPT rule will be added to the MTC and the Report on Action 7 (*Preventing the Artificial Avoidance of Permanent Establishment Status*, OECD, 2015) puts forward changes to the Commentary on Article 5 that will also deal with the issue.[146]

<u>Hiring-out of labour cases:</u> Where a taxpayer attempts to obtain, inappropriately, the benefits of the exemption from source taxation provided for in Article 15(2) by hiring-out of labour.

- The OECD notes that these treaty abuses can already be dealt with by the guidance provided in paragraphs 8.1 to 8.28 of the Commentary on Article 15 and in the alternative provision found in paragraph 8.3 of that Commentary. [147]

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142 OECD/G20 2015 Final Report on Action 6 at 21.
143 OECD/G20 2015 Final Report on Action 6 in para 27.
144 OECD/G20 2015 Final Report on Action 6 in para 28.
145 OECD/G20 2015 Final Report on Action 6 in para 29.
146 OECD/G20 2015 Final Report on Action 6 in para 30.
147 OECD/G20 2015 Final Report on Action 6 in para 31.

Transactions intended to avoid dividend characterisation: The OECD notes that in some cases, transactions may be entered into for the purpose of avoiding domestic law rules that characterise a certain item of income as a dividend and to benefit from a treaty characterisation of that income (e.g. as capital gain) that prevents source taxation. [148]

- The OECD notes that its work on hybrid mismatch arrangements, examined whether the treaty definitions of dividends and interest could be amended, as is done in some treaties, in order to permit the application of domestic law rules that characterise an item of income as such. Although it was concluded that such a change would have a very limited impact with respect to hybrid mismatch arrangements, it was decided to further examine the possibility of making such changes after the completion of the work on the BEPS Action Plan. [149]

Dividend transfer transactions: In dividend transfer transactions, a taxpayer entitled to the 15 per cent portfolio rate of Article 10(2)(b) may seek to obtain the 5 per cent direct dividend rate of Article 10(2)(a) or the 0 per cent rate that some bilateral conventions provide for dividends paid to pension funds.[150] The concern is that Article 10(2)(a) does not require that the company receiving the dividends must have owned at least 25 per cent of the capital for a relatively long time before the date of the distribution. This means that all that counts regarding the holding is the situation prevailing at the time material for the coming into existence of the liability to the tax to which Article 10(2)(a) applies. To prevent any abuse that might arise, it is necessary to require the parent company to have possessed the minimum holding for a certain time before the distribution of the profits could involve extensive inquiries. Internal laws of certain OECD member countries provide for a minimum period during which the recipient company must have held the shares to qualify for exemption or relief in respect of dividends received.

- The OECD recommends that Contracting States may include a similar condition in their conventions to ensure that the reduction envisaged in Article 10(2)(a) is not granted in cases of abuse of this provision, for example, where a company with a holding of less than 25 per cent has, shortly before the dividends become payable, increased its holding primarily for the purpose of securing the benefits of the abovementioned provision, or otherwise, where the qualifying holding was arranged primarily in order to obtain the reduction. [151]

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148 OECD/G20 2015 Final Report on Action 6 in para 32.
149 OECD/G20 2015 Final Report on Action 6 in para 33.
150 See paragraph 69 of the Commentary on Article 18 and also OECD/G20 2015 Final Report on Action 6 in para 34.
151 OECD/G20 2015 Final Report on Action 6 in para 35.

- The OECD concluded that in order to deal with such transactions, a minimum shareholding period should be included in Article 10(2)(a) to read as follows:

  > *a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends throughout a 365 day period that includes the day of the payment of the dividend (for the purpose of computing that period, no account shall be taken of changes of ownership that would directly result from a corporate reorganisation, such as a merger or divisive reorganisation, of the company that holds the shares or that pays the dividend).* [152]

- It was also concluded that additional anti-abuse rules should be included in Article 10 to deal with cases where certain intermediary entities established in the State of source are used to take advantage of the treaty provisions that lower the source taxation of dividends.[153]

<u>Transactions that circumvent the application of Article 13(4):</u> Article 13(4) allows the Contracting State in which immovable property is situated to tax capital gains realised by a resident of the other State on shares of companies that derive more than 50 per cent of their value from such immovable property. [154] Paragraph 28.5 of the Commentary on Article 13 already provides that States may want to consider extending the provision to cover not only gains from shares but also gains from the alienation of interests in other entities, such as partnerships or trusts, which would address one form of abuse.

- It was agreed that Article 13(4) should be amended to include such wording. [155]

The OECD also notes that there might also be cases, however, where assets are contributed to an entity shortly before the sale of the shares or other interests in that entity in order to dilute the proportion of the value of these shares or interests that is derived from immovable property situated in one Contracting State.

- In order to address such cases, it was agreed that Article 13(4) should be amended to refer to situations where shares or similar interests derive their value primarily from immovable property at any time during a certain period as opposed to at the time of the alienation only. [156]

<u>Tie-breaker rule for determining the treaty residence of dual-resident persons other than individuals:</u> The OECD notes that one of the key limitations on the granting of treaty benefits is the requirement that a person be a resident of a

[152] OECD/G20 2015 Final Report on Action 6 in para 36.
[153] OECD/G20 2015 Final Report on Action 6 in para 37.
[154] OECD/G20 2015 Final Report on Action 6 in para 41.
[155] OECD/G20 2015 Final Report on Action 6 in para 42.
[156] OECD/G20 2015 Final Report on Action 6 in para 43.

Contracting State (article 4) for the purposes of the relevant tax treaty. Article 4(3), which deals with persons other than individuals, provides that the dual-resident person “shall be deemed to be a resident only of the State in which its place of effective management is situated”. When this rule was originally included in the 1963 *Draft Convention*, the OECD Fiscal Committee expressed the view that “it may be rare in practice for a company, etc. to be subject to tax as a resident in more than one State” but because that was possible, “special rules as to the preference” were needed. [157] The 2008 Update to the OECD Model Tax Convention introduced an alternative version of Article 4(3) (in paragraphs 24 and 24.1 of the Commentary on Article 4) according to which the competent authorities of the Contracting States shall, having regard to a number of relevant factors, endeavour to determine, by mutual agreement, the State of which the person is a resident for the purposes of the Convention. The OECD discussed an alternative version, and the view of many countries was that cases where a company is a dual resident often involve tax avoidance arrangements.

- It was recommended that the current POEM rule found in Article 4(3) should be replaced by the alternative found in the Commentary, which allows a case-by-case solution of these cases. [158]
- Thus instead of providing that a person, other than an individual, that is a resident of both Contracting States, shall be deemed to be a resident only of the State in which its place of effective management is situated, article 4(3) shall be amended to provide that:.

  the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States. [159]

The option is, however, still provided to States negotiating tax treaties to include a tie-breaker rule that refers to where the POEM is situated.[160]

Anti-abuse rule for permanent establishments situated in third States: Paragraph 32 of the Commentary on Article 10, paragraph 25 of the Commentary on Article 11 and paragraph 21 of the Commentary on Article 12 refer to potential abuses that may result from the transfer of shares, debt-claims, rights or property to permanent establishments set up solely for that

[157] OECD/G20 2015 Final Report on Action 6 in para 46.
[158] OECD/G20 2015 Final Report on Action 6 in para 47.
[159] OECD/G20 2015 Final Report on Action 6 in para 48.
[160] OECD/G20 2015 Final Report on Action 6 in para 49 refer to replacement suggestion para 24.5.

purpose, in countries that offer preferential treatment to the income from such assets. Where the State of residence exempts, or taxes at low rates, profits of such permanent establishments situated in third States, the State of source should not be expected to grant treaty benefits with respect to that income. [161]

- The last part of paragraph 71 of the Commentary on Article 24 deals with that situation and it is suggested that an anti-abuse provision could be included in bilateral conventions to protect the State of source from having to grant treaty benefits where income obtained by a permanent establishment situated in a third State is not taxed normally in that State.[162]

Triangular abuse cases may also arise. If the Contracting State of which the enterprise is a resident exempts from tax the profits of the permanent establishment located in the other Contracting State, an enterprise can transfer assets such as shares, bonds or patents to permanent establishments in States that offer very favourable tax treatment and, in certain circumstances, the resulting income may not be taxed in any of the three States.

- To prevent such abusive practices, a provision can be included in the convention between the State of which the enterprise is a resident and the third State (the State of source) stating that an enterprise can claim the benefits of the convention only if the income obtained by the permanent establishment, situated in the other State, is taxed normally in the State of the permanent establishment. [163] Thus the OECD concluded that a specific anti-abuse provision will be included in the Model Tax Convention to deal with that and similar triangular cases where income attributable to the permanent establishment in a third State is subject to low taxation.

4.3 OECD RECOMMENDATIONS IN CASES WHERE A PERSON TRIES TO ABUSE THE PROVISIONS OF DOMESTIC TAX LAW USING TREATY BENEFITS

The OECD notes that many tax avoidance risks that threaten the tax base are not caused by tax treaties but may be facilitated by treaties. In these cases, it is not sufficient to address the treaty issues: changes to domestic law are also required. Avoidance strategies that fall into this category include:

- Thin capitalisation and other financing transactions that use tax deductions to lower borrowing costs;
- Dual residence strategies (e.g. a company is resident for domestic tax purposes but non-resident for treaty purposes);
- Transfer mis-pricing;

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161 OECD/G20 2015 Final Report on Action 6 in para 49.
162 OECD/G20 2015 Final Report on Action 6 in para 50.
163 OECD/G20 2015 Final Report on Action 6 in para 50.

- Arbitrage transactions that take advantage of mismatches found in the domestic law of one State and that are
  - related to the characterisation of income (e.g. by transforming business profits into capital gain) or payments (e.g. by transforming dividends into interest);
  - related to the treatment of taxpayers (e.g. by transferring income to tax-exempt entities or entities that have accumulated tax losses; by transferring income from non-residents to residents);
  - related to timing differences (e.g. by delaying taxation or advancing deductions).
- Arbitrage transactions that take advantage of mismatches between the domestic laws of two States and that are
  - related to the characterisation of income;
  - related to the characterisation of entities;
  - related to timing differences.
- Transactions that abuse relief of double taxation mechanisms (by producing income that is not taxable in the State of source but must be exempted by the State of residence or by abusing foreign tax credit mechanisms).[164]

The OECD notes that its work on other aspects of the Action Plan, in particular Action 2 (Neutralise the effects of hybrid mismatch arrangements), Action 3 (Strengthen CFC rules), Action 4 (Limit base erosion via interest deductions and other financial payments) and Actions 8, 9 and 10 dealing with Transfer Pricing has addressed many of these transactions.[165]

The OECD notes that main objective of its work aimed at preventing the granting of treaty benefits with respect to these transactions is to ensure that treaties do not prevent the application of specific domestic law provisions that would prevent these transactions. Granting the benefits of these treaty provisions in such cases would be inappropriate to the extent that the result would be the avoidance of domestic tax. Such cases include situations where it is argued that

- Provisions of a tax treaty prevent the application of a domestic GAAR;
- Article 24(4) and Article 24(5) prevent the application of domestic thin-capitalisation
- Article 7 and/or Article 10(5) prevent the application of CFC rules;
- Article 13(5) prevents the application of exit or departure taxes;
- Article 24(5) prevents the application of domestic rules that restrict tax consolidation to resident entities;

164 OECD/G20 2015 Final Report on Action 6 in para 53.
165 OECD/G20 2015 Final Report on Action 6 in para 54.

- Article 13(5) prevents the application of dividend stripping rules targeted at transactions designed to transform dividends into treaty-exempt capital gains;
- Article 13(5) prevents the application of domestic assignment of income rules (such as grantor trust rules). [166]

The Commentary on the Articles of the OECD Model already addresses a number of these issues. For instance:

- Paragraph 23 of the Commentary on Article 1 provides that treaties do not prevent the application of CFC rules.
- Paragraph 3 of the Commentary on Article 9 suggests that treaties do not prevent the application of thin capitalisation rules "insofar as their effect is to assimilate the profits of the borrower to an amount corresponding to the profits which would have accrued in an arm's length situation".
- The Commentary does not, however, address a number of other specific domestic anti-abuse rules. [167] Nevertheless, paragraphs 22 and 22.1 of the Commentary on Article 1 provide a more general discussion of the interaction between tax treaties and domestic anti-abuse rules. These paragraphs conclude that a conflict would not occur in the case of the application of certain domestic anti-abuse rules to a transaction that constitutes an abuse of the tax treaty. [168]
- The Commentary does also address other forms of abuse of tax treaties (e.g. the use of a base company) and possible ways to deal with them, including "substance-over-form", "economic substance" and general anti-abuse rules, particularly as concerns the question of whether these rules conflict with tax treaties. Paragraph 9.5 of the commentary on article 1 clearly provides a general rule that such rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability; these rules are not addressed in tax treaties and are therefore not affected by them and they are not in conflict with tax treaties.[169]
- Paragraph 9.5 of the Commentary on Article 1 currently offers the following guidance as to what constitutes an abuse of the provisions of a tax treaty: "A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions".[170]

[166] OECD/G20 2015 Final Report on Action 6 in para 54.
[167] OECD/G20 2015 Final Report on Action 6 in para 55.
[168] OECD/G20 2015 Final Report on Action 6 in para 56.
[169] OECD/G20 2015 Final Report on Action 6 in para 56.
[170] OECD/G20 2015 Final Report on Action 6 in para 57

As indicated above new general anti-abuse rule will be included in the OECD Model to reinforce the principle already recognised in paragraph 9.5 of the Commentary on Article, which will provide a clear statement that the Contracting States want to deny the application of the provisions of their treaty when transactions or arrangements are entered into in order to obtain the benefits of these provisions in inappropriate circumstances. The incorporation of that principle into a specific treaty provision does not modify, however, the conclusions already reflected in the Commentary on Article 1 concerning the interaction between treaties and domestic anti-abuse rules; such conclusions remain applicable, in particular with respect to treaties that do not incorporate the new general anti-abuse rule.[171] In this regard, it is suggested that the section on "Improper use of the Convention" currently found in the Commentary on Article 1 be revised to reflect that conclusion and better articulate the relationship between domestic anti-abuse rules and tax treaties as indicated above.[172]

<u>Departure or exit taxes</u>

In a number of States, liability to tax on some types of income that have accrued for the benefit of a resident (whether an individual or a legal person) is triggered in the event that the resident ceases to be a resident of that State. Taxes levied in these circumstances are generally referred to as "departure taxes" or "exit taxes" and may apply, for example, to accrued pension rights and accrued capital gains.[173]

To the extent that the liability to such a tax arises when a person is still a resident of the State that applies the tax, and does not extend to income accruing after the cessation of residence, nothing in the Convention, and in particular in Articles 13 and 18, prevents the application of that form of taxation. Thus, tax treaties do not prevent the application of domestic tax rules according to which a person is considered to have realised pension income, or to have alienated property for capital gain tax purposes, immediately before ceasing to be a resident. It should be noted though that the provisions of tax treaties do not govern when income is realised for domestic tax purposes (see, for example, paragraphs 3 and 7 to 9 of the Commentary on Article 13); also, since the provisions of tax treaties apply regardless of when tax is actually paid (see, for example, paragraph 12.1 of the Commentary on Article 15), it does not matter when such taxes become payable.[174]

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171 OECD/G20 2015 Final Report on Action 6 in para 58.
172 OECD/G20 2015 Final Report on Action 6 in para 59.
173 OECD/G20 2015 Final Report on Action 6 in para 65.
174 OECD/G20 2015 Final Report on Action 6 in para 66.

The OECD notes however that the application of such taxes, creates risks of double taxation where the relevant person becomes a resident of another State which seeks to tax the same income at a different time, e.g. when pension income is actually received or when assets are sold to third parties. The OECD notes that such double taxation which is the result of that person being a resident of two States at different times and of these States levying tax upon the realisation of different events, is discussed in paragraphs 4.1 to 4.3 of the Commentary on Article 23 A and 23 B, where it is indicated that mutual agreement procedure could be used to deal with such cases.

In the case of pensions, for instance, the competent authorities of the two States could agree that each State should provide relief as regards the residence-based tax that was levied by the other State on the part of the benefit that relates to services rendered during the period while the employee was a resident of that other State.[175] In the case of double taxation situations arising from the application of departure taxes, the competent authorities of the two States could agree, through the mutual agreement procedure, that each State should provide relief as regards the residence-based tax that was levied by the other State on the part of the income that accrued while the person was a resident of that other State. This would mean that the new State of residence would provide relief for the departure tax levied by the previous State of residence on income that accrued whilst the person was a resident of that other State, except to the extent that the new State of residence would have had source taxation rights at the time that income was taxed. The OECD recommends that states wishing to provide expressly for that result in their tax treaties are free to include provisions to that effect.[176]

4.4 OECD CLARIFICATION THAT TAX TREATIES ARE NOT INTENDED TO BE USED TO GENERATE DOUBLE NON-TAXATION

The existing provisions of tax treaties were developed with the prime objective of preventing double-taxation. This was reflected in the title proposed in both the 1963 Draft Double Taxation Convention on Income and Capital and the 1977 Model Double Taxation Convention on Income and Capital, which was: "Convention between (State A) and (State B) for the avoidance of double taxation with respect to taxes on income and on capital".[177] In 1977, however, the Commentary on Article 1 was modified to provide expressly that tax treaties were not intended to encourage tax avoidance or evasion. The relevant part of paragraph 7 of the Commentary read as follows: "The purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons;

175 OECD/G20 2015 Final Report on Action 6 in para 66.
176 OECD/G20 2015 Final Report on Action 6 in para 67.
177 OECD/G20 2015 Final Report on Action 6 in para 69.

they should not, however, help tax avoidance or evasion".[178] In 2003, that paragraph was amended to clarify that the prevention of tax avoidance was also a purpose of tax treaties. Paragraph 7 now reads as follows: "The principal purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons. It is also a purpose of tax conventions to prevent tax avoidance and evasion".[179]

In order to provide the clarification required by Action 6, it has been decided to state clearly, in the title recommended by the OECD Model Tax Convention, that the prevention of tax evasion and avoidance is a purpose of tax treaties. Thus preamble to the OECD MTC will expressly provide that States that enter into a tax treaty intend to eliminate double taxation without creating opportunities for tax evasion and avoidance. Given the particular concerns arising from treaty shopping arrangements, it has also been decided to refer expressly to such arrangements as one example of tax avoidance that should not result from tax treaties.[180] As a result of work on Action 6 the preamble to the convention will now read as follows:

> *"(State A) and (State B),*
> *Desiring to further develop their economic relationship and to enhance their co-operation in tax matters, Intending to conclude a Convention for the elimination of double taxation with respect to taxes on income and on capital without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States."*

4.5 OECD RECOMMENDATIONS ON TAX POLICY CONSIDERATIONS THAT, IN GENERAL, COUNTRIES SHOULD CONSIDER BEFORE DECIDING TO ENTER INTO A TAX TREATY WITH ANOTHER COUNTRY OR TO TERMINATE ONE

The OECD under its BEPS project identified tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country (or to terminate a treaty if changes to the domestic law of a treaty partner raises BEPS concerns). This is especially so for treaties with certain low or no-tax jurisdictions.[181] It was however recognised, that there may be non-tax factors that can lead to the conclusion of a tax treaty and that each country has a sovereign right to decide to enter into tax treaties with any jurisdiction with which it decides to do so.[182]

178 OECD/G20 2015 Final Report on Action 6 in para 70.
179 OECD/G20 2015 Final Report on Action 6 in para 71.
180 OECD/G20 2015 Final Report on Action 6 in para 72.
181 OECD/G20 2015 Final Report on Action 6 in para 76.
182 OECD/G20 2015 Final Report on Action 6 in para 76; OECD *Action Plan on Base Erosion and Profit Shifting* (2013) at 19.

The OECD has proposed to come up with paragraph 15 in its Introduction to the MTC, which will set out the following factors that countries should take into consideration if they wish to conclude or terminate a treaty:

- Where a State levies no or low income taxes, other States should consider whether there are risks of double taxation that would justify a tax treaty;
- States should also consider whether there are elements of another State's tax system that could increase the risk of non-taxation – these may include tax advantages that are ring-fenced from the domestic economy;
- States should evaluate the extent to which the risk of double taxation actually exists in cross-border situations involving their residents; and they should note that many cases of residence/source juridical double taxation can be eliminated through domestic provisions for the relief of double taxation (ordinarily in the form of either the exemption or credit method) which can operate without the need for tax treaties;
- States should consider the risk of excessive taxation that may result from high withholding taxes in the source State. Even though double taxation relief methods may ensure that high withholding taxes do not result in double taxation, to the extent that such taxes levied in the State of source exceed the amount of tax normally levied on profits in the State of residence, they may have a detrimental effect on cross-border trade and investment
- considerations that should be taken into account when considering entering into a tax treaty include the various features of tax treaties that encourage and foster economic ties between countries, such as the protection from discriminatory tax treatment of foreign investment that is offered by the non-discrimination rules of Article 24, the greater certainty of tax treatment for taxpayers who are entitled to benefit from the treaty and the fact that tax treaties provide, through the mutual agreement procedure, together with the possibility for Contracting States of moving to arbitration, a mechanism for the resolution of cross-border tax disputes.
- Since one of the objectives of tax treaties is the prevention of tax avoidance and evasion, States should also consider whether their prospective treaty partners are willing and able to implement effectively the provisions of tax treaties concerning administrative assistance, such as the ability to exchange tax information and the willingness to provide assistance in the collection of taxes would also be a relevant factor to take into account. However, this could still be achieved by participation in the multilateral Convention on Mutual Administrative Assistance in Tax Matters. [183]

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[183] OECD/G20 2015 Final Report on Action 6 in para 77.

In addition to the above, the OECD also noted that a State that may be concerned that certain features of the domestic law of the State with which it is negotiating may raise BEPS concerns or that changes that might be made after the conclusion of a tax treaty and it may want to protect its tax base against such risks. In such cases, the OECD suggests that it might be useful to include in its treaties provisions that would restrict treaty benefits with respect to taxpayers that benefit from certain preferential tax rules or with respect to certain drastic changes that could be made to a country's domestic law after the conclusion of a treaty. [184] In this regard the OECD came up with certain proposals on "special tax regimes" and also on ensuring that a tax treaty responsive to certain future changes in a country's domestic tax laws; to be finalised in 2016.[185]

5 PREVENTING TREATY SHOPPING IN SOUTH AFRICA

The list of double tax treaties on the SARS' website as at 31 March 2015 shows that South Africa has entered into 75 double tax treaties, which have been published in the Government Gazette, 21 of these DTAs are with African countries. Another 36 treaties are in the process of negotiation or have been finalised but not yet signed. The preamble to most of the double tax treaties provides that the purpose of the treaties is "for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital". Some of the DTAs merely have the object to avoid double taxation.[186]

5.1 THE STATUS OF DOUBLE TAX TREATIES IN SOUTH AFRICA

DTAs are international treaties and thus subject to international (public) law rules regarding such treaties. Most of the customary rules of international law concerning treaties are contained in the Vienna Convention on the Law of Treaties.[187] The Convention also contains new elements which aim to promote the progressive development of international law.[188] Whilst South Africa has not signed the Vienna Convention, most of the rules contained in the Convention will apply under South African law since they constitute customary rules of

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184 OECD/G20 2015 Final Report on Action 6 in para 79-80.

185 OECD/G20 2015 Final Report on Action 6 in para 81.

186 See for example the DTAs with Germany, Austria and Denmark.

187 Vienna Convention on the Law of Treaties https://treaties.un.org/doc/Publication/UNTS/Volume%201155/volume-1155-I-18232-English.pdf.

188 R Lenz "The Interpretation of Double Taxation Conventions, General Report" *Cahiers de Droit Fiscal International* Vo. XLII, 1960 at 294; Van Houtte "Auslengungsgrundsaetze im internen und im internationalen Steuerrecht in der Entwicklung des Steuerwesens seit dem ersten Weltkrieg" IBFD, Amsterdam, 1968 at I1-41; DA Ward Principles to be applied in interpreting Tax Treaties" *IBFD Bulletin* 1980 at 546-7.

international law[189] which must be applied by South African Courts in accordance with section 232 of the Constitution, unless the rule is inconsistent with the Constitution or an act of Parliament. Furthermore, in terms of section 231 of the Constitution, South Africa is bound by international agreements.[190] If a court is faced with the task of interpreting any provisions of a DTA, section 233 of the Constitution needs to be taken into account, which requires that when interpreting any legislation, every court must prefer any reasonable interpretation of the legislation that is consistent with international law over any alternative interpretation that is inconsistent with international law.

International agreements do not form part of South African law unless a legislative enactment gives the relevant provisions the force of law. This was clearly stated by Chief Justice Steyn in *Pan American Airways v SA Insurance Co Ltd*. He made the following remarks:[191]

> "It is common cause, and trite law I think, that in this country the conclusion of a treaty, convention or agreement by the South African government with any other government is an executive and not a legislative act. As a general rule, the provisions of an international instrument so concluded are not embodied in our municipal law except by legislative process."

This is confirmed under section 231 of the Constitution. In terms of section 108(1) of the Income Tax Act, the National Executive may enter into DTAs with the governments of other countries, whereby arrangements are made with a view to the prevention, mitigation or discontinuance of the levying of tax in respect of the same income, profits or gains or tax imposed in respect of the same donation, or to the rendering or reciprocal assistance in the administration of and the collection of taxes. Section 231 of the Constitution provides that a treaty becomes part of South African law when it is approved by the National Assembly and by the National Council of Provinces. As soon as the DTA is approved by Parliament, it is required that notice of the arrangements made in such an agreement be given by proclamation in the Government Gazette.[192] The proclamation has the effect that the arrangements made by the DTA apply as if they were enacted in the Income Tax Act.[193]

The question arises whether the provisions of a DTA can be overridden by subsequent domestic legislation. Since DTAs form part of national law, the normal rules of interpretation of statutes provide that subsequent legislation

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189 Ibid.

190 Several of the South African DTAs have incorporated provisions contained in the United Nations Model DTA into the DTAs which means they may be somewhat different to the OECD Model DTA definition.

191 See also South Atlantic Inlands Development Corporation Ltd v. Buchan 1971 (1) SA 234 (C).

192 Sec 108(2) of the ITA.

193 Ibid.

which is contrary to a provision of the DTA may override the DTA provision.[194] However, South African courts take judicial notice of international law.[195] This implies that the courts will ascertain and administer the appropriate rule of international law as if it were part of South African law.[196] This does not mean, however, that the courts are bound to apply all rules of international law. In accordance with the provisions of the Constitution and case law, international law enjoys no privileged position in South Africa's legal system.[197] Nevertheless, a court must take notice of the requirement under section 231 of the Constitution, i.e. that South Africa is bound by international agreements and section 233 of the Constitution which requires that, when interpreting any legislation, every court must prefer any reasonable interpretation of the legislation that is consistent with international law over any alternative interpretation that is inconsistent with international law.

Article 27 of the Vienna Convention on the Law of Treaties reads as follows:

> "A party may not invoke the provisions of its national law as justification for its failure to perform a treaty."

This rule is a well-established rule of international law.[198] The principle expressed in this article is codified in article 26 of the Vienna Convention which reads as follows:

> "Every treaty in force is binding upon the parties to it and must be performed by them in good faith."

A State should thus abstain from acts calculated to defeat the object and purpose of a treaty. Therefore, when a contracting State applies its domestic anti-tax avoidance measures to deny DTA benefits to a resident of the other contracting State, it may possibly contravene the basic prohibition under Article 27 of the Vienna Convention, particularly when it causes double taxation which thus contravenes the main objective of a DTA.

However, Article 31(1) of the Vienna Convention determines that a treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.[199] Paragraph 2 defines the "context" for the purpose of

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194 The *lex posterior derogat priori* rule – see L du Plessis *Re-Interpretation of Statutes* (2002) at73; also L Olivier Tax "Treaties and Tax Avoidance: application of anti-avoidance provisions; South Africa branch report" Cahiers IFA 2010 Congress in Rome at 724.

195 The Buchan case at 238.

196 Ibid.

197 The SA IFA Report at 723.

198 TO Elias "The Modern Law of Treaties" *Leiden: Oceana Public* (1974) at 45.

199 RG Wetze *The Vienna Convention on the Law of Treaties* edited by D Rausching, Frankfurt: Alfred Metzner (1978) at 49; also the OECD Commentary on Article 1 of the OECD Model DTA, para 9.3 page 60; and the comments of Nathalie Goyette "Tax Treaty Abuse: A Second Look" *Canadian Tax Journal* Vol 51, no 2 (2003) at 768 where she remarks that "in light of the principle that States must execute a treaty in good faith, it is

interpretation.[200] Paragraph 3(a) and (b) specify that any subsequent agreement between the parties regarding the interpretation of the treaty or any subsequent practice in the application of the treaty which establishes the understanding of the parties regarding its interpretation should be taken into account when the treaty is interpreted. A third element which has to be considered within the context is any relevant rules of international law applicable in the relations between the parties (paragraph 3(c)). Paragraph 4 provides for the case where it is clear that the parties intended a term to have a special meaning and not its ordinary (literal) meaning.

When the interpretation in terms of Article 31 leaves the meaning obscure or ambiguous, or leads to a result which is manifestly absurd or unreasonable, recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion[201] (article 32).

Most of the rules of treaty interpretation contained in the Vienna Convention on the Law of Treaties are, as pointed out, customary rules of international law.[202] It is sometimes claimed that the "new" rules of interpretation included in the Vienna Convention have also since acquired the status of customary rules of international law.[203] To the extent that this can be confirmed, the South African courts would be required to apply these rules, but only to the extent that the rule is not inconsistent with an act of Parliament.[204]

The application of these rules by a South African court can also be justified on other grounds. A basic rule of interpretation under South African law is that effect must be given to the intention of the legislature if this intention is clear.[205] To establish the intention of the legislature, the surrounding circumstances must be taken into account.[206] The fact that a DTA is an international treaty implies that its international nature should be taken into account by a South African court when it has to establish the intention of the contracting

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legitimate to doubt that the residents of those states are entitled to abuse the treaty in question."

200 Vienna Convention on the Law of Treaties https://treaties.un.org/doc/Publication/UNTS/Volume%201155/volume-1155-I-18232-English.pdf.

201 Wetzel *The Vienna Convention on the Law of Treaties*t.

202 Lenz at 294; Van Houtte at II-40-41; Ward at 546-7; Klaus Vogel *Vogel on Double Taxation Conventions* 3rd Edition (1999) in para 28 at 21.

203 Vogel at 22.

204 As per section 232 of the Constitution.

205 Du Plessis at 102; See also T van Wyk *Probleme by die uitleg van belastingwetgewing*, LLM, Universiteit van Suid-Afrika, 31 Januarie 1975 at 83-84; T Van Wyk "Tax law: The interpretation of double taxation agreements" *De Rebus Procuratoriis*, (Jan. 1977) at 51.

206 Du Plessis,at 111; *Bhana v Dönges* 1950 4 SA 653 (A) at page 662D – 667H; Van Wyk, Probleme, at 84 -85.

governments.[207] This implies that the agreement should have the same meaning in South African law as it has in international law.[208]

The rules of interpretation contained in the Vienna Convention place emphasis on the textual or formalistic approach but considerable scope is left for the application of the teleological approach.[209] This implies that the ordinary meaning of a treaty term is not to be determined in the abstract, but in the light of the object and purpose of the treaty as a whole.[210] Furthermore, subsequent practice of the contracting States can modify provisions of the treaty.[211] It also sanctions the ambulatory approach, i.e. the interpreter may take the evolution of the laws of the contracting States into account, provided the change in the national law of a respective State does not defeat the object and purpose of the treaty.[212]

The Appellate Division of the Supreme Court considered the interpretation of a tax treaty in the case of *Secretary for Inland Revenue v Downing.*[213] The respondent left South Africa in 1960 to live in Switzerland. Apart from an allowance of R20 000, he was not permitted to take his assets with him. The balance of his assets consisted of a large share portfolio which he entrusted to a broking member of the Johannesburg Stock Exchange to manage. The basic issue before the Court was whether or not the respondent had carried on business in South Africa "through a permanent establishment situated therein", within the meaning of Article 7(1) of the DTA between South Africa and Switzerland. Article 7(1) of the treaty reads as follows:

> "The profits of an enterprise of a Contracting State shall be taxable only in that State, unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment."

The Court acknowledged that the terms of the DTA are based upon the OECD Model DTA of 1963. It was further recognised that this model served as the basis for the network of DTAs existing between this country and other countries. It did not indicate, however, to what extent it regarded the OECD Commentary as binding on South African courts. The lower Court did, however,

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207 Van Wyk, Probleme at 84.
208 Ibid.
209 Schwarzenberger *International Law* vol. I, 3rd Edition (1957) at 492-493.
210 Ibid; also see Wetzel at 49.
211 Ibid.
212 Ibid; also see the criticism of Vogel in para 125b at 66, that a contracting state should not introduce domestic rules to circumvent its DTA obligations, for example, the introduction of the Secondary Tax on Companies by South Africa which replaced the non-resident shareholders tax could be regarded as such an instance since the new tax was no longer covered by older South African DTAs as confirmed in Volkswagen case.
213 1975 (4) SA 518 (A).

base its argument on a passage from the OECD Commentary.[214] To interpret the relevant DTA terms, the court first considered the definitions of the relevant terms in the DTA. The appellant's counsel argued that the terms of the definition of "permanent establishment" (Article 5 of the DTA) should be narrowly construed, i.e. since the first two requirements (Article 5(1), read with Article 5(2)(c)) of the definition had been fulfilled, the respondent fell within the ambit of the permanent establishment concept. The Court rejected this approach and pointed out that Article 5 must be read as a whole. It expressed the opinion that such an interpretation would make Article 5(5) redundant which could not have been the intention of the contracting parties. In determining the meaning of the words "acting in the ordinary course of their business" (see Article 5(5)), the Court stressed that the words should be ascribed their natural meaning. It came to the conclusion that the respondent did not fall within the ambit of the permanent establishment concept.

The approach adopted by the Court corresponds with the guidelines for interpretation contained in the Vienna Convention, although no reference was made in the decision to those guidelines. This approach was subsequently applied in *ITC 1503*[215] where the Court considered the OECD Commentary and then concluded that the income in question should be treated as ancillary to the main stream of income, as suggested by the OECD Commentary.

The courts have since often applied the OECD Commentary and other international guidelines in considering cases involving DTAs.[216] In *CSARS v Tradehold Ltd*,[217] the Court made the statement that a DTA overrides domestic law:

> "Double tax agreements effectively allocate taxing rights between the contracting states where broadly similar taxes are involved in both countries. They achieve the objective of s 108, generally, by stating in which contracting state taxes of a particular kind may be levied or that such taxes shall be taxable only in a particular contracting state or, in some cases, by stating that a particular contracting state may not impose the tax in specified circumstances. A double tax agreement thus modifies the domestic law and will apply in preference to the domestic law to the extent that there is any conflict."[218]

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214 See page 526 of the case report.

215 (53) SATC 342, at 349.

216 See the decisions in *CSARS v Tradehold Ltd* (132/11) [2012] ZASCA 61; *Oceanic Trust* 2012 74 SATC 127; also the UK High Court decision *Ben Nevis (Holdings) Limited and Another v CHMRC* [2013] EWCA Civ 578 which considered a request by SARS for the assistance by the HMRC under the UK/South Africa DTA to collect taxes due by a resident of South Africa.

217 (132/11) [2012] ZASCA 61

218 *CSARS v Tradehold Ltd*; Ibid in para 17.

5.2 TREATY SHOPPING IN SOUTH AFRICA

There is no case law in South Africa on issues pertaining to treaty shopping that can be used to give an indication as to whether treaty shopping is a major BEPS concern for South Africa. An indication of the scale of treaty shopping could be determined by considering aggregate statistics on foreign direct investment (FDI). However, even with statistics on FDI, it is difficult to distinguish indirect investment through intermediaries from direct investment, and even more difficult to separately identify cases involving indirect investment for tax planning purposes. Moreover, the use of intermediaries may involve tax planning other than treaty shopping. Nevertheless, a comparison of FDI and trade data, and an understanding of the domestic tax and treaty policies of those countries that rank among the largest in terms of FDI in South Africa, can provide circumstantial evidence about the scale of treaty shopping. [219] In general, high levels of inbound and outbound FDI can be an indicator that a country commonly serves as a conduit investment country. [220] However, indirect investment is not always driven by treaty shopping; it may reflect other objectives of a multinational enterprise.

5.2.1 TREATY SHOPPING: REDUCING SOURCE TAX ON DIVIDENDS, ROYALTIES AND INTEREST WITHHOLDING TAXES

A number of withholding taxes have been introduced in South Africa.[221] It is hoped that these will be instrumental in eliminating base erosion. However, these withholding taxes (generally at a uniform rate of 15%) are more effective when the non-resident's country of residence does not have a double tax treaty with South Africa. Where a double tax treaty exists, the rate at which

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219 OECD “Tax Conventions and Related Questions: Written Contributions from Members of the Focus Group on Treaty shopping”(2013) in para 2.

220 Ibid.

221 The following withholding taxes apply in South Africa.

- The interest withholding tax; levied in terms of section 50A-H of the Act at a rate of 15% with effect from 1 March 2015 in respect of interest that is paid or becomes due and payable on or after that date.
- The dividend withholding tax levied in terms of section 64D – N of the Act, introduced from years of assessment commencing 1 April 2012 at a rate of 15%.
- The withholding tax on royalties (which was historically levied under repealed section 35(1) of the Act at a final rate of 12%), now levied at a rate of 15% in terms of section 49A – G of the Act with effect from 1 January 2015 in respect of royalties that are paid or become due and payable on or after such date;
- The withholding tax on foreign entertainers and sportspersons which is levied at a rate of 15% in terms of section 47A – K of the Act, with effect from 1 August 2006;
- The withholding tax on the disposal of immovable property by non-resident sellers levied in terms of section 35A of the Act, at a rate of 5% if the non-resident is an individual, 7.5% if the non-resident is a company and 10% if the non-resident is a trust with effect from 1 September 2007;

For a detailed discussion of South Africa's withholding tax regime please refer to: AW Oguttu "*An Overview of South Africa's Withholding Tax Regime*" TaxTalk (March/April 2014).

withholding taxes may be levied by South Africa as the source country is usually limited, as there is a requirement that a treaty state entity has a PE in South Africa before South Africa has any rights to levy any tax. Most of South Africa's DTAs, based on the OECD MTC do not contain favourable withholding tax rates for South Africa. This puts South Africa in a vulnerable position as in some cases the withholding tax is zero. With the predominantly uniform domestic rate of 15% now in place, the DTAs to which South Africa is party, require renegotiation. The potential for treaty shopping has now become more significant for South Africa, especially with the introduction of the new withholding taxes on dividends and interest. In particular, the risk of conduit companies being used as a means of reducing South African withholding taxes can be significant.

A foreign company carrying on business operations through a South African subsidiary can reduce the Dividends Withholding Tax (DWT),[(61)] imposed (at a statutory rate of 15%) in South Africa on dividend distributions by the subsidiary to its parent company, by using a treaty shopping scheme. For example, if the investment is channeled through an intermediate holding company (Dutch Holdco) established in the Netherlands, the Dutch/South African DTA will function to limit the DWT tax to 5%.[222]

With proper construction, the dividends should qualify for the Dutch participation exemption for foreign dividends and the net dividend income (a small margin is required in the Netherlands) could also be extracted from the Netherlands without any Dutch withholding tax. The Dutch/South African DTA will also function to reduce the withholding tax on interest (IWT) from 15% to 0%. Therefore, the ultimate investor could loan funds to the Dutch Holdco, which would on-lend the funds to the South African subsidiary, thus avoiding the IWT. The Netherlands does not impose any withholding tax on interest paid to a non-resident, subject to rather generous thin capitalization restrictions, i.e. again requiring a small margin for Dutch Holdco.

The Dutch/South African DTA will also function to reduce the withholding tax on royalties (RWT) from 15% to 0%. Therefore, the ultimate investor could license the supply of intellectual property (IP) to the Dutch Holdco, which would sub-license the use of the IP to the South African subsidiary, thus avoiding the RWT. The Netherlands does not impose any withholding tax on royalties paid to a non-resident and merely requires a small margin for Dutch Holdco.

The benefits of a DTA could also be accessed by a non-resident on a temporary basis by ceding the right to the income to a company in a country

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222 Article 10(2) of the DTA – provided the Dutch Holdco held at least directly or indirectly 25% of the voting power in the company paying the dividends.

which has a beneficial DTA with South Africa, before such income accrues to the non-resident cedent. For example, a right to royalties, dividends or interest could be ceded to such a resident of the other contracting state, thus potentially qualifying for the benefits of that DTA at the time when such income accrues.[223]

In the case of dividends, it may be difficult to ensure qualification for the particular requirements under the typical DTA, for example, the requirement that the intermediary holding company needs to hold at least 10% of the shares in the South African company. However, even this could be temporarily manipulated to ensure the required shareholding at the point in time when the dividend is declared, with the subsequent redemption of the additional shares acquired merely for this purpose.

The total tax burden on such dividends, interest and royalties could thus be reduced significantly through the treaty shopping scheme.

It is however worth noting that South Africa is taking measures to adopt its tax treaty negotiation policy to cater for the new policy on withholding taxes. Currently, all DTAs with zero rates are under renegotiation so that they are not used for treaty shopping purposes. It should however be noted that, in practice, the process of negotiating or renegotiating DTAs is long.

- It is recommended that when re-negotiating the new limits for treaty withholding tax rates, caution is exercised since high withholding taxes can be a disincentive to foreign investment. Equilibrium must be achieved between encouraging foreign investment and protecting South Africa's tax base from erosion.

5.2.2 TREATY SHOPPING: ACCESSING CAPITAL GAINS BENEFITS

A resident of a country which has no DTA or a less beneficial DTA with South Africa could make an investment in a property holding company in South Africa via a country, such as the Netherlands, in order to protect the eventual capital gains realized on the sale of the shares from South African capital gains tax. Treaties based on the OECD MTC provide in article 13(4) that the Contracting State in which immovable property is situated may tax capital gains realised by a resident of the other State on shares of companies that derive more than 50 per cent of their value from such immovable property.[224] However in Article 13(4) of the Dutch/South African DTA, only the Netherlands may impose tax on the gains realized from the sale of shares in a South African company. The Dutch/South African DTA does not follow the OECD MTC in this regard, unlike the US South African DTA, which allows South Africa to impose tax on such

223 See the example of such arrangements in the OECD Report on Abuse, para 42 at 15.
224 OECD/G20 2015 Final Report on Action 6 in para 41.

gains if the South African property company derives 50% or more of its value from immovable property. In the Netherlands, the gain on the sale of the shares should enjoy the protection under the Dutch participation exemption, and it is possible to extract the gain from the Dutch intermediate company without incurring withholding tax.

A resident of a country that has no DTA with South Africa could use a treaty shopping scheme to obtain the benefit of the limitation of South African tax by the "permanent establishment" concept (see further discussion below). It could, for example, create a conduit company in Switzerland and channel its South African activities through this company to enjoy the protection from South African tax offered by the permanent establishment provisions under the Swiss/South African DTA.

As discussed above, the OECD Final Report on Action 6 recommends schemes to take advantage of capital gains benefits should be curtailed if countries ensure that they sign article 13(4) of the OECD Model Convention, which is an anti-abuse provision that allows the Contracting State in which immovable property is situated to tax capital gains realised by a resident of the other State on shares of companies that derive more than 50 per cent of their value from such immovable property.[225] Paragraph 28.5 of the Commentary on Article 13 provides that States may want to consider extending the provision to cover not only gains from shares but also gains from the alienation of interests in other entities, such as partnerships or trusts, which would address one form of abuse.

- The OECD noted that Article 13(4) will be amended to include such wording.[226]
- In cases where assets are contributed to an entity shortly before the sale of the shares or other interests in that entity in order to dilute the proportion of the value of these shares or interests that is derived from immovable property situated in one Contracting State. The OECD noted that Article 13(4) also will be amended to refer to situations where shares or similar interests derive their value primarily from immovable property at any time during a certain period as opposed to at the time of the alienation only.[227]
- These anti-abuse provisions can be adopted by South Africa if it signs the envisaged multilateral instrument under Action 15, which will alleviate the need to renegotiate all its double tax treaties to cover these changes.

225 OECD/G20 2015 Final Report on Action 6 in para 41.
226 OECD/G20 2015 Final Report on Action 6 in para 42.
227 OECD/G20 2015 Final Report on Action 6 in para 43.

5.2.3 SCHEMES TO CIRCUMVENT DTA LIMITATIONS

(a) Using the "dual residence" concept

The concept of "dual residence" can be used to avoid the DWT. Many countries regard a company as resident in their territory if it is managed and controlled there, whereas other countries consider the place of incorporation of a company as a factor determining its residence. It is thus possible that a company can be regarded as a "resident" of both contracting States in terms of the general definition of a "resident" under the domestic laws of the respective contracting states which definition is usually confirmed in the DTA. DTAs generally solve such cases of "dual residence" by providing that such a company shall be deemed to be resident in the contracting State in which its place of effective management is situated.[228]

If a company incorporated in South Africa is effectively managed in the United Kingdom (UK), it will be deemed to be a resident of the UK for purposes of the DTA between South Africa and the UK. A UK resident parent company can thus avoid South African DWT on dividends derived from its South African subsidiary by transferring the effective management of the subsidiary to the UK. The subsidiary will then be treated as a UK tax resident which is not subject to DWT in terms of section 64C of the ITA.

Nevertheless, that subsidiary will incur a CGT exit tax in South Africa in terms of section 9H of the ITA and paragraph 12(2)*(a)* of the Eighth Schedule to the ITA which provides that when a South African tax resident ceases to be a tax resident by virtue of the application of the provisions of a tax treaty entered into by South Africa with another jurisdiction, the resident must, subject to certain exclusions, be treated as having disposed of all his/her assets. The provision would for instance apply if a company moves its place of effective management out of South Africa.

- It is worth noting that the OECD Final Report on Action 6, the OECD intends to make changes to the OECD MTC to the effect that treaties do not prevent the application of domestic “exit taxes”. [229]
- It should also be noted treaty abuses relating to dual resident entities will also be dealt with in light of that the OECD recommendation that the current POEM rule found in Article 4(3) will be replaced with a case-by-case solution of these cases. [230] The competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a

228 See Article 4(3) of the UK/South Africa DTA.
229 OECD/G20 2015 Final Report on Action 6 in para 65-66.
230 OECD/G20 2015 Final Report on Action 6 in para 47.

resident for the purposes of the Convention, having regard to its POEM the place where it is incorporated and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any treaty benefits.[231]

- South Africa can adopt this change in its tax treaties if it signs the multilateral instrument envisaged under Action 15, which will alleviate the need to renegotiate all double tax treaties.

Using the Permanent Establishment Concept

The "permanent establishment" concept in DTAs functions to limit the source tax liability of a resident of one contracting State, who carries on business in the other contracting State. South African DTAs generally provide that an enterprise of one contracting State will not be taxed on business profits derived from the other contracting State, unless that enterprise carries on business in the other State through a permanent establishment situated therein. Therefore, if a resident of a State that has concluded such a DTA with South Africa carries on trading activities in South Africa, without establishing a fixed place of business in South Africa, the income derived will not be subject to South African tax by virtue of the DTA.

The permanent establishment concept in most South African DTAs does not include a building site or construction or assembly project if the project does not exist for more than twelve months (in some DTAs, e.g. the DTA with Israel, the period is limited to six months). A resident of those contracting States will, therefore, not be subject to South African tax on building or construction activities if the specific project does not last longer than twelve months (six months for residents of Israel).

A resident of the other contracting state could split up the project into different parts, which are performed by different legal entities, thus allowing the fuller project to be performed in South Africa without incurring a tax liability in South Africa.

In the context of e-commerce, a resident of the other contracting state could conduct fully fledged sales activities in South Africa via a website without creating a permanent establishment in South Africa, provided the enterprise operates via a server based outside South Africa or an independent server based in South Africa.

- It should be noted that treaty abuse through splitting-up of contracts to take advantage article 5 of the OECD Model Convention and the e-

[231] OECD/G20 2015 Final Report on Action 6 in para 48.

commerce concerns[232] will also be curtailed by the OECD recommendation that the Principle Purpose Test rule that will be added to the model convention in terms of the OECD Report on Action 7 (*Preventing the Artificial Avoidance of Permanent Establishment Status*, 2015).[233]

- Concerns about renegotiating all its tax treaties will be alleviated if South Africa signs the envisaged multilateral instrument under Action 15.

It should also be noted that, in the case of *AB LLC and BD Holdings Tax,*[234] the Tax Court ruled that a service PE had been created in light of article 5 of the South African/USA DTA. The facts of the case were that a USA company provide strategic and financial services in South Africa whereby its employees occupied the board room at the recipient's premises to conduct those services. The company's employees spent a period exceeding 183 days in South Africa. The Commissioner assessed the company for income earned from the services rendered on the basis that the company operated from a PE as contemplated in article 5(2)(k) of the DTA which included in the meaning of a PE the furnishing of services, including consultancy services, by an enterprise through employees if the activities continue (for the same or a connected project) for an aggregate period of more than 183 days in any twelve-month period. The court ruled that since the company provided consulting services through its employees in South Africa for a period exceeding 183 days, a PE had been created. Even article 5(1) of the DTA could be applied in that boardroom where the services were performed constituted a fixed place of business. So the income earned by the company was attributable to that PE and taxable in South Africa.

(a) Artificial Arrangements Qualifying for Reduced Rates

The DTAs generally contain provisions which function to reduce an exposure to withholding taxes in the source country if the resident of the other contracting state qualifies under certain criteria, e.g. that the latter should hold at least 10% of the capital of the company in the source state to qualify for the reduced DTA rate of 5% (from 15% in other cases). The resident of the other contracting state could arrange for a temporary increase in its shareholding, e.g. by taking up additional shares in the company in the source state (if there is no PE established there)[235], shortly before a dividend declaration (in respect of the ordinary shares) which shares are then redeemed shortly after the dividend declaration. This could thus secure a 10% saving.

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232 OECD/G20 2015 Final Report on Action 6 in para 29.
233 OECD/G20 2015 Final Report on Action 6 in para 30.
234 Tax Court Case number 13276 February 2015.
235 Unless article 10(4) of the OECD MTC applies.

The above transactions can also be curtailed by the recommendation in OECD Final Report on Action 6 regarding specific treaty provisions to deal with circumstances where taxpayers get involved in dividend transfer transactions, whereby a taxpayer entitled to the 15 per cent portfolio rate of Article 10(2)(b) may seek to obtain the 5 per cent direct dividend rate of Article 10(2)(a) or the 0 per cent rate that some bilateral conventions provide for dividends paid to pension funds.[236] The concern is that Article 10(2)(a) does not require that the company receiving the dividends to have owned at least 25 per cent of the capital for a relatively long time before the date of the distribution. This may encourage abuse of this provision, for example, where a company with a holding of less than 25 per cent has, shortly before the dividends become payable, increased its holding primarily for the purpose of securing the benefits of the provision, or where the qualifying holding was arranged primarily in order to obtain the reduction.[237]

- The OECD concluded that in order to deal with such transactions, a minimum shareholding period before the distribution of the profits will be included in Article 10(2)(a).
- Additional anti-abuse rules will also be included in Article 10 to deal with cases where certain intermediary entities established in the State of source are used to take advantage of the treaty provisions that lower the source taxation of dividends.[238]
- These anti-abuse provisions can be adopted by South Africa if it signs the envisaged multilateral instrument under Action 15, which will alleviate the need to renegotiate all its double tax treaties to cover these changes.

5.2.4 TREATY SHOPPING IN SOUTH AFRICA'S PREVIOUS TREATY WITH MAURITIUS

South African investors have used Mauritius as a vehicle for investing in other countries with which Mauritius has treaties. Likewise, international investors from other countries that have tax treaties with Mauritius have used Mauritius as an intermediary to invest in South Africa.

The first tax treaty between South Africa and Mauritius came into force in 1960, through the South Africa/United Kingdom tax treaty, which was extended to Mauritius. During that time, Mauritius was still a colony of the United Kingdom. It is important to note that even though Mauritius gained its independence from the UK in 1968, the above-mentioned tax treaty was still applicable to Mauritius until termination in 1997 with the coming into force of a new tax treaty in 1997,

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236 See paragraph 69 of the Commentary on Article 18 and also OECD/G20 2015 Final Report on Action 6 in para 34.

237 OECD/G20 2015 Final Report on Action 6 in para 35.

238 OECD/G20 2015 Final Report on Action 6 in para 37.

directly between South Africa and Mauritius. However South Africa signed a new treaty with Mauritius on 17 May 2013. The South African Parliament ratified the treaty on 10 October 2013. Mauritius ratified the new treaty on 28 May 2015. In terms of section 108 of the Income Tax Act No 58 of 1962 (Act), on 17 June 2015, the treaty was published in the Government gazette (GG 38862). The new South Africa-Mauritius tax treaty, entered into force on 28 May 2015, and replaces the 1996 South Africa-Mauritius tax treaty.

The main reason for the signing of the new tax treaty was due to perceived "abuse" of the 1997 tax treaty, and resultant erosion of the South African tax base. The World Bank and the International Finance Corporation have consistently ranked Mauritius as one of the best Sub-Saharan African countries in which to do business. The main drivers are that Mauritius:

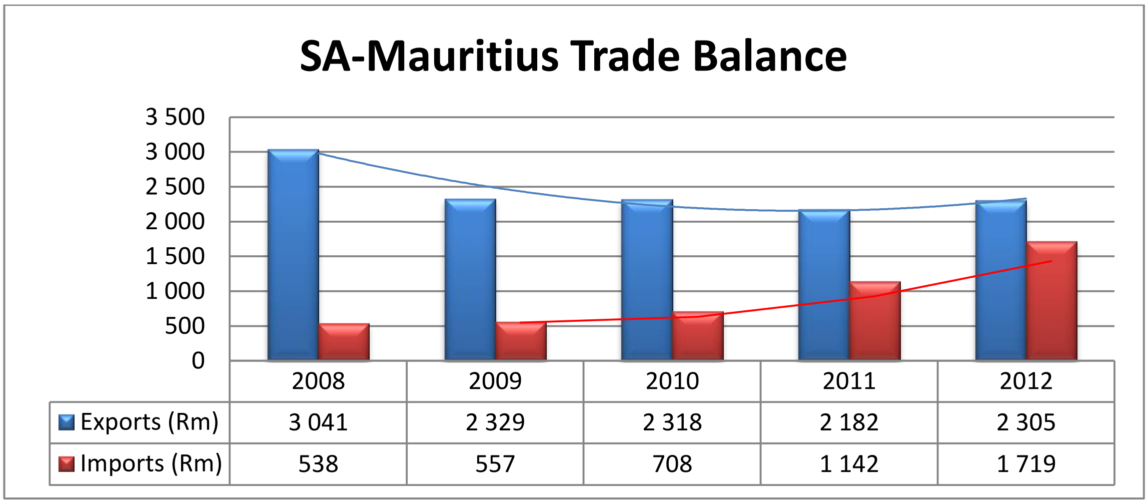
- Is a member of SADC, WTO and COMESA.
- Has a vast network of treaties with countries. It is party to 35 double taxation agreements.
- has no capital gains tax.
- has a low corporate income tax rate at 15%, which translates into an effective tax rate of 3% after taking into account available credits. (GBL1 gets up 80% credit while GBL2 qualifies for exemption).

The Economic Perspective

From an economic perspective, South Africa is, today, a major trade and economic partner of Mauritius. South Africa invests heavily in various sectors of the Mauritian economy such as banking and finance, retail, ICT, real estate, manufacturing, agribusiness as well as logistics. South Africa's foreign direct investment (FDI) into Mauritius over the past six years has grown significantly, making South Africa the largest single foreign investor after the United Kingdom.

Graph 1 below regarding current trade and values between South Africa and Mauritius shows that import values from Mauritius have ranged from R538m in 2008 to R1,719m in 2012 (CAGR of 36%), while export values have ranged from R3,041m in 2008 to R2,305m in 2012 (CAGR of -6%). While exports have shown negative growth in the years 2008 to 2012, they are still well above our imports from the region (R2,305m exports in 2012 vs. R1,719m imports in 2012). Below is SA-Mauritius Trade Balance.

Graph 1

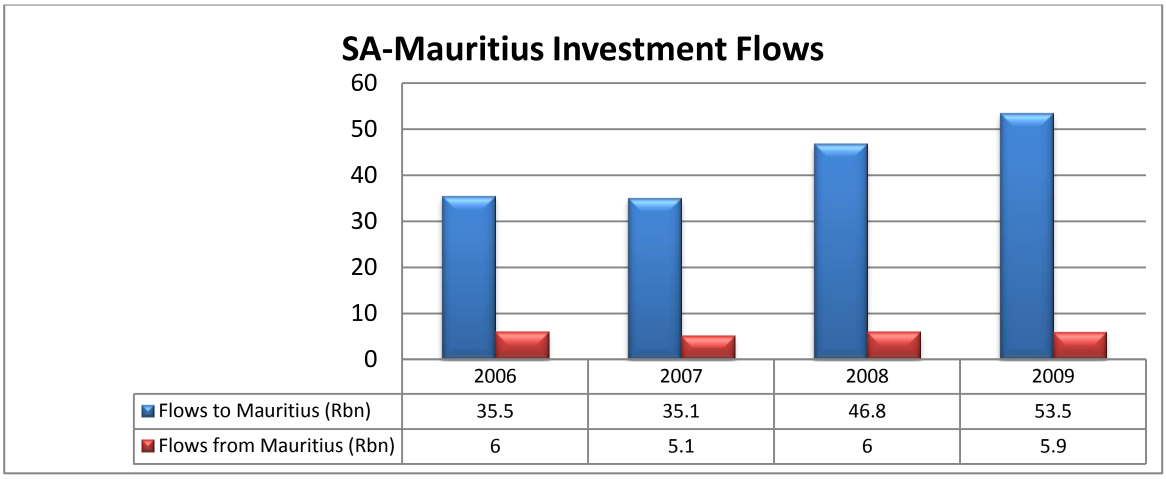


	2008	2009	2010	2011	2012
Exports (Rm)	3 041	2 329	2 318	2 182	2 305
Imports (Rm)	538	557	708	1 142	1 719

(Source: Finweek 27 May, 2013)

Graph 2 below shows the investment flows between South Africa and Mauritius.

Graph 2



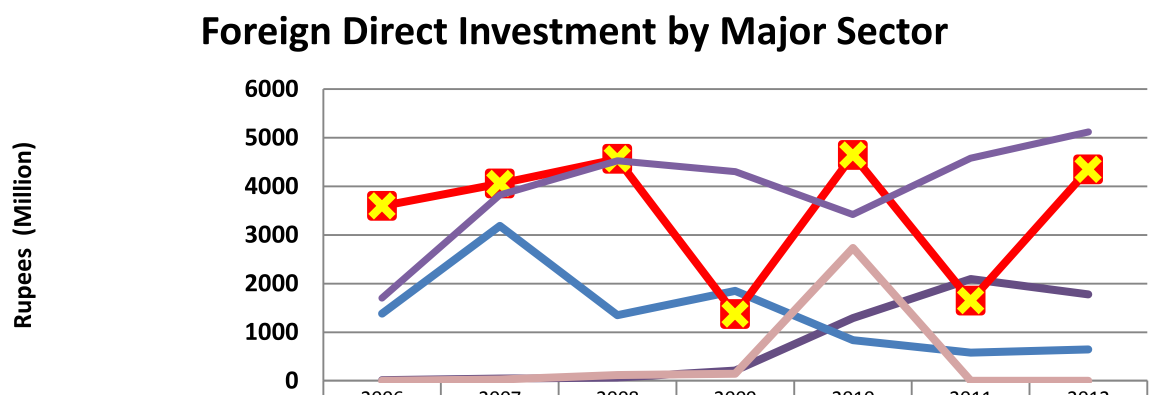
	2006	2007	2008	2009
Flows to Mauritius (Rbn)	35.5	35.1	46.8	53.5
Flows from Mauritius (Rbn)	6	5.1	6	5.9

(Source: Finweek 27 May, 2013)

South Africa's FDI flows into Mauritius have been steadily increasing while Mauritius' flows into South Africa have been flat in the period 2006 to 2009. This is indicative of the ease of doing business as well as the attractiveness of the Mauritius tax regime. However, with the new treaty, these flows could reverse as it will not be beneficial for South African companies to use Mauritius as a gateway for Sub-Saharan African expansion.

Graph 3 below shows that although foreign direct investment into Mauritius has been volatile over the last few years, finance and insurance has seen significant growth in investment. Accommodation and Food has been declining while Construction has seen tremendous growth off a low base. Real Estate investment growth is testimony to Mauritius being a tourist destination. This mirrors South African company investments in Mauritius as indicated in Appendix A to this document. The fallout of the euro zone's financial troubles had a negative impact on flows to the Indian Ocean Island, resulting in an inbound flow of 9.46 billion in 2011 from 13.9 billion rupees a year earlier. Conditions improved during 2012 with direct investments totalling 12.7 billion Rupees. Mauritius is shifting from an economy traditionally focused on sugar, textiles and tourism towards offshore banking, business outsourcing, luxury real estate and medical tourism. From the graph below, it can be observed that the largest investments are made in Real Estate (est.40%) and Finance and Insurance (est.34%) activities.

Graph 3

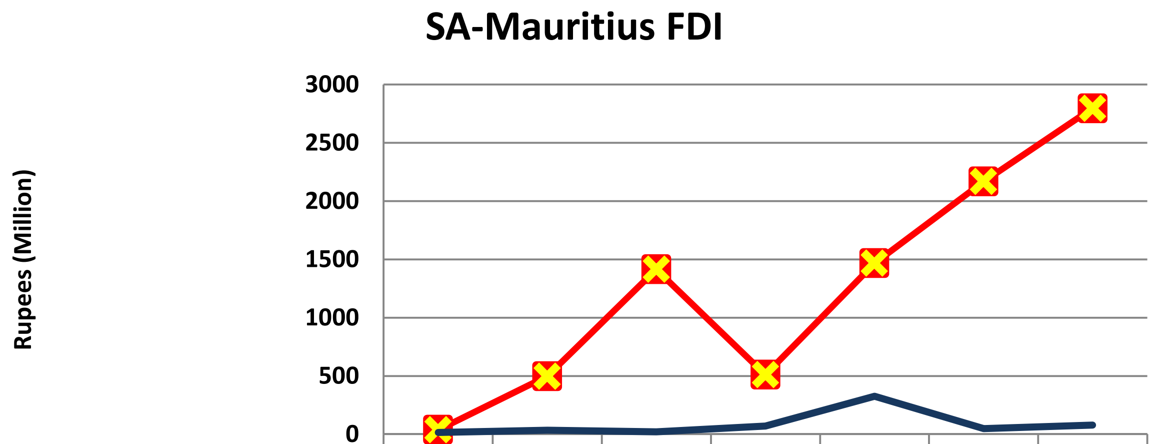


	2006	2007	2008	2009	2010	2011	2012
Construction	12	45	68	211	1292	2094	1775
Accommodation and Food	1382	3189	1348	1850	836	579	645
Finance and Insurance	3593	4056	4564	1371	4645	1646	4348
Real Estate	1701	3820	4525	4305	3422	4580	5122
Health and Social Work	2	29	120	145	2732	0	0

Source: Bank of Mauritius (Provisional)

Statistics from the Bank of Mauritius as indicated in graph 4 below show that South Africa is the 2nd largest investor in Mauritius (2,797 million rupees = 22%) behind the UK. From the analysis of investments by South Africa in Mauritius, a robust growth trend can be observed. The magnitude of foreign investment growth into Mauritius by South Africa is well pronounced post the 2008/2009 financial crisis.

Graph 4



	2006	2007	2008	2009	2010	2011	2012
Flows from SA to Mauritius	38	498	1415	510	1468	2169	2797
Flows from Mauritius to SA	14	35	20	70	325	49	77

Source: Bank of Mauritius (Provisional)

The tax perspective

Putting the above statistics into a tax context**,** the high FDI flows into Mauritius point to Mauritius being an enabler for arbitrage opportunities. This was encouraged by both its business-friendly environment as well as lower tax rates for offshore companies. Tax credits of up 80% for GBL1 (Global Business Licence) companies are available. Aslo GBL2 companies can invoke tax exemptions. Putting the above FDI flows into context, below is a discussion as to how South African residents make use of treaties Mauritius has signed for treaty shopping purposes.

The Mauritius/India Tax Treaty – Sale of Shares Taxable only in Shareholder Country

South African residents wishing to invest in India often take advantage of the Mauritius/India treaty by routing investments via Mauritius in order to gain tax advantages. In terms of the South Africa/India treaty (and most other treaties with India) capital gains derived from the sale of shares in a company may be taxed in the country in which the company whose shares are being sold is a resident (i.e. in India), and since India has a tax on capital gains the gain does not escape taxation. In short, where a South African company invests directly into India it will be subject to CGT on the sale of the shares in the Indian company.

To avoid such taxation, South African investors route investments via Mauritius by setting up a GB1 company in Mauritius which takes advantage of the provisions in the Mauritius/India treaty, which provides that capital gains arising from the sale of shares are taxable only in the country of residence of the shareholder and not in the country of residence of the company whose shares are being sold. As a result, a company resident in Mauritius selling shares of an Indian company will not pay tax in India on the disposal of the Indian company's shares. Since there is no capital gains tax in Mauritius, the gain will escape tax altogether. The capital gain can then be repatriated back to the South African shareholder free of withholding taxes as Mauritius does not levy tax on dividends, interest or royalties for GBL1 companies.

Mauritius/African Tax Treaty Network – Lower Withholding Tax Rates

South African companies often route investments into other Africa countries via Mauritius since Mauritius has negotiated better benefits in its tax treaties with some African countries than South Africa has. This is especially so with regard to withholding tax rates (on dividends, interest, royalties and management/technical fees) in treaties between Mauritius and other African countries, which are generally lower than the withholding tax rates in tax treaties between South Africa and other African countries.

Avoiding South African Dividends Tax

Hypothetical example: South Africa imposes a dividends tax at a rate of 15% on dividends paid by a company which is tax resident in South Africa (SACo) to its holding company (HoldCo) that is tax resident in a "tax favourable" non-treaty country (Country A). Country A however has a treaty with Mauritius, which in turn has a treaty with South Africa. In terms of the Mauritius SA treaty, South Africa is prohibited from imposing dividends tax in excess of 5% where the beneficial owner of the shares in SACo is a company which is tax resident in Mauritius and the beneficial owner owns more than 10% of the shares in the SACo.

HoldCo establishes a company in Mauritius (SubCo) that, in terms of the domestic law in both Country A and Mauritius is tax resident in Mauritius. HoldCo is able to demonstrate that the place of effective management of SubCo is not South Africa. HoldCo disposes of the shares in SACo to SubCo. By virtue of having moved the ownership of SACo to Mauritius, HoldCo is able to reduce the SA dividends tax burden by two thirds. This is because Mauritius imposes local corporate tax in respect of the dividends received from SACo, so no or little Mauritian tax would be payable because of its foreign tax credit regime.

No dividends tax withholding regime applies in Mauritius. It is open for South Africa to challenge whether SubCo is truly the "beneficial owner" of the shares.

While Mauritius is used in this example, any other jurisdiction providing for a similar reduction in dividends tax rate could have been chosen (keeping in mind that many of those jurisdictions would themselves have a dividends tax withholding regime which would negate the benefit of any treaty shopping).

However, it may be that a country has a dividends tax withholding regime but, because of specific provisions in its domestic tax law or its general corporate law, the dividends tax withholding regime does not apply. For example, notwithstanding that the Netherlands has a dividends tax withholding regime and foreign dividends constitute taxable income, the domestic law regards distributions from certain legal entities, such as the Dutch Co-Operative entity, as not being subject to the dividends tax regime. Thus, the dividends derived from SACo would be exempt from tax in the Netherlands in terms of its participation exemption. The Netherlands could work just as well as Mauritius, but for a different reason.

Avoiding Other Withholding Taxes

A similar approach could be adopted in relation to royalties (and interest and services once the withholding taxes become effective in South Africa). For example, Cyprus would be a good jurisdiction to divert royalties to as the withholding tax rate is reduced to 0% where the beneficial owner is resident in Cyprus. Once again South Africa would need to challenge the nature of the ownership of the Cyprus intermediate holding company that is in receipt of the relevant royalties.

Capital Gains Tax (CGT) Carve-Out for Property Rich Companies

Mauritius and the Netherlands are jurisdictions through which many inbound investments flow into South Africa. This is especially so in circumstances where investment funds are routed towards acquiring ownership of South African immovable property. The reason for this is that the current treaties[239] that South Africa has a treaty with Netherlands that provides protection against a South African CGT charge on companies based in Netherlands which own shares in a South African company holding immovable property. This was the case also in Mauritius's previous treaty with South Africa – but the treaty was renegotiated as is discussed before, so this matter is no longer a concern in this treaty.
In terms of the Eighth Schedule to the Income Tax Act,[240] non-residents are subject to CGT when they dispose of immovable property, an interest in immovable property, or assets of a permanent establishment[241] located in South Africa. An interest in immovable property includes shares or trust

[239] These treaties are not based on the more robust/fair OECD Model Tax Conventions.
[240] To the Income Tax Act, 1962.
[241] Par 2(1) of the Eighth Schedule.

interests where more than 80% the market value of such share or trust interest is attributable to the immovable property (so-called "property rich companies"). It should be noted that immovable property includes not only land and buildings, but also mineral rights and improvements which accede to the land (such as happens with redraftable energy projects).

Many inbound foreign direct investments are planned in advance for an exit with the time horizon being as short as five years. Investments are therefore structured to ensure a CGT free exit, particularly where a good portion of the management fees charged by the foreign investor to the local company are embedded within the eventual selling price ("the free carry"). As a result, many companies, lately also those investing in renewable energy projects, routed their investments into South Africa via Mauritius or the Netherlands[242] to avoid the CGT cost.

It should, however, be noted that the CGT carve-out was removed from the new treaty between South Africa and Mauritius.[243] The capital gains Article of the new treaty now specifically provides that a country may tax gains derived from the alienation of shares deriving more than 50% of their value directly or indirectly from immovable property situated in such country. The treaty between South Africa and the Netherlands still contains a CGT carve-out clause, and therefore continues to pose a source of possible leakage to the fiscus.

<u>Aspects of the new Mauritius/South Africa treaty designed to prevent treaty abuse</u>

The new treaty between Mauritius and South Africa applies to normal tax, to withholding taxes on royalties and on foreign entertainers and sportsmen and the secondary tax on companies (which has been abolished). Although dividends tax has not been expressly included in Article 2 of the new treaty, Mauritius has been advised by SARS that it will form part of the treaty, which Mauritius has implicitly accepted.

(a) Mutual agreement on residence

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242 The relevant clause (article 13(4)) of the Netherlands treaty reads as follows: "Gains from the alienation of any property other than that referred to in paragraphs 1, 2 and 3, shall be taxable only in the Contracting State of which the alienator is a resident." There is a school of thought to suggest "immovable property" as envisaged by article 6(2) of the Netherlands treaty (see below) would include the expanded definition of immovable property as envisaged by par 2(2) of the 8th Schedule. It is however generally accepted the meaning refers to the general meaning of immovable property under our law and not the par 2(2) meaning.

243 The renegotiated treaty has been signed, and has been ratified in South Africa but not yet in Mauritius.

The most significant change brought about by the new treaty concerns companies that are tax resident in both Mauritius and South Africa. In terms of the OECD Model Tax Convention tie breaker rules, double taxation of dual residents companies is resolved by ensuring that the company is tax resident in the State in which its “place of effective management” is situated. A South African incorporated company which is effectively managed in Mauritius would thus, in terms of the OECD tie breaker rules, be deemed to be tax resident in Mauritius and South Africa would lose its "taxing rights”. One of the perceived “abuses” of the 1997 Mauritius/South Africa treaty is by companies incorporated in Mauritius that purport to be effectively managed there, but are in fact run from South Africa. That is the case where significant functions that benefit the Mauritian company’s operations take place in South Africa.

Under the new treaty the dual-residence tiebreaker rules provide that the competent authorities of the two states shall endeavour to determine, by mutual agreement, the Contracting State of which such person shall be deemed to be resident for the purposes of the treaty. This “mutual agreement procedure” as a manner for determining the tax residence status of a taxpayer is contemplated by the commentary on Article 4 of the OECD Model Tax Convention and, as discussed above, supported by the discussion in Action 6 of the BEPS Action Plan.

The alternative provision provides that, in endeavouring to come to agreement on where the taxpayer shall be deemed to be resident, regard must be had to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. Where it is clear as to where the company is in fact effectively managed, such a provision would bring about no change. Accordingly, companies that are currently incorporated in Mauritius and are clearly managed there will not be affected by this provision. In a case where both South Africa and Mauritius believe that a company is incorporated in and purportedly effectively managed in Mauritius, and is also managed in South Africa, South Africa may wish to assert that the company is resident in South Africa. Unless South Africa and Mauritius can agree on where the company is resident, it will be a resident, for treaty purposes, of both countries and taxable in both countries. The contracting states are not required to grant the dual resident entity treaty benefits.

There is no obligation on the competent authorities to reach an agreement on the residency of an entity and it is probably practical to assume that the chances are remote of reaching agreement swiftly or even at all. The competent authority of Mauritius, for example, would, in principle, not have an active interest in coming to a mutual agreement where this would involve losing its taxing rights to South Africa. The fate of a dual resident company is that there is the potential for it to suffer tax in both countries but the effect of this could be ameliorated by any applicable domestic exemptions or credits (such as section 6*quat*). However, because Mauritius is a low tax jurisdiction, domestic relief for foreign tax paid is unlikely to offset the disadvantage of being subject to tax in both states (especially in light of the repeal of the tax sparing clause).

The practical effect of the above is that the dual resident company could be denied the benefits of the treaty and be subject to double taxation in South Africa and Mauritius if no agreement is reached between the two contracting states regarding the residence of the company. A binding arbitration process as per the current provisions of the OECD is not applicable under the proposed treaty.

Some consequences of the new treaty are:

- It may force companies to stop creating dual residence situations. The new treaty will necessitate taxpayers to relook at their position as it places the onus on them to ensure that they structure effective management and substance of their entities so as to avoid double taxation. Since the Mauritian tax rates are lower than those in South Africa, it could imply that South African companies will also be unable to benefit from the section *6quat* rebate if effective management is deemed to be in South Africa. The double taxation impact could result in decreased South African FDI into Mauritius – albeit minimal.
- The new treaty widens South Africa's tax net as it increases South Africa's ability to identify Mauritian companies that should be regarded as resident here, given the way in which they in fact operate.
- The new treaty may also help to bring into the tax net certain Mauritian branches of South African companies, in that, if the branch houses the company's only activity, it may be possible to claim that the company is dual resident by virtue of incorporation in South Africa and effective management in Mauritius.
- The new treaty does not affect Mauritian companies that clearly have their effective management in Mauritius.

(b) Withholding rates

<u>Interest:</u> Under the old treaty, interest paid out of South Africa to a Mauritian beneficial owner would not be taxable in South Africa. Under the new treaty, the amount that South Africa is able to withhold on interest paid to a Mauritian beneficial owner has increased from nil to 10% of the gross amount of the interest. Mauritius does not currently impose a withholding tax on interest paid. South African lenders to Mauritian borrowers would thus not be negatively affected by the amendment of the interest article, while on the other hand Mauritian lenders to South African borrowers would be affected.

Dividends: In terms of the new treaty, dividends tax will be withheld at a 10% rate unless the beneficial holder of the dividend holds at least 10% of the capital of the company paying the dividends, in which case the tax will be 5%.

Royalties: In terms of the new treaty, the amount that South Africa is able to withhold on royalties paid to Mauritius has increased from nil to 5%. The above withholding tax rates will have an impact on Mauritian financing or IP licensing entities that derive Interest or royalty income from South Africa.

(c) Capital Gains Tax (CGT) Carve-Out for Property Rich Companies

As noted above, apart from being a low tax jurisdiction in which to operate, Mauritius has also been a favourable base for investing into South African land rich companies. The new treaty provides that capital gains earned by Mauritian tax residents could be subject to South African CGT if the gain is from the disposal of shares in a South African company holding immovable property - a "land rich" company. This will have an impact on Mauritian companies that currently hold South African based investments in the mining or property sector. Thus the capital gains article of the new treaty repeals the so called "CGT cut out" clause as it specifically provides that a country may tax gains derived from the alienation of shares deriving more than 50% of their value directly or indirectly from immovable property situated in that country.

However, this gives rise to the potential for investors to channel this type of investment through companies in other countries that still have a treaty with South Africa that still have CGT cut out clause. This was the case for example with South Africa/Netherlands treaty. Note however that the South Africa/Netherlands DTA has been renegotiated and is awaiting signature. This matter is also of concern in the South Africa/Luxembourg DTA. It is also worth noting that the South Africa/Austria DTA and 18 other DTAs that have a zero rate on interest and/or royalties and those that do not have 13(4) of OECD are under renegotiation. These renegotiations will ensure that changes in ownership of shares in Mauritian land rich companies prevent the incentive to change the ownership to residents in other treaty countries now that there is South African CGT on disposal.

(d) Tax Sparing

The new treaty no longer includes a tax sparing clause. Rather, it allows for relief in the form of a foreign tax credit.

(e) Exchange of information on tax matters and assistance in the collection of taxes

The 1996 tax treaty had a limited version of exchange of information provision that did not extend to bank secrecy. The new tax treaty contains the latest OECD standard for the exchange of taxpayer information on tax matter as set out in article 26 of the OECD MTC. This will assist in the auditing of South African residents domiciled in Mauritius. The treaty also contains provision relating to assistance in tax collection of taxes.

(f) Remarks and Recommendations

There is no doubt that the new treaty will put Mauritian companies in a less beneficial position vis-à-vis South Africa than is currently the case. This is so, specifically in the context of dual-resident companies, loans to South African borrowers, and investments in companies owning immovable property in South Africa. However, this does not necessarily mean that the use of Mauritian companies is no longer beneficial in international structures. The other concern is that MNE are now more likely to prefer being based in Mauritius (for example manufacturing companies) instead of being based in South Africa.

It should be noted that treaty shopping can never be entirely stamped out and the chances are that some multinationals may look to other tax treaties to avoid having to pay CGT. One must bear in mind that the withholding taxes in the new treaty are still lower than the normal South African holding tax rate. Where there is an entity in a third country either from which the Mauritian incorporated dual resident entity is receiving payments or to which it is making payments, being a dual resident could offer the advantage of the ability to cherry pick treaty rates.

The dual resident company may thus be able to avail itself of either the tax treaty that South Africa has with a third country or the tax treaty that Mauritius has with the third country. In these circumstances, since the “mutual agreement procedure” has to be initiated by the taxpayer, where the taxpayer takes advantage of other treaties, it would be difficult for such a taxpayer to initiate the mutual agreement procedure. In the absence of a specific fact scenario it is difficult to predict the extent to which the ability of a dual resident to “cherry pick” could lead to revenue leakage for South Africa, but it is a matter to be borne in mind during future risk profiling of Mauritian structures.

As noted above, the withholding tax rates provides in the new treaty are still lower than the normal South African withholding tax rates. Although headquarter companies enjoy exemptions from withholding taxes, headquarter companies cannot be used for investment into South Africa. Foreign investors would thus still prefer investing into South Africa via Mauritius, or they could look for another suitable jurisdiction to act as holding company jurisdiction for investment into Africa, including South Africa.

5.2.5 TREATY SHOPPING: SOUTH AFRICA'S TREATIES ENCOURAGING DOUBLE NON-TAXATION

(a) The Treaty with Switzerland

An example of double non-taxation has arisen in the context of the previous treaty between Switzerland and South Africa. In particular, that treaty provided for relief in respect of double taxation by way of exemption. It stated as follows:

> "Where a resident of a Contracting State derives income…which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall exempt such income from tax…"

In terms of this arrangement if Switzerland had, and exercised, its right to tax certain income, South Africa was obliged to exempt that income from tax. Switzerland offered various beneficial effective tax rates in respect of, *inter alia*, financing transactions. Transactions existed where South African companies operated through permanent establishments in Switzerland. Substantially all the income of the entity was attributable to the permanent establishment and Switzerland exercised its taxing rights in respect of the income.

However, the effective rate in Switzerland was often as low as approximately 1.5%. In terms of the previous treaty between South Africa and Switzerland; South Africa was then required to exempt these amounts from tax. This resulted in non-taxation due to the low effective rate applied in Switzerland. The previous treaty was re-negotiated and now provides a tax credit for foreign tax suffered by South African residents in Switzerland.

(b) The Treaty with Zambia

The treaty between South Africa and Zambia provides taxing rights to Zambia in respect of interest paid on certain debt instruments advanced by South African residents. South Africa may not tax such interest.

- In circumstances where interest is tax deductible in terms of South African domestic law. There is no requirement that such amounts be taxed in the other jurisdiction in terms of the OECD Model Tax Convention.
- There is also no "subject-to-tax" clause in respect of such amounts in terms of South African domestic tax law.
- This is one of the oldest DTAs in South Africa's network (it came into operation in 1956) was first renegotiated in 2002 and was finalised in December 2010. The treaty is now awaiting signature.

The above matter should be considered by the South African tax authorities at the time of entering into treaties with other jurisdictions.

- South Africa entered into treaties with, *inter alia*, Ireland, Belgium and Luxembourg, which jurisdictions have provisions effectively mitigating the quantum of tax paid in those jurisdictions. For example, an investor may set up a Luxembourg company and invest in equity in that company in the form of redeemable preference shares. The Luxembourg entity may then advance a loan to the South African entity. As a matter of Luxembourg tax law a deduction will be granted for the dividends payable in respect of the redeemable preference shares, leaving the Luxembourg entity taxable only on its spread/margin. Belgium has a similar provision. Ireland merely taxes at a low rate.
- In this regard there is significant competition for tax revenues on a world-wide basis. Jurisdictions are incentivised to enter into as many treaties as possible and then also to offer tax incentives, *inter alia*, to attract multi-nationals into their jurisdictions.
- South Africa is one such jurisdiction. For example, South Africa introduced the headquarter company regime in terms of which foreign investors may invest through South Africa into, *inter alia*, Africa. As part of marketing this initiative South Africa has made mention of its many treaties with African jurisdictions. In particular South Africa competes directly with Mauritius in respect of attracting foreign investment into Africa. Unfortunately there have been uncertainties regarding South Africa's headquarter company regime and it has not been very attractive as the Mauritius one, despite South Africa's extensive treaty network.

5.2.6 TREATIES WITH TAX SPARING PROVISIONS

To encourage foreign investment, developing countries often grant fiscal incentives to foreign investors.[244] When countries sign a double tax treaty, and an investor from the developed country is offered a tax incentive by the developing country, the tax incentive may be eliminated or reduced by the tax regime of the investor's country.[245] This often occurs where the investor's country applies the credit method to prevent the double taxation of income. In reaction to this possibility, some double tax treaties preserve the benefit of source country tax incentives through "tax sparing" provisions, in terms of which developed countries amend their taxation of foreign source income to allow

244 A Easson *Tax Incentives For Foreign Direct Investment* (2004) 1-2; JR Hines "Tax Sparing and Direct Investment in Developing Countries" in Hines JR *International Taxation and Multinational Activity* (2001) 40; D Holland & R Vann "Income Tax Incentives for Investment" in V Thuronyi *Tax Law Design and Drafting* (1989) 986.

245 Hines at 40.

their residents, who invest in developing countries to retain the tax incentives provided by those countries.[246]

In effect, tax sparing provisions preserve the tax incentive granted by the developing country by requiring the developed country to give a tax credit for the taxes that would have been paid to the developing country if the incentive had not been granted.[247] Tax sparing has, however, become rather unpopular and several developed countries have become restrictive in including tax sparing provisions in their tax treaties.[248] It is reasoned that tax sparing may not be that instrumental in promoting foreign investment and that it encourages abusive tax practices.[249]

Tax sparing also encourages "treaty shopping".[250] This is mainly done by interposing a "conduit company"[251] in one of the contracting states so as to shift profits out of those states.[252] Generous tax sparing credits in a particular treaty can encourage residents of third countries to establish conduit entities in the country granting the tax incentive.[253]

The OECD set out the following best practice guidelines for countries for drafting tax sparing provisions:

(a) Tax incentives should be precisely defined to refer to specific incentives so as to prevent open-ended tax sparing that encourages abusive practices.[254]

(b) Tax sparing should ideally be restricted to local as opposed to export activities.[255]

(c) A maximum tax rate should be set for tax sparing credits to prevent the artificial increase of the rates.[256]

(d) Anti-abuse clauses should be included to prevent abusive practices.[257]

(e) Time limitations or sunset clauses should be included, so that the provision is not indefinitely used for abusive practices.[258]

(f) Tax sparing should ideally be restricted to business income rather than passive income. This would discourage harmful tax practices involving geographically

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246 Hines at 40; R Rohatgi *Basic International Taxation* (2002) 213.

247 AW Oguttu "The Challenges of Tax Sparing: A Call to Reconsider the Policy in South Africa" *Bulletin for International Taxation* (2011) (Vol 65) No 1 in para 2; K Brooks "Tax Sparing: A Needed Incentive for Foreign Investment in Low-Income Countries or an Unnecessary Revenue Sacrifice?" (2008-2009) 34 *Queen's Law Journal* 508.

248 V Thuronyi "Recent Treaty Practice on Tax Sparing" (2003) 29 *Tax Notes International* 301.

249 BJ Arnold & MJ McIntyre MJ *International Tax Premier* 2ed (2002) at 52-53.

250 H Becker & FJ Wurm *Treaty Shopping: An Emerging Tax Issue and its Present Status in Various Countries* (1988) 1; S Van Weeghel *The Improper Use of Tax Treaties with Particular Reference to the Netherlands and The United States* (1998) 119.

251 A Rappako *Base Company Taxation* (1989) 16.

252 Ibid.

253 Arnold & McIntyre at 53.

254 OECD Tax Sparing: A Reconsideration (1998) at 35-36.

255 OECD Tax Sparing Report at 36-37.

256 Ibid.

257 Ibid.

258 OECD Tax Sparing Report at 37-38.

mobile activities.[259]

Since tax sparing provisions are difficult to design and they often create undesirable and unintended economic and fiscal effects,[260] the OECD recommends that countries follow the form in Annex VI of the OECD Report on Tax Sparing when designing their tax sparing provisions.

As a member of the South African Development Community (SADC), South Africa espouses the recommendations of the Memorandum of Understanding (MOU) on Co-operation in Taxation and Related Matters among SADC countries,[261] which encourages member states to include tax sparing provisions in their tax treaties so as to promote foreign investment. However, in paragraph 2 and 3 of article 23 of the SADC Model, South Africa has reserved its right not to provide tax sparing. Although, South Africa previously stated, in its OECD non-member country position, that it reserves the right to add tax sparing provisions in its treaties with regard to the tax incentives provided for under its laws, since the 2008 version of the OECD MTC, South Africa removed its reservation on tax sparing and it no longer includes tax sparing in its treaties. South Africa's Model Treaty does not cover tax sparing provisions.[262] Before, this new position on tax sparing was taken, South Africa had concluded 16 tax treaties with tax sparing provisions. The first one was with Israel in 1979, then Romania, Thailand, Mauritius, Ireland, Egypt, Pakistan, Tunisia, Algeria, Uganda, Greece, Seychelles, Botswana, Ethiopia, Brazil and the last one with Mozambique, came into force in 2009, although negotiations of the same were completed in 2002.[263] Since then South Africa no longer includes tax sparing in its DTAs.

The tax sparing provisions in the treaties with Thailand (1996), Egypt (1999), Tunisia (1999), Pakistan (1999), Uganda (2000), Algeria (2001) and Greece (2003) have reciprocal tax sparing provisions. The terms are that: an investor's state of residence allows an exemption against tax due on the tax which the state of source could have imposed, even if the source state has waived all or part of that tax under its tax incentive laws that promote economic development.[264] Notably, these provisions are too widely drafted as they do not refer to any specific tax incentive but to all "laws designed to promote economic

259 OECD Tax Sparing Report at 36 and 43.
260 International Chamber of Commerce.
261 SADC "Memorandum of Understanding on Cooperation in Taxation and Related Matters" (art 4). Retrieved June 25 2009 from http://www.sadc.int/index/browse/page/167
262 Olivier & Honiball at 334; Oguttu "The Challenges of Tax Sparing: A Call to Reconsider the Policy in South Africa" in para 7.2.
263 SARS "Comprehensive Treaties in Force". Retrieved June 7 2010 from http://www.sars.gov.za/home.asp?pid=391931983 dd 13/03/2009
264 Oguttu "The Challenges of Tax Sparing: A Call to Reconsider the Policy in South Africa" in para 7.2; Olivier & Honiball at 334.

development in that Contracting State".[265] Furthermore, these provisions have no time limits and nor do they contain anti-abuse clauses that can be applied to prevent tax abuse.

The tax sparing provisions in the 1995 treaty with Romania and the (now re-negotiated) 1997 treaty with Mauritius have a much wider scope than the ones mentioned above. These two provisions, worded in almost a similar manner, extend the tax sparing provision not only to "laws designed to promote economic development … effective on the date of entry into force" of the treaty but also to "provisions which may be introduced in future in modification of, or in addition to, the existing laws".[266] The tax sparing provision in the treaty with Romania further extends this wide scope in that it refers not only to "laws designed to promote economic development" but also to laws designed to promote "decentralization".[267]

The tax sparing provisions in the relatively newer treaties with Seychelles (late 2003), Botswana (2004), Ethiopia (2006) and Mozambique (2009), are limited to schemes for the promotion of economic development that have been mutually agreed upon by the competent authorities of the Contracting States. It is important to note that when agreeing to tax sparing South Africa retained the right to reach mutual agreement in respect of the economic development schemes before allowing tax sparing to operate. Indeed, no schemes have ever been agreed with any of these countries with which mutual agreement is required.[268] Although the competent authorities have the power to settle the mode of application of the tax sparing provisions and thus limit their scope, these provisions still fall short of the OECD recommendations in that they lack sunset and anti-abuse clauses.

There are also some obsolete tax sparing provisions, such as the one in the 1979 treaty with Israel (which refers to tax holiday scheme for new investments in terms of 37H of the Income Tax Act,[269] which was abolished on 30 September 1999). The other obsolete tax sparing provision is in the 1997 treaty with Ireland which referred to the now defunct Undistributed Profits Tax.[270]

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265 E.g art 23(2) of the South African/Algeria treaty. Government Gazette 21303 dd 21/06/2000.

266 Art 23 (2) of the South Africa/Mauritius treaty. Government Gazette 18111 dd 02/07/1997.

267 Art 23(3) of the South Africa/Romania treaty. Government Gazette 16680 dd 27/09/1995.

268 Oguttu "The Challenges of Tax Sparing: A Call to Reconsider the Policy in South Africa" in para 7.2; Olivier & Honiball at 335.

269 Introduced s 12(1) of Revenue Laws Second Amendment Act 46 of 1996.

270 Oguttu "The Challenges of Tax Sparing: A Call to Reconsider the Policy in South Africa" in para 7.2; Deneys Reitz "Editorial comment: Tax-sparing Clauses" *Integritax* (Dec 1998) 1.

The treaty with Brazil: This treaty has a tax sparing provision in respect of government bonds. Article 11(1) of the treaty between South Africa and Brazil provides that interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State. However, Articles 11(4)(a) and (b) provide that notwithstanding the provisions of paragraphs 1 and 2:

> "(a) interest arising in a Contracting State and derived and beneficially owned by the Government of the other Contracting State, a political subdivision thereof, the Central Bank or any agency (including a financial institution) wholly owned by that Government or a political subdivision thereof shall be exempt from tax in the first-mentioned State;
>
> (b) subject to the provisions of subparagraph (a), interest from securities, bonds or debentures issued by the government of a Contracting State, a political subdivision thereof or any agency (including a financial institution) wholly owned by that government or a political subdivision thereof, shall be taxable only in that State".

Article 11(4)(b) read with Article 11(4)(a) of the treaty therefore applies, *inter alia*, to provide exclusive taxing rights to Brazil in respect of interest derived from bonds issued by the Brazilian government and derived and beneficially owned by South African residents other than the South African government, South African Reserve Bank or other governmental agencies set out in Article 11(4)(a) of the treaty.

Recommendations on Tax Sparing

- It is acknowledged that tax treaties are not generally negotiated on tax considerations alone and often countries' treaty policies take into account their political, social and other economic needs.[271] Nevertheless, care should be taken to adhere to international recommendations when designing tax sparing provisions, so as to prevent tax abuse. The OECD recommends that such designs should follow the form set out in its 1998 Report on Tax Sparing.
- The problem in the older treaties may be resolved by renegotiation of the treaty or through a protocol. The protocol should, for instance, ensure that the relevant tax sparing provision refers to a particular tax incentive and should contain a sunset clause or expiry date to ensure that it is not open to abuse.[272]
- As the process of removing or modifying existing tax sparing provisions to prevent such abuses is often slow and cumbersome,[273] South Africa's legislators should ensure that future tax sparing provisions are drafted circumspectly.

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271 Weeghel at 257-260.

272 RJ Vann & RW Parsons "The Foreign Tax Credit and Reform of International Taxation" (1986) 3(2) *Australian Tax Forum* 217.

273 Para 76 of the OECD commentary on art 23A & 23B.

- It is thus desirable for South Africa to adhere to the OECD's recommendations and best practices in drafting tax sparing provisions.
- All the obsolete tax sparing provisions should be brought up to date with the current laws if they are still considered necessary.

5.2.7 ISSUES PERTAINING TO MIGRATION OF COMPANIES

In the case of *CSARS v Tradehold Ltd,*[274] *a* South African company was "migrated" to Luxembourg from a tax perspective. This had the effect of capital gains which had accumulated in the company during the period that it was a resident of South Africa being taxable only in Luxembourg. Luxembourg then did not exercise its domestic tax law to tax any such gain. As a result of the decision in this case, South Africa's domestic law was amended in order to prevent such arrangements. Specifically, section 9H of the Income Tax Act states that, *inter alia*, where a company that is a resident ceases to be a resident, or a controlled foreign company ceases to be a controlled foreign company, the company or controlled foreign company must be treated as having disposed of its assets on the date immediately before the day on which that company so ceased to be a resident or a controlled foreign company, for an amount equal to the market value of its assets.

- It is worth noting that the OECD Final Report on Action 6, the OECD intends to make changes to the OECD MTC to the effect that treaties do not prevent the application of domestic "exit taxes". [275]

5.2.8 ISSUES PERTAINING TO DIVIDEND CESSIONS

Shortly after the introduction of dividends tax in section 64D of the Income Tax Act, various transactions were entered into by non-resident shareholders of South African shares in order to mitigate the tax. In particular, non-resident shareholders of listed South African shares in respect of which dividends were to be declared transferred their shares to South African resident corporate entities. The dividends were therefore declared and paid to the South African resident corporate entities which claimed exemption from dividends tax on the basis that, as set out in section 64F(1) of the Income Tax Act, the entities constituted companies which were residents of South Africa.

- The South African resident corporate entities then paid "manufactured dividend" or other derivative payments to the non-resident. These payments did not constitute dividends and were therefore not subject to the dividends tax.
- The South African resident corporate entities therefore received dividends which were not exempt from normal tax, but in respect of

274 (132/11) [2012] ZASCA 61.
275 OECD/G20 2015 Final Report on Action 6 in para 65-66.

which they obtained a tax deduction for the "manufactured dividend" payments made to the non-resident shareholder.

- The non-resident shareholder received amounts that did not constitute dividends and therefore did not attract any dividends tax.
- The provisions of section 64EB of the Act were therefore introduced in August 2012. These provisions have subsequently been updated. The provisions adequately deal with such transactions since, *inter alia*; they deem the "manufactured dividend" payments to constitute dividends which are liable for dividends tax.
- A variation on this transaction is the transfer of the shares to an entity situated in a jurisdiction which has a treaty with South Africa that reduces dividends tax from the domestic rate of 15% to 5%. It is also envisaged that similar transactions will be entered into in respect of debt instruments now that the interest withholding tax has been imposed from 1 March 2015. The recommendation in respect of applying the GAAR and including anti-tax-avoidance language in the relevant treaties should be considered in respect of these transactions.

5.2.9 BASE EROSION RESULTING FROM EXEMPTION FROM TAX FOR EMPLOYMENT OUTSIDE THE REPUBLIC

Section 10(1)(o)(ii) of the Income Tax Act, exempts from tax any remuneration received or accrued by an employee by way of any salary, leave pay, wage, overtime pay, bonus, gratuity, commission, fee, emolument, including an amount referred to in paragraph(i) of the definition of gross income (fringe benefits):

- For a period exceeding 183 full days in aggregate during any 12 month period commencing or ending during that or any other year of assessment
- For a continuous period of 60 days during such the 12 months period.
- If such services were rendered during such periods worked outside the Republic. Provided that days in transit in the Republic are deemed to be outside the Republic. Days on holiday outside of the Republic count towards the number of days required.

Section 10(1)(o) was implemented along with the residence basis of taxation in 2001. It was supposed to be reviewed after 3 years. More than ten years have passed without a review. The concern about the provision is that there are many South Africans working abroad but whose home is still South Africa, so the exemption takes away the right for South Africa to tax on a residence basis.

Because of the section 10(1)(o) exemption, an SA resident individual working in a foreign tax free country will not pay tax anywhere in the world on his/her remuneration for services rendered if he/she meets the 183 day (broken) and

60 day (continuous) outside SA requirements per tax year. At present it is not clear as to how many taxpayers are taking advantage of the exemption. SARS does not have reliable statistics on this matter.

In a double tax treaty context, article 15 of treaties based on the OECD MTC deals with income from employment. The article provides that:

(a) Salaries, wages and other similar remuneration derived by a resident of one state in respect of an employment are subject to tax in that state only, unless the employment is exercised in the other state, in which case the remuneration derived from the other state may be taxed in that state.

(b) Notwithstanding the general rule described in *(a)*, remuneration derived by a resident of one state in respect of an employment exercised in the other state may be taxed in the state of residence only if three conditions are met:

(i) the recipient is present in the state in which he or she is not resident for a period or periods not exceeding in the aggregate 183 days in any twelve-month period commencing or ending in the fiscal year concerned;

(ii) the remuneration is paid by or on behalf of an employer who is not a resident of the state in which the recipient is not resident; and

(iii) the remuneration is not borne by a permanent establishment which the employer has in the state in which the recipient is not resident.

- It is recommended that either:
  - the exemption should be withdrawn and a foreign tax rebate granted if foreign tax is imposed on the basis that the ongoing income stream should be taxable in RSA, even if the capital is invested abroad. or
  - the exemption is amended to only apply where the employee will be taxed at a reasonable rate in the other country.

5.2.10 BASE EROSION RESULTING FROM SOUTH AFRICA GIVING AWAY ITS TAX BASE

Some foreign jurisdictions, especially in Africa, are incorrectly claiming source jurisdiction on services (especially management services) rendered abroad and yet those services should be considered to be from a South African source. These foreign jurisdictions are withholding taxes from amounts received by South African residents in respect of services rendered in South Africa. The withholding taxes are sometimes imposed even if a treaty that exists between South Africa and the foreign country specifies otherwise, in that the treaties do not have an article dealing with management fees or South African residents have no permanent establishments in these countries. This results in double taxation.

In South Africa, the source of income from services is where the services are rendered rather than the quarter from which the service fees are received, as was held by the Appellate Division in the *Lever Brothers* case. Where double taxation arises, there is no foreign tax credit available to provide relief for taxpayers. This has made South Africa unattractive as a headquarter location.[276] Taxpayers can only claim a deduction of the foreign tax in the determination of taxable income in accordance with section 6*quat*(1C). However, this deduction only gives partial relief and is therefore insufficient to fully alleviate double taxation.[277]

In 2011, a special foreign tax credit for service fees was introduced to operate as some form of a relief from double or potential double taxation on cross-border services for South African multinational companies that render services to their foreign subsidiaries. This foreign tax credit applied to foreign withholding taxes imposed in respect of service fees from a South African source (i.e. services rendered in South Africa by a South African resident to a foreign resident). The special tax credit applied on an income-by-income basis.

National Treasury noted that section 6*quin* was intended to be a temporal measure aimed at addressing interpretation issues arising out of three DTAs where the treaty partners did not apply the provisions of the DTAs in respect of services rendered by SA residents in those countries. Nevertheless this temporary measure could be interpreted that SA had departed from the tax treaty principles in the OECD MTC in its treaties with African countries, in that it gave them taxing rights over income not sourced in those countries. As a result, South Africa effectively eroded its own tax base as it was obliged to give credit for taxes levied in the paying country.

In the 2015 Tax Laws Amendment Act the section 6*quin* special foreign tax credit was withdrawn with effect from 1 January 2016.[278] National Treasury's reason for the change was that the special tax credit regime was a departure from international tax rules and tax treaty principles in that it indirectly subsidised countries that do not comply with the tax treaties.

South Africa was the only country in the world that provided for this kind of tax concession. This provision effectively encouraged its treaty partners not to abide by the terms of the tax treaty in respect of the taxation of fees and thus

276 PWC "Comments on DTC BEPS First Interim Report" (30 March 2015) at 22.
277 PWC "Comments on DTC BEPS First Interim Report" (30 March 2015) at 21.
278 Section 5 of the Draft Taxation Laws Amendment Bill 2015.

give them taxing rights over income that is not sourced in those countries. Consequently, it defeated the whole purpose of the tax treaty.

While the enactment of this relief was well intended, it resulted in a significant compliance burden on the South African Revenue Service. Some taxpayers also exploited this relief by claiming it even for other income such as royalties and interest that are not intended to be covered by this special tax credit.[279] Mutual Agreement Procedure (MAP) under tax treaties is the forum that ought to be used to solve such problems.

There have been concerns that withdrawal of section 6*quin* could undermine South Africa as a location for headquarters and could see banking, retail, IT and telecommunication companies which could end up relocating their service centers elsewhere. The tax credit under section 6quin was reasoned to be one of the reasons why such service companies based their headquarters in South Africa.[280] Its removal could lead to increased project costs for local service providers due to double taxation; which would impact on their cash flow.[281] This could compel such companies to move their management centers to lower tax jurisdictions. Alternatively, such costs could be cut by relocating skilled personal into other African countries, which is now considered rather than deal with the tax issues in South Africa.

In order to mitigate against such concerns and any double taxation that could be faced by South African taxpayers doing business with the rest of Africa, section 6*quat*(1C) Income Tax Act has been amended to allow for a deduction in respect of foreign taxes which are paid or proved to be payable without taking into account the option of the mutual agreement procedure under tax treaties. All tax treaty disputes should be resolved by competent authorities of the respective countries through mutual agreement procedure available in the tax treaties as a mechanism to resolve disputes. Section 6quat(1C) previously stated that:

> "For the purpose of determining the taxable income derived by any resident from carrying on any trade, there may at the election of the resident be allowed as a deduction from the income of such resident so derived the sum of any taxes on income (other than taxes contemplated in subsection (1A) proved to be payable by that resident to any sphere of government of any country other than the Republic, without any right of recovery by any person other than a right of recovery in terms of any entitlement to carry back losses arising during any year of assessment to any year of assessment prior to such year of assessment".

279 Explanatory Memorandum to the Taxation Laws Amendment Bill, 2015.

280 BusinessDay "MTN Warns Against Removing African Tax Incentive". Available at http://www.bdlive.co.za/business/technology/2015/09/17/mtn-warns-against-removing-african-tax-incentive accessed 21 October 2015.

281 BusinessDay "MTN Warns Against Removing African Tax Incentive". Available at http://www.bdlive.co.za/business/technology/2015/09/17/mtn-warns-against-removing-african-tax-incentive accessed 21 October 2015.

In terms of the Taxation Laws Amendment Act 2015, the amended s 6quat(1C)(a) provision which came into effect from 1 January 2016 reads:

> "For the purpose of determining the taxable income derived by any resident from carrying on any trade, there may at the election of the resident be allowed as a deduction from the income of such resident so derived the sum of any taxes on income (other than taxes contemplated in subsection (1A)) paid or proved to be payable by that resident to any sphere of government of any country other than the Republic, without any right of recovery by any person other than in terms of a mutual agreement procedure in terms of an international tax agreement or a right of recovery in terms of any entitlement to carry back losses arising during any year of assessment to any year of assessment prior to such year of assessment".

In terms of SARS Interpretation Note 18, the phrase "proved to be payable" should be interpreted as an "unconditional legal liability to pay the tax."

The concern though is whether the deduction method is a feasible approach that will offer taxpayers relief. The word "paid" as used in the section could be interpreted as requiring an "unconditional legal liability to pay the tax". If so, there would be no relief in cases where tax is incorrectly withheld (e.g. contrary to treaty provisions).

- To avoid such a situation, it is recommended that the wording in the previous 6quin, should be reintroduced in section 6quat1(C) which gives access to the section if tax was "levied" or "imposed" by a foreign government.
- It is submitted that the rationale behind the introduction of section 6*quin* remains valid; in that it was intended to make South Africa an attractive as a headquarter location. However this does not detract from the fact that it resulted in the erosion of its own tax base.
- South Africa's need to develop a coherent policy in respect of treaty negotiation and interpretation, especially with respect to its response to Africa's needs. SARS is encouraged to actively engage with the African countries which are incorrectly applying the treaties with the objective of reaching agreement on the correct interpretation and application of the treaties. South African taxpayers should not be subjected to double taxation simply because SARS is not able to enforce binding international agreements with other countries.[282]

- South African has a model tax treaty which informs its treaty negotiations. This model treaty should be made publicly available and any treaties that provide for the provision of taxing rights on technical service fees should be renegotiated insofar as possible to bring them in line with the model in this regard.[283]

[282] PWC "Comments on DTC BEPS First Interim Report" (30 March 2015) at 22.
[283] PWC "Comments on DTC BEPS First Interim Report" (30 March 2015) at 22.

- As noted above, the Mutual Agreement Procedure (MAP) under tax treaties is the forum that ought to be used to solve problems arising from the improper application of the treaty, such as in this case, where treaty services rendered by South African residents in treaty countries ought to be taxed in South Africa but those countries still impose withholding taxes on services rendered in these countries despite the fact that the DTAs with these countries do not have an article dealing with management fees or South African residents have no permanent establishments in these countries. MAP has however not been effective in Africa.
- It is recommended that solving this problem, that is affecting intra-Africa trade, will require organisations such as ATAF to play a significant role.

5.2.11 TREATY SHOPPING THAT COULD BE ENCOURAGED BY SOUTH AFRICA'S HEAD QUARTER REGIME

South Africa has a Head Quarter Company (HQC) regime under section 9I and several other relevant provisions[284] of the ITA. The objective of the HQC regime is to allow non-residents to establish a holding company in South Africa which would be used to make acquisitions in other countries, i.e. to promote the use of South Africa as the base for holding international investments.

The South African tax impact of the regime is that a HQC will be able to earn dividends, interest, royalties and realisation gains from its foreign investments without incurring any South Africa tax on the flow of such items of income into and out of South Africa to the ultimate third party beneficiaries. This is achieved as follows:

- Dividends derived by a HQC from its equity investments in foreign companies should qualify for the exemption under section 10B(2) of the ITA, since it needs to hold at least 10% of the equity shares and voting rights in the foreign company to qualify.
- Dividends declared by a HQC will be exempt from dividends withholding tax ("DT") in terms of section 64E(1) of the ITA.
- Interest derived by a HQC from loans advanced to the foreign companies will be subject to normal tax. However, the HQC should be entitled to deduct the interest expense incurred in respect of loans raised to advance such loans to the foreign companies since the HQC is not subject to the transfer pricing (including thin capitalisation) restrictions under section 31 of the ITA. Therefore, any

[284] Sec 9(2)(d) read with sec 35, sec 9D, sec10B, sec 31, section 37K and par 64B(2) of the ITA.

such loans could be arranged on a back-to-back basis to avoid any tax liability for the HQCs.[285]

  - In should be noted that in terms of the current version of section 23M, which was introduced with effect from 1 January 2015, a HQC is not excluded from its scope, which may then apply to restrict the interest deduction. It is, however, expected that this will be amended as it was not the intention to subject the HQC to tax on such interest earned from its foreign acquisitions. In the same vein it is necessary that HQCs are exempted from s 8F and s 8FA.

- In terms of section 20C of the ITA, the interest deduction will be ring-fenced to the interest earned on foreign loans. Therefore, to the extent that there is a margin between the incoming interest and the payment of interest, the difference will be taxed in South Africa. However, no margin is required.
- The HQCs will be exempt from the interest withholding tax (IWT
- The royalties derived by the HQCs from the foreign companies would be subject to South African tax but the corresponding royalties paid to the non-resident owner of the IP would be tax deductible. In terms of section 49D(b), royalties paid by a HQC are not subject to the withholding tax on royalties. Therefore, the non-resident owner of the IP could licence the right to use the IP to the HQC which would sub-licence the use to the foreign companies without incurring any South African tax. Since the transfer pricing rules would not apply, no margin would be required.
- In terms of paragraph 64B(2) of the Eighth Schedule to the ITA, a HQC must disregard any capital gain or capital loss in respect of the disposal of any equity share in any foreign company, provided the HQC held at least 10% of the equity shares and voting rights in that foreign company. The shares to be acquired by the HQCs should be regarded as capital investments (as opposed to trading stock), which means that the realisation gains would be of a capital nature, subject to the provisions of the Eighth Schedule to the ITA. Therefore, the realisation gains would not be subject to tax and no DT would be imposed on the distribution of such gains.
- The HQC will thus be subject to tax by virtue of its incorporation in South Africa, but the various exemptions from withholding taxes and the transfer pricing rules should have the impact that the HQC would not effectively be subject to any tax. Nevertheless, since the HQC

285 In terms of the current version of section 23M, which was introduced with effect from 1 January 2015, a HQC is not excluded from its scope, which may then apply to restrict the interest deduction. It is, however, expected that this will be amended as it was not the intention to subject the HQC to tax on such interest earned from its foreign acquisitions. In the same vein it is necessary that HQCs are exempted from s8F and s8FA.

will be "liable to tax by virtue of its incorporation", it will generally be entitled to the benefits of the South African DTA network[286].

The HQC regime could thus encourage treaty shopping by non-residents. The question arises whether a court could conceivably condemn a treaty shopping scheme by a non-resident to access a DTA with South Africa if the South African Legislator has effectively sanctioned treaty shopping by non-residents to access South African DTAs with other countries.

6 CURRENT MEASURES TO CURB TREATY SHOPPING IN SOUTH AFRICA

6.1 USE OF DOMESTIC PROVISIONS

The use of domestic law provisions to prevent tax treaty abuse are endorsed by both the OECD in its 2015 Final Report on Action 6 (as discussed above) and the UN.[287] Both organizations consider that tax treaties may be subject to domestic anti-avoidance rules in cases involving treaty shopping.[288] The OECD 2015 Final Report on Action 6 also recommends that in order to prevent treaty shopping where a person tries to circumvent the domestic tax law provisions using treaty benefits, domestic anti-avoidance rules have to be applied. The OECD 2015 Final Report on Action 6 outlines the avoidance strategies that fall into this category, namely:[289]

- Thin capitalisation and other financing transactions that use tax deductions to lower borrowing costs;
- Dual residence strategies (*e.g.* a company is resident for domestic tax purposes but non-resident for DTA purposes);
- Transfer mispricing;
- Arbitrage transactions that take advantage of mismatches found in the domestic law of one state and that are

286 Article 1 of the UK/South Africa DTA, which is the typical requirement to qualify as a resident of South Africa for DTA purposes.

287 See sections 1 and 2 of the Annex. For example, paragraph 9.4 of the Commentary to Article 1 of the OECD Model Convention states that countries do not have to grant the benefit of a double taxation convention where arrangements that constitute an abuse of the convention have been entered into and any such denial of treaty benefits may be achieved under either a domestic law or treaty-based approach.

288 Subject to the caveat in paragraph 9.5 of the Commentary on Article 1 of the OECD Model Convention that "...it is not to be lightly assumed that a taxpayer is entering into the type of abusive transactions referred to above." In addition, paragraph 9.5 sets out the guiding principle that "…the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions."

289 OECD/G20 2015 Final Report on Action 6 in Section A.

- o related to the characterization of income (*e.g.* by transforming business profits into capital gain) or payments (*e.g.* by transforming dividends into interest);
  - o related to the treatment of taxpayers (*e.g.* by transferring income to tax-exempt entities or entities that have accumulated tax losses; by transferring income from non-residents to residents);
  - o related to timing differences (*e.g.* by delaying taxation or advancing deductions);
- Transactions that abuse relief of double taxation mechanisms (by producing income that is not taxable in the state of source but must be exempted by the state of residence or by abusing foreign tax credit mechanisms).

As seen above, some of these avoidance strategies could also be utilized in the context of South African DTAs, subject to the potential application of the General Anti Avoidance Rules (GAAR) or other specific anti-tax avoidance legislation.

The GAAR contained in sections 80A-L of the Income Tax Act[290] provides a significant weapon to SARS in attacking any transactions which seek to abuse a DTA. Although South Africa's GAAR provisions can be applied on any impermissible tax avoidance arrangements which would result in a tax benefit in a domestic context, they can also apply to international tax avoidance schemes in a treaty context. In many situations this will not result in ignoring South Africa's obligations under the particular DTA, but using domestic tax law to re-characterise the transaction. In this regard section 80B provides wide powers to the Commissioner to determine the tax consequences of any "impermissible avoidance arrangement" for any party by, *inter alia*, disregarding, combining or re-characterising any steps in or parts of the impermissible avoidance arrangement. South Africa can also apply the common law doctrine of "substance over form" to prevent tax avoidance in a treaty context where the parties are involved in sham or simulated transactions.

However, it could be argued that the application of such domestic provisions in a treaty context amounts to treaty override.[291] In terms of section 108(2) of the Income Tax Act[292], read with section 231 of the Constitution of the Republic of South Africa,[293] when the National Executive of South Africa enters into a double tax agreement with the government of any other country, and the

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290 Act 58 of 1962

291 Domestic law provisions to prevent tax treaty abuse are endorsed by both the OECD and the United Nations, both organizations consider that tax treaties may be subject to domestic anti-avoidance rules in cases involving treaty shopping.

292 Ibid

293 108 of 1996.

agreement is ratified and published in the Government Gazette, its provisions are as effective as if they had been incorporated into the Income Tax Act.[294]

Since both the GAAR and double tax treaties can be used to prevent tax avoidance, there would be no conflict in purpose.

- However to prevent treaty override disputes the OECD recommends that the onus is on countries to preserve the application of these rules in their treaties.[295]
- South Africa should ensure it preserves the use of the application of domestic ant- avoidance provisions in its tax treaties.

Regarding the issue of possible conflicts in the interactions between domestic and treaty rules, it has been pointed out above the OECD 2015 Final Report on Action 6 clearly states that treaties do not prevent the application of such domestic anti-avoidance rules.

The other concern is that although the OECD recommends that treaty abuse can be countered by domestic provisions, currently the preamble of the OECD Model Tax Treaty does not include a reference to the objective to prevent tax avoidance. It merely refers to the "prevention of fiscal evasion". Likewise, currently, the preamble to most of South Africa's DTAs provides that the purpose of the treaties is "for the avoidance of double taxation and the prevention of fiscal evasion". This does not include a reference to the object to prevent tax avoidance. It merely refers to the "prevention of fiscal evasion". As indicated above, there is a significant difference between the concept of "avoidance" and "evasion" of tax.[296] Therefore, whilst a DTA should be interpreted in the light of its object and purpose stated in its preamble,[297] it is not certain that the object could be expanded to also include the avoidance of tax if such object is not specifically stated.[298] It may be arguable that the "prevention of fiscal evasion", as stated in the preamble of many DTAs was intended to cover a wider concept including tax avoidance. However, this may stretch even the teleological approach to treaty interpretation.

The South African country International Fiscal Association Report (the SA IFA Report) on 2010 concludes that since the relationship between DTAs and domestic anti-abuse provisions has not been considered by the South African courts, this relationship has to be determined according to South Africa's

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294 Ibid

295 Arnold at 245.

296 SARS Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act, 1962, (2005) in para 221, where it refers to the definition of "tax evasion" by the OECD as encompassing "illegal arrangements through or by means of which liability to tax is hidden or ignored; also see Goyette at 766.

297 Article 33 of the VC.

298 Goyette at 766 – 768.

specific legal framework,[299] i.e. the status of DTAs under South African law and in relation to the provisions of the ITA.

The analysis above, on the status of DTAs under South African law, indicates that our courts have expressed the view on several occasions that the OECD Commentary on the OECD Model DTA should be taken into consideration when a DTA provision is to be interpreted. In accordance with the OECD Commentary, the domestic anti-tax avoidance rules of a contracting state may be applied to counter the improper use of a DTA, provided it can be shown that obtaining the tax benefit under the DTA was one of the main purposes for entering into the transactions or arrangements and obtaining such a benefit would be contrary to the object and purpose of the relevant provisions of the DTA.[300]

Since the essential test under the general anti-tax avoidance rules (GAAR) (contained in Part IIA of Chapter III of the ITA) is whether the sole or main purpose of the transaction, scheme or arrangement is to obtain a tax benefit, our courts would be able to apply the GAAR to counter DTA abuse, unless such application could be regarded, under the circumstances, as contrary to the object and purpose of the relevant provisions of the DTA. On the same basis, the common law doctrines of substance versus form or the sham transactions could be applied to counter artificial arrangements which are merely aimed at achieving a tax benefit.

However, the object and purpose requirement may not be so easy to apply, especially since the South African DTAs do not provide clearly in the preamble of the DTAs that tax avoidance is one of the objects and purpose of the DTA. Furthermore, there is uncertainty about the scope of the substance versus form and sham doctrines to counter tax avoidance schemes, particularly if there is some commercial rational for the arrangements.[301]

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299 SA IFA Report at 723.

300 OECD Commentary, op cit, para 9.5 on page 61.

301 Erf 3183/1 Ladysmith (Pty) Ltd and Another v CIR, 1996(3) SA 942 (A), 58 SATC 229; Commissioner for SARS v NWK Ltd 2011 (2) SA 67 (SCA) where the court said: If the purpose of the transaction is only to achieve an object that allows the evasion of tax, or of a peremptory law, then it will be regarded as simulated.“; also see the subsequent decision in Bosch and Another v CSARS [2013] 2 All SA 41 (WCC) where the court remarked: “If there is no commercial rationale, in circumstances where the form of the agreement seeks to present a commercial rationale, then the avoidance of tax as the sole purpose of the transaction, would represent a powerful justification for approaching the set of transactions in the manner undertaken by the Court in NWK.”; see also the recent decision in Roshcon (Pty) Limited v Anchor Auto Body Builders CC 2014 JDR 0644 (SCA) where the Supreme Court of Appeal commented as follows:” If it meant that whole categories of transactions were to be condemned without more, merely because they were motivated by a desire to avoid tax or the operation of some law, that would be contrary to what Innes J said in Zandberg v Van Zyl in the concluding sentence of the passage quoted above, namely that: 'The inquiry, therefore, is in each case one of fact, for the right solution of which no general rule can be laid down.'”

As is recommended in the OECD 2015 Final Report on Action 6, it is submitted that the wider scope of the DTA, apart from the mere general statement in the preamble, should be included in all South Africa's DTAs in order to determine the object and purpose of particular provisions of the DTA. Concerns about renegotiating a big number of treaties will be solved when South Africa signs up to the Multilateral Instrument as recommended in Action 15 of the OECD BEPS Project.

The advantage of applying domestic law to treaty shopping is that amendments can be implemented in a timely manner. Such a domestic approach would have immediate effect across South Africa's entire tax treaty network, which would facilitate a greater consistency in practice than would unfold if South Africa were to rely exclusively on treaty-based solutions.[302] The effectiveness of the GAAR has however not been tested in any court. Since GAAR was introduced, there have been no reported cases applying GAAR. In this regard one may wonder to what extent SARS could use it to prevent treaty-abusive transactions. It is however notable that the proposed "principle purpose provision" in the OECD 2015 Final Report on Action 6, is akin to the "main purpose test" in the GAAR, which is applied to determine whether the main/primary purpose of a transaction (or series of transactions of which the transaction was a part) was to achieve a tax benefit, broadly defined. In effect, the application of the GAAR to prevent treaty shopping, would be in line with the OECD recommendations.

6.2 SPECIFIC TREATY PROVISIONS

6.2.1 THE BENEFICIAL OWNERSHIP PROVISION

Currently, the main specific treaty provision that is applied in South Africa's treaties to curb conduit company treaty shopping is the "beneficial ownership" provision as set out in article 10, which deals with dividends, article 11 which deals with interest and article 12 which deals with royalties. As explained above, the term "beneficial ownership" is not clearly defined in the OECD Model Tax Convention and nor is it defined generally in South Africa's domestic tax law (see discussion below). Article 3(2) of many of South Africa's treaties provides that, should a term not be defined in the treaty, it shall have the meaning ascribed to it in terms of the domestic law of the contracting states.

The erstwhile definition of a "shareholder" in section 1 of the ITA, although it did not specifically refer to "beneficial ownership", defined a shareholder as the

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302 OECD "Tax Conventions and Related Questions: Written Contributions from Members of the Focus Group on Treaty shopping" para 6.2.

registered shareholder, except where some other person is entitled "to all or part of the benefit of the rights of participation in the profits, income or capital attaching to the share so registered." In such instance, the "other person" was also deemed to be the shareholder. This definition was deleted with effect from 1 April 2012, when the new Dividends Tax legislation came into effect (section 64D – 64N of the ITA). The term "beneficial ownership" is now defined, specifically in relation to dividends tax in section 64D of South Africa's Income tax Act, to mean "a person entitled to the benefit of the dividend attaching to a share". This is a very vague definition and no guidance regarding its interpretation has been provided in the accompanying Explanatory Memorandum. The definition applies only for purpose of the Dividends Tax provisions of the ITA. It therefore does not apply to the rest of the ITA and/or to other tax legislation. The concept of "beneficial ownership" is used in the Securities Transfer Tax Act (STT Act).[303] Although the concept is not defined in the STT Act, the Explanatory Memorandum to the STT said the following in this regard:

> "The concept of transfer relates to economic ownership, as opposed to the mere registration of a security as in the case of a share registered in the name of a nominee. For that reason transfer excludes any event that does not result in a change in beneficial ownership."

South African company law points out that the registration of shares in one person's name does not imply that such a person is the beneficial owner of the shares since the registered holder may merely be a nominee. This was confirmed in *Dadabhay v Dadabhay*[304] and in *Standard bank of South Africa Ltd v Ocean Commodities Inc.*[305] However the real question which remains is under what circumstances a conduit company could be regarded as a mere nominee, as opposed to the real owner of the shares. In this regard, South African courts could apply the criteria for the substance versus form and sham doctrines developed by our courts to determine who a "beneficial owner" is for purposes of the DTA provision in question. However, every case would have to be considered on its own facts to determine whether the actual transactions may be ignored on the basis that they represent a sham and to give effect to the real transaction between the parties.

To date, only a handful of South African cases have touched on the meaning of the concept of beneficial ownership. In *Holley v Commissioner for Inland Revenue* 1947 (3) SA 119 (A), the main question for consideration was whether the taxpayer received certain amounts (derived from assets he inherited from his uncle) as a conduit for the benefit of his aunt, or whether he was the beneficial owner of the funds in question, but with an obligation to make

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303 Act No 25 of 2007

304 3 SA 1039 (AD).

305 1983 1 SA 276 (A).

payment to her of certain amounts. The Court held that his uncle's Will created a *fideicommissum* in favour of his aunt and that the taxpayer did not receive the amounts in his personal capacity, but in a representative capacity on behalf of his aunt.

In *Standard Bank of SA Ltd and Another v Ocean Commodities Inc and Others* 1980 (2) SA 175 (T), the Court considered the scenario where shares (in compliance with Rhodesian exchange control rules) were registered in the name of Standard Bank Nominees on behalf of two of the respondents. The Court said the following regarding the ownership of the shares:

> "In respect of registered shares, a court can go behind the register to ascertain the identity of the true owner. The fact, therefore, that the shares are registered in the name of Standard Bank Nominees does not mean that it is the actual owner or that one cannot look behind the register to ascertain the identity of the true owner."

The Court then dealt with the position of the purchaser where shares are sold, but not yet transferred:

> "Until registration of the transfer, however, the transferor or his nominee is a trustee of the shares for the transferee. The trustee must act according to the instructions of the transferee who becomes the beneficial owner of the proprietary rights in respect of the shares by means of the conclusion of the contract of cession."

In *Commissioner, South African Revenue Service v Dyefin Textiles (Pty) Ltd* 2002 (4) SA 606 (N), the Court considered the concept of beneficial ownership in the context of a discretionary trust to determine whether the trust or the sole beneficiary of the trust should be regarded as the shareholder of the shares in a company. The Court made the following remarks in this regard:

> "The trustees admittedly did not have the beneficial ownership of these shares, but nevertheless they were under an obligation to hold same and transfer them to a third party if directed to do so by the taxpayer's directors. This aspect of the matter points away from the notion that at all material times the taxpayer was in reality the beneficial owner of the shares."

The Court rejected the view expressed in the lower Court, which held that the trustees did not hold the assets of the trust on behalf of the trust as a separate legal entity (which it is not) but on behalf of the sole beneficiary. It appears that the High Court acknowledged that the trustees could not be regarded as the beneficial owners of the shares, but it came to the conclusion above because the trustees were under the obligation to hold the shares and potentially transfer them to a third party if so directed to do so by the directors. Therefore, the Court held that the trust was the shareholder and not the beneficiary. The reasoning by the Court could imply that a beneficiary with vested rights under the trust deed in respect of all the benefits of the shares, e.g. the right to share in a portion of the dividends and any proportionate proceeds from the disposal of the shares, would indeed be regarded as the beneficial owner of the shares in the proportion to his entitlement. However, it should be noted that the trust deed in question specifically provided that the “shares shall be held by the trust as nominees and subject to any terms and conditions as laid down by the board of directors of Dyefin Textiles (Pty) Ltd.”

Although all the remarks regarding beneficial ownership in the cases considered above were *obiter*, it appears that the courts commonly accept the beneficial ownership concept in those instances where a party holds assets as nominee, agent or trustee for the beneficial owner. It is submitted that the scope to interpret the meaning to be wider than such nominee or agency relationships is thus very limited.

Despite the above domestic definitions, for treaty purposes the meaning of beneficial ownership should not be limited to a narrow South African interpretation. Care should be taken to ensure that it carries a wide international meaning that is in line with the guidelines offered by the OECD.

Nevertheless as explained above, internationally it is not precisely clear what the concept of “beneficial ownership” means. We have pointed out that section 233 of the Constitution of the Republic of South Africa requires that a court, when interpreting legislation, must prefer any reasonable interpretation of the legislation that is consistent with international law over any alternative interpretation that is inconsistent with international law. Therefore, our courts will consider the interpretation by foreign courts of new concepts used in the international arena. However, foreign judgments must be considered taking into account the relevant legislation and specific context. In the context of a DTA, our domestic courts and foreign courts often refer to the OECD Commentary on the OECD Model DTA for support of an interpretation. Therefore, the comments of the OECD Commentary noted above should also be considered by a court in considering the application of the beneficial ownership criterion used in a DTA.

As illustrated in the discussion of the international approaches to treaty shopping, the analysis of the foreign case law shows that there is no universally accepted interpretation of the “beneficial ownership” concept and courts in different countries have adopted different views in this regard. The UK *Indofood* case[306] is often referred to as support for the “expansion” of the concept of beneficial ownership to give effect to the “substance of the matter”. However, the decisions of the Canadian courts in the *Velcro Canada Inc. v The Queen*[307] *and Prevost Car Inc. v Her Majesty the Queen,*[308] cases indicate a more formalistic approach,[309] in line with the South African courts cases analysed

306 See the analysis of the case under the analysis of the UK approach.
307 2012 TCC 57.
308 2008 TCC 231.
309 See the analysis of the Canadian approach above.

above. It is therefore most likely that the South African courts would apply the tests for beneficial ownership as confirmed in the Velcro case, i.e. the attributes of beneficial ownership are “possession”, “use”, “risk” and “control”. If these attributes are considered in the context of a treaty shopping arrangement, they could lead to a conclusion that the intermediary company in the country which has a beneficial DTA with South Africa did not qualify for DTA relief, since it may not have sufficient control or use of the funds if it was clearly required to immediately on-distribute the dividends, interest or royalties to a third party. However, the factual circumstances would have to be taken into account to determine whether the intermediary company may fulfil the requirements of a beneficial owner.

Nevertheless the decisions in the *Prévost* and *Velcro* cases show that there are challenges in effectively applying the beneficial ownership provision to prevent treaty shopping. It is therefore submitted that the “beneficial ownership” provision cannot be fully relied on in South Africa to prevent treaty shopping.

It should be noted that although the “beneficial ownership” has proved ineffective in curbing conduit company treaty shopping, the OECD does not recommend that this provision should be completely done away with. The OECD explains that this provision can still be applied with respect to certain matters, but it cannot be relied on as the main provision to curb treaty shopping. In this regard, the concept of “beneficial ownership” can still be applied with respect to the relevant income in articles 10, 11 and 12.

- Where that is the case, in the South African context, it is important that SARS should address the practical application or implementation of the tax treaty by coming up with measures of how a beneficial owner is to be determined. This could be achieved by introducing measures such as:
  - Beneficial Ownership Certificate;
  - Tax Registration Form;
  - Permanent Establishment Confirmation Form.
  - A definition of beneficial ownership in section 1 of the Income Tax Act, which is in line with the treaty definition as set out in the OECD MTC.

6.2.2 THE LIMITATION OF BENEFITS PROVISION

Apart from the “beneficial ownership” provision, South Africa has a “limitation of benefits” (LOB) provision in its treaty with the United States, as the United States chooses to use this provision in its double taxation treaties. The basic premise of the LOB provision is that every person in a chain of ownership must be entitled to the benefits of the treaty (i.e. must be a resident of either of the two contracting states). Only persons satisfying specific and objective tests are eligible for treaty benefits. The premise underlying this provision is that if any of the objective tests for eligibility are satisfied, the requisite treaty shopping motive is not present then treaty benefits should be granted.[310] Although more targeted and certain in application, this LOB approach can also be over-inclusive and generally contains a provision enabling contracting states to grant treaty benefits on a discretionary basis in appropriate circumstances.

7 RECOMMENDATIONS TO ADDRESS TREATY SHOPPING IN SOUTH AFRICA IN LIGHT OF 2015 FINAL REPORT ON ACTION 6

To ensure protection against treaty abuse, including treaty shopping the OECD recommends that a minimum level countries should include in their tax treaties an express statement that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements; and countries should implement this common intention through either: [311]

- using the combined LOB and PPT approach described above; or
- the inclusion of the PPT rule or;
- the inclusion of LOB rule supplemented by a mechanism (such as a restricted PPT rule applicable to conduit financing arrangements or domestic anti-abuse rules or judicial doctrines that would achieve a similar result) that would deal with conduit arrangements not already dealt with in tax treaties. [312]

On the common intention of tax treaties:

- ➢ It is recommend that in line with this recommendation, South Africa ensures that all its treaties refer to the common intention that its treaties are intended to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements. The costs and challenges of re-negotiating all treaties will be alleviated by signing the multilateral instrument that is recommended under Action 15 which will act as a simultaneous renegotiation of all tax treaties.

Feasibility of applying the LOB provision in South Africa

- ➢ The proposed LOB is modelled after the US LOB provision. Essentially, the LOB provision requires that treaty benefits (such as

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310 These specific and objective tests are similar in principle to certain of the exceptions discussed above in the context of some general anti-treaty shopping approaches which are likely to be over-inclusive. However, countries using objective rules in LOB articles to determine eligibility for treaty benefits would also tend to provide more specific guidance on the interpretation of those rules in other authoritative sources. This is the case in the US where in practice taxpayers and practitioners refer to the US Model Convention and other treaties for specific and technical guidance in addition to the technical explanation for any particular treaty.

311 OECD/G20 2015 Final Report on Action 6 at 10.

312 OECD/G20 2015 Final Report on Action 6 at 22 -23.

reduced withholding rates) are available only to companies that meet specific tests of having some genuine presence in the treaty country. However such an LOB provision has not been applied in many DTAs other than those signed by the USA, and even then, the provisions vary from treaty to treaty. South Africa for instance (one of the few African countries that has a DTA with the USA - others are Egypt, Morocco and Tunisia)[313] has an LOB provision in article 22 of its 1997 DTA with the USA.[314] The structure of the LOB provision as was set out in the September 2014 the OECD Report[315] on Action 6 was however criticised for its complexity. Even in the US, application of the LOB has given rise to considerable difficulties in practice and is continuously being reviewed and refined.[316] In its 2015 Final Report, the OECD considered some simplified versions of LOB provisions to be finalised in 2016.[317]

- If the simplified versions of the LOB provision are found feasible when complete, South Africa should consider adopting the same.

Feasibility of apply the PPT test in South Africa

- The PPT rule requires tax authorities to make a factual determination as to whether the principle purpose (main purpose) of certain creations or assignments of income or property, or of the establishment of the person who is the beneficial owner of the income, was to access the benefits of a particular tax treaty.
- As alluded to above, the factual determination required under the "principle purpose test" is similar to that required to make an "avoidance transaction" determination under the GAAR in section 80A-80L of the Income Tax Act – in particular, whether the primary purpose of a transaction (or series of transactions of which the transaction was a part) was to achieve a tax benefit, broadly defined. Since the two serve a similar purpose, the GAAR can be applied to prevent the abuse of treaties. Based on that one could argue that there is no need for South Africa to amend its treaties to include a PPT test since the GAAR could serve a similar purpose. Nevertheless, much as the OECD Final Report clearly explains that domestic law provisions can be applied to prevent treaty abuse, there could be concerns of treaty override if South Africa applies it GAAR in a treaty context. Besides South Africa's GAAR may

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313 IRS 'United States income tax treaties - A to Z'. Available at https://www.irs.gov/Businesses/International-Businesses/United-States-Income-Tax-Treaties---A-to-Z accessed 18 February 2016.

314 Published in Government Gazette No. 185553 of 15/12/1997.

315 OECD/G20 Base Erosion and Profit Shifting Project "Preventing the Granting of Treaty Benefits in Inappropriate Circumstances Action 6: 2014 Deliverable" (2014). (OECD/G20 September 2014 Report on Action 6).

316 PWC "Comment on DTC BEPS First Interim Report (30 March 2015) at 20.

317 OECD/G20 2015 Final Report on Action 6 n 135 above in para 25.

not be exactly worded like a similar provision with its treaty partner. It is thus recommended that South Africa inserts a PPT test in its tax treaties.[318] Required re-negotiation of treaties can be effected by signing the Multilateral Instrument that could have a standard PPT test as is recommended in Action 15 of the OECD's BEPS Project.

It is also worth noting that Canada implements a main purpose test in many of its recent treaties,[319] and that the main purpose test is actually applied in some of South Africa tax treaties. For example the treaty with Brazil provides in article 11(9) that:

> "The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the debt-claim in respect of which the interest is paid to take advantage of this Article by means of that creation or assignment".

This article requires the tax authorities to determine whether the main or one of the main purposes of such "person" was "to take advantage" of Article 11 of the treaty "by means of that creation or assignment". The intention of Article 11(9) is to deny the benefits of, *inter alia*, Article 11 where transactions have been entered into for the main purpose of restricting the <u>source state's</u> (Brazil's) ability to tax the interest income. This is confirmed by the OECD Commentary on Article 11(9), which states that: "The provision has the effect of denying the benefits of specific articles of the Convention <u>that restrict source taxation where transactions have been entered into for the main purpose of obtaining these benefits</u>. The Articles concerned are 10, 11, 12 and 21…" (Emphasis added).

- Article 11(9) of the treaty is therefore aimed at preventing "treaty shopping" in circumstances which circumvent the source state's (Brazil) ability to impose withholding tax on income flows from the source state to the resident state (South Africa).
- In particular, in the context of Article 11, it is aimed at preventing a situation where a source state, such as Brazil imposes withholding tax on interest paid to low tax jurisdictions at the rate of 25%. If the holder in a low tax jurisdiction of a debt instrument issued by a Brazilian resident transfers the debt instrument to, say, a South African resident in order to ensure that Brazil may only impose withholding tax at the rate stipulated in Article 11(2) of the treaty, namely, 15%, then the provisions of Article 11(9) of the treaty should apply.

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318 Arnold at 245.

319 For example, paragraph 7 of Article 10 (and paragraph 9 of Article 11 and paragraph 7 of Article 12) of the Canada-Hong Kong tax treaty reads as follows:
"A resident of a Party shall not be entitled to any benefits provided under this Article in respect of a dividend if one of the main purposes of any person concerned with an assignment or transfer of the dividend, or with the creation, assignment, acquisition or transfer of the shares or other rights in respect of which the dividend is paid, or with the establishment, acquisition or maintenance of the person that is the beneficial owner of the dividend, is for that resident to obtain the benefits of this Article."

- This may be distinguished from the provisions of Article 11(4)(b) of the treaty, which specifically incentivises a resident of South Africa or Brazil to invest in government bonds issued by the other Contracting State.

It is recommended that South Africa follows the approach in its treaty with Brazil by ensuring it has a PPT clause in all its future treaties. This this would imply re-negotiating all its treaties; which could be done under the umbrella of the multilateral instrument that the OECD is working on under Action 15.

- Apart from the above, in light of the OECD recommendations in paragraph 5.2 above, it is also recommended that South Africa ensures its tax treaties also cover the targeted specific treaty anti-abuse rules in specific articles of its tax treaties (as pointed out in the OECD Report) to prevent treaty abuse where a person seeks to circumvent treaty limitations.

- South Africa should also take heed of the OECD recommendations on tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country or to terminate one (see discussion in paragraph 5.5 above).

ANNEXURE 7

DAVIS TAX COMMITTEE: SECOND INTERIM REPORT ON BASE EROSION AND PROFIT SHIFTING (BEPS) IN SOUTH AFRICA*

SUMMARY OF REPORT ON ACTION 7: PREVENT THE ARTIFICIAL AVOIDANCE OF PERMANENT ESTABLISHMENT STATUS

The permanent establishment concept creates a tax nexus between a country where an entity carries on business and the entity itself. It has been noted that multinationals often structure their business operations such that they avoid creating permanent establishments in the countries in which they operate. This deprives countries of the ability to tax profits arising from such business operations.

In the main, the OECD considers that the main tax risk is occasioned by the following: (i) *commissionnaire* arrangements (ii) artificial avoidance of permanent establishment status through the specific activity exemptions; (iii) fragmentation of activities between closely related parties; and (iv) splitting up of contracts.

The OECD recommends that a principal purposes test (PPT) be added to the OECD Model Tax Convention to address the BEPS concerns related to the abusive splitting-up of contracts. Under the principal purpose rule, if one of the principal purposes of transactions or arrangements is to obtain treaty benefits, these benefits would be denied unless it is established that granting these benefits would be in accordance with the object and purpose of the provisions of the treaty.[1]

The OECD further recommends that for states that are unable to address the issue through domestic anti-abuse rules, a more automatic rule that prevents transactions that are known to cause treaty shopping concerns should also be included in the Commentary as a provision that should be used in treaties that would not include the PPT or as an alternative provision to be used by countries specifically concerned with the splitting-up of contracts issue.[2]

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1 OECD/G20 Base Erosion and Profit Shifting Project Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 (2015 Final Report) in para 17..

2 OECD/G20 Base Erosion and Profit Shifting Project Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 (2015 Final Report) in para 17. See also OECD/G20 Base Erosion and Profit Shifting Project Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 (2015 Final Report) at p.22.

South Africa has the same concerns. As such recommendations are made herein that mirror the above recommendations made by the OECD, *inter alia* that source rules should be revamped, the *commissionnaire* arrangements be considered in South Africa to determine the extent of the problem and that South Africa should adopt the OECD recommendations on changes to the model tax convention.

Recommendations for South Africa

Where the South African Revenue Service (SARS) is not able to pin down the existence of a PE in terms of the current OECD rules, South Africa's source rules should be made strong enough to ensure that the activities of such non-residents in South Africa are taxed on a source basis.

- In this regard, it is recommended that South Africa's source rules in section 9 of the Income Tax Act are refined in line with the OECD 2015 recommendations on Action 7 to ensure they capture all income that is derived by non-residents from goods or services used or consumed in South Africa.

There are concerns in South Africa over the inability for SARS to detect and monitor whether PEs have been established in South Africa. This is especially so where non-residents engage in activities that are allegedly of a temporary nature, such as service activities or, for instance, consultants offering engineering services, or other technical or specialised services. Then there are also challenges where non-residents may escape PE status on allegations of being involved in preparatory or auxiliary activities. This is especially so when non-residents set up representative offices in South Africa. Various solutions to these detection problems could be considered, including the following:

- A system could be put in place to ensure such non-residents are brought into the tax system through filing tax returns. This will ensure that SARS is aware of the business activities of such non-residents in the country. Lack of proper registration means that certain foreign entities are improperly avoiding South African tax altogether.
- Since these representative offices would be renting some offices in South Africa, an obligation could be placed on residents who rent out properties for non-residents to use as representative offices, to ensure they file tax returns.

In South Africa, a PE is defined in section 1 of the Income Tax Act, as defined from time to time in Article 5 of the OECD Model Tax Convention. It should also be noted that South African courts have taken cognizance of the OECD Commentary in interpreting the scope of DTA provisions.

- In this regard, it is recommended that South Africa adopts the new OECD Guidelines on the meaning of the PE concept – even as section 1 of the Income Tax Act clearly provides that PE concept will be defined in South Africa as it is defined from time to time in the OECD Model Tax Convention.

A company that is not tax resident in South Africa but conducts business in South Africa through a PE is taxable in South Africa on the income of that PE that is sourced in South Africa.[3] The reduction of the rate of income tax applicable to non-resident companies from 33% to 28% means that it is more tax efficient for a foreign company to conduct its South African operations through a PE located in South Africa, than to establish a South African subsidiary because the subsidiary would be liable to normal corporate tax at 28% and the dividends paid by a resident subsidiary to a non-resident company are also subject to dividends withholding tax at 15% if there is no tax treaty in place or, where a treaty is in place, the rate of dividends tax may be reduced in terms of an applicable treaty. This uneven playing field in favour of PEs in the form of branches costs the South African fiscus a loss in potential tax revenue.

- It is recommended that above concerns could be corrected by an introduction of a tax on branch profit remittances. It is recommended that South Africa should consider the legal, constitutional and DTA implications of introducing such a tax.

As is discussed in detail in the main report attached hereto, the concept of a “foreign business establishment” in section 9D(1) of the Act which (deals with controlled foreign companies) is key to the base erosion issues. The foreign business establishment exemption is therefore fundamental in determining what amounts are attributed to, and taxed in, South Africa. To address PE concerns relating to foreign business establishments it is noted and recommended that:

- The exemption from tax in respect of income arising in a controlled foreign company with a foreign business establishment is correct as a policy matter.
- Transfer pricing principles together with PE attribution principles should be used to test whether the correct amounts are attributable to the foreign business establishment. In this regard section 9D(9)(b) should be re-considered and consideration should be given to applying the transfer pricing rules and profit attribution principles contained in double tax agreements to the determination of whether amounts qualify for the foreign business establishment exemption.

On a tax policy level, it is important that South Africa does not emphasise legislative amendments to tax laws applicable to outbound MNEs, (for example, CFC rules), over tax laws applicable to inbound MNEs (for example, PE rules and source rules). It is necessary to balance legislation so as to ensure that South African companies are not overtaxed in comparison to non-residents, which would affect their competitiveness. South African outbound MNEs should not be taxed and audited disproportionately higher compared to inbound MNEs. It is therefore recommended that:

[3] See part I section 4(f) of the Taxation Laws Amendment Act 7 of 2010. See also Olivier L ‘The “Permanent Establishment” requirement in an International and Domestic Taxation Context: An Overview’ (2002) *SALJ* 866.

- The current source rules should be revamped to ensure that they adequately enable SARS to determine when a PE exists so that SARS is able to determine how profits must be attributable to such PEs. Some countries, such as the UK, which is a member of the OECD and signs treaties based on the OECD MTC (as is the case with South Africa) has enacted rules relating to the tax treatment of branches in order to attend to these challenges. South Africa should emulate the UK by enacting provisions which clearly explain the tax treatment of PEs in South Africa. The rules should complement the PE definition in section 1 of the Act and further explain that the OECD rules for attributing profits to PEs would be applied. The rules that require non-residents carrying on business in South Africa to register with SARS aid enforce the source rules in this regard. As a residual matter the normal source rules and/or withholding taxes would apply for those that don't meet the PE threshold.
- Government should consider the prevalence of *commissionnaire* type arrangements to determine the extent of the risk to the South African fiscus.
- South Africa should adopt the OECD recommendations on changes to the MTC and ensure that its double tax treaties are amended as deemed appropriate in line with changes to the OECD MTC.
- It is recommended that South Africa should consider the legal, constitutional and DTA implications of introducing a tax on branch profit remittances.

DTC REPORT ON ACTION 7: PREVENT THE ARTIFICIAL AVOIDANCE OF PERMANENT ESTABLISHMENT STATUS

Table of Contents

1 INTRODUCTION

For any country to levy tax on any item of income, a connection or nexus should be established between that country and that item of income. The main connecting factors entitling a country to tax income is the connection of that country and the income (source) or the connection of that country to the person who receives the income or to whom the income accrues (residence).[1] Thus a company that is not tax resident in South Africa but conducts business in South Africa through a PE is taxable in South Africa on the income of that PE that is sourced in South Africa.[2] Where double taxation may arise as a result of a resident of one country earning income that is sourced in another country, tax treaties generally provide that the business profits of a foreign enterprise are taxable in a State only to the extent that the enterprise has in that State a permanent establishment (PE) to which the profits are attributable. The definition of PE included in tax treaties is therefore crucial in determining whether a non-resident enterprise must pay income tax in another State.

The PE issue is perhaps one of the most challenging action items that OECD policymakers face.[3] PE concept is established when a source country has the right to tax the activities of a resident of another country. It is the international standard agreed to for dividing up or sharing profits of a business enterprise where a company is resident elsewhere.[4] Thus the rule is designed to ensure that business activities will not be taxed by a State unless and until the non-resident enterprise has created significant and substantial economic bonds between itself and that State.[5]

The PE concept is defined in Article 5 of the OECD Model Tax Convention (OECD MTC). The general definition of a PE in Article 5(1) is that it is a fixed place of business through which the business of an enterprise is wholly or partly carried out. Article 5 also has a special meaning of PEs with respect to building and constructions sites. Then there is a deemed PE provision, in terms of which a dependent agent is considered a PE if he habitually enters into contracts on behalf of the enterprise in the other contracting state, and that bind the principal. Article 5(4)

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1 Olivier & Honiball *International Tax: A South African Perspective* (2011) 50; Croome et al *Tax Law: An Introduction* (2013) 26-27); Oguttu International Tax Law: Offshore Tax Avoidance in South Africa (2015) 71 – 72).

2 See part I section 4(f) of the Taxation Laws Amendment Act 7 of 2010. See also Olivier L 'The "Permanent Establishment" requirement in an International and Domestic Taxation Context: An Overview' (2002) *SALJ* 866.

3 DL Glenn "Transfer Pricing and Defining PE Most Challenging BEPS Action Items, Practitioners Say" *Tax Analyst* 4 February 2014.

4 AW Oguttu "The Challenges of Taxing Profits Attributed To Permanent Establishments: A South African Perspective" *Bulletin for International Taxation* Vol 64 No.3 (2010) at 165.

5 K Vogel *Double Tax Conventions* (1997) at 280 in para 4.

provides exclusions to the PE concept for activities that are generally considered to be solely of a preparatory and auxiliary nature to activities performed elsewhere.

In South Africa, the Income Tax Act[6] (the Act) applies the PE concept in determining various amounts that are exempt from the withholding taxes on the basis of such amount being taxable in South Africa on the basis of source.[7] Permanent establishment is defined in section 1 of the Act as follows:

> "permanent establishment means a permanent establishment as defined from time to time in Article 5 of the Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development: Provided that in determining whether a qualifying investor in relation to a partnership, trust or foreign partnership has a permanent establishment in the Republic, any act of that partnership, trust or foreign partnership in respect of any financial instrument must not be ascribed to that qualifying investor".

2 CURRENT MEANING OF THE PE CONCEPT

2.1 ARTICLE 5(1)

Article 5(1) contains the general rule regarding the definition of the PE concept. The article defines a PE as "a fixed place of business through which the business of an enterprise is wholly or partly carried on".[8] From this definition, three elements can be identified:

- the existence of a "place of business"
- this place of business must be "fixed"
- the carrying on of the business of the enterprise through this fixed place of business.

Each of the factors identified above is analysed in further detail.

2.1.1 Place of business

A PE will only exist if the enterprise has a physical presence in the source state.[9] In terms of the OECD Commentary, the term "place of business" includes any premises, facilities or installations used for carrying on the business of the enterprise. Article 5(2) discussed below provides examples of facilities that can be considered places of business. The "place of business" as a whole must be used and not necessarily each of its individual component parts. Special facilities for carrying on the business are not necessarily required.[10] The enterprise must wholly or partly carry on its business at that place of business. Any activity related to the business of the enterprise would be sufficient to constitute the "carrying on of the

6 Act 58 of 1962.
7 See sections 49D, 50D and 51D.
8 Paragraph 2 of the Commentary to Article 5 of the OECD Model Convention op cit note 3.
9 L Olivier "The 'Permanent Establishment' Requirement in an International and Domestic Taxation Context: An Overview" (2002) 19 *SALJ* at 871.
10 K Vogel *Double Tax Conventions* (1997) in para 4.

business" of the enterprise.[11] The activities carried on at the place of business must be business related and cannot merely consist of, for instance, living quarters of employees.[12]

A place of business may exist where no premises are available or required for carrying on the business of the enterprise and it simply has a "certain amount of space at its disposal" which is used for business activities. Space is considered to be at the disposal of the enterprise:

- Whether or not the premises, facilities or installations are owned, or rented at the disposal of the enterprise.[13]
- No formal legal right to use that place is required.[14]
- A place of business may be constituted by a pitch in a market place, or by a certain permanently used area in a customs depot (e.g. for the storage of dutiable goods).[15]
- A PE exists where a foreign enterprise has at its constant disposal certain premises or a part thereof for use by the enterprise.

2.1.2 The place of business must be "fixed"

For a place of business to be fixed, two components have to be met, namely: a specific geographical spot (the location test); and a certain degree of permanence at each geographical spot (the duration test). The location test requires that there must be a link between the place of business and a specific geographical point, but the place of business does not necessarily need to be physically connected to the ground. In a situation where, by the nature of the business, the activities carried on by an enterprise are often moved between neighbouring locations, there may be difficulties in determining whether there is a single "place of business".[16] The test for determining whether a single place of business exists is to consider whether in light of the nature of the business, a particular location within which the activities are conducted constitutes a *coherent whole commercially and geographically* with respect to that business.[17] To be fixed at a specific geographical point does not also mean that the equipment constituting the place of business has to be actually fixed

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11 K Holmes International Tax Policy and Double Tax Treaties: An Introduction to Principles and Application (2007) at 151.

12 Richard L Doernberg, Luc Hinnekens, Walter Hellerstein and Jinyan Li *Electronic Commerce and Multijurisdictional Taxation* (2001) at 206.

13 BJ Arnold & M McIntyre *International Tax Primer* 2nd ed (2002) at 119.

14 Holmes "International Tax Policy and Double Tax Treaties" at 151.

15 Para 4.1 of the Commentary on article 5(1).

16 Para 5.1 of the Commentary on article 5(1).

17 Para 5.1 of the Commentary on article 5(1). See AW Oguttu & S Tladi "E-commerce: A Critique on The Determination of a 'Permanent Establishment' for Income Tax Purposes From a South African Perspective (2009) 20 No 1 *Stellenbosch Law Review* 74-96; H Pijl "The Concept of Permanent Establishment and the Proposed Changes to the OECD Commentary With Special Reference to Dutch Case Law (2002) 56 *Bulletin for International Fiscal Documentation* 554 at 555.

to the soil on which it stands. It is enough that the equipment remains on a particular site. [18]

Under the duration test, a certain degree of permanence is required in order for a PE to exist. The business should not be temporary in nature.[19] In South Africa, the courts hold the view that the word "permanent" in "permanent establishment" does not refer to mere temporary use of premises for purposes of trade. In *Transvaal Associated Hide and Skin Merchants v Collector of Taxes, Botswana*[20] it was decided on the facts that the taxpayer's regular occupation of the shed at an annual rental showed that its occupation of the premises was permanent and not temporary. It should also be noted that the word "fixed" does not mean that no interruption of operations may occur, but operations must at least be carried out on a regular basis.[21]

2.1.3 Through which business of the enterprise is carried on

The OECD MTC does not define the term enterprise *per se.* It provides that "the question whether an activity is performed within an enterprise or is deemed to constitute in itself an enterprise has always been interpreted according to the provisions of the domestic laws of the Contracting States".[22] The OECD MTC does, however, state that the term "enterprise applies to the carrying on of any business"[23] and the term "business includes the performance of professional services and activities of an independent character".[24]

The question which arises in this regard is what constitutes the "carrying on of any business" of an enterprise. The business of the enterprise has to be carried on wholly or partly through the fixed place of business.[25] The phrase "carried on through" infers that the business activities are carried on at a particular location that is at the disposal of the enterprise for that purpose.[26] Mere business relations with

18 Para 5 of the Commentary on article 5(1).

19 L Olivier & M Honiball *International Tax: A South African Perspective* (2011) at 99; Cristián Gárate "The Fixed Place of Business in the Context of Electronic Commerce" in Hans-Jörgen & Mario Züger *Permanent Establishments in International Tax Law* (2003) at 46; Pijl at 556.

20 29 SATC 97 at 115, 1967 (BCA).

21 Paragraph 6.1 & 11 of the Commentary on Article 5(1) of the OECD Model Convention; Olivier & Honiball at 99. Richard L Doernberg, Luc Hinnekens, Walter Hellerstein and Jinyan Li *Electronic Commerce and Multijurisdictional Taxation* (2001) at 206 notes that this implies that the activities carried on at the establishment must be business related and cannot merely consist of, for instance, living quarters of employees; Pijl at 557.

22 Para 6 of the Commentary on article 3(1)(c) of the OECD MTC.

23 Article 3(1)(c) of the OECD MTC.

24 Article 3(1)(h) of the OECD MTC.

25 Paragraph 7 of the Commentary on Article 5(1) of the OECD Model Convention.

26 AW Oguttu & S Tladi "E-commerce: A Critique on The Determination of a 'Permanent Establishment' for Income Tax Purposes From a South African Perspective" at 76; Doernberg et al at 206 notes that the word "through" suggests that the establishment cannot itself be the business (for instance, by itself being traded, rented or produced). The "carrying on" of the activity need not take place through human intervention alone. See also Kesnia J Levouchkina

the enterprise or other customers in the contracting state are not sufficient.[27] The business does not have to be of a productive character in that it contributes to the profits of the enterprise.[28] The word "through" suggests that the establishment cannot itself be the business (for instance, by itself being traded, rented or produced).[29] The "carrying on" of the activity need not take place through human intervention alone.[30]

Automated equipment: Although the business of the enterprise needs to be carried on through the PE, this does not mean that a PE will exist only if individuals are present. Although the presence of individuals may be required for the setting up of a PE, their ongoing presence is not required.[31] The presence of fully automatic equipment operated and maintained by the enterprise in the host country may constitute a PE. However, if the enterprise merely sets up the machines and then leases them to other enterprises, a PE does not exist.[32]

Employees: Generally, a business is conducted through the employees of the enterprise who are in a paid employment type relationship with such enterprise. Viewed formalistically the employees are generally those of the subsidiary and not the multi-national enterprise. However, the employees of the subsidiary could also create a permanent establishment for the multi-national enterprise if they act as "*de facto*" employees of the multi-national enterprise and not of the subsidiary.

De facto employees: In order to test whether the employees of the subsidiary do not constitute *de facto* employees of the multi-national enterprise (and therefore result in a PE for the multi-national enterprise in South Africa) cognisance should be had to the following guidelines (which are not exhaustive):

- The employees should be under the supervision and control of the subsidiary (as opposed to the multi-national enterprise).
- In particular, the employees of the subsidiary should at all times take instructions from representatives of the subsidiary.
- All employees should report to the directors/managers of the subsidiary and not the multi-national enterprise.

"Relevance of Permanent Establishment for Taxation of Business Profits and Business Property" in Hans-Jörgen & Mario Züger *Permanent Establishments in International Tax Law* (2003) at 20-21.

27 Vogel *Double Tax Conventions (Supra)* at 285 in para 23.

28 P Baker *Double Taxation Conventions* (2005) in para 5B.06.

29 Doernberg et al Electronic Commerce and Multijurisdictional Taxation (Supra) at 206.

30 KJ Levouchkina "Relevance of PE for Taxation of Business Profits and Business Property" in Hans-Jörgen & Mario Züger *PEs in International Tax Law* (2003) at 20-21.

31 OECD "Clarification on the Application of the Permanent Establishment Definition in E-commerce: Changes to the Commentary on the Model Tax Convention Article 5 (Dec 22 2000) at 36, available at http://www.oecd.org/dataoecd/46/32/1923380.pdf (visited 4 September 2008).

32 Ibid.

Even if the employees do not constitute *de facto* employees of the multi-national enterprise it must still be considered whether the subsidiary, by virtue of its activities could create a permanent establishment for the multi-national enterprise in the source state by virtue of the agency provisions in article 5(5) considered below. Often the multi-national enterprise will enter into various contractual arrangements with a subsidiary in the source state. It must then be analysed whether the activities of the subsidiary could create a PE for the multi-national enterprise in the source state. In particular, it must be considered whether the business of the multi-national enterprise is carried on through a fixed place of business constituted by the subsidiary.

The OECD MTC does not specifically state the duration that the foreign enterprise should spend in another country in order to create a PE, however a minimum of 6 months is seen as a guideline duration.[33]

2.2 ARTICLE 5(2)

Article 5(2) contains an illustrative list of places that often constitute a PE. These include especially: a place of management; a branch; an office; a factory; a workshop; a mine, an oil or gas well, a quarry or any other place of extraction of natural resources. The list is not exhaustive.[34]

Article 5(2) is not self-standing in that, in considering the examples of a PE, the requirements of article 5(1) must also be met.[35] Article 5(2) simply provides an indication that a PE may well exist; it does not provide that one necessarily does exist.[36]

In South Africa, the above is supported by SARS Binding Private Ruling 102 issued on 4 May 2011, which addresses the question whether the registration as an external company for company law purposes results in the creation of a PE in South Africa. In this regard, SARS is of the view that the registration of an external company would not create a PE for the applicant. The ruling was, however, subject to the following conditions and assumptions:

- the applicant’s place of effective management would be located in the country in which the applicant was resident;
- the applicant would not have any employees or conduct any business activities in South Africa, other than the maintenance of its external company status for exchange control purposes; and

[33] See Para 6 of OECD Commentary on Article 5(1). The submission by Deloitte to the DTC dated 17 August 2015 is hereby acknowledged.
[34] K Vogel *Double Tax Conventions* (1997) in para 47.
[35] Vogel Double Tax Conventions in para 47.
[36] Para 4 of the Commentary on art 5(2).

- the applicant would not have a dependent agent operating on its behalf in South Africa.

This provides some indication that, in terms of South African domestic tax law, the registration of an external company in its self will not result in the creation of a PE for a non-resident in South Africa.

2.2.1 Furnishing of services

Some South African DTAs contain an additional inclusion applicable to the furnishing of services in Article 5(2) which provides that the definition of PE specifically includes:

> "the furnishing of services, including consultancy services, within a Contracting State by an enterprise through employees or other personnel engaged by the enterprise for such purposes, but only if activities of that nature continue (for the same or a connected project) within that State for a period or periods aggregating more than 183 days in any twelve-month period commencing or ending in the taxable year concerned."

The OECD MTC does not contain a provision similar to this provision. However, the United Nations Model Double Taxation Convention between Developed and Developing Countries (the UN Model) contains a similar provision in Artice 5(3)(b) which states that:

> "the term 'permanent establishment' also encompasses… The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the fiscal year concerned."

The South African Tax Court has pronounced on the interpretation of this services clause in relation to Article 5(1) in the case of *AB LLC and BD Holdings LLC v Commissioner of the South African Revenue Services*.[37]

Facts

The appellant was an advisory group with global reach that was incorporated in the United States of America concentrating on the airline industry. The appellant came to South Africa in 2007 to provide certain strategic and financial advisory services to an airline company, and once done left the country in 2008. The services were delivered from February 2007 and ended in May 2008. During this period, the appellant's employees came to South Africa as and when required. During the 2007 calendar year, the appellant's employees were in South Africa for a period exceeding 183 days.

[37] (13276) [2015] ZATC 2.

The nature of the work provided required the appellant's employees to be based at the premises of the service recipient for which the service recipient provided the appellant with space in the boardroom inside the service recipient's premises. The employees of the appellant only had access to the premises on weekdays during working hours. At times the employees were based at different geographical areas within the premises of the service recipient, and would, for short periods, have to go to other departments of the service recipient. The South African Revenue Service ("SARS") assessed the appellant for the 2007, 2008 and 2009 tax years.

The applicable provisions

As is the case in article 5(2) of the OECD MTC of the DTA between South Africa and the USA (the DTA) contains a list of specific items as examples of PEs. However, the salient inclusion is contained in para (k) of Article 5(2) of the DTA which is not contained in the OECD MTC. Article 5(2)(k) provides that the definition of PE specifically includes:

> "the furnishing of services, including consultancy services, within a Contracting State by an enterprise through employees or other personnel engaged by the enterprise for such purposes, but only if activities of that nature continue (for the same or a connected project) within that State for a period or periods aggregating more than 183 days in any twelve-month period commencing or ending in the taxable year concerned."

It is worth noting that the Article 5(1) of the DTA is identical to Article 5(1) of the OECD MTC, and the interpretation of this provision of the DTA will be of wide application and relevance as South African treaties generally follow the OECD Model Convention. The identical nature of the general provisions of the DTA and the OECD MTC were the basis upon which the court ruled that it would rely on the commentary to the OECD Model Convention to the interpretation of the definition of PE

Judgment

(i) The relationship between Article 5(1) and Article 5(2)(g)

The court analyzed the import of the word "includes". The court began by looking at the definition of the word in the Collins English Dictionary (Complete and Unabridged), which states that "include" means, *inter alia*, "to add as part of something else; put in as part of a set group, or category" (par 25). The court then proceeded to explore various judicial pronouncements (to wit *Jones & Co v Commissioner for Inland Revenue* 1926 CPD 1; *Rosen v Rand Townships Registrar* 1939 WLD 5 and *R v Debele* 1956 (4) SA 570 (A)) on the word which have a common factor that include has an attribute of enlarging a meaning of a word or phrase, by adding things that would ordinarily not be covered by the word or phrase that is enhanced by the word "include".[38]

[38] Par 28 – 29.

The court then deduced from the use of the words “specifically includes” that the drafters of the treaty intended that the factors referred to in the specific inclusion be made part of the definition referred to in the general provision and be given special attention when determining whether an enterprise is operating through a PE.[39] It therefore has to be interpreted that the contents of the specific inclusion must be read to mean that they are an integral part of the general provision.[40] On this analysis, as soon as an enterprise’s activities fall within the ambit of the specific inclusion it becomes liable for taxation in the non-resident country. The court held that there is no need for a further or separate enquiry as to whether the requirements of the general provision have been met and that the two articles cannot be read disjunctively.

The court acknowledged that this interpretation of the word "include" might be contrary to the position the OECD takes in this regard in para 12 of the OECD Commentary on Article 5, which is as follows:[41]

> “This paragraph (i.e. 5(2)(a)-5(2)(f)) contains a list, by no means exhaustive, of examples, each of which can be regarded prima facie, as constituting a permanent establishment. As these examples are to be seen against a background of the general definition given in paragraph 1, it is assumed that the Contracting States interpret the terms listed, ‘a place of management’, ‘a branch’ ‘an office’ etc., in such a way that such places of business constitute permanent establishments only if they meet the requirements of paragraph 1".

The court held that what is recommended by the OECD for these articles has no bearing on the issue of the relationship between the general provision and specific inclusion. The court stated that Article 5(2)(k) is specific in nature and different from articles 5(2)(a) – 5(2)(f) of the OECD MTC. Unlike the said articles 5(2)(a) – 5(2)(f), Article 5(2)(k) does not refer to a place of work, but rather to a form of work. It is a different species. Therefore, the interpretive approach adopted with regard to articles 5(2)(a) – 5(2)(f) cannot be replicated without thought or input with regards to Article 5(2)(k). The court further held that as far as Article 5(2)(k) is directly concerned, the OECD Commentary is of no assistance. Given that there is no such article in the OECD MTC, its silence on the matter is understandable. However, its silence does not mean that an inference to the effect that what it says or recommends with regard to the relationship between Article 5(1) and Articles 5(2)(a) – 5(2)(f) is applicable to the relationship between the general provision and the specific inclusion. The court therefore concluded that there is no room for such an inference given the material differences between the specific inclusion and articles 5(2)(a) – 5(2)(f) of the OECD Commentary.[42]

39 Par 30.
40 Par 30.
41 Par 30.
42 Par 31.

(II)   “fixed place of business…wholly or partly carried on”

The appellant referred to the Canadian case of *The Queen v Dudney* (WA (2000) D.T.C. 6169) whose facts were particularly similar to the current case. However, the main difference is that in *Dudney*, the taxpayer would, from time to time, provide training to the employees of the local service recipient and the training would take place in different parts of the local service recipient's premises where these employees were based. The taxpayer could not do any of his own business while located on any of the local service recipient's premises. He could not use the telephone for any business other than that which was related to the services he was providing to the local service recipient.[43] The court distinguished *Dudney* from the current case, stating that in the current case the appellant was, at all times, present in the boardroom during the tenure of the contract. Further that the appellant had exclusive use of this space for the entire duration of the contract. The court stated that the appellant "had at its disposal constant access to the boardroom during working hours. Access during non-working hours was neither necessary nor requested. This flows directly from the fact that compliance with its obligations in terms of the contract required regular intensive interaction with employees of the service recipient, which, it goes without saying, was most suitable during normal working hours".[44] The court then concluded that there can be no doubt that the appellant had established a fixed place of business in South Africa, while carrying out its obligations in terms of its contract with the service recipient.[45]

The appellant contended that, as it did not have access to the boardroom after normal working hours, and the fact that it was restricted to solely conduct the business relating to the contract with the service recipient, it was not able to conduct any of its business not relating to the service recipient. The appellant argued that this limitation demonstrates that the appellant was not able to conduct all its business from the service recipient premises, and that therefore the appellant could not have established a PE at the service recipient’s premises. The court found that the difficulty faced by this contention is that it flies in the face of the definition of PE in the DTA. The defining characteristic in terms of the general provision is that it must be “a fixed place of business through which the business of an enterprise is wholly *or partly* carried on”. Thus, the appellant is not required to carry out all its business from the “fixed place of business”. Even if the appellant performed some of its obligations to the service recipient from another premises, the appellant would, nevertheless, have established a PE if it performed only some of its obligations to the service recipient.[46]

[43] Par 34.
[44] Par 42.
[45] Par 42.
[46] Par 43.

The court then concluded that to the extent that it is necessary for there to be compliance with the general provision before a finding that the existence of a PE has been proved, such has been proven in this case.[47]

(III) 183 day requirement

The court had to consider whether the appellant rendered services for periods aggregating more than 183 days in any twelve-month period commencing or ending in the taxable year concerned. It was common cause that the appellant satisfied the 183 day requirement for the 2007 and 2008 years. With regards to the 2009 tax years the appellant contended that if an entity spends less than 183 days in any twelve month period commencing or ending in a taxable year in a non-resident state, then that entity cannot be said to have set up a PE in that state.[48] Holding that the appellant was liable to tax in South Africa for the 2009 year in which the appellant spent less than 183 days in the tax year, the court stated:[49]

> "The fact that the duration spanned over two fiscal years does not mean that the 183 day period has to be separately calculated for each fiscal year for, as stated in the Commentary on the OECD Model, if the presence in each fiscal year was only 5½ months, then the entity would avoid paying tax to the country in which the income was earned (or profits made) despite the fact that its presence in that country was for longer than 183 days. This interpretation, which is the one we are enjoined by the appellant to adopt, defeats the object of the DTA, is contrary to the intention of the parties and stands in stark contrast to the interpretation proffered in the OECD Commentary."

2.3 ARTICLE 5(3)

This Article provides that a building site or construction or installation project constitutes a PE only if it lasts more than twelve months. The twelve month time limit is intended to encourage businesses to undertake preparatory or ancillary operations in another State so as enable permanent commitment without becoming immediately subject to tax in that State. There are, however, concerns that the twelve month time limit could be subject to abuse:

- The building site or construction or installation project could, as a result of modern technology, be of very short duration and still result in a substantial profit for the enterprise.
- The time limits could be used by foreign enterprises to set up artificial arrangements to avoid taxation in their territory.[50]

2.4 ARTICLE 5(4)

Article 5(4)(a)-(f) sets out certain exclusions to the PE definition, namely:

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47 Par 44.
48 Par 46.
49 Par 48.
50 Para 10 of the Commentary on art 5(3) of the UN Model Tax Convention.

- the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise;
- the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
- the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose processing by another enterprise;
- the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collection of information, for the enterprise;
- the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character, for example, solely for the purpose of advertising or the supply of information or for scientific research; and
- the maintenance of a fixed place of business solely for any combination of activities mentioned above provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.[51]

The common feature of these activities is that they are, in general, preparatory or auxiliary activities.[52] The provisions of Article 5(4) limit the otherwise wide scope of the definition of a PE in Article 5(1). Article 5(4) is thus designed to prevent an enterprise of one State from being taxed in the other State if it carries on, in that other State, activities of a purely preparatory or auxiliary character.[53] It should be noted that Article 5(4) requires that the place of business is used solely for the purpose mentioned in the sub-paragraphs. If the activity goes beyond the purpose specified in the paragraph, the exclusion offered by Article 5(4) does not apply.[54] The OECD is of the view that the decisive criterion in distinguishing between activities that are of a preparatory or auxiliary nature and those that are not, is whether or not the activity of a fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole.[55]

A fixed place of business which has the function of managing an enterprise or even only a part of an enterprise cannot be regarded as doing preparatory or auxiliary activity, for such a managerial activity exceeds this level.[56]

2.5 ARTICLE 5(5)

This article provides that:

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51 Article 5(4) of the OECD Model Convention.
52 Oguttu & Tladi "E-commerce: A Critique on The Determination of a 'Permanent Establishment' for Income Tax Purposes From a South African Perspective" 78.
53 Holmes International Tax Policy and Double Tax Treaties at 156.
54 Holmes International Tax Policy and Double Tax Treaties at 156.
55 Paragraph 24 of the Commentary on article 5 of the OECD MTC.
56 Paragraph 24 of the Commentary on article 5 of the OECD Model Convention.

> "Notwithstanding the provisions of paragraphs 1 and 2 of this Article, where a person - other than an agent of an independent status to whom paragraph 6 of this Article applies – *is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts on behalf of the enterprise,* that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 of this Article which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph" (emphasis added).

Although an enterprise may not have a fixed place of business in a host state, a PE is deemed to exist where a dependent agent has authority to conclude contracts on behalf of the enterprise and habitually exercises this authority in the source country.[57]

Accordingly, there is a two-stage enquiry as to whether an agent constitutes a PE of its principal. The first enquiry is whether the agent is dependent or independent. If the agent is independent, no PE would exist. If the agent is a dependent agent, the next enquiry is whether he has, and habitually exercises, authority to conclude contracts on behalf of the principal. The person making use of the authority must do so repeatedly and not merely in isolated cases.[58] Persons (whether individuals or juristic persons) whose activities may create a PE should not be independent agents. According to the OECD, the factors which play an important role in deciding whether a person is a dependent or independent agent are:

- the amount of freedom the person has to enter into contracts on behalf of the enterprise. Where the person operates under detailed instructions and control, this indicates a dependent status; and
- If the risk is borne by the agent, then the agent acts independently.[59]

2.5.1 Authority to conclude contracts

Paragraph 31 of the Commentary on Article 5(5), states that it is a generally accepted principle that an enterprise should be treated as having a PE in a State if there is, under certain conditions, a person acting for it, even though the enterprise may not have a fixed place of business in that State within the meaning of paragraphs 1 and 2 of the OECD Model Convention.

Paragraph 32 of the Commentary on Article 5(5) then provides that persons whose activities may create a PE for the enterprise are so-called dependent agents, i.e. persons, whether or not they are employees of the enterprise, who are not independent agents under Article 5(6). Such persons may be either individuals or

57 Article 5(5) of the OECD Model Convention. See also L Dazinger *International Tax Law* (1991) at 334; and R Rohatgi *Basic International Taxation* (2002) at 77; see also Pijl at 560.

58 Olivier & Honiball at 105; Oguttu & Tladi "E-commerce: A Critique on The Determination of a 'Permanent Establishment' for Income Tax Purposes From a South African Perspective" at 78.

59 Paragraph 37-38 of the Commentary on article 5 of the OECD Model Convention.

companies and need not be residents, nor have a place of business in the state in which they act for the enterprise.

In circumstances where a subsidiary has been set up in order to avoid the creation of a PE in South Africa it is unlikely that the subsidiary will constitute an "independent agent" as contemplated in Article 5(6) - discussed below. In this regard, it is relevant to note that the OECD Commentary acknowledges that it would not have been in the interest of international economic relations to provide that the maintenance of any dependent person in itself would lead to a PE for the enterprise. Such treatment is therefore limited to persons who, in view of the scope of their authority, or the nature of the activity, involve the enterprise to a particular extent in business activities in the State concerned. Therefore, Article 5(5) proceeds on the basis that only persons who have the authority to conclude contracts can lead to a PE for the enterprise maintaining them. In such a case, the person has sufficient authority to bind the enterprise's participation in the business activity in the state concerned.

The use of the PE concept in this context pre-supposes that the person makes use of this authority repeatedly and not merely in isolated cases. It is further acknowledged that the lack of active involvement by an enterprise in transactions may be indicative of a grant of authority to an agent; for example, an agent may be considered to possess actual authority to conclude contracts where he solicits and receives but does not formally finalise orders which are sent directly to a warehouse from which goods are delivered and where the foreign enterprise routinely approves transactions.

Paragraph 33 of the Commentary on Article 5(5) states:

> "The authority to conclude contracts must cover contracts relating to operations which constitute the business proper of the enterprise... A *person who is authorised to negotiate all elements and details of a contract in a way binding on the enterprise can be said to exercise this authority "in that State", even if the contract is signed by another person in the State in which the enterprise is situated* or if the first person has not formally been given power of representation. The mere fact, however, that a person has attended or even participated in negotiations in a State between an enterprise and a client will not be sufficient, by itself, to conclude that the person has exercised in that State an authority to conclude contracts in the name of the enterprise". The fact that the person has attended or even participated in such negotiations could, however, be a relevant factor in determining the exact functions performed by that person on behalf of the enterprise" (emphasis added).

Whilst the South African courts have not considered the meaning of the dependent agency provisions in any treaty concluded by South Africa and, in particular, what is meant by the phrase "*is acting on behalf of an enterprise and has, an habitually exercises, in a contracting state, an authority to conclude contracts on behalf of the enterprise*", this aspect has been considered in a number of international cases, which may be considered to provide guidance in this regard. Whilst such cases will not be binding on South African courts, they may provide persuasive authority.

__DDIT v B4U International Holdings Limited__

In the Indian case of *DDIT v B4U International Holdings Limited* [(ITA 880/MUM/2005) (AY2001/02)], the Indian court had to decide, in the context of the treaty between India and Mauritius on:

- whether the Mauritian principal ("MCo") was subject to tax in India as a result of the Indian agent establishing a dependent agency PE for MCo in India and;
- if such a PE indeed existed, and on the assumption that the Agent was remunerated on an arm's length basis, whether there were there any additional profits of MCo that could be taxed in India.

The facts of the case were, broadly as follows: MCo's business comprised the telecasting of TV channels such as B4U Music, MCM, etc. During the year of assessment under consideration, MCo's revenues from India consisted of collections from time slots given to advertisers in India. It is relevant to note that the channels broadcast by MCo in India, were all "free to air" channels, which meant that they could be shown on cable networks without any subscription fee. In other words, the sole purpose of the business of MCo in India was to generate revenue by offering advertisement slots or time slots to Indian advertisers. The activities and duties of the Agents were therefore essentially the "lifeblood" of the business of MCo in India.

The Indian Tax Commissioner argued that on a plain reading of the agreement entered into between MCo and its Agents, it was evident that the Agents were working exclusively and wholly for MCo. He further stated that the Agent was authorised to conclude contracts, by relying on the following clause in the agreement entered into between MCo and its Agents:

> "in the event of the termination of this agreement by B4 International, B4 Multi shall supply to B4 International such information as B4 International may request, to invoice and collect any outstanding amounts from advertisers and/ or agencies which were earned, but not invoiced or collected, prior to determination of the agreement".

The Commissioner submitted that if the power to conclude contracts was not with the Agents, this clause would not have been required.

In delivering judgment in this case, the court referred to the following important clauses of the agreement between MCo and its Agents and made the following observations as to the functions of the Agents:

> "It will create a rate card for the sale of advertising time on the B4U channels, which will be used only after it is approved by B4 International. Any sales, which deviate from the approved rate card, must be approved by B4 International which will be provided from time to time to RBI..."

With regard to the above clause, it was held that the above showed that the decision on any pricing was controlled by MCo exclusively.

> "B4 International shall invoice advertisers ... B4 Multi will collect and keep all sales revenue until such as the approval of the Reserve Bank of India is obtained to remit such sales revenue to B4 Multi...".

The court held that the aforementioned clause shows that invoices were raised by MCo only. The Agent only obtained approval, collected money and remitted same to the owner of the revenue, namely MCo. The court further referred to the contractual clause which stated as follows:

> "[B4 Multi acknowledges that B4 International shall retain the absolute right to reject any advertisement submitted to be exhibited on the B4 channels at its sole discretion. B4 Multi acknowledges that it cannot bind B4 International to accept any requisition made by a potential advertiser to exhibit its advertisement on the B4 channels and that it shall merely forward the requisitions of such advertisers to B4 International. In this regard B4 International will make best efforts to provide B4 Multi with general guidelines regarding unacceptable advertisement ... "

The court held that the above clause clarified that the Agent only forwarded the advertisements to MCo, who had a right to reject same. No control vested in the Agent. The contract further provided that [e]xcept with the prior written consent of B4 International, B4 Multi shall not bind, whether directly or indirectly, B4 International or seek to act on behalf of B4 International".

It was held that the above clause was very clear on the roles of each partner, being that both are independent of each other.

The court ruled that, on a plain reading of the aforementioned clauses, it was demonstrated that the Agent was not the decision maker, nor did it have the authority to conclude contracts. In particular, the Agent had no authority to fix the rate or to accept an advertisement. It could merely forward the advertisement to MCo, who had the right to reject it. No deviation could be made from the rate card by the advertiser until MCo approved it. The Agent was an independent contractor and was therefore not a servant or employee of the MCo. It was further held that the job of the Indian Agent was well defined namely:

- to generate the maximum amount of advertising sales;
- not to deviate from the approved rate card without permission from the principal;
- to ensure all advertisers had the valid Indian documentation required;
- the Agents were not permitted to represent other television networks which contain non-fictional programming broadcast in the same languages as the B4 channels;
- to undertake market analysis;
- to forward advertisements to the principal. The principal had the absolute right to reject any advertisement;
- the principal retained the right to sell advertisement time and such right was not given to the Agent;

- all activities were subject to control of the principal, and the Agent could not bind the principal without prior consent. It could only forward requests of advertisers, collect payment and obtain approvals.

In light of the above, the court held that it was clear that the Agent did not have any power to conclude contracts and furthermore that, on the facts, it could not be said that the Agent had habitually exercised its authority to conclude contracts binding the principal. It was held that the term “has” has reference to legal existence of such authority (i.e. to conclude contracts) in terms of a contract between a principal and agent. The court held that on reading the agreement, it was evident that such powers were not conferred on the Agent. It was further stated that the words “habitually exercises”, have reference to a systematic course of conduct on the part of the Agent. In the case on hand, there was neither legal existence of such authority, nor was there any evidence to prove that the Agent had habitually exercised such authority. In fact, the principal had raised all the invoices to advertisers.

In light of this decision, it is evident that the point of departure in determining whether an agent may constitute a PE for its principal on the basis of the agency provisions of the treaty, regard must first be had to the agreement entered into between principal and agent. Where the agreement clearly stipulates the functions of the agent and it is evident that the agent has no authority to negotiate, conclude, vary any term or represent the principal in dealings with the principal’s customers, *prima facie*, the agent will not create a PE for its principal. However, regard should also be had to whether such agent, outside the scope of any legal existence of such authority, habitually exercises the authority to conclude contracts on behalf of its principal. Therefore, it must be ensured that the parties’ conduct corresponds with the wording of the agreement and that all agreements are implemented in accordance with its form.

2.5.2 Remarks from the South African perspective

A typical attempt to avoid a PE in South Africa is for a foreign multinational entity to establish a South African subsidiary and pay an arm’s length fee to the subsidiary. The subsidiary will then employ the various entities required by the multi-national enterprise.

- In this regard it is important to note that a PE will not necessarily be avoided if a multi-national enterprise sets up a subsidiary and pays it an arm’s length fee. The subsidiary will be taxed in South Africa on its fee. However, there is a separate enquiry which must be undertaken as to whether the multi-national enterprise itself is carrying on business through a permanent establishment in South Africa by virtue of the control and influence that the multinational entity exercises over the subsidiary. If so then the multi-national enterprise, as a separate entity, will be taxable in South Africa in respect of the profits attributable to the subsidiary's activities in South Africa.

- In conducting this enquiry it is necessary to focus on the facts of the arrangement using the OECD Guidelines and South African domestic law concepts of, for example, *de facto* employment relationships. If, *inter alia*, the employees look to the multi-national enterprise as their true employer they may create a *de facto* employment relationship with it, thereby creating a PE for that multi-national enterprise in South Africa.
- In terms of the dependent agency provisions it is principally a factual enquiry as to whether the subsidiary in South Africa is both legally and economically independent of the multi-national enterprise and acts in the ordinary course of its business. If it is a dependent agent then it is also a factual enquiry as to whether it has and habitually exercises the right to conclude contracts on behalf of its principal. Since this is not a formalistic test of where the contract is signed, but rather where, in substance, it is concluded, the facts will determine whether a PE exists.
- The substance of the agent's powers should be rigorously tested, i.e., the fact that the contracts are formally signed outside South Africa does not mean that they are not concluded in South Africa by the dependent agent.
- The tests provided by the OECD and applicable foreign case law are sufficient in order to avoid the concern expressed in relation to this Action, i.e., the artificial avoidance of a PE in the source state (South Africa).
- There is a concern relating to the setting up of *commissionnaire* arrangements in the context of multi-national enterprises investing in South Africa.

2.6 ARTICLE 5(6)

This Article states that:

> "An enterprise of a Contracting State shall not be deemed to have a PE in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

In accordance with paragraph 37 of the OECD Commentary on Article 5(5) of the OECD MTC, a person will be independent and will therefore not constitute a PE of the enterprise on whose behalf he acts, if:

- he is independent of the enterprise both legally and economically; and
- he acts in the ordinary course of his business when representing his principal.

In terms of paragraph 38 of the OECD Commentary, where the person's commercial activities for the enterprise are subject to detailed instructions or comprehensive control by it, the person is legally dependent on the enterprise. Another important criterion will be whether the entrepreneurial risk has to be borne by the agent or the enterprise it represents.

2.6.1 Legal independence

South Africa has no case law on the concept of legal independence. International case law has commented on this concept as follows:

- In *Taisei Fire and Marine Insurance Co. Ltd* 104 TC No. 27 (May 2, 1992), the tax court in the United States of America referred to the commentaries by the OECD on the 1963 draft Model Convention. With regard to legal independence, the court noted that the principal had no shareholder interest in the agent and no representative of the principal was a director, officer or employee of the agent. The court also considered other factors, including whether the agent had complete discretion in conducting the business on behalf of the principal.
- In *Donroy Ltd v United States*, 301 F.2d 200, 206 (9th Circuit.1982), an independent agent was compared with an employee. The court found that, in contrast to a dependent agent/employee, an independent agent contracts to do a piece of work according to his own methods and without being subject to the control of his employer except as a result of the work.

In summary, an agent is legally independent if he can conduct the business of the principal according to his own view, expertise and methods without intervention from the principal.

2.6.2 Economic independence

Vogel[60] states the following:

> "The main criteria for assessing an agent's economic independence of the enterprise he represents are the details of how his business relations with the enterprise are shaped, particularly in economic respects. The personal independence… of an agent may thus well be questioned if the latter, while retaining his independent status in legal respects, were to work for only one principal and were, therefore, to be economically dependent on the principal. It will in those cases by no means be rare for such agent to be bound – though not legally, but at any rate factually – to obey his principal's instructions to the same degree as an employee and consequently to be regarded as being a dependent agent…"

In light of the above, in order for an agent to be economically independent from his principal, the agent's business must be able to stand on its own and not look to the principal for its very economic viability. A further consideration when determining economic independence is whether the agent shares business risk with the principal or carries his own business risk. These factors indicate whether or not the agent's business is integrated with that of his principal.

It is also relevant to consider how many principals the agent represents. If the agent represents a single principal for a long period of time, it may be more difficult to

60 K Vogel Double Taxation Conventions (1997) at 345.

demonstrate that the agent is economically independent of the principal. The key consideration therefore, is whether on balance of all the relevant facts and considerations, the agent's activities constitute an autonomous business conducted by him in which he bears the risk and receives the reward through the use of his entrepreneurial skills and knowledge.

2.6.3 Ordinary course of business

Paragraph 38.7 of the Commentary on Article 5(6) states that a company is not acting in the ordinary course of its business when it performs activities that belong to its principal and which do not form part of its own business.

2.7 ARTICLE 5(7)

The Article states that:

> "The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a PE or otherwise), shall not of it itself constitute either company a PE of the other".

Article 5(7) implies that the existence of a subsidiary company does not, of itself, constitute that subsidiary company a PE of its parent company. This Article makes it clear that a controlling interest by a parent company in its subsidiary does not automatically result in the controlled subsidiary being a PE of its controlling parent company.[61] In other words, tax treaty law recognises the independence which a company has under private law.[62]

The inclusion of the words "…shall not of itself…" implies that a subsidiary may still constitute a PE of its parent company based on other factors. For example a subsidiary may be deemed a~~n~~ dependent agent on the basis of a special parent/subsidiary relationship (other than that of control under company law) and thus become a PE of its parent company.[63] Thus if the activities of the subsidiary on behalf of the parent fall within the other provisions of article 5, this may constitute a PE.[64] A parent company may, under Article 5(1), be found to have a PE in a State where a subsidiary has a place of business if space or premises belonging to the subsidiary are at the disposal of the parent company and constitute a fixed place of business through which the parent carries on its own business (unless those activities are of a preparatory or auxiliary nature).[65]

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61 B Arnold & M McIntyre *International Tax Primer* at 121.
62 Vogel *Double Tax Conventions* in para 189.
63 Vogel *Double Tax Conventions* in para 192.
64 Baker Double Taxation Conventions in para 5B.33.
65 Holmes International Tax Policy and Double Tax Treaties at 163.

3 THE 2013 OECD BEPS REPORT

The *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan, OECD, 2013) called for a review of that definition to prevent the use of certain common tax avoidance strategies that are currently used to circumvent the existing PE definition.

The 2013 OECD report on *Addressing Base Erosion and Profit Shifting,* the OECD notes the following about the current treaty definition of permanent establishment:

> "It had already been recognised way in the past that the concept of permanent establishment referred not only to a substantial physical presence in the country concerned, but also to situations where the non-resident carried on business in the country concerned via a dependent agent (hence the rules contained in paragraphs 5 and 6 of Article 5 of the OECD Model Tax Convention). Nowadays it is possible to be heavily involved in the economic life of another country, *e.g.* by doing business with customers located in that country via the internet, without having a taxable presence therein (such as substantial physical presence or a dependent agent). In an era where non-resident taxpayers can derive substantial profits from transactions with customers located in another country, questions are being raised as to whether the current rules ensure a fair allocation of taxing rights on business profits, especially where the profits from such transactions go untaxed anywhere".

The 2013 OECD BEPS Report noted that the PE concept is a crucial element of the model treaty, which is designed to limit a source country's tax jurisdiction over foreign businesses.[66] It has been under attack for years, from both sides - from multinationals that abuse it by compartmentalising, and from developing countries that want to reclaim their jurisdiction.

Following up on the BEPS Report, the OECD published its BEPS Action Plan in July 2013. The BEPS Action 7 which deals with preventing the Artificial Avoidance of PE Status recommended that countries ***"****Develop changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionnaire arrangements and the specific activity exemptions. Work on these issues would also address related profit attribution issues".*

- The BEPS Report recognises that the current definition of PE must be changed in order to address BEPS strategies.
- The BEPS Action Plan also recognises that in the changing international tax environment, a number of countries have expressed a concern about how international standards, on which bilateral tax treaties are based, allocate taxing rights between source and residence States. However, the BEPS Action Plan indicates that whilst actions to address BEPS will restore both source and residence taxation in a number of cases where cross-border income would otherwise go untaxed or would be taxed at very low rates, these actions are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income. [67]

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66 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 19.

67 OECD/G20 2015 Final Report on Action 7 in para 3.

Action 7 of the 2013 OECD BEPS Report called on countries to develop measures to prevent the artificial avoidance of PE status. On the international front, the OECD embarked on developing changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of *commissionnaire* arrangements (see below for definition) and the specific activity exemptions. The 2013 Report also envisaged that the work on these issues will also address related profit attribution issues. [68]

In the 2013 OECD BEPS Report, the OECD notes that "in many countries, the interpretation of the treaty rules on agency-PE allows contracts for the sale of goods belonging to a foreign enterprise to be negotiated and concluded in a country by the sales force of a local subsidiary of that foreign enterprise without the profits from these sales being taxable to the same extent as they would be if the sales were made by a distributor".[69]

4 THE 2015 OECD REPORT

4.1 ARTIFICIAL AVOIDANCE OF PE STATUS THROUGH *COMMISSIONNAIRE* ARRANGEMENTS AND SIMILAR STRATEGIES

The OECD states that a *commissionnaire* arrangement may be loosely defined as an arrangement through which a person sells products in a State in its own name, but on behalf of a foreign enterprise that is the owner of these products. Through such an arrangement, a foreign enterprise is able to sell its products in a State without technically having a PE to which such sales may be attributed for tax purposes and without, therefore, being taxable in that State on the profits derived from such sales. Since the person that concludes the sales does not own the products that it sells, that person cannot be taxed on the profits derived from such sales and may only be taxed on the remuneration that it receives for its services (usually a commission). A foreign enterprise that uses a *commissionnaire* arrangement does not have a PE because it is able to avoid the application of Article 5(5) of the OECD Model Tax Convention, to the extent that the contracts concluded by the person acting as a *commissionnaire* are not binding on the foreign enterprise.

- Since Article 5(5) relies on the formal conclusion of contracts in the name of the foreign enterprise, it is possible to avoid the application of that rule by changing the terms of contracts without material changes in the functions performed in a State.
- *Commissionnaire* arrangements have been a major preoccupation of tax administrations in many countries with a civil law code. A c*ommissionnaire* agent does not conclude contracts in the principal's name which results in the shifting of profits out of the country where the sales take place without a

68 Ibid.
69 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 9.

substantive change in the functions performed in that country. Accordingly, a number of court cases, principally *Zimmer Ltd*[70] in France, *Dell AS*[71] in Norway, and *Boston Scientific International BV*[72] in Italy, have held that a *commissionnaire* agent does not fall within article 5(5) and so is not a taxable PE. On the other hand, a recent decision concerning *Dell Spain*[73] held that the *commissionnaire* agent constituted a Spanish PE, mainly because it performed other services for its Irish principal, such as logistics and marketing. In most of those cases the tax administration's arguments were rejected.

- Similar strategies that seek to avoid the application of Article 5(5) involve situations where contracts which are substantially negotiated in a State are not formally concluded in that State because they are finalised or authorised abroad, or where the person that habitually exercises an authority to conclude contracts constitutes an "independent agent" to which the exception of Article 5(6) applies even though it is closely related to the foreign enterprise on behalf of which it is acting.
- The OECD notes that clearly, in many cases, *commissionnaire* arrangements and similar strategies were put in place primarily in order to erode the taxable base of the State where sales took place. Changes to the wording of Article 5(5) and 5(6) are therefore needed in order to address such strategies. In this regard, the OECD recommends that:
  - As a matter of policy, where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise should be considered to have a taxable presence in that country unless the intermediary is performing these activities in the course of an independent business.
  - Changes are therefore to be made to Article 5(5) and 5(6) and the Commentary thereon to address *commissionnaire* arrangements and similar strategies by ensuring that the wording of these provisions better reflect this underlying policy. [74]
  - Such changes, however, are not intended to address BEPS concerns related to the transfer of risks between related parties through low-risk distributor arrangements. In these arrangements, sales generated by a local sales workforce are attributed to a resident taxpayer, which is not the case in the situations that the changes to Article 5(5) and 5(6) are intended to address. Given this difference, BEPS concerns related to low-risk distributor arrangements are best addressed through the work on Action 9 (Risks and Capital) of the BEPS Action Plan.[75]

70 French Supreme Court, No. 3047 15, Mar. 31, 2010.
71 Norwegian Supreme Court, HR-2011-02245A, Dec. 2, 2011.
72 Italian Supreme Court, No. 3769, Mar. 9, 2012.
73 Spanish Central Economic Administrative Court, RG 2107-07, Mar. 15, 2012.
74 OECD/G20 2015 Final Report on Action 7 in the Executive Summary.
75 OECD/G20 2015 Final Report on Action 7 in para 9.

4.2 ARTIFICIAL AVOIDANCE OF PE STATUS THROUGH THE SPECIFIC ACTIVITY EXEMPTIONS

Article 5(4) of the OECD Model Tax Convention includes a list of exceptions (the "specific activity exemptions") according to which a permanent establishment is deemed not to exist where a place of business is used solely for activities that are listed in that paragraph.

4.2.1 List of activities included in Article 5(4)

Action 1 of the OECD Report on *Addressing the Tax Challenges of the Digital Economy*, OECD, 2015b) notes that when the exceptions to the definition of permanent establishment that are found in Article 5(4) of the OECD Model Tax Convention were first introduced, the activities covered by these exceptions were generally considered to be of a preparatory or auxiliary nature. Since the introduction of these exceptions, however, there have been dramatic changes in the way that business is conducted.

The OECD 2014 Discussion Draft on Action 7, [76] states that it is difficult to justify the application of exception (a) and (b):

a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise; and
b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery

to the PE concept where an enterprise maintains a very large warehouse in which a significant number of employees work for the main purpose of delivering goods that the enterprise sells online.[77]

Regarding Article 5(4)(b) MNEs often carry out significant business in the source state where they have a dependent agent who maintains a stock of goods from which delivery is made to customers in that state. Article 5(5) of the OECD MTC deems a PE to exist if a dependent agent habitually concludes contracts on behalf of the enterprise in the other contracting state, even if there is no physical place of business

Article 5(4)(c) excludes from the PE concept the "maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose processing by another enterprise". An important BEPS issue is whether an enterprise's stock of goods maintained with a toll-manufacturer will cause the location where the goods are maintained to be at the disposal of the enterprise. In terms of the current PE rules, if the stock of goods is at the disposal of the enterprise, and the other

[76] OECD Public Discussion Draft on Action 7 (31 October 2014 – 9 January 2015) in paras 18-19.

[77] OECD Public Discussion Draft on Action 7 (31 October 2014 – 9 January 2015) in para 19.

conditions for PE status under article 5(1) are satisfied, then a PE would be created. If however, the maintenance of that stock of goods by a toll manufacturer is for purposes of storage display or delivery a PE would not be constituted. However, in modern business models a toll manufacturer could be part of the MNE group of companies. As a connected enterprise, it is necessary to determine whether maintaining of the goods will meet or fail the preparatory and auxiliary test.

Article 5(4)(d) excludes from the PE concept "the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise". However with modern business models, an MNE can collect information for the enterprise and disguise it by repackaging it into reports prepared for these enterprises, thereby avoiding PE status.[78] This is particularly so for companies dealing in electronic products, which can collect user data in one country and use that data to sell targeted advertisements to advertisers in another country. Revenues collected from advertisements targeted to users in one country are then be funnelled through subsidiaries in low tax jurisdictions, thus avoiding PE status in those countries in which the advertisements are collected.[79] With modern businesses where an MNE has a connected affiliate in a source state that collects information that is related to the business as a whole, such an affiliate should be considered a PE of the MNE.

Article 5(e) and 5(f) exclude from the PE concept other activities of "preparatory or auxiliary" nature. The purpose of these exclusions is to prevent an enterprise from being taxed in the other State, if it only carries on activities of a purely preparatory or auxiliary character.[80] There is however uncertainty about the meaning of the phrase "preparatory or auxiliary" and so the need for guidance on its meaning. An example of preparatory of auxiliary activities given in article 5(4)(e) is the maintenance of a fixed place of business solely for the purpose of advertising or the supply of information or for scientific research. However, not all scientific research activities can qualify as "preparatory or auxiliary" activities. In the modern world, real value can be created through scientific research as well as the development and testing of products and services, in continuous processes of innovation and improvement. Spending on innovation is key to the success of many businesses today. However under the current rules, a MNE could continue to claim that an affiliate in a country carrying out research and development is a contract researcher, and that its activities are "preparatory or auxiliary" to the sales of final products.

78 OECD Public Discussion Draft on Action 7 (31 October 2014 – 9 January 2015) in para 28.

79 SS Jonstone "News Analysis: Chasing Google -- The Global Struggle to Tax Ecommerce" 10 February 2014.

80 Para 18 of the Commentary on art 5(4); see also K. Holmes *International Tax Policy and Double Tax Treaties: An Introduction to Principles and Application* (IBFD, 2007), p. 156.

In its 2015 final Report on Action 7, the OECD notes that depending on the circumstances, activities previously considered to be merely preparatory or auxiliary in nature may nowadays correspond to core business activities.[81]

- OECD recommendation: In order to ensure that profits derived from core activities performed in a country can be taxed in that country, Article 5(4) is to undergo modification to ensure that each of the exceptions included therein is restricted to activities that are otherwise of a "preparatory or auxiliary" character.
- BEPS concerns related to Article 5(4) also arise from what is typically referred to as the "fragmentation of activities". Given the ease with which multinational enterprises (MNEs) may alter their structures to obtain tax advantages, it is important to clarify that it is not possible to avoid PE status by fragmenting a cohesive operating business into several small operations in order to argue that each part is merely engaged in preparatory or auxiliary activities that benefit from the exceptions of Article 5(4).
- Thus the OECD has come up with an anti-fragmentation rule to address these BEPS concerns.[82]

4.2.2 Fragmentation of activities between closely related parties

Concerns have been raised about MNEs avoiding PE status by "fragmenting activities" and taking advantage of article 5(4)(f) which excludes from the PE concept "the maintenance of a fixed place of business solely for any combination of activities in article 5(4)(a)-(e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character".

Currently paragraph 27.1 of the Commentary on article 5(4)(f) which deals with the application of Article 5(4)*f*) in the case of what has been referred to as the "fragmentation of activities" provides that:

> "Subparagraph f) is of no importance in a case where an enterprise maintains several fixed places of business within the meaning of subparagraphs a) to e) provided that they are separated from each other locally and organisationally, as in such a case each place of business has to be viewed separately and in isolation for deciding whether a permanent establishment exists. Places of business are not "separated organisationally" where they each perform in a Contracting State complementary functions such as receiving and storing goods in one place, distributing those goods through another etc. An enterprise cannot fragment a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity".

However, the wide application of the article 5(4)(f), since it covers a combination of activities, often creates nexus in the source country that is not preparatory or auxiliary.

[81] OECD/G20 2015 Final Report on Action 7 in the Executive Summary.
[82] Ibid.

MNEs can avoid PE status by artificially fragmenting their operations among multiple group entities to qualify for the exceptions to PE status for preparatory and ancillary activities. This is especially so in relation to delivery warehouses used as part of the digital trading model. Concerns about the fragmentation of group operations among multiple group entities in order to avoid PE status, can be exemplified by the decisions in *Dell Spain* and in the Italian case of *Philip Morris GmbH*,[83] both of which adopted a substantive approach in determining that multiple PEs of foreign group companies existed as a result of fragmented group operations.

The OECD explains that, given the ease with which subsidiaries may be established, the logic of the last sentence in paragraph 27.1 "an enterprise cannot fragment a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity" should not be restricted to cases where the same enterprise maintains different places of business in a country but should be extended to cases where these places of business belong to closely related enterprises.

- The OECD recommends that some BEPS concerns related to Article 5(4) will therefore be addressed by the anti-fragmentation rule which will take account not only of the activities carried on by the same enterprise at different places but also of the activities carried on by closely related enterprises at different places or at the same place. This new rule is the logical consequence of the decision to restrict the scope of Article 5(4) to activities that have a "preparatory and auxiliary" character because, in the absence of that rule, it would be relatively easy to use closely related enterprises in order to segregate activities which, when taken together, go beyond that threshold.[84]
- The new *anti-fragmentation rule will read as follows:*
  "Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting State and
  a) that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of this Article, or
  b) the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character, provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation".

4.3 OTHER STRATEGIES FOR THE ARTIFICIAL AVOIDANCE OF PE STATUS

4.3.1 Splitting-up of contracts

83 Italian Supreme Court, Nos. 3667, 3368, 7682, and 1095, Mar. 7, 2002.
84 OECD/G20 2015 Final Report on Action 7 in para 15.

Article 5(3) of the OECD MTC provides for a special PE rule for building sites, construction, and installation projects that last for more than 12 months. However, contractors and sub-contractors especially those engaged in exploration and exploitation on the continental shelf often split contracts to abuse the 12 months PE time in article 5(3) so that they each cover a period less than the prescribed time limit, thereby avoiding PE status through such artificial arrangements.

Currently, the splitting-up of contracts in order to abuse the exception in Article 5(3) is dealt with in paragraph 18 of the Commentary on Article 5 so as to address the abuse to the exception.[85]

The paragraph states as follows:

> "The twelve month threshold has given rise to abuses; it has sometimes been found that enterprises (mainly contractors or subcontractors working on the continental shelf or engaged in activities connected with the exploration and exploitation of the continental shelf) divided their contracts up into several parts, each covering a period less than twelve months and attributed to a different company which was, however, owned by the same group. Apart from the fact that such abuses may, depending on the circumstances, fall under the application of legislative or judicial anti-avoidance rules, countries concerned with this issue can adopt solutions in the framework of bilateral negotiations".

The splitting-up of contracts in order to avoid the existence of a PE is a concern with regard to MNE service activities such as those of consultants or engineers who often allege that their services are of a temporary nature. To address these concerns paragraph 42.23 of the Commentary on article 5 suggests an alternative service-PE provision that countries may be include in treaties. Paragraph 42.45 of the OECD Commentary on article 5(4) also recommends that legislative or judicial anti-avoidance rules may apply to prevent such abuses.

<u>OECD recommendation:</u>

- The Principal Purposes Test (PPT) rule that will be added to the OECD Model Tax Convention as a result of the adoption of the Report on Action 6 (*Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*) will address the BEPS concerns related to the abusive splitting-up of contracts. Under the principal purpose rule, if one of the principal purposes of transactions or arrangements is to obtain treaty benefits, these benefits would be denied unless it is established that granting these benefits would be in accordance with the object and purpose of the provisions of the treaty.[86]
- For States that are unable to address the issue through domestic anti-abuse rules, a more automatic rule that prevents transactions that are known to cause treaty shopping concerns will also be included in the Commentary as a provision that should be used in treaties that would not include the PPT or as

[85] OECD/G20 2015 Final Report on Action 7 in para 16.
[86] OECD/G20 2015 Final Report on Action 6 in the Executive Summary.

an alternative provision to be used by countries specifically concerned with the splitting-up of contracts issue. [87]

4.3.2 Strategies for selling insurance in a State without having a PE therein

Insurance companies may do large scale business in a State without having a permanent establishment in that State. The OECD acknowledges that insurance (including re-insurance) raises difficult issues as regards the question of where profits that represent the remuneration of risk should be taxed.[88] Currently paragraph 39 of the Commentary on Article 5 suggests that:

According to the definition of the term "permanent establishment" an insurance company of one State may be taxed in the other State on its insurance business, if it has a fixed place of business within the meaning of paragraph 1 or if it carries on business through a person within the meaning of paragraph 5. Since agencies of foreign insurance companies sometimes do not meet either of the above requirements, it is conceivable that these companies do large-scale business in a State without being taxed in that State on their profits arising from such business.

In order to obviate this possibility, various conventions concluded by OECD Member countries include a provision which stipulates that insurance companies of a State are deemed to have a PE in the other State if they collect premiums in that other State through an agent established there — other than an agent who already constitutes a PE by virtue of paragraph 5 — or insure risks situated in that territory through such an agent. The decision as to whether or not a provision along these lines should be included in a convention will depend on the factual and legal situation prevailing in the Contracting States concerned. Frequently, therefore, such a provision will not be contemplated. In view of this fact, it did not seem advisable to insert a provision along these lines in the Model Convention.

In its 2015 Final Report on Action 7, the OECD notes that:

- As part of the work on Action 7, BEPS concerns related to situations where a large network of exclusive agents is used to sell insurance for a foreign insurer were also examined.
- It was ultimately concluded, however, that it would be inappropriate to try to address these concerns through a PE rule that would treat insurance differently from other types of businesses and that BEPS concerns that may arise in cases where a large network of exclusive agents is used to sell insurance for a foreign insurer should be addressed through the more general changes to Article 5(5) and 5(6). [89]

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[87] OECD/G20 2015 Final Report on Action 7 in para 17. See also OECD/G20 2015 Final Report on Action 6 at 22.

[88] OECD Public Discussion Draft on Action 7 (31 October 2014 – 9 January 2015) in para 40.

[89] OECD/G20 2015 Final Report on Action 7 in para 18.

4.4 PROFIT ATTRIBUTION TO PES AND INTERACTION WITH ACTION POINTS ON TRANSFER PRICING

The OECD work on Action 7 also addresses attribution of profit issues. This work focusses on whether the existing rules of Article 7 of the OECD Model Tax Convention would be appropriate for determining the profits that would be allocated to PEs resulting from the changes included in this report.

- The conclusion of that work is that these changes do not require substantive modifications to the existing rules and guidance concerning the attribution of profits to a PE under Article 7 but that there is a need for additional guidance on how the rules of Article 7 would apply to PEs resulting from the changes in this report, in particular for PEs outside the financial sector.
- There is also a need to take account of the results of the work on other parts of the BEPS Action Plan dealing with transfer pricing, in particular the work related to intangibles, risk and capital.[90]

However work on attribution of profit issues related to Action 7 could not be undertaken before the work on Action 7 and Actions 8-10 had been completed. Follow-up work on attribution of profits issues related to Action 7 and the necessary guidance will be provided before the end of 2016, which is the deadline for the negotiation of the multilateral instrument that will implement the results of the work on treaty issues mandated by the BEPS Action Plan. [91]

5 ADDRESSING PE ISSUES IN SOUTH AFRICA

5.1 REVAMPING THE SOURCE RULES

The concept of *commissionnaire* is not provided for in South African legislation *per se*. The OECD defines commissionnaire as an arrangement through which a person sells products in a State in its own name but on behalf of a foreign enterprise that is the owner of these products.The PE issues pertaining to *commissionnaire* agency are of concern in South Africa regardless of the fact that South Africa in not a civil law country and the *commissionnaire* agency concept is not applied as is especially where proxies are employed to escape the PE rules, which could pose a risk for South Africa.

The OECD's concerns articulated above refer to circumstances where a multi-national enterprise avoids creating a PE in the source state in order to avoid source based taxation in that jurisdiction. With respect to South Africa the issues that arise relate *inter-alia* to:

- Concerns about the issue of tax compliance;

[90] OECD/G20 2015 Final Report on Action 7 in para 19.
[91] OECD/G20 2015 Final Report on Action 7 in para 20.

- Concerns about calculating the profit attributable to the PE and ensuring compliance with the transfer pricing rules in the source state (South Africa); and
- Concerns by MNEs that having a PE in a source state means claiming foreign tax credits in the resident state of the multi-national enterprise, which credits are sometimes in excess of the resident state's tax (so the excess constitutes an additional permanent tax cost) or, in the case of, *inter alia*, the USA, the resident state places restrictions on the use of foreign tax credits.

Where the South African Revenue Service (SARS) is not able to pin down the existence of a PE in terms of the current OECD rules, South Africa's source rules should be made strong enough to ensure that the activities of such non-residents in South Africa are taxed on a source basis.

- In this regard, it is recommended that South Africa's source rules in section 9 of the Act[92] are refined in line with the OECD 2015 recommendations on Action 7 to ensure they capture all income that is derived by non-residents from goods or services used or consumed in South Africa.

5.2 DETECTING NON-RESIDENT'S REPRESENTATIVE OFFICES - ALLEGEDLY PREPARATORY OR AUXILIARY ACTIVITIES

There are concerns in South Africa over the inability for SARS to detect and monitor whether PEs have been established in South Africa.

- This is especially so where non-residents engage in activities that are allegedly of a temporary nature, such as service activities or, for instance, consultants offering engineering services, or other technical or specialised services.
- Then there are also challenges where non-residents may escape PE status on allegations of being involved in preparatory or auxiliary activities. This is especially so when non-residents set up representative offices in South Africa.

Various solutions to these detection problems could be considered, including the following:

- A system could be put in place to ensure such non-residents are brought into the tax system through filing tax returns. This will ensure that SARS is aware of the business activities of such non-residents in the country. Lack of proper registration means that certain foreign entities are improperly avoiding South African tax altogether.
- Since these representative offices would be renting some offices in South Africa, an obligation could be placed on residents who rent out properties for non-residents to use as representative offices, to ensure they file tax returns.

5.3 DEFINITION OF PE

92 Ibid

As stated earlier, in South Africa, a PE is defined in section 1 of the Income Tax Act, as defined from time to time in Article 5 of the OECD Model Tax Convention. Even though South Africa is not a member of the OECD, it has got OECD Observer Status. As member of the G20, which has worked together with the OECD on the BEPS project, South Africa, is expected to follow the minimum standards and the reinforced international standards such as those relating to the PE concept in tax treaties so as to prevent double taxation and double non-taxation. It should also be noted that South African courts have taken cognizance of the OECD Commentary in interpreting the scope of DTA provisions.[93]

- In this regard, it is recommended that South Africa adopts the new OECD Guidelines on the meaning of the PE concept – even as section 1 of the Income Tax Act clearly provides that PE concept will be defined in South Africa as it is defined from time to time in the OECD Model Tax Convention.

5.4 TAXATION OF SOUTH AFRICAN BRANCHES

As stated in the introduction, a company that is not tax resident in South Africa but conducts business in South Africa through a PE is taxable in South Africa on the income of that PE that is sourced in South Africa.[94] Under the secondary tax on companies (STC) regime (now repealed) a resident company was, in addition to tax on its income at a rate of 28%, also liable for secondary tax on companies at the rate of 10% of dividends declared by the company to its shareholders. With income tax and STC combined, a resident company was thus subject to an effective tax rate of 34,5%. As non-resident companies with South African sourced income were not subject to STC, the income tax rate of non-resident companies on South African income was increased to 33% following the introduction of STC, so as to place non-resident companies on par with resident companies.

With the introduction of dividends tax on 1 April 2012 (and the repeal of STC) resident companies paid tax at a lower rate than non-resident companies. The reason is that insofar as cash dividends are concerned, the person liable for dividends tax is the beneficial owner of the dividend and not the company declaring the dividend. As the resident company is not liable for dividends tax its effective rate of tax is 28%. The result is that following the introduction of dividends tax, non-resident companies were subject to tax at an additional 5%, being the difference between the rate at which it is taxed (33%) and the rate applicable to resident companies (28%). The income tax rate for PEs was therefore reduced to 28% to create parity and avoid discriminating against non-resident companies.

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93 *SIR v Downing* 1975 (4) SA 518 (A).

94 See part I section 4(f) of the Taxation Laws Amendment Act 7 of 2010. See also Olivier L 'The "Permanent Establishment" requirement in an International and Domestic Taxation Context: An Overview' (2002) *SALJ* 866.

The reduction of the rate of income tax applicable to non-resident companies from 33% to 28% means that it is more tax efficient for a foreign company to conduct its South African operations through a PE located in South Africa, than to establish a South African subsidiary because the subsidiary would be liable to normal corporate tax at 28% and the dividends paid by a resident subsidiary to a non-resident company are also subject to dividends withholding tax at 15% if there is no tax treaty in place or, where a treaty is in place, the rate of dividends tax may be reduced in terms of an applicable treaty. This uneven playing field in favour of PEs in the form of branches costs the South African fiscus a loss in potential tax revenue.

- It is recommended that above concerns could be corrected by an introduction of a tax on branch profit remittances. It is recommended that South Africa should consider the legal, constitutional and DTA implications of introducing such a tax.

It is noted that South African resident companies are exempt from the withholding tax on dividends and that is of no concern in this regard as there is no loss to the South African fiscus.

5.5 PE CONCERNS RELATING TO CREATING A FOREIGN BUSINESS ESTABLISHMENT IN A JURISDICTION

The concept of a "foreign business establishment" in section 9D(1) of the Act which (deals with controlled foreign companies)[95] is key to the base erosion issues. In particular, controlled foreign companies which qualify for the "foreign business establishment exemption" contained in section 9D(9)(b) read with section 9D(9A) of the Act do not have any amounts equal to their taxable income attributed to their South African resident shareholders in terms of section 9D(2) of the Act. The foreign business establishment exemption is therefore fundamental in determining what amounts are attributed to, and taxed in, South Africa.

This is particularly important in respect of controlled foreign companies set up in low tax jurisdictions, since those with operations in high tax jurisdictions may:

- qualify for the "high tax exemption" contained in the proviso to section 9D(2A) of the Act;
- even if they do not qualify for this exemption, the income allocated to the South African resident shareholders brings with it foreign tax credits in terms of section 6*quat* of the Act which reduce the amount of South African tax payable in respect of such amounts.

A "foreign business establishment" is in many ways similar to a PE and therefore it is appropriate that this aspect be considered in this discussion on Action 7. A "foreign business establishment" is *inter alia* defined in section 9D(9)*(b)* of the Act as "a fixed place of business located in a country other than the Republic that is used or will

[95] Ibid

continue to be used for the carrying on of the business of that controlled foreign company for a period of not less than one year…". This issue is the opposite of that articulated in Action 7, in that it relates to the setting up of a foreign business establishment in, typically, a low tax jurisdiction in order to shelter income from allocation to South Africa under the controlled foreign company rules. It should therefore be analysed whether the current foreign business establishment exemption achieves its objective or whether amendments should be made to this concept in section 9D of the Act.

The exclusions from the foreign business establishment exemption principally relate to the so-called "diversionary rules", which deal with tax deductible amounts payable by South African residents to the controlled foreign company. Therefore, amounts which reduce the South African tax base, as a matter of principle, do not qualify for the foreign business establishment exemption. However, it should be considered whether these exclusions are wide enough and still appropriate. Many of the exclusions were first legislated when section 9D was enacted in 2000/2001.

The second issue for consideration is whether there should be further exclusions from the foreign business establishment exemption in respect of amounts which do not directly reduce the South African tax base. This is so in relation to interest payments from a controlled foreign company in a high tax jurisdiction to a controlled foreign company in a low tax jurisdiction. Often this results in double non-taxation of such interest payments. The same issue arises in respect of other amounts falling within the ambit of the foreign business establishment exemption.

To address PE concerns relating to foreign business establishments it is noted and recommended that:

- The exemption from tax in respect of income arising in a controlled foreign company with a foreign business establishment is correct as a policy matter.
- Transfer pricing principles together with PE attribution principles should be used to test whether the correct amounts are attributable to the foreign business establishment. In this regard section 9D(9)(b) currently states as follows:

  "subject to subsection (9A), in determining the net income of a controlled foreign company in terms of subsection (2A), there must not be taken into account any amount which…is attributable to any foreign business establishment of that controlled foreign company (whether or not as a result of the disposal or deemed disposal of any assets forming part of that foreign business establishment) and, in determining that amount and whether that amount is attributable to a foreign business establishment

  (i) that foreign business establishment must be treated as if that foreign business establishment were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and

dealing wholly independently with the controlled foreign company of which the foreign business establishment is a foreign business establishment; and

(ii) that determination must be made as if the amount arose in the context of a transaction, operation, scheme, arrangement or understanding that was entered into on the terms and conditions that would have existed had the parties to that transaction, operation, scheme, agreement or understanding been independent persons dealing at arm's length.."

Instead of this wording, consideration should be given to applying the transfer pricing rules and profit attribution principles contained in double tax agreements to the determination of whether amounts qualify for the foreign business establishment exemption.

5.6 WITHHOLDING TAXES IN SOUTH AFRICA

The challenges of identifying non-residents' activities of a temporary nature (such as engineering and consultancy services) and the need to pin down such activities have been ameliorated by South Africa's withholding tax regime. In 2012, the National Treasury considered that withholding taxes relating to dividends, interest and royalties differed as to rates, timing, refunds and other procedures. While some of these differences can be justified, the National Treasury considered that many of these differences have arisen simply due to the dates on which these provisions were enacted, and that the result is a lack of coordination among these withholding taxes, which thereby complicates administration of, and compliance with, these taxes. Concluding that greater uniformity was needed to greatly reduce these burdens, the National Treasury sought to unify these withholding taxes to remedy the lack of coordination. In terms of the Explanatory Memorandum to the Taxation Laws Amendment Act 2013, an effort was made to unify South Africa's withholding tax regime as a measure to prevent base erosion. South Africa imposes the following withholding taxes in the Act:

- Withholding Tax on Royalties:[96] South Africa has a long history of imposing withholding tax in the case of cross-border royalties (previously levied at 12%). To ensure uniformity of withholding taxes, in 2013 a 15% final withholding tax on royalties was enacted, which is levied on the amount of any royalty paid by any person to or for the benefit of any foreign person to the extent that the amount is regarded as having been received by or accrued to that foreign person from a source within the Republic in terms of section 9(2)*(c)*, *(d)*, *(e)* or *(f)* of the Act.
- Withholding Tax on Dividends:[97] Dividends tax at a rate of 15% is levied on shareholders in respect of dividends paid by any company other than a headquarter company. The dividends tax is levied on dividends paid by South

[96] Sections 49C-49G

[97] Sections 64D-64N.

African resident companies or by non-resident companies listed on a South African stock exchange.

- Withholding Tax on Interest:[98] A withholding tax on interest is levied, at a rate of 15% on the amount of any interest paid by any person to or for the benefit of any foreign person to the extent that the amount is regarded as having been received or accrued from a source within the Republic in terms of section 9(2)*(b)* (effective from 1 March 2015).
- Withholding Tax on Service Fees:[99] A withholding tax on service fees was legislated and was to be levied, at a rate of 15% on the amount of any service fee paid by any person to or for the benefit of any foreign person, to the extent that the amount is regarded as having been received by or accrued to that foreign person from a source within the Republic. This has been repealed prior to coming into effect.[100]
- Withholding Tax on Entertainers and Sportspersons:[101] A final withholding tax at a flat rate of 15% is levied on the amount received by or accrued to a non-resident entertainer or sportsperson.
- Withholding Tax on Proceeds of Immovable Property disposed of by a Non-resident:[102] Any person who purchases immovable property situated in the Republic which is disposed of by a non-resident must withhold from the amount payable to the non-resident a withholding tax equal to: 5% if the non-resident is an individual; 7.5% if the non-resident is a company; and 10% if the non-resident is a trust. If the actual tax on the transaction is less than the withholding tax, the non-resident may apply to SARS for a directive as to the lesser amount to be withheld.

South Africa requires that non-residents with South African sourced income register for tax in South Africa. Where there non-residents comply with this requirement, the SARS is able to collect taxes on South African sourced income. However, there are enforcement challenges where the non-resident merely chooses not to comply.

To prevent double taxation, there are exemptions to each of these withholding taxes in the relevant provisions. For instance, the rules relating to the withholding taxes on interest and royalties provide that a foreign person will be exempt from the withholding tax if the foreign person is a natural person who was physically present in the Republic for a period exceeding 183 days in aggregate during the twelve-month period preceding the date on which such payment is made. The relevant rules also provide for an exemption from the relevant withholding tax if the interest or

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98 Sections 50A-50H.

99 Sections 51A-51H.

100 On the details of the withholding tax on service fees, see AW Oguttu "An Overview of South Africa's Withholding Tax Regime" *TaxTalk* (March/April 2014).

101 Sections 47A-47K.

102 Section 35A.

royalty is effectively connected with a permanent establishment of that foreign person in the Republic.[103]

The effectiveness of these withholding taxes is greater in cases where the non-resident's country of residence does not have a double tax treaty with South Africa. Treaties based on the OECD MTC often set limits on the rates of withholding taxes that may be levied by source countries while the UN MTC is more in favour of withholding taxes.

The optimal effectiveness of South Africa's withholding tax regime will have to be backed up through double tax treaty reforms, through the re-negotiation of older treaties or signing protocols to take into consideration the withholding taxes now in place. Most of South Africa's treaties do not provide favourable withholding tax rates for South Africa. Now that the domestic withholding tax rate is generally uniform at 15%, it is imperative that, if withholding taxes are to be relied on, then the South Africa's treaty negotiators re-negotiate and negotiate better treaty rates for South Africa.[104]

It should however be noted that high withholding taxes can be a deterrent to foreign investment. Foreign investors prefer to base investments in jurisdictions with low withholding tax rates. Thus, in treaty negotiations, efforts should be made to ensure a balanced approach that does not stifle foreign investment and at the same time preserves South Africa's tax base.[105]

Even though the OECD principles suggest that the taxation of income of non-residents in a source state should be limited to those attributable to a PE, the mere existence of a PE should not shield all locally sourced income from withholding taxes. South African sourced interest, royalties or service fees earned by foreign entities outside of the PE rule should still be subject to a 15% withholding tax.

6 CONCLUDING REMARKS AND MORE RECOMMENDATIONS

On a tax policy level, it is important that South Africa does not emphasise legislative amendments to tax laws applicable to outbound MNEs, (for example, CFC rules), over tax laws applicable to inbound MNEs (for example, PE rules and source rules). It is necessary to balance legislation so as to ensure that South African companies are not overtaxed in comparison to non-residents, which would affect their competitiveness. South African outbound MNEs should not be taxed and audited disproportionately higher compared to inbound MNEs. Based on the above, the following recommendations are made:

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103 See sections 49D, 50D and 51D.

104 AW Oguttu "An Overview of South Africa's Withholding Tax Regime" *TaxTalk* (March/April 2014).

105 Ibid.

- The current source rules should be revamped to ensure that they adequately enable SARS to determine when a PE exists so that SARS is able to determine how profits must be attributable to such PEs. Some countries, such as the UK, which is a member of the OECD and signs treaties based on the OECD MTC (as is the case with South Africa) has enacted rules relating to the tax treatment of branches in order to attend to these challenges. South Africa should emulate the UK by enacting provisions which clearly explain the tax treatment of PEs in South Africa. The rules should complement the PE definition in section 1 of the Act[106] and further explain that the OECD rules for attributing profits to PEs would be applied. The rules that require non-residents carrying on business in South Africa to register with SARS aid enforce the source rules in this regard. As a residual matter the normal source rules and/or withholding taxes would apply for those that don't meet the PE threshold.
- Government should consider the prevalence of *commissionnaire* type arrangements to determine the extent of the risk to the South African fiscus.
- South Africa should adopt the OECD recommendations on changes to the MTC and ensure that its double tax treaties are amended as deemed appropriate in line with changes to the OECDMTC.[107]
- It is recommended that South Africa should consider the legal, constitutional and DTA implications of introducing a tax on branch profit remittances.
- In view of the status of a DTA under South African law and since the South African courts have taken cognizance of the OECD Commentary in interpreting the scope of DTA provisions, it is submitted that our courts would be entitled to apply the substance versus form doctrine of our common law or the general anti-tax avoidance rules (GAAR) contained in Part IIA of Chapter III of the ITA to counter abuse of the PE provisions of a DTA to avoid, postpone or reduce South African tax. In respect of the specific examples of potential abuse of the PE concept outlined in the BEPS Action 7 Report, it is submitted that either the substance versus form doctrine or the GAAR could potentially be applied to counter such abusive practices.[108]

106 Ibid
107 This recommendation is supported by Deloitte in its submission to the DTC dated 17 August 2015.
108 This recommendation was submitted by Wally Horak in his report to the DTC in October 2015.

ANNEXURE 8

DAVIS TAX COMMITTEE: SECOND INTERIM REPORT ON BASE EROSION AND PROFIT SHIFTING (BEPS) IN SOUTH AFRICA*

SUMMARY OF DTC REPORT ON ACTIONS 8 TO 10: ALIGNING TRANSFER PRICING OUTCOMES WITH VALUE CREATION; AND 13: RE-EXAMINING TRANSFER PRICING DOCUMENTATION

GENERAL ON TRANSFER PRICING

The term "transfer pricing" describes the process by which related entities set prices at which they transfer goods or services between each other.[1] When multinational companies operate in different countries, where they are subject to different tax laws, they may resort to tax planning in relation to transfer pricing, whereby they ensure that the profits arise in countries with lower tax rates.

The concepts of transfer pricing and "Illicit financial flows" are often confused and it is important to distinguish between these two concepts upfront. 'Transfer pricing' is, as indicated above, simply the price at which goods and services are transferred between connected parties. Provided the arrangements between the parties, and the consequent pricing, reflect what would arise between unconnected parties acting in their own interests (ie a price that would be negotiated arm's length), the transfer pricing is not illegal, and cannot be viewed as an 'illicit financial flow".

Global bodies[2] which advise Governments on tax policy-setting generally recommend the use of the arm's length principle in curbing transfer pricing. Paragraph 1 of Article 9 of the OECD MTC provides for the arm's length principle on the basis that when conditions are made or imposed between two associated enterprises in their commercial or financial relations, which differ from those which would have been made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

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1 South African Revenue Services Practice Note No. 7 'Section 31 of the Income Tax Act, 1962: *Determination of Taxable Income of Certain Persons from International Taxation: Transfer Pricing* (6 Aug 1999) in par 2.1.

2 For example: Article 9(1) of the OECD and the UN Model Tax conventions.

The original commentary on Action 8 of the 2013 OECD Report on Base Erosion and Profit Shifting (BEPS)[3] noted that although, in many instances, the existing transfer pricing rules, based on the arm's length principle, effectively and efficiently allocate the income of multinationals among taxing jurisdictions, in other instances multinationals have been able to use and/or misapply those rules to separate income from the economic activities that produce income and to shift the income into low-tax environments. The final Report[4] notes that the perceived emphasis on *contractual* allocations of functions, assets and risks in the existing transfer pricing guidance can result in outcomes that don't correspond to actual value created by underlying economic activity. The Report (final), it states, thus seeks to clarify and strengthen the rules against this misalignment.

Therefore, the BEPS Action Plan require the guidance on the arm's length principle to be clarified and strengthened and, furthermore, if transfer pricing risks remain after clarifying and strengthening the guidance, the BEPS Action Plan foresees the possibility of introducing special measures either within or beyond the arm's length principle. [5]

It should be noted that the BEPS Action Plan rejects a radical switch to a formulary apportionment system ("Unitary approach") in resolving these transfer pricing problems. Rather, due to difficulties in developing such a method which would be suitable for universal adoption, it advocates building on the existing separate entity approach in terms of the arm's length principle.

That notwithstanding, the essence of the favoured approach should give rise to similar results to the what, it is advocated, the unitary approach should achieve due to the principle, set out in the proposed revised guidelines emanating from Actions 8-10, that profits arise where activities take place and value is created, and increased transparency of the results of the arm's length principle (as determined through the recommendations on documentation as indicated by Action 13, including country-by-country reporting).

Thus, although the allocation of an MNE's global profits will not be based on a 'formula', by using factors which quantify the actual geographical location of its activities, and applying the arm's length principle to those activities with the benefit of visibility of where all other activities take place, tax administrations like SARS will be able to secure tax on the income which reflects the true profits based on South African activities, risks and functions[6].

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3 OECD *Action Plan on Base Erosion and Profit Shifting* (2013) at 20.

4 OECD/G20 2015 Final Report on Actions 8-10.

5 OECD/G20 2015 Final Report on Actions 8-10 at 9.

6 View supported by SACTWU submission 18/8/2015 at 3/4.

The OECD's work on transfer pricing under the BEPS Action Plan focuses on four key areas:

- Action 8 deals with transfer pricing issues relating to transactions involving intangibles, since misallocation of the profits generated by valuable intangibles has significantly contributed to base erosion and profit shifting.
- Action 9 deals with the contractual allocation of risks, and the resulting allocation of profits to those risks, which may not correspond with the activities actually carried out. The guidelines set out under this Action effectively set out the underlying principles to be followed under the other OECD transfer pricing guidelines (e.g. Action 8), in order to achieve the arm's length principle.
    - Action 9 also addresses the level of returns to funding provided by a capital-rich MNE group member, where those returns do not correspond to the level of activity undertaken by the funding company.
- Action 10 focuses on other high-risk areas. These include:
    - the scope for addressing profit allocations resulting from transactions which are not commercially rational for the individual enterprises concerned (re-characterisation);
    - the scope for targeting the use of transfer pricing methods in a way which results in diverting profits from the most economically important activities of the MNE group, including a specific focus on the pricing of commodities; and
    - neutralising the use of certain types of payments between members of the MNE group (such as management fees and head office expenses) to erode the tax base in the absence of alignment with value creation.

  The importance of the last two of these categories, for developing countries, has been highlighted in the Report.
- Action 13 re-examines transfer pricing documentation with a view to enhancing transparency for tax administrations by ensuring that they will be provided with adequate information to conduct transfer pricing risk assessments and examination. This is considered to be an essential part of tackling the BEPS problem. Action 13 thus introduces the country-by-country reporting standard.

In reviewing the above aspects of the OECD BEPS recommendations it is important to bear in mind the OECD's views on how they are to be implemented:[7] the country-by-country reporting standard, recommended in Action 13, is viewed as a minimum standard (ie all countries should commit to consistent application thereof). Actions 8-10 reinforce international standards to eliminate double taxation, in order to stop abuses and close BEPS opportunities.

[7] OECD/G20 BEPS Explanatory Statement.

The OECD's Report on Actions 8-10 contains detailed revised guidance which responds to the above issues and ensures that the transfer pricing rules secure outcomes that see operational profits allocated to the economic activities which generate them. The guidance in the Report takes the form of specific amendments to the Transfer Pricing Guidelines.[8]

The revised guidance[9] advocates analysing the contractual obligations between the parties against the actual transaction between the parties, and ensuring that the profits are allocated where value is created. It furthermore, guardedly, advocates the disregard of transactions that lack commercial rationality.

So, for example:

- Where a company contractually assumes risks over which it has no meaningful control or financial capacity to assume them, the risks and consequent rewards related thereto are to be allocated to the party who does.
- Similarly for intangibles, the income is to be allocated to the companies which perform important functions, control economically significant risks and contribute assets.
- A capital-rich company merely providing funds to a group company without assessing financial risk will be entitled only to a risk-free return, or less. Such "cash-boxes" will thus not be entitled to excessive profits.

As indicated above, the importance of the adoption of the recommendations made in Action 13 (documentation and transparency) in achieving the successful implementation of the arm's length principle for the intra group movement of goods and services, covered in Actions 8 to 10, globally, is emphasised.

Furthermore, the need for using dispute resolution procedures in the form of Mutual Agreement Procedures (also a minimum standard) and Advance Pricing Agreements (see DTC work on Action 14 and part 9 of this DTC Report), to ensure double taxation does not arise as a consequence of different transfer pricing results being determined by different tax authorities, is clear.

GENERAL ON TRANSFER PRICING IN SOUTH AFRICA

South Africa has transfer pricing legislation in section 31 of the Income Tax (Act 58 of 1962) (the ITA). As the OECD recommends, South Africa applies the arm's length principle to curb transfer pricing. The legislation focuses on cross-border transactions, operations, schemes, agreements or understandings that have been effected between, or undertaken for the benefit of, connected persons.

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8 OECD/G20 2015 Final Report on Actions 8-10 at 10.
9 OECD/G20 2015 Final Report on Actions 8-10.

If the terms or conditions made or imposed by the connected persons 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 benefitted must be calculated as if the terms and conditions had been at arm's length. To determine an arm's length price South Africa makes use of the methods set out in the OECD Transfer Pricing Guidelines,[10] which are also set out in SARS Practice Note 7.[11] This process is designed to combat the shifting of profits which should rightly be taxed in South Africa, to elsewhere.

Transfer pricing is a key focus area for SARS and an integral part of the Compliance Programme announced and reiterated by the Ministers of Finance (in office at various times).

It is not currently possible to reliably calculate the extent of base erosion and profit shifting as a result of transfer pricing schemes either globally or in South Africa (see OECD and DTC Reports on Action 11, respectively).

ANALYSIS OF ACTIONS 8 to 10 and 13

This detailed DTC Report attempts to follow a logical order when addressing the OECD Actions 8 to 10 and 13, by dealing first with Action 9, on the basis that it lays down the framework for the principles to be applied for ensuring that the outcomes are in line with value creation. Only thereafter are Actions 8 and10 covered and, finally, Action 13, as follows:

Part 1: General Principles for Transfer Pricing
Part 2: OECD Guidance for Applying the Arm's Length Principle;
Part 3: General on South African Transfer Pricing
Part 4: Action 9: Assure Transfer Pricing Outcomes are in Line with Value Creation with regard to Risks and Capital
Part 5: Action 8: Assure Transfer pricing outcomes are in line with value creation with regard to intangibles;
Part 6: Action 8: Updating the Guidance on Cost contribution arrangements;
Part 7: Action10: Ensure Transfer pricing outcomes are in line with value creation: Other high risk transactions.
Part 8: Action 10: Provide Protection against Common Types of Base Eroding Payments such as Management Fees and Head Office expenses- Low Value Added Intra Group Services; Commodity Transactions.
Part 9: Consideration of Advanced Pricing Agreements in the South African context.
Part 10: Action 13: Re-examine Transfer Pricing Documentation;

10 OECD *Transfer Pricing for Multinational Enterprises and Administrations* (July 2010).
11 SARS Practice Note No. 7 in par 9.1.2 - 9.1.3.

The detail of the discussion in each of these sections is not repeated in this summary, but should be referred to for the purposes of providing context to the recommendations made by the DTC, as set out below.

PER PARTS 3 and 4: UPGRADING SOUTH AFRICA'S TRANSFER PRICING RULES, IN GENERAL and ACTION 9: ASSURE TRANSFER PRICING OUTCOMES ARE IN LINE WITH VALUE CREATION WITH REGARD TO RISKS AND CAPITAL:

Based on the general discussion on the current legislative position in South Africa, set out in part 3 of the detailed DTC Report, and the discussion in part 4: Action 9: Assure Transfer Pricing Outcomes are in Line with Value Creation with regard to Risks and Capital the DTC recommends that:

- although the OECD report on Actions 8 to10 indicates that further work is still to follow, based on the DTC's analysis of the recommended changes to be made to the Transfer Pricing Guidelines as a consequence of the Action 8 to10 OECD Report, and in line with the recommendations on the OECD Action 13 Report, in order to reduce the incidence of income not being taxed in South Africa when the risks, functions and values actually take place here, South Africa adopts all the OECD recommendations pertaining to transfer pricing rules and documentation.
- the South African legislators ensure that section 31 of the ITA refers to the OECD guidelines, on the basis that it is obligatory to apply these guidelines for companies that are part of a group that falls above the threshold (EU750mn) requiring country-by-country reporting, but also recommended for smaller companies. Thus, as part of the mandatory application for groups above the threshold, it is recommended that all the documentation requirements should also be compulsory in terms of the legislation. This will ensure global consistency of application and documentation for such groups, as is recommended by the OECD, and foster a system on which foreign investors can rely (in line with the National Development Plan).
- at least one legally Binding General Ruling (BGR), as provided for in section 89 of the Tax Administration Act, 2011, be enacted on section 31. Without departing from the OECD Transfer Pricing Guidelines, the suggested General Ruling should include a set of principles reflecting the South African reality eg to define the method for converting the threshold amount to SA Rands.
- when taxpayers perform benchmarking studies to arrive at an arm's length price, due to the absence of local comparable data, it only be mandatory to take to make adjustments to the results as a consequence of location savings advantages/disadvantages, following the issue of guidance by SARS/

Treasury in the BGR, as to how to make the specific adjustments for South Africa's specific circumstances.[12]

- ➢ for the purposes of providing certainty to inbound investors where loans are not significant, the BGR defines a safe harbour e.g specified debt to equity ratio (or refers to the calculation set out in section 23M of the ITA), together with an interest rate (e.g. prime +2% - or in line with prevailing EXCON requirements) for inbound loans not exceeding, say, R100mn. In this manner inbound investors will not need to spend significant amounts on professional fees to determine an arm's length amount for loans below the pre-defined limit. .
- ➢ the implementation of an Advanced Pricing Agreement (APA) regime, which would also provide certainty for investors. In order to introduce the option for APAs to be obtained in South Africa, SARS will be need to be given the resources to build an APA unit.
- ➢ SARS ensures that the enforcement capacity of its transfer pricing unit is adequate. It should also ensure that there is sufficient transfer pricing training and capacity building in its transfer pricing unit to audit the results.[13]

To reiterate the last point, above, the adoption of the recommendations set out above, however, requires "sufficient transfer pricing resources at SARS to provide the guidance and to audit the results".[14]

The DTC, however, cautions that, although the objective of the transfer pricing rules, proposed by the OECD, is to secure the taxation of the profits of MNE's in those countries where the functions, risks, and value lie, South Africa could be a net loser in the equation if it fails to successfully lure MNE's to the country, due to other unattractive non-tax practices and policies.

PER PART 5: ACTION 8: ASSURE TRANSFER PRICING OUTCOMES ARE IN LINE WITH VALUE CREATION WITH REGARD TO INTANGIBLES;

Based on the discussion in Part 5, on Action 8: Assure Transfer pricing outcomes are in line with value creation with regard to intangibles, which focuses on determining the location of income and costs in the locations where the development, enhancement, maintenance, protection and exploitation of intangibles are capable of and actually take place, the DTC recommends that:

- ➢ South Africa adopts the principles set out in the OECD Action 8 Report in order to align with its trading partners' methodologies relating to intangibles, but that like the OECD, it reserves its rights to review and refine the methodology over time, as it becomes clear whether it satisfies the correct allocation of profits principle.

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12 Per recommendation by Deloitte 26 July 2015 at 7.
13 Per SACTWU submission 18 August 2015 at 4.
14 Per SACTWU submission 18 August 2015 at 4.

- Greater transparency of the exchange control rules be considered.[15] The exchange control legal and regulatory framework that exists between the SARB and the delegated powers of the Authorised Dealers (and the DTI) results in the rules relating to the import, export and the use of intellectual property not being readily available, and not being consistently applied, to persons wishing to apply them properly.
- OECD's BEPS Action 8, which requires countries to enact legislation to prevent transfer pricing using intangibles, may not require major legislative attention in South Africa at this stage, since current exchange controls restrict the outbound movement of intangibles and royalty payments. In addition, South African CFC rules exclude intangibles from the CFC exemption benefits, section 23I of the ITA is an anti-avoidance provision which prohibits the claiming of an income tax deduction in respect of "tainted IP", and the "beneficial ownership" requirement in the royalty article (12) of DTAs can also be applied to deny the reduced withholding tax treaty rate if the recipient lacks substance. This can be further reinforced by cross boarder reporting rules on intangibles.
- any future developments of EXCON rules for IP (and specifically any liberalisation of these rules) be carefully considered from a transfer pricing point of view. As indicated above, South African developed IP cannot be readily exported without Exchange Control or the Department of Trade and Industry (DTI) approval and royalty rates are often capped. Therefore Ideally EXCON policy development in this area should be informed by tax (and specifically transfer pricing) considerations.
- care be taken, when developing tax legislation on transferring of intangibles, to ensure that the legislation is not so restrictive that it limits South Africa's ambitions to be a global player in the development of IP. It may for instance be advisable to revisit South Africa's R&D tax incentive to ensure that it is comparable to that in South Africa's trading partners.
- as a separate but related point, Government considers the attractiveness of South Africa as a destination for intangible related activity and consequent intangible related returns. The Key factors that influence South Africa's attractiveness as:
    - The effective tax rate of the South African operations (considering all tax factors);
    - The certainty of tax treatment;
    - The availability of local skills; and
    - The ability of foreign skills to sustainably migrate to South Africa. On this point current immigration laws and their application do not promote the attraction of highly skill individuals to South Africa. The impact of this can be to limit the case for greater intangible returns to SA.[16]

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[15] PWC "Comments on DTC BEPS First Interim Report" (30 march 2015) at 23.
[16] PWC "Comments on DTC BEPS First Interim Report" (30 march 2015) at 23.

PER PART 6: ACTION 8: UPDATING THE GUIDANCE ON COST CONTRIBUTION ARRANGEMENTS

Set out in the OECD Transfer Pricing Guidelines there are various methods which are considered to be acceptable for determining the arm's length principle. One of these, which is, at times, used when different group companies are involved in contributing to the same transaction e.g. in particular, the development of IP, is the cost contribution method. Guidelines of how this method may be applied more effectively are set out in Action 8. Based on the discussion on such cost contribution arrangements, on part 6 of the DTC's detailed report, the DTC recommends that:

- notwithstanding that CCA's may be rarely seen in the South African context, as such arrangements arise offshore and may include South African entities, South Africa adopts the proposed guidelines for CCA's and ensures that it has sufficient exchange of information agreements in place to be able to derive the information that it requires should the taxpayer not be forthcoming.
- in line with the other recommendations, this recommendation again requires that SARS has the necessary resources and training to evaluate CCAs and obtain the necessary information.

PER PART 7: ACTION10: ENSURE TRANSFER PRICING OUTCOMES ARE IN LINE WITH VALUE CREATION: OTHER HIGH RISK TRANSACTIONS

TRANSACTIONAL PROFIT SPLIT METHOD (TPSM)

As indicated above, set out in the OECD Transfer Pricing Guidelines there are various methods which are considered to be acceptable for determining the arm's length principle. Another one of these, which it was felt required clarification, is the Transactional Profit Split Method (TPSM), which may be used in the context of global value chain, but which is often considered a method of last resort ie when no other 'one-sided' method appears to provide a suitable result e.g. in highly integrated operations, due to the complexities around applying it. Based in the discussion on this method, in part 7 of te DTC Report the DTC recommends that:

- South Africa does not attempt to issue its own guidelines regarding the TPSM, but waits for the outcome of the OECD work still to be performed.
- the absence of local South African comparables should not be considered the determinant that the TPSM is the most appropriate method. The availability of all data should first be assessed. Failure to do so will lead to all countries that have no data adopting the TPSM, which will potentially give rise to corresponding double taxation and transfer pricing disputes risks.[17] This could potentially detriment inward investment to South Africa.

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[17] Deloittes submission to DTC July 2015 at 6.

- the South African Regulators consider the need for publication of data by South African companies, or for SARS and/or Stats SA to issue information, based on data available to them, that may be suitably be used for South African comparability purposes. Such data is common in the rest of the World, and is what the currently available databases[18] are based upon.

PER PART 8: ACTION 10: PROVIDE PROTECTION AGAINST COMMON TYPES OF BASE ERODING PAYMENTS SUCH AS MANAGEMENT FEES AND HEAD OFFICE EXPENSES - LOW VALUE ADDED INTRA GROUP SERVICES; COMMODITY TRANSACTIONS

LOW VALUE ADDED SERVICES

A major BEPS concern among many developing countries in which MNE enterprises operate, including South Africa and other African countries, is that these enterprises claim deductions for various head office expenses such as management, technical and service fees, often leaving little or no profit in the paying country. Based on the discussion on this issue in part 8 the DTC recommends that:

- in line with other countries, and to ensure the success of the simplified approach, South Africa adopts the simplified approach for low value added services, as defined. This approach is based on the actual cost of the services (with a pre-determined suitable allocation key) plus a standard mark-up, recommended to be 5%, as proposed by the OECD, but also implements a suitable threshold for the amount of such services, to which this method can be applied . The level of this threshold to be evaluated once the further OECD work is complete.
- SARB be approached to align with this approach.
- in line with the Minister of Finance's 2016 Budget Speech, the services withholding tax be scrapped.

COMMODITIES

Developing countries, including South Africa, have identified commodities as of critical importance to them insofar as BEPS challenges are concerned. Action 10 recommends the application of comparable uncontrolled price (CUP) method for pricing such transactions for transfer pricing purposes and advises that this may be determined using quoted prices with suitable comparability adjustments. Based on the discussion in Part 8 of the DTC Report, the DTC recommends that:

- South Africa follows the OECD Guidelines on Commodities, including the additional guidelines, set out in Actions 8-10, with particular reference to

[18] Eg Bureau van Dijk's Amadeus; Thompson Reuters; Royaltysource; Lexisnexis; Onesource; (all commonly used by taxpayers and tax authorities globally).

quoted prices[19] and dates on which to apply these, as well as necessary adjustments, taking into account the comparability factors mentioned in the report (and others), and uses these as the basis on which to establish a benchmark price. Such a price should be one that results in an appropriate level of profit for the affiliate based on its activities in the country, and taking into account the value it creates for the MNE as a whole. This includes the benefits of providing a source of supply combined with the management of stocks and of ultimate delivery, and access to raw materials which is a type of location-specific advantage;

- SARS consults with Industry to understand the "quoted price" data, its origins and how MNE's actually price the sale of commodities through the value chain, as well as South Africa's location in the context of key markets, the transport logistics and demurrage risks in order to determine the situations when it might be appropriate to apply the "deemed pricing date";[20]
- SARS issues guidance on the nature of adjustments that would be expected to be made to the quoted price, from a South Africa specific perspective, and only make such adjustments mandatory once such guidance has been issued;
- South African considers the implementation of Advanced Pricing Agreements to ensure certainty for both taxpayers and SARS.
- SARS has the resources to apply these Guidelines, in particular, to facilitate the timely conclusion of APA/MAP procedures with respect to commodity transactions to ensure non-double taxation. In addition, the SARS resources are sufficiently trained.

PER PART 9: CONSIDERATION OF ADVANCE PRICING AGREEMENTS IN THE SOUTH AFRICAN CONTEXT

There are various types of Advance Pricing Agreements (APAs) which may be reached between taxpayers and their own revenue authorities and, potentially, also another revenue authority where the other side of a transaction takes place. Such agreements generally increase certainty for taxpayers and tax authorities regarding the transfer pricing amounts of a particular transaction, and thereby encourage trade. Based on the discussion in part 9, the DTC recommends that

- SARS considers putting in place an APA regime in South Africa, subject to it ensuring it has adequate resources.

(It will be noted that this recommendation appears in other parts of this Report as it supports other areas discussed).

[19] The EFF's submission to the Davis Tax Committee supports the recommendation of the application of the quoted price (Sixth method) in South Africa at 31 and 39.

[20] Deloittes submission to DTC: 26 July 2015 at 5.

PER PART 10: ACTION 13: RE-EXAMINE TRANSFER PRICING DOCUMENTATION

That taxpayers supply sufficient documentation to enable Revenue authorities to determine how business operate globally and where transfer pricing risks may arise is considered a critical aspect of the work performed by the OECD team working on the Action Plan.

Action 13 sets out revised guidance for transfer pricing documentation in order to achieve this objective, together with examples of how such documentation, which takes the form of: 1. Master File setting out an overall picture of the group's operations; 2. A country file setting out the detailed functions and risks taking place in each country that the global group operations; and 3. A country by country report providing, in template format, detailed numerical information on what and where the MNE's people, assets, income and costs arise, for the purposes of facilitating risk assessment by each Revenue authority which will receive it (on an automatic exchange of information basis).

Based on the discussion on Action 13, and the fact that this is considered to be a Minimum Standard, the DTC recommends that:

- preparing a master file, local file and country-by-country reporting be compulsory for large Multinational businesses ie legislated via reference to the OECD Guidelines in section 31. In line with the OECD Guidelines, MNE groups with annual consolidated group revenue in the immediately preceding fiscal year of €750 million (converted at year end) could be considered to be large MNEs.
- a Binding General Ruling (see under general notes above) be issued setting out *inter alia* how the conversion be performed locally eg based on SARS average rates for the year.
- as the OECD recommends, with regard to compliance matters under the heading "materiality", disproportionate and costly documentation requirements should not imposed on SMEs (groups with consolidated turnover less than the defined threshold (currently EU750)). SMEs should not be required to produce the same amount of documentation that might be expected from larger enterprises. Such documentation could be recommended but not obligatory, leaving the amount of transfer pricing documentation produced to support the pricing to the relevant SME group. However, SMEs could be obliged to provide information about their material cross-border transactions in their tax returns to facilitate risk assessment (as is presently the case), and upon a specific request of the tax administration in the course of a tax examination or for further transfer pricing risk assessment purposes. It is however important that definition of material transactions be clarified.
- SARS revises PN 7 to be in line with the OECD revised Transfer Pricing Documentation Guidelines in Chapter V and recommended for companies that

are part of smaller groups.The OECD's recommendation that countries should adopt a standardised approach to transfer pricing documentation that follows a three-tiered structure consisting of a master file, a local file and country-by-country reporting could be adopted in South Africa, as a recommendation even for groups of companies with turnover below the OECD threshold.

- although with regard to country-by country reporting, South Africa, along with other emerging economies, is of the view that the country-by-country report should require additional transactional data (beyond that available in the master file and local file for transactions of entities operating in their jurisdictions) regarding related party interest payments, royalty payments and especially related party service fees in order to perform risk assessments where it is found challenging to obtain information on the global operations of an MNE group headquartered elsewhere, since the OECD plans to take these views into consideration and review the implementation thereof no later than end of 2020, South Africa monitors the OECD's final recommendations in this regard and then implements them, but remains in line with the prevailing OECD guidelines at any particular time. This will ensure consistency of treatment of companies in groups globally. Furthermore, as the country-by country report is designed to provide information for risk assessment only the relevant authority (e.g. SARS) would still be in a position to ask for detailed information regarding any particular transaction paid/received by the local company.

- for the purposes of providing certainty to inbound investors where loans are not significant, the revised PN7 defines a safe harbour eg debt to equity ratio (or in line with s23M), together with interest rate (eg prime +2% - or in line with prevailing EXCON requirements) for inbound loans not exceeding, say, R100mn. In this manner inbound investors will obtain the certainty they need regarding loan requirements without having to expend significant amounts to determine an arm's length amount for loans below the pre-defined limit.
- the various provisions in the Tax Administration Act which deal with confidentiality, which include sections 21, 56 and Chapter 6 of the Tax Administration Act be strengthened in line with the OECD recommendations. The OECD recommends that tax administrations should take all reasonable steps to ensure that there is no public disclosure of confidential information (trade secrets, scientific secrets, *etc.*) and other commercially sensitive information contained in the documentation package (master file, local file and country-by-country report).
- SARS clarifies what its expectations are with respect to the timing of submission of each of the three reports, in line with the OECD recommendations. The OECD notes that practices regarding the timing of the preparation of the documentation differ among countries. The OECD however recommends that the local file should be finalised no later than the due date for the filing of the tax return for the fiscal year in question. The master file should be updated by the tax return due date for the ultimate parent of the

MNE group. And that the country-by-country report, should be submitted when the final statutory financial statements and other financial information are finalised, which may be after the due date for tax returns for a given fiscal year.

- clear guidance should be issued on *which* group company has the legal obligation to retain what transfer pricing documentation. In this respect a distinction should be made between in-bound and outbound groups. [21] The OECD recommends that taxpayers should not be obliged to retain documents beyond a reasonable period consistent with the requirements of domestic law at either the parent company or local entity level. In South Africa, the rules in relation to retention of documents are contained in Chapter 4 of the Tax Administration Act 28 of 2011, particularly sections 29 to 32 which deal with "returns and records". It is thus probably not necessary, other than as recommended here, for SARS to provide additional detail as regards retention of documents except to the extent that it is considered necessary to have rules which are specific to transfer pricing documentation.
- SARS considers including guidance in the recommended update to the Practice Note 7 and the BGR with regard to the requirement of frequency of documentation updates. The OECD recommends that transfer pricing documentation be periodically reviewed in order to determine whether functional and economic analyses are still accurate and relevant and to confirm the validity of the applied transfer pricing methodology. Furthermore that the master file, the local file and the country-by-country report should be reviewed and updated annually. And that database searches for comparables be updated every 3 years. It is recommended that SARS adhere to these recommendations.
- Clarity be provided in in the legislation or the revised PN 7/BGR that the secondary adjustment mechanism results in a tax equivalent to the 15% withholding tax with no DTA relief available.
- SARS considers coming up with additional measures to encourage compliance. Apart from imposing penalties on taxpayers, the OECD recommends that another way for countries to encourage taxpayers to fulfil transfer pricing documentation requirements is by designing compliance incentives. For example, where the documentation meets the requirements and is timely submitted, the taxpayer could be exempted from tax penalties or subject to a lower penalty rate if a transfer pricing adjustment is made and sustained, notwithstanding the provision of documentation.
- SARS continues to reinforce and expand its highly skilled transfer pricing team, including not only lawyers and accountants but also business analysts and economists, to ensure an understanding of commercial operations. This will require that measures are taken to identify, employ and retain skilled personnel especially in the regions.

21 PWC "Comments on DTC BEPS First Interim Report" (30 march 2015) at 23.

- SARS improves Information required from corporates via the ITR14 submissions so that timely decisions can be made on the risk assessment of companies, and any consequent queries and adjustments, especially SME's that are not compelled to compile country by country reporting information. The guidance provided by SARS in the Tax Return Guide in respect of the relevant information is often unclear and needs significant improvement. In addition, the Tax Return Guide is updated once in a while, however, taxpayers are not notified of these updates, which may result in a taxpayer completing transfer pricing related disclosure following specific guidance, but at the time the tax return is submitted via e-filing, the guidance (or even the question in the tax return) may have changed without the taxpayer being sufficiently notified of this.[22]
- the collection and sharing of data be extended to include other holders of vital information such as exchange control information about capital outflows collected by the South African Reserve Bank.
- care be taken to ensure that even when SARS builds a data base, taxpayers such as financial institutions can still make use of non-publically available data so that they are able to defend their positions against these comparables, since with respect to financial institutions, financial data available to SARS usually includes publically available and non-publically available data. This will also minimise the uncertainties for taxpayers with respect to updating their data and other administrative issues surrounding data keeping.[23]
- the use of safe harbour rules, which can be easily applied and documented be considered.

[22] SAICA "Comment on DTC 1st Interim BEPS Report" (31 March 2015) para 26.

[23] Comments submitted to the DTC by the Banking Association South Africa (BASA) on the "DTC First Interim Report on BEPS Action Plan 1" (25 March 2015) at 2.

DTC REPORT ON ACTIONS 8 TO 10: ALIGNING TRANSFER PRICING OUTCOMES WITH VALUE CREATION; AND 13: RE-EXAMINING TRANSFER PRICING DOCUMENTATION

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1 GENERAL ON TRANSFER PRICING

"Over several decades and in step with the globalisation of the economy, world-wide intra-group trade has grown exponentially"[1] This together with differing tax rates adopted by countries who guard their sovereign rights to determine their own tax regimes, has encouraged multinational companies to get involved in transfer pricing planning schemes.

The term "transfer pricing" describes the process by which related entities set prices at which they transfer goods or services between each other.[2] When multinational companies operate in different countries, where they are subject to different tax laws, they may resort to structuring their affairs in order to achieve a transfer pricing outcome whereby profits are lower in a country with higher tax rates and yet higher in a country with lower tax rates.[3]

Global bodies[4] which advise Governments on tax policy setting generally recommend the use of the arm's length principle in curbing transfer pricing. Paragraph 1 of Article 9 of the OECD MTC provides that when conditions are made or imposed between two associated enterprises in their commercial or financial relations, which differ from those which would have been made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

The 2013 OECD Report on Base Erosion and Profit Shifting (BEPS)[5] noted that although, in many instances, the arm's length principle has effectively and efficiently allocated the income of multinationals among taxing jurisdictions, and although it has proven useful as a practical and balanced standard for tax administrations and taxpayers to evaluate transfer prices between associated enterprises, and to prevent double taxation, in other instances multinationals have been able to use and/or misapply those rules to separate income from the economic activities that produce income and to "shift" the income into low-tax environments.

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1 OECD/G20 2015 Final Report on Actions 8-10 at 9.

2 South African Revenue Services Practice Note No. 7 'Section 31 of the Income Tax Act, 1962: *Determination of Taxable Income of Certain Persons from International Taxation: Transfer Pricing* (6 Aug 1999) in par 2.1.

3 A Ginsberg *International Tax Havens* 2nd ed (1997) at 20.

4 For example the OECD and the UN Model Tax conventions.

5 OECD *Action Plan on Base Erosion and Profit Shifting* (2013) at 20.

With the arm's length principle's perceived emphasis on contractual allocations of functions, assets and risks, the existing guidance on the application of the principle has also proven vulnerable to manipulation. This manipulation can lead to outcomes which do not correspond to the value created through the underlying economic activity carried out by the members of an MNE group.[6]

Therefore, the BEPS Action Plan requires the guidance on the arm's length principle to be clarified and strengthened and, furthermore, if transfer pricing risks remain after clarifying and strengthening the guidance, the BEPS Action Plan foresees the possibility of introducing special measures either within or beyond the arm's length principle. [7]

The OECD's work on transfer pricing under the BEPS Action Plan focuses on four key areas.

- Action 8 deals with transfer pricing issues relating to transactions involving intangibles, since misallocation of the profits generated by valuable intangibles has contributed to base erosion and profit shifting.
- Action 9 deals with the contractual allocation of risks, and the resulting allocation of profits to those risks, which may not correspond with the activities actually carried out. The guidelines set out under this Action effectively set out the underlying principles to be followed under the other OECD guidelines (e.g. Action 8), in order to achieve the arm's length principle.
    - Action 9 also addresses the level of returns to funding provided by a capital-rich MNE group member, where those returns do not correspond to the level of activity undertaken by the funding company.
- Action 10 focuses on other high-risk areas. These include:
    - the scope for addressing profit allocations resulting from transactions which are not commercially rational for the individual enterprises concerned (re-characterisation);
    - the scope for targeting the use of transfer pricing methods in a way which results in diverting profits from the most economically important activities of the MNE group; and
    - neutralising the use of certain types of payments between members of the MNE group (such as management fees and head office expenses) to erode the tax base in the absence of alignment with value creation.
- Action 13 re-examines transfer pricing documentation with a view to enhancing transparency for tax administrations by ensuring that they will be provided with adequate information to conduct transfer pricing risk assessments and examination. This is considered to be an essential part of tackling the BEPS problem. Action 13 thus introduces the country by country reporting standard.

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6 OECD/G20 2015 Final Report on Actions 8-10 at 9.
7 OECD/G20 2015 Final Report on Actions 8-10 at 9.

In reviewing the above aspects of the OECD BEPS recommendations it is important to bear in mind the OECD's views on how they are to be implemented:[8] the country by country reporting standard, recommended in Action 13, is viewed as a minimum standard (ie all countries should commit to consistent application thereof). Actions 8-10 reinforce international standards to eliminate double taxation, in order to stop abuses and close BEPS opportunities.

The OECD's Report on Actions 8-10 contains detailed revised guidance which responds to the above issues and ensures that the transfer pricing rules secure outcomes that see operational profits allocated to the economic activities which generate them. The guidance in the Report takes the form of specific amendments to the Transfer Pricing Guidelines.[9]

The guidance on Actions 8-10 is linked in a holistic way with other Actions, in particular:

- interest deductibility rules in Action 4 - with regard to capital-rich entities.
- preventing treaty abuse in Action 6.
- CFC rules under Action 3.
- Since transfer pricing analysis depends on access to relevant information, access to the transfer pricing documentation under Action 13 is relevant and, since these aspects (analysis and documentation) are so intrinsically linked the discussion on the re-examination of transfer pricing documentation is included in this report.
- Since transfer pricing depends on a facts and circumstances analysis and can involve subjective interpretations of these facts and circumstances, in order to address the risk of double taxation, the work under Action 14 to improve the effectiveness of dispute resolution mechanisms includes a new minimum standard providing for access to the Mutual Agreement Procedure of Article 25 of the Model Tax Convention for all transfer pricing cases.

The OECD Final Report on Actions 8-10 also contains guidance on transactions involving commodities as well as on low value-adding intra-group services. These two areas were identified by developing countries as being of critical importance to them since they create additional transfer pricing BEPS challenges for developing countries. Guidance on these matters in Action 8-10 will be supplemented with further work mandated by the G20 Development Working Group, which will provide knowledge, best practices, and tools for developing countries to use to price commodity transactions for transfer pricing purposes and to prevent the erosion of their tax bases through common types of base eroding payments. [10]

8 OECD/G20 BEPS Explanatory Statement.
9 OECD/G20 2015 Final Report on Actions 8-10 at 10.
10 OECD/G20 2015 Final Report on Actions 8-10 at 11.

In a nutshell, the work under Actions 8-10 of the BEPS Action Plan will ensure that transfer pricing outcomes better align with value creation of the MNE group. Moreover, the holistic nature of the BEPS Action Plan will ensure that the role of capital-rich, low-functioning entities in BEPS planning will become less relevant. As a consequence, the goals set by the BEPS Action Plan in relation to the development of transfer pricing rules have been achieved without the need to develop special measures outside the arm's length principle.

Commentators, like Chorvat[11], have proposed, especially in relation to intangibles, the use of financial/economic models as a way to allocate profits among related parties. She suggests the use of models such as the "Capital Asset Pricing Model" which allocates value based on capital and risk. Chorvat[12] argues that such a model allows for the allocation of profits among related parties based on the risk assumed. She notes that this would better comprehend corporate behaviour, aid in alleviating the shortcomings of the traditional arm's length approach and is consistent with economic theory.[13]

It should be noted, however, that the BEPS Action Plan rejects a radical switch to a formulary apportionment system ("Unitary approach") in resolving these transfer pricing problems. Rather, due to difficulties in developing such a method which would be suitable for universal adoption[14], it advocates building on the existing separate entity approach in terms of the arm's length principle. That notwithstanding, the essence of the favoured approach should, the DTC submits, give rise to similar results to what, it is advocated, the unitary approach should achieve.

This is due to the principle, set out in the proposed revised guidelines emanating from Actions 8-10, that profits arise where activities take place and value is created. Furthermore, increased transparency of the results of the arm's length principle (as determined through the recommendations on documentation as indicated by Action 13, including country-by-country reporting), will increase the ability of Revenue authorities to establish the position.

Thus, although the allocation of an MNE's global profits will not be based on a 'formula', by using factors which quantify the actual geographical location of its activities, and applying the arm's length principle to those activities with the benefit of visibility of where all other activities take place, tax administrations, like SARS, will be able to secure tax on the income which reflects the true profits based on South African activities, risks and functions[15].

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11 Chorvat at 1266.

12 Chorvat at 1260.

13 Chorvat at 1260.

14 Explanation by UN representative, Ilke Ritter, at TP Minds seminar, Cape Town, 24/25 November 2015.

15 Objective supported by SACTWU submission 18/8/2015 at 3/4.

It should further be noted that the OECD has indicated that further work will be undertaken on the transactional profit split method (TPSM) and financial transactions.[16]

In addition to the discussion on Actions 8-10 and 13 of the BEPS Action Plan, this report will cover the question of the suitability of, and need for, advance pricing agreements (APA's) in the South African transfer pricing context. It should be noted that APA's are also discussed in the DTC report on Action 14.

The concepts of transfer pricing and "Illicit financial flows" are often confused and it is important to distinguish these two concepts upfront. 'Transfer pricing' is, as indicated above, simply the price at which goods and services are transferred between connected parties. Provided the arrangements between the parties, and the consequent pricing, reflect what would arise between unconnected parties acting in their own interests (ie a price that would be negotiated arm's length), the transfer pricing is not illegal, and cannot be viewed as an 'illicit financial flow".

An 'illicit financial flow' is "money that is illegally earned, transferred or utilized. If it breaks laws in its origin, movement or use, it merits the label".[17] Such flows include the proceeds of activities commonly understood to be illegal eg money laundering (drugs, arms etc) but also include the proceeds of such illegal activities as tax evasion. This can, thus, include illegal transfer mis-pricing[18]. Actions to counter BEPS can thus assist in countering illicit financial flows[19] but are not designed specifically, or only, for that purpose, as to counter such flows requires a much broader initiative. (It should be noted that a combination of South African organisations and government departments are working together to combat illicit financial flows).[20]

The transfer pricing guidelines issued by the OECD and UN are designed to assist MNEs to determine what the arm's length market prices and arrangements of their cross border arrangements should be, and how, once determined, they can demonstrate this to tax administrations. Since, as indicated above, the rules have not been clear and transparent enough to achieve this objective in the past, the Reports on Actions 8-10 and 13 have been designed to significantly tighten the guidelines to ensure the arm's length principle is achieved.

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16 OECD/G20 2015 Final Report on Actions 8-10 at 12.

17 "Illicit Financial Flows from Africa: Hidden Resources for Development" by Global Financial Integrity (prepared by Dev Kar and Devon Cartwright Smith (www.gfip.org) at p7.

18 Presentation by Kathy Nicolaou-Manias on 'Illicit Financial Flows, AbusiveTransfer Pricing and Trade Mis-pricing' (11 Sept 2015) Slide 5.

19 Ibid.

20 Presentation by Kathy Nicolaou-Manias on 'Illicit Financial Flows, AbusiveTransfer Pricing and Trade Mis-pricing' (11 Sept 2015) Slide 19.

2 OECD GUIDANCE FOR APPLYING THE ARM'S LENGTH PRINCIPLE

The guidance set out in the OECD's 2015 Final Report on Actions 8-10 requires the development of transfer pricing rules which create transfer pricing outcomes in line with value creation. In this regard, the current provisions of Chapter I, Section D of the 1995 Transfer Pricing Guidelines are deleted in their entirety and replaced.

In brief, the revised guidance[21] advocates analysing the contractual obligations between the parties against the actual transaction between the parties, and ensuring that the profits are allocated where value is created. It furthermore, guardedly, advocates the disregard of transactions that lack commercial rationality.

So, for example:

- where a company contractually assumes risks over which it has no meaningful control or financial capacity to assume them, the risks and consequent rewards related thereto are to be allocated to the party who does.
- Similarly for intangibles, the income is to be allocated to the companies which perform important functions, control economically significant risks and contribute assets.
- A capital-rich company merely providing funds to a group company without assessing financial risk will be entitled only to a risk-free return, or less. Such "cash-boxes" will thus not be entitled to excessive profits.

The importance of the adoption of the recommendations made in Action 13 (documentation and transparency) in achieving the successful implementation of the arm's length principle for the intra group movement of goods and services, covered in Actions 8 to 10, globally, is emphasised.

Furthermore, as indicated above, the need for using dispute resolution procedures in the form of Mutual Agreement Procedures (see DTC work on Action 14) to ensure double taxation does not arise as a consequence of different transfer pricing results being determined by different tax authorities is clear.

The details of the revised Chapter 1, Section D are as follows:

OECD notes that "comparability analysis" is at the heart of the application of the arm's length principle. Application of the arm's length principle is based on a comparison of the conditions in a controlled transaction with the conditions that would have been made had the parties been independent and undertaking a comparable transaction under comparable circumstances. There are two key aspects in such an analysis:

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21 OECD/G20 2015 Final Report on Actions 8-10.

- the first aspect is to identify the commercial or financial relations between the associated enterprises and the conditions and economically relevant circumstances attaching to those relations in order that the controlled transaction is accurately delineated; and
- the second aspect is to compare the conditions and the economically relevant circumstances of the controlled transaction as accurately delineated with the conditions and the economically relevant circumstances of comparable transactions between independent enterprises.

In this regard, the OECD provides the following guidance on identifying the commercial or financial relations between the associated enterprises and on accurately delineating the controlled transaction.[22]

2.1 IDENTIFYING THE COMMERCIAL OR FINANCIAL RELATIONS

The typical process of identifying the commercial or financial relations between the associated enterprises and the conditions and economically relevant circumstances attaching to those relations requires a broad-based understanding of the industry sector in which the MNE group operates (e.g. mining, pharmaceutical, luxury goods) and of the factors affecting the performance of any business operating in that sector. The understanding is derived from an overview of the particular MNE group which outlines how the MNE group responds to the factors affecting performance in the sector, including its business strategies, markets, products, its supply chain, and the key functions performed, material assets used, and important risks assumed. This information is likely to be included as part of the master file as described in Action 13 in support of a taxpayer's analysis of its transfer pricing, and provides useful context in which the commercial or financial relations between members of the MNE group can be considered.[23]

The process then narrows to identify how each MNE within that MNE group operates, and provides an analysis of what each MNE does (e.g. a production company, a sales company) and identifies its commercial or financial relations with associated enterprises as expressed in transactions between them. The accurate delineation of the actual transaction or transactions between the associated enterprises requires an analysis of the economically relevant characteristics of the transaction. These economically relevant characteristics consist of the conditions of the transaction and the economically relevant circumstances in which the transaction takes place. The application of the arm's length principle depends on determining the conditions that independent parties would have agreed in comparable transactions in comparable circumstances. Before making comparisons with uncontrolled

22 OECD/G20 2015 Final Report on Actions 8-10 in para 1.33.
23 OECD/G20 2015 Final Report on Actions 8-10 in para 1.33.

transactions, it is therefore vital to identify the economically relevant characteristics of the commercial or financial relations as expressed in the controlled transaction. [24]

The economically relevant characteristics or comparability factors that need to be identified in the commercial or financial relations between the associated enterprises in order to accurately delineate the actual transaction can be broadly categorised as follows (explained in some detail below):

- The contractual terms of the transaction.
- The functions performed by each of the parties to the transaction, taking into account assets used and risks assumed, including how those functions relate to the wider generation of value by the MNE group to which the parties belong, the circumstances surrounding the transaction, and industry practices.
- The characteristics of property transferred or services provided.
- The economic circumstances of the parties and of the market in which the parties operate.
- The business strategies pursued by the parties.

This information about the economically relevant characteristics of the actual transaction should be included as part of the local file (for purposes of Action 13) in support of a taxpayer's analysis of its transfer pricing. [25]

(i) <u>The contractual terms of the transaction</u>

A transaction is the consequence or expression of the commercial or financial relations between the parties. The controlled transactions may have been formalised in written contracts which may reflect the intention of the parties at the time the contract was concluded in relation to aspects of the transaction covered by the contract including, in typical cases, the division of responsibilities, obligations and rights, assumption of identified risks, and pricing arrangements. Where a transaction has been formalised by the associated enterprises through written contractual agreements, those agreements provide the starting point for delineating the transaction between them and how the responsibilities, risks, and anticipated outcomes arising from their interaction were intended to be divided at the time of entering into the contract. The terms of a transaction may also be found in communications between the parties other than a written contract. [26]

However, the written contracts alone are unlikely to provide all the information necessary to perform a transfer pricing analysis, or to provide information regarding the relevant contractual terms in sufficient detail. Further information will be required by taking into consideration evidence of the commercial or financial relations provided by the economically relevant characteristics: the functions performed by each of the parties to the transaction, taking into account assets used and risks

[24] OECD/G20 2015 Final Report on Actions 8-10 in para 1.34.
[25] OECD/G20 2015 Final Report on Actions 8-10 in para 1.36.
[26] OECD/G20 2015 Final Report on Actions 8-10 in para 1.42.

assumed, together with the characteristics of property transferred or services provided, the economic circumstances of the parties and of the market in which the parties operate, and the business strategies pursued by the parties. Taken together, the analysis of economically relevant characteristics in all five categories provides evidence of the actual conduct of the associated enterprises. [27]

(ii) Functional analysis

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 delineating the controlled transaction and determining comparability between controlled and uncontrolled transactions or entities, a functional analysis is necessary. This functional analysis seeks to identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed by the parties to the transactions.

The analysis for each transaction focuses on what the parties actually do and the capabilities they provide. Such activities and capabilities will include decision-making, including decisions about business strategy and risks. For this purpose, it may be helpful to understand the structure and organisation of the MNE group and how they influence the context in which the MNE operates. In particular, it is important to understand how value is generated by the group as a whole, the interdependencies of the functions performed by the associated enterprises with the rest of the group, and the contribution that the associated enterprises make to that value creation. It will also be relevant to determine the legal rights and obligations of each of the parties in performing their functions. While one party may provide a large number of functions relative to that of the other party to the transaction, it is the economic significance of those functions in terms of their frequency, nature, and value to the respective parties to the transactions that is important. [28]

The functional analysis should consider the type of assets used, such as plant and equipment, the use of valuable intangibles, financial assets, etc., and the nature of the assets used, such as the age, market value, location, property right protections available, etc. [29]

Analysis of risks in commercial or financial relations

A functional analysis is incomplete unless the material risks assumed by each party have been identified and considered, since the actual assumption of risks would influence the prices and other conditions of transactions between the associated enterprises. A detailed discussion of this process is set out in the discussion on Action 9 (see 3.1 *et seq* below.

27 OECD/G20 2015 Final Report on Actions 8-10 in para 1.43.
28 OECD/G20 2015 Final Report on Actions 8-10 in para 1.51.
29 OECD/G20 2015 Final Report on Actions 8-10 in para 1.54.

(iii) Characteristics of property or services

Differences in the specific characteristics of property or services often account, at least in part, for differences in their value in the open market. Therefore, comparisons of these features may be useful in delineating the transaction and in determining the comparability of controlled and uncontrolled transactions. Characteristics that may be important to consider include the following: in the case of transfers of tangible property, the physical features of the property, its quality and reliability, and the availability and volume of supply; in the case of the provision of services, the nature and extent of the services; and in the case of intangible property, the form of transaction (e.g. licensing or sale), the type of property (e.g. patent, trademark, or know-how), the duration and degree of protection, and the anticipated benefits from the use of the property. [30]

(iv) Economic circumstances

Arm's length prices may vary across different markets even for transactions involving the same property or services. Therefore, to achieve comparability requires that the markets in which the independent and associated enterprises operate do not have differences that have a material effect on price or that appropriate adjustments can be made. As a first step, it is essential to identify the relevant market or markets, taking account of available substitute goods or services. Economic circumstances that may be relevant to determining market comparability include the geographic location; the size of the markets; the extent of competition in the markets and the relative competitive positions of the buyers and sellers; the availability (risk thereof) of substitute goods and services; the levels of supply and demand in the market as a whole and in which particular regions, if relevant; consumer purchasing power; the nature and extent of government regulation of the market; costs of production, including the costs of land, labour, and capital; transport costs; the level of the market (e.g. retail or wholesale); the date and time of transactions; and so forth. [31]

(iv) Business strategies pursued by the parties.

Business strategies must also be examined in delineating the transaction and in determining comparability for transfer pricing purposes. Business strategies would take into account many aspects of an enterprise, such as innovation and new product development, degree of diversification, risk aversion, assessment of political changes, input of existing and planned labour laws, duration of arrangements, and other factors bearing upon the daily conduct of business. Such business strategies may need to be taken into account when determining the comparability of controlled and uncontrolled transactions and enterprises. [32]

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30 OECD/G20 2015 Final Report on Actions 8-10 in para 1.107.

31 OECD/G20 2015 Final Report on Actions 8-10 in para 1.110.

32 OECD/G20 2015 Final Report on Actions 8-10 in para 1.114.

2.2 RECOGNITION OF THE ACCURATELY DELINEATED TRANSACTION

Every effort should be made to determine pricing for the actual transaction as accurately delineated under the arm's length principle. A tax administration should not disregard the actual transaction or substitute other transactions for it unless there are exceptional circumstances.[33] Because non-recognition can be contentious and a source of double taxation, every effort should be made to determine the actual nature of the transaction and apply arm's length pricing to the accurately delineated transaction, and to ensure that non-recognition is not used simply because determining an arm's length price is difficult. The key question in the analysis is whether the actual transaction possesses the commercial rationality of arrangements that would be agreed between unrelated parties under comparable economic circumstances, not whether the same transaction can be observed between independent parties. The non-recognition of a transaction that possesses the commercial rationality of an arm's length arrangement is not an appropriate application of the arm's length principle.[34]

2.3 LOSSES

When an associated enterprise consistently realizes losses while the MNE group as a whole is profitable, the facts could trigger some special scrutiny of transfer pricing issues. Of course, associated enterprises, like independent enterprises, can sustain genuine losses, whether due to heavy start-up costs, unfavourable economic conditions, inefficiencies, or other legitimate business reasons. However, an independent enterprise would not be prepared to tolerate losses that continue indefinitely. An independent enterprise that experiences recurring losses will eventually cease to undertake business on such terms. In contrast, an associated enterprise that realizes losses may remain in business if the business is beneficial to the MNE group as a whole.[35]

2.4 THE EFFECT OF GOVERNMENT POLICIES

There are some circumstances in which a taxpayer will consider that an arm's length price must be adjusted to account for government interventions such as price controls (even price cuts), interest rate controls, controls over payments for services or management fees, controls over the payment of royalties, subsidies to particular sectors, exchange control, anti-dumping duties, or exchange rate policy. As a general rule, these government interventions should be treated as conditions of the market in the particular country, and in the ordinary course they should be taken into account in evaluating the taxpayer's transfer price in that market. The question then presented is whether in light of these conditions the transactions undertaken by the

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[33] OECD/G20 2015 Final Report on Actions 8-10 in para 1.121.
[34] OECD/G20 2015 Final Report on Actions 8-10 in para 1.123.
[35] OECD/G20 2015 Final Report on Actions 8-10 in para 1.129.

controlled parties are consistent with transactions between independent enterprises.[36]

2.5 USE OF CUSTOMS VALUATIONS

The arm's length principle is applied, broadly speaking, by many customs administrations as a principle of comparison between the value attributable to goods imported by associated enterprises, which may be affected by the special relationship between them, and the value for similar goods imported by independent enterprises. Valuation methods for customs purposes, however, may not be aligned with the OECD's recognised transfer pricing methods. That being said, customs valuations may be useful to tax administrations in evaluating the arm's length character of a controlled transaction transfer price and vice versa. In particular, customs officials may have contemporaneous information regarding the transaction that could be relevant for transfer pricing purposes, especially if prepared by the taxpayer, while tax authorities may have transfer pricing documentation which provides detailed information on the circumstances of the transaction. [37]

2.6 LOCATION SAVINGS AND OTHER LOCAL MARKET FEATURES

The features of the geographic market in which business operations occur can affect comparability and arm's length prices. Difficult issues can arise in evaluating differences between geographic markets and in determining appropriate comparability adjustments. Such issues may arise in connection with the consideration of cost savings attributable to operating in a particular market. Such savings are sometimes referred to as location savings. In other situations comparability issues can arise in connection with the consideration of local market advantages or disadvantages that may not be directly related to location savings. [38]

<u>Location savings</u>

In determining how location savings are to be shared between two or more associated enterprises, it is necessary to consider (i) whether location savings exist; (ii) the amount of any location savings; (iii) the extent to which location savings are either retained by a member or members of the MNE group or are passed on to independent customers or suppliers; and (iv) where location savings are not fully passed on to independent customers or suppliers, the manner in which independent enterprises operating under similar circumstances would allocate any retained net location savings. [39]

<u>Other local market features</u>

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36 OECD/G20 2015 Final Report on Actions 8-10 in para 1.132.
37 OECD/G20 2015 Final Report on Actions 8-10 in para 1.137.
38 OECD/G20 2015 Final Report on Actions 8-10 in para 1.139.
39 OECD/G20 2015 Final Report on Actions 8-10 in para 1.141.

Features of the local market in which business operations occur may affect the arm's length price with respect to transactions between associated enterprises. While some such features may give rise to location savings, others may give rise to comparability concerns not directly related to such savings. For example, the comparability and functional analysis conducted in connection with a particular matter may suggest that the relevant characteristics of the geographic market in which products are manufactured or sold, the purchasing power and product preferences of households in that market, whether the market is expanding or contracting, the degree of competition in the market and other similar factors affect prices and margins that can be realised in the market. Similarly, the comparability and functional analysis conducted in connection with a particular matter may suggest that the relative availability of local country infrastructure, the relative availability of a pool of trained or educated workers, proximity to profitable markets, and similar features in a geographic market where business operations occur create market advantages or disadvantages that should be taken into account. Appropriate comparability adjustments should be made to account for such factors where reliable adjustments that will improve comparability can be identified. [40]

2.7 ASSEMBLED WORKFORCE

Some businesses are successful in assembling a uniquely qualified or experienced cadre of employees. The existence of such an employee group may affect the arm's length price for services provided by the employee group or the efficiency with which services are provided or goods produced by the enterprise. Such factors should ordinarily be taken into account in a transfer pricing comparability analysis. Where it is possible to determine the benefits or detriments of a unique assembled workforce *vis-à-vis* the workforce of enterprises engaging in potentially comparable transactions, comparability adjustments may be made to reflect the impact of the assembled workforce on arm's length prices for goods or services. [41]

2.8 MNE GROUP SYNERGIES

Comparability issues, and the need for comparability adjustments, can also arise because of the existence of MNE group synergies. In some circumstances, MNE groups and the associated enterprises that comprise such groups may benefit from interactions or synergies amongst group members that would not generally be available to similarly situated independent enterprises. Such group synergies can arise, for example, as a result of combined purchasing power or economies of scale, combined and integrated computer and communication systems, integrated management, elimination of duplication, increased borrowing capacity, and numerous similar factors. Such group synergies are often favourable to the group as

[40] OECD/G20 2015 Final Report on Actions 8-10 in para 1.144.
[41] OECD/G20 2015 Final Report on Actions 8-10 in para 1.152.

a whole and therefore may heighten the aggregate profits earned by group members, depending on whether expected cost savings are, in fact, realised, and on competitive conditions. In other circumstances such synergies may be negative, as when the size and scope of corporate operations create bureaucratic barriers not faced by smaller and more nimble enterprises, or when one portion of the business is forced to work with computer or communication systems that are not the most efficient for its business because of group wide standards established by the MNE group.[42]

2.9 CONCLUSION

Only once comparability, as set out above, has been established, can truly effective benchmarking be performed.

3 GENERAL ON TRANSFER PRICING IN SOUTH AFRICA

South Africa has transfer pricing legislation in section 31 of the Income Tax Act ("ITA"). As the OECD recommends, South Africa applies the arm's length principle to curb transfer pricing. The legislation focusses on cross-border transactions, operations, schemes, agreements or understandings that have been effected between, or undertaken for the benefit of, connected persons. If the terms or conditions made or imposed by the connected persons differ from the terms and conditions that would have otherwise existed between independent persons transacting 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 benefitted must be calculated as if the terms and conditions had been at arm's length. To determine an arm's length price South Africa makes use of the methods set out in the OECD Transfer Pricing Guidelines,[43] which are also set out in SARS Practice Note 7.[44]

There have been no cases covering transfer pricing issues that have been heard in the South African tax or higher courts. A number of cases have, however, been settled between the taxpayers and SARS prior to reaching court, the details of which are not available to the public. The "Large Business Centre" (LBC) at SARS is the one that deals with transfer pricing issues.

Transfer pricing is a key focus area for SARS and an integral part of the Compliance Programme announced by the Minister of Finance. The Programme aims to protect the depletion of the tax base as a result of base erosion and profit shifting.

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[42] OECD/G20 2015 Final Report on Actions 8-10 in para 1.157.
[43] OECD *Transfer Pricing for Multinational Enterprises and Administrations* (July 2010).
[44] SARS Practice Note No. 7 in par 9.1.2 - 9.1.3.

It is impossible to reliably calculate the extent of base erosion and profit shifting as a result of transfer pricing structures or transfer mis-pricing (evasion). In an effort to determine some sense of the magnitude of the transfer pricing BEPS challenge, the DTC has been advised that SARS has had consultations with the South African Reserve Bank to get an indication of the numbers of payments directed offshore. The Reserve Bank indicated that tracking the import and export of physical goods through formal trade channels was not particularly challenging, as major risks were classified and value of goods was disclosed. However, non-goods trade, such as services, royalties, and licence fees, because they are intangible, do not necessarily follow easily defined or clear transaction lines. There is a level of ambiguity present in the nature of these transactions as well as the values associated with it. In this ambiguous domain, non-goods transactions are rife and pricing mechanisms overly complex, with multiple layers attached to them.

Recommendations on transfer pricing in general

- Although the report on Actions 8-10 indicates that further work is still to follow, based on the DTC's analysis of the recommended changes to be made to the Transfer Pricing Guidelines as a consequence of the Action 8-10 report, and in line with the recommendations on the Action 13 report (see part 10 below), the DTC recommends that, in order to reduce the incidence of income not being taxed in South Africa when the risks, functions and values actually take place here, South Africa adopts all the recommendations pertaining to transfer pricing rules.
- It also recommends that the South African legislators should ensure that section 31 of the ITA refers to the OECD guidelines on the basis that it is obligatory to apply these guidelines for companies that are part of a group that falls above the threshold (EU750mn) requiring country by country reporting, but also recommended for smaller companies. Thus, as part of the mandatory application for groups above the threshold, it is recommended that all the documentation requirements should also be compulsory. This will ensure global consistency of application and documentation for such groups, as is recommended by the OECD.
- The legislators should, thus, ensure that section 31 of the Income Tax Act refers to the OECD guidelines. This is stated in SARS Practice Note 7, but SARS Practice Notes are not legally binding. At least one legally binding General Ruling, as provided for in section 89 of the Tax Administration Act, 2011, should be enacted on section 31. Without departing from the OECD Transfer Pricing Guidelines, the suggested General Ruling should include a set of principles reflecting the South African reality.
- Reference to the OECD Guidelines in section 31 will address any ambiguities and inconsistencies that may occur where the OECD Transfer Pricing Guidelines are for example updated, and the proposed updated South African Transfer Pricing Guidance is not. This will ensure clarity and foster a system

on which foreign investors can rely (in line with the National Development Plan), it is submitted that following the OECD Transfer Pricing Guidelines is preferable to ensure international compatibility, clarity and consistency.[45]

- In addition, the DTC recommends that it only be mandatory to take account of location savings advantages/disadvantages when determining the arm's length price following upon the issue of guidance by SARS/ Treasury as to how to make the specific adjustments for South Africa's specific circumstances.[46]
- The DTC, however, cautions that the determination of what is and what is not a "commercial transaction" may be difficult to determine and that the principles set out in South Africa's current general anti-avoidance rules be relied upon to determine whether SARS may simply ignore a transaction altogether.[47]
- It is also recommended that, for the purposes of providing certainty to inbound investors where loans are not significant, the BGR defines a safe harbour e.g debt to equity ratio (or in line with section 23M of the ITA), together with an interest rate (e.g. prime +2% - or in line with prevailing excon requirements) for inbound loans not exceeding, say, R100mn. In this manner inbound investors will obtain the certainty they need regarding loan requirements without having to expend significant amounts, on professional fees, to determine an arm's length amount for loans below the pre-defined limit. Without departing from the OECD Transfer Pricing Guidelines, the suggested BGR should include a set of principles reflecting the South African reality i.e as indicated above, guidance on local adjustments that should be made to non-South African comparables, safe harbours etc. (see also commentary on Actions 4 and 10 for more discussion on this point).
- The implementation of an Advanced Pricing Agreement (APA) regime would also facilitate certainty for investors. When APAs are introduced in South Africa, resourcing will be needed to build an Advanced Pricing Agreement unit (see section 8 below).
- As there are no South African company databases available to assist in determining an arm's length price in South Africa, and in order to ensure a level playing field for companies operating in South Africa and provide certainty, SARS/ Treasury should issue a set of guidelines for making adjustments to predefined global comparables to take account of the South African environment or, alternatively, make a decision not to require adjustment; It is, however, reiterated, as set out above that it is also recommended that, in order to ensure consistency and certainty, SARS/Treasury do not require locational (dis)advantage adjustments until it has issued such guidelines thereon, based on specifically defined country database sets.

45 SAICA "Comment on DTC 1st Interim BEPS Report" (31 March 2015) para 17 and 18.
46 Per recommendation by Deloitte 26 July 2015 at 7.
47 Per recommendation by Deloitte 26 July 2015 at 7.

- SARS should ensure that the enforcement capacity of its transfer pricing unit is adequate. It should also ensure that there is sufficient transfer pricing training and capacity building in its transfer pricing unit to audit the results[48].

The DTC, however, cautions that, although the objective of the transfer pricing rules, proposed by the OECD, is to secure the taxation of the profits of MNE's in those countries where the functions, risks, and value lie, South Africa could be a net loser in the equation if it fails to successfully lure MNE's to the country, due to other unattractive non-tax practices and policies.

The review of the detailed OECD recommendations, set out below, commences with Action 9, as the principles and guidelines set out therein set out the basis for those provided in the remaining actions 8, 10 and 13.

4 ACTION 9: ASSURE TRANSFER PRICING OUTCOMES ARE IN LINE WITH VALUE CREATION WITH REGARD TO RISKS AND CAPITAL

Determining risk is a matter that is difficult to determine in practice.
Commentators such as Monsenego[49] note the following:

> "The scope of the notion of risk may be difficult to determine. For example, if a distributor sells a drug that is proved to have side effects, risks may include decreased sales of the drug, damages paid to customers, bad reputation etc. In addition, each of these risks may have consequences from both a geographical and time perspective".

The above difficulties of determining risk have been compounded by the fact the 1995 OECD Transfer Pricing Guidelines did not provide a clear definition of the notion of risk, so differences in view existed regarding the extent to which risk is or may be assumed by associated enterprises so as to satisfy the economic substance requirement. This resulted in potentially conflicting views between tax administrators and taxpayers regarding whether or not a risk should be assumed by such associated enterprise.[50] Chorvat[51] for instance notes that "because current transfer pricing methods depend upon comparable transactions, the allocation of risk is inadequately addressed for transactions involving intangibles".

Writing on this matter, in 2003, Chorvat[52] suggested that a functional analysis (as applied in order to determine an arm's length return) should include a process analysis which considers the business risks and responsibilities of each business unit, the identifying aspects of the value added process which contribute to profit,

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48 Per SACTWU submission 18 August 2015 at 4.

49 J Monsenego "The Substance requirement in the OECD Transfer Pricing Guidelines: What is the substance of the substance requirement?" (January/February 2014) *International Transfer Pricing Journal* at 13.

50 Monsenego at 13.

51 E Chorvat "Forcing Multinationals to Play Fair: Proposals for a Rigorous Transfer Pricing Theory" (2003) 54 *Alabama Law Review* at 1260.

52 Chorvat at 1279.

specifically (but not limited to) business strategy, management, support, sales and marketing, operations, procurement as well as after sales support.[53] A similar approach appears to be followed in Germany[54] where a distinction is drawn between intermittent and routine risk, with higher return suggested for intermittent than routine risk.[55]

When the OECD issued its 2013 BEPS Action Plan, attention was given, under Action 9, to ensuring that transfer pricing outcomes are in line with value creation with regard to risks and capital. Action 9 required that:

- Countries should develop rules to prevent BEPS that result from transferring risks among, or allocating excessive capital to, group members.
- This would involve adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital.
- The rules to be developed would also require that returns are aligned with value creation and that income is not separated from the economic activities that produce it.

On the international front, the OECD noted that its work on this Action Plan would be co-ordinated with the work on interest expense deductions and other financial payments.

In October 2015, the OECD released its final report on the combined Actions 8-10 which all deal with ensuring that transfer pricing outcomes are in line with value creation. With respect to risks, the OECD work resulted in revisions to Section D of Chapter I of the Transfer Pricing Guidelines. In terms of these revisions the OECD defines risks as “the effect of uncertainty on the objectives of the business”.[56] In all of a company’s operations, every step taken to exploit opportunities, every time a company spends money or generates income, uncertainty exists, and risk is assumed. No profit seeking business takes on risk associated with commercial opportunities without expecting a positive return. This economic notion- that higher risks warrant higher anticipated returns- is what makes MNE groups pursue tax planning strategies based on contractual re-allocations of risks, sometimes without any change in the business operations.

- In order to address this, the Report determines that risks contractually assumed by a party that cannot in fact exercise meaningful and specifically defined control over the risks, or do not have the financial capacity to assume

53 Chorvat at 1279.
54 Para 3b of the German Regulations on Documentation of Income Allocation (“GAufzV”).
55 A Voegele & C Zhang “Function and Risk Analysis in Germany” (2010) 11 *Corporate Business Taxation Monthly* at 16.
56 OECD/G20 2015 Final Report on Actions 8-10 at 10.

the risks, will be allocated to the party that does exercise such control and does have the financial capacity to assume the risks. [57]

- The revised guidance also addresses the situation where a capital-rich member of the group provides funding but performs few activities. If this associated enterprise does not in fact control the financial risks associated with its funding (for example because it just provides the money when it is asked to do so, without any assessment of whether the party receiving the money is creditworthy), then it will not be allocated the profits associated with the financial risks and will be entitled to no more than a risk-free return, or less if, for example, the transaction is not commercially rational and therefore the guidance on non-recognition applies. [58]

The guidance ensures that:

- actual business transactions undertaken by associated enterprises are identified, and transfer pricing is not based on contractual arrangements that do not reflect economic reality;
- contractual allocations of risk are respected only when they are supported by actual decision-making;
- capital without functionality will generate no more than a risk-free return, assuring that no premium returns will be allocated to cash boxes without relevant substance;
- tax administrations may disregard transactions when the exceptional circumstances of commercial irrationality apply; and
- The mere fact that a transaction can't be seen between the parties does not mean that it should not be recognized. [59]

The concerns regarding transfer pricing with respect to transferring risks and allocating excessive capital to group members have particular relevance to determining how the business currently operates as well as to business restructurings. Risk is intricately linked to the flow of capital within a group- this in turn has significant implications on profits. Due to the seemingly amorphous nature of risk, it is often difficult to quantify the risk involved as well as its degree of correlation to profits. From an economic perspective authors such as Chorvat[60] explain the linkage between risk and capital in the following manner:

> The question on how to allocate capital so as to maximise income has been studied by economists for decades, if not centuries. As long as one assumes that multinational enterprises are trying to maximize profits, the question of how to allocate income among members of an integrated group is very similar to the question of how the group should allocate among investments… Thus, if we can determine the amount of capital allocated to a business unit, and

[57] OECD/G20 2015 Final Report on Actions 8-10 at 10.
[58] OECD/G20 2015 Final Report on Actions 8-10 at 11.
[59] OECD/G20 2015 Final Report on Actions 8-10 at 13.
[60] E Chorvat "Forcing Multinationals to Play Fair: Proposals for a Rigorous Transfer Pricing Theory" (2003) 54 *Alabama Law Review* at 1266.

> the degree of risk to which that capital is subject, we should be able to determine the amount of income that should be allocated to that business unit.

Risk bears a strong relation to the capital flow of a multinational entity (whether through a capital outflow's effect on risk and return or via over-capitalising through loan finance and shifting profits through excessive interest). The concern for tax officials is, firstly, how to prevent the transfer of risks by multinational enterprises to group members, designed to divert returns to desired jurisdictions and, secondly, how best to align returns with actual value creation within the inter-enterprise context.

The OECD notes that the assumption of risk by a party to a transaction can significantly affect the pricing of that transaction at arm's length. To assume a risk for transfer pricing purposes, the associated enterprise needs to control the risk and have the financial capacity to assume the risk:[61]

- The guidance on risks helps to accurately determine the actual contributions made by an associated enterprise that solely provides capital. Where the capital provider does not exercise control over the investment risks that may give rise to premium returns, that associated enterprise should expect no more than a risk-free return.
- The revised guidance ensures that a transfer pricing analysis is based on an accurate delineation of what the associated enterprises actually contribute in the transaction, and not on contractual terms, including contractual assumption of risk, that are not in practice performed.
- The guidance provides a basis for any transfer pricing analysis, but in so doing it also addresses some of the key BEPS challenges: allocating risks on paper does not in itself shift profits.
- The revisions reinforce the need for tax administrations to be able to disregard transactions between associated enterprises when the exceptional circumstances of commercial irrationality apply. The guidance emphasises that the mere fact that the transaction may not be seen between independent parties does not mean that it should not be recognised. Instead, the key question is whether the actual transaction possesses the commercial rationality of arrangements that would be agreed between unrelated parties under comparable economic circumstances.
- the guidance responds to the mandate to prevent inappropriate returns to capital and misallocation of risk by encouraging thoroughness in determining the actual arrangements between the associated enterprises so that pricing takes into account the actual contributions of those parties, including risks actually assumed, and by authorizing the non-recognition of transactions which make no commercial sense. [62]

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[61] OECD/G20 2015 Final Report on Actions 8-10 at 14.
[62] OECD/G20 2015 Final Report on Actions 8-10 at 14.

The OECD recommends that the following relevant characteristics or comparability factors need to be identified in commercial or financial transactions between associated enterprises:

- The contractual terms. This is the starting point. However, other communications and actions will define whether these terms have been adhered to or are commercially realistic;
- The functions performed, taking into account assets used and risks assumed, will assist in the determining of the allocation of profits. The economic significance, in terms of frequency, nature and value to the respective parties to the transactions needs to be carefully evaluated. Fragmented activities need to be identified, the nature of their interdependencies and how they are coordinated. The ability of a party assuming a risk to, firstly, make the decision to bear that risk and, secondly, to carry the risk (together with risk mitigation strategies it adopts) needs to be determined, and the determination of another party that does so if these determinations fail. ('The purported assumption of risk ….when a risk outcome is certain is by definition not an assumption of risk, since there is no… risk. Similarly the *ex post* reallocations of risk by a tax administration, when outcomes are certain, may be inappropriate'[63];
- The characteristics of property transferred and services provided. Important characteristics include: for tangibles- physical features, their quality and reliability, availability and volume of supply; for services-nature and extent; for intangibles- form of transaction (license or sale, type (patent, trademark, know-how) duration and degree of protection and anticipated benefits;
- The economic circumstances of the parties. Comparability can be affected for equal transactions when they take place in different markets eg government policies like exchange controls and location savings. Thus, adjustments may be required to achieve true comparability.
- The business strategies of the parties eg market penetration schemes.

    - Regarding the penultimate bullet above, as there are no South African company databases available to assist in determining an arm's length price in South Africa, and in order to ensure a level playing field for companies operating in South Africa and provide certainty, DTC recommends that SARS/ Treasury issues a set of guidelines for making adjustments to predefined global comparables to take account of the South African environment or alternatively makes a decision not to require adjustment;

The factors, set out above are dealt with in more detail below.

4.1 TRANSFER PRICING FUNCTIONAL ANALYSIS WITH RESPECT TO RISK

[63] OECD/G20 2015 Final Report on Actions 8-10 at 28.

The general guidance on transfer pricing, as discussed above, also applies with respect to risks and capital. The OECD Guidance for applying the arm's length principle requires conducting a "comparability analysis" which is based on a comparison of the conditions in a controlled transaction with the conditions that would have been made had the parties been independent and undertaking a comparable transaction under comparable circumstances. The first step in carrying out a comparability analysis requires identifying the commercial or financial relations between the associated enterprises.[64]

The economically relevant characteristics or comparability factors that need to be identified in the commercial or financial relations between the associated enterprises requires one to determine the functions performed by each of the parties to the transaction, taking into account assets used and risks assumed.

4.2 ANALYSIS OF RISKS IN COMMERCIAL OR FINANCIAL RELATIONS

The OECD notes that a functional analysis is incomplete unless the material risks assumed by each party have been identified and considered since the actual assumption of risks would influence the prices and other conditions of transactions between the associated enterprises. Usually, in the open market, the assumption of increased risk would also be compensated by an increase in the expected return, although the actual return may or may not increase depending on the degree to which the risks are actually realised. The level and assumption of risk, therefore, are economically relevant characteristics that can be significant in determining the outcome of a transfer pricing analysis.[65] Further details on risk are dealt with in the discussion on Action 9 below, which deals with Guidance on "assure transfer pricing outcomes are in line with value creation with regard to risks and capital". The rest of the explanation below deals with other relevant issues relating to transfer pricing in general.

Risk is inherent in business activities. Enterprises undertake commercial activities because they seek opportunities to make profits, but those opportunities carry uncertainty that the required resources to pursue the opportunities either will be greater than expected or will not generate the expected returns. Identifying risks goes hand in hand with identifying functions and assets and is integral to the process of identifying the commercial or financial relations between the associated enterprises and of accurately delineating the transaction or transactions.[66]

The steps in the process for analysing risk in a controlled transaction, in order to accurately delineate the actual transaction in respect to that risk, can be summarised as follows:

[64] OECD/G20 2015 Final Report on Actions 8-10 in para 1.33
[65] OECD/G20 2015 Final Report on Actions 8-10 in para 1.56.
[66] OECD/G20 2015 Final Report on Actions 8-10 in para 1.57.

- Identify economically significant risks with specificity.
- Determine how specific, economically significant risks are contractually assumed by the associated enterprises under the terms of the transaction.
- Determine through a functional analysis how the associated enterprises that are parties to the transaction operate in relation to assumption and management of the specific, economically significant risks, and in particular which enterprise or enterprises perform control functions and risk mitigation functions, which enterprise or enterprises encounter upside or downside consequences of risk outcomes, and which enterprise or enterprises have the financial capacity to assume the risk.
- Steps 2-3 will have identified information relating to the assumption and management of risks in the controlled transaction. The next step is to interpret the information and determine whether the contractual assumption of risk is consistent with the conduct of the associated enterprises and other facts of the case by analysing:
    - whether the associated enterprises follow the contractual terms and
    - whether the party assuming risk, as analysed under (i), exercises control over the risk and has the financial capacity to assume the risk.
- The actual transaction, as accurately delineated by considering the evidence of all the economically relevant characteristics of the transaction, should then be priced taking into account the financial and other consequences of risk assumption, as appropriately allocated, and appropriately compensating risk management functions.[67]

The term "risk management" is used to refer to the function of assessing and responding to risk associated with commercial activity. Risk management comprises three elements:

- the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function;
- the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function; and
- the capability to mitigate risk, that is the capability to take measures that affect risk outcomes, together with the actual performance of such risk mitigation. [68]

Some risk management functions can be undertaken only by the party performing functions and using assets in creating and pursuing commercial opportunities, while

[67] OECD/G20 2015 Final Report on Actions 8-10 in para 1.60.
[68] OECD/G20 2015 Final Report on Actions 8-10 in para 1.61.

other risk management functions can be undertaken by a different party. Risk management should not be thought of as necessarily encompassing a separate function, requiring separate remuneration, distinct from the performance of the activities that optimise profits. [69]

It should also be noted that risk management is not the same as assuming a risk. Risk assumption means taking on the upside and downside consequences of the risk with the result that the party assuming a risk will also bear the financial and other consequences if the risk materialises. A party performing part of the risk management functions may not assume the risk that is the subject of its management activity, but may be hired to perform risk mitigation functions under the direction, and for the benefit, of the risk-assuming party. For example, the day-to-day mitigation of product recall risk may be outsourced to a party performing monitoring of quality control over a specific manufacturing process according to the specifications of the party assuming the risk. [70]

The financial capacity to assume risk can be defined as “access to funding to take on the risk or to lay off the risk, to pay for the risk mitigation functions and to bear the consequences of the risk if the risk materializes”. Access to funding by the party assuming the risk takes into account the available assets and the options realistically available to access additional liquidity, if needed, to cover the costs anticipated to arise should the risk materialise. This assessment should be made on the basis that the party assuming the risk is operating as an unrelated party in the same circumstances as the associated enterprise, as accurately delineated under the principles of this section. Where a party assuming risk receives intra-group funding to meet the funding demands in relation to the risk, the party providing the funding may assume financial risk but does not, merely as a consequence of providing funding, assume the specific risk that gives rise to the need for additional funding. Where the financial capacity to assume a risk is lacking, then the allocation of risk requires further consideration. [71]

Control over risk involves the first two elements of risk management defined above, that is:

- the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function and
- the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision making function. [72]

[69] OECD/G20 2015 Final Report on Actions 8-10 in para 1.62.
[70] OECD/G20 2015 Final Report on Actions 8-10 in para 1.63.
[71] OECD/G20 2015 Final Report on Actions 8-10 in para 1.64.
[72] OECD/G20 2015 Final Report on Actions 8-10 in para 1.65.

It is not necessary for a party to perform the day-to-day mitigation as, in having control of the risks, such day-to-day mitigation may be outsourced. However, where these day-today mitigation activities are outsourced, control of the risk would require capability to determine the objectives of the outsourced activities, to decide to hire the provider of the risk mitigation functions, to assess whether the objectives are being adequately met, and, where necessary, to decide to adapt or terminate the contract with that provider, together with the performance of such assessment and decision-making. In accordance with this definition of control, a party requires both capability and functional performance in order to exercise control over a risk. [73]

The capability to perform decision-making functions and the actual performance of such decision-making functions relating to a specific risk involve an understanding of the risk based on a relevant analysis of the information required for assessing the foreseeable downside and upside risk outcomes of such a decision and the consequences for the business of the enterprise. Decision-makers should possess competence and experience in the area of the particular risk for which the decision is being made and possess an understanding of the impact of their decision on the business. They should also have access to the relevant information, either by gathering this information themselves or by exercising authority to specify and obtain the relevant information to support the decision making process. [74]

Risk mitigation refers to measures taken that are expected to affect risk outcomes. Such measures may include measures that reduce the uncertainty or measures that reduce the consequences in the event that the downside impact of risk occurs. Control should not be interpreted as requiring risk mitigation measures to be adopted, since in assessing risks businesses may decide that the uncertainty associated with some risks, including risks that may be fundamental to their core business operations, after being evaluated, should be taken on and faced in order to create and maximise opportunities. [75]

4.3 THE PROCESS OF ANALYSING RISK

Step 1: Identify economically significant risks with specificity: There are many definitions of risk, but in a transfer pricing context it is appropriate to consider risk as the effect of uncertainty on the objectives of the business. In all of a company's operations, every step taken to exploit opportunities, every time a company spends money or generates income, uncertainty exists, and risk is assumed. A company is likely to direct much attention to identifying uncertainties it encounters, in evaluating whether and how business opportunities should be pursued in view of their inherent risks, and in developing appropriate risk mitigation strategies which are important to shareholders seeking their required rate of return. Risk is associated with

73 OECD/G20 2015 Final Report on Actions 8-10 in para 1.66.
74 OECD/G20 2015 Final Report on Actions 8-10 in para 1.66.
75 OECD/G20 2015 Final Report on Actions 8-10 in para 1.68.

opportunities, and does not have downside connotations alone; it is inherent in commercial activity, and companies choose which risks they wish to assume in order to have the opportunity to generate profits. No profit-seeking business takes on risk associated with commercial opportunities without expecting a positive return.

Downside impact of risk occurs when the anticipated favourable outcomes fail to materialise. Companies are likely to devote considerable attention to identifying and managing economically significant risks, in order to maximise the positive returns from having pursued an opportunity. It will look at how to identify changing market trends, how to anticipate political and social changes, and how to create demand. The significance of a risk depends on the likelihood and size of the potential profits or losses arising from the risk. [76]

Risks can be categorised in various ways, but a relevant framework in a transfer pricing analysis is to consider the sources of uncertainty which give rise to risk. The OECD provides the following non-exclusive list of sources of risk, which is intended to provide a framework that may assist in ensuring that a transfer pricing analysis considers the range of risks likely to arise from the commercial or financial relations of the associated enterprises, and from the context in which those relations take place. Reference is made to risks that are externally driven and those that are internally driven in order to help clarify sources of uncertainty.

- Strategic risks or marketplace risks;
- Infrastructure or operational risks;
- Financial risks;
- Transactional risks; and
- Hazard risks. [77]

Determining the economic significance of risk and how risk may affect the pricing of a transaction between associated enterprises is part of the broader functional analysis of how value is created by the MNE group, the activities that allow the MNE group to sustain profits, and the economically relevant characteristics of the transaction. The analysis of risk also helps to determine comparability. Where potential comparables are identified, it is relevant to determine whether they include the same level of risks and management of risks. [78]

Step 2: Contractual assumption of risk: The identity of the party or parties assuming risks may be set out in written contracts between the parties to a transaction involving these risks. A written contract typically sets out an intended assumption of risk by the parties. Some risks may be explicitly assumed in the contractual arrangements. Other risks might be implicitly assumed.[79]

76 OECD/G20 2015 Final Report on Actions 8-10 in para 1.71.
77 OECD/G20 2015 Final Report on Actions 8-10 in para 1.72.
78 OECD/G20 2015 Final Report on Actions 8-10 in para 1.73.
79 OECD/G20 2015 Final Report on Actions 8-10 in para 1.73.

The assumption of risk has a significant effect on determining arm's length pricing between associated enterprises, and it should not be concluded that the pricing arrangements adopted in the contractual arrangements alone determine which party assumes risk. Therefore, one may not infer from the fact that the price paid between associated enterprises for goods or services is set at a particular level, or by reference to a particular margin, that risks are borne by those associated enterprises in a particular manner. It is the determination of how the parties actually manage and control risks, as set out in the remaining steps of the process of analysing risk, which will determine the assumption of risks by the parties, and consequently dictate the selection of the most appropriate transfer pricing method. [80]

Step 3: Functional analysis in relation to risk: In this step the functions in relation to risk of the associated enterprises that are parties to the transaction are analysed. The analysis provides information about how the associated enterprises operate in relation to the assumption and management of the specific, economically significant risks, and in particular about which enterprise or enterprises perform control functions and risk mitigation functions, which enterprise or enterprises encounter upside or downside consequences of risk outcomes, and which enterprise or enterprises have the financial capacity to assume the risk. [81]

Step 4: Interpreting steps 1-3: Carrying out steps 1-3 involves the gathering of information relating to the assumption and management of risks in the controlled transaction. The next step is to interpret the information resulting from steps 1-3 and to determine whether the contractual assumption of risk is consistent with the conduct of the parties and the other facts of the case by analyzing whether the associated enterprises follow the contractual terms and whether the party assuming risk, exercises control over the risk and has the financial capacity to assume risk. The significance of step 4 will depend on the findings. [82]

Step 5: Allocation of risk: If it is established that the associated enterprise assuming the risk based on steps 1 – 4 does not exercise control over the risk or does not have the financial capacity to assume the risk, then the risk should be allocated to the enterprise exercising control and having the financial capacity to assume the risk. If multiple associated enterprises are identified that both exercise control and have the financial capacity to assume the risk, then the risk should be allocated to the associated enterprise or group of associated enterprises exercising the most control. The other parties performing control activities should be remunerated appropriately, taking into account the importance of the control activities performed. [83]

80 OECD/G20 2015 Final Report on Actions 8-10 in para 1.80.
81 OECD/G20 2015 Final Report on Actions 8-10 in para 1.82.
82 OECD/G20 2015 Final Report on Actions 8-10 in para 1.86.
83 OECD/G20 2015 Final Report on Actions 8-10 in para 1.98.

In exceptional circumstances, it may be the case that no associated enterprise can be identified, that both enterprises exercise control over the risk and have the financial capacity to assume the risk. As such a situation is not likely to occur in transactions between third parties, a rigorous analysis of the facts and circumstances of the case will need to be performed, in order to identify the underlying reasons and actions that led to this situation. Based on that assessment, the tax administrations will determine what adjustments to the transaction are needed for the transaction to result in an arm's length outcome. [84]

Step 6: Pricing of the transaction, taking account of the consequences of risk allocation

The accurately delineated transaction should then be priced in accordance with the tools and methods available to taxpayers and tax administrations taking into account the financial and other consequences of risk-assumption, and the remuneration for risk management. The assumption of a risk should be compensated with an appropriate anticipated return, and risk mitigation should be appropriately remunerated. Thus, a taxpayer that both assumes and mitigates a risk will be entitled to greater anticipated remuneration than a taxpayer that only assumes a risk, or only mitigates, but does not do both. [85]

5 ACTION 8: ASSURE TRANSFER PRICING OUTCOMES ARE IN LINE WITH VALUE CREATION WITH REGARD TO INTANGIBLES

With regard to transfer pricing of intangibles, it is worth noting that the current tax regimes were developed in economies largely concerned with the exchange of physical products made and sold in physical locations. Trends in the international tax environment such as globalisation of business, increased tax competition among countries for tax revenues, and a growing proportion of company assets that are made up of intangible assets or intellectual property (IP) such as patent, brand names, trademarks, copyrights and know how have transformed the tax landscape.[86]

IP is often a key component of any group-wide restructuring within a multi-national enterprise (MNE) in order to achieve overall tax savings. Such exercises are sometimes referred to as supply chain optimisation exercises. In the context of BEPS, IP is particularly relevant because of the overall significance of IP to the area of transfer pricing. This is demonstrated by cases such as the Canadian case of *Canada v GlaxoSmithKline Inc,* [87] and the Australian case of *Commissioner of Taxation v SNF (Australia) Pty Ltd.*[88]

84 OECD/G20 2015 Final Report on Actions 8-10 in para 1.99.
85 OECD/G20 2015 Final Report on Actions 8-10 in para 1.100.
86 PWC "Paying Taxes: The Global Picture" (2014) at 19.
87 2012 SCC.
88 [2011] FCAFC 74.

Profit shifting which involves the use of IP has two important characteristics: Firstly, it is a driver of value creation in multinational firms; and secondly, it is highly mobile. It is, thus, no surprise that most of the companies currently accused of avoiding taxes have IP intensive business models[89] involved in intra-company allocation of IP.[90] This is because cross-border transfer of IP often attracts high taxes. Furthermore, the deductions that various countries allow in respect of expenditure on research and development (R&D) or on the acquisition of IP may differ greatly.[91]

In order to avoid such high taxes, taxpayers often take advantage of the fact that IP is intangible in nature and, as mentioned, it can be easily moved from country to country through the use of planned licensing structures.[92] A taxpayer can, for instance, establish a licensing and patent holding company suitably located offshore to acquire, exploit, license or sublicense IP rights for its foreign subsidiaries in other countries.[93] Profits can then be effectively shifted from the foreign subsidiary to the offshore patent owning company which may end up paying little or no tax on the royalties received.[94] Fees derived by the licensing and patent holding company from the exploitation of the IP will be either exempt from tax or subject to a low tax rate in the tax-haven jurisdiction.[95]

Licensing and patent holding companies can also be used to avoid high withholding taxes that are usually charged on royalties flowing from the country in which they are derived.[96] In most cases, high withholding taxes can be reduced when countries enter into double taxation treaties.[97] In order to benefit from the reduced withholding taxes that taxpayers in treaty countries enjoy, a royalty conduit company can be established in a low-tax jurisdiction. The royalty conduit company can then be used to own licence rights which it sublicenses to a second licensing company that is located in a territory with a favourable network of double-taxation treaties. The second licensing company will usually be responsible for the exploitation of the licensing rights from which it would earn only a small margin on the royalties (which

89 C Fuest, C Spengel, K Finke; JH Heckemeyer; H Nusser “Discussion Paper No. 13-078 on “Profit shifting and 'aggressive' tax planning by multinational firms: Issues and options for reform” (2013) at 1.

90 M Dischinger & N Riedel “Corporate taxes and the location of intangible assets within multinational firms” (2011) *Journal of Public Economics* at 691-707.

91 E Tomsett “Treaty Shopping and Debt/equity Ratios in the United Kingdom” *Bulletin for international Fiscal Documentation* (March 1990) at 43.

92 WH Diamond & DB Diamond *Tax Havens of the World* at INTRO /2.

93 P Roper & J Ware *Offshore Pitfalls* (2000) at 9; L Olivier & M Honiball *International Tax: A South African Perspective* (2011) at 557.

94 A Rappako *Base Company Taxation* (1989) at 194; C Doggart “Tax Havens and Their Uses” *The Economist Publication* (1990) Special Report No 1191 at 36-37.

95 B Arnold *The Taxation of Foreign Controlled Corporations: An International Comparison* (1986) at 121.

96 B Spitz & G Clarke *Offshore Service* (March 2002) Issue 66 at LEX/26.

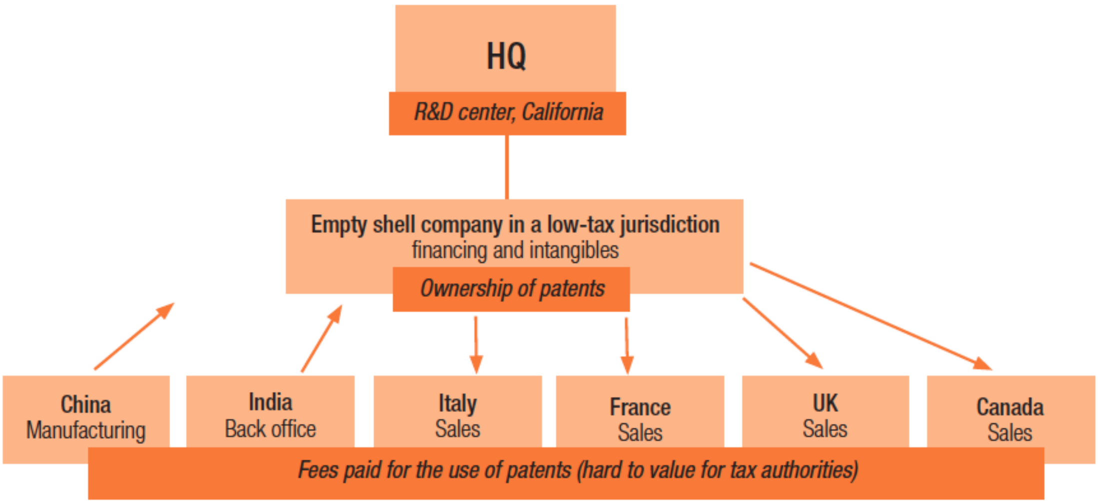
97 Tomsett at 48-49.

would be subject to local corporate income tax) and the balance would be paid to the ultimate licensor.

Setting up a royalty conduit company in one of the treaty countries can result in income being shifted from those countries by taking advantage of the tax concessions the treaty offers.[98] The Netherlands is an example of a country which has been utilised for establishing sublicensing companies with the aid of such structures.[99] Large international firms with extensive intra-firm trade and high R&D generally make use of tax havens to avoid taxes.[100]

Figure 6 below illustrates how the patent rights of R&D activities produced at the headquarters of the multi-national enterprise (the figure uses California as an example) are owned by the empty shell company (for example, Ireland). In this kind of structure the manufacturing subsidiary in China would pay a fee for the use of the patented methodology in its manufacturing process and the sales subsidiaries would pay royalties for selling the patented product under its patented name. Aggressive tax planning then takes two forms: firstly, profit shifting from California to Ireland, which retains a portion of the royalties that, without its existence, would flow directly to the US and, secondly, base erosion in the subsidiaries (when the fee paid is excessive compared to the value of the patent).

FIGURE 6: INTANGIBLES



5.1 PROMINENT SCHEMES FOR IP PROFIT SHIFTING

Although multinationals do not all use exactly the same techniques for shifting income via licensing, the strategies they apply follow similar patterns. The following discussion presents two prominent IP-based tax planning strategies and identifies

98 Spitz & Clarke at 94.

99 Ginsberg at 50; Doggart at 36-37; Tomsett at 48-49.

100 MA Desai, CF Foley, JR Hines "The demand for tax haven operations" (2006) *Journal of Public Economics* at 513-531.

the central flaws and loopholes in current national and international tax laws rendering these tax avoidance strategies possible. [101]

5.1.1 THE "DOUBLE IRISH DUTCH SANDWICH"

A prominent IP tax planning scheme which Google (based in the USA) and other e-commerce businesses have been using to reduce their tax liability is the "Double Irish Dutch Sandwich" scheme. As its name implies, the "Double Irish Dutch Sandwich" involves two companies incorporated in Ireland; the one an IP-Holding and the other an Operating Company. A Conduit Company is incorporated in the Netherlands.[102] In this structure the IP-Holding Company (using the USA as a typical example) is a direct subsidiary of a USA Parent Company and the single owner of the Irish Operating Company and the Dutch Conduit Company. The IP-Holding Company would usually be managed and controlled in a low tax jurisdiction such as Bermuda and would therefore considered resident in Bermuda for Irish tax purposes. The US, on the contrary, treats the IP-holding company as an Irish corporation because tax residency is based on jurisdiction of incorporation according to US tax law. [103] The US Parent Company developed the IP and is therefore the owner thereof. The tax consequences of this structure are as follows:

(a) <u>This structure often results in low tax payment on the initial IP transfer from the US Parent Company:</u>

To achieve this result, the US Parent Company first has to transfer the rights to use its IP outside the US to the IP-Holding Company. As transferring the full-fledged intangible would trigger taxation of hidden reserves and future income generated by the intangible according to the US super royalty rule[104], the IP-Holding Company typically makes a buy-in payment and concludes a cost-sharing agreement on the future modification and enhancement of the IP with the US Parent Company. Consequently, the IP-Holding Company owns the non-US IP rights developed under the cost-sharing agreement and therefore no periodic licence payments have to be made to the US Parent Company. Determining the arm´s length price for the buy-in payment is usually very difficult as the intangible asset is only partially developed at the time of transfer and risk is associated with future earnings. Hence, multinationals have considerable leeway in determining the price and are often able to avoid high exit taxes. [105]

(b) <u>The structure results in almost no taxation in the country of final consumption:</u>

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101 C Fuest, Clemens; Spengel, Christoph; Finke, Katharina; Heckemeyer, Jost H.; Nusser, Hannah, Discussion Paper No. 13-078 on "Profit shifting and 'aggressive' tax planning by multinational firms: Issues and options for reform" (2013) at 3.

102 ED Kleinbard "Stateless Income" (2011) *Florida Tax Review* at 707-714; J Sandell "The Double Irish and the Dutch Sandwich: How Some U.S. Companies Are Flummoxing the Tax Code" (2012) *Tax Notes International* at 867-878.

103 Fuest et al at 4.

104 The US Income Tax Reform Act (1986) requires transfer of intangibles to related foreign parties to be transferred at arm's length.

105 Fuest *et al* at 5.

The Irish Operating Company exploits the IP and usually earns high revenues. In Google´s case the Operating Company provides advertising services and acts as the contractual partner of all non-US customers. Hence, no physical presence is created in the country of final consumption and the profits cannot be taxed there. Functions in the customers' residence states like the delivery of products or marketing activities are usually assigned to low-risk group companies. These group service providers work on a cost-plus basis, keeping the tax base in the country of final consumption low. [106]

(c) The structure allows reduced tax on high royalty payments at the level of the Operating Company:

Basically, the profits from customer sales earned by the Operating Company are subject to tax in Ireland. However, the tax base of the Operating Company is close to zero because it pays high tax-deductible royalties for the use of the IP held by the IP-Holding Company. As Ireland has only recently introduced transfer pricing rules and these rules do not apply to contracts and terms agreed on before July 2010, most companies using the "Double Irish Dutch Sandwich" are able to erode the tax base in Ireland by paying very high royalty payments. [107]

(d) Interposition of Dutch Conduit Company results in no withholding taxes on royalties leaving the European Union:

This is achieved because the royalties are not paid directly to the IP-Holding Company but are passed through a Conduit Company in the Netherlands, which sublicenses the IP. The Dutch Conduit Company does not perform any economic activity. It is interposed because the IP-Holding Company is a Bermuda resident for Irish tax purposes and Ireland levies withholding tax on royalty payments to Bermuda. By channelling the royalties through the Dutch Conduit Company, withholding taxes can be completely circumvented as royalties paid from Ireland to the Netherlands are tax-free under the EU Interest and Royalties Directive and the Netherlands does not impose withholding tax on any royalty payments, irrespective of the residence state of the receiving company. The tax liability of the Conduit Company in the Netherlands consists only of a small fee payable for the use of the Dutch tax system. [108]

(e) IP-Holding Company is not taxed in Ireland and in Bermuda:

The IP-Holding Company is neither subject to tax in Ireland nor in Bermuda since Ireland considers the company a non-resident and Bermuda does not impose income tax on corporations. Hence, the profits earned in the European Union leave the European Union virtually untaxed. [109]

(f) US CFC rules are circumvented:

[106] Ibid.
[107] Fuest *et al* at 6.
[108] Ibid.
[109] Ibid.

The United States also does not tax the non-US income as long as it is not redistributed as dividends or qualified as Subpart F income[110]. To avoid the latter, the Irish Operating Company and the Dutch Conduit Company file a check-the-box election with the consequence that both Irish subsidiaries and the Dutch Conduit Company are treated as one single Irish corporation and their incomes are combined for US tax purposes. The royalty payments between the companies thus are disregarded and only revenues from transactions with customers, which due to exceptions included in the Subpart F provisions typically do not constitute Subpart F income, are considered from a US perspective. [111]

5.1.2 THE IP-HOLDING STRUCTURE USING AN IP BOX REGIME

Another example of how IP-Holdings can be used to minimise taxes is the possibility to transfer the IP to an IP-Holding Company resident in a European country that offers a special IP Box Regime, like for example Luxembourg, Belgium or the United Kingdom[112]. The Operating Company can generally be resident in any EU Member State. However, locating it in a country that does not strictly apply the arm´s length principle facilitates increasing the amount of profits shifted. As in the case of the "Double Irish Dutch Sandwich", the structure requires that no CFC rules in the residence country of the Parent Company apply and that the IP can be transferred without triggering high exit taxes.[113] The following are the tax consequences of the IP-Holding structure

(a) Avoidance of withholding tax on royalties due to the EU Interest and Royalties Directive:

The Operating Company pays royalties directly to the IP-Holding Company. No conduit company needs to be interposed to avoid withholding tax as the IP-Holding Company is located in an EU Member State and therefore the Interest and Royalties Directive applies. [114]

(b) Low taxation of the royalties at the level of the IP-Holding Company:

The royalties are not completely untaxed at the level of the IP-Holding Company. However, as IP Box Regimes either exempt a large share of royalty income from taxation or offer reduced tax rates for such income, the tax liability of the IP-Holding Company is very low. [115]

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110 The purpose of the Subpart F provisions is to eliminate deferral of USA tax on some categories of foreign income by taxing certain USA persons currently on their pro rata share of such income earned by their controlled foreign corporations (CFCs). See further on Subpart F https://www.irs.gov/pub/int_practice_units/DPLCUV_2_01.PDF accessed on 25 January 2016.

111 Ibid.

112 In light of the OECD BEPS initiative the UK is currently dismantling its current patent box regime.

113 Fuest *et al* at 7.

114 Fuest *et al* at 8.

115 Ibid.

The tax planning structures described above reveal substantial flaws in the existing national and international tax systems that result in a waiver of residence taxation due to:

- no or ineffective CFC rules;
- a conflicting definition of tax residence in different countries;
- low general tax rates; and;
- special tax regimes such as IP Boxes.

The structures result in no or little source taxation due to:

- the non-existence of withholding taxes on royalties both within the European Union and with respect to third countries;
- difficulties in the valuation of IP and relating royalty payments, and;
- the absence of the taxable presence of multinationals doing business via the internet in customers' residence countries. [116]

5.2 OECD WORK ON TRANSFER PRICING OF INTANGIBLES

Transfer pricing issues pertaining to intangibles have long been identified by the OECD as a key area of concern to governments and taxpayers, due to insufficient international guidance, in particular on the definition, identification and valuation of intangibles for transfer pricing purposes. [117] Transfer pricing of intangibles is particularly challenging for the OECD's "preferred" transaction pricing method based on the arm's length principle. Since intangibles are unique in nature, and hence in value, there is generally no market benchmark against which to conduct an objective comparability analysis. That is why the OECD Transfer Pricing Guidelines for Multinational Enterprises, revised in 2010, allow for the tax treatment of intangibles to depart from the market-based arm's length principle and to use the "profit split method". The profit split method measures the combined profits of the two multi-national enterprises entities involved in the transfer and then splits the profits between the two based on allocation keys – sales, staff and investment.

5.2.1 OECD 2013 BEPS REPORT: RECOMMENDATIONS ON TRANSFER PRICING OF INTANGIBLES

The 2013 OECD BEPS Report[118] recommended that countries should develop rules to prevent BEPS that result from moving intangibles among MNE group members by:

- adopting a broad and clearly delineated definition of intangibles;

[116] Ibid.

[117] OECD "Revised Discussion Draft on Transfer Pricing Aspects of Intangibles" (30 July 2013) in para 35.

[118] OECD *Action Plan on Base Erosion and Profit Shifting* (2013) at 20.

- ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation;
- developing transfer pricing rules or special measures for transfers of hard-to-value intangibles; and
- updating the guidance on cost contribution arrangements.

Pre-dating the 2013 OECD BEPS report, on 6 June 2012 the OECD published a "Discussion Draft on Transfer Pricing Aspects of Intangibles".[119] This was followed on 19 July 2013 by the "Revised Discussion Draft on the Transfer Pricing Aspects of Intangibles"[120] which culminated in the September 2014 "Report on Transfer Pricing Aspects of Intangibles"[121] and chapter on Intangibles in the Report on Actions 8-10 issued in October 2015, which provide guidance on determining arm's length conditions for transactions that involve the use or transfer of intangibles.

5.3 THE SEPTEMBER 2014 REPORT AND OCTOBER 2015 FINAL REPORT ON TRANSFER PRICING OF INTANGIBLES

The OECD September 2014 and October 2015 reports on the transfer pricing for intangibles refer to the to the final revisions to Chapters I, II and VI of the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) which have been developed in connection with Action 8 of the OECD 2013 *Action Plan on Base Erosion and Profit Shifting*. The changes to the Transfer Pricing Guidelines are discussed below:

- clarify the definition of intangibles;
- provide guidance on identifying transactions involving intangibles,
- provide supplemental guidance for determining arm's length conditions for transactions involving intangibles; and
- provide final modifications to the guidance on the transfer pricing treatment of local market features and corporate synergies.[122]

The 2015 Report summarises the guidance provided in its chapter on intangibles as being to ensure that:

- legal ownership alone does not necessarily generate a right to all (or indeed any) of the return that is generated by the exploitation of the intangible. The group companies performing important functions, controlling economically significant risks and contributing assets, as determined through the accurate delineation of the actual transaction, will be entitled to an appropriate return reflecting the value of their contributions. Thus, it is necessary to determine

119 Ibid.
120 Ibid.
121 OECD/G20 Base Erosion and Profit Shifting Project Guidelines on Transfer Pricing Aspects of Intangibles Action 8: 2014 Deliverable (2014) (OECD/G20 2014 Report on Action 8)
122 OECD/G20 2014 Report on Action 8 at 9.

who *controls* the risk, funding, and performance of outsourced functions in relation to the development, enhancement, maintenance, protection and exploitation of the intangible-associated enterprises performing value creating functions related to the development, maintenance, enhancement, protection and exploitation of the intangibles can expect appropriate remuneration. Where risk is assumed, the ability of the enterprise, assuming that risk, to exercise control there-over, and to financially support such risks must be clear;

- entitlement of a member of an MNE group to profits and losses will depend on the entity's true risks and functions, and an arm's length remuneration must be determined for these risks and functions;
- an associated enterprise providing funding must only be entitled to a risk adjusted return on funding (this will be a risk-free return where that enterprise does not exercise control over the financial risks);
- the guidance on valuation techniques is appropriately expanded;
- a rigorous transfer pricing analysis must be performed by taxpayers to ensure hard-to-value intangibles are priced at arm's length. The Guidance also considers the aspects of *ex-post* versus *ex-ante* information on the valuation of such hard-to-value intangibles and when the use of *ex-post* information is appropriate for use by tax administrations. [123]

The guidelines indicate that further guidance will be issued in 2016 and the full set of guidelines reviewed in 2020, in view of experience seen by then.

5.3.1 CHAPTER VI: TRANSFER PRICING GUIDELINES FOR INTANGIBLES

Chapter VI of the 2010 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations has been revised to provide guidance specifically tailored to determining arm's length conditions for transactions that involve the use or transfer of intangibles. In the Guidelines, the OECD notes that Article 9 of the OECD Model Tax Convention is concerned with the conditions of transactions between associated enterprises, not with assigning particular labels to such transactions. Consequently, the key consideration when a transaction conveys economic value from one associated enterprise to another, is whether that benefit derives from tangible property, intangibles, services or other items or activities. [124]

The OECD notes that, as is the case with other transfer pricing matters, the analysis of cases involving the use or transfer of intangibles should begin with a thorough comparability analysis, including a functional analysis. That functional analysis should identify the functions performed, assets used and risks assumed by each

[123] OECD/G20 2015 Final Report on Actions 8-10 at 64.
[124] OECD/G20 2014 Report on Action 8 at 27; OECD/G20 2015 Final Report on Actions 8-10 at 66.

relevant member of the MNE group.[125] In cases involving the use or transfer of intangibles, it is especially important to ground the comparability and functional analysis on an understanding of the MNE's global business and the manner in which intangibles are used by the MNE to add or create value across the entire supply chain. The OECD recommends that in order to determine arm's length conditions for the use or transfer of intangibles it is important to consider as part of the comparability and functional analysis:

(i) the identification of specific intangibles;
(ii) the legal ownership of intangibles;
(iii) the contributions of MNE group members to their development, enhancement, maintenance, protection and exploitation; and
(iv) the nature of the controlled transactions involving intangibles, including the manner in which such transactions contribute to the creation of value.[126]

On that foundation, it is then necessary to consider the compensation that would be paid between independent parties in transactions involving intangibles.

5.3.2 IDENTIFYING INTANGIBLES

The OECD notes that difficulties can arise in a transfer pricing analysis as a result of definitions of the term intangible that are either too narrow or too broad. If an overly narrow definition of the term intangible is applied, either taxpayers or governments may argue that certain items fall outside the definition and may therefore be transferred or used without separate compensation, even though such use or transfer would give rise to compensation in transactions between independent enterprises. If too broad a definition is applied, either taxpayers or governments may argue that the use or transfer of an item in transactions between associated enterprises should require compensation in circumstances where no such compensation would be provided in transactions between independent enterprises.[127] In the Transfer Pricing Guidelines, the word "intangible" is thus intended to address:

- 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 compensated had it occurred in a transaction between independent parties in comparable circumstances.[128]

For an item to be considered an intangible:

- it need not be an intangible for accounting purposes;

[125] OECD/G20 2014 Report on Action 8 at 28; OECD/G20 2015 Final Report on Actions 8-10 at 66.
[126] Ibid.
[127] OECD/G20 2014 Report on Action 8 at 28; OECD/G20 2015 Final Report on Actions 8-10 at 67.
[128] OECD/G20 2014 Report on Action 8 at 28-29; OECD/G20 2015 Final Report on Actions 8-10 at 67.

- it need not be an intangible for general tax or treaty withholding tax purposes;
- it need not be legally protected (e.g. goodwill is not protected in some countries); and
- it need not be separately transferable (e.g. goodwill does not move separately).[129]

In a transfer pricing analysis of a matter involving intangibles, it is important to identify the relevant intangibles with specificity. Rather than focusing on accounting or legal definitions, the thrust of a transfer pricing analysis involving intangibles should be the determination of the conditions that would be agreed on between third parties for a comparable transaction.[130] The functional analysis should, thus, identify the relevant intangibles at issue, the manner in which they contribute to the creation of value in the transactions under review, the important functions performed and specific risks assumed in connection with the development, enhancement, maintenance, protection and exploitation of the intangibles, and the manner in which they interact with other intangibles, with tangible assets and with business operations to create value. A thorough functional analysis, including an analysis of the importance of identified relevant intangibles in the MNE's global business, should support the determination of arm's length conditions. [131]

5.3.3 CATEGORIES OF INTANGIBLES

The OECD gives the following examples of items often considered as intangibles. It makes clear, however, that this guidance is purely for the purposes of transfer pricing and not for other purposes eg double tax treaties (article 12) or customs. These examples are not intended to be comprehensive or to provide a complete listing of items that may constitute intangibles.

(a) <u>Patents</u>
- A patent is a legal instrument that grants an exclusive right to its owner to use a given invention for a limited period of time within a specific geography. A patent may relate to a physical object or to a process. [132]

(b) <u>Know-how and trade secrets</u>
- Know-how and trade secrets are proprietary information or knowledge that assist or improve a commercial activity. They generally consist of undisclosed information of an industrial, commercial or scientific nature arising from previous experience, which has practical application in the operation of an

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129 OECD/G20 2014 Report on Action 8 at 29; OECD/G20 2015 Final Report on Actions 8-10 at 67.
130 Actions 8-10 Report 2015 at 66
131 OECD/G20 2014 Report on Action 8 at 30; OECD/G20 2015 Final Report on Actions 8-10 at 68.
132 OECD/G20 2014 Report on Action 8 at 33; OECD/G20 2015 Final Report on Actions 8-10 at 70.

enterprise. Know-how and trade secrets may relate to manufacturing, marketing, research and development, or any other commercial activity. [133]

(c) Trademarks, trade names and brands

- A trademark is a unique name, symbol, logo or picture that the owner may use to distinguish its products and services from those of other entities. The registered owner of a trademark may exclude others from using the trademark in a manner that would create confusion in the marketplace.
- A trade name (often but not always the name of an enterprise) may have the same force of market penetration as a trademark and may indeed be registered in some specific form as a trademark.
- The term "brand" is sometimes used interchangeably with the terms "trademark" and "trade name." In other contexts a brand is thought of as a trademark or trade name imbued with social and commercial significance. [134]

(d) Rights under contracts and government licences

- Government licences and concessions may be important to a particular business and can cover a wide range of business relationships. They may include, among others, a government grant of rights to exploit specific natural resources or public goods (*e.g.* a licence of bandwidth spectrum), or to carry on a specific business activity. However, government licences and concessions should be distinguished from company registration obligations that are preconditions for doing business in a particular jurisdiction, and are not intangibles.
- Rights under contracts may also be important to a particular business and can cover a wide range of business relationships. They may include, among others, contracts with suppliers and key customers, and agreements to make available the services of one or more employees. [135]

(e) Licences and similar limited rights in intangibles

- Limited rights in intangibles are commonly transferred by means of a licence or other similar contractual arrangement, whether written, oral or implied. Such licensed rights may be limited as to field of use, term of use, geography or in other ways. [136]

(f) Goodwill and ongoing concern value

- Depending on the context, the term goodwill can be used to refer to a number of different concepts. In some accounting and business valuation contexts, goodwill reflects the difference between the aggregate value of an operating

133 OECD/G20 2014 Report on Action 8 at 33; OECD/G20 2015 Final Report on Actions 8-10 at 71.
134 OECD/G20 2014 Report on Action 8 at 34; OECD/G20 2015 Final Report on Actions 8-10 at 71.
135 OECD/G20 2014 Report on Action 8 at 34-35; OECD/G20 2015 Final Report on Actions 8-10 71-72.
136 OECD/G20 2014 Report on Action 8 at 35; OECD/G20 2015 Final Report on Actions 8-10 at 72.

business and the sum of the values of all separately identifiable tangible and intangible assets. Alternatively, goodwill is sometimes described as a representation of the future economic benefits associated with business assets that are not individually identified and separately recognised. In still other contexts goodwill is referred to as the expectation of future trade from existing customers.

- The term ongoing concern value is sometimes referred to as the value of the assembled assets of an operating business over and above the sum of the separate values of the individual assets. It is generally recognised that goodwill and ongoing concern value cannot be segregated or transferred separately from other business assets.[137]

  The absence of a single precise definition of goodwill makes it essential for taxpayers and administrations to specifically describe the relevant intangibles and to consider whether independent enterprises would provide compensation therefor.[138]

5.3.4 DISTINGUISHING INTANGIBLES FROM LOCATION SAVINGS AND OTHER LOCAL MARKET FEATURES

The OECD further explains that an intangible has to be distinguished from market conditions or other circumstances that are not capable of being owned or controlled by a single enterprise. For example, location savings and other local market features. These market conditions are comparability factors which may affect the determination of an arm's length price for a particular transaction and should be taken into account in a comparability analysis. They are, however, not intangibles for the purposes of Chapter VI of the OECD Transfer Pricing Guidelines.[139] Difficult issues can arise in evaluating differences between geographic markets and in determining appropriate comparability adjustments. Such issues may arise in connection with the consideration of cost savings attributable to operating in a particular market. Such savings are sometimes referred to as 'location savings'. In other situations comparability issues can arise in connection with the consideration of local market advantages or disadvantages that may not be directly related to location savings.[140] In determining how location savings are to be shared between two or more associated enterprises, the OECD recommends that it is necessary to consider:

(i) whether location savings exist;
(ii) the amount of any location savings;
(iii) the extent to which location savings are either retained by a member or members of the MNE group or are passed on to independent customers or suppliers; and

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137 OECD/G20 2014 Report on Action 8 at 35; OECD/G20 2015 Final Report on Actions 8-10 at 72.
138 OECD/G20 2015 Final Report on Actions 8-10 at 73.
139 OECD/G20 2014 Report on Action 8 at 13.
140 Ibid.

(iv) where location savings are not fully passed on to independent customers or suppliers, the manner in which independent enterprises operating under similar circumstances would allocate any retained net location savings.[141]

(a) MNE group synergies

- Comparability issues, and the need for comparability adjustments, can also arise because of the existence of MNE group synergies. In some circumstances, MNE groups and the associated enterprises that comprise such groups may benefit from interactions or synergies amongst group members that would not generally be available to similarly situated independent enterprises. Such group synergies can arise, for example, as a result of combined purchasing power or economies of scale, combined and integrated computer and communication systems, integrated management, elimination of duplication, increased borrowing capacity, and numerous similar factors. Such group synergies are often favourable to the group as a whole and therefore may heighten the aggregate profits earned by group members, depending on whether expected cost savings are, in fact, realised, and on competitive conditions. [142] Group synergies may have an effect on the determination of arm's length conditions for controlled transactions and should be addressed for transfer pricing purposes as comparability factors. As they are not owned or controlled by an enterprise, they are not intangibles.[143]

(b) Market specific characteristics

- Specific characteristics of a given market may affect the arm's length conditions of transactions in that market. For example, the high purchasing power of households in a particular market may affect the prices paid for certain luxury consumer goods. Similarly, low prevailing labour costs, proximity to markets, favourable weather conditions and the like may affect the prices paid for specific goods and services in a particular market. Such market specific characteristics are not capable, however, of being owned or controlled, and are therefore not intangibles and should be taken into account in a transfer pricing analysis through the required comparability analysis. [144]

5.3.5 OWNERSHIP OF INTANGIBLES AND TRANSACTIONS INVOLVING THE DEVELOPMENT, ENHANCEMENT, MAINTENANCE, PROTECTION AND EXPLOITATION OF INTANGIBLES

The OECD advises that, even though countries must ensure that transfer pricing outcomes for intangibles are in line with value creation, there are challenges in

141 Ibid.
142 OECD/G20 2014 Report on Action 8 at 13.
143 OECD/G20 2014 Report on Action 8 at 18.
144 OECD/G20 2014 Report on Action 8 at 37.

determining the value of an intangible when pricing a MNE's operations. SAICA[145] explains as follows: when a MNE conducts its businesses operations, the various components of the business can be attributed to a country where the cost, including tax cost, is the lowest. However, the commercial reality is that an end product that generates revenue results from this global effort, which revenue usually arises wherever the item is sold. The further reality is that a company only has actual cost to really determine what the input is to the final product, but realises the revenue as a single amount elsewhere. Yet, because of the company's global operations, local fiscal authorities in each country will require a fictional determination of the value of the goods to ensure that an "appropriate" portion of the revenue benefits are attributed to that country. What is "appropriate" becomes a debate specific to each country.

The OECD refers to the challenges that can arise for a MNE allocating the profits of an intangible appropriately so that each country gets its fair share.[146] SAICA[147] gives this simplistic example: "If it costs R10 to generate the intellectual property pertaining to the product in country 1, R10 to source the raw materials in country 2 and R10 to assemble in country 3, then how much of a profit should go to each country if the product is sold for R40 in country 4? Is the value add the same in each country for it to be fair or is the IP, for example, a larger contributor to the ultimate value, as market forces dictate it to be so at such time or is the country where the ultimate sale price is extracted the largest contributor? Are value creation, risk and capital input really the best factors to determine 'fair' as they ostensibly tend to favour the manufacturing leg of the value chain?"

SAICA[148] notes that it should be acknowledged that the task of determining the fictional arm's length price as opposed to actual cost is not a mundane one. The complexity imposed and uncertainty this complexity brings, may be a contributing factor as to why certain taxpayers are enabled to "abuse" the pricing system whereas others are just overly burdened by it. When solutions and proposals are sought to address unwanted practices, it should be done with due consideration of the complex task at hand and the principles of administrative fairness and simplicity to the taxpayer.

The OECD advises[149] that "(n)otwithstanding these potential challenges, applying the arm's length principle and the provisions of Chapters I-III within an established framework can, in most cases, yield an appropriate allocation of returns derived by an MNE group from the exploitation of intangibles".

145 SAICA "Comment on DTC 1st Interim BEPS Report" (31 March 2015) para 11.
146 OECD/G20 2015 Final Report on Actions 8-10 at 74.
147 SAICA "Comment on DTC 1st Interim BEPS Report" (31 March 2015) para 13.
148 SAICA "Comment on DTC 1st Interim BEPS Report" (31 March 2015) para 14.
149 OECD/G20 2015 Final Report on Actions 8-10 at 74.

- Although the proposed changes to Chapter VI of the OECD Guidelines have yet to be tested, the DTC is of the view that, on this basis, South Africa needs to adopt the principles set out in order to align with its trading partners' methodology, but like the OECD, the DTC recommends that South Africa reserves its rights to review and refine the methodology over time, as it becomes clear whether it satisfies the correct allocation of profits principle.

In summary, then, the framework for analysing transactions involving intangibles between MNE's requires the following steps[150]:

- Identify the intangibles used or transferred with specificity, together with the economically significant risks associated with the development, enhancement, maintenance, protection and exploitation of the intangibles;
- Identify the full contractual arrangements to determine the true legal ownership. If no legal owner is identified under applicable law or contracts, the member of the MNE group which controls decisions regarding exploitation and has practical capacity to restrict others from using the intangible will be the legal owner for transfer pricing purposes;
- Identify the parties performing important functions using a functional analysis. In performing this work it is necessary to determine which member(s) of the MNE group perform and exercise control over the development, enhancement, maintenance, protection and exploitation functions, which member(s) provide funding and which members assume the various risks relating to the intangible(s). Where intangibles are self-developed these factors may be difficult to determine. Thus, the evaluation needs to carefully identify which parties control outsourced functions and what compensation is attributable to e.g. the legal owner versus the associated enterprises involved in development, enhancement, maintenance, protection and exploitation functions;
- Confirm the consistency of the contractual arrangements to the conduct of the parties, noting in particular whether any particular party who carries economic risk actually controls those risks and has the financial capacity to assume the risks relating to development, enhancement, maintenance, protection and exploitation of the intangibles; and
- Delineate the actual control relating to the development, enhancement, maintenance, protection and exploitation of the intangibles taking into account the legal ownership, the contractual relations, and the conduct of the parties;
- Determine the arm's length price consistent with each parties' contribution of functions, risks assumed and assets used. It should be noted that the determination of the legal owner, for example, does not determine the required remuneration on an arm's length basis - all the factors will ultimately

150 OECD/G20 2015 Final Report on Actions 8-10 at 74.

need determine this, and suitable compensation must be provided to each party providing input (control, risk, assets and functions) to the intangible.

The OECD warns that, because the actual outcomes and manner in which the risks associated with the intangible are unknown at the time of the MNE making decisions regarding the intangibles, it is important to distinguish between the anticipated (*ex-ante*) remuneration (i.e. expected at the time of the transaction) and the actual *(ex-post)* remuneration (i.e. the actual remuneration earned by a group member.[151]

As in third party transactions, the terms and level of compensation payable to a group member will be determined *ex-ante.* The actual *ex-post* profit and loss may differ from the expected results depending on how the risks associated with the intangible play out. The OECD suggests that tax authorities rely on the *ex-ante* returns determined by the MNE, provided that the evaluation of the where the risks lay was reasonably performed upfront ie the companies which actually carried the risks receive the increased or decreased compensation,[152] on the basis that the MNE could not reasonably have been expected to anticipate unforeseen circumstances. The ultimate compensation of each member of the group should ultimately reflect the compensation that a comparable third party would have received in similar circumstances[153].

The OECD advises that the marketing entity/distributor which may enhance marketing intangibles eg trademarks, through its operations should not specifically be compensated for the enhancement of intangibles, over and above its distribution activities, if it is acting merely as an agent (with the owner providing promotional expenditure), whereas where it performs its own marketing activities and the enhancement can clearly be attributed to its activities, its relative compensation should reflect this[154]

In order to determine the most appropriate method for measuring the transfer prices for intangibles the Guidelines look at the use of databases and the need to assess whether comparability adjustments may be needed. They state that any of the 5 methods may be appropriate, depending on the circumstances, but state that 'one sided methods, including the resale price method and the TNMM are generally not reliable methods for directly valuing intangibles'.[155] The CUP method may be considered provided it is appropriate in light of the available comparables. Where such comparables do not exist, the transactional profit split method ("TPS") is considered to be most appropriate. In evaluating the reliability of the TPS methods, however, the availability of reliable and adequate data regarding combined profits,

151 OECD/G20 2015 Final Report on Actions 8-10 at 77.
152 OECD/G20 2015 Final Report on Actions 8-10 at 84.
153 OECD/G20 2015 Final Report on Actions 8-10 at 85.
154 OECD/G20 2015 Final Report on Actions 8-10 at 86.
155 OECD/G20 2015 Final Report on Actions 8-10 at 99.

appropriately allocable expenses, and the reliability of factors used to divide combined income should be fully considered.[156]

Where intangibles are transferred in combination with other business transactions, the OECD advises that the various parts of the package must be separately identified, but the interactions of the eg services and intangibles may enhance both (eg in a franchising arrangement). In addition, delineating the transaction as the provision of products or services, or the transfer of intangibles, does not necessarily dictate the use of a particular transfer pricing method. For example the cost plus method will not be appropriate for *all* services transactions and the profit split method will not be appropriate for *all* intangible transactions.[157]

In order to determine the value of an intangible that is being transferred the OECD recommends the following factors be taken into account:

- Exclusivity;
- Extent and duration of legal protection;
- Geographic scope;
- Useful life;
- Stage of development
- Rights to enhancements, revisions and updates; and
- Expectations of future benefits.

The Guidelines look at valuation techniques, such as discounted cash flows, but caution that it is essential to consider the assumptions and other motivations that underlie the particular applications of the techniques.[158] It is furthermore made clear that valuations of intangibles used in purchase price allocations for accounting purposes are not appropriate for transfer pricing purposes and should be used with caution.

Where the value is highly uncertain at the time of transfer (Hard to Value Intangibles or "HTVI"), there are a variety of methods independent enterprises might adopt e.g. the use of anticipated benefits, or alternatively they may look at shorter term agreements which cater for contingent events with milestone payments. [159] Specialised knowledge, expertise and insight may be required to determine which events are relevant or could have been foreseen.

It is acknowledged that tax administrations may not have the expertise to deal with these instances and tend to rely on taxpayer information. In such circumstances *ex-post* outcomes may provide some insight to *ex-ante* pricing arrangements between associated enterprises, and differences may give the tax administration an indication

156 OECD/G20 2015 Final Report on Actions 8-10 at 101.
157 OECD/G20 2015 Final Report on Actions 8-10 at 91.
158 OECD/G20 2015 Final Report on Actions 8-10 at 102.
159 OECD/G20 2015 Final Report on Actions 8-10 at 108.

that the pricing arrangement agreed upon at the time of the transaction may not adequately have taken into account the relevant developments or events that would affect the intangible and the pricing arrangement adopted.[160] However, this situation should be distinguished from the situation in which hindsight is used by taking *ex-post* results for tax assessment purposes, without considering whether such *ex-post* results could reasonably been anticipated at the time the transaction was entered into. The information provided by the taxpayer will be critical to this determination.

5.4 ADDRESSING TRANSFER PRICING OF INTANGIBLES IN SOUTH AFRICA

South Africa's transfer pricing rules in relation to intangibles exist in close conjunction with the Exchange Control rules. For this reason, in assessing the potential impact of BEPS in relation to IP in the South African context, it is necessary to reflect on the relevant exchange control rules. In this section we concentrate on:

- the transfer pricing implications associated with foreign owned IP which is licensed to South African related parties, and;
- the transfer pricing implications associated with South African owned IP which is made available to foreign related parties.

5.4.1 TRANSFER PRICING IMPLICATIONS ASSOCIATED WITH FOREIGN OWNED IP LICENSED TO SOUTH AFRICAN RELATED PARTIES

(a) <u>Exchange Control Rules</u>

Royalties payable by a South African resident entity to a foreign related party require prior exchange control (EXCON) approval. Royalties are divided into two categories, namely, royalties associated with a process of manufacture; and other royalties.

In this regard, it is important to clarify the extent to which transfer pricing rules for intangibles specifically are aligned with rules and practice of the South African Reserve Bank (SARB) and the Department of Trade and Industry (DTI). As regards the first category (royalties associated with a process of manufacture), the SARB has delegated its authority to the DTI. This means that applications for approval of such royalties are required to be submitted to the DTI. Although there are guidelines issued relating to manufacturing royalties, the arm's length standard is not applicable to such transactions. The EXCON and DTI restrictions mean that, in practice, South Africa allows a lower royalty rate in respect of manufacturing royalties than the rates which are considered to be arm's length in global transfer pricing studies of MNE's. In practice the DTI generally restricts the royalty rate to 6% of the turnover of the South African licensee. Royalties in excess of this threshold can be motivated and approved on an exceptional basis. However, in practice royalties exceeding 8% are

160 OECD/G20 2015 Final Report on Actions 8-10 at 109.

rarely approved. This may lead to double taxation where the Revenue Authority of the licensor seeks to enforce a greater royalty.

There is arguably a further inconsistency between the treatment of inbound and outbound royalties due to different EXCON rules for inbound royalties and the current operation of section 31 of the ITA. While section 31 of the ITA is applicable to the use of foreign owned intangibles in South Africa, it is not applicable to the circumstances prescribed in sections 31(5) of the ITA ie in relation to headquarter companies. Further, this section arguably does not take account of the pricing of any value added in South Africa to the underlying intangibles. These issues should be considered in light of the objectives of the relief afforded to headquarter companies and in respect of high tax foreign group companies.

As regards other royalties, applications for approval are required to be submitted to the SARB itself. The SARB is less inflexible than the DTI as regards the royalty rate. Thus, in practice royalties of much higher rates are only sometimes not approved. Parties applying for approval are generally required to submit an opinion from an independent transfer pricing specialist that the proposed royalty is acceptable for South African transfer pricing purposes. Also, there is a considerable onus placed on local office bearers, who are required to confirm that the SA company has received, and benefited from, the IP in question.

A further key point that is discussed fully below, is that South Africa's EXCON rules generally limit the transfer of South African owned IP to a foreign related party to circumstances where it can be demonstrated that the consideration will be arm's length:

> The EXCON Regulations state:
>
> **4.3.2 Disposal of patents, copy-rights, trademarks, franchises and/or intellectual property in general**
>
> The disposal of any of the aforegoing requires prior approval of the Financial Surveillance Department. Applications should be supported by the agreement or contract of sale. If not evident therefrom, a clear explanation of how the values were arrived at must accompany the application. The transfer of South African owned intellectual property by way of sale, assignment or cession and/or the waiver of rights in favour of non-resident in whatever form, directly or indirectly, is not allowed without the prior approval of the Financial Surveillance Department."

This assists in inhibiting the potential, in the South Africa environment, for transactions involving transfers of intangibles or rights in intangibles as described in the OECD's Guidelines on the Transfer pricing of intangibles, although it does not remove the risk to the South African fisc altogether.

(b) <u>Implications of the exchange control restrictions</u>

The EXCON and DTI restrictions mean that, in practice, South Africa often permits only a lower royalty rate in respect of manufacturing royalties than the rates which are considered to be arm's length in global transfer pricing studies of MNE's. Also, royalties are only approved by the DTI to the extent that the DTI is persuaded that the South African licensee receives, and benefits from, the IP rights in question. One of the main possible strategies for BEPS is to transfer valuable IP to a low tax (or tax free-jurisdiction) so as to ensure a flow of royalty income to that jurisdiction. However the potential for such a strategy – as regards South Africa owned IP – may be limited[161] (as discussed above, due to the limitations placed on such strategies, by EXCON). As is discussed fully below, there are also punitive tax consequences for payments of royalties by South African taxpayers which previously used to own the relevant IP. Against this background the following points can be made in relation to South Africa owned IP within a MNE:

- Base erosion often arises in a business restructuring arrangement, as a result of the relocation of IP to a lower tax jurisdiction. However, in the current regulatory arrangement, there appears to be more limited scope for this type of strategy in the South African environment than in other countries which do not have exchange control rules.
- It should be acknowledged that there are still strategies which can be employed to externalise value associated with South African IP. This can for example, be done via sub-license arrangements, in terms of which the South Africa entity retains a steadily diminishing interest in "old" IP whereas "new" IP is developed outside South Africa (or owned outside South Africa). However, the validity – including the substance – of such strategies must still be demonstrated by the South African taxpayer both to the South African tax authorities and EXCON. Thus this matter is not of primary concern in the South African environment.

➢ However, the tax and transfer pricing implications of any future liberalisations of the EXCON rules should be carefully considered since, if the EXCON rules which currently act as an effective means of blocking many of the BEPS strategies relating to IP, which exist in the global tax planning community, were to be removed, the exposure of the South African fiscus would be increased.

➢ It should be also be noted that, due to the exchange control legal and regulatory framework that exists between the SARB and the delegated powers of the Authorised Dealers (and the DTI), the rules relating to the application of the EXCON requirements on the import, export and the use of intellectual property are not readily available and not consistently applied. Greater transparency of these exchange control rules should be considered. [162]

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161 The Exchange Control regulations do not prohibit the transfer of IP outside South Africa, but do require that approval be obtained before such a transfer is made. See rule 4.3.2 quoted above.

162 PWC "Comments on DTC BEPS First Interim Report" (30 March 2015) at 23.

5.4.1.1 Section 23I of the Income Tax Act

Section 23I of the ITA is an anti-avoidance provision which prohibits the claiming of an income tax deduction in respect of “tainted IP” as defined, which essentially refers to IP which was previously owned by the South African person that uses it, or a connected person to that person. Therefore, even if it were possible to obtain EXCON approval to export IP from South Africa, any subsequent licensing back of that IP, to the South African person who sold it offshore or a group company, would have adverse tax implications.

5.4.1.2 Significance of people functions in relation to IP

One of the key OECD BEPS concerns in relation to the transfer pricing of intangibles is to “align profits with value creation”. In the context of IP, the significance of this concern is demonstrated by the following common scenario:

- Normally there would be a group initiative to develop IP (or to relocate and centrally house an ongoing IP development process)
- The selection of a location for this initiative is made primarily on the basis of a low tax – or tax free – jurisdiction.
- The legal entity (IPCo) which is formed to house this initiative has minimal (if any) fulltime employees.
- IPCo is capitalized to fund the development of IP (typically on a contract Research and Development - R&D – in terms of which the R&D work is remunerated on a cost plus basis).
- The royalty streams associated with any IP which is successfully developed flows to IPCo and is either tax free or taxed at a very favourable rate.

Historically the validity of such an arrangement has been argued by pointing out that IPCo bears the risk in the IP development process. More specifically, that IPCo pays for the R&D process regardless of whether that results in commercially exploitable IP. Further that IPCo may also bear additional risks such as the risk of legal claims by licensees or creditor risk. However the increased international focus on people functions questions whether this assumption of risk is sufficient to justify receipt by IPCo of the full royalty income. The suggestion is that, in determining where the royalty income should go, regard should be had to the location where “important people functions” are performed. In the context of IP development, a key significant factor that should be taken into account is the location of the people who created the IP (at the time they created the IP).

At this point it is not clear exactly how, if the R&D activity is to be remunerated by means of more than a cost plus remuneration, such remuneration should be determined. It must be emphasised that the risking of the capital associated with the IP development process is by no means an insignificant factor. Therefore, even if it is considered that other functions require more than just a cost plus remuneration, the entity which risks the capital should continue to share in a significant portion of the royalty income. One possibility would be some form of profit split arrangement. This would be in line with the OECD proposals, where appropriate.

Also of relevance would be the people functions associated with the following aspects:

- The strategic decision-making process involving the IP development and commercialization and
- Legal registration and protection of the IP.

The following elements (amongst others) would also be relevant as regards contract R&D activities conducted in South Africa:

- The extent to which such R&D is supervised or directed from outside the country on an ongoing basis;
- Does the R&D activity form part of a global contract R&D arrangement with a strong central strategic focus? If the South African entity is the sole contract R&D service provider, this might provide a greater indication of possible artificiality; and
- As regards the overall strategic function of the group, to what extent is this outside South Africa? If it is only the IP related functionality which is represented as sitting outside South Africa (with the balance of the strategy being driven in SA), this might also be an indicator of lack of substance.

In line with the proposed recommendations and the OECD Guidelines the DTC recommends that:

- Research should be undertaken into the volume and values of deductions for the various deductions or allowances, such as the section 11D R&D tax deduction as this may provide an indication if this is an actual concern.
  The tax return information and the information reported to the Department of Science and Technology may assist in this regard. [163]
- Furthermore, where a South African taxpayer acts as a contract R&D service provider to a non-South African taxpayer with little substance, but which has the contractual risks and provides the capital for the development of the IP, the following should be considered to evaluate the arm's length nature of the transaction between South Africa and the non-resident:
  - The substance and control by the intangible owner over the development, enhancement, maintenance or protection of the intangibles;
  - Where a profit split method or cost contribution arrangement is used, consideration should be given to i) the 'separate entity approach', i.e. recognition of the terms and conditions between the parties and the terms and conditions which would exist were the parties dealing at

[163] PWC "Comments on DTC BEPS First Interim Report" (30 March 2015) at 23.

arm's length; ii) legal and economic ownership of the underlying intangibles and the tax and exchange control impact hereof; and iii) the appropriate allocation keys for the costs or profit to be split;

- o Another corroborative measure could be to evaluate the non-resident's return on capital employed to evaluate the arm's length nature of the intangible owner's expenses and income (i.e. downstream license income from other group companies); and
- o Whether the income of the intangible owner is imputed under SA CFC rules. [164]

5.4.1.3 Double Taxation Agreements

One of the factors which creates potential for tax avoidance within MNE's is the flow streams of royalty income to low tax jurisdictions. In the South African context, this strategy would be of limited benefit for countries with which South Africa does not have a DTA as such royalties would be subject to withholding tax at 15% in terms of Part IVA of the ITA. For countries with which South Africa has a DTA, the withholding tax is normally relieved in terms of Article 12 of the treaties based on the OECD MTC.

However DTAs generally only provide relief from withholding taxes on royalties to the extent that the recipient of the royalties is the "beneficial owner" of the relevant IP. In practice, such an owner is required to have a certain degree of substance and activity in relation to IP in order to be regarded as the beneficial owner of that IP for DTA relief. For example, in the 2012 Canadian case of *Velcro Canada vs The Queen,*[165] the court considered the issue of beneficial ownership by reference to four elements that must be considered in determining whether the recipient is the beneficial owner: possession, use, risk and control. It would therefore be relevant to take into account this – and other – international tax guidance on the issue of beneficial ownership.

5.5 SUMMARY OF DTC CONCLUSION AND RECOMMENDATIONS ON TRANSFER PRICING OF INTANGIBLES FOR SOUTH AFRICA

- ➢ The DTC recommends that South Africa should adopt the OECD Guidelines set out above in order to align with its trading partners' methodology, but like the OECD, South Africa should reserve the right to review and refine the methodology over time, as it becomes clear whether it satisfies the correct allocation of profits principle.
- ➢ In principle, the OECD guidance on transfer pricing of intangibles should be adopted in South Africa. However the OECD's BEPS Action 8, which requires

164 PWC "Comments on DTC BEPS First Interim Report" (30 March 2015) at 23.

165 2012 TCC 273.

countries to enact legislation to prevent transfer pricing using intangibles, may not require major legislative attention in South Africa at this stage, since current EXCON restricts the outbound movement of intangibles and royalty payments, and local legislation, act as deterrents. This is unlike other countries, especially in Europe where taxpayers have greater freedom as regards excessive payments of royalties or relocation of IP, this does not appear to have the same local traction in terms of audit and disputes.[166]

  - South African developed IP cannot be readily exported without Exchange Control or the Department of Trade and Industry (DTI) approval, and royalty rates for payments in respect of offshore IP are often capped. Therefore any future developments of EXCON rules for IP (and specifically any liberalisation of these rules) should be carefully considered from a transfer pricing point of view. Ideally EXCON policy development in this area should be informed by tax (and specifically transfer pricing) considerations.
  - South African CFC rules exclude intangibles from the CFC exemption benefits.
  - The current application of section 31 of the ITA – or even the general anti-avoidance provisions contained in sections 80A to 80L of the ITA – can also be applied to challenge the limited remuneration of a South African entity involved in the process of IP development.
  - Section 23I of the ITA is an anti-avoidance provision which prohibits the claiming of an income tax deduction in respect of "tainted IP".
  - The "beneficial ownership" in terms of the royalty article 12 of DTAs can also be applied to deny the reduced withholding tax treaty rate if the recipient lacks substance. This can be further reinforced by cross boarder reporting rules on intangibles.
- Despite the above measures, the potential undervaluation of local intangibles in determining profit splits is a potential concern for South Africa.
- There could also be concerns as regards contract R&D arrangements which are highly artificial or lacking in substance. However, from an EXCON point of view, it would be possible to argue that any resultant IP is South African owned IP (or partly owned in South Africa). This would render any transfer of the resultant IP an EXCON transgression.
- Measures should be taken to ensure that the exchange control legal and regulatory framework that exists between the SARB and the delegated powers of the Authorised Dealers (and the DTI) relating to the import, export and the use of intellectual property are made readily available and that they are consistently applied. Greater transparency of these exchange control rules should be considered.[167]
- Consideration needs to be given to implementing an Advanced Pricing

166 SAIT: Comments on DTC Interim Report on BEPS (March 2015) at 3.
167 PWC "Comments on DTC BEPS First Interim Report" (30 March 2015) at 23.

Agreement regime which will assist investors to gain certainty regarding flows from intangibles (see section on APA's below).

- When legislative provisions are enacted, the following are some uncertainties and risks that need to be addressed:
  - If a low tax entity is the legal owner of intangibles and bears the costs of developing the intangibles, but does not perform any of the important functions, what profits should be attributed in terms of the arm's length principle? Consideration could also be given to expanding the provisions of section 23I to prohibit the deduction of royalties payable/paid to connected entities which bear tax at a rate which is less than eg 75%[168] of the prevailing South African tax rate.
  - How is the transfer of intangibles, with highly uncertain values going to be priced (Reference may be had to the OECD Action 8-10 report)?
- Care should be taken, when developing tax legislation on transferring of intangibles, to ensure that the legislation is not so restrictive that it limits South Africa's ambitions to be a global player in the development of IP. It may for instance be advisable to revisit South Africa's R&D Tax Incentive to ensure that it is comparable to that in South Africa's trading partners (This will be addressed further in the DTC report, still to be issued, on incentives).
- As a separate but related point, the South African Government could consider the attractiveness of South Africa as a destination for intangible related activity and consequent intangible related returns. The key factors that influence South Africa's attractiveness as:
  - The effective tax rate of the South African operations (considering all tax factors);
  - The certainty of tax treatment;
  - The availability of local skills; and
  - The ability of foreign skills to sustainably migrate to South Africa. On this point current immigration laws and its application do not promote the attraction of high skill individuals to South Africa. The impact of this can be to limit the case for greater intangible returns to SA. [169]

6 ACTION 8: UPDATING THE GUIDANCE ON COST CONTRIBUTION ARRANGEMENTS

The 2013 OECD BEPS Report[170] recommends that countries should develop rules to prevent BEPS that result from moving intangibles among MNE group members without arm's length compensation. This Report also required the OECD to update the guidance on cost contribution arrangements, the guidance which was in Chapter VIII of the Transfer Pricing Guidelines is now revised.

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168 This links into SARS current view of what constitutes a 'tax haven' see explanatory booklet to 2015 corporate income tax return (IT14) and is considered by the DTC to be reasonable.

169 PWC "Comments on DTC BEPS First Interim Report" (30 March 2015) at 23.

170 OECD *Action Plan on Base Erosion and Profit Shifting* (2013) at 20.

The OECD 2015 Final Report on Action 8-10 defines Cost Contribution Arrangements (CCAs) as 'a contractual arrangement among business enterprises to share the contributions and risks of joint development, production or obtaining intangibles, tangible assets or services with the understanding that such intangibles, tangible assets or services are expected to create benefits for the individual businesses of each of the participants'[171].

A CCA does not require the participants to combine their operations in order, for example, to exploit any resulting intangibles jointly or to share the revenues or profits. Rather, CCA participants may exploit their interest in the outcomes of a CCA through their individual businesses. The transfer pricing issues focus on the commercial or financial relations between the participants and the contributions made by the participants that create the opportunities to achieve those outcomes. [172]

If contributions to and benefits of the CCA are not valued appropriately, this will lead to profits being shifted away from the location where the value is created through the economic activities performed.[173]

- The guidance provides for determining whether the conditions established by associated enterprises for transactions covered by a CCA are consistent with the arm's length principle.
- The guidance addresses some of the opportunities for BEPS resulting from the use of CCAs.
- Parties performing activities under arrangements with similar economic characteristics should receive similar expected returns, irrespective of whether the contractual arrangement in a particular case is termed a CCA.
- The guidance ensures that CCAs cannot be used to circumvent the new guidance on the application of the arm's length principle in relation to transactions involving the assumption of risks, or on intangibles.
- The analysis of CCAs follows the framework set out in that guidance to ensure that:
    - The same analytical framework for delineating the actual transaction, including allocating risk, is applicable to CCAs as to other kinds of contractual arrangements.
    - The same guidance for valuing and pricing intangibles, including hard-to-value intangibles, is applicable to CCAs as to other kinds of contractual arrangements.
    - The analysis of CCAs is based on the actual arrangements undertaken by associated enterprises and not on contractual terms that do not reflect economic reality.

[171] OECD/G20 2015 Final Report on Actions 8-10 at 161 and 163.
[172] OECD/G20 2015 Final Report on Actions 8-10 at 163.
[173] OECD/G20 2015 Final Report on Actions 8-10 at 161.

- An associated enterprise can only be a participant to the CCA if there is a reasonable expectation that it will benefit from the objectives of the CCA activity and it exercises control over the specific risks it assumes under the CCA and has the financial capacity to assume those risks.

In summary the guidance ensures that CCAs are appropriately analysed and produce outcomes that are consistent with how and where value is created. [174]

A key feature of a CCA is the sharing of contributions. In accordance with the arm's length principle, at the time of entering into a CCA, each participant's proportionate share of the overall contributions to a CCA must be consistent with its proportionate share of the overall expected benefits to be received under the arrangement. Further, in the case of CCAs involving the development, production or obtaining of intangibles or tangible assets, an ownership interest in any intangibles or tangible assets resulting from the activity of the CCA, or rights to use or exploit those intangibles or tangible assets, is contractually provided for each participant. [175]

In a CCA, each participant's proportionate share of the overall contributions to the arrangement will be consistent with the participant's proportionate share of the overall expected benefits to be received under the arrangement. Each participant in a CCA would be entitled to exploit its interest in the CCA separately as an effective owner thereof, without requiring businesses to be combined. Each participant will not need to pay additional consideration to exploit the benefits (other than their contributions and balancing payments - see below).

In a CCA there is always an expected benefit that each participant seeks from its contribution. Each participant's interest in the results of the CCA activity should be established from the outset, even where the interest is inter-linked with that of other participants, *e.g.* because legal ownership of developed intangible property is vested in only one of them but all of them have effective ownership interests. [176] Like any other kind of contractual arrangement, the contractual agreement provides the starting point for delineating the actual transaction and performing the functional analysis to establish the division of responsibilities, risks and anticipated outcomes. The evaluation is the same as any other arrangement, including determining whether the parties contractually assuming risks are actually assuming these risks.[177]

The guidance issued in the 2015 revisions to the CCA transfer pricing guidelines (chapter VIII) is designed to support the revised guidance on intangibles, and ensure that CCA's address opportunities that arise for BEPS using CCAs.[178] Thus, parties

174 OECD/G20 2015 Final Report on Actions 8-10 at 161.
175 OECD/G20 2015 Final Report on Actions 8-10 at 165.
176 OECD "Cost Contribution Arrangements" in *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) at 8.3 reiterated in OECD/G20 2015 Final Report on Actions 8-10 at 161.
177 OECD/G20 2015 Final Report on Actions 8-10 at 163.
178 OECD/G20 2015 Final Report on Actions 8-10 at 161.

performing activities under arrangements with similar economic characteristics should receive similar returns irrespective of the contractual arrangements, and the guidance ensures that CCA's are appropriately analysed and produce outcomes that are consistent with how and where value is created.

6.1 TYPES OF CCAs

There are two types of commonly encountered of CCAs: an arrangement for the joint development, production or the obtaining of intangible or tangible assets ("Development CCAs"), and those for obtaining services ("Services CCAs"). The main differences between the two types is that whilst development CCAs should create ongoing future benefits, but involve higher risks due to uncertainties, services CCAs create current benefits only which are more certain and less risky.[179]

Under a developed CCA each participant receives a share of rights in the developed property. In such a CCA, each participant is accorded separate rights to exploit the intangible property, for example in specific geographic areas or applications. The separate rights obtained may constitute actual legal ownership; or it may be that only one of the participants is the legal owner of the property, but economically all the participants are co-owners. In cases where a participant has an effective ownership interest in any property developed by the CCA and the contributions are in the appropriate proportions, there is no need for a royalty payment or other consideration for use of the developed property consistent with the interest that the participant has acquired. [180]

Service CCAs could exist for any joint funding or sharing of costs and risks, for developing or acquiring property or for obtaining services. For example, business enterprises may decide to pool resources for acquiring centralised management services, or for the development of advertising campaigns common to the participants' markets. [181]

6.2 APPLYING THE ARM'S LENGTH PRINCIPLE

A participant's contributions must be consistent with what an independent enterprise would have agreed to contribute under comparable circumstances given the benefits it reasonably expects to derive from the arrangement. What distinguishes contributions to a CCA from an ordinary intra-group transfer of property or services is that part or all of the compensation intended by the participants is the expected

[179] OECD/G20 2015 Final Report on Actions 8-10 at 165.

[180] OECD "Cost Contribution Arrangements" in *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) at 8.6 reiterated in OECD/G20 2015 Final Report on Actions 8-10 at 166.

[181] OECD "Cost Contribution Arrangements" in *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) at 8.7 amended by OECD/G20 2015 Final Report on Actions 8-10 at 166.

benefits to each from the pooling of resources and skills.[182] In addition, especially for development CCAs the participants agree to share in the upside and the downside consequences of the risks.

The expectation of mutual and proportionate benefit is fundamental to the acceptance by independent enterprises of an arrangement for sharing the consequences of risks materialising and pooling resources and skills. Independent enterprises would require that each participant's proportionate share of the actual overall contributions to the arrangement is consistent with the participant's proportionate share of the overall expected benefits to be received under the arrangement.

To apply the arm's length principle to a CCA, it is therefore necessary to determine that all the parties to the arrangement have the expectation of benefits, then to calculate each participant's relative contribution to the joint activity (whether in cash or in kind), and finally to determine whether the allocation of CCA contributions (as adjusted for any balancing payments) accords with their respective share of the benefits. It should be recognised that these determinations may bear a degree of uncertainty, particularly in relation to development CCAs. The potential exists for contributions to be allocated among CCA participants so as to result in an overstatement of taxable profits in some countries and the understatement of taxable profits in others, measured against the arm's length principle. For that reason, taxpayers should be prepared to substantiate the basis of their claim with respect to the CCA.[183]

6.3 DETERMINING PARTICIPANTS

Because the concept of mutual benefit is fundamental to a CCA, it follows that a party may not be considered a participant if that party does not have a reasonable expectation that it will benefit from the CCA activity itself (and not just from performing part or all of that activity). A participant therefore must be assigned an interest or rights in the intangibles, tangible assets or services that are the subject of the CCA, and have a reasonable expectation of being able to benefit from those interests or rights.[184] In the absence of such a potential benefit a participant may be considered to simply be a service provider to the CCA.[185]

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182 OECD "Cost Contribution Arrangements" in *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) at 8.8 amended by OECD/G20 2015 Final Report on Actions 8-10 at 166.

183 OECD "Cost Contribution Arrangements" in *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) at 8.9 reiterated by OECD/G20 2015 Final Report on Actions 8-10 at 166.

184 OECD "Cost Contribution Arrangements" in *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) at 8.10 and updated in OECD/G20 2015 Final Report on Actions 8-10 at 167.

185 OECD/G20 2015 Final Report on Actions 8-10 at 168.

A party would also not be a participant in a CCA if it does not exercise control over the specific risks it assumes under the CCA, and does not have the financial capacity to do so. Furthermore, as would be expected of an independent party, a participant would be expected to perform a risk mitigation assessment and decision-making exercise regarding the risks it undertakes as a consequence of being a party to the CCA[186].

It will also be necessary for the participant to assess the benefits of participation in the CCA. If the activity continues to fail to produce any actual benefit over a period in which the activity would normally be expected to produce benefits, tax administrations may question whether the parties would continue their participation had they been independent enterprises. [187]

If the participants in a CCA decide that all or part of the subject activity will be outsourced to a separate company that is not a participant, an arm's length charge would be appropriate to compensate the company for services being rendered to the CCA participants.[188] In addition, the participants would each be expected to assess their control over the outsourced functions and the associated risks attached thereto. If the CCA is developing intangibles at least one of the participants in the CCA would be expected to exercise control over the development, maintenance, enhancement, protection, and exploitation of that intangible.

6.4 EXPECTED BENEFITS FROM THE CCA

The relative share of expected benefits might be estimated based on the anticipated additional income generated or costs saved or other benefits of each participant as a result of the arrangement. A frequently used method for services CCAs would be to reflect each participant's expected benefits using a relevant allocation key. The possibilities for allocation keys include: sales, units used, produced, or sold, gross or operating profit, the number of employees, capital invested, and so forth. Whether any particular allocation key is appropriate depends on the nature of the CCA activity and the relationship between the allocation key and the expected benefits. [189]

For development CCAs where the benefit may not be expected to materialise during the year of assessment projections of benefits may be used. This may, however, cause problems for tax administrations who will need to verify assumptions, especially when the eventual actual results are significantly different to the

186 OECD/G20 2015 Final Report on Actions 8-10 at 168.

187 OECD "Cost Contribution Arrangements" in *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) at 8.11.

188 OECD "Cost Contribution Arrangements" in *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) at 8.12.

189 OECD "Cost Contribution Arrangements" in *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) at 8.19.

projections. In some cases the CCA may end a number of years before the benefits are realised[190].

Adjustments may thus be required as circumstances change.

6.5 THE VALUE OF EACH PARTICIPANT'S CONTRIBUTION

For the purpose of determining whether a CCA satisfies the arm's length principle – i.e. whether each participant's proportionate share of the overall contributions to the CCA is consistent with the participant's proportionate share of the overall expected benefits – it is necessary to measure the value or amount of each participant's contributions to the arrangement. [191]

Irrespective of the type of CCA (development or services) all contributions of current or pre-existing value must be identified and accounted for appropriately with the arm's length principle. Since the value of each participants relative share of contributions should accord with its share of expected benefits, balancing payments may be required to ensure consistency.[192]

The evaluation process should recognise all contributions made by participants to the arrangement, at the time they are contributed, including property or services that are used partly in the CCA activity and also partly in the participant's separate business activities, and taking into consideration the mutual sharing of risks.[193] Whilst contributions should be measured at value, it is suggested that current contributions could be measured at cost. However, for development CCAs this will generally not provide a reliable basis for the application of the arm's length principle. Uncontrolled comparable arrangements then need to be sought.

Since contributions are based on expected benefits, this generally implies that where a cost reimbursement basis for valuing current contributions is permitted the analysis should initially be based on budgeted costs. Differences between actual and budgeted costs need to be analysed and explained.[194]

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190 OECD/G20 2015 Final Report on Actions 8-10 at 169.

191 OECD "Cost Contribution Arrangements" in *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) at 8.13 and OECD/G20 2015 Final Report on Actions 8-10 at 169.

192 OECD/G20 2015 Final Report on Actions 8-10 at 170.

193 OECD "Cost Contribution Arrangements" in *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) at 8.16 and OECD/G20 2015 Final Report on Actions 8-10 at 170.

194 OECD/G20 2015 Final Report on Actions 8-10 at 171-172.

6.6 BALANCING PAYMENTS

Where the value of a participant's overall contributions under a CCA, at the time the contributions are made, is not consistent with that participants share of expected benefits under the CCA, the arm's length principle will require that an adjustment be made because the consideration received by at least one of the participants for its contributions will be inadequate, and the consideration received by at least one other participant for its contribution will be excessive, relative to what independent enterprises would have received.

Such an adjustment will be made through a "balancing payment" which "tops up" the value of the contributions. Tax administrations may also require balancing payments where the value of contributions has been incorrectly determined. However, the guideline cautions that tax administrations should try to refrain from basing such adjustments on the results of a single fiscal year. They should rather evaluate the position over a period of years. The balancing payments should be treated as an additional contribution for the payer and a reduction in contributions for the recipient.

Where the commercial reality of an arrangement differs from the terms purportedly agreed by the participants, it may be appropriate to disregard part or all of the terms of the CCA. [195]

6.7 CCA ENTRY, WITHDRAWAL, OR TERMINATION

An entity that becomes a participant in an already active CCA might obtain an interest in any results of prior CCA activity, such as intangible property developed through the CCA, work in-progress and the knowledge obtained from past CCA activities. In such a case, the previous participants effectively transfer part of their respective interests in the results of prior CCA activity. Under the arm's length principle, any transfer of pre-existing rights from participants to a new entrant must be compensated based upon an arm's length value for the transferred interest. This compensation is called a "buy-in" payment. [196]

The amount of a buy-in payment should be determined based upon the arm's length value of the rights the new entrant is obtaining, taking into account the entrant's

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[195] OECD "Cost Contribution Arrangements" in *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) at 8.26 and OECD/G20 2015 Final Report on Actions 8-10 at 173.

[196] OECD "Cost Contribution Arrangements" in *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) at 8.31 and OECD/G20 2015 Final Report on Actions 8-10 at 174.

proportionate share of overall expected benefits to be received under the CCA and any contribution it may be making going forward. [197]

Issues similar to those relating to a buy-in could arise when a participant leaves a CCA. In particular, a participant who leaves a CCA may dispose of its interest in the results of past CCA activity (including work in progress) to the other participants. If there is an effective transfer of property rights or interest at the time of a participant's withdrawal, the transferor should be compensated according to the arm's length principle. This compensation is called a "buy-out" payment. [198] It should be noted that where a services CCA is being transferred there may be not need to a buy-out payment as the benefits are generally current ie there is no future value.

When a CCA terminates, the arm's length principle would require that each participant receives a beneficial interest in the results of the CCA activity consistent with the participant's proportionate share of contributions to the CCA throughout its term (adjusted by balancing payments actually made including those made incident to the termination). Alternatively, a participant could be properly compensated according to the arm's length principle by one or more other participants for transferring its interest in the results of the CCA activity. [199]

6.8 DOCUMENTATION

In line with the documentation requirements set out in Action 13 the details of a CCA should be set out in the Master File and Local Files. Implicit in this is that each participant should have access to the details of the activities to be conducted under the CCAs, the identity and location of other parties involved in the CCA, the projections on which the contributions are to be made and the expected benefits determined, and the budgeted and expenditures for the CCA activity, at a level of detail commensurate with the complexity and importance of the CCA to the taxpayer. The guidelines provide a list of information that would be relevant and useful concerning the initial CCA and also over its duration.

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197 OECD "Cost Contribution Arrangements" in *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) at 8.32 and OECD/G20 2015 Final Report on Actions 8-10 at 174.

198 OECD "Cost Contribution Arrangements" in *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) at 8.34 and OECD/G20 2015 Final Report on Actions 8-10 at 174.

199 OECD "Cost Contribution Arrangements" in *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) at 8.39 and OECD/G20 2015 Final Report on Actions 8-10 at 175.

6.9 RECOMMENDATIONS FOR SOUTH AFRICA ON CCAs

The DTC recommends that:

- Notwithstanding that CCA's may be rarely seen in the South African context, as such arrangements arise offshore and may include South African entities, South Africa should adopt the proposed guidelines for CCA's and ensure that it has sufficient exchange of information agreements in place to be able to derive the information that it requires should the taxpayer not be forthcoming;
- In line with the other recommendations, this recommendation again requires that SARS has the necessary resources and training to evaluate CCAs and obtain the necessary information.

7 ACTION 10: ENSURE TRANSFER PRICING OUTCOMES ARE IN LINE WITH VALUE CREATION: OTHER HIGH RISK TRANSACTIONS

The 2013 BEPS Action Plan Report required that countries should develop rules to prevent BEPS that result from engaging in transactions which would not, or would very rarely, occur between third parties. This would involve adopting transfer pricing rules or coming up with special measures to:

a) clarify the circumstances in which transactions can be recharacterised;
b) clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains; and
c) provide protection against common types of base eroding payments, such as management fees and head office expenses.

The OECD's guidance on these matters is set out below.

7.1 ACTION 10: CLARIFY THE APPLICATION OF TRANSFER PRICING METHODS, IN PARTICULAR TRANSACTIONAL PROFIT SPLIT METHOD, IN THE CONTEXT OF GLOBAL VALUE CHAINS

Traditionally considered one of the methods of last resort, the OECD has revisited the transactional profit split method ("TPSM").[200]

It released a discussion draft on 16 December 2014, raising questions on difficulties encountered with the method. Based on the consultation that followed, the OECD concluded that it is necessary to clarify, improve and strengthen the guidance on when it is appropriate to apply the TPSM and when to do so, since experiences indicate that this method may not be straightforward for taxpayers to apply, and may not be straightforward for tax administrations to evaluate. It, furthermore, concluded that, when properly applied, the method has the potential to "align profits with value

200 Deloittes submission to DTC: 26 July 2015 at 6.

creation in accordance with the arm's length principle"[201] and may be the most appropriate method where the other methods prove problematic.

In summary, it concluded that:

- Improved guidance needs to be developed to clarify the circumstances in which transactional profit splits are the most appropriate method for a particular case and to describe what approaches can be taken to split profits in a reliable way.
- The guidance on TPSM also needs to take into account changes to the transfer pricing guidance in pursuit of other BEPS actions, including changes in the guidance on applying the arm's length principle in performing a robust functional analysis; identifying and allocating risks, synergies; and intangibles.
- The guidance should take into account the conclusions of the Report on *Addressing the Tax Challenges of the Digital Economy* (OECD, 2015), developed in relation to BEPS Action 1, which noted that attention should be paid to the consequences of greater integration of business models as a result of the digitised economy, and the potential role for profit splits to account for such integration.
- In addition, the guidance should reflect further work being undertaken to develop approaches to transfer pricing in situations where the availability of comparables is limited, for example due to the specific features of the controlled transaction; and clarify how in such cases, the most appropriate method should be selected.
- This guidance is relevant to the work mandated by the G20 Development Working Group, on the impact of BEPS in developing countries, which includes the development of a toolkit for low income countries to address challenges these countries face due to the lack of comparables.

The OECD notes, in its 2015 Report that the TPSM will form the basis for draft guidance to be developed by WP6 during 2016 and expected to be finalised in the first half of 2017. A discussion draft of guidance will be released for public comments and a public consultation will be held in May 2016. [202]

In the meantime the scope of the revised guidance states that the current guidance should be supplemented with considerations of the following:

- The TPSM should not be the automatic alternative, should suitable comparables not be available, when the sharing of combined profits would not be expected if the parties are acting at arm's length;

201 OECD/G20 2015 Final Report on Actions 8-10 at 55.
202 OECD/G20 2015 Final Report on Actions 8-10 at 57.

- The use of the TPSM is not warranted simply because business operations are highly integrated - the businesses of all MNE's are integrated to a higher or lesser degree. The revised guidance will refer to the relevance of value chain analysis and look at sequential integration and parallel integration (which is often seen in the global trading of financial instruments where the TPSM may be viewed as appropriate);
- The current guidelines indicate that the TPSM may be appropriate where both parties make "unique and valuable contributions". Little guidance is given, however, as to what this is. Consideration is to be given to whether the sharing of risks would fall under this heading. In addition, a review of when independent enterprises adopt the method is to be undertaken;
- The method for splitting profits requires further guidance ie how to fulfil the need for a strong correlation between profit allocation factors and the creation of value in order to align with the arm's length principle;
- The TPSM can be used to support the TNMM range or determine royalty rates. The occasions when this is appropriate are to be spelt out.

More detail on the existing guidance and why the above is considered necessary is set out below.

7.1.1 CURRENT GUIDANCE ON TRANSACTIONAL PROFIT SPLIT METHOD

The TPSM is one of the methods advocated by the OECD in order to arrive at arm's length price in its 1995 Transfer Pricing Guidelines. This method is traditionally considered one of the methods of last resort.[203] Under the "profit split" method, the combined profit is identified and split between the connected parties in a controlled transaction. The profit is split by economically approximating the division of profits that would have been anticipated and reflected in an agreement made at arm's length.[204] The TPSM is usually applied where transactions are so interrelated that they cannot be evaluated separately.[205] The application of the TPSM relies on access to world-wide group data, which may be difficult to obtain.[206] The current guidance on the application of the TPSM indicates that:

- the main strength of the method is that it can provide solutions for highly integrated operations for which a one-sided method would not be appropriate (such as global trading of financial instruments);

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203 Deloittes submission to DTC: 26 July 2015 at 6.

204 OECD Report of the Committee on Fiscal Affairs 'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators' (1994) 172 *Intertax* 346 in para 131; G Campos 'Transfer Pricing of Major Trading Nations' (1996) *Bulletin for International Fiscal documentation* at 217; D Hay, F Horner, J Owens 'Past and Present Work in the OECD on Transfer Pricing and Selected Issues' (1994) 10 *Intertax* 435 in para 82.

205 Hay *et al* at 435 in para 84.

206 Hay *et al* at 435 in para 84.

- the TPSMs may also be found to be the most appropriate method in situations where both parties to the transaction make unique and valuable contributions, for example in the form of unique intangibles;
- the guidance makes the point that where each party makes unique and valuable contributions, reliable comparables information may be insufficient to apply another method; and
- the guidance stresses that the selection of a TPSM should be determined in accordance with the overall guidance for method selection in the Guidelines. [207]

While the guidance on splitting profits provides a number of examples of potential allocation keys, it focusses on asset-based and cost-based allocation keys. There is tentative mention of an approach which splits profits so that each party achieves the same return on capital.

Chapter VI of the Transfer Pricing Guidelines, which deals with Special Considerations for Intangibles, makes a number of references to the TPSM and to situations where the current guidance on its application may need to be clarified. For example, the guidance suggests:

- In some cases profit splits or valuation techniques may be useful for evaluating arm's length allocations of profit in situations involving the outsourcing of important functions where information on comparable uncontrolled transactions is unavailable.
- Where no information on comparable uncontrolled transactions is available, a TPSM is a method that may be useful in situations involving the pricing of transfers of intangibles. This may include the transfer of partially developed intangibles; or the transfer of all, or limited rights in a fully developed intangible. [208]

Aspects of Chapter I of the Transfer Pricing Guidelines may also prompt consideration of TPSM, but specific guidance has not yet been provided. Areas of particular interest in this regard include situations where multiple parties exercise control over a risk such that a sharing in the potential upside and downside of the risk may be appropriate, and the sharing of group synergies arising from deliberate concerted group action. [209]

7.1.2 SCOPE OF REVISED GUIDANCE

The OECD states that the revised guidance on the profits shift method will follow the current structure in Chapter II of the Transfer Pricing Guidelines, but should clarify and supplement the following matters.

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207 OECD/G20 2015 Final Report on Actions 8-10 at 57.
208 OECD/G20 2015 Final Report on Actions 8-10 at 57.
209 OECD/G20 2015 Final Report on Actions 8-10 at 57.

Most appropriate method*:* The December 2014 discussion draft on the use of TPSM stated that the consideration of TPSM does not imply any changes to the guidance for selecting the most appropriate method for arriving at an arm's length price. Nevertheless, comments on the discussion draft pointed to significant concerns regarding the potential for TPSMs to be misused; particularly so in cases where the nature of the transaction itself, based on the functional analysis of the parties, suggests that a sharing of combined profits would not be expected at arm's length. Concerns were also expressed that the method would be used in the absence of reliable comparables, without considering whether the TPSM was itself appropriate.[210]

Selecting the most appropriate method is particularly acute where there is a lack of reliable comparables data, as is very often the case in developing countries, and is relevant to the work mandated by the G20 Development Working Group on the development of toolkits to help low income countries address the challenge of the lack of comparables. [211]

Highly integrated business operations*:* While the current Guidelines state that TPSM may be found to be the most appropriate method where business operations are highly integrated, integration alone may be insufficient to warrant the use of such a method. All MNE groups are integrated to a greater or lesser degree, and so it is unclear how the criterion of integration should be applied. [212]

Additional guidance will be provided on when significant integration of business operations may lead to the conclusion that a TPSM is the most appropriate method.[213]

Unique and valuable contributions*:* The existing guidance on the application of TPSMs notes that such methods may be the most appropriate method in situations where both parties to the transaction make unique and valuable contributions. However, there is little further guidance in the current Guidelines about what constitutes a "unique and valuable contribution" aside from an example where intangibles are contributed by both parties to the transaction. [214]

Additional guidance and examples will be provided to clarify what is meant by "unique and valuable" contributions in order to distinguish those circumstances when transactional profit split methods are likely to be the most appropriate method.[215]

210 OECD/G20 2015 Final Report on Actions 8-10 at 58.
211 OECD/G20 2015 Final Report on Actions 8-10 at 60.
212 OECD/G20 2015 Final Report on Actions 8-10 at 58.
213 OECD/G20 2015 Final Report on Actions 8-10 at 58.
214 OECD/G20 2015 Final Report on Actions 8-10 at 58.
215 OECD/G20 2015 Final Report on Actions 8-10 at 58.

Synergistic benefits: The guidance on group synergies provides that, where the synergistic benefits arise as a result of deliberate concerted action, such benefits must be shared by group members in proportion to their contribution to the creation of the synergy. While it may, in some circumstances be possible to benchmark the contributions of each part of the business, such a process may not be able to account for the potentially significant integration benefits which are achieved by the two parts acting in concert. [216]

Additional guidance will be provided on the circumstances to take into account in determining whether a TPSM could be the most appropriate method for dealing with scenarios with significant group synergies, and how such profit split methods could be applied.

Profit splitting factors: The over-arching objective of the BEPS Actions 8-10 is to ensure that transfer pricing outcomes are in line with economic value creation. Such an objective is achieved by accurately delineating the actual transaction and pricing it in accordance with the most appropriate method. The December 2014 discussion draft noted that TPSMs could make a contribution to achieving this aim and asked about experiences in using various approaches to splitting profits that might indicate ways of ensuring both greater objectivity and alignment with value creation in circumstances where application of the transactional profit split method is appropriate.

While there is general agreement that the splitting of profits should be based on a functional analysis of the parties' contributions, the mechanism by which the value of those contributions is quantified is not always clear.

- Possible mechanisms that are used in practice to various extents include invested capital, costs, surveys of functional contributions, weighting of factors, as well as equalised expected rates of return. Commentators observed advantages and disadvantages in these mechanisms, based on issues such as availability of information, measurability, subjectivity, and practicality, and the observations emphasise the current lack of guidance on what is a key aspect of applying a profit split method – how the profits should reliably be split. [217]
- Additional guidance will be provided that explains how to fulfil the need for a strong correlation between profit allocation factors and the creation of value in order to ensure an outcome that is consistent with the arm's length principle. Various mechanisms will be explained in detail, with examples of their application. In addition, the sensitivities and practical application of the various mechanisms, including the capability independently to verify the

216 OECD/G20 2015 Final Report on Actions 8-10 at 58.
217 OECD/G20 2015 Final Report on Actions 8-10 at 58.

underlying data, will be compared, in order that guidance is provided about the appropriate application of the mechanisms. [218]

<u>Use of profit split to determine TNMM range, or converting to a royalty:</u> The 2014 December discussion draft raised questions about the use of TPSM to vary the range of results derived from a TNMM analysis by reference to increase or decrease in consolidated profits achieved by the parties to the transaction. The draft also raised a question about using a profit split method to determine the expected share of profits, and then converting the analysis to a running royalty.[219]

- Additional guidance will be provided on the circumstances to take into account in evaluating whether a TPSM can be used to support results under a TNMM, or to determine royalty rates, or in other ways that are practical, respect the form of the contractual arrangements, and help simplify pricing outcomes.

7.1.4 RECOMMENDATIONS FOR SOUTH AFRICA ON THE PROFIT SPLIT METHOD

The DTC recommends that:

- South Africa should not attempt to issue its own guidelines regarding the TPSM, but should wait for the outcome of the OECD work still to be performed;
- The absence of local comparables should not be considered the determinant that the TPSM is the most appropriate method. The availability of all data should first be assessed. Failure to do so will lead to all countries that have no data adopting the TPSM, which will give rise to corresponding double taxation and transfer pricing disputes risks.[220]
- In the meantime, consideration should be given, by the South African Regulators, to the requirement for publication of data by South African companies, or for SARS and/or Stats SA to issue information, based on data available to them, that may be suitably be used for South African comparablilty purposes. Such data is common in the rest of the world, and is what the currently available databases[221] are based upon.

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218 OECD/G20 2015 Final Report on Actions 8-10 at 58.
219 OECD/G20 2015 Final Report on Actions 8-10 at 58.
220 Deloittes submission to DTC July 2015 at 6.
221 E.g. Bureau van Dijk's Amadeus; Thompson Reuters; Royaltysource; Lexisnexis; Onesource; (all commonly used by taxpayers and tax authorities globally).

8 ACTION 10: PROVIDE PROTECTION AGAINST COMMON TYPES OF BASE ERODING PAYMENTS, SUCH AS MANAGEMENT FEES AND HEAD OFFICE EXPENSES - LOW VALUE-ADDING INTRA-GROUP SERVICES

8.1 BACKGROUND

A major BEPS concern among many developing countries in which MNE enterprises operate, including South African and other African countries, is that these enterprises keep claiming deductions for various head office expenses such as management, technical and service fees. Thus, they often pay little or no taxes in source countries alleging that they make losses year after year, yet they keep investing in those apparently unprofitable operations. Often there is no justification for such fees other than tax avoidance[222]. One possible explanation for the alleged losses is that profits are shifted to low tax jurisdiction while taxes are minimized in the source state.

In South Africa National Treasury has proposed the imposition of withholding taxes on certain forms of cross-border services. As a result, a withholding tax on service fees was enacted to come into effect on 1 January 2017.[223] It was, however, proposed in the 2016 Budget speech that this legislation will be deleted. This proposal, which is in line with the UN MTC, had been supported by the DTC[224], but on a more limited basis than set out in the current legislation.

However, as a Government Gazette[225] was issued on 3 February 2016, setting out the Ministers updated list of transactions considered to be reportable arrangements, which now includes specified services performed in South Africa, it is considered that this will act as a satisfactory mechanism for facilitating the identification of companies required to pay tax in South Africa in a more investor friendly manner (see further discussion on withholding tax in the DTC report on Action 6).

Concerns about excessive deductions of management fees are the reasons why some developing countries have signed treaties with specific articles on services, management and technical fees that deviate from the OECD and the UN MTC. Broadly these articles define services, management and technical fees in a similar manner as being "payments of any kind to any person, other than an employee of the person making the payments, in consideration for any services of a managerial, technical or consultancy nature, rendered in a contracting state".[226] In terms of these articles, the relevant fees may be taxed in the resident state.

222 ActionAid 'Calling Time' 21.
223 The withholding tax on service fees is contained in Part IVC of the Income Tax Act 58 of 1962.
224 For further discussion see DTC report on Action 7.
225 Government Gazette number 39650
226 Article 12(4) of the Ghana and Germany treaty.

However these fees may also be taxed in the source state if the beneficial owner thereof is a resident of the other contracting state. In that case, the charge for the fee shall not exceed a certain percentage of the gross amount as agreed upon. For example, Ghana has signed treaties with Germany and Netherlands which combine “royalties and service fees”. Uganda has signed treaties with South Africa, Mauritius and the United Kingdom which contain an article on “technical fees”. Ghana has also signed treaties with Italy and Belgium that cover “management fees”.

Provisions on services, managements and technical fees do not only appear in treaties signed by small developing countries, there is also one in, for example, the US-India tax treaty. However there is no standard way of drafting these articles which makes treaty negotiations very difficult and creates uncertainties for tax payers who have to check the provisions of each treaty to be sure they’ve got it right. Since the articles on these types of fees deviate from what is in MTCs, the provisions adopted tend to be less well thought-out than those arising from debate and negotiation and adopted under the OECD or the UN MTCs.

Despite the widespread use of these articles, the OECD does not advocate for an article on these fees in the MTC. Currently under article 5 of the OECD MTC, a source country may only tax a foreign service provider (such as construction companies or management consultants) if it has a PE in the country for more than six month in a one year period, or under the UN MTC, the consultant must have a “fixed base” that they use regularly. However, MNE’s are able to come up with artificial schemes to avoid PE status (see also suggested changes to PE definition in OECD Report on Actions 7). Secondly since only profits attributable to a PE are taxed in the source state, where services are offered between the PE and its office, the arm’s length principle has to be applied to prevent transfer pricing.

Enforcing the arm’s length principle with respect to service fees is cumbersome for source countries because it is difficult to verify whether the service fee payments are appropriate. In 2012, the UN started work on a proposal for a new article on income from technical services that would allow developing countries to levy a tax on payments made to overseas providers of ‘technical services’. The UN Committee’s proposal allows a country to tax the income of a service provider even if it has no physical presence in their country. If, in future, South Africa signs a treaty with a country that is based on the UN MTC, it will have to deal with the implications of such an article.

The discussion on cross-border management services is also relevant to the principle of the attribution to profits to permanent establishments. Article 7(1) of the OECD and the UN Model Treaty provide that “the profits of an enterprise of a contracting state shall be taxable only in that state unless the enterprise carries on business in the other contracting state through a permanent establishment situated therein. And it is only the profits attributable to that permanent establishment that may be taxed in that state. Article 7(2) of the OECD MTC (inserted in the 2010 version) sets out the OECD authorised approach for attributing profits to PEs. The article states that:

> "For the purposes of this article and article 23A and 23B, the profits attributable in each Contracting State to the permanent establishment … are those <u>it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise"</u> (emphasis added)

In terms of this approach, the profits to be attributed to a PE are those which that PE would have earned if instead of dealing with its head office, it had dealings with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market. Thus the PE is treated as if it were an affiliate company, and the income taxable in the source country is determined by estimating, through a series of assumptions, the amount of income that the PE would have earned if indeed it were an independent corporation.

The OECD recommends that 'transfer pricing' rules applicable to transfers between related persons be used to attribute income to a PE. This requires that the 'arm's length' principle be applied in determining the profits attributable to the PE. The 'arm's length' principle, as set out in art 9(1) of OECD Model Tax Convention, provides that when conditions are made between two associated enterprises in their commercial or financial relations which differ from those which would have been made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly. In line with the OECD approach, SARS Practice Note 7 advises taxpayers to take make use of transfer pricing rules to assist them to determine the amount of such an attribution.

The OECD approach of attributing profits to PEs, tries to recognise the economic differences between permanent establishments and subsidiaries by adopting the "functionally separate entity" approach whereby in attributing profits to a PE, its internal dealings are recognised by pricing them on an arm's length basis, without regard to the actual profits of the enterprise of which the PE is a part. This implies that non-actual management expenses, notional interest and royalties from head office may be charged on the PE.

However this approach differs from the UN Model Convention and the 2008 version of the OECD MTC (upon which many treaties are still based). The wording in the UN Model which is similar to that in the previous 2008 OECD MTC states that:

> "Subject to the provisions of paragraph 3, where an enterprise of a contracting state carries on business in the other contracting state through a permanent establishment situated

therein, there shall in each contracting state be attributed to the permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment." (emphasis added)

The similarity between the OECD and the UN MTC in attributing profits to a PE is that both require that the "arm's length" principle, as set out in article 9, has to be applied to transfers between related persons by analogy to attribute income to the PE.[227] This requires that the OECD Transfer Pricing Guidelines[228] have to be applied to determine an arm's length price. In terms of both the OECD and the UN MTCs, the expenses incurred by the PE whether in the state in which the PE is situated or elsewhere are deductible.

The UN MTC and also the 2008 version of the OECD MTC differ from the current OECD MTC in that in the former, a "single entity" approach is used to attribute profits to a PE such that only the actual income and expenses of the PE are allocated, rather than the OECD "functionally separate entity" approach.

It has been argued that this approach may result in exploitation since it allows deductions for notional internal payments that exceed expenses actually incurred by the taxpayer.[229] Many countries,[230] including South Africa, have, consequently, not adopted the new Article 7 at this stage as it is presumed that this approach would have serious detrimental tax revenue consequences particularly through allowing financial services businesses deductions for notional payments on internal loans and derivatives involving PEs.[231] This is designed to preserve the source country's tax base.

Although the OECD advocates for the dynamic interpretation of treaties that takes into account the ongoing national and international developments in tax law, rather than the static approach of interpreting treaties in accordance with the contents of its

227 AW Oguttu 'The Challenges of Taxing Profits Attributed To Permanent Establishments: A South African Perspective' *Bulletin for International Taxation* 64 No.3 (2010), 169; R. Russo 'Tax Treatment of 'Dealings' Between Different Parts of the Same Enterprise Under Article 7 of the OECD Model: Almost a Century of Uncertainty' *Bulletin for International Fiscal Documentation* 10 (2004), 24.

228 Para 18 of the Commentary on art 7(2).

229 Deloitte 'ATO paper on Profit Allocation to Bank Branches'. Available at http://www.deloitte.com/view/en_au/au/a79b8ba975c53310VgnVCM3000001c56f00aRCRD.htm accessed 14 October 2013.

230 A number of OECD countries (including New Zealand) have entered reservations to the change and the United Nations Committee of Experts on International Cooperation in Tax Matters has not viewed changes as relevant to the United Nations Model Convention. A number of key economies (Brazil, China, Hong Kong, Indonesia, Malaysia, Thailand and India) are known to have reserved their position on the new Article 7.

231 Deloitte 'Transfer Pricing Law Reforms' (2013). Available at http://www.deloitte.com/view/en_AU/au/insights/browse-by-job-title/cfos/f364b564daf7c310VgnVCM2000003356f70aRCRD.htm accessed 14 October 2013.

terms at the time it was concluded,[232] the OECD acknowledges that where the latest version of the Convention is "different in substance" from the previous version,[233] the previous version has to be applied in interpreting the treaty. As the current provisions relating to attribution of profits to PEs are "different in substance" to the 2008 version, the dynamic interpretation of the treaty would not apply. Since the OECD Model Tax Convention is not legally binding and it is the treaty that is a binding contract between the two States, if the two states wish to follow the new OECD approach, the two states can re-negotiate and amend the treaty or add a Protocol that incorporates the new OECD approach.[234]

Developing countries like South Africa are very concerned about the treatment of deductions and they are very sceptical about adopting the new article 7. Developing countries are especially sceptical about multinational companies that often try to avoid taxes levied on the PE by claiming deductions of various forms of fees charged to the headquarter office on the PE. Conflicts normally arise when the developing countries deny or limit the deductions for such fees.

Unlike article 7 of the OECD MTC, which permits the deduction of notional expenses between the PE and its foreign head office, article 7(3) of the UN MTC, clearly denies the deduction of such expenses. It states that:

> In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the Contracting State in which the permanent establishment is situated or elsewhere. However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment. Likewise, no account shall be taken, in determining the profits of a permanent establishment, of amounts charged (otherwise than towards reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the head office of the enterprise or any of its other offices.[235]

As indicated above, the South African Revenue Service has indicated that, like its Africa counterparts, South African taxpayers must not adopt the latest OECD proposal, and rather remain in line with the UN Model.[236]

232 Para 35 of the Introduction to the OECD MTC. Note that article 31 of the Vienna Convention on the Law of Treaties does not explicitly advocate a static or dynamic method of interpretation. See also Schenk-Geers, *International Exchange of information*, 48.
233 Para 35 of the Introduction to the OECD MTC.
234 See examples of Protocols to existing DTAs signed by South Africa and various countries as discussed below.
235 GG 22313 dd 2001-05-24 which entered into force 9 April 2001.
236 OECD MTC 2010 reference to country specific approaches.

8.1.2 OECD GUIDANCE ON "LOW VALUE-ADDING INTRA-GROUP SERVICES"

In its 2015 Final Report on Action 8-10, "low value-adding intra-group services", the OECD notes that nearly every MNE group must arrange for a wide scope of services to be available to its members, in particular, administrative, technical, financial and commercial services. Such services may include management, coordination and control functions for the whole group. The cost of providing such services may be borne initially by the parent, by one or more specially designated group members ("a group service centre"), or other group members.

An independent enterprise in need of a service may acquire the services from a service provider who specialises in that type of service or may perform the service for itself (i.e. in-house). In a similar way, a member of an MNE group in need of a service may acquire it from independent enterprises, or from one or more associated enterprises in the same MNE group (i.e. intra-group), or may perform the service for itself. Intragroup services often include those that are typically available externally from independent enterprises (such as legal and accounting services), in addition to those that are ordinarily performed internally (e.g. by an enterprise for itself, such as central auditing, financing advice, or training of personnel). It is not in the interests of an MNE group to incur costs unnecessarily, and it is in the interest of an MNE group to provide intra-group services efficiently. [237]

The OECD acknowledges that a number of countries have indicated that excessive charges for intragroup management services and head office expenses constitute one of their major BEPS challenges. In order to guide taxpayers regarding how to benchmark transactions involving cross-border services, and thereby provide protection against common types of base eroding payments, the OECD has proposed revisions to Chapter VII dealing specifically with management fees and head office expenses.

In combination with the G20 Development Working Group mandated to develop of toolkits which can be implemented by developing countries and which will protect these countries from base-eroding payments, the objective of this measure will assist developing countries in protecting their tax base from excessive intra-group service charges. [238]

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[237] OECD/G20 2015 Final Report on Actions 8-10 at 143.

[238] OECD/G20 2015 Final Report on Actions 8-10 at 142.

8.1.3 THE SIMPLIFIED METHOD FOR DETERMINING ARM'S LENGTH CHARGES FOR LOW VALUE-ADDING INTRA-GROUP SERVICES

The aim of the "simplified approach", as its name suggests, is to propose an elective simplified approach which:

- specifies a wide category of common intra-group services which command a very limited profit mark-up on costs;
- applies a consistent allocation key for all recipients for those group services; and
- provides greater transparency through specific reporting requirements.[239]

The approach is designed to ensure, for payer countries, that the system through which the costs are allocated leads to an equal treatment for all associated enterprises that are operating in similar circumstances. Thus, the implications for South African taxpayers are that, where the approach is adopted, they will be charged for such services in a consistent manner to all other members of the MNE of which they are a part, and by all their different cross border connected parties providing similar services (clearly in order for this to apply the methodology needs to be applied by as many countries as possible). Equally, they will charge for such services, to their cross border connected parties in the same manner.

The approach "aims to guarantee that no overpricing takes place due to general agreement on categories of costs included in the cost base and general agreement on the determined moderate mark-up of 5% that should be charged".[240] The approach is designed to ensure that intermediate companies which have low functionality, will be transparent to payor companies.

A further benefit of the approach is that it removes the detailed benchmarking and testing of the benefits received and therefore creates a low cost methodology consistently applied for low value added services i.e. reduced compliance burden, but simultaneously provides the certainty that the relevant tax authorities will accept the approach.

Low value-adding intra-group services are defined as 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

239 OECD/G20 2015 Final Report on Actions 8-10 at 141.

240 OECD/G20 2015 Final Report on Actions 8-10 at 141.

- do not involve the assumption or control of substantial or significant risk by the service provider and do not give rise to the creation of significant risk for the service provider. [241]

Examples of services that would meet the definition of low value-adding services are:

- accounting and auditing,
- processing and management of accounts receivable and accounts payable
- human resources activities,
- monitoring and compilation of data relating to health, safety, environmental and
  other standards regulating the business.
- information technology services
- internal and external communications and public relations support
- legal services,
- activities with regard to tax obligations,
- general services of an administrative or clerical nature.[242]

Activities that do not qualify for the simplified approach for low value-adding intra-group services are:

- services constituting the core business of the MNE group;
- research and development services (including software development unless falling within the scope of information technology services)
- manufacturing and production services;
- purchasing activities relating to raw materials or other materials that are used in the manufacturing or production process;
- sales, marketing and distribution activities;
- financial transactions;
- extraction, exploration, or processing of natural resources
- insurance and reinsurance; and
- services of corporate senior management (other than management supervision of services that qualify as low value-adding intra-group services).[243]

The Simplified method for determining arm's length charges for low value-adding intra-group services requires calculating, on an annual basis, the pool of costs incurred by all members of the group in performing services that fall within the category of low value-added beneficial intra-group services, but not including those services where a company performs services only for one other company. Once the costs have been identified, suitable allocation keys must be determined e.g HR cost determined by headcount. These must be used consistently and reasonably reflect the benefit received by the recipient of the service.

241 OECD/G20 2015 Final Report on Actions 8-10 at 153.
242 OECD/G20 2015 Final Report on Actions 8-10 at 154.
243 OECD/G20 2015 Final Report on Actions 8-10 at 153-154.

Pre-defined documentation and reporting is required to support the simplified approach for submission to the tax administration:

- A description of the low- value added services, the beneficiaries, why the services are considered low-value added, the rationale for the provision of the services, the expected benefits thereof, the allocation keys and justification that they reasonably reflect the benefits received, and mark-up applied;
- Written contracts and agreements for the services; and
- Documentation and calculations showing the cost pool and the mark-up applied, and also the application of the allocation keys.

In order to assist developing countries, where excessive charges for intra group management services are viewed as being a major BEPS challenge, it suggested that a threshold be put in place whereby, if such services exceed the relevant threshold a full transfer pricing analysis would need to be performed, including evidence demonstrating detailed specific benefits received by the payor. It is suggested that the threshold be based on fixed financial ratios of the recipient party (e.g. proportion of intra group costs to total costs/turnover).[244]

A two-step implementation of the simplified approach is proposed: The first is for a large group of countries to agree on adopting the mechanism before 2018. OECD members have agreed to the approach in principle, and associated countries (which include South African) are considering it.[245] The second is for the OECD to perform further work on the design of the threshold and other implementation issues (To be finalised by end 2016).

8.1.4 OECD PROPOSED GUIDELINES

The proposed OECD Guidelines for Chapter VII of the transfer pricing guidelines refer to administrative, technical, financial and commercial services. Such services often include those that are typically available externally from third parties (legal and accounting) as well as those often performed internally (e.g. by the entity itself, such as internal auditing, financing advice, training or personnel). Such services may be provided together with other goods and services, including intangibles, and it is important for the principles of aggregation and segregations (in Chapter III of the Guidelines) to be considered to ensure no duplication.

The Guidelines set out the principles for the simplified method, but also advise on how to deal with these services in the absence of this method and also if the threshold for this method has been exceeded.

244 OECD/G20 2015 Final Report on Actions 8-10 at 159.
245 OECD/G20 2015 Final Report on Actions 8-10 at 142.

There are two issues in the analysis for intra group services. One is whether the services have actually been provided (the benefits test) and the other is what the charge for such a service should be, for tax purposes.

The benefits test provides that if the activity is not one that independent enterprises would have been willing to pay for, or which it would perform for itself, the activity should not be considered as an intra-group service under the arm's length principle. It should be noted that this principle applies equally to the simplified approach. However, under the simplified approach the taxpayer need only demonstrate that e.g. payroll services were provided rather than needing to demonstrate the individual acts that have given rise to the costs charged.

It is furthermore essential that reliable documentation is provided to the tax administration to verify that the costs have been incurred by the service provider.[246] A 'shareholder activity' would not ordinarily be an activity that would be charged for. Such activities include *inter alia* costs relating to the juridical structure of the parent (meeting, listing aspects etc.), costs relating to reporting requirements of the parent (e.g. consolidation, audit requirements for subsidiaries purely for parent reporting purposes), costs of raising funds for acquisition of new entities, investor relations etc., costs ancillary to corporate governance of the group as whole. If, on the other hand a parent company raises funds for its subsidiary to e.g. buy a new company, the parent would be viewed as providing a service to the subsidiary.

Intra-group services should not be viewed as providing benefit if they merely duplicate a service that another group member is performing for itself, or that is being performed by a third party. In addition, benefits that are incidental to a group company would also not be considered to be a service for which a charge should be levied e.g. the decision of the holding company to analyse whether to reorganise the group, or if the company has a higher credit rating merely by virtue of being a member of the group. If, however, the group member is provided a guarantee, in order that its credit rating is improved, then a charge would be warranted.

Centralised services like *inter alia* planning coordination, budgetary control, financial advice, accounting auditing, legal advice, computer services, assistance in the fields of production, buying, distribution and marketing, staff related services (e.g. recruitment and training), order management, customer service, call centres, R+D, and protecting IP would be considered to be intra-group services as an independent enterprise would be willing to pay for them.

The nature of the consideration for such services will depend on whether they are charged as and when supplied (a user charge) or whether the service provider

246 OECD/G20 2015 Final Report on Actions 8-10 at 144.

company is ‘on call’ i.e. having staff and equipment available for use at any time[247]. In such circumstances an independent enterprise might agree to a ‘retainer’. However, this would not be appropriate if the potential need for the service would be remote, or where the services are readily available from other sources. In order to determine the level of benefit, the extent of the use of the service over several years should be considered. The guideline is clear that the mere payment for “management fees” is not evidence of services rendered.

On the basis that services have been rendered they can be charged for on the direct-charge method i.e. a specific charge for a specified service or an indirect charge method i.e. using a cost allocation and apportionment method. The latter is usually necessary because it is difficult for the service provider to determine exactly what costs were rendered to which group entity, but is not generally considered appropriate where third parties are provided the same services. In addition, it must be clear that the recipient has received an identifiable benefit, and the method for apportionment must make sense e.g. the allocation key must reflect a method that might apply for third parties e.g. sales promotion activities carried on centrally (trade fares, ad campaigns) may benefit the sales of a number of affiliates. The method for allocation must be one that a third party would be willing to accept.[248]

The Guideline requires that in determining the method for calculating the arm’s length compensation the perspective of the service provider and recipient must be considered. Generally, the method for compensating for services will be based on either a CUP or a cost based method (cost-plus or TNMM). If a cost-based method is used, it is important that if third party services are procured only the agency aspect is marked-up and not the third party costs. In addition, if a CUP method establishes a price, and the group costs exceed this it would not be appropriate to add an additional mark-up.

The Guidelines also recommend that where withholding taxes are levied on services they should only be applied to the mark-up and not the costs, as such withholding taxes can result in the service provider not recovering its costs.

8.1.5 THE SOUTH AFRICAN PERSPECTIVE

South Africa has EXCON rules that need to be considered in proposing the adoption of the ‘simplified method’.[249] However, on the basis that the approach is designed to provide a standardised ‘arm’s length’ approach it is recommended that SARB be approached to accept the method on the same basis as the tax authorities.

247 OECD/G20 2015 Final Report on Actions 8-10 at 147.
248 OECD/G20 2015 Final Report on Actions 8-10 at 48-49.
249 Deloitte submission to DTC 26 July 2015 at 8.

On this basis, the reduced documentation and cost burden based on the safe harbour mark-up should be adopted in line with the OECD recommendations[250].

It is submitted that, in order to protect South Africa's tax base where such transactions are significant, a suitable threshold be determined, above which the normal rules, as set out in the guidelines should be applied.

8.1.6 RECOMMENDATIONS FOR SOUTH AFRICA

The DTC recommends that:

- In line with other countries, and to ensure the success of the simplified approach, South Africa adopts the simplified approach for low value added services, as proposed by the OECD, but also implements a suitable threshold. The level of this threshold should be evaluated once the further OECD work is complete.
- The proposed guidance on low value added services should be applied where real (as opposed to notional) expenses have been incurred.
- SARB should be approached to align with this approach.
- The withholding tax on service fees be scrapped (as per the 2016 Budget speech).

8.2 ACTION 10: TRANSFER PRICING GUIDANCE ON COMMODITY TRANSACTIONS

As noted above, developing countries identified transfer pricing of commodities as of critical importance to them since they create additional BEPS challenges for developing countries. Under the mandate of Action 10 of the BEPS Action Plan, which requires the development of transfer pricing rules to provide protection against common types of base eroding payments; the G20 and OECD countries have examined the transfer pricing aspects of cross-border commodity transactions between associated enterprises ("commodity transactions"). The outcome of this work is an improved framework for the analysis of commodity transactions from a transfer pricing perspective which should lead to greater consistency in the way that tax administrations and taxpayers determine the arm's length price for commodity transactions and should ensure that pricing reflects value creation.[251]

The IMF has noted that developing countries lose substantial amounts of revenue from MNEs involved in tax planning schemes especially, but not only, in the extractive industries.[252] However although the problem of transfer pricing in the extractive industry is a BEPS issue in developing countries, it was not initially a transfer pricing focus area in the BEPS Action Plan. This concern is, as the IMF

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250 Deloitte submission to DTC 26 July 2015 at 9.
251 OECD/G20 2015 Final Report on Actions 8-10 in para 51.
252 See IMF "Spillovers in International Corporate Taxation" (2014) at 7.

says, one of the "many situations that are more significant to or common in developing countries receive relatively little attention in existing transfer pricing guidance". [253] In this regard, the IMF explains that it is common for a MNE company to locate low risk, routine, light manufacturing or commercial ventures in developing countries so that productivity gains rarely translate themselves into higher local profit margins. In terms of the transfer pricing rules, these operations will be assigned a low fixed profit rates for tax purposes.[254]

Many developing countries incur tax losses from commodities that are exported at under- value to other companies in MNEs which are located in low tax jurisdictions. Tax losses also occur from equipment and other goods being imported at inflated prices into a given country from other companies in the MNE group, which are located in low tax jurisdictions, to obtain excessive tax deductible depreciation charges.[255] Developing countries are also concerned about schemes involving the interposition of entities between the multinational mining companies based in their countries and the market, leading to the developing country receiving a significantly low price on the end market price or contract price.[256] In most cases the interposed entities have little or no substance in the low tax jurisdiction, and often tax administrations face significant challenges obtaining information on the final market in the low tax jurisdictions and on the substance of the foreign entity involved.[257]

The International Mining for Development Centre[258] notes that "transfer pricing in the mining sector is crucial in sub-Saharan Africa, "particularly given the rapid growth in the economic importance of this sector, its technical and logistical complexity, the prevalence of multinational enterprise groups, increasingly fragmented supply chains, and high volumes of cross-border transactions between related parties. These factors create opportunities for transfer mispricing, which can take the form of underpayment for outbound supplies of mineral products and overpayment for inbound assets, services and finance provided to their mining operations in developing countries by foreign subsidiaries of MNE groups". Even relatively small percentage variations in transaction prices can translate into significant tax leakages where they relate to very large flows. [259] Similar leakages may also occur when payments for capital goods, finance or services provided by a related entity are overpriced.[260]

253 IMF "Spillovers in International Corporate Taxation" (2014) at 32.
254 IMF "Spillovers in International Corporate Taxation" (2014) at 32.
255 ATAF "ATAF News: Giving Africa a voice on the burning issue of base erosion and profit shifting" (April 2015) at 1.
256 ATAF "2nd Meeting: Cross Border Taxation Technical Committee" (3-4 March 2015) at 5.
257 ATAF "ATAF News: Giving Africa a voice on the burning issue of base erosion and profit shifting" (April 2015) at 1.
258 International Mining for Development Centre "Transfer Pricing in the Mining Section: An African Perspective – A Briefing Note" (September 2014) at 5.
259 International Mining for Development Centre "Transfer Pricing in the Mining Section: An African Perspective – A Briefing Note" (September 2014) at 8.
260 Ibid.

8.2.1 CONCERNS IN SOUTH AFRICA

In South Africa, SARS has identified the following key transfer pricing risks within the mining industry: fragmentation of the supply chain using intermediary marketing and sales entities; excessive debt deductions through thin capitalization; intra-group charges including services and royalty payments.[261]

SARS claims to have had some success in auditing these abuses and it has established a specialist unit to tackle transfer pricing.[262] SARS has stated that "over the last three years the transfer-pricing unit has audited more than 30 cases and has made transfer-pricing adjustments of just over R20-billion, at a conservative estimate, with an income tax impact of more than R5-billion."[263] Further that the auditing of a similar number of cases is in progress and others are in the process of being risk assessed.[264]

Since 1 October 2012, when the Tax Administration Act 28 of 2011 came into effect, SARS has been imposing hefty understatement penalties (up to 200%) on any transfer pricing adjustments made to a taxpayer's tax position (whether it results in actual tax being payable or not) followings audits conducted on mining and prospecting companies. Nevertheless SARS acknowledges that transfer pricing audits do not often yield quick results since certain schemes are complex and require much time and resources. One of the major risks area SARS identified, that is often very difficult to audit, is transactions involving fragmentation whereby MNEs enter in convoluted structures involving the inter-positioning of multiple companies, generally in low tax jurisdictions, (where they split out functions and risks) to divide profits.[265]

In such cases, SARS tries to test if there is substance in the transactions by scrutinising the broader structure or supply chain, looking out for elements of artificiality of transaction flows and/or agreements; high volumes as well as changes in transactions especially when there are changes in legislation.[266] SARS

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261 Nishana Gosai (SARS) "Transfer Pricing in the Mining Industry" (December 2011). Available at http://www.eisourcebook.org/cms/files/attachments/other/Transfer%20Pricing%20in%20the%20Mining%20Industry%20(RSA%20view).pdf accessed 3 August 2015.

262 PWC "International Transfer Pricing: African Regional". Available at http://www.pwc.com/gx/en/international-transfer-pricing/assets/south-africa.pdf accessed 9 March 2015.

263 Times Live "Billions of Rands leave SA under the radar" Available at http://www.timeslive.co.za/thetimes/2015/01/11/billions-of-rands-leave-sa-under-the-radar accessed 8 March 2015.

264 Ibid.

265 Nishana Gosai (SARS) "Transfer Pricing in the Mining Industry" (December 2011). Available at http://www.eisourcebook.org/cms/files/attachments/other/Transfer%20Pricing%20in%20the%20Mining%20Industry%20(RSA%20view).pdf accessed 3 August 2015.

266 Ibid.

acknowledges that "there is no easy solution to the problem" and that it is addressing the problem both from a domestic and international front.[267]

Although there are no cases on transfer pricing that have yet gone to court in South Africa, there have also been strong allegations and circumstantial evidence of mining companies shifting profits from South Africa to low tax jurisdictions exit using transfer pricing schemes. An October 2014 Business Times News Paper[268] put a spotlight on allegations of transfer pricing by the platinum mining company – Lonmin (whose parent company is based in the UK), which was been embroiled in the protracted wage demands by its Marikana rock drillers in 2012. The revelations arose from the materials made public in the proceedings of the "Farlam Commission of Inquiry" into the death of 34 Miners at the Marikina Mine in 2012.

The cross-examination of the company's former Operations Chief revealed that between 2002 and 2008, Lonmin's platinum marketing was done by its subsidiary Western Metals Sales Limited which was registered in tax-free Bermuda but operating out of London. For those marketing services, Lonmin paid about $170-million (R1.8-billion today) to Western Metals Sales Limited (Bermuda) even though it was not clear if the Bermuda company kept an office with staff who marketed its platinum.

The concern that arose was: if the marketing operations of Western Metals Sales Limited were done by the marketing staff in London, it was hard to imagine the commercial purpose the Bermuda-offshore company served, if not to reduce the tax burden. The cross-examination revealed that after 2007, Lonmin moved its marketing staff from London to its South Africa branch, Lonmin Management Services (LMS). So its marketing fees were diverted from Bermuda to the South African branch. Thus more millions were moved to the UK parent company through Lonmin's South African branch (LMS).

From 2008 to 2012, Lonmin's South African mines paid over R1-billion in sales commissions to LMS, according to figures before the commission. Lonmin disclosed in its 2013 annual report that 92% of its revenues were drawn from platinum sales to just two key customers. Concerns about the limited workload of the marketing division were raised and there were also transfer pricing concerns as to whether the service fees were fairly priced. Lonmin provided documents to the Farlam commission regarding its marketing function costs, which show that in 2011, for example, the marketing function cost LMS R17-million, while it received a marketing fee of R280-million – suggesting an enormous profit margin which Lonmin could not justify. There was also "management fees" paid by the South African mine, Western

267 Ibid.

268 A Crotty "Lonmin's Failed gag Bid puts spotlight on transfer Pricing" *Business Times* 19 October 20142.

Platinum Limited to LMS from 2007 to 2012, this amounted to a further R1.4-billion that was channelled away from the South African mines.[269]

Further allegations of transfer pricing in the mining sector were made in a submission before the Portfolio Committee on Trade and Industry by the South African Mining Development Association (SAMDA)[270] - a mining Initiative by South African junior and black economic empowerment (BEE) mining investors. In its submission on “Transfer Pricing and Transformation within the Mining Industry” SAMDA alleges that large mining companies may be involved in transfer pricing to the detriment of BEE companies.[271] SAMDA alleges that some mining companies sell commodities to their marketing divisions in low tax jurisdictions and tax haven at lower than market related prices. This results in the shifting of profits to such jurisdictions; the declaration of low profits in South Africa and consequently the payment of low tax in the South Africa where the commodity is being produced, which is a loss to South Africa. [272]

Some of the schemes that mining companies are involved in, as cited by SAMDA include: under reporting of commodity prices in favour of contract pricing or recommended pricing; non-reporting of full range of products sold; inflated expenditure used to reduce profits locally; transfer of funds between connected South African companies, whereby funds are transferred to a company carrying an assessed loss so as to reduce prices; and exchange rate misreporting.[273] SAMDA states such schemes have impacted on the mining sector in that: the outflows of funds significantly exceeds what is spent locally; often projects committed to are scaled down, delayed or underfunded because of a perceived loss of profitability. Such schemes also impact on BEE partners to mining companies whose profits may be reduced as the dividends, which would have gone towards re-paying loans and funding products are shifted offshore, sometimes leading to cancelled BEE deals.[274] SAMDA alleges that engaging in transfer pricing schemes has contributed to the non-compliance with Mining Charter by mining companies.

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269 C Mckune “Questions Lonmin Must Answer” Mai& Guardian 16 October 2014.

270 South African Mining Development Association (SAMDA): Submission to the Portfolio the Committee on Trade and Industry on “Transfer Pricing and Transformation within the Mining Industry” (3 September 2014). Available at https://www.google.co.za/#q=foreign+owned+mines+in+south+africa+ accessed 8 March 2015.

271 Ibid.

272 Ibid.

273 South African Mining Development Association (SAMDA): Submissions to the Portfolio Committee on Trade and Industry on “Transfer Pricing and Transformation within the Mining Industry” on 3 September 2014 Available at https://www.google.co.za/#q=foreign+owned+mines+in+south+africa+ accessed 8 March 2015.

274 Ibid.

8.2.2 RESPONSES TO TRANSFER PRICING OF COMMODITIES BY OTHER DEVELOPING COUNTRIES

The ability of a developing country like South Africa to curtail these abuses is hampered by challenges in the administration of transfer pricing legislation due in particular to the paucity of specialist expertise and experience and the difficulties in obtaining the information necessary for applying the arm's length principle. When it comes to commodities, these challenges are compounded by the "relative complexity of the mining sector, which can involve hard-to-value intangibles and other complex transactions, and by a lack of industry specific knowledge and experience within tax administrations."[275] These factors place significant pressure on tax administrations, limiting their current capacity to adequately monitor and address transfer pricing risks in the mining sector.[276]

Tax administrations also face difficulties in accessing information on the offshore entity that is party to the transaction, often this is complicated by the web of treaty network that the parties take advantage of.[277] In September 2014, the International Mining for Development Centre issued a briefing note which stated that reviews conducted by the World Bank Group of the mining taxation policy and administrative procedures of a number of mineral-rich African countries identified a strong need for a study focusing specifically on the administration of transfer pricing in the African mining sector. To date the results from this study have not been published, but it is clear that the focus on transfer pricing within the mining sector shows that all mining MNE's are coming under increased scrutiny.[278]

In response to these challenges some developing countries have adopted specific unilateral approaches for pricing commodity transactions, such as the so-called "sixth method" that was employed initially in Argentina but is now used by other South American countries such as Brazil, Peru and Chile. India is also applying this method.[279] This method makes specific reference to the use of publicly quoted commodity prices. Although there are difficulties in applying this method, the sixth method which uses quoted prices as a guide is considered clear in that it uses an objective standard that is easy to administer, since many commodities are traded on

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275 International Mining for Development Centre "Transfer Pricing in the Mining Section: An African Perspective – A Briefing Note" (September 2014) at 5.

276 International Mining for Development Centre "Transfer Pricing in the Mining Section: An African Perspective – A Briefing Note" (September 2014) at 5.

277 Nishana Gosai (SARS) "Transfer Pricing in the Mining Industry" (December 2011). Available at http://www.eisourcebook.org/cms/files/attachments/other/Transfer%20Pricing%20in%20the%20Mining%20Industry%20(RSA%20view).pdf accessed 3 August 2015.

278 International Mining for Development Centre "Transfer Pricing in Mining: An African Perspective – A briefing Note" (September 2014). Available at http://im4dc.org/wp-content/uploads/2013/07/Transfer-pricing-in-mining-An-African-perspective-A-briefing-note1.pdf accessed 3 August 2015.

279 International Mining for Development Centre "Transfer Pricing in the Mining Section: An African Perspective – A Briefing Note" (September 2014) at 9.

public exchanges. A quoted price can provide a clear and relatively objective point of reference. Hence, it can provide a basis for rules which are easy to administer and do not involve either subjective judgment or detailed examination of facts and circumstances.

In South Africa, there have been calls from civil society that the sixth method should be implemented, but the South African government has not considered applying this method presumably because there has not been internal guidance in the use of the method. [280]

With the emergence of unilateral approaches, the need to respond to the challenges of pricing commodity transactions, such as the use of the sixth method, highlighted the need for clearer guidance on the application of transfer pricing rules to commodity transactions. The OECD considered the difficulties faced by some countries: in determining adjustments made to quoted prices; verifying the pricing date, and accounting for the involvement of other parties in the supply chain.

It is further noted that several problems and policy challenges have been identified in respect of commodity transactions faced by tax administrations generally and, most acutely, by tax administrations of commodity-dependent developing countries. Countries have reported the following key transfer pricing issues that may lead to base erosion and profit shifting ("BEPS") in cross-border commodity transactions:

- The use of pricing date conventions which appear to enable the adoption by the taxpayer of the most advantageous quoted price;
- Significant adjustments to the quoted price, or the charging of significant fees to the taxpayer in the commodity producing country, by other group companies in the supply chain (e.g. processing, transportation, distribution, marketing); and,
- The involvement in the supply chain of entities with apparently limited functionality, which may be located in tax opaque jurisdictions with nil or low taxation. [281]

The OECD notes that these issues are pertinent for commodity dependent developing countries, for which the commodity sector provides the major source of economic activity, contributing in a significant manner to employment, government revenues, income growth and foreign exchange earnings. For many of these countries, dependence on commodities has defined their economic policy (making commodity exports the primary driver of growth and investment) and development trajectory.[282]

280 International Mining for Development Centre "Transfer Pricing in the Mining Section: An African Perspective – A Briefing Note" (September 2014) at 9.
281 OECD/G20 2015 Final Report on Actions 8-10 at 53.
282 OECD "Discussion Daft on a BEPS Action 10: Cross-border Commodity Transactions" (16 December 2014 – 16 February 2015) in para 1.

8.2.3 OECD GUIDANCE ON TRANSFER PRICING OF COMMODITIES

In December 2014, the OECD issued a Discussion Draft on a BEPS Action 10 dealing with Cross-border Commodity Transactions.[283] In line with the OECD Work on Action 10, Chapter II of the Transfer Pricing Guidelines has been amended to include new guidance especially applicable to commodity transactions. In summary the new guidance, set out in the 2015 OECD Report (explained in detail below):

- clarifies how the comparable uncontrolled price (CUP) method can be applied to commodity transactions.
- advises that the CUP method would generally be an appropriate transfer pricing method for commodity transactions between associated enterprises.
- advises that quoted prices can be used under the CUP method, as a reference to determine the arm's length price for the controlled commodity transaction; and
- reasonably accurate comparability adjustments should be made, to ensure that the economically relevant characteristics of the controlled and uncontrolled transactions are sufficiently comparable.

The OECD recommends that with respect to the guidance for selecting the most appropriate transfer pricing method in the circumstances of a particular case, the CUP method would generally be an appropriate transfer pricing method for establishing the arm's length price for the transfer of commodities between associated enterprises.[284]

- In this regard, the OECD defines the term "commodities" to encompass physical products for which a quoted price is used as a reference by independent parties in the industry to set prices in uncontrolled transactions.
- The term "quoted price" is defined by the OECD to mean the price of the commodity in the relevant period obtained in an international or domestic commodity exchange market. In this context, a quoted price also includes prices obtained from recognised and transparent price reporting or statistical agencies, or from governmental price-setting agencies, where such indexes are used as a reference by unrelated parties to determine prices in transactions between them.[285]

Under the CUP method, the arm's length price for commodity transactions may be determined by reference to comparable uncontrolled transactions and by reference to comparable uncontrolled arrangements represented by the quoted price.

- Because quoted commodity prices generally reflect the agreement between independent buyers and sellers in the market on the price for a specific type

283 OECD "Discussion Daft on a BEPS Action 10: Cross-border Commodity Transactions" 16 December 2014 – 16 February 2015.
284 OECD/G20 2015 Final Report on Actions 8-10 in para 2.16A.
285 OECD/G20 2015 Final Report on Actions 8-10 in para 2.16A.

and amount of commodity, traded under specific conditions at a certain point in time.

- A relevant factor in determining the appropriateness of using the quoted price for a specific commodity is the extent to which the quoted price is widely and routinely used in the ordinary course of business in the industry to negotiate prices for uncontrolled transactions comparable to the controlled transaction. Accordingly, depending on the facts and circumstances of each case, quoted prices can be considered as a reference for pricing commodity transactions between associated enterprises. Taxpayers and tax administrations should be consistent in their application of the appropriately selected quoted price. [286]

For the CUP method to be reliably applied to commodity transactions, the economically relevant characteristics of the controlled transaction and the uncontrolled transactions or the uncontrolled arrangements represented by the quoted price need to be comparable.

- For commodities, the economically relevant characteristics include, among others, the physical features and quality of the commodity; the contractual terms of the controlled transaction, such as volumes traded, period of the arrangements, the timing and terms of delivery, transportation, insurance, and foreign currency terms.
- For some commodities, certain economically relevant characteristics (e.g. prompt delivery) may lead to a premium or a discount.
- If the quoted price is used as a reference for determining the arm's length price or price range, the standardised contracts which stipulate specifications on the basis of which commodities are traded on the exchange and which result in a quoted price for the commodity may be relevant.
- Where there are differences between the conditions of the controlled transaction and the conditions of the uncontrolled transactions or the conditions determining the quoted price for the commodity that materially affect the price of the commodity transactions being examined, reasonably accurate adjustments should be made to ensure that the economically relevant characteristics of the transactions are comparable.
- Contributions made in the form of functions performed, assets used and risks assumed by other entities in the supply chain should be compensated in accordance with the guidance provided in these Guidelines. [287]

The Guidelines provide methods for determining comparability by looking at economically relevant characteristics eg physical features and quality of the commodity, contractual terms, volumes traded, period of arrangements, timing and

286 OECD/G20 2015 Final Report on Actions 8-10 in para 2.16B.
287 OECD/G20 2015 Final Report on Actions 8-10 in para 2.16C.

terms of delivery, transport, insurance and foreign currency terms. It requires adjustments where differences materially affect the price.

In order to assist tax administrations in conducting an informed examination of the taxpayer's transfer pricing practices, taxpayers should provide reliable evidence and document, as part of their transfer pricing documentation, the price-setting policy for commodity transactions, the information needed to justify price adjustments based on the comparable uncontrolled transactions or comparable uncontrolled arrangements represented by the quoted price and any other relevant information, such as pricing formulas used, third party end-customer agreements, premia or discounts applied, pricing date, supply chain information, and information prepared for non-tax purposes. [288]

A particularly relevant factor for commodity transactions determined by reference to the quoted price is the pricing date, which refers to the specific time, date or time period (e.g. a specified range of dates over which an average price is determined) selected by the parties to determine the price for commodity transactions. Thus the OECD provides Guidance on the determination of the pricing date for commodity transactions. This should prevent taxpayers from using pricing dates in contracts that enable the adoption of the most advantageous quoted price.

It also allows tax authorities to impute, under certain conditions, the shipment date (or any other date for which evidence is available) as the pricing date for the commodity transaction. [289]

- Where the taxpayer can provide reliable evidence of the pricing date agreed by the associated enterprises in the controlled commodity transaction at the time the transaction was entered into (e.g. proposals and acceptances, contracts or registered contracts, or other documents setting out the terms of the arrangements may constitute reliable evidence) and this is consistent with the actual conduct of the parties or with other facts of the case.
- Tax administrations should determine the price for the commodity transaction by reference to the pricing date agreed by the associated enterprises. If the pricing date specified in any written agreement between the associated enterprises is inconsistent with the actual conduct of the parties or with other facts of the case, tax administrations may determine a different pricing date consistent with those other facts of the case and what independent enterprises would have agreed in comparable circumstances (taking into considerations industry practices).
- When the taxpayer does not provide reliable evidence of the pricing date agreed by the associated enterprises in the controlled transaction and the tax administration cannot otherwise determine a different pricing date they

[288] OECD/G20 2015 Final Report on Actions 8-10 in para 2.16D.
[289] OECD/G20 2015 Final Report on Actions 8-10 in para 51.

may deem the pricing date for the commodity transaction on the basis of the evidence available to the tax administration; this may be the date of shipment as evidenced by the bill of lading or equivalent document depending on the means of transport.

- This would mean that the price for the commodities being transacted would be determined by reference to the average quoted price on the shipment date, subject to any appropriate comparability adjustments based on the information available to the tax administration.
- It is important to permit resolution of cases of double taxation arising from application of the deemed pricing date through access to the mutual agreement procedure under the applicable Treaty. [290]

The guidance developed under other BEPS actions is also relevant in dealing with issues relating to commodity transactions. In particular, the revised standards for transfer pricing documentation (Action 13 of the BEPS Action Plan) and the guidance in the chapter "Guidance for Applying the Arm's length Principle" (Action 9 of the BEPS Action Plan). [291]

This new guidance will be supplemented with further work mandated by the G20 Development Working Group, following reports by the OECD on the impact of base erosion and profit shifting (BEPS) in developing countries. The outcome of this work will provide knowledge, best practices and tools for commodity-rich countries in pricing commodity transactions for transfer pricing purposes. [292]

8.2.4 RECOMMENDATIONS FOR SOUTH AFRICA WITH RESPECT TO TRANSFER PRICING OF COMMODITIES

The DTC recommends, with respect to transfer pricing of commodities:

- South Africa should follow the OECD Guidelines on Commodities, including the additional guidelines, set out in Actions 8-10, with particular reference to quoted prices[293] and dates on which to apply these, as well as necessary adjustments, taking into account the comparability factors mentioned in the report (and others), and use these as the basis on which to establish a benchmark price. Such a price should be one that results in an appropriate level of profit for the affiliate based on its activities in the country, and taking into account the value it creates for the MNE as a whole. This includes the benefits of providing a source of supply combined with the management of stocks and of ultimate delivery, and access to raw materials which is a type of location-specific advantage.

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290 OECD/G20 2015 Final Report on Actions 8-10 in para 2.16E.

291 OECD/G20 2015 Final Report on Actions 8-10 in para 51.

292 OECD/G20 2015 Final Report on Actions 8-10 in para 51.

293 The EFF's submission to the Davis Tax Committee supports the recommendation of the application of the quoted price (Sixth method) in South Africa at 31 and 39.

- Concern has been expressed[294] that one of the biggest risks facing the commodities sector is that most commodities are transported by sea. Bad weather, logistical problems and delays all impact the shipment date and result in demurrage. Since such delays and risk occur in transactions between independent parties, tax administrations should take such events into account before imputing a pricing date different to the contract date. It is submitted that the OECD recommendations now align with this proposal.
- SARS should consult with Industry to understand the "quoted price" data, its origins and how MNE's actually price the sale of commodities through the value chain, as well as South Africa's location in the context of key markets, the transport logistics and demurrage risks in order to:
  - determine the situations when it might be appropriate to apply the "deemed pricing date";[295] and
  - and to make it clear how it will implement the OECD proposals and the level of comparability adjustment it expects taxpayers to consider.
- SARS should issue guidance on the nature of adjustments that would be expected to be made to the quoted price, from a South Africa specific perspective, and only make such adjustments mandatory once such guidance has been issued;
- Consider the implementation of Advanced Pricing Agreements, discussed below, to ensure certainty for both taxpayers and SARS.
- Resources should be availed to ensure that SARS has capacity to apply the Guidelines on commodities, in particular, to facilitate the timely conclusion of MAP procedures to ensure non-double taxation).[296]

9 CONSIDERATION OF ADVANCE PRICING AGREEMENTS IN THE SOUTH AFRICAN CONTEXT

The recommendations set out above refer to Advance Pricing Agreements (APAs) as being a mechanism which may enhance the ability of SARS and MNEs operating in South Africa to achieve more certainty that transfer pricing is being appropriately determined in the context of the OECD Guidelines which, it is being recommended, will be adopted in the South African context. It is, thus, appropriate to consider the nature of the application of APAs in more detail.

'An APA is an "arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables, and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a period of time".

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294 Deloittes' submission to DTC (26 July 2015) at 5.
295 Deloittes' submission to DTC: 26 July 2015 at 5.
296 EFF Submission to the Davis Tax Committee on Illicit Financial Flows.

Where concluded bilaterally between treaty partner competent authorities, bilateral APAs provide an increased level of tax certainty in both jurisdictions, lessen the likelihood of double taxation and may proactively prevent transfer pricing disputes.'[297]

There are three types of APAs:

- A unilateral APA is an agreement between a taxpayer and the tax authority on the appropriate transfer pricing method to apply to its transactions with international parties. Such agreements typically operate for a period of five years, once finalised.
- A Bilateral APA is an agreement between tow tax authorities signed by the Competent Authorities under the relevant DTA through the mutual agreement procedure (MAP) article.
- A multilateral APA relates to an agreement between multiple tax authorities and taxpayers. These are rare and tend to be used only for specific projects.

APAs are generally applied looking forward but can be rolled back (per domestic rules permitting this).[298]

The United States established its APA programme in 1991 and has executed more than 1400 APAs since that date[299] (more than any other country) and the period for completion of such agreements ranges between 2.6 to 3.3 years[300].

Global inventories of disputes between treaty partners, largely composed of transfer pricing issues, have increased from 2352 cases in 2006 to 4566 in 2013.[301] With the adoption of the BEPS actions plans, especially country by country reporting, the number of transfer pricing disputes between treaty partners is likely to increase.[302] This is likely to make the attractiveness of the APA process more attractive to taxpayers wishing to avoid such disputes.

Despite the costs and time it takes to reach an APA, there are benefits to both the tax administration and the taxpayer in having this facility available.

Benefits to tax administrations include:

- Increased transparency, trust and credibility of tax authority;

297 Section H, para 21 of the OECD draft paper "BEPS Action 14: Make dispute resolution mechanisms more effective".

298 Types of APA's per presentation by PWC to DTC 24 August 2015 at slide 5.

299 Bloomberg BNA: Article (26 November 2015): Do Advance Pricing Agreements still make Sense? By Steven C Wrappe.

300 Presentation by PWC to DTC 24 August 2015 at slide 6.

301 OECD Mutual Agreement Procedure Statistics for 2013 as quoted in Bloomberg BNA: Article (26 November 2015): Do Advance Pricing Agreements still make Sense? By Steven C Wrappe.

302 OECD/G20 BEPS Project discussion on draft action 14 (Dec 18 2014) as quoted in Bloomberg BNA: Article (26 November 2015): Do Advance Pricing Agreements still make Sense? By Steven C Wrappe.

- Encourages FDI in country through upfront certainty provided to taxpayers through a contract sanctioned by law;
- Fosters closer and deeper relationships with treaty partners (bilateral and multilateral APAs);
- Reduces number of potential MAP disputes with other tax authorities;
- Provides solutions to complex transactions that are BEPS complianct;
- Promotes solutions and knowledge sharing through increased industry/taxpayer insight and thereby increased levels of TP competency of tax authority TP team, in part through discussing cases with other APA teams;
- Increase efficiency as less time needed to monitor compliance through TP audits;
- More cost effective as costs covered by taxpayer; and
- Gives control over the process – discuss TP considerations with taxpayer, but set out critical assumptions to provide protection if there are material changes to the taxpayer transaction.[303]

Benefits to taxpayers include:

- Gives upfront certainty (freedom from penalties and double tax, certainty in financial reporting and tax return disclosure) – essential for investment decisions;
- Enhanced relationship with tax administration due to greater transparency and thus trust;
- Controls costs (defined costs of APA versus undefined costs of subsequent transfer pricing dispute in the absence of an APA). In addition the potential to request roll forward and/or roll back of principles. Generally during the APA period the taxpayer needs only to produce documentation to support compliance with the APA and not other TP documentation; and
- Control over process- discuss TP considerations with tax administration, but set out critical assumptions to provide protection if there are material changes to the taxpayer transaction.[304]

9.1 CONSIDERATIONS FOR SOUTH AFRICA

Based on the above, APA arrangements clearly provide benefits to both tax administrations and taxpayers. Considerations that will need to be borne in mind in the South African context will be:

- The availability of qualified resources. Since taxpayers requesting APAs will be required to pay fees to support their request for an APA (much like the current advanced tax ruling regime in South Africa), the cost of ensuring that SARS has the relevant resources available should be covered. However, it will be important

[303] Presentation by PWC to DTC 24 August 2015 at slide 10.
[304] Presentation by PWC to DTC 24 August 2015 at slide 14 + Bloomberg BNA: Article (26 November 2015): Do Advance Pricing Agreements still make Sense? By Steven C Wrappe at 4-5.

that, if bilateral or multilateral APAs are to be entered into, the resources have sufficient authority and experience to ensure that the pricing in the APAs are correctly determined and that there is no bias in favour of a specific country, merely due to the negotiating abilities of the respective parties.

- The facility of APAs, and corresponding certainty of tax positions for both SARS and the taxpayer in South Africa, will assist in promoting the case for a hub for African investment.

9.2 DTC RECOMMENDATIONS

- ➢ The DTC recommends that SARS considers putting in place an APA regime in South Africa, subject to it ensuring it has adequate resources.

10 ACTION 13: RE-EXAMINE TRANSFER PRICING DOCUMENTATION.

10.1 BACKGROUND

In its 2013 Base Erosion and Profit Shifting (BEPS) Report,[305] the OECD noted that a key issue in the administration of transfer pricing rules is the asymmetry of information between taxpayers and tax administrations. This potentially undermines the administration of the arm's length principle and enhances opportunities for BEPS. The OECD further noted that:

- o In many countries, tax administrations have little capability of developing a "big picture" view of a taxpayer's global value chain.
- o There are divergences between approaches to transfer pricing documentation requirements which lead to significant administrative costs for businesses.
- o It is important that adequate information about the relevant functions performed by other members of the MNE group in respect of intra-group services and other transactions is made available to the tax administration.[306]

10.2 OECD 2013 BEPS REPORT ON ACTION 13

On a domestic front, the OECD recommended, in 2013, that:

- o Countries should develop rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business.
- o The rules to be developed should include a requirement that MNEs provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template.[307]

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305 OECD *Action Plan on Base Erosion and Profit Shifting* (2013) at 22.
306 Ibid.
307 Ibid.

- All actions to counter BEPS must be contemplated with actions that ensure certainty and predictability for business.

On an international front, the OECD planned to develop requirements for taxpayers to report income, taxes paid, and indicators of economic activity to governments according to a common country-by-country reporting template. In developing the country-by-country reporting template; the OECD noted that:

- A balance needs to be sought between the usefulness of the data to tax administrations for risk assessment and other purposes, and the compliance burdens placed on taxpayers.
- There would be compliance related advantages if it were possible to limit the required information to data readily available to corporate management so that companies do not need to go through a time consuming and expensive process of constructing new data.[308]

10.3 OECD "DISCUSSION DRAFT ON TRANSFER PRICING DOCUMENTATION AND CBC REPORTING"

In January 2014, the OECD released a "Discussion Draft on Transfer Pricing Documentation and Country-by-Country Reporting", in which it was noted that when Chapter V of the OECD Transfer Pricing Guidelines[309] was adopted in 1995, tax administrations and taxpayers had less experience in creating and using transfer pricing documentation.[310] The Transfer Pricing Guidelines put an emphasis on the need for reasonableness in the documentation process from the perspective of both taxpayers and tax administrations, as well as on the desire for a greater level of cooperation between tax administrations and taxpayers in addressing documentation issues in order to avoid excessive documentation compliance burdens while at the same time providing for adequate information to apply the arm's length principle reliably. However, the previous language of Chapter V did not provide for a list of documents to be included in a transfer pricing documentation package nor did it

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308 Ibid.

309 OECD "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators" (1995) provide guidance on the application of the "arm's length principle", which is the international consensus on transfer pricing. The Guidelines were originally published in 1979 and were approved by the OECD Council in 1995. A limited update was made in 2009, primarily to reflect the adoption, in the 2008 update of the *Model Tax Convention,* of a new paragraph 5 of Article 25 dealing with arbitration, and of changes to the Commentary on Article 25 on mutual agreement procedures to resolve cross-border tax disputes. In the 2010 edition, Chapters I-III were substantially revised, with new guidance on: the selection of the most appropriate transfer pricing method to the circumstances of the case; the practical application of transactional profit methods (transactional net margin method and profit split method); and on the performance of comparability analyses. Furthermore, a new Chapter IX, on the transfer pricing aspects of business restructurings, was added. Consistency changes were made to the rest of the *Guidelines*. See http://www.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2010_tpg-2010-en accessed 16 may 2014.

provide clear guidance with respect to the link between the process for documenting transfer pricing, the administration of penalties and the burden of proof.[311]

Since then, many countries have adopted transfer pricing documentation rules. The proliferation of these rules, combined with a dramatic increase in the volume and complexity of international intra-group trade and the heightened scrutiny of transfer pricing issues by tax administrations, has resulted in a significant increase in compliance costs for taxpayers. Nevertheless, tax administrations often find transfer pricing documentation to be less than fully informative and not adequate for their tax enforcement and risk assessment needs.[312]

The OECD Discussion Draft on Transfer Pricing and country-by-country reporting[313] came up with draft guidance that tax administrations ought to take into account when developing rules and procedures on documentation to be obtained from taxpayers in connection with a transfer pricing inquiry or risk assessment. It also came up with draft guidelines to assist taxpayers in identifying documentation that would be most helpful in showing that their transactions satisfy the arm's length principle so as to resolve transfer pricing issues and facilitate tax examinations. The draft guidelines went through a public consultation process conducted by the OECD. The finalised guidelines were then set out in the September 2014 Report on Action 13 (discussed below).

10.4 OECD SEPTEMBER 2014 REPORT AND OCTOBER 2015 FINAL REPORTS ON ACTION 13

The September 2014 Report, on Action Plan 13[314] noted that Chapter V of the Transfer Pricing Guidelines has been revised to provide for:[315]

- The objectives of transfer pricing documentation rules;[316]
- Revised standards for transfer pricing documentation and;
- A template for country-by-country reporting of income, earnings, taxes paid and certain measures of economic activity.

The October 2015 final report largely confirms the principles set out in the 2014 Report and, thus, only where there are differences between the two Reports are such differences highlighted below.

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310 OECD/G20 2014 Discussion Draft on Action 13 in para 2.
311 OECD/G20 2014 Discussion Draft on Action 13 in para 2; OECD/G20 2014 Report on Action 13 at 13.
312 OECD/G20 2014 Discussion Draft on Action 13 in para 3; OECD/G20 2014 Report on Action 13.
313 OECD/G20 2014 Discussion Draft on Action 13 in para 2.
314 OECD/G20 2014 Report on Action 13 and OECD/G20 2015 Final Report on Action 13.
315 OECD/G20 2014 Report on Action 13 and OECD/G20 2015 Final Report on Action 13.
316 Ibid.

10.4.1 OBJECTIVES OF TRANSFER PRICING DOCUMENTATION REQUIREMENTS

In terms of the Transfer Pricing Documentation Guidelines, there are three objectives of transfer pricing documentation, namely:

10.4.4.1 To ensure taxpayers can assess their compliance with the arm's length principle[317]

- This ensures 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.
- By requiring taxpayers to articulate convincing, consistent and cogent transfer pricing positions, transfer pricing documentation can help to ensure that a culture of compliance is created. Well-prepared documentation will give tax administrations some assurance that the taxpayer has analysed the positions it reports on tax returns, has considered the available comparable data, and has reached consistent transfer pricing positions.
- This compliance objective may be supported in two important ways.
    - First, tax administrations can require that transfer pricing documentation requirements be satisfied on a contemporaneous basis. This would mean that the documentation would be prepared at the time of the transaction, or in any event, no later than the time of completing and filing the tax return for the fiscal year in which the transaction takes place.
    - The second way to encourage compliance is to establish transfer pricing penalty regimes in a manner intended to reward timely and accurate preparation of transfer pricing documentation and to create incentives for timely, careful consideration of the taxpayer's transfer pricing positions.
- Issues such as taxpayers' costs, time constraints, and competing demands for the attention of relevant personnel can sometimes undermine these objectives. The OECD recommends that it is therefore important for countries to keep documentation requirements reasonable and focused on material transactions in order to ensure mindful attention to the most important matters.[318]

10.4.1.2 To provide tax administrations with the information necessary to conduct an informed transfer pricing risk assessment [319]

Effective risk identification and assessment constitute an essential early stage in the process of selecting appropriate cases for transfer pricing audits or enquiries and in focusing such audits on the most important issues. Because tax administrations

317 OECD/G20 2014 Report on Action 13 and OECD/G20 2015 Final Report on Action 13.
318 OECD/G20 2014 Report on Action 13 and OECD/G20 2015 Final Report on Action 13.
319 Ibid.

operate with limited resources, it is important for them to accurately evaluate, at the very outset of a possible audit, whether a taxpayer's transfer pricing arrangements warrant in-depth review and a commitment of significant tax enforcement resources.

Proper assessment of transfer pricing risk by the tax administration requires access to sufficient, relevant and reliable information at an early stage. While there are many sources of relevant information, transfer pricing documentation is one critical source of such information. The other tools and sources of information that can be used for identifying and evaluating transfer pricing risks of taxpayers and transactions, include:

- transfer pricing forms (to be filed with the annual tax return);
- transfer pricing mandatory questionnaires focusing on particular areas of risk;
- general transfer pricing documentation requirements identifying the supporting evidence necessary to demonstrate the taxpayer's compliance with the arm's length principle, and
- cooperative discussions between tax administrations and taxpayers. [320]

10.4.1.3 To provide tax administrations with useful information to employ in conducting an appropriately thorough transfer pricing audit[321]

The OECD notes that transfer pricing audit cases tend to be fact intensive. They often involve difficult evaluations of the comparability of several transactions and markets. They can require detailed consideration of financial, factual and other industry information. The availability of adequate information from a variety of sources during the audit is critical to facilitating a tax administration's orderly examination of the taxpayer's controlled transactions with associated enterprises and enforcement of the applicable transfer pricing rules. In situations where a proper transfer pricing risk assessment suggests that a thorough transfer pricing audit is warranted, a tax administration must have the ability to obtain, within a reasonable period, all of the relevant documents and information in the taxpayer's possession.

This includes information regarding the taxpayer's operations and functions, relevant information on the operations, functions and financial results of associated enterprises with which the taxpayer has entered into controlled transactions, information regarding potential comparables, including internal comparables, and documents regarding the operations and financial results of potentially comparable uncontrolled transactions and unrelated parties. [322]

In cases where the documents and other information required for a transfer pricing audit are in the possession of members of the MNE group other than the local

[320] OECD/G20 2014 Report on Action 13 and OECD/G20 2015 Final Report on Action 13.
[321] OECD/G20 2014 Report on Action 13 and OECD/G20 2015 Final Report on Action 13.
[322] Ibid.

affiliate under examination, it is important that the tax administration is able to obtain directly or through information sharing, such as exchange of information mechanisms, information that extends beyond the country's borders.[323]

10.4.2 THE THREE-TIERED APPROACH TO TRANSFER PRICING DOCUMENTATION

In order to achieve the above three objectives of transfer pricing documentation requirements, the OECD recommends that countries should adopt a standardised approach to transfer pricing documentation by following a three-tiered structure consisting of:

(i) a master file containing standardised information relevant for all MNE group members;

(ii) a local file referring specifically to material transactions of the local taxpayer; and

(iii) a country-by-country report containing certain information relating to the global allocation of the MNE's income and taxes paid together with certain indicators of the location of economic activity within the MNE group.[324]

10.4.2.1 The Master file

The master file should provide an overview of the MNE group business, including the nature of its global business operations, its overall transfer pricing policies, and its global allocation of income and economic activity. The master file would be available to all relevant country tax administrations in order to assist tax administrations in evaluating the presence of significant transfer pricing risk.

- The master file is intended to provide a high-level overview in order to place the MNE group's transfer pricing practices in their global economic, legal, financial and tax context.
- It is not intended to require exhaustive listings of minutiae (*e.g*. a listing of every patent owned by members of the MNE group).
- The information required in the master file provides a "blueprint" of the MNE group and contains relevant information that can be grouped in five categories:
    - a) the MNE group's organisational structure;
    - b) a description of the MNE's business or businesses;
    - c) the MNE's intangibles;
    - d) the MNE's intercompany financial activities; and
    - (e) the MNE's financial and tax positions.
- Taxpayers should present the information in the master file for the MNE as a whole. However, line of business presentation would be acceptable where well justified by the facts. In this instance, care should be taken to assure that

[323] Ibid.

[324] OECD/G20 2014 Report on Action 13 and OECD/G20 2015 Final Report on Action 13.

centralised group functions and transactions between business lines are properly described in the master file.[325]

10.4.2.2 The Local file

In contrast to the master file which provides a high-level overview, MNEs are also expected to have a "local file" which provides more detailed information relating to specific intercompany transactions in each country they operate in; identifying relevant related party transactions, the amounts involved in those transactions, and the company's analysis of the transfer pricing determinations they have made with regard to those transactions.

- The information required in the local file supplements the master file and helps to meet the objective of assuring that the taxpayer has complied with the arm's length principle in its material transfer pricing positions affecting a specific jurisdiction.
- The local file focuses on information relevant to the transfer pricing analysis related to transactions taking place between a local country affiliate and associated enterprises in different countries and which are material in the context of the local country's tax system.
- Such information would include relevant financial information regarding those specific transactions, a comparability analysis, and the selection and application of the most appropriate transfer pricing method.
- Cross reference to information already contained in the Master File may, however, suffice.[326]

10.4.2.3 The Country-by-Country report

The country-by-country report requires:

- Aggregate tax jurisdiction-wide information relating to the global allocation of the income, the taxes paid, and certain indicators of the location of economic activity among tax jurisdictions in which the MNE group operates. In effect, the "country-by-country" report requires MNEs to:
  - report annually and for each tax jurisdiction in which they do business the amount of revenue, profit before income tax and income tax paid and accrued; and
  - report their total employment, capital, retained earnings and tangible assets in each tax jurisdiction.
- The report also requires a listing of all the constituent entities for which financial information is reported, including the tax jurisdiction of incorporation, where different from the tax jurisdiction of residence, as well as the nature of the main

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325 OECD/G20 2014 Report on Action 13 and OECD/G20 2015 Final Report on Action 13.

326 OECD/G20 2014 Report on Action 13 and OECD/G20 2015 Final Report on Action 13.

business activities carried out by that constituent entity. In effect, MNEs are required to:

- identify each entity within the group doing business in a particular tax jurisdiction and to provide an indication of the business activities each entity engages in. [327]

The country-by-country report will be helpful for:

- high-level transfer pricing risk assessment purposes; and
- it may be used by tax administrations in evaluating other BEPS related risks and where appropriate for economic and statistical analysis. [328]

However, the information in the country-by-country report:

- should not be used as a substitute for a detailed transfer pricing analysis of individual transactions and prices based on a full functional analysis and a full comparability analysis;
- on its own does not constitute conclusive evidence that transfer prices are or are not appropriate; and
- should not be used by tax administrations to propose transfer pricing adjustments based on a global formulary apportionment of income. [329]

Annex III to Chapter V of these Guidelines contains a model template for the country-by-country report together with its accompanying instructions.

Taken together, these three documents (master file, local file and country-by-country report) will:

- require taxpayers to articulate consistent transfer pricing positions,
- provide tax administrations with useful information to assess transfer pricing risks,
- make determinations about where audit resources can most effectively be deployed, and,
- in the event audits are called for, provide information to commence and target audit enquiries.

This information should make it easier for tax administrations to identify whether companies have engaged in transfer pricing and other practices that have the effect of artificially shifting substantial amounts of income into tax-advantaged environments. The countries participating in the BEPS Project agree that these new reporting provisions, and the transparency they will encourage, will contribute to the objective of understanding, controlling, and tackling BEPS behaviours.

- ➢ The specific content of the various documents reflects an effort to balance tax administration information needs, concerns about inappropriate use of the information, and the compliance costs and burdens imposed on business.

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327 OECD/G20 2014 Report on Action 13 and OECD/G20 2015 Final Report on Action 13.
328 Ibid.
329 Ibid.

- Some countries would strike that balance in a different way by requiring reporting in the country-by-country report of additional transactional data (beyond that available in the master file and local file for transactions of entities operating in their jurisdictions) regarding related party interest payments, royalty payments and especially related party service fees. Countries expressing this view are primarily those from emerging markets (Argentina, Brazil, China, Colombia, India, Mexico, South Africa and Turkey) who state they need such information so as to perform risk assessment and who find it challenging to obtain information on the global operations of an MNE group headquartered elsewhere.
- Other countries expressed support for the way in which the balance has been struck in this document. Taking all these views into account, it is mandated that countries participating in the BEPS project will carefully review the implementation of these new standards and will reassess, no later than the end of 2020, whether modifications to the content of these reports should be made to require reporting of additional or different data.

10.4.3 COMPLIANCE ISSUES

10.4.3.1 Contemporaneous documentation

The OECD recommends that:

- Each taxpayer should endeavour to determine transfer prices, for tax purposes, that are in accordance with the arm's length principle, based upon information reasonably available at the time of the transaction.
- Taxpayers should not be expected to incur disproportionately high costs and burdens in producing documentation.
- Tax administrations should balance requests for documentation against the expected cost and administrative burden to the taxpayer.
- Where a taxpayer reasonably demonstrates, having regard to the principles of these Guidelines, that either no comparable data exists or that the cost of locating the comparable data would be disproportionately high relative to the amounts at issue, the taxpayer should not be required to incur costs in searching for such data. [330]

10.4.3.2 Time frame

The OECD states that:

- Practices regarding the timing of the preparation of the documentation differ among countries.
- These differences in the time requirements for providing information can add to taxpayers' difficulties in setting priorities and in providing the right information to the tax administrations at the right time.

- The OECD recommends that:

[330] OECD/G20 2014 Report on Action 13 and OECD/G20 2015 Final Report on Action 13.

- With regard to the local file, the best practice is to require that this file be finalised no later than the due date for the filing of the tax return for the fiscal year in question.
- The master file should be reviewed and, if necessary, updated by the tax return due date for the ultimate parent of the MNE group. In countries pursuing policies of auditing transactions as they occur under cooperative compliance programmes, it may be necessary for certain information to be provided in advance of the filing of the tax return.
- With regard to the country-by-country report, it is recognised that in some instances final statutory financial statements and other financial information that may be relevant for the country-by-country data may not be finalised until after the due date for tax returns in some countries for a given fiscal year. Under the given circumstances, the date for completion of the country-by-country report described may be extended to one year following the last day of the fiscal year of the ultimate parent of the MNE group. [331]

10.4.3.3 Materiality

Not all transactions that occur between associated enterprises are sufficiently material to require full documentation in the local file. The OECD recommends that:

- Individual country transfer pricing documentation requirements based on Annex II to Chapter V of The OECD Transfer Pricing Guidelines should include specific materiality thresholds that take into account the size and the nature of the local economy, the importance of the MNE group in that economy, and the size and nature of local operating entities, in addition to the overall size and nature of the MNE group.
- Measures of materiality may be considered in relative terms (*e.g*. transactions not exceeding a percentage of revenue or a percentage of cost measure) or in absolute amount terms (*e.g*. transactions not exceeding a certain fixed amount).
- Individual countries should establish their own materiality standards for local file purposes, based on local conditions. The materiality standards should be objective standards that are commonly understood and accepted in commercial practice.
- In order not to impose on taxpayers costs and burdens disproportionate to their circumstances, it is recommended to not require SMEs to produce the amount of documentation that might be expected from larger enterprises. However, SMEs should be obliged to provide information and documents about their material cross-border transactions upon a specific request of the tax administration in the course of a tax examination or for transfer pricing risk assessment purposes.

[331] OECD/G20 2014 Report on Action 13 and OECD/G20 2015 Final Report on Action 13.

- The country-by-country report should include all tax jurisdictions in which the MNE group has an entity resident for tax purposes, regardless of the size of business operations in that tax jurisdiction. [332]

10.4.3.4 Retention of documents

The OECD recommends that:

- Taxpayers should not be obliged to retain documents beyond a reasonable period consistent with the requirements of domestic law at either the parent company or local entity level.
- However, at times materials and information required in the documentation package (master file, local file and country-by-country report) may be relevant to a transfer pricing enquiry for a subsequent year that is not time barred, for example where taxpayers voluntarily keep such records in relation to long-term contracts, or to determine whether comparability standards relating to the application of a transfer pricing method in that subsequent year are satisfied.
- Tax administrations should bear in mind the difficulties in locating documents for prior years and should restrict such requests to instances where they have good reason in connection with the transaction under examination for reviewing the documents in question.
- The way that documentation is stored - whether in paper, electronic form, or in any other system - should be at the discretion of the taxpayer provided that relevant information can promptly be made available to the tax administration in the form specified by the local country rules and practices. [333]

10.4.3.5 Frequency of documentation updates

- The OECD recommends that transfer pricing documentation be periodically reviewed in order to determine whether functional and economic analyses are still accurate and relevant; and to confirm the validity of the applied transfer pricing methodology.
- In general, the master file, the local file and the country-by-country report should be reviewed and updated annually.
- In order to simplify compliance burdens on taxpayers, tax administrations may determine, as long as the operating conditions remain unchanged, that the searches in databases for comparables supporting part of the local file be updated every 3 years rather than annually.
- Financial data for the comparables should nonetheless be updated every year in order to apply the arm's length principle reliably. [334]

10.4.3.6 Language

The OECD recommends that:

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[332] OECD/G20 2014 Report on Action 13 and OECD/G20 2015 Final Report on Action 13.
[333] Ibid.
[334] Ibid.

- The language in which transfer pricing documentation should be submitted should be established under local laws.
- Countries are encouraged to permit filing of transfer pricing documentation in commonly used languages where it will not compromise the usefulness of the documents.
- Where tax administrations believe that translation of documents is necessary, they should make specific requests for translation and provide sufficient time to make such translation as comfortable a burden as possible. [335]

10.4.3.7 Penalties

The OECD states that:

- Many countries have documentation-related penalties to ensure efficient operation of transfer pricing documentation requirements.
- These penalties are designed to make non-compliance more costly than compliance.
- Penalty regimes are governed by the laws of each individual country.
- Documentation-related penalties imposed for failure to comply with transfer pricing documentation requirements or failure to timely submit required information are usually civil (or administrative) monetary penalties.
- The OECD recommends that:
    - Care should be taken not to impose a documentation-related penalty on a taxpayer for failing to submit data to which the MNE group did not have access. However, a decision not to impose documentation-related penalties does not mean that adjustments cannot be made to income where prices are not consistent with the arm’s length principle.
    - An assertion by a local entity that other group members are responsible for transfer pricing compliance is not a sufficient reason for that entity to fail to provide required documentation, nor should such an assertion prevent the imposition penalties for failure to comply with documentation rules where the necessary information is not forthcoming.
    - Another way for countries to encourage taxpayers to fulfil transfer pricing documentation requirements is by designing compliance incentives. For example, where the documentation meets the requirements and is timely submitted, the taxpayer could be exempted from tax penalties or subject to a lower penalty rate if a transfer pricing adjustment is made and sustained, notwithstanding the provision of documentation. Another alternative is that the burden of proof could be shifted to the tax administration where adequate documentation has been provided. [336]

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335 OECD/G20 2014 Report on Action 13 and OECD/G20 2015 Final Report on Action 13.
336 Ibid.

10.4.3.8 Confidentiality

The OECD recommends that:

- Tax administrations should take all reasonable steps to ensure that there is no public disclosure of confidential information (trade secrets, scientific secrets, *etc.*) and other commercially sensitive information contained in the documentation package (master file, local file and country-by-country report).
- Tax administrations should also assure taxpayers that the information presented in transfer pricing documentation will remain confidential.[337]
- In cases where disclosure is required in public court proceedings or judicial decisions, every effort should be made to ensure that confidentiality is maintained and that information is disclosed only to the extent needed. [338]

10.4.3.9 Other issues

<u>Local/regional comparables</u>: The OECD recommends that:

- The requirement to use the most reliable information will usually, but not always, require the use of local comparables over the use of regional comparables where such local comparables are reasonably available.
- The use of regional comparables in transfer pricing documentation prepared for countries in the same geographic region in situations where appropriate local comparables are available will not, in some cases, comport with the obligation to rely on the most reliable information.
- While the simplification benefits of limiting the number of comparable searches a company is required to undertake are obvious, and materiality and compliance costs are relevant factors to consider, a desire for simplifying compliance processes should not go so far as to undermine compliance with the requirement to use the most reliable available information. [339]

<u>Certifying of documentation</u>: The OECD states that:

- It is not recommended, particularly at the stage of transfer pricing risk assessment, to require that the transfer pricing documentation should be certified by an outside auditor or other third party.
- Mandatory use of consulting firms to prepare transfer pricing documentation is not recommended. [340]

10.4.4 IMPLEMENTATION AND REVIEW

- The OECD advises that it is essential that the new guidance in Chapter V of the Transfer Pricing Guidelines, and particularly the new country-by-country report, be implemented effectively and consistently.

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337 Reference to the OECD Guide "Keeping it Safe" regarding confidentiality of exchanged information is recommended Final Report (2015) in para 45.

338 OECD/G20 2014 Report on Action 13 and OECD/G20 2015 Final Report on Action 13.

339 Ibid.

340 Ibid.

- The OECD is of the view that taxpayers should deliver the master file[341] and local file directly to tax administrations in the relevant local jurisdiction.
- Following consultation, based on the 2014 Report on Action 13, the OECD recommends, in the 2015 Report, that the first country-by-country report be required to be files for MNE fiscal years beginning on or after 1 January 2016. However, the OECD acknowledges that some countries may need time to follow their domestic legislative processes in order to make adjustments to the law. In order to assist MNE groups, model legislation has been developed to assist the parent in the group to file the country by country report in their jurisdiction of residence. Based on the recommendation that companies be required to submit the country by country report to the relevant tax authorities up to one year after the tax return has been submitted, it is envisaged that the first country by country reports would be submitted by 31 December 2017. Groups with consolidated accounts for year ends different to December will thus submit during 2018 (reporting on the first year beginning on or after 1 January 2016).[342]

  The OECD recommends that all MNE groups be required to submit country by country reports each year except those with annual consolidated turnover less than EU750mn (or the nearest domestic currency equivalent). Using this criterion the OECD believes that 85% to 90% of MNE groups will not be required to submit country by country reports, but that those that will be required to submit control approximately 90% of global corporate revenues. The burden of reporting is thus matched with the benefit to tax administrations.[343]

  It is the intention of countries participating in the OECD/G20 BEPS project to reconsider the appropriateness of the applicable revenue threshold described in the preceding paragraph in connection with their 2020 review of implementation of the new standard, including whether additional or different data should be reported, as set out in the September Report.

  The OECD advises that no exemptions from filing the country by country report should be adopted apart from the exemption based on consolidated turnover, indicated above. In particular, no special industry exemptions should be provided, no general exemption for investment funds should be provided, and no exemption for non-corporate entities or non-public corporate entities should be provided. Notwithstanding this conclusion, countries participating in the OECD/G20 BEPS Project agree that MNE groups with income derived from international transportation or transportation in inland waterways that is covered by treaty provisions that are specific to such income and under which

[341] OECD/G20 2015 Final Report on Action 13 in para 49.
[342] OECD/G20 2015 Final Report on Action 13 in para 50.
[343] OECD/G20 2015 Final Report on Action 13 in para 53.

the taxing rights on such income are allocated exclusively to one jurisdiction, should include the information required by the country by country template with respect to such income only against the name of the jurisdiction to which the relevant treaty provisions allocate these taxing rights. [344]

Countries participating in the country by country reporting initiative are required to adopt the following underlying principles:

-Confidentiality: Jurisdictions should have in place and enforce legal protections of the confidentiality of the reported information. Such protections would preserve the confidentiality of the country by country report to an extent at least equivalent to the protections that would apply if such information were delivered to the country under the provisions of the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, a TIEA or a tax treaty that meets the internationally agreed standard of information upon request as reviewed by the Global Forum on Transparency and Exchange of Information for Tax Purposes. Such protections include limitation of the use of information, rules on the persons to whom the information may be disclosed. [345]

-Consistency: Jurisdictions should use their best efforts to adopt a legal requirement that MNE groups' ultimate parent entities resident in their jurisdiction prepare and file the country by country report, unless exempted because they don't meet the threshold. Jurisdictions should utilise the standard template contained in Annex III of Chapter V of the Transfer Pricing Guidelines. Consequently no jurisdiction will require that the country by country report contain either additional information not contained in Annex III, nor will it fail to require reporting of information included in Annex III. [346] Thus, the country by country reports should reflect consistent information regardless of where they are prepared.

-Appropriate use: Jurisdictions should use appropriately the information in the country by country report template. In particular, with respect to using the country by country report for assessing high-level transfer pricing risk in assessing other BEPS-related risks. Jurisdictions should not propose adjustments to the income of any taxpayer on the basis of an income allocation formula based on the data from the country by country report. If such adjustments based on country by country report data are made by the local tax administration of the jurisdiction, the jurisdiction's competent authority will promptly concede the adjustment in any relevant competent authority proceeding. This does not imply, however, that jurisdictions would

[344] OECD/G20 2014 Report on Action 13 in para 8 and OECD/G20 2015 Final Report on Action 13 in para 55. .

[345] OECD/G20 2014 Report on Action 13 in para 13 and OECD/G20 2015 Final Report on Action 13 in para 57.

[346] OECD/G20 2014 Report on Action 13 in para 13 and OECD/G20 2015 Final Report on Action 13 in para 58.

be prevented from using the country by country report data as a basis for making further enquiries into the MNE's transfer pricing arrangements or into other tax matters in the course of a tax audit. [347]

10.5 INTERNATIONAL CONCERNS

- In its September 2014 report on Action 13, the OECD stressed the need to consider business' compliance costs. Despite the transfer pricing documentation guidance provided by the OECD, costs and confidentiality are still the top concerns that taxpayers have with regard to the master file, local file and country-by-country reporting. From a taxpayer perspective, compliance with the reporting template represents an absolutely massive investment in terms of human resources and systems capability enhancements.[348] Confidentially is also a major concern because some tax authorities don't have confidentiality provisions under their local laws. Some taxpayers prefer that this type of information should be shared under the exchange of information provisions under treaty networks in order to maintain confidentiality of taxpayer information.[349]
- The OECD has also been called upon to consider whether the information sharing system should be structured in a way that it excludes delivery of information to countries where adequate provisions do not exist to protect the confidentiality of competitively sensitive data and how this might be accomplished.
- Concerns have been raised regarding the currencies in which information should be presented in the country by country template. It is not clear whether the information should be reported in the functional currencies of each individual entity or if it should be translated into a single consistently used currency (functional currency of the ultimate parent), or some combination.
- Concerns have also been raised regarding whether the taxes paid in each country should be reported on a cash or accrual basis. Governments would ordinarily be most interested in cash taxes paid in a given year, or alternatively cash taxes paid with respect to the income reported in a given year, for risk assessment purposes. While tax accruals would perhaps align better with accrual based financial statement income (assuming income from statutory financials is ultimately what is reported), there could be a question as to whether reporting tax accruals as opposed to cash tax paid would introduce distortions related to deferred tax accounting, tax provisions and

347 OECD/G20 2014 Report on Action 13 in para 13 and OECD/G20 2015 Final Report on Action 13 in para 59.

348 DA Glenn, Tax Analysts "Costs and Confidentiality Are Biggest Concerns With OECD Discussion Draft, Practitioners Say" 18 February 2014; DD Stewart and DL Glenn "BEPS Project on Track to Meet 2014 Deadlines, OECD's Saint-Amans Says" Tax Analyst 24 January 2014.

349 DA Glenn, Tax Analysts "Costs and Confidentiality Are Biggest Concerns With OECD Discussion Draft, Practitioners Say" 18 February 2014.

other accrual accounting issues. The difficulty with such an approach is that some companies in an MNE group may not be obliged to file a tax return in any country and may not be obliged to report some portion or all of their financial statement income on a tax return in any country.

In the first quarter of 2015, the OECD released a report on Action 13 which provided guidance on the Implementation of Transfer Pricing Documentation and Country-by-Country Reporting,[350] in which the OECD recommended that:

- The master file and local file elements of the new transfer pricing documentation standard should be implemented through local country legislation or administrative procedures and that the master file and local file should be filed directly with the tax administrations in each relevant jurisdiction as required by those administrations. [351]
- Confidentiality and consistent use of the standards contained in Annex I and Annex II of Chapter V of the Transfer Pricing Guidelines, and included in the September Report, should be taken into account when introducing these elements in local country legislation or administrative procedures. [352]
- The OECD plans to develop mechanisms to monitor jurisdictions' compliance with their commitments and to monitor the effectiveness of the filing and dissemination mechanisms. The OECD also recognises the need for more effective dispute resolution which may increase as a result of the enhanced risk assessment capability following the adoption and implementation of a country by country reporting requirement and that the work under Action 14 of the BEPS Project should take that into account. [353]

It is clear that these considerations were taken into account when finalising the Action 13 Report as released in October 2015.

10.6 THE FRAMEWORK FOR GOVERNMENT-TO-GOVERNMENT MECHANISMS TO EXCHANGE COUNTRY BY COUNTRY REPORTS AND THE IMPLEMENTATION PACKAGE

- The OECD recommends that jurisdictions should require, in a timely manner, country by country reporting from ultimate parent entities of MNE groups resident in their country (that qualify for country by country reporting as explained above) and exchange this information on an automatic basis with the jurisdictions in which the MNE group operates and which fulfil the above conditions for obtaining and the use of the country by country report. In case a jurisdiction fails to provide information to a jurisdiction fulfilling the conditions for obtaining and the use of the country by country report, because:

[350] OECD/G20 2014 Report on Action 13.
[351] OECD/G20 2014 Report on Action 13 in para 5.
[352] OECD/G20 2014 Report on Action 13 in para 6.
[353] OECD/G20 2014 Report on Action 13 in para 6.

(a) it has not required country by country reporting from the ultimate parent entity of such MNE groups;
(b) no competent authority agreement has been agreed in a timely manner under the current international agreements of the jurisdiction for the exchange of the country by country reports: or
(c) it has been established that there is a failure to exchange the information in practice with a jurisdiction after agreeing with that jurisdiction to do so,
a secondary mechanism would be accepted as appropriate, through local filing or through filing the country by country reports by a designated member of the MNE group acting in place of the ultimate parent entity and automatic exchanging these reports by its country of residence. [354]

Countries participating in the OECD/G20 BEPS Project have therefore developed an implementation package for government-to-government exchange of country by country reports and incorporated into the Guidelines. More specifically:

- Model legislation requiring the ultimate parent entity of an MNE group to file the country by country report in its jurisdiction of residence has been developed. Jurisdictions will be able to adapt this model legislation to their own legal systems, where changes to current legislation are required. Key elements of secondary mechanisms have also be developed.
- Implementing arrangements for the automatic exchange of the country by country reports under international agreements have been developed, incorporating the above conditions for obtaining and using the country by country report. Such implementing arrangements include the competent authority agreements ("CAAs") based on existing international agreements (the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, bilateral tax treaties and TIEAs), and inspired by existing models developed by the OECD working with G20 countries for the automatic exchange of financial account information.

Participating jurisdictions endeavour to introduce necessary domestic legislation in a timely manner. They are also encouraged to expand the coverage of their international agreements for exchange of information. The implementation of the package will be monitored on an ongoing basis. The outcomes of this monitoring will be taken into consideration in the 2020 review.[355]

10.7 TRANSFER PRICING DOCUMENTATION IN SOUTH AFRICA

South African Revenue Service's (SARS) Practice Note 7, which was issued on 6 August 1999 contains quite detailed but rather unclear "documentation

[354] OECD/G20 2014 Report on Action 13 in para 60.
[355] OECD/G20 2014 Report on Action 13 in para 62.

guidelines".[356] Submitting transfer pricing documentation is not compulsory in South Africa. SARS Practice Note 7 states that SARS documentation guidelines "broadly follow Chapter V of the OECD Guidelines". [357]

However the version of the OECD Guidelines which was applicable when SARS Practice Note 7 was issued was the "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" as issued by the OECD in July 1995, being a revision of the 1979 guidelines. Additional Chapters to these Guidelines have been issued since 1995, including Intra-group Services (1996), Intangible Property (1996) and Cost Contribution Arrangements (1997). Revised Transfer Pricing Guidelines were issued in 2009 (with relatively minor changes) and more material revisions were published by the OECD in 2010 transfer pricing guidelines. In light of the OECD BEPS Action 13, Chapter V of the Transfer Pricing Guidelines have also been revised to provide for transfer pricing documentation rules as discussed above.

It is noted that the 2015 Tax Administration Laws Amendment Act added sub-paragraph 3(b) to section 3 of the Tax Administration Act Laws Amendment Act (promulgated January 2016). The subsection now permits SARS to, retain information obtained in accordance with an international tax standard, and retain such information as 'relevant material' and treat it as 'taxpayer information' for purposes of the other provisions of the Act[358]. An international tax standard is defined, in short, as a) the OECD standard for the Automatic Exchange of Information in Tax Matters; b) the country by country reporting standard for multinational enterprises specified by the Minister; and c) any other standard for the exchange of information.

Thus, the mechanism facilitating the exchange of information on MNE's and country by country reporting has already been put in place. The definition of whom such MNE's are remains to be determined. However, a draft gazette has been issued setting out the documentary requirements for MNE's and indicates that it is those with a group turnover exceeding R1bn that would be required to maintain the documentation set out. This documentation appears to go beyond the requirements set out in OECD Action 13.

- The DTC recommends that South Africa remains in line with the OECD provisions in order to be perceived to be investor or business unfriendly. Furthermore, it is recommended that the threshold be retained at OECD levels of EU750mn, converted at the year end of the group, in order to ensure consistency throughout the global group.

356 SARS Practice Note 7 in para 10.3.
357 Ibid.
358 Tax Administration Act (28 of 2011).

10.8 RECOMMENDATIONS FOR SOUTH AFRICA

- The OECD's view that one of the purposes of transfer pricing documentation guidelines is to ensure that taxpayer's can assess their compliance with the arm's length principle, is consistent with the fundamental change that was made to South Africa's transfer pricing provisions in section 31 of the Income Tax Act for tax years starting from 1 April 2012. More specifically, whereas transfer pricing adjustments previously could only be made by SARS (in terms of a discretion), the amended version of section 31 provides in section 31(2), that a taxpayer must itself make any transfer pricing adjustments that might be required in the calculation of its taxable income. This places a significantly greater onus on taxpayers. Thus under the revised version of section 31(2), an onus is placed on each taxpayer with foreign related party transactions to "confirm the arm's length nature of its financial results at the time of filing its tax return". This onus exists, regardless of whether or not the taxpayer has transfer pricing documentation.

- Since the current transfer pricing documentation guidelines, as contained in SARS Practice Note 7 (PN 7), are not specific, and are based on the 1995 OECD Guidelines, it is recommended that section 31 be amended to require that the OECD guidelines be followed by companies that are part of a group, the consolidated turnover of which is greater than the stated OECD threshold for transfer pricing documentation, currently EU750mn. This figure is recommended on the basis that the South African Rand fluctuates widely and, in order to comply with the OECD minimum standard for documentation, the group turnover figure should be measured, converted to Rands using the exchange rate at the end of each financial year of the group. This will ensure consistency of treatment of all companies in an MNE, globally, as is the OECD intention.

- In addition, it is recommended that SARS revises PN 7 to be in line with the OECD revised Transfer Pricing Documentation Guidelines in Chapter V and recommended for companies that are part of smaller groups. For several years there have been indications from SARS and the National Treasury that an updated transfer pricing Interpretation Note is imminent. SARS PN 7 is now 17 years old and has not been changed to keep pace with developments at the OECD. As mentioned above, currently, preparing transfer pricing documentation is not compulsory in South Africa. It is recommended that transfer pricing documentation guidelines and requirements should be introduced in line with the above discussed OECD Guidelines.

  Consequently, the OECD's recommendation that countries should adopt a standardised approach to transfer pricing documentation that follows a three-tiered structure consisting of a master file, a local file and country-by-country reporting for companies that are part of an MNE group with turnover greater that EU750mn should be adopted in South Africa. This approach will encourage a consistent approach to transfer pricing documentation in different countries, which will help contain the cost of global transfer pricing documentation. The table at the end of this section illustrates which countries have adopted the OECD documentation by the beginning of March 2016, which in the DTC's view supports the need for South Africa to be fully aligned. For smaller groups, similar documentation should be encouraged (see below for more specific point on this) on the basis that they need to support the terms and pricing of material transactions with transfer pricing documentation reflecting that methodologies in line with the OECD Guidelines have been followed.

- SARS PN 7 also makes references to certain provisions of the Income Tax Act which have been repealed and now form part of the Tax Administration Act 28 of 2011 (examples are provisions dealing with record keeping requirements and penalty provisions). It is therefore imperative that an updated Interpretation Note be prioritized.

- It should be noted that with regard to country by country reporting, South Africa, along with other emerging economies, is of the view that the country by country report should require additional transactional data (beyond that available in the master file and local file) for transactions of entities operating in their jurisdictions regarding related party interest payments, royalty payments and especially related party service fees. Such information would be needed to perform risk assessments where it is found challenging to obtain information on the global operations of an MNE group, headquartered elsewhere. The OECD plans to take these views into consideration and review the implementation thereof no later than end of 2020. It is therefore recommended that South Africa monitors the OECD's final recommendations in this regard and then implements the same, but remains in line with the prevailing OECD guidelines at any particular time. This will ensure consistency of treatment of companies in groups globally. Furthermore, as the country by country report is designed to provide information for risk assessment only, the relevant authority (e.g. SARS) would still be in a position to ask for detailed information regarding service fees paid by the local company.

- As the OECD recommends, with regard to compliance matters under the heading "materiality", disproportionate and costly documentation requirements should not imposed on smaller groups (than those with EU750mn). Smaller groups should not be required to produce the same amount of documentation that might be expected from larger enterprises. Such documentation could be recommended but not be obligatory, leaving the amount of transfer pricing documentation produced to support the pricing to the relevant smaller group. However, smaller groups should be obliged to provide information about their material cross-border transactions in their tax returns to facilitate risk assessment (as is presently the case), and upon a specific request of the tax administration in the course of a tax examination or for transfer pricing risk assessment purposes. It is however important that the thresholds for 'SMEs' and less material transactions be clarified. The tax administration could for instance consider the significance of the cross-border connected party transactions.[359]

- Furthermore, on the matter of materiality, the OECD recommends that individual country transfer pricing documentation requirements should be based on Annex II to Chapter V of The OECD Transfer Pricing Guidelines and should include specific materiality thresholds that take into account the size and the nature of the local economy, the importance of the MNE group in that economy, and the size and nature of local operating entities, in addition to the overall size and nature of the MNE group. The OECD recommends that individual countries should establish their own materiality standards for local file purposes, based on local conditions. The materiality standards should be objective standards that are commonly understood and accepted in commercial practice. In this regard, it is important that when SARS updates its PN 7 in line with the OECD transfer pricing documentation guidelines, it should provide taxpayers with much more specific guidance on what information is actually required, especially in relation to financial assistance, instead of the rather vague information which exists in the Addendum to SARS PN 7.

- It is furthermore recommended that, for the purposes of providing certainty to inbound investors, where loans are not significant, the replacement IN for PN7 should define a safe harbour eg debt to equity ratio (or in line with s23M), together with interest rate (eg prime +2% - or in line with prevailing excon requirements) for inbound loans not exceeding, say, R100mn. In this manner inbound investors will obtain the certainty they need regarding loan requirements without having to expend significant amounts of money to determine an arm's length amount for loans below the pre-defined limit.

- With respect to the compliance matter under the heading "confidentiality", the OECD recommends that tax administrations should take all reasonable steps to ensure that there is no public disclosure of confidential information (trade secrets, scientific secrets, *etc.*) and other commercially sensitive information contained in the documentation package (master file, local file and country by

359 SAICA "Comment on DTC 1st Interim BEPS Report" (31 March 2015) para 23.

country report). In this regard, there are various provisions in the Tax Administration Act which deal with confidentiality. These include sections 21, 56 and Chapter 6 of the Tax Administration Act. Confidentiality is therefore an important element of South Africa's income tax system. It is however important that these provisions are strengthened in line with the OECD recommendations.

- With regard to compliance matters under the heading of "contemporaneous documentation" the OECD recommends that taxpayers should not be expected to incur disproportionately high costs and burdens in producing documentation. SARS should balance requests for documentation against the expected cost and administrative burden to the taxpayer of creating it. This guidance is directly in line with the "Addendum to SARS PN 7: Submission of Transfer Pricing Policy Document", where it is explicitly stated in para 10.2.6 that:

  > "SARS acknowledges that the preparation of transfer pricing documentation is time-consuming and expensive. The important general rule is that it is not expected of taxpayers to go to such lengths that the compliance costs related to the preparation of documentation are disproportionate to the nature, scope and complexity of the international agreements entered into between the taxpayers and connected persons. Furthermore, where a taxpayer has provided full details of the international agreements that it has entered into with connected parties, the absence of formal transfer pricing documentation will not be regarded as non-disclosure. Taxpayers choosing not to prepare documentation must, however, realise that they are at risk and that it may be more difficult to discharge the onus of proving that an arm's length price has been established."

  - This additional guidance therefore continues to be relevant. The cautionary note in the last sentence is more strongly applicable than ever – in view of the greater onus which is now placed on taxpayers in relation to transfer pricing.

- With respect to the compliance matter relating to "time frames" the OECD notes that practices regarding the timing of the preparation of the documentation differ among countries. The OECD however recommends that the local file should be finalised no later than the due date for the filing of the tax return for the fiscal year in question. The master file should be updated by the tax return due date for the ultimate parent of the MNE group. And that the country by country report, if applicable, should be submitted by no later than the year following the tax return filing deadline. In view of these OECD recommendations, it is important that SARS clarifies what its expectations are with respect to each of the three reports.

- With regard to the compliance matter under the heading "retention of documents", the OECD recommends that taxpayers should not be obliged to retain documents beyond a reasonable period consistent with the requirements of domestic law at either the parent company or local entity level. In South Africa, the rules in relation to retention of documents are contained in Chapter 4 of the Tax Administration Act 28 of 2011, particularly sections 29 to 32 which deal with "returns and records". It is thus probably not necessary for SARS to provide additional detail as regards retention of documents except to the extent that it is considered necessary to have rules which are specific to transfer pricing documentation. However clear guidance should be issued on which group company has the legal obligation to retain what transfer pricing documentation. In this respect a distinction should be made between in-bound and outbound groups. [360]

- With regard to the compliance matter under the heading "frequency of documentation updates" the OECD recommends that transfer pricing documentation be periodically reviewed in order to determine whether functional and economic analyses are still accurate and relevant and to confirm the validity of the applied transfer pricing methodology. Furthermore that the master file, the local file and the country by country report should be reviewed and updated annually, albeit that only the financial information is updated if no significant changes have arisen in the business. Database searches for comparables should, however, be updated at least every 3 years. It is recommended that SARS should consider including the above guidance in the recommended update to the PN 7.

- As regards the compliance matter under the heading "penalties" the OECD acknowledges that countries normally have documentation-related penalties imposed for failure to comply with transfer pricing documentation requirements or failure to timely submit required information. Such penalties are usually civil (or administrative) monetary penalties. It however states that care should be taken not to impose a documentation-related penalty on a taxpayer for failing to submit data to which the MNE group did not have access. In the South African context, with effect from 1 April 2012, the onus to make transfer pricing adjustments has been shifted to taxpayers. Therefore the general penalty regime applicable in terms of the Tax Administration Act applies to transfer pricing matters as well – specifically in circumstances where a taxpayer fails to make an appropriate transfer pricing adjustment. In this regard it is appropriate to refer to Chapters 15 and 16 of the Tax Administration Act.

360 PWC "Comments on DTC BEPS First Interim Report" (30 March 2015) at 23.

- Furthermore secondary adjustments are also applicable. Based on the principle that the transfer of economic value, arising from an incorrect transfer price, results in depletion in the asset base of the South African taxpayer; and a resultant potential loss of future taxable income for the fiscus, transfer pricing adjustments are economically similar to outbound payments of dividends to foreign related parties since they represent a distribution of value from South Africa to the foreign company. Therefore the secondary adjustment mechanism results in a tax equivalent to the proposed 15% withholding tax. Because the imposition of the 15% withholding tax is an anti-avoidance measure and it is a tax levied on the South African company rather than on the foreign related party, no DTA relief would be available. This latter point needs to be made clear in the legislation or the revised PN 7.

- Apart from imposing penalties on taxpayers, the OECD recommends that another way for countries to encourage taxpayers to fulfil transfer pricing documentation requirements is by designing compliance incentives. For example, where the documentation meets the requirements and is timely submitted, the taxpayer could be exempted from tax penalties or subject to a lower penalty rate if a transfer pricing adjustment is made and sustained, notwithstanding the provision of documentation. It is recommended that SARS should consider such an incentive programme to encourage compliance. SARS could consider the incentive that the secondary adjustment will be waived if the documentation has been prepared in line with the guidelines.

- With regard to the compliance matters under the heading “other issues”, the OECD recommends that use the most reliable information which is usually local comparables over the use of regional comparables where such local comparables are reasonably available. In 2014, the OECD released a discussion draft entitled “Transfer Pricing Comparability Data and Developing Countries”, in respect of which many comments and suggestions were submitted to the OECD regarding the fact that most developing countries do not have (reliable) comparables, which could be used to benchmark the pricing in respect of transactions between connected persons. The reasons for the lack of suitable comparables vary; often there is no requirement for private companies to disclose financial information, or the financial reporting standards applied vary. Listed companies normally operate within a group and can therefore not be used as reliable comparables in that these companies are not independent, and connected party transactions may impact on their financial results. The OECD, in its 2014 discussion draft “Transfer Pricing Comparability Data and Developing Countries” provided four possible approaches to deal with the issue:
    - primarily focus was placed on improving the availability of direct comparables from local sources (expanding the range of data in

commercial databases to include data from developing countries and providing such countries with access);
  - using the available data more effectively (guidance or assistance in the use of commercial databases, adjustments etc.);
  - relying on approaches which do not focus on direct comparable data (e.g. safe harbours, value chain analysis, use of the profit split method, sixth method); and
  - advance pricing agreements and mutual agreement proceedings.

- It is therefore important that SARS builds a database of comparable information and that this data base is accessible to taxpayers. Until such database is built and made available to taxpayers, SARS should provide taxpayers with clear guidance regarding alternative options, i.e. ideally all the above four approaches recommended by the OECD with clear guidance regarding the use thereof from a South African perspective.

- SARS needs to ensure that it maintains and grows its highly skilled transfer pricing team, and to ensure it includes lawyers and accountants, business analysts and economists. Such a team will ensure an understanding of commercial operations. This will require that measures are taken to identify, employ and retain sufficient skilled personnel, especially in the regions.

- Information required from corporates, via the ITR14 submissions, needs to be improved so that timely decisions can be made on the risk assessment of companies, and any consequent queries and adjustments. The guidance provided by SARS in the Tax Return Guide in respect of the relevant information is often unclear and needs significant improvement. In addition, the Tax Return Guide is updated once in a while, however, taxpayers are not notified of these updates, which may result in a taxpayer completing transfer pricing related disclosure following specific guidance, but at the time the tax return is submitted via e-filing, the guidance (or even the question in the tax return) may have changed without the taxpayer being sufficiently notified of this.[361]

- Guidance regarding the transfer pricing related disclosures in the ITR14 should be clarified either in the Tax Return Guide, and any changes should be brought to the attention of taxpayers, or guidance should be included in the overall South African transfer pricing guidance.[362]

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361 SAICA "Comment on DTC 1st Interim BEPS Report" (31 March 2015) para 26.

362 SAICA "Comment on DTC 1st Interim BEPS Report" (31 March 2015) para 27.

- The collection and sharing of data should be extended to include other holders of vital information, such as exchange control information about capital outflows collected by the South African Reserve Bank.
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- With respect to financial institutions, financial data available to SARS usually includes publically available and non-publically available data. Care should therefore be taken to ensure that even when SARS builds a database, taxpayers such as financial institutions can still make use of non-publically available data so that they can be able to defend their positions against these comparables. This will also minimise the uncertainties for taxpayers with respect to updating their data and other administrative issues surrounding data keeping.[363]

- The use of safe harbour rules is often disputed. However, recent developments in the OECD have led to a change in the relevant guidance and there is globally more support for the use of safe harbour rules. Despite the concern that safe harbour rules limit the arm's length principle in that, when applying a safe harbour rule, less focus is placed on what independent third parties would have achieved in similar circumstances, particularly where less significant transactions are considered, the use of safe harbours may help contain compliance costs. For example, a safe harbour rule has been proposed by the OECD/G20 in terms of the BEPS initiative regarding the pricing for low value adding services. The use of safe harbours in South Africa should be considered. In particular, see recommendation regarding inbound loans amounting to less than, say R100mn.

[363] Comments submitted to the DTC by the Banking Association South Africa (BASA) on the "DTC First Interim Report on BEPS Action 1" (25 March 2015) at 2.

ANNEXURE 9

DAVIS TAX COMMITTEE: SECOND INTERIM REPORT ON BASE EROSION AND PROFIT SHIFTING (BEPS) IN SOUTH AFRICA*

SUMMARY OF DTC REPORT ON ACTION 11: MEASURING AND MONITORING BEPS

It is commonly accepted that multinationals engage in activities that are intended to shift profits from jurisdictions where they do business to low tax jurisdictions and thereby erode tax bases of their residence or source countries. So far, not much attention has been paid to measuring the scale and impact of tax avoidance resulting in base erosion and profit shifting ("BEPS"). The OECD concedes that although measuring the scale of BEPS proves challenging because the complexity of BEPS and the serious limitations of data, it is now known that the fiscal effects of BEPS are significant.[1]

In light of this the OECD Report adopts six indicators referred to as a "dashboard of indicators" that are used to measure and effectively confirm the existence of BEPS. The limitation of currently available data remains a serious constraint in the effectiveness of the proposed indicators. Additionally, in the general examination of profit shifting, the said indicators being no exception, it has been found to be difficult to separate the effects of BEPS from real economic factors and the effects of deliberate tax policy choices.[2]

Action 11 acknowledges the existence of other empirical studies that cement their position on that occurrence of BEPS through transfer pricing, strategic location of intangibles and debt and treaty abuse. Unfortunately, the said studies are also impacted by the serious data limitation and, consequently, the same inability to separate the effects of BEPS from real economic factors and effects of deliberate tax policy choices.

As a result, the OECD Action 11 Report emphasises the notion that improving tools and data available to measure BEPS will be critical for measuring and monitoring BEPS in the future, as well as evaluating the impact of countermeasures developed in the OECD Action Plans. These sentiments are seen and reiterated throughout the entire text of the Report and reflected in the six proposed recommendations for improving BEPS data

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1 OECD/G20 2015 Final Report on Action 11 at 15.

2 OECD/G20 2015 Final Report on Action 11 at 16.

collection and analysis. While the need to improve the economic and fiscal analysis of BEPS requires greater access to this data, the Report suggests that any recommendations around the availability of data in the future must take into account the need to protect the confidentiality of taxpayer information and minimise the administrative burden for governments and taxpayers.[3]

The structure of the Report is as follows: Chapter 1 of the Report examines existing data sources relevant for BEPS analysis and concedes that the existing insufficiency can be addressed by improved tools and data sources. The gist of Chapter 1 eventually culminates *mutatis mutandis* into recommendations 1, 4 and 5 to the Report. Chapter 2 on the other hand looks specifically at indicators of base erosion and profit shifting, the deficit of which ultimately metamorphoses into recommendation 3 to the Report. In tune with the golden thread, the report states that the endeavour to develop more refined indicators can only be materialised once data sources are improved.[4] Chapter 3 looks towards measuring the scale and economic impact of BEPS and countermeasures and the result is reflected in recommendation 2 with certain relevant aspects emanating in recommendations 4 and 5.[5]

In line with the OECD recommendations, this report recommends the following for South Africa, that:

1. South Africa works with the OECD to publish a new Corporate Tax Statistics publication, which would compile a range of data and statistical analyses relevant to the economic analysis of BEPS;
2. South Africa works with the OECD to produce periodic reports on estimated revenue impacts of proposed and enacted BEPS countermeasures;
3. The South African government improves the public reporting of Business Tax Statistics particularly for MNEs;
4. South Africa continues to make improvements in non-tax data relevant to BEPS; and
5. South Africa considers current best practices and explores new approaches to collaborating on BEPS research with academics and other researchers.

[3] OECD/G20 2015 Final Report on Action 11 at 250.
[4] OECD/G20 2015 Final Report on Action 11 at 42.
[5] See para 3 below.

DTC REPORT ON ACTION ON ACTION 11: MEASURING AND MONITORING BEPS

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1 INTRODUCTION

Much is talked about base erosion and profit shifting (BEPS), and all the activities and practices that multinationals undertake in order to achieve BEPS. The need to combat such activities is evidenced by efforts that countries make developing tax provisions, and improving certain existing tax provisions, in order to combat tax avoidance resulting in BEPS. Such efforts are now being further supported by the enormous work that the OECD has undertaken in developing the BEPS Action Plan.

Not much attention has, however, so far been paid on measuring the scale and impact of tax avoidance resulting in BEPS. The amount of effort and resources that countries place on measures to combat BEPS should be relative to the impact that BEPS has on tax revenues. Without a proper indication of such impact, the effort and resources could be disproportionate (either on the upside or the downside) to the effort and resources applied.

Along with most other jurisdictions, South Africa has not developed a measuring and monitoring system to determine the economic impact of tax avoidance and BEPS. As such the scale of the economic impact of BEPS in South Africa is unknown. Focus has been placed on closing tax loopholes and curbing tax avoidance using instruments such as reportable arrangements and general and specific anti-avoidance measures. The South African Revenue Authority's Tax Avoidance and Reportable Arrangements division employs huge resources in monitoring tax avoidance schemes and behaviour. However, no resources are placed on specifically monitoring and measuring the impact of such tax avoidance and BEPS.

It is against this background that Action 11 of the OECD is important for South Africa.

2 THE OECD 2015 FINAL REPORT ON ACTION 11: MEASURING AND MONITORING BEPS

2.1 BACKGROUND

According to the OECD, an analysis of financial accounts from a cross-country database estimates the global corporate income tax revenue losses as a result of BEPS to be in the range of 4% to 10% of corporate income tax revenues, i.e. USD 100 to 240 billion annually[1] at 2014 levels. The studies estimating the fiscal effects on developing

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countries, as a percentage of their GDP, find that these effects are higher than in developed countries, given the greater reliance on CIT revenues and often weaker tax enforcement capabilities of developing countries, but in some cases these studies also include revenue lost from non-BEPS behaviours.[2] The Report considers that BEPS countermeasures would increase taxes paid by multinational enterprises (MNEs) engaging in BEPS, but other businesses and households will benefit from lower taxes or increased public infrastructure or increased government services, and indirectly through a more level playing field.

The Report on Action 11 acknowledges that the fiscal effects of BEPS are thus significant, although there is only anecdotal evidence that shows that tax planning activities of some MNEs take advantage of the mismatches and gaps in the international tax rules, separating taxable profits from the underlying value-creating activity. The OECD, 2013 BEPS Report recognised that the scale of the negative global impacts on economic activity and government revenues have been uncertain.[3]

Given developing countries' greater reliance on corporate income tax revenues, estimates of the impact on developing countries, as a percentage of GDP, are higher than for developed countries. As indicated above, in addition to significant tax revenue losses, BEPS is said to cause other adverse economic effects, including tilting the playing field in favour of tax-aggressive MNEs, exacerbating the corporate debt bias, misdirecting foreign direct investment, and reducing the financing of needed public infrastructure. Six indicators of BEPS activity highlight BEPS behaviours using different sources of data, employing different metrics, and examining different BEPS channels.[4] When combined and presented as a dashboard of indicators, they confirm the existence of BEPS, and its continued increase in scale in recent years.

Existing empirical studies and new empirical analysis of the fiscal and economic effects of BEPS find the existence of profit shifting through transfer mispricing, strategic location of intangibles and debt, as well as treaty abuse.[5] In addition these studies and analyses and BEPS indicators confirm that profit shifting is occurring, is significant in scale and is likely to be increasing, and that it also creates adverse economic distortions. The Report states that "empirical analysis indicates that BEPS adversely affects competition between businesses, levels and location of debt, the location of

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(University of Johannesburg - LLD,) and Ms Deborah Tickle, DTC BEPS Sub-Committee member (Director International and Corporate Tax Managing Partner KPMG).

1 OECD/G20 2015 Final Report on Action 11 at 15.

2 OECD/G20 2015 Final Report on Action 11 at 80.

3 See 2013 OECD/G20 BEPS report on action 11 at 58-60.

4 *Ibid.*

5 OECD/G20 2015 Final Report on Action 11 at 16.

intangible investments, and causes fiscal spillovers between countries and wasteful and inefficient expenditure of resources on tax engineering."[6]

The Report states that it is critical that the tools and data available to measure and monitor BEPS should be improved, as well as evaluating the impact of the countermeasures developed under the BEPS Action Plan. The Report also makes a number of recommendations that will improve the analysis of available data. The Report acknowledges that some of the information needed to improve the measurement and monitoring of BEPS is already collected by tax administrations, but not analysed or made available for analysis. The focus of the Report's recommendations in this area is on improved access to, and enhanced analysis of, existing data, and new data proposed to be collected under Actions 5, 13 and, where implemented, Action 12 of the BEPS project.[7]

The report recommends that the OECD work with governments to report and analyse more corporate tax statistics and to present them in an internationally consistent way. These improvements in the availability of data will ensure that governments and researchers will, in the future, be better able to measure and monitor BEPS and the actions taken to address BEPS.[8]

2.2 ASSESMENT OF EXISTING DATA SOURCES RELEVANT FOR BEPS ANALYSIS

The Report acknowledges that having a thorough understanding of the available data would provide a solid base for working towards 'best practices' in future data collection to 'fill the gaps' and strive for more comprehensive data and comparability across countries. This should be done with full recognition of the trade-offs between the objectives of improved tax policy analysis, and the need to minimize administrative costs for tax administrations and businesses.[9]

One of the key challenges with currently available data sources is that it is difficult for researchers to disentangle real economic effects from the effects of BEPS-related behaviours. Accordingly the Report assesses a range of existing data sources with specific reference to the availability and usefulness of existing data for the purposes of developing indicators, and undertaking an economic analysis, of the scale and impact of BEPS and BEPS countermeasures.

6 OECD/G20 2015 Final Report on Action 11 at 16.
7 *Ibid.*
8 *Ibid.*
9 OECD/G20 2015 Final Report on Action 11 at 18.

2.3 POTENTIAL CRITERIA FOR EVALUATING AVAILABLE DATA FOR BEPS RESEARCH

In evaluating available data, the Report recommends that the following set of criteria could be considered:

Coverage/Representativeness – BEPS is a global issue and significant profit shifting may occur through “small” entities with large profits but with little economic activity. Determining the coverage and representativeness of the underlying data is critical to assessing the results of any analysis. Most databases are limited to individual countries or a region, and there is no truly comprehensive global database of MNE activity.[10]

Usefulness for separating real economic effects from tax effects – Separating BEPS-related activity from real economic activity is important, but must be estimated. National Accounts and macroeconomic statistics, such as foreign direct investment data, combine both real and BEPS related activity. Firm-level data provides researchers with more information to attempt to more accurately separate BEPS-related activities from a firm’s real economic activities.[11]

Ability to focus on specific BEPS activity – BEPS is driven by practices that artificially segregate taxable income from the real economic activities that generate it. A MNE’s financial profile can be very different between financial and tax accounts. Differences in financial and taxable income can be large, and the country of taxation can differ from the firm’s country of incorporation. In some cases, specific tax information may be available for a limited number of MNEs from specific parliamentary enquiries.[12]

Level of detail – As BEPS behaviours involve cross-border transactions, typically between related parties, information on related and unrelated party transactions should be used when available. Affiliate-level information should supplement worldwide consolidated group information when available. Different types of foreign direct investment data should be used when available.[13]

Timeliness – Access to timely information enables policymakers to monitor and evaluate the changes in the BEPS environment and the effects of legislation. If the time lag is too long, empirical analysis may be more of an historical assessment, rather than an analysis of recent developments.[14]

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[10] OECD/G20 2015 Final Report on Action 11 at 19.
[11] OECD/G20 2015 Final Report on Action 11 at 19.
[12] OECD/G20 2015 Final Report on Action 11 at 19-22.
[13] OECD/G20 2015 Final Report on Action 11 at19-22.
[14] OECD/G20 2015 Final Report on Action 11 at 19-23.

Access to the information – MNE tax reports are available to tax administrators, However, BEPS behaviour cannot be necessarily identified as specific entries on tax returns or financial accounts. Therefore an analysis of the data is required to separate BEPS behaviours from real economic activity. To that end, policymakers need economic analyses of BEPS and BEPS countermeasures, rather than just compilations of descriptive statistics. The extent to which access to data is provided to statisticians and economists within government, and potentially outside of government, with strict confidentiality rules, represents an important policy issue.[15]

There are other data issues to be dealt with by analysts before conclusions can be reached on BEPS e.g. balance sheets typically reflect only purchased, and not developed intangibles; intangibles include not only intellectual property but also trade names and brands; accounting tax rates (headline or effective) which are not always reflective of BEPS or non-BEPS related activities; data collected through sampling raises questions as to weighting; data collection may only reflect historical positions and may also be impacted by economic conditions. [16]

Currently available data sources for BEPS analysis includes: (i) national accounts, (ii) balance of payments (BOP); (iii) foreign direct investment (FDI) statistics; (iv) aggregate data on bilateral trade by product; (v) corporate income tax revenue, and tax return and tax audit information; (vi) customs data; (vii) company financial information from public and proprietary databases and government databases; (viii) tax audit information; and (ix) detailed specific company tax information.[17]

Analysis of BEPS requires identifying where MNE behaviours or arrangements "achieve no or low taxation by shifting profits away from jurisdictions where the activities creating those profits take place. No or low taxation is not *per se* a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it.''[18] This description of BEPS is important in assessing the currently available data.

This initial analysis requires the following:[19]

- Firm-level data for the best analysis of BEPS;
- More complete information about global MNE activity to analyse BEPS;
- Additional analysis of tax return information; and

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15 OECD/G20 2015 Final Report on Action 11 at 19 and 23.
16 OECD/G20 2015 Final Report on Action 11 at 23.
17 OECD/G20 2015 Final Report on Action 11 at 24-26.
18 OECD/G20 2015 Final Report on Action 11 at 26.
19 OECD/G20 2015 Final Report on Action 11 at 26-32.

- Making the most of available information and identifying gaps.

Some current best practices in using available data for BEPS analysis are the following:[20]

Germany – The Deutsche Bundesbank houses the Micro database on Direct Investment, which is a full census of foreign firms' affiliates in Germany. It covers directly and indirectly foreign affiliates of German firms above a certain size and ownership thresholds. It contains balance sheet data at firm level (including at affiliates and parent company levels), ownership variables, information on liabilities of shareholders, shares in the assets and liability positions of non-residents. The information is kept confidential but made available, under strict conditions, for research purposes.

Sweden – Government analysts in Sweden have access to detailed, anonymised taxpayer information from filed tax returns, including balance sheets and information on domestic employees, employee compensation and the value of tangible and intangible assets. It distinguishes between MNEs and purely domestic Firms. However, the data lacks detailed income information on foreign subsidiaries. The OECD Report notes that this type of practice could be replicated in other countries.

Latin America – Some tax authorities, such as in Argentina, request companies to present special forms with information relating to transactions with related parties as well as with entities located in non-cooperative jurisdictions, and non-related parties. The information covers trade in goods and specifies prices, volumes and trading partners. Some countries share such data with international organizations, upon request, which suggests that comparable data for developing countries may be possible.

United States – The United States Bureau of Economic Analysis (BEA) surveys both United States headquartered firms (and their affiliates abroad) and subsidiaries in the United States of foreign headquartered firms. Firms are obliged to participate in surveys, the aggregated data outcomes of which are available publicly and micro data can be accessed by non-governmental researchers under strict confidentiality rules.
The US Internal Revenue Service also collects data regarding CFC's of US parents and vice versa. Such information is tabulated and made available for certain government analysts and approved non-government researchers.

[20] OECD/G20 2015 Final Report on Action 11 at 33.

In 2011, the OECD Expert Group for International Collaboration on Microdata Access was formed to examine the challenges for cross-border collaboration with micro data. The resulting 2014 report 21 notes: "*The challenge in the 21st Century is to change practices in access to micro data so that the access services can cross borders and support trans-national analysis and policy making. This is necessary to reflect the increasingly international (global) reach and impact of comparative analysis and shared policy making*."[21] Highlighting the importance of comparability and working towards homogeneity in data collection across countries, the Expert Group report recommends smarter deployment of what already exists in most OECD countries.[22]

The Report concludes that existing databases used for economic analysis of BEPS should be checked to see if identified cases of BEPS are included in the data. However, it further concludes that its assessment of the currently available data for economic analysis of BEPS and potential countermeasures identified significant data limitations, data issues, and in some cases data gaps in the various data sources currently available for analysing BEPS and BEPS countermeasures.[23]

2.4 INDICATORS OF BEPS

OECD Action 11 states that the first step in developing useful indicators is defining the concept:

"BEPS relates to arrangements that achieve low or no taxation by shifting profits away from the jurisdictions where the activities creating those profits take place or by exploiting gaps in the interaction of domestic tax rules where corporate income is not taxed at all. No or low taxation is not *per se* a cause of BEPS, but becomes so when it is associated with practices that artificially segregate taxable income from the generate it."[24]

OECD Action 11 Report then outlines dictionary definitions of an indicator to include;[25]

- An index that provides an indication, especially of trends;
- A meter or gauge measuring and recording variation;
- A device to attract attention, such as a warning light;
- An instrument that displays certain operating conditions such as temperature; and
- A pointer on a dial showing pressure or speed.

[21] OECD/G20 2015 Final Report on Action 11 at 34.
[22] OECD/G20 2015 Final Report on Action 11 at 35.
[23] OECD/G20 2015 Final Report on Action 11 at 35.
[24] OECD/G20 2015 Final Report on Action 11 at 42.
[25] OECD/G20 2015 Final Report on Action 11 at 42.

The idea of BEPS indicators is closely woven into Action 11's golden thread and immediately highlights that as with any gauge," the degree of precision depends on the available information and the accuracy of the measurement tools."[26] Simply, the better the tools and information available, the more precise and accurate the indicator becomes. The Action 11 Report further notes that one of the main deficiencies with the current data analysis is that" 'at this stage BEPS indicators can only provide some general insights into the scale and economic impact of BEPS, but will necessarily lack the precision that may become possible if more comprehensive and improved data sources where to be used in the future"[27]

The OECD Report further concedes that no single indicator can be used to provide a complete picture of the scale and economic impact of BEPS and as such the concept followed in developing the BEPS indicators has been to create a "dashboard of indicators" that provide an indication of the scale of BEPS and help policymakers monitor changes in the scale of BEPS overtime. In light of this and given the currently available data, multiple indicators help identify trends regarding the scale of BEPS and changes in BEPS and specific BEPS behaviours.

As a further acknowledgement of the need for more thorough and targeted data, current BEPS indicators, developed from currently available data, give a view of how such indicators could be enhanced if more comprehensive data was to become available in the future.[28] To cement this proposition the Report outlines three scenarios i.e. the current state, future state and ideal state, the substance of which is to demonstrate the benefit that more comprehensive tools and data will have on the indicators. In the "future state" for example, the emergence of new data sources will make the indicators more insightful and enable them to give a deeper economic analysis whereas in the "ideal state" the indicators would have more accurate and direct in estimates of BEPS and effectiveness of BEPS countermeasures.

One of the biggest challenges underpinning the production and refinement of analytical tools and BEPS indicators (couched in the Report as a "significant caution") is that BEPS activity is amalgamated into and effectively taints available measures of real economic activity such as corporate income tax bases, financial accounting statements, and even national aggregate measures of economic activity in the corporate sector. In light of this and the existing limitations in the current data, the indicators are designed to be illustrative rather than definitive.

26 *Ibid*

27 *Ibid.*

28 OECD/G20 2015 Final Report on Action 11 at 43.

Despite these shortcomings, the Report presents six indicators and a further two potential indicators to assist with the measurement and monitoring of BEPS. These indicators are intended to be viewed like a meter or a gauge, capable of measuring trends and variations over time and acting as “warning lights” that might point to the existence of BEPS. No single indicator is capable of providing the complete picture, but by presenting a “dashboard” of BEPS indicators this report provides new insights regarding the presence and scale of BEPS.[29]

The following five categories of indicators containing six indicators of BEPS, have been identified in the report:

1. <u>Disconnect between financial and real economic activities (Indicator 1): concentration of high levels of foreign direct investment relative to GDP).</u> This indicator is based on foreign direct investment (FDI) relative to GDP and shows that both the net and gross FDI stocks relative to GDP of a group of countries with high-ratios (above 50% for net and above 200% for gross) have continued to grow in recent years, when compared with the average of all other countries. The net FDI to GDP ratio of those countries increased from 38 times higher than all other countries in 2005 to 99 times higher in 2012.

   The information for this indicator was sourced from the OECD Foreign Direct Investment Statistics providing data on inward and outward FDI stock to and from OECD countries for the 214 countries identified in the OECD database. According to the Report the indicator showed a concentration of FDI in a select group of countries that is disproportionate to the real economic activity (as measured by GDP) in the said countries. It is worthy to note that FDI includes real investment and purely financial transactions (such as mergers and acquisitions) and cannot distinguish between BEPS and other transactions. Action 11 concludes that a high indicator may flag potential BEPS.[30]

2. <u>Profit rate differentials within top global MNEs.[31] (Indicators 2 and 3:</u>
    a. <u>differential profit rates compared to effective tax rates; and</u>
    b. <u>differential profit rates between low-tax locations and worldwide MNE operations);</u>

   This dual pronged indicator shows that lower effective tax rates (ETRs) are correlated with higher profit rates amongst affiliates. It shows that 45% of the income of the largest global MNEs was reported by affiliates with below-average ETRs and above average profit rates. These affiliates represented only 33% of

29 OECD/G20 2015 Final Report on Action 11 at 46.
30 OECD/G20 2015 Final Report on Action 11 at 49-51.
31 OECD/G20 2015 Final Report on Action 11 at 52-56.

total affiliates in the MNE. The value of the indicator increased 32% between 2007 and 2011.

The use of ratios of profits to measure economic activity recognises that BEPS is characterised by disconnecting where the profit is reported and where the economic activity generating the profit is. Indicators herein use a relative measure. The indicator on differential profit rates compared to effective tax rates focuses on the percentage of the total reported income being earned by those lower tax, higher profit affiliates. Indicator 2's findings state that in 2011 lower-tax, higher-profit affiliates accounted for 45% of the total income reported by affiliates in the sample.

The indicator on differential profit rates between low-tax locations and worldwide MNE operations compares the profit rate (i.e. profit/assets) of top global MNE affiliates in low-tax rate jurisdictions with the MNE worldwide profit rate. Findings under this indicator state that in 2011 profit rates of affiliates in lower-tax countries of 171 of the largest MNEs were on average almost twice as high as their worldwide MNE group profit rates (i.e. ratio of 2:0).

3. <u>MNE vs. "comparable" non-MNE effective tax rate differentials[32] (Indicator 4): effective tax rates of large MNE affiliates relative to non-MNE entities with similar characteristics).</u> This indicator shows that lower ETRs are correlated with higher profit rates amongst affiliates. It shows that reported profit rates of MNE affiliates in lower-tax countries were, on average, almost twice as high as their group's worldwide profit rate.

   This indicator compares the ETR of large MNE affiliates with non-MNE entities with similar characteristics in the same country. It measures the extent to which large MNE's have lower ETRs than comparable non-MNE (domestic) entities. Indicator 4 finds that on average, a large MNE affiliate ETR over domestic firms with similar characteristics fluctuating around the level of -3 percentage points with fluctuations not being significant from a statistical point of view.

4. <u>Profit shifting through intangibles[33] (Indicator 5: concentration of high levels of royalty receipts relative to research and development spending).</u> This indicator shows that royalties received relative to R&D expenditures in a group of countries with ratios above 50% are six times higher than for the average of all other countries, up from three times higher in 2009. Based on macro level data

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[32] OECD/G20 2015 Final Report on Action 11 at 56-57.
[33] OECD/G20 2015 Final Report on Action 11 at 60-62.

this indicator provides for an indirect measure of BEPS related to intangible property i.e. it being based on macro-level data on royalty payments. The rationale is that transferring intellectual property from a higher tax country where R&D takes place to a lower tax country is one channel facilitating BEPS. The indicator used Balance of Payments and R&D expenditure from the World Bank, World Development Indicators. The findings from the 59 countries in 2011 are evidence of four countries having a ratio of over 50%. It should, however, be noted that the indicator evidences the existence of BEPS but does not measure the scale of BEPS; and

5. Profit shifting through interest[34] (Indicator 6: interest expense to income ratios of MNE affiliates with above average statutory tax rates (STR)). This indicator shows the concentration of high interest-to-income ratios in higher statutory tax rate countries. It shows that the largest global MNEs' affiliates with high interest-to-EBITDA ratios, located in high-tax countries have an interest-to-EBITDA ratio almost three times higher than their groups' worldwide unrelated-party interest-to-EBITDA ratio.

   Based on MNE and firm level financial information from ORBIS database, this indicator measures excess interest-to-income ratio reported by MNE affiliates with relatively high income-to-interest ratios located in countries with STR's above the weighted average. This was done by dividing the affiliates into four quadrants, based on their interest-to-income ratios and their statutory tax rates. The results show the above average interest-to-income ratio by MNE affiliates with relatively high interest-to-income ratios located in high tax countries. Before interest, depreciation and amortisation expenses, interest accounted for 29% of their pre-tax income. This exceeded the average ratio (10%) by 19%.

Two additional indicators are also described that could, in the future, be calculated when new data becomes available:

6. A comparison of profit rates and ETRs for MNE domestic (headquarter); and ~~(B)~~ foreign operations. This indicator compares the profit rate differential between the MNE's domestic operations in the jurisdiction of its headquarters and the MNE's foreign operations to the MNE's differential between domestic and foreign operations. These differentials are then measured as the difference between the domestic and foreign values. Both differentials can be positive or negative.

[34] OECD/G20 2015 Final Report on Action 11 at 63-65.

7. Differential rates of return on FDI investment from special purpose entities. This macro-economic indicator could measure the extent to which FDI inward positions are coming from countries with significant outbound FDI through SPEs, serving as investment conduits. These are countries with relatively large shares of FDI outward investment stocks accounted for by SPEs.

The Report also provides formulas for calculating indicators.[35]

The Report advocates the use of these indicators because they can be calculated historically, on an annual basis, to track direct changes in BEPS over time, as well as to make future calculations once more accurate and comprehensive data is made available. Further, it is provided that the said indicators can be updated relatively quickly from data that is available on a timely basis. Action 11 further highlights that the nature of the current indicators permits them to be refined and extended by academics and other researchers to improve their ability to transparently measure BEPS. This ties well with Recommendation 6 which calls upon governments to encourage academics, researchers and scholars to undertake studies to improve the understanding of BEPS.[36] On the other hand the Report discloses that all indicators should be interpreted taking into account their inherent limitations. With the notion of multiple indicators or a "dashboard of indicators" Action 11 Report concedes that no single indicator can be used to effectively measure the scale of BEPS and changes in BEPS over time. Further, indicators should acknowledge the existence of genuine economic activity unrelated to BEPS in the data they interpret. An example is given with specific reference to Indicator 1 on FDI data in Category A because attracting high levels of real FDI may come as a result of an attractive investment climate divorced from any BEPS activity. This limitation extends from the realisation that currently available data is unable to draw a clear distinction between BEPS related activity and genuine economic activity.[37]

2.5 MEASURING THE SCALE AND ECONOMIC IMPACT OF BEPS AND COUNTERMEASURES

The Report summarises the available empirical analyses of profit shifting and the effects of previously implemented anti-avoidance countermeasures. The Report finds that recent research has focused on specific types of BEPS behaviours, mostly on transfer mispricing and debt shifting, but also on treaty abuse, controlled foreign corporation rules, hybrid mismatch arrangements, and disclosure rules, but more empirical analysis is needed in all of these areas. No empirical studies comprehensively cover global MNE

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35 OECD/G20 2015 Final Report on Action 11 in Annex2.A1.
36 OECD/G20 2015 Final Report on Action 11 at 47.
37 OECD/G20 2015 Final Report on Action 11 at 41.

activity as most studies are constrained by a lack of data relating to MNE entities in many countries, and where information regarding MNE entities is available it is often incomplete.[38]

Statistical analyses based upon data collected under the Action 13 Country-by- Country Reports have the potential to significantly enhance the economic analysis of BEPS. However, even with additional data and sophisticated estimation methodologies, researchers of the scale, prevalence and intensity of BEPS will still have difficulty in fully separating BEPS from real economic activity and from non- BEPS tax preferences.[39]

The Report points to recent studies that have presented estimates of the scale of BEPS globally or for individual countries which show significant fiscal effects using different types of data and different estimation methodologies.[40] As stated earlier an OECD analysis of financial accounts from a cross-country database estimates the global corporate income tax revenue losses to be in the range of 4% to 10% of corporate income tax revenues, i.e. USD 100 to 240 billion annually at 2014 levels. The studies estimating the fiscal effects on developing countries, as a percentage of their GDP, find that these effects are higher than in developed countries, given the greater reliance on corporate income tax revenues and often weaker tax enforcement capabilities of developing countries, but in some cases these studies also include revenue lost from non-BEPS behaviours.

The Report finds that BEPS involves MNEs manipulating the location of external and internal debt; reduces the effective tax rate on intangible investments, thereby distorting the types of investments made; affects the location of patent registrations, and to a lesser extent actual R&D activity; affects the location of different types and forms of foreign direct investment; and creates tax base and policy spillovers between countries.

OECD research finds that BEPS reduces the effective tax rate of large MNE entities by 4 to 8½ percentage points on average compared to similarly-situated domestic-only affiliates, providing a competitive advantage in product and capital markets.[41] The reduction in effective tax rates is larger for very large firms and firms with patents. Analyses of BEPS make comparisons of current business activity with some alternative or “counterfactual.” The counterfactual could be a hypothetical “world without BEPS” or a hypothetical “world without co-ordinated multilateral action.” When evaluating BEPS

38 OECD/G20 2015 Final Report on Action 11 at 79.
39 *Ibid.*
40 OECD/G20 2015 Final Report on Action 11 at 88-90.
41 OECD/G20 2015 Final Report on Action 11 at 80.

countermeasures, the estimated counterfactual of the effects of implementing countermeasures can be compared with current law rules and revenues.[42]

BEPS anti-avoidance measures previously implemented by countries have been found to be effective, in countries' fiscal estimates, in academic studies, and in OECD research, to reduce tax planning. Thus, countries with higher statutory corporate tax rates do not necessarily have higher fiscal losses from BEPS if they have strict anti-avoidance rules. International co-ordination of those rules will increase the effectiveness of BEPS countermeasures while reducing the cost of compliance for businesses.[43]

The Report states that the extent of BEPS-induced distortions depends on two factors, namely

- who currently benefits from BEPS: and
- whether the tax savings from BEPS are passed along in lower consumer prices, higher wages to workers, or to higher returns to capital owners.[44]

As earlier stated BEPS countermeasures will increase taxes paid by MNEs engaging in BEPS, but other businesses and households will benefit from lower taxes or increased public infrastructure or increased government services, and indirectly through a more level playing field. The report suggests that the effects on all businesses and households need to be included in analyses of countermeasures. The analysis needs to consider who benefits from BEPS, since if BEPS increases the after-tax economic rents of MNEs engaging in BEPS, countermeasures may not affect some of their investment decisions. Additional research is required on MNEs' investment decisions, determinants of profitability, business tax preferences, and total business taxes to enhance the economic analysis of BEPS and BEPS countermeasures.[45]

The key issues in measuring and analyzing BEPS are:[46]

- Defining BEPS;
- The counter-factual for BEPS analysis, i.e. using the hypothetical world without BEPS;
- Separating BEPS from real economic activity;
- Determining what profits are generated;
- Separating BEPS from non-BEPS tax preferences; and
- Measuring the appropriate tax rate for BEPS analysis.

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42 *Ibid.*
43 *Ibid.*
44 *Ibid.*
45 OECD/G20 2015 Final Report on Action 11 at 80.
46 OECD/G20 2015 Final Report on Action 11 at 82-88.

2.6 DIFFERENT APPROACHES USED TO ESTIMATE PROFIT SHIFTING

Different approaches are used to estimate profit shifting such as:

- coverage by country;
- coverage by MNE relationships;
- tax rate variables;
- tax rate differential variables;
- explanatory economic variables;
- fixed effects variables;
- semi-elasticity v elasticity measures;
- cost of tax planning or linear vs non-linear tax effects; and
- time period and different methodologies.[47]

The Report describes the empirical analyses of overall profit shifting, estimates of the fiscal effects of BEPS, the empirical analyses of the effects of BEPS countermeasures and particular channels of BEPS, and the economic impacts of BEPS and countermeasures.

2.7 BEPS AND DEVELOPING COUNTRIES

As South Africa is a developing country, an analysis of the impact of BEPS in developing countries is important as is determined in the Report. According to the Report, due to limitations of the available data, both in terms of quality and quantity, empirical research of profit shifting in developing countries is quite limited. Attempting to fill the gap on developing country studies of BEPS, Fuest, Hebous and Riedel[48] empirically examine income shifting from developing countries by focusing on related party loans. Their results show that related party debt in developing countries is significantly more sensitive to changes in corporate tax rates than in developed countries. The study concludes that profit shifting, measured relative to current CIT collections, is about twice as large in developing countries as in developed economies. The IMF[49] suggests that revenue losses as a percent of corporate income tax revenues in developing countries could be several multiples of those in developed countries, due to weaker enforcement resources.[50]

47 OECD/G20 2015 Final Report on Action 11 at 91.

48 Fuest C, Hebous S and Reidel N (2011) "International debt shifting and multinational firms in developing economies" *Economics Letters* page 135 – 138.

49 IMF (2014) "Spillovers in International Corporate Taxation" *IMF Policy Paper*.

50 OECD/G20 2015 Final Report on Action 11 at 98.

Many studies focusing on developing countries do not separate the revenue lost from BEPS behaviours from individual tax evasion and illicit financial flows. Developing countries have higher ratios of CIT to GDP, so their revenue base is potentially more at risk from BEPS behaviours than developed countries, and loss of CIT revenue could lead to critical underfunding of public investment that could help promote economic growth. The Report quotes a report by the African Tax Administration Forum that shows that African tax administrators find that transfer-pricing abuse is a major obstacle not only to effective revenue mobilisation, but also to development and poverty alleviation, and that most countries lack the necessary skills to identify and analyse complex cases. Better understanding of the economic effects of BEPS on developing countries is important for the design of tax policies that account for country differences in tax systems and levels of enforcement capabilities.[51]

It is important in assessing the effectiveness of the BEPS countermeasures to take into account the level of enforcement. Some countries may choose not to enforce certain regulatory rules strongly for tax competitiveness reasons. Other countries may not have the resources or capacity to fully enforce their existing laws and regulations.[52]

A recent working paper by UNCTAD provides a tax and investment perspective on the tax consequences of FDI for developing economies and looked, in particular, at the use of special purpose entities (SPE), tax havens and offshore investment hubs as major players in FDI in developing countries. It found a relatively large effect of SPE and tax haven investment in developing countries.[53] Such a finding implies a greater need in such countries to ensure that they have, and can enforce, anti-avoidance measures.

2.8 FUTURE RESEARCH AND ANALYSIS

The Report also highlights areas for future research and analysis beyond the Action 11 mandate which will add to the understanding of BEPS. These include:[54]

- The prevalence and intensity of BEPS ie how pervasive are BEPS behaviours?.
- Differences in the profitability of MNEs vs. comparable domestic entities.
- Factors contributing to group profitability.
- Factors contributing to affiliate profitability.
- The extent to which non-tax factors affect location decisions.
- The extent of the effects of uncertainty, reputation, compliance costs and disclosures on investment decisions.

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51 OECD/G20 2015 Final Report on Action 11 at 99.
52 OECD/G20 2015 Final Report on Action 11 at 106.
53 OECD/G20 2015 Final Report on Action 11 at 99.
54 OECD/G20 2015 Final Report on Action 11 at 122-123.

- Mobility of different types of labour.
- The impact of Government's strategic behaviours impact countries' co-operative versus competitive behaviours.

2.9 THE IMPACT OF TAX PLANNING

The analysis contained in the Report assesses the fiscal and economic implications of international differences in statutory and effective corporate tax rates and as such it also covers domestic tax incentives. The following points show that tax planning is widespread among MNEs and entails tax revenue losses:[55]

- Robust empirical evidence shows that MNEs engage in international tax planning. MNEs shift profit from higher to lower-tax rate countries. Large MNEs also exploit mismatches between tax systems (e.g. differences in the tax treatment of certain entities, instruments or transactions) and preferential tax treatment for certain activities or incomes to reduce their tax burden.

- Transfer price manipulation, strategic allocation of intangible assets and manipulation of internal and external debt levels are important profit shifting channels.

- The empirical patent analysis suggests that preferential tax treatment of intellectual property influences the location of intangible assets. Preferential intellectual property regimes attract research activities and the ownership of patents invented in other countries. Preferential regimes may also encourage the relabeling of certain incomes to benefit from the regime.

- Tax planning reduces the effective tax rate of large MNEs by 4-8½ percentage points on average. The reduction is even greater for very large firms and firms intensive in the use of intangible assets. Small MNEs also engage in tax planning but to a lesser extent.

- The net tax revenue loss from tax planning is estimated at 4-10% of global corporate tax revenues. These estimates based on 2000-10 data are surrounded by uncertainty and should be interpreted with caution.

- Strict anti-avoidance rules reduce tax planning. Strict anti-avoidance rules, such as transfer pricing, interest deductibility, GAARs and CFCs rules, are found to

55 OECD/G20 2015 Final Report on Action 11 at 135.

reduce profit shifting. However, complex rules generate compliance costs for all firms, hampering profitability, as well as administrative and enforcement costs for tax authorities. These costs could be reduced by international co-ordination.

The following points show that tax planning effects on economic efficiency are unclear.[56]

- Tax planning may allow certain MNEs to increase their market power, resulting in more concentrated markets. The reduced competitive pressure may entail welfare losses. However, these losses may be partially offset by the associated reallocation of resources to high-productivity MNEs.

- The possibility to manipulate the location of internal and external debt lowers the cost of debt for MNE groups and can compound the "debt-bias" present in most tax systems. Even so, domestic firms have on average higher external leverage than MNE groups. Information on internal debt is not available.

- International tax planning reduces effective tax rates and the effect of cross-country corporate tax differences on the location of investment by tax planning MNEs. However, this is achieved at the cost of additional distortions (e.g. uneven playing field between tax-planning MNEs and other firms) as compared with a situation in which corporate tax rates were cut across the board.

2.10 BEPS COUNTER-MEASURES

In determining measures that could be used to counter BEPS, authors such as Grubert[57] who used a sample of USA corporate tax return data of large non-financial USA MNE's between 1996 and 2002 are cited authoritatively. His paper finds that companies with lower foreign effective tax rates have higher foreign profit margins and lower domestic profit margins. He concludes that the introduction of the US "check-the-box" regulation in 1997, together with research and development, reduces the foreign effective tax rates indirectly indicating that the strategic location of intangible assets can facilitate BEPS.

Others authors like Dharmapala[58] and Dowd, Landefeld, and Moore[59] summarize empirical literature on profit shifting analyses and reports. Dharmapala finds that

[56] OECD/G20 2015 Final Report on Action 11 at 135-136.

[57] Grubert H "Foreign taxes and the growing share of U.S. multinational company income abroad: profits, not sales, are being globalized" *National Tax Journal* 65(2) 247-282.

[58] Dharmapala D "What do we know about base erosion and profit shifting? A review of empirical literature" *Fiscal Studies* Vol 35 page 421-448.

recently the estimated magnitudes of BEPS are smaller than found in earlier literature. Dowd, Landefeld and Moore on the other hand examined United States tax returns for foreign controlled companies of United States parent MNEs, which they deemed to have non-linear effects of profit shifting.

Reference is also made to databases such as ORBIS and Huzinga and Laeven[60] analysing the Amadeus database of the European Union's MNEs unconsolidated affiliate financial information to investigate profit shifting incentives due to international tax differences.

Thereafter, the OECD Action 11 Report presents an outline of the different approaches adopted in the estimate of profit shifting. There is coverage by country, coverage by MNE, estimated profit variable, tax rate variable and linear and non-linear tax effects *inter alia.* Ultimately, the adopted formula in the Report for the estimate of profit shifting is calculated by:

CIT Revenues Lost from Profit Shifting =

A worldwide responsiveness of profit-to-asset ratio to tax rate differentials *(estimated from the ORBIS database with particular regression on specification for profitable entities -0.1)* ***x average asset/profit ratio*** *(6.2& from ORBIS data)* ***x average tax rate differential*** *(3.6% from ORBIS data)* ***x MNEs' average share of total profits*** *(59% from ORBIS data supplemented with aggregate tax return tabulations for several countries; tax credit as a percentage of before credit-corporate tax collections (19%) from OECD Survey; and an estimate of USD 2.3 trillion of after credit tax collections in 2014 adjusted for expected growth from 2011)* ***x estimated global CIT Revenue***[61]

The formula sets out the key parameters and estimates based on a number of assumptions. Some of the factors lead to an underestimation of revenue losses while others lead to an overestimation of the loss. Additionally the Report makes specific reference to ten empirical analyses of BEPS fiscal effects from various entities like the International Monetary Fund (IMF), United Nations Conference on Trade and Development (UNCTAD), MSCI, the United States JCT economists, Christian Aid, Oxfam, Bach, Clausing, and Vicard.[62]

The IMF estimated the spillover effects of profit shifting and reported an unweighted average revenue loss across all sampled countries at 5% of current CIT Revenue but

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59 Dowd T, Landesfeld P and Moore A "Profit shifting on U.S. multinationals" *Joint Committee on Taxation Working Paper*.

60 Huzinga H and Laeven L "International profit-shifting within multinationals: A multi-country perspective" Journal of Public Economics 88(6) Page 1149 – 1168.

61 OECD/G20 2015 Final Report on Action 11 at 102.

62 OECD/G20 2015 Final Report on Action 11 at 104.

almost 13% in the non-OECD countries.[63] The study unfortunately assumes that all the variation in cross-country CIT efficiency ratios is attributable to profit shifting. UNCTAD on the other hand estimates revenue losses for developing countries due to profit shifting to range from USD 66 billion to USD 122 billion in 2012.[64] Christian Aid and Oxfam conclude that Trade Mispricing in non-EU countries and developing countries reducing tax revenues at USD 122 billion and USD 11billion respectively.[65]

On BEPS countermeasures, the Report also notes that several studies have been conducted on it providing insight into the scale of the particular BEPS channel. In assessing the effect of BEPS countermeasures, it is important to take into account the different levels of enforcement. In some instances countries may choose not to enforce certain regulatory rules strongly for tax competitiveness reasons while others may not have the resources and capacity to fully enforce their existing laws and regulations.[66]

Five BEPS countermeasures are discussed, making specific reference to the BEPS Actions embodying them, and some of the studies exploring them to various degrees. These are:

i) **Neutralising the effect of hybrid mismatch rules** as reflected in **Action 2** and canvassed by authors like Grubert[67] together with the OECD Analysis in Annex 3.A1.

ii) **Strengthening CFC Rules** through **Action 3** and embracing the study of Ruf and Weichenrieder[68] who examined the German Micro-database Direct Investment (MiDi) on German MNEs to investigate the effect of the German CFC legislation change that had arisen in response to a decision by the European Court of Justice. Others such as Markle and Robinson[69] use ORBIS and COMPUSTAT data to investigate whether CFC Rules, bilateral investment treaties and withholding taxes affect the behaviour of MNEs.

63 IMF (2014), "Spillovers in International Corporate Taxation", *IMF Policy Paper*, International Monetary Fund.

64 UNCTAD (2015), "FDI, Tax and Development, The fiscal role of multinational enterprises: towards guidelines for Coherent International Tax and Investment Policies", *Working paper for review and feedback, 3/26/2015*.

65 Oxfam (2015), "Africa: Rising for the few", www.oxfam.org/sites/www.oxfam.org/files/world_economic_forum_wef.africa_rising_for_the_few.pdf.

66 OECD/G20 2015 Final Report on Action 11 at 106.

67 *Supra.*

68 Ruf M and Weichenrieder A.J. "CFC legislation, passive assets and the impact of the ECJ's Cardbury-Schweppes decision" *CESifo Working Paper No.44*61.

69 Markle K.S and Robinson L (2012) "Tax haven use across international tax regimes".

iii) **Limit Base Erosion via interest deductions** proposed in **Action 4** cemented by several studies that have found that MNEs' strategic placement of debt and associated interest deductions are sensitive to tax differentials and tax interest limitations.[70]

iv) **Prevent Treaty Abuse** as enunciated by **Action 6** and an acknowledgement that empirical analyses of tax treaties are limited and often included with other BEPS behaviours, or with specific reference to particular countries. The Report does speak to the simulation analysis conducted by Van't Reit and Lejour[71] showing the potential reduction in withholding taxes due to treaty shopping, although the analysis is not based on actual taxpayer behaviour.

v) **Assure that Transfer Pricing outcomes are line with value creation** as reflected in **Actions 8 to 10.** Undoubtedly OECD Action 11 Report highlights that Transfer Pricing has been identified as a key area in BEPS studies with four Actions dedicated to addressing BEPS through this channel. Studies from as early as 2003, demonstrating an increase in inter-affiliate or inter-company transactions shows the tendency of BEPS-like behaviour in transfer pricing. Mutti and Grubert[72] analyse United States MNE tax return data to investigate whether their "check-the-box" regulation has encouraged the relocation of intangible assets abroad. The study reveals evidence of substantial migration of intangible assets abroad in particular to low tax countries.[73]

vi) **Benefits of better disclosure** catered for by **Actions 5, 11, 12 and 13.** The Report makes specific reference to a paper by Dyreng, Hoopes and Wilde[74] which has evidence suggesting that UK public companies decreased tax

70 See Desai, Foley and Hines (2004) that undertook a survey to identify the determinants of the capital structure of foreign affiliates in the United States MNEs. They find that higher tax rates increase the use of both external and internal debt for United States foreign affiliates, with more intense effect of internal debt. Huzinga, Laeven and Nicodeme (2008) use the European Amadeus database to test whether differences in taxation among countries have a statistically significant effect on the firm's capital structure and internal debt.

71 Van't Reit M and Lejour A "Ranking the stars: Network analysis of bilateral tax treaties" *CPB Discussion Paper No 290*.

72 Mutti J and Grubert H (2009) "The effect of taxes on royalties and the migration of intangible assets abroad" in Reinsdorf M and Slaughter M (ed.) *International trade in Services and Intangibles in the Era of Globalisation*, University of Chicago Press.

73 See OECD/G20 2015 Final Report on Action 11 in para 209 on a more recent 2012 study by Karkinsky and Riedel which merges from Amadeus financial statement database and PATSTAT information to examine MNE patent applications in Europe. They find that low tax rates increase the probability that MNE apply for patent boxes in low tax locations.

74 Dyreng S, Hoopes J.L and Wilde J.H "Public Pressure and corporate tax behaviour" *Working Paper*.

avoidance when there was increased public disclosure. The same sentiments of reduced profit shifting were found in a study by Lohse and Riedel[75] where more stringent transfer pricing documentation was put in place.

As a more general observation, the Report notes that some corporations are already changing their international tax structures due to the progress of the BEPS Project and expected change by government.[76] Further that studies show positive effects of current unilateral measures shifting BEPS behaviour away from countries with anti-avoidance rules towards countries without anti-avoidance rules.[77]

2.11 TOOLKIT

When countries consider introducing BEPS countermeasures, estimates of the fiscal and economic effects may be needed. Tax policy analysts can provide government officials and other stakeholders with evidence-based analysis of the fiscal and economic effects of options to curtail BEPS behaviours.

Annex 3.A2[78] provides government tax administrations and tax policy officers, as well as other stakeholders, with a toolkit of methodological approaches that could be used to estimate the fiscal effects of BEPS countermeasures.

The annex provides potential approaches that could be used by government tax policy analysts to estimate the fiscal effects of BEPS countermeasures for their respective countries. A general approach is described before potential approaches are explained for the individual BEPS Actions. The proposed methodologies are set out according to the individual countermeasures of the BEPS Actions. Some methodologies are more comprehensive than others, given the variation in data availability; the extent of insights from empirical studies; and depending on the design of the countermeasures.

Countries will have different datasets and some may be more useful for particular BEPS countermeasures than others. It is recognised that estimating the fiscal effects of BEPS countermeasures may rely on applicable tax return data, financial account micro-data, macro-data (aggregated from tax return or financial accounts), a combination of micro

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75 Lohse T and Riedel N "The impact of transfer pricing regulations on profit shifting within European multinationals" *FZID Discussion Paper* No. 61-2012.

76 OECD/G20 2015 Final Report on Action 11 at110.

77 OECD/G20 2015 Final Report on Action 11 in Annex 3.A1 analysis provides a more detailed analysis of unilateral measures by combining different five (the report erroneously says four) anti avoidance measures being different transfer pricing documentation levels, different levels of interest limitations, the presence of CFC rules, the presence of General Anti-Avoidance Rules and the levels of withholding tax taking into account tax treaties.

78 OECD/G20 2015 Final Report on Action 11 at 193.

and macro-data sources, or in some cases to data analogous to the country. Where possible, multiple approaches based on different sources of data are described. Some countries have estimated the fiscal effects of BEPS-related countermeasures enacted or proposed.

The Annex considers that as better data becomes available (both as a result of CbCR and countries recognising the need to draw on taxpayer micro-data to make more informed and evidence-based tax policy decisions) tax policy analysts will be in a better position to evaluate and monitor trends in BEPS behaviours and the effect of countermeasures. An important consideration is the evaluation of *ex post* estimates relative to *ex ante* estimates. Separating the effects of unexpected macroeconomic changes from unexpected taxpayer behaviours from technical estimation issues can provide valuable learning to tax policy analysts as they assess the underlying causes in cases of large differences. Even small differences do not necessarily mean that all assumptions *ex ante* were correct. Evaluation of past estimates can improve understanding of key parameters, including behavioural changes.

3 RECOMMENDATIONS

Based on the aforegoing, the Report makes the following recommendations:

Recommendation 1

> *The OECD should work with all OECD members, BEPS Associates and any country willing to participate to publish on a regular basis, a new Corporate Tax Statistics publication, which would compile a range of data and statistical analyses relevant to the economic analysis of BEPS in an internationally consistent format. Among other information this publication will include aggregated and anonymised statistical analyses prepared by governments based on data collected under Action 13 Country-by-Country Reports.*[79]

Unlike some of the other recommendations discussed below, Recommendation 1 doesn't arise from only one specific Chapter of the Action 11 Report but from various aspects of the Report. Chapter 1 on assessment of existing data sources enables this Recommendation because it concedes that there is a deficit in the precision and comprehensiveness of the currently available data. It is therefore understandable why this particular recommendation, advocating for consistency and the compilation of a range of data relevant to the economic analysis of BEPS can arise.

[79] OECD/G20 2015 Final Report on Action 11 at 262.

The Report divides the currently available data along the lines of macro data sources and micro data sources. With the former, these include national accounts, balance of payments, foreign direct investment (FDI), trade, corporate income tax revenue, and customs data. With the latter, currently available BEPS data includes company financial information from public or proprietary databases, company financial information from government databases, tax return CIT information, tax audit information, and detailed specific tax company information.

Various difficulties arise with the currently available data such as the underlying notion that BEPS activities are intertwined with real economic activities reflected in FDI, national accounts and balance of payments on a macro level; to different reporting requirements, strict rules limiting reported information, and the protection of confidential tax payer information on the micro level.

Since the proposed indicators of BEPS emerge as a direct consequence of the data available, the discussion on indicators of BEPS is consequently indirectly relevant to this recommendation. However, since an incontrovertible link exists between the discussion on Indicators and Recommendation 3, the lucid discussion on Recommendation 3 below specifically explores the current and proposed indicators thus no further mention is required here save as to highlight that the comprehensiveness of the available data has an impact on one's dexterity to effectively use the indicators.

The OECD Report briefly examines the economic impact of BEPS and advocates for the introduction of measures to ensure the effectiveness of BEPS countermeasures.[80] The publication of a new Corporate Tax Statistic as recommended herein would facilitate a better assessment of the economic analysis of BEPS in an internationally consistent format. This position is reiterated in Annex 3.A2 to the Report which is the toolkit for estimating the country-specific fiscal effects of BEPS countermeasures. The Annex further expresses the need for publication such as the one recommended herein as important sources of information.

Moreover, the Recommendation falls squarely within the parameters of the intricately woven golden thread that has already been highlighted above. This recommendation, if successfully implemented, effectively improves the tools and data available to measure BEPS because it is geared to compile a range of data and statistical analyses in an internationally consistent format thereby augmenting the mandate of Action 11. The Recommendation also makes a direct reference to Action 13 on the Country-by-Country Reports which also have the potential to significantly enhance the economic analysis of BEPS. The OECD's Action 11 Report however concedes that despite Action 13 and the

80 See Chapter 3 of the OECD/G20 2015 Final Report on Action 11.

new proposed publication under recommendation 1, it may still prove challenging to separate BEPS from real economic activity.

Recommendation 2

The OECD should work with all OECD members, BEPS associates and any willing participating governments to produce periodic reports on estimated revenue impacts of proposed and enacted BEPS countermeasures.[81]

This recommendation comes on the backdrop of an extensive discussion on BEPS related literature from several astute authors. Despite their extensive accounts, it is conceded that most of the studies are limited to a single country (such as Germany or the United States of America) or an MNE headquartered in a single country where company surveys, corporate tax returns and company trade data are made available to researchers on a confidential basis.

Recommendation 3

The OECD should continue to produce and refine analytical tools and BEPS Indicators to monitor the scale and economic impact of BEPS and to evaluate the effectiveness and economic impact of BEPS countermeasures.[82]

As indicated earlier, the OECD Action 11 Report advocates for the use of the indicators because they can be calculated historically on an annual basis to track direct changes in BEPS over time as well as make future calculations once more accurate and comprehensive data is made available.[83] Further, it is provided that the said indicators can be updated relatively quickly from data that is available on a timely basis.[84] It should be noted that Recommendation 6 below specifically targets the data relevant for Future Indicator B (foreign operations and differential rates of return on FDI investment from special purpose entities); this doesn't however suggest that such data would not be valuable for the other indicators. It could in fact be used to give better results for Indicator 1.[85]

Recommendation 4

Governments should improve the public reporting of Business Tax Statistics particularly for MNEs.[86]

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81 OECD/G20 2015 Final Report on Action 11 at 263.
82 OECD/G20 2015 Final Report on Action 11 at 263.
83 See para 2.5 above.
84 *Ibid.*
85 *Ibid.*
86 OECD/G20 2015 Final Report on Action 11 at 264.

Recommendation 4 has inherent similarities to Recommendation 1 except it is not on the international plane. The request here is for governments to internally improve the public reporting of business statistics particularly in relation to MNEs. The direct referral to MNE's is not unusual because the issue of BEPS and BEPS activities is rooted on the existence of MNEs which unscrupulously implement artificial corporate structures to reap from the benefits of double non-taxation or single digit taxation.[87]

Governments are therefore requested and encouraged under Recommendation 4 to enhance and refine their public reporting.

It flows from the discussion in existing data sources[88] relevant to BEPS analysis that the inclusion of improved Business Tax Statistics advocated by this recommendation will yield better results. In fact, the improved Business Tax Statistics will add to the fabric of BEPS data and ultimately BEPS jurisprudence after analysis and critique by astute academics, researchers, tax policy officials, tax administrators *inter alia* as advocated in Recommendation 6.

The OECD report acknowledges the administrative burden that this places on government.[89] Despite the insufficiencies in the currently available data, government does still need to collect and compile copious amounts of data. It is submitted that the recommendation does necessarily require an increase in the quantity of the data collected but in the quality. Undoubtedly improving quality may inadvertently lead to an increase in quantity but that should not be understood to be the primary aim of this recommendation.

Recommendation 5

> *Governments should continue to make improvements in non-tax data relevant to BEPS such as the broadening country coverage and improving data on FDI associated with resident special purpose entities, trade in services and intangible investments.*[90]

Similarly, the recommendation has no overt link to any of the other recommendations. This recommendation refers to the measurement of intangible investments including the capitalisation of investments in research and development as this will enable researchers to better identify the contributors to profitability and the scale of their contribution.

87 OECD/G20 2015 Final Report on Action 11 at 82.
88 See paras 2.1 and 2.2 above.
89 See para 2 above and OECD/G20 2015 Final Report on Action 11 at 250.
90 OECD/G20 2015 Final Report on Action 11 at 264.

Specific reference is made to *Benchmark Definition of Foreign Direct Investment 4th Edition*[91] which recommends that countries should include transactions with special purpose entities in their FDI statistics to ensure comparability with other countries. These refined statistics enable policymakers to assess the impact of FDI into their economies because the statistics will better reflect FDI into businesses with a real presence in the economy.

With regards to the discussion of future indicators, Future Indicator B (foreign operations and differential rates of return on FDI investment from special purpose entities) will emerge directly as a consequence of the availability of the data recommended herein. This information will also assist in the key objective of differentiating between BEPS activity and genuine economic activity.

Recommendation 6

> *Governments should consider current best practices and explore new approaches to collaborating on BEPS research with academics and other researchers. Governments should encourage more research on MNE activity within tax administrations, tax policy officials, national statistical offices, and by academic researchers, to improve the understanding of BEPS and to better separate BEPS from real economic effects and non-BEPS tax preferences.*[92]

This Recommendation is the final touch to the entire Report and aims to capture all the central tenets and stakeholders in the successful implementation of measuring and monitoring BEPS. It is therefore covered by various aspects of the Action 11 with no stand-alone akin to the one demonstrated in Recommendation 3.

Firstly the Recommendation encourages governments to consider current best practices and explore collaborate efforts between the various stakeholders. This request is not a standalone in isolation from the Action 11 OECD Report but in fact summarises it together with the recommendation aptly. In all the previous Recommendations the underlying aim is to improve the available data and tools to monitor the said data, this Recommendation seals it up by encouraging that such efforts be done in a collaborative fashion.

The second aspect speaking to the involvement of academics and researches is also reflected throughout the entire text of the Report. For example the discussion on countermeasures in Recommendation 2 involves many key studies conducted by various academics in different jurisdictions. The concern expressed therein is that most

91 *Benchmark Definition of Foreign Direct Investment 4th Edition (2008).*
92 OECD/G20 2015 Final Report on Action 11 at 265.

information relevant to a comprehensive BEPS analysis is confidential and therefore sometimes inaccessible. As noted in the above discussion the studies effectively have a lacuna disenabling them from getting a more thorough understanding of BEPS and a better separation of BEPS activities from real economic effects. These deficits result in BEPS studies being merely illustrative and not definitive. These sentiments are echoed in this Recommendation with a request that governments should encourage further research not only to academics and researchers but also to tax administrators, national statistical offices and tax policy officials.[93]

4 THE DAVIS TAX COMMITTEE RECOMMENDATIONS ON ACTION 11

The Davis Tax Committee considers that it is essential for South Africa to measure the scale and economic impact of BEPS in South Africa. It is acknowledged that so far there is no measuring and monitoring system for BEPS in South Africa and, therefore, the scale of BEPS and the economic impact thereof are not known. As such it is impossible to determine whether more or less resources should be placed towards the curbing of BEPS.

The recommendations made by the OECD, in this regard, mainly place on governments the obligation to enhance the collection and maintenance of information that would help determine the extent of BEPS and therefore the economic impact of BEPS. In the absence of a monitoring and measuring system for BEPS in South Africa, it is recommended that South Africa should adopt the recommendations of the OECD in developing the monitoring and measuring system.

It is noted that Recommendation 3 of the OECD places an obligation on the OECD to "*continue to produce and refine analytical tools and BEPS indicators to monitor the scale and economic impact of BEPS and to evaluate the effectiveness and economic impact of BEPS countermeasures".* This recommendation places no obligation or expectation of action on the governments, therefore no recommendation is made in that regard. Along with the other recommendations of the OECD, the DTC therefore recommends that:

1. South Africa works with the OECD to publish, on a regular basis, a new Corporate Tax Statistics publication, which would compile a range of data and statistical analyses relevant to the economic analysis of BEPS in an internationally consistent format. This publication could include aggregated and anonymised statistical analyses prepared by the National Treasury based on data collected under Action 13 Country-by-Country Reports. South Africa already publishes comprehensive data on tax collections by segment of

93 OECD/G20 2015 Final Report on Action 11 at 265.

taxpayer, which is to be complimented. It has the systems in place to determine much more from the information that can be collected via tax returns. It is therefore recommended that that South Africa publishes a new Corporate Tax Statistics report in line with this OECD Recommendation.

2. South Africa works with the OECD to produce periodic reports on estimated revenue impacts of proposed and enacted BEPS countermeasures.
3. The South African government improves the public reporting of Business Tax Statistics particularly for MNEs.
4. South Africa continues to make improvements in non-tax data relevant to BEPS such as the broadening country coverage and improving data on FDI associated with resident special purpose entities, trade in services and intangible investments.
5. South Africa considers current best practices and explores new approaches to collaborating on BEPS research with academics and other researchers. The government could encourage more research on MNE activity within the South African Revenue Service, the National Treasury, Statistics South Africa and by academic researchers, to improve the understanding of BEPS and to better separate BEPS from real economic effects and non-BEPS tax preferences.

ANNEXURE 10

DAVIS TAX COMMITTEE: SECOND INTERIM REPORT ON BASE EROSION AND PROFIT SHIFTING (BEPS) IN SOUTH AFRICA

SUMMARY OF ACTION 12: REQUIRE TAXPAYERS TO DISCLOSE THEIR AGGRESIVE TAX PLANNING ARRANGEMENTS

The OECD notes that lack of timely, comprehensive and relevant information on aggressive tax planning strategies is one of the main challenges faced by tax authorities worldwide. Early access to such information provides the opportunity to quickly respond to tax risks through informed risk assessment, audits, or changes to legislation or regulations. Action 12 of the OECD 2013 *Action Plan on Base Erosion and Profit Shifting* recognises the benefits of tools designed to increase the information flow on tax risks to tax administrations and tax policy makers. It therefore called for recommendations regarding the design of mandatory disclosure rules for aggressive or abusive transactions, arrangements, or structures, taking into consideration the administrative costs for tax administrations and businesses and drawing on experiences of the increasing number of countries that have such rules.

The 2015 OECD Final Report on Action 12 provides a modular framework that enables countries without mandatory disclosure rules to design a regime that fits their need to obtain early information on potentially aggressive or abusive tax planning schemes and their users. The recommendations in this Report do not represent a minimum standard and countries are free to choose whether or not to introduce mandatory disclosure regimes. Where a country wishes to adopt mandatory disclosure rules, the recommendations provide the necessary flexibility to balance a country's need for better and more timely information with the compliance burdens for taxpayers. The Report also sets out specific recommendations for rules targeting international tax schemes, as well as for the development and implementation of more effective information exchange and co-operation between tax administrations. A summary of the main aspects of the Report is as follows:

(i) Design principles and key objectives of a mandatory disclosure regime

Mandatory disclosure regimes should be clear and easy to understand, should balance additional compliance costs to taxpayers with the benefits obtained by the tax administration, should be effective in achieving their objectives, should accurately identify the schemes to be disclosed, should be flexible and dynamic enough to allow the tax administration to adjust the system to respond to new risks (or carve-out obsolete risks), and should ensure that information collected is used effectively.

The main objective of mandatory disclosure regimes is to increase transparency by providing the tax administration with early information regarding potentially aggressive or abusive tax planning schemes and to identify the promoters and users of those schemes. Another objective of mandatory disclosure regimes is deterrence: taxpayers may think twice about entering into a scheme if it has to be disclosed. Pressure is also placed on the tax avoidance market as promoters and users only have a limited opportunity to implement schemes before they are closed down. Mandatory disclosure regimes both complement and differ from other types of reporting and disclosure obligations, such as co-operative compliance programmes, in that they are specifically designed to detect tax planning schemes that exploit vulnerabilities in the tax system early, while also providing tax administrations with the flexibility to choose thresholds, hallmarks and filters to target transactions of particular interest and perceived areas of risk.

(ii) Key design features of a mandatory disclosure regime

In order to successfully design an effective mandatory disclosure regime, the following features need to be considered: who reports, what information to report, when the information has to be reported, and the consequences of non-reporting. In relation to the above design features, the Report recommends that countries introducing mandatory disclosure regimes:

- impose a disclosure obligation on both the promoter and the taxpayer, or impose the primary obligation to disclose on either the promoter or the taxpayer;
- include a mixture of specific and generic hallmarks, the existence of each of them triggering a requirement for disclosure. Generic hallmarks target features that are common to promoted schemes, such as the requirement for confidentiality or the payment of a premium fee. Specific hallmarks target particular areas of concern such as losses;
- establish a mechanism to track disclosures and link disclosures made by promoters and clients as identifying scheme users, as this is also an essential part of any mandatory disclosure regime. Existing regimes identify these through the use of scheme reference numbers and/or by obliging the promoter to provide a list of clients. Where a country places the primary reporting obligation on a promoter, it is recommended that they also introduce scheme reference numbers and require, where domestic law allows, the production of client lists;
- link the timeframe for disclosure to the scheme being made available to taxpayers when the obligation to disclose is imposed on the promoter; link it to the implementation of the scheme when the obligation to disclose is imposed on the taxpayer;
- introduce penalties (including non-monetary penalties) to ensure compliance with mandatory disclosure regimes that are consistent with their general domestic law.

(iii) Coverage of international tax schemes

There are a number of differences between domestic and cross-border schemes that make the latter more difficult to target with mandatory disclosure regimes. International schemes are more likely to be specifically designed for a particular taxpayer or transaction and may involve multiple parties and tax benefits in different jurisdictions, which can make these schemes more difficult to target with domestic hallmarks. In order to overcome these difficulties, the Report recommends that:

- Countries develop hallmarks that focus on the type of cross-border BEPS outcomes that cause them concern. An arrangement or scheme that incorporates such a cross-border outcome would only be required to be disclosed, however, if that arrangement includes a transaction with a domestic taxpayer that has material tax consequences in the reporting country and the domestic taxpayer was aware, or ought to have been aware, of the cross-border outcome.
- Taxpayers that enter into intra-group transactions with material tax consequences are obliged to make reasonable enquiries as to whether the transaction forms part of an arrangement that includes a cross-border outcome that is specifically identified as reportable under their home jurisdictions' mandatory disclosure regime.

(iv) Enhancing information sharing

Transparency is one of the three pillars of the OECD/G20 BEPS Project and a number of measures developed in the course of the Project will give rise to additional information being shared with, or between, tax administrations. The expanded Joint International Tax Shelter Information and Collaboration Network (JITSIC Network) of the OECD Forum on Tax Administration provides an international platform for an enhanced co-operation and collaboration between tax administrations, based on existing legal instruments, which could include co-operation on information obtained by participating countries under mandatory disclosure regimes.

Mandatory disclosure rules in South Africa and recommendations to enhance their effectiveness

South Africa has Reportable Arrangements provisions in Part B of the Tax Administration Act 28 of 2011 (TAA - fully discussed in the main report below), which are supposed to work as an "early warning system" for SARS, allowing it to identify potentially aggressive transactions when they are entered into. Over the years the SARS Unit responsible for Reportable Arrangements started managing the listed Reportable Arrangements in a more proactive manner, which has resulted in an increase in the number of arrangements reported in line with SARS expectations. SARS statistics on Reportable Arrangements[1] show that between 2009 and first quarter of 2016, 838 arrangements have been reported (see details in paragraph 9.2 of the Report below).

The OECD recommends that where a country places the primary reporting obligation on the promoter, it should introduce scheme reference numbers and require the preparation of client lists in order to fully identify all users of a scheme and to enable risk assessment of individual taxpayers.[2] South Africa has a dual reporting system. in term of section 38 of the TAA, the "promoter" has the primary obligation to report. If there is no promoter in relation to the "arrangement" or if the promoter is not a resident, the "participants" must disclose the information.

- In light of the dual reporting mechanism in South Africa and in the interest of not placing administrative burdens on taxpayers to submit client lists it is recommended that client lists should not be introduced in South Africa. Such information could be easily accessed from the disclosures submitted by the participants in terms of section 38 of the TAA. It should also be noted that SARS Form RA 01 for Reporting Reportable Arrangements contains detailed aspects of what must be disclosed by a participate or a promoter – the information that would be provided on completion of these Forms is broad enough to capture what could be required from client lists. It should, however be noted that the RA01 Form available on the SARS website refers to pre-TAA legislation and is, thus, not up to date with current law (see below). It is recommended that it be updated.
- Section 38 of the TAA provides that an arrangement must be disclosed in the prescribed form. Disclosing the arrangement in any other manner than with the prescribed form would therefore not constitute compliance to the TAA. Form RA-01 expressly stipulates that it is the form in which to report arrangements in terms of sections 80M – 80T of the ITA. Sections 80M – 80T were repealed by the TAA in 2011. No form exists in terms of the TAA with which to disclose reportable arrangements. It is, thus, important that SARS urgently provides a form that is line with the current law. Without a valid prescribed form, it is impossible to comply with the provisions.

The OECD provides certain recommendations regarding structuring monetary penalties for non-disclosure. It recommends that in setting penalty levels:

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[1] SARS "Tax Avoidance and Reportable Arrangements Unit". See reportable@sars.gov.za.

[2] OECD/G20 2015 Final Report on Action 12 in para 172.

- Jurisdictions may take into account factors such as whether negligence or deliberate non-compliance or tax benefit may be linked to the level of penalties levied.
- Penalties should be set at a level that maximises their deterrent value without being overly burdensome or disproportionate.
- Consideration should be given to percentage based penalties based upon transaction size or the extent of any tax savings.[3]

In South Africa, section 212 of the TAA, sets out the penalties "a participant" to a reportable arrangement is liable for in case of failure to disclose the reportable arrangement. Section 34(c) of the TAA defines a "participant" as "any other person who is a party to an arrangement". However the TAA does not explain who is included or excluded in the term "party to an arrangement". It is for instance not clear whether it includes beneficiaries of discretionary trusts. If the phrase "a party to an arrangement" is interpreted so widely, there are concerns that SARS may impose unfair and unjust penalties on innocent persons i.e. those who have no knowledge of the actions of the trust. It should be noted though (in line with the OECD recommendations on penalties) that in terms of section 217 of the TAA, SARS does apply some discretion in the way the section 212 reportable arrangements penalties are levied. Section 217(2) provides that SARS may "remit the 'penalty' or a portion thereof if appropriate, up to an amount of R2000 if SARS is satisfied that:

(i) reasonable grounds for non-compliance exist; and
(ii) the non-compliance in issue has been remedied".

Specific recommendations on certain issues regarding penalties in South Africa's reportable arrangements provisions:

- As mentioned above, the reportable arrangements penalty provision - section 212(1) of the TAA - stipulates that participant who has the duty to report the arrangement but fails to do so is liable for the penalty 'penalty', for each month that the failure continues (up to 12 months), in the amount of—
  (*a*) R50 000, in the case of a 'participant' other than the 'promoter'; or
  (*b*) R100 000, in the case of the 'promoter'.
  However, the conjunction "or" used between subsections 1(a) and 1(b) makes it unclear whether only one person will be held liable for the penalty, in the corresponding amount, or whether all persons will be held liable simultaneously, in the amount applicable to their role in the arrangement. It is not clear whether SARS imposes a penalty on each of the promoters or if the penalty will be imposed jointly and severally. It is suggested that the legislation be made clearer.
- The penalties have serious economic implications for participants and promoters. Non-disclosure by a promoter for up to 12 months could amount to penalties of 1.2million (100, 000 per month). It is possible that the amount

[3] OECD/G20 2015 Final Report on Action 12 in para 183.

could even be higher if a promoter is involved in more than one arrangement that must be reported. With such hefty penalties, it is important that SARS ensures that the provisions are well worded and clear, so that taxpayers are not left to their own devices to interpret what was meant. It is also important that SARS raises more awareness to taxpayers about the reportable arrangements provisions especially regarding the penalties for not complying with the provisions.

The OECD notes that many countries have lower numbers of disclosures of international schemes because the way international schemes are structured and the formulation of some countries' disclosure regimes may not be effective in curtailing BEPS in a cross-border context, since such structures typically generate multiple tax benefits for different parties in different jurisdictions.[4] In South Africa, Government Gazette No. 39650 issued on 3 February 2016 which has extended the scope of reportable arrangements, has the potential of making the rules more appropriate from a BEPS angle, as much of what BEPS is concerned with relates to commercial arrangements. For example, paragraph 2.3 of the Gazetted list covers any arrangement in terms of which a person that is a resident makes any contribution or payment on or after the date of publication of this notice to a trust that is not a resident and has or acquires a beneficial interest in that trust. Section 37 of the TAA also provides that if the promoter of a scheme is not a resident, all other "participants" (whether resident or non-resident) must disclose the information regarding to the arrangement to SARS.

- Nevertheless more needs to be done to ensure the provisions are more effective in preventing BEPS.
- There are however concerns about the phrasing of the reporting provisions listed in Government Gazette No. 39650 of 3 February 2016. As is explained fully in the main report below, wording of certain terms and phrases in the provisions is not clear. For example it is important that SARS clarifies the meaning of terms such as "beneficial interest" and "contribution or payment" where a resident makes a contribution to a non-resident trust. The lack of clarity has implications on who is liable to report. It is uncertain whether a beneficiary of a discretionary trust in terms of which it is completely within the discretion of the trustees whether or not any distribution will be made to a specific beneficiary, has a beneficial interest. Unless the trustees have decided to vest any capital or income in the beneficiary, that beneficiary only has a contingent right, which is no more than a *spes* - a hope or an expectation.
- Where reporting in the case of a trust applies where "the value of that interest exceeds or is reasonably expected to exceed R10 million", there are some uncertainties as to how this value is to be determined. One may not be sure when the value is likely to exceed R10 million at any point in the future, and

[4] OECD/G20 2015 Final Report on Action 12 in para 227.

thus when there is the obligation to report.[5] Even if the value of the interest of a beneficiary can be established and even if can be expected to exceed the threshold, there are numerous factors which could influence the value: changes in the exchange rate, a decrease or crash in the markets, a discretionary distribution made to another beneficiary, *et cetera*. SARS need to come up with a more concrete, rather than a very broad, way of determining the value.

- Paragraph (c) of the definition of participant provides that "any other person who is a party to an arrangement" is a participant. However the TAA does not explain who is included or excluded in the term "party to an arrangement". It is, for instance, not clear whether it includes beneficiaries of discretionary trusts i.e. persons who are appointed beneficiaries but have no other connection or discourse with the trust and, thus, may have no knowledge of the trust's activities. If the phrase "a party to an arrangement" is interpreted so widely, it may impose unfair and unjust penalties on innocent persons.

The OECD notes that there is a need to ensure that the generic hallmarks for disclosure discriminate between schemes that are wholly-domestic and those that have a cross-border component. [6] The OECD specifically points out the ineffectiveness (in a cross-border context) of disclosure regimes that require reportable schemes to meet a formal threshold condition for disclosure (such as the *main benefit* or *tax avoidance* test) since some cross-border schemes may not meet this threshold if the taxpayer can demonstrate that the value of any domestic tax benefits was incidental when viewed in light of the commercial and foreign tax benefits of the transaction as a whole.[7] In South Africa section 36(3)(a) and (b) make it clear that an arrangement is reportable if the main purpose, or one of the main purposes, of entering into the arrangement is to obtain a tax benefit (i.e. the intention of the taxpayer); or if the arrangement is entered into in a specific manner or form that enhances or will enhance a tax benefit (i.e. even if there is no intention but the result is a tax benefit).

- Thus both the intention to gain a tax benefit and the result of a tax benefit without intention are taken into consideration; the South African rules are not dependent on the "main purpose to obtain a tax benefit" as the threshold condition for disclosure. Thus even though a taxpayer can reason that the value of any domestic tax benefits was incidental (not main purpose) when viewed in light of the commercial and foreign tax benefits of the transaction as a whole, the arrangement is still reportable, in light of section 36(b), if it is

[5] *SARS gazettes new list of arrangements deemed reportable,* News & Press: Tax Talk (22 September 2015). Available at http://www.thesait.org.za/news/251710/SARS-gazettes-new-list-of-arrangements-deemed-reportable-.htm accessed 9 June 2016.

[6] OECD/G20 2015 Final Report on Action 12 in para 227.

[7] OECD/G20 2015 Final Report on Action 12 in para 229.

entered into in a specific manner or form that enhances or will enhance a tax benefit.

The OECD notes that cross-border tax planning schemes are often incorporated into broader commercial transactions such as acquisitions, refinancing or restructuring and they tend to be customised so that they are taxpayer and transaction specific, and may not be widely-promoted in the same way as a domestically marketed scheme. Thus generic hallmarks that are primarily focussed at promoted schemes that can be easily replicated and sold to a number of different taxpayers may not be effective in curtailing BEPS. [8] In this regard, the OECD recommends the use of specific hallmarks to target cross-border tax schemes to address particular tax policy or revenue risks in the country. Examples include leasing and income conversion schemes which can apply equally in the domestic and cross-border context.

- Although South Africa has specific hallmarks in section 35(1) of the TAA; as well as arrangements listed by the Commissioner by public notice in section 35(2) of the TAA, the DTC recommends that more international schemes be targeted that could cause potential loss of revenue – for example conversion, restructuring, acquisition schemes and other innovative tax planning techniques.
- In targeting more international schemes, cognisance could be taken of the challenge the OECD points to, of ensuring that, in the design of specific hallmarks, the relevant definition is sufficiently broad to pick up a range of tax planning techniques and narrow enough to avoid over-disclosure. To effectively deal with this challenge the OECD suggests that focus should be placed on *outcomes* that raise concerns from a tax policy perspective, rather than the techniques that are used to achieve them (e.g. using the effects-based, approach of the USA, that extends the disclosure obligations to "substantially similar" transactions). [9]

The OECD recommends that countries should have a broad definition of "arrangement" that includes offshore tax outcomes. The definition of "arrangement" in section 34 of the TAA states that it "means any transaction, operation, scheme, agreement or understanding (whether enforceable or not)". Although this definition does not specifically refer to offshore arrangements, the use of the word "any" implies that it includes both domestic and offshore arrangements. Reference to offshore outcomes is also indicated in section 37, which provides that if there is no promoter in relation to the "arrangement", or if the promoter is not a resident, all other "participants' must disclose the information.

- Perhaps to make this offshore implication much more clear, the legislation should consider re-drafting the definition of an arrangement to specifically

[8] OECD/G20 2015 Final Report on Action 12 in para 230.
[9] OECD/G20 2015 Final Report on Action 12 in para 232.

state that the word “any” covers both domestic and offshore outcomes.

- The rules that apply to domestic schemes for identifying the promoter, and for determining who has the primary disclosure obligation, should also apply in the international context.

To ensure there are no undue administrative burdens on domestic taxpayers, disclosure obligations should not be placed on persons that are not subject to tax in South Africa, or on arrangements that have no connection with South Africa. At the same time, disclosure obligations should not be framed in such a way as to encourage a taxpayer to deliberately ignore the offshore aspects of a scheme simply to avoid disclosure. [10]

- Taxpayers should only be required to disclose information that is within their knowledge, possession or control. They can however be expected to obtain information on the operation and effect of an intra-group scheme from other group members. Outside of the group context, a reporting taxpayer should not be required to provide any more information than the taxpayer would be expected to have obtained in the course of ordinary commercial due diligence on a transaction of that nature. [11]

The OECD recommends that information that should be required to be disclosed in respect of domestic schemes should be the same as the information required for cross-border schemes. Such information should include information about the operation of the scheme including key provisions of foreign law relevant to the elements of the disclosed transaction. [12] Where information about the scheme is held offshore and may be subject to confidentiality or other restrictions that prevent it from being made available to the person required to make disclosure then;

- Domestic taxpayers, advisors and intermediaries should only be required to disclose the material information about the scheme that is within their knowledge, possession or control.
- In the case where the person holds only incomplete information about the scheme or is unable to disclose such information, that person should be required, to the extent permitted by domestic law, to:
    - Identify the persons with possession or control of that information; and
    - certify that a written request for that information has been sent to such persons. [13]
    - If this is applied by SARS, it can then use this certification as the basis of an exchange of information request under the relevant double tax treaty or under a Tax Information Exchange Agreement (TIEA) that may have been signed with a country.

[10] OECD/G20 2015 Final Report on Action 12 in para 234.
[11] OECD/G20 2015 Final Report on Action 12 in para 235.
[12] OECD/G20 2015 Final Report on Action 12 in para 253.
[13] OECD/G20 2015 Final Report on Action 12 in para 236.

The OECD does recommend the use of monetary thresholds, set at levels that avoid over-disclosure, to filter-out irrelevant or non-material disclosures.[14] In South Africa, Government Gazette No 39650 issued on 3 February 2016 which lists reportable arrangements and excluded arrangements excludes from the rules any arrangement referred to in s 35(1) of the if the aggregate tax benefit which is or may be derived from that arrangement by all participants to that arrangement does not exceed R5 million.

- It is important that this limit is reviewed regularly taking into consideration cross-border perspectives.

14 OECD/G20 2015 Final Report on Action 12 in para 244.

DTC REPORT ON ACTION 12: REQUIRE TAXPAYERS TO DISCLOSE THEIR AGGRESIVE TAX PLANNING ARRANGEMENTS

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1 BACKGROUND

To prevent global tax exposure, taxpayers often get involved in tax avoidance schemes that result in the erosion of countries' tax bases and shifting of profits to low tax jurisdictions. Aggressive tax planning has been defined as consisting of "taking advantage of the technicalities of a tax system or of mismatches between two or more tax systems for the purpose of reducing tax liability". [1] The OECD uses the term "aggressive tax planning strategies"[2] to refer to sophisticated tax schemes that include a number of steps and make use of complex mechanisms, which may comply with the letter but abuse the spirit of the law. Often these transactions blur the dividing line between tax evasion and tax avoidance. Aggressive tax planning schemes can take a multitude of forms. It frequently involves circular movements of funds, shell companies or the use of financial instruments or hybrid entities that are treated differently depending on the tax jurisdictions. [3] Its consequences include double deductions (e.g. the same loss is deducted both in the state of source and residence) and double non-taxation (e.g. income which is not taxed in the source state is exempt in the state of residence)."[4]

Even before the OECD issued its BEPS report, countries have been concerned about aggressive tax planning. In September 2006, members of the OECD Forum on Tax Administration held a meeting in Korea in which they identified compliance with tax legislation as one of the two main challenges facing tax administrations in the coming years. They emphasized that:

> "[e]nforcement of our respective tax laws has become more difficult as trade and capital liberalisation and advances in communications technologies have opened the global marketplace to a wider spectrum of taxpayers. While this more open economic environment is good for business and global growth, it can lead to structures which challenge tax rules, and schemes and arrangements by both domestic and foreign taxpayers to facilitate non-compliance with our national tax laws."[5]

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1 Quebec Ministry of Finance "Aggressive Tax Planning Working paper" (2009) at 13. Available at http://www.finances.gouv.qc.ca/documents/Autres/en/AUTEN_DocCons_PFA.pdf accessed 9 July 2015.

2 OECD May 2015 Public Discussion Draft on Action 12 in the Executive Summary.

3 Quebec Ministry of Finance "Aggressive Tax Planning Working paper" (2009) at 13. Available at http://www.finances.gouv.qc.ca/documents/Autres/en/AUTEN_DocCons_PFA.pdf accessed 9 July 2015.

4 European Commission "Recommendation on Aggressive Tax Planning" 6 December 2012. Available at http://ec.europa.eu/taxation_customs/resources/documents/taxation/tax_fraud_evasion/c_2012_8806_en.pdf accessed 9 July 2015.

5 OECD "*Seoul Declaration*, third meeting of the OECD Forum on Tax Administration" (14-15 September 2006). Available at ttp://www.oecd.org/dataoecd/38/29/37415572.pdf accessed 9 July 2015).

In order to prevent the tax benefits arising from these aggressive tax planning structures, tax administrations normally detect them by auditing taxpayers' returns, which usually results in tax administrations enacting anti-avoidance rules to block the relevant scheme - a process that can extend over many years.[6] However audits pose various constraints as tools for the early detection of tax planning schemes.[7] Tax audits often take a long time and yet governments need timely access to relevant information in order to identify and respond to tax risks posed by tax planning schemes. Aggressive taxpayers and their advisers are often a step ahead as they often devise other schemes outside the scope of the rule that has been enacted, and the cycle goes on. Thus, in most countries, tax authorities find it challenging to respond adequately to prevent aggressive tax planning transactions that exploit their tax systems. The inevitable delays between the conclusion of taxpayers' transactions, submission of annual returns and then the assessment and the audits; implies that years may pass by before tax-avoidance transactions are detected, analysed and challenged.

The OECD notes that "one of the challenges faced by tax authorities is a lack of comprehensive and relevant information on potentially aggressive or abusive tax planning strategies". If tax authorities can obtain or have access to such information, at an early stage, this would give them an opportunity to respond quickly to tax risks either through timely and informed changes to legislation and regulation or through improved risk assessment and compliance programs.[8] If countries can have early access to such information, this could provide them with the opportunity to quickly respond to tax risks through informed risk assessment, audits, or changes to legislation or regulations.[9]

2 INTERNATIONAL RESPONSES

One measure to improve response times that is increasingly being adopted worldwide involves enacting "mandatory disclosure rules" that entail the advance reporting of transactions meeting criteria that indicate that they may give rise to concern. The USA was the first country to introduce such rules in 1984, which have undergone many changes since. This was followed by Canada which in 1989 enacted a Tax Shelter regime for specific tax planning arrangements involving gifting arrangements and the acquisition of property. Then in June 2013, Canada enacted

6 LARIN, Gilles N., Robert DUONG, and Lyne LATULIPPE. "Effective Responses to Aggressive Tax Planning What Canada Can Learn from Other Jurisdictions Instalment 4: United Kingdom-Disclosure Rules." (2009). Available at http://www.usherbrooke.ca/chaire-fiscalite/fileadmin/sites/chaire-fiscalite/documents/Tax_avoidance/Avoidance_Instalment4.pdf accessed on 15 June 2015.

7 OECD May 2015 Public Discussion Draft on Action 12 in para 5.

8 OECD/G20 2015 Final Report on Action 12 at 9.

9 OECD/G20 2015 Final Report on Action 12 at 9.

Reportable Tax Avoidance transactions legislation with much broader reporting requirements. South Africa introduced Reportable Arrangements legislation in 2003 which came into force in 2005, subsequently revised in 2008, and which is now set out in the Tax Administration Act 28 of 2011 (TAA), supported by Government Gazettes which set out additional arrangements that specifically fall within the provisions.

The UK enacted mandatory disclosure rules named the "Disclosure of Tax Avoidance Schemes" (DOTAS) Rules in 2004. The rules were revised substantially in 2006 and came into force on 1 January 2011. The DOTAs rules require promoters of certain types of tax avoidance schemes, or in some cases users of the schemes, to disclose them to HMRC. The DOTAS regime has two objectives. Primarily, it is intended to ensure that HMRC becomes aware of potential avoidance schemes as early as possible. It is also intended to act as a deterrent to more egregious schemes. HMRC claims DOTAS as a successful part of their multi-pronged strategy for dealing with tax avoidance. Most of the professional firms and the tax directors of large companies agreed that DOTAS had proved important, and that the number of disclosures in which they had been involved was now small.[10]

Ireland introduced its mandatory disclosure regime in 2011 and since then Korea, Portugal and Israel have also introduced mandatory disclosure rules. The design (and consequently the effect) of these regimes varies from one country to another.[11]

In 2004, the UK, Australia, Canada and the USA, formed the "Joint International Tax Shelter Information Centre", which aims to deter promotion of investment in abusive tax schemes, by sharing information, experience and best practices. Membership has since expanded to include China, France, Germany, Japan and Korea. In 2009, the then permanent secretary of the HRMC, Dave Hartnett, estimated that the sharing of information by JITSIC members had "saved or prevented the loss of more than £1 billion for the UK alone in four years." [12]

3 PREVIOUS OECD WORK ON MANDATORY DISCLOSURE PROVISIONS

On an international front, the OECD has also done some work on ensuring disclosure of aggressive tax planning schemes.

- In 2008, the OECD conducted a study on the role of Tax Intermediaries[13] which encouraged tax authorities to establish enhanced relationships with their large business taxpayers. This 2008 Report was followed by the 2013

10 UK House of Lords Committee on Fiscal Affairs "Tackling Corporate Tax Avoidance In A Global Economy: Is A New Approach Needed?"(July 2013) in para 41.

11 OECD May 2015 Public Discussion Draft on Action 12 in para 37.

12 UK House of Lords Committee on Fiscal Affairs "Tackling Corporate Tax Avoidance In A Global Economy: Is A New Approach Needed?" (July 2013) in para 46.

13 OECD "Study into the role of Tax Intermediaries" (OECD, 2008).

Report on co-operative compliance programmes.[14] In terms of the 2013 Report, by using co-operative compliance programmes, taxpayers agree to make full disclosure of material tax issues and transactions they have undertaken to enable tax authorities to understand their tax impact. Co-operative compliance relationships allow for a joint approach to tax risk management and compliance and result in more effective risk assessment and better use of resources by the tax administration. The 2013 Report noted the number of countries that had developed co-operative compliance programmes since the publication of the 2008 Report concluded that their value was now well-established.[15]

- In 2011, the OECD issued a report on transparency and disclosure initiatives.[16] This report explained the importance of timely, targeted and comprehensive information to counter aggressive tax planning and it provided an overview of disclosure initiatives introduced in certain OECD countries and discussed their experiences regarding such initiatives.[17]
- In 2013 the OECD issued a report on co-operative compliance programmes.[18]
- The OECD's previous work on aggressive tax planning includes its Aggressive Tax Planning Directory[19] - a database of tax planning schemes maintained by certain OECD and G20 countries who adhere to certain confidentiality undertakings and agree to submitting aggressive tax planning schemes to the directory, which now covers over 400 aggressive tax planning schemes.[20] The purpose of the directory is to allow government officials from member countries to share information on aggressive tax planning trends. Timely sharing of information on aggressive tax planning schemes assists member states in understanding new tax planning techniques, facilitates their detection, enables countries to rapidly adapt their risk management strategies and to identify appropriate legislative and administrative responses.[21] Some countries are intensively drawing on this work to improve their audit performance. Since improving tax compliance for both, on-shore and off-shore

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14 OECD "Co-operative Compliance: A Framework: From Enhanced Relationship to Co-Operative Compliance" (OECD, 2013).

15 OECD May 2015 Public Discussion Draft on Action 12 in para 9.

16 OECD "Tackling Aggressive Tax Planning through Improved Transparency and Disclosure" (OECD, 2011).

17 OECD May 2015 Public Discussion Draft on Action 12 in para 8.

18 OECD "Co-operative Compliance: A Framework: From Enhanced Relationship to Co-Operative Compliance" (OECD, 2013).

19 OECD "Aggressive Tax Planning Directory". The directory is a secure online resource for government officials which is intended to help governments keep pace with aggressive tax planning. See http://www.oecd.org/tax/exchange-of-tax-information/oecdaggressivetaxplanningdirectory.htm accessed 16 May 2014.

20 OECD "OECD's work on tax planning". Available at http://www.oecd.org/tax/aggressive/ accessed 9 July 2015.

21 OECD "Co-operation and exchange of information on ATP" Available at http://www.oecd.org/ctp/aggressive/co-operation-and-exchange-of-information-on-atp.htm accessed 8 July 2015.

remains a key priority for securing government revenue and levelling the playing field for businesses, there is need for determined action from tax administrations, which should co-operate in exchanging intelligence and information, as well as monitoring the effectiveness of the strategies used collecting tax revenue and for enhancing compliance".[22]

With public concerns engineered by non-governmental organizations like Christian Aid,[23] the Tax Justice Network[24] and ActionAid[25] about MNEs paying little or no corporation tax in the countries they do business in, after the 2007/8 global financial crisis, national leaders at the 2012 G20[26] summit in Mexico, called for the need to prevent base erosion and profit shifting (BEPS).[27] Thus at the behest of the G20, in February 2013 the OECD issued a report in which it noted that "BEPS constitutes a serious risk to tax revenues, tax sovereignty and tax fairness for OECD member countries and non-members alike".[28] Subsequently it came up with a 15 Point BEPS Action Plan which is intended to ensure that profits are taxed where the economic activities generating those profits are performed and where value is created.

4 THE 2013 OECD BEPS REPORT: ACTION 12

In its 2013 BEPS report,[29] the OECD notes that comprehensive and relevant information on tax planning strategies is often unavailable to tax administrations. Yet the availability of timely, targeted and comprehensive information is essential to enable governments to quickly identify risk areas. Further that, while audits remain a key source of relevant information, they suffer from a number of constraints as tools for the early detection of aggressive tax planning techniques.[30]

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22 OECD "Addressing Base Erosion and Profit Shifting (2013) at 49.

23 Christian Aid "Death and Taxes: The True Toll of Tax Dodging" (May 2008) at 21-23. Available at http://www.christianaid.org.uk/images/deathandtaxes.pdf; accessed on 28 September 2010.

24 Tax Justice Network "Economic Crisis + Offshore". Available at http://www.taxjustice.net/cms/front_content.php?idcat=136 accessed on 6 June 2015.

25 See ActionAid on Tax Justice on http://www.actionaid.org.uk/policy-and-research/research-and-publications/tax-justice accessed on 04 February 2016.

26 The G20 (Group of twenty) is an international forum for the governments and central bank governors from 20 major economies. The members, include European Union and 19 countries: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom and the United States. The G-20 was founded in 1999 with the aim of studying, reviewing, and promoting high-level discussion of policy issues pertaining to the promotion of international financial stability. For details see Wikipedia "G-20 Major Economies" available at http://en.wikipedia.org/wiki/G-20_major_economies accessed 78 May 2015.

27 G 20 Leaders' Declaration) Los Cabos Mexico 2012). Available at http://g20mexico.org/images/stories/temp/G20_Leaders_Declaration_2012.pdf accessed 3 August 2013.

28 OECD *Addressing Base Erosion and Profit Shifting* op cit note 1 at 5.

29 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 22.

30 OECD "Action Plan on Base Erosion and Profit Shifting" at 22.

In Action 12, the OECD recognises the usefulness of “Mandatory disclosure” rules in availing tax authorities comprehensive and relevant information, on tax planning strategies, and it calls on OECD and G20 countries to:

- require taxpayers to disclose their aggressive tax planning arrangements;
- come up with measures to improve information flow about tax risks to tax administrations and tax policy makers;
- develop mandatory disclosure rules for aggressive or abusive transactions, arrangements, or structures, taking into consideration:
  - the administrative costs for tax administrations and businesses and
  - draw on experiences of the increasing number of countries that have such rules;
- design and put in place models of information sharing for international tax schemes between tax administrations; and
- develop measures regarding co-operative compliance programmes between taxpayers and tax administrations.[31]

On the international front the OECD planned to:

- use a modular design allowing for maximum consistency but allowing for country specific needs and risks;
- focus on international tax schemes and explore the use of a wide definition of "tax benefit" in order to capture such transactions;
- co-ordinate its work on this Action Plan with the work on co-operative compliance; and
- design and put in place enhanced models of information sharing for international tax schemes between tax administrations. [32]

In May 2015, the OECD issued a discussion draft[33] which provides an overview of mandatory disclosure regimes as applied in certain countries and it sets out recommendations for the design of a mandatory disclosure regime, to ensure some consistency, and also options that can be applied to provide sufficient flexibility to deal with country specific risks and to allow tax administrations to control the quantity and type of disclosure.[34] Subsequently in October 2015, the OECD issued its final report on Action 12[35] which recognises the benefits of tools designed to increase the information flow on tax risks to tax policy makers and tax administrations. Action 12 covers three key outputs:

(i) recommendations for the modular design of mandatory disclosure rules to provide flexibility for country specific needs;

31 OECD “Action Plan on Base Erosion and Profit Shifting” at 22.
32 OECD “Action Plan on Base Erosion and Profit Shifting” (2013) at 22.
33 OECD May 2015 Public Discussion Draft on Action 12 at 1.
34 OECD May 2015 Public Discussion Draft on Action 12 at 10.
35 OECD/G20 2015 Final Report on Action 12.

(ii) a focus on international tax schemes and consideration of a wide definition of tax benefit to capture relevant transactions; and
(iii) designing and putting in place enhanced models of information sharing for international tax schemes.

5 SUMMARY OF THE OECD/G20 2015 FINAL REPORT ON ACTION 12 ON MANDATORY DISCLOSURE RULES

5.1 ADVANTAGES OF MANDATORY DISCLOSURE RULES OVER OTHER DISCLOSURE RULES IN DETECT TAX PLANNING SCHEMES

The OECD notes that a number of countries have different types of disclosure initiatives used by tax administrations to collect taxpayer compliance information. Such include:

- Rulings regimes that enable taxpayers to obtain a tax authority's view on how the tax law applies to a particular transaction or set of circumstances and provides taxpayers with some degree of certainty on the tax consequences.
- Additional reporting obligations that require taxpayers to disclose particular transactions, investments or tax consequences usually as part of the return filing process.
- Surveys and Questionnaires that are used by some tax administrations to gather information from certain groups of taxpayers with a view to undertaking risk assessments.
- Voluntary disclosure as means of reducing taxpayer penalties.
- Co-operative compliance programmes where participating taxpayers agree to make full and true disclosure of material tax issues and transactions and provide sufficient information to understand the transaction and its tax impact.[36]

The objective of these disclosure initiatives is, normally to require, or incentivise taxpayers and their advisers to provide tax authorities with relevant information on taxpayer behaviour that is either more detailed, or more timely, than the information recorded on a tax return. These objectives are different from those of mandatory disclosure rules, since the other disclosure initiatives are not exclusively focused on identifying the tax policy and revenue risks raised by aggressive tax planning. Such disclosure initiatives typically lack the broad scope of mandatory disclosure rules which can capture any type of tax or taxpayer and they do not focus on obtaining specific information about promoters, taxpayers and defined schemes.[37] The key feature that distinguishes mandatory disclosure from these other types of disclosure rules are:

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36 OECD/G20 2015 Final Report on Action 12 in para 24.
37 OECD/G20 2015 Final Report on Action 12 in para 25.

- Mandatory disclosure rules are specifically designed to ensure early detection of tax planning schemes that exploit vulnerabilities in the tax system while also providing tax administrations with the flexibility to choose thresholds, hallmarks and filters in order to target transactions of particular interest and perceived areas of risk.[38]
- Mandatory disclosure applies to a broader range of persons: All taxpayers (both large and small) and not simply those who choose to disclose for example through a voluntary compliance measure. [39]
- Mandatory disclosure provides specific information on the scheme, users and suppliers: the focus on tax avoidance enables tax authorities to identify the scheme from available information so as to prevent significant revenue loss. [40] Because mandatory disclosure requires promoters and taxpayers to report specific scheme information directly to the tax administration it is a more efficient and effective method of obtaining comprehensive information on tax planning than relying on an analysis or audit of tax return information. Mandatory disclosure also provides tax administrations with information on the users of the scheme and those responsible for promoting and implementing them. The use of client lists and scheme identification numbers allows the tax administration to rapidly obtain an accurate picture of the extent of the tax risk posed by a scheme and to easily identify when a taxpayer has used a scheme. [41]
- Mandatory disclosure provides information early in the tax compliance process: early warning allows tax administrations to respond more quickly to tax policy and revenue risks through operational, legislative or regulatory changes. Other disclosure initiatives do not generally provide tax administrations with the same degree of advanced warning.[42]

Countries that have introduced mandatory disclosure rules indicate that these rules help to deter aggressive tax planning behaviour and they improve the quality, timeliness and efficiency in gathering information on tax planning schemes allowing for more effective compliance, legislative and regulatory responses. [43]

5.2 CO-ORDINATION WITH OTHER DISCLOSURE AND COMPLIANCE TOOLS

The OECD notes that decisions as to whether to introduce a mandatory disclosure regime and the structure and content of such a regime depend on a number of factors including an assessment of the tax policy and revenue risks posed by tax

38 OECD/G20 2015 Final Report on Action 12 in para 25.
39 OECD/G20 2015 Final Report on Action 12 in para 26.
40 OECD/G20 2015 Final Report on Action 12 in para 28.
41 OECD/G20 2015 Final Report on Action 12 in para 29.
42 OECD/G20 2015 Final Report on Action 12 in para 31.
43 OECD/G20 2015 Final Report on Action 12 in para 32.

planning within the jurisdiction and the availability as well as effectiveness of other disclosure and compliance tools.[44]

The OECD clarifies that mandatory disclosure rules cannot replace or remove the need for other types of disclosure and compliance tools. Mandatory disclosure can, however, reinforce other disclosure and tax compliance tools such as co-operative compliance or voluntary disclosure in ensuring a more level playing field as between large corporates and other taxpayers that do not have the same kind of compliance relationship with the tax administration.[45]

There is also some inevitable (and desirable) overlap between the operation and effects of mandatory disclosure and General Anti-Avoidance Rules ('GAARs'). GAARs can provide tax administrations with an ability to respond directly to instances of tax avoidance that have been disclosed under a mandatory disclosure regime. Equally, from a deterrence perspective, a taxpayer is less likely to enter into a tax planning scheme knowing that the tax outcomes will need to be disclosed and may subsequently be challenged by the tax administration. Mandatory Disclosure and GAARs are therefore mutually complementary from a compliance perspective. Equally, however, the purpose of a mandatory disclosure regime is to provide the tax administration with information on a wider range of tax policy and revenue risks other than those raised by transactions that would be classified as avoidance under a GAAR. Accordingly the definition of a "reportable scheme" for disclosure purposes will generally be broader than the definition of tax avoidance schemes covered by a GAAR and should also cover transactions that are perceived to be aggressive or high-risk from a tax planning perspective.[46]

The OECD notes that its BEPS Action Plan covers a number of other disclosure and information exchange initiatives, such as country by country reporting under Action 13 and the work on spontaneous exchange of rulings as part of the work on Action 5. The work of the Forum on Tax Administration is also developing a framework for cooperation between tax administrations. Recommendations for the design of enhanced models of information sharing will need to take into account the outcome of these initiatives and developments.[47]

5.3 OBJECTIVES OF MANDATORY DISCLOSURE RULES

The main objectives of mandatory disclosure rules can be summarised as follows:

(i) obtaining early information about tax avoidance schemes, which enhances tax authorities' effectiveness in their compliance activities;

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44 Ibid.

45 OECD/G20 2015 Final Report on Action 12 in para 34.

46 OECD/G20 2015 Final Report on Action 12 in para 35.

47 OECD May 2015 Public Discussion Draft on Action 12 in para12.

(ii) identifying schemes, the users and promoters of schemes; and

(iii) acting as a deterrent to reduce the promotion and use of avoidance schemes. Taxpayers may think twice about entering into a scheme if it has to be disclosed and they know that the tax authorities may take a different position on the tax consequences of that scheme or arrangement. In addition, pressure is placed on the tax avoidance market as promoters and users only have a limited opportunity to implement schemes before they are closed down. In order to enhance the deterrence effect of a disclosure regime it is therefore important that countries' tax administrations and legislative systems can react rapidly to close down opportunities for tax avoidance. [48]

5.4 PRINCIPLES TO BEAR IN MIND IN THE DESIGN OF EFFECTIVE MANDATORY RULES

The OECD notes that although mandatory disclosure rules will vary from country to country, the design of rules should adhere to the following key principles:

- Mandatory disclosure rules should be clear and easy to understand so as to provide taxpayers with certainty about what is required by the regime. Lack of clarity and certainty can lead to inadvertent failure to disclose (and the imposition of penalties), which may increase resistance to such rules from taxpayers and in tax administrations receiving poor quality or irrelevant information; [49]
- Mandatory disclosure rules should balance additional compliance costs to taxpayers with the benefits obtained by the tax administration**;**[50]
- Mandatory disclosure rules should be effective in achieving the intended policy objectives and accurately identify relevant schemes: Thus the rules need to be drafted so that they capture sufficient information on the schemes and arrangements a tax administration is concerned about. In addition they should provide information to enable identification of users and promoters. Since it is not practical for a mandatory disclosure regime to target all transactions that raise tax avoidance concerns, the identification of "hallmarks" is a key factor to setting the scope of the rules; and
- Information collected under mandatory disclosure should be used effectively. This implies setting up a process to review disclosures and identify the potential tax policy and revenue implications. [51]

5.5 OPTIONS FOR A MODEL MANDATORY DISCLOSURE RULE

48 OECD/G20 2015 Final Report on Action 12 in para 15.
49 OECD/G20 2015 Final Report on Action 12 in para 19.
50 OECD/G20 2015 Final Report on Action 12 in para 20.
51 OECD/G20 2015 Final Report on Action 12 in para 23.

Internationally existing mandatory disclosure regimes fall under two basic categories:

(a) The Transaction-based approach (United States and South Africa)):

- Under this approach mandatory disclosure begins by identifying transactions that the tax administration considers give rise to tax revenue or policy risks (a reportable scheme) and then it requires disclosure from taxpayers who derive a tax benefit from, and any person who provides material assistance in relation to, that reportable scheme.
- The approach defines a reportable scheme with reliance on specific hallmarks and places identical disclosure obligations on both taxpayers and promoters. [52]

(b) The Promoter-based approach (United Kingdom and Ireland)

- Under this approach greater focus is placed on the role played by promoters of tax planning schemes but it does also consider what types of reportable schemes promoters and taxpayers are required to disclose.
- The approach places the primary disclosure obligation on the promoter.
- The approach defines a reportable scheme by focussing on supply of tax planning schemes, may rely more heavily on generic hallmarks and limit the disclosure to those arrangements where tax is one of the main benefits of the scheme.[53]

In general, although both the approaches may have slightly different starting points they cover the same ground and have the same basic set of objectives, design features and effects. Generally existing mandatory disclosure regimes exhibit a purely transaction or promoter-based approach. [54]

5.6 DESIGN FEATURES WHEN CONSTRUCTING A MANDATORY DISCLOSURE REGIME

The OECD recommends that in order to successfully obtain early information about tax planning schemes and the users and promoters of those schemes, certain design features need to be considered when constructing a mandatory disclosure regime. These are:

- Who has to report;
- What has to be reported;
- What information they report;
- When the information is reported;
- Obligations be placed on promoters and/or scheme users;
- Consequences of non-compliance;
- The consequences of disclosure; and

52 OECD/G20 2015 Final Report on Action 12 in paras 57-58.
53 OECD/G20 2015 Final Report on Action 12 in paras 57-58.
54 OECD/G20 2015 Final Report on Action 12 in paras 58-59.

- How to use the information collected**.**

Action 12 recognises that the design of a mandatory disclosure regime has to be flexible to the needs and risks in specific countries.

5.6.1 WHO HAS TO REPORT

Mandatory disclosure rules need to identify the person who is obliged to disclose information under the regime. There are two options that countries can apply:

(i) impose an obligation on both the promoter and the taxpayer; or

(ii) impose the primary obligation to disclose on either the promoter or the taxpayer.[55]

Option A: Both the promoter **and** the taxpayer have the obligation to disclose separately. This is applied in Canada and USA.

<u>Advantages</u>:

- This option may have a stronger deterrent effect on both the supply (promoter) and demand (user) of avoidance schemes; and
- It reduces the risk of inadequate disclosure.[56]

<u>Disadvantage:</u>

- This option poses greater costs due to the dual disclosure obligation imposed, as tax authorities may require the taxpayer to file a separate form for each reportable transaction in which the taxpayer participated; and
- It increases the administrative and compliance costs for the taxpayer, and potentially those of the tax administration.[57]

Option B: Either the promoter **or** the taxpayer has the obligation to disclose. However the promoters have the primary obligation to disclose. This is applied in UK and in South Africa.[58]

- The promoter must provide the participant or user with a scheme reference number to put on their return. The participant's obligation to disclose only falls away when the participant has obtained written confirmation that disclosure has been made by a promoter or another participant. This is applied in South Africa.
  - The focus on the promoter as having the primary obligation to disclose may have the advantage of efficiency particularly in the context of mass-marketed scheme as it is the promoter who has a better

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55 OECD/G20 2015 Final Report on Action 12 in para 61.
56 OECD/G20 2015 Final Report on Action 12 in paras 63-64.
57 OECD/G20 2015 Final Report on Action 12 in paras 63-64.
58 OECD/G20 2015 Final Report on Action 12 in para 66.

understanding of the scheme and the tax benefit arising under the scheme.

- The primary disclosure obligation is placed on the user where:
  - The Promoter is offshore: this is due to practical difficulties in ensuring compliance so a scheme user is instead required to disclose the scheme details to the tax authority (applied in UK).[59]
  - Where there is no promoter: disclosure is required of the person using the scheme.[60]
  - Where the promoter asserts legal professional privilege: where legislation recognises legal professional privilege, this may act to prevent the promoter from providing the information required to make a full disclosure.[61]

<u>OECD recommendation on who has to report:</u> The OECD recommends that even though countries are free to choose either option, where the primary obligation is placed on the promoter (option (ii)) that obligation should switch to the taxpayer where; the promoter is offshore; there is no promoter or the promoter asserts legal professional privilege.[62]

5.6.2 WHAT HAS TO BE REPORTED

This can be broken down into two issues:

(i) Countries need to decide what types of schemes and arrangements should be disclosed under their regime (i.e. what transactions are reportable).

(ii) Countries also need to determine what specific information needs to be disclosed about a reportable scheme (i.e. name, taxpayer number, details of transaction, etc.).[63]

<u>Deciding what types of schemes and arrangements should be disclosed:</u>

To determine what is reportable, countries can use tests such as: **threshold requirements**, **de-minimis filters** or use of certain **hallmarks** – each of these tests, and the options for applying them, is discussed below.

(i) **Threshold requirements**

[59] OECD/G20 2015 Final Report on Action 12 in para 68.
[60] OECD/G20 2015 Final Report on Action 12 in para 69.
[61] OECD/G20 2015 Final Report on Action 12 in para 70.
[62] OECD/G20 2015 Final Report on Action 12 in para 18.
[63] OECD/G20 2015 Final Report on Action 12 in para 78.

Countries can use **threshold requirements** to determine what is reportable. A transaction is reportable if it falls within the descriptions or hallmarks set out in the regime. Some regimes first apply a threshold or pre-condition that a scheme must satisfy before it is assessed against the hallmarks. Threshold tests:

- may consider whether a transaction has the features of an avoidance scheme or whether a main benefit of the scheme was obtaining a tax advantage;[64]
- can be used to filter out irrelevant disclosures and reduce the compliance and administration burden;[65] and
- target only tax motivated transactions that are likely to pose the greatest tax policy and revenue risks.[66]

The challenges of the main benefit test are that:

- o it sets a relatively high threshold for disclosure;
- o it can be used inappropriately as a justification for not disclosing tax avoidance schemes that would be of interest to a tax administration; and
- o such a pre-condition may also make enforcement of the disclosure obligations more complex and create uncertain outcomes for taxpayers.[67]

Based on the above analysis there are two options for thresholds: the multi-step or single step approach to defining the scope of a disclosure regime.

Option A: Countries can adopt a single-step approach

Under this option, the threshold conditions are excluded in that a domestic tax benefit does not need to be identified as tax avoidance or as the main benefit of the transaction (this is applied in USA)

- o Disadvantage: The adoption of this option could generate a large number of disclosures increasing the costs to both taxpayers and tax administrations and also diluting the relevance of the information received. (However this can be prevented by using tightly defined hallmarks, and/or filtering disclosures by reference to a monetary threshold or listing specific transactions).[68]

Option B: Countries can adopt a multi-step or threshold approach

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[64] OECD/G20 2015 Final Report on Action 12 in para 79.
[65] OECD/G20 2015 Final Report on Action 12 in para 80.
[66] Ibid.
[67] OECD/G20 2015 Final Report on Action 12 in para 82.
[68] OECD/G20 2015 Final Report on Action 12 in paras 84-85.

Under this approach all schemes need to meet a threshold condition (e.g. tax benefit) as part of their mandatory disclosure regime (this applies in UK, Ireland, Canada, Portugal and South Africa).

- Advantages:
  - This approach separately identifies the tax planning element in each scheme by reference to a common standard;
  - Thus, hallmarks can be targeted at particular categories of transaction (such as leasing transactions) without the need to separately identify and define any tax planning element; and
  - Generic hallmarks, that do not necessarily identify a separate tax motive, can be used.
- Disadvantages:
  - A precondition that focuses on a tax benefit may not work well in the context of international schemes so those countries who apply a pre-condition may need to limit its application to domestic schemes.
  - The tax benefit threshold condition may be used by taxpayers to justify non-disclosure (as noted above, this could be addressed by lowering the threshold for disclosure or exempting certain hallmarks from the threshold requirement). This approach is one that applies in South Africa in that certain arrangements are excluded where the tax benefit is not the main or one of the main benefits unless the arrangement is listed (i.e. equivalent to specific hallmarks), in which case it is reportable, regardless of whether it satisfies the main benefit test. [69]

(ii) The *de-minimis* filter

A *de-minimis* filter could be considered as an alternative to, or in addition to, a broader threshold test and could operate to remove smaller transactions, below a certain amount, from the disclosure requirements. [70] A *de-minimis* filter could be applied to all transactions potentially within scope or just to certain categories of transactions where there might otherwise be large numbers of reportable transactions. Different threshold amounts could also be applied to specific hallmarks to calibrate the disclosures in a particular area, and some countries already adopt this approach. For instance, in the US regime, reportable loss transactions have their own dollar thresholds.

The advantages of the *de-minimis* filters are that they:

- narrow the ambit of the mandatory disclosure regime;
- reduce the risk of over-disclosure;

[69] OECD/G20 2015 Final Report on Action 12 in para 86.
[70] OECD/G20 2015 Final Report on Action 12 in para 87.

- may enhance the usefulness of the information collected because the focus would be on more significant transactions and excessive or defensive filings could be reduced; and
- could reduce the costs and administrative burden for certain taxpayers and for the tax administration. [71]

The disadvantage of the *de-minimis* filters is that they could unhelpfully suggest that tax avoidance, in small amounts, is acceptable.

(iii) Hallmarks

Hallmarks act as tools to identify the features of schemes that tax administrations are interested in. Hallmarks are generally divided into two categories:

- Generic hallmarks (which target schemes that promoters replicate and sell to more than one person); and
- Specific hallmarks (the disclosure obligation is triggered by describing certain potentially abusive transactions and including them as a hallmark.

Generic hallmarks

Generic hallmarks target features that are common to promoted schemes. Generic hallmarks can also be used to capture new and innovative tax planning arrangements that may be easily replicated and sold to a variety of taxpayers.[72] Two typical generic hallmarks used for targeting promoted schemes are:

- the requirement for "confidentiality", where the promoter or adviser requires the client to keep the scheme confidential - implies that the arrangements may be innovative or aggressive (used the UK, the US, Canada and Ireland); and
- the requirement for a "premium fee" or "contingent fee", where the amount the client pays for the advice can be attributed to the value of the tax benefits obtained under the scheme (this is applied in UK, Irish and Canadian regimes).[73]

<u>Advantages of generic hallmarks</u>

- may increase the amount of reportable transactions
- may be a useful tool for capturing new and innovative transactions which specific hallmarks have difficulty in capturing
- may enable tax administrations to detect and react quickly to new schemes.
- may also have the effect of reducing such transactions in the market.

<u>Disadvantages of generic hall marks</u>:

[71] OECD/G20 2015 Final Report on Action 12 in para 87.
[72] OECD/G20 2015 Final Report on Action 12 in para 91.
[73] OECD/G20 2015 Final Report on Action 12 in para 92.

- potentially increase costs for taxpayers [74]

Specific hallmarks

Specific hallmarks are used to target known vulnerabilities in the tax system and techniques that are commonly used in tax avoidance arrangements.[75] They are designed to target particular transactions, or particular elements of a transaction.

Specific hallmarks should be drafted broadly and avoid providing too much in the way of technical detail. If specific hallmarks are overly narrow or technical they can be given a restrictive interpretation by taxpayers or may provide opportunities for taxpayers and promoters to structure around their disclosure obligations.[76]

Examples of specific hallmarks that reflect the particular or current concerns of tax authorities can target areas of perceived high risk, for example:

- Loss schemes (the US, the UK, Canada, Ireland, Portugal);
- Leasing arrangements (UK);
- Employment schemes (Ireland);
- Converting income schemes (Ireland, Portugal);
- Schemes involving entities located in low-tax jurisdictions (Portugal);
- Arrangements involving hybrid instruments (South Africa);
- Transactions with significant book-tax differences (the US);
- Listed transactions (the US); and
- Transactions of interest (the US).

Advantages of specific hallmarks:

- Listed transactions allow tax administrations to target known or common areas of risk. For example, in South Africa it has been found that specific hallmarks can be more effective in collecting relevant information than generic hallmarks;[77]
- They are useful way of keeping a disclosure regime up to date and for dealing with avoidance on non-mainstream taxes;
- They generally reflect the key risk areas in a given jurisdiction; and
- They provide flexibility in terms of enabling tax administrations to strike a balance between costs and capacity issues for the tax administration and the reporting burden on taxpayers and promoters.[78]

Disadvantages of specific hallmarks:

[74] OECD/G20 2015 Final Report on Action 12 in para 132.
[75] OECD/G20 2015 Final Report on Action 12 in para 91.
[76] OECD/G20 2015 Final Report on Action 12 in para 118-119.
[77] OECD/G20 2015 Final Report on Action 12 in para 136.
[78] OECD/G20 2015 Final Report on Action 12 in para 133.

- May impose costs and reporting burdens on promoters or taxpayers
- Require administrative capacity for tax administrations. [79]

<u>The OECD recommendation on hallmarks</u>: The OECD recommends that where countries introduce a mandatory disclosure regime they have the option to use a single-step approach or a multi-step/threshold approach. It is, however, recommended that mandatory disclosure regimes include a mixture of generic and specific hallmarks.

- Generic hallmarks should include a confidentiality and premium fee hallmark.
- A country may also want to adopt additional generic hallmarks such as the one applying to standardised tax products.
- Countries can choose whether or not to adopt a hypothetical approach or adopt purely factual objectives tests.
- Specific hallmarks should reflect the particular risks and issues in individual countries. The design and selection of specific hallmarks should be left to each country taking into account their own tax policy and enforcement priorities.
- Countries are free to choose whether or not specific hallmarks are linked to a *de-minimis* amount to limit the number of disclosures.
- It is recommended that where a scheme or transaction triggers one hallmark that should be sufficient to require disclosure. [80]

5.6.3 WHEN INFORMATION IS REPORTED

The purpose of mandatory disclosure rules is to provide the tax administration with early information on certain tax planning schemes and their users, and to deter the use of those schemes. The determination of the timeframe of when promoters and/or users are required to make a disclosure is therefore key to achieving that goal. The more quickly a tax administration can act against a scheme the more it may enhance the deterrent effects by reducing the time available to take advantage of any tax benefit, so altering the economics of the transaction. [81]

- The timing of the disclosure depends on the relevant trigger event and the time period for reporting allowed under a regime.[82]
- This time period can vary from within days, months, or longer.

Questions that need to be considered in setting the timeframe for disclosure are:

- o At what point should the obligation to disclose start, or what event or action should trigger the need to report?
    - o How soon after that event should a disclosure be made?

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79 OECD/G20 2015 Final Report on Action 12 in paras 135-137.
80 OECD/G20 2015 Final Report on Action 12 in para 134.
81 OECD/G20 2015 Final Report on Action 12 in para 139.
82 OECD/G20 2015 Final Report on Action 12 in para 18.

- Should there be different reporting timeframes for promoters and taxpayers?

(i) Options for timing of promoter disclosure

<u>Option A: Timeframe linked to availability of a scheme</u>
In terms of this option, the earliest event that can realistically trigger a disclosure requirement is the point at which a promoter makes a scheme available to users.

- For example under the UK legislation a scheme is regarded as "made available for implementation" at the point when all the elements necessary for implementation of the scheme are in place and a communication is made to a client suggesting that the client might consider entering into transactions forming part of the scheme, it does not matter whether full details of the scheme are communicated at that time.[83] Thus in the UK a promoter must disclose a scheme within 5 working days of making a scheme available for implementation by another person.
- Portugal promoters who are involved in any tax planning must disclose within 20 days following the end of the month in which the scheme was made available.[84]

<u>Option B: Timeframe linked to implementation</u>
Reporting time frames can link the reporting requirement to when a scheme has been implemented by users. However at this point it is more likely that there is a real tax loss and there is also limited potential to influence the taxpayer's behaviour which means that the overall revenue loss could be greater.

- In Canada for example, reportable transaction must be disclosed by 30 June of the calendar year following that in which the transaction became a reportable transaction. The timeframe for reporting is therefore triggered by the transaction becoming reportable. This would occur once it has been implemented.[85]
- In South African section 37 of the TAA (discussed below) provides that an arrangement has to be reported within 45 business days from the date it become a reportable arrangement.

(ii) Options for reporting by the user
Mandatory disclosure regimes either require both the promoter and the taxpayer to disclose (the US and Canada) or they put the primary obligation on the promoter and only require the taxpayer to disclose where there is no promoter or the promoter is unlikely to disclose, for instance, because the promoter is offshore (the UK, Ireland, Portugal and South Africa).[86] Where only the taxpayer/user reports then the reporting

[83] OECD/G20 2015 Final Report on Action 12 in para 141.
[84] OECD/G20 2015 Final Report on Action 12 in para 141.
[85] OECD/G20 2015 Final Report on Action 12 in para 147.
[86] OECD/G20 2015 Final Report on Action 12 in para 148.

requirement can be linked to implementation since it may be difficult to identify another point or event that provides an objective trigger for the reporting obligation. [87]

Similar policy considerations would therefore apply to the timing of a disclosure by a taxpayer as apply to the promoter. This is especially so where there is no promoter disclosure and only the taxpayer discloses.

- In the US the taxpayer reports their involvement in a reportable scheme as part of the tax return process
- The UK, Ireland, Portugal and South Africa only require the taxpayer to disclose in relatively limited circumstances.
- The South African regime applies the same timeframe for taxpayers and promoters. A taxpayer must disclose a reportable arrangement within 45 days after an amount has first been received by or accrued to a taxpayer or is first paid or actually incurred by a taxpayer.[88]

OECD Considerations on time frames: The OECD recommends that the earlier the disclosure, the greater the ability of a disclosure regime to meet its objectives. The bigger the gap between a scheme being marketed and the eventual disclosure, the more users there will be. The tax administration will therefore need to challenge more cases, potentially tying up resources, and if the scheme is successful there will be a greater loss of tax revenues.[89]

- The OECD recommends that where the promoter has the obligation to disclose, then the timeframe for disclosure should be linked to the availability of the scheme and the timescale for disclosure should aim to maximise the tax administration's ability to react to the scheme quickly and to influence taxpayers' behaviour. This would be achieved by setting a short timescale for reporting once a scheme is available.[90]
- Where a taxpayer has to disclose it is recommended that the disclosure is triggered by implementation rather than availability of a scheme. In addition if only the taxpayer discloses (i.e. because there is no promoter or the promoter is offshore) the timescale for reporting should be short to maximise the tax administration's ability to act against a scheme quickly.[91]

The OECD however notes that there is less need to have early disclosure if a government is unable to react quickly to change their legislation. Thus, the administrative constraints on each tax administration do need to be taken into account:

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[87] OECD/G20 2015 Final Report on Action 12 in para 152.
[88] OECD/G20 2015 Final Report on Action 12 in para 153. See further section 37 of the Tax Administration Act 28 of 2011.
[89] OECD/G20 2015 Final Report on Action 12 in para 155.
[90] OECD/G20 2015 Final Report on Action 12 in para 156.
[91] OECD/G20 2015 Final Report on Action 12 in para 157.

- The timeframe for disclosure should be as efficient as possible within the context of the country's domestic law.[92]
- In case of administrative constraints, the OECD recommends that there are many ways that governments and tax administrations can influence taxpayer behaviour. They could, for instance, publish a view on a scheme or transaction that they would be looking out for.[93]

5.6.4 WHAT OTHER OBLIGATIONS SHOULD BE PLACED ON THE PROMOTERS OR USERS

(i) Process of identifying scheme users

Identifying scheme users is an essential part of any mandatory disclosure regime. Two different ways can be used to identify users:

- through the use of scheme reference numbers which enable the tax authorities to identify which taxpayer has used a specific scheme; and
- instead of (or in addition to) using an identifying number, they impose an obligation on the promoter to provide a list of clients who have made use of a disclosed scheme. [94]

<u>Identification through use of schemes reference number:</u>
Where a scheme reference number is used, the process generally needs to cover three steps:

- The tax authority issues a scheme reference number to a promoter or the user (as appropriate). Where the user is the person required to disclose the scheme then the tax authority will allocate a scheme reference number directly to the user.
- The promoter provides the scheme reference number to the user within a given timeframe. For example in the UK provides a 30 day deadline and the US gives 60 calendar days).
- The user reports the scheme reference number to the tax authority. [95] Thereafter the user must include the scheme reference number on their tax return for every subsequent year or period until the advantage ceases to apply.
- In South Africa a reference number is issued to taxpayers, who must disclose that they entered into a reportable transaction and include the reference number in their annual tax returns. [96]

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92 OECD/G20 2015 Final Report on Action 12 in para 155.
93 This is effected in South Africa through the issue of Government Gazettes setting out the nature of transactions to be included in the regime.
94 OECD/G20 2015 Final Report on Action 12 in para 158.
95 OECD/G20 2015 Final Report on Action 12 in para 159.
96 OECD/G20 2015 Final Report on Action 12 in para 164.

- The allocation of a scheme reference number does not indicate that a tax authority accepts the efficacy of the disclosed scheme or the completeness of a disclosure.

Identification through use of clients list

- Client lists can provide an alternative for user identification if countries do not use a scheme reference number system.
- A promoter is obliged to provide the tax administration with a list of clients who have used a scheme.
- The time limits for providing client lists vary. Under the Irish regime the list must be provided within 30-days of the promoter first becoming aware of any transaction forming part of the reportable transaction having been implemented. On the other hand the UK requires the promoter to provide lists quarterly. [97]
- A variation of this approach is to require the promoter to maintain lists identifying each person to whom the promoter has provided a scheme reference number and furnishing such list to the tax authority upon request. For example, the US requires client lists to be provided to the IRS within 20 business days after the date of a written request by the IRS. [98]

Identification through scheme reference numbers and client lists

- In the USA, the UK and Canada taxpayers must include the scheme reference number on their tax returns and lists of clients must be furnished. [99] For example under the Canada Tax Shelter (TS) regime (introduced in 1989) a promoter is required to obtain a tax shelter identification number, provide the number to participants and provide the list of scheme users. Canada has additionally introduced a new Reportable Tax Avoidance Transaction (RTAT) regime that extends disclosure to avoidance schemes that were not caught under the TS regime. However the scheme reference number only applies to tax shelters under the TS regime and does not apply to reportable transactions under RTAT. [100]
- In South Africa client lists are not currently required to be provided.

Considerations

Identification of users is an essential part of a mandatory disclosure regime. It allows a tax administration to improve risk assessment and the targeting of enquiries, it also enables them to better quantify the extent of any tax loss.

- All scheme details are filed per that the scheme reference number, facilitating the easy retrieval of the details at a later date if required.

97 OECD/G20 2015 Final Report on Action 12 in para 166.
98 OECD/G20 2015 Final Report on Action 12 in para 167.
99 OECD/G20 2015 Final Report on Action 12 in para 164.
100 OECD/G20 2015 Final Report on Action 12 in para 164.

- Requiring that the promoter provide a list also may identify other taxpayers that participated in a scheme but did not disclose.[101]
- The fact that the user knows they will be identified either through a client list or more directly, through entering a number on their tax return, may deter some from undertaking a scheme in the first place.
- There is therefore need for scheme reference number's *and* client lists.[102]

Using a scheme reference number may initially increase both the resource costs for the tax administration and the compliance costs for the promoter/taxpayer user.

- However, once a process has been set up the on-going costs become low.
- Balanced against this a tax administration not only obtains information on the users of a specific scheme, it can also build up a picture of the risk presented by individual taxpayers.
- The use of scheme reference numbers may also improve administrative processes: In South Africa, a scheme reference number is issued as a control measure to indicate the date and the sequence of the reporting.
- There may also be a greater deterrent effect if a taxpayer is personally obliged to include a scheme reference number on their returns. [103]

Client lists are generally received before a tax return so they provide information about the uptake of avoidance schemes much earlier than scheme reference numbers alone.

- This allows compliance plans to be put in place before tax returns are received, sometimes a year in advance.
- Client lists also enable a tax authority to carry out early interventions such as contacting taxpayers who appear on the lists to advise them not to claim the effects of the avoidance scheme on their returns.

These benefits are likely to be more obvious if client lists are automatically provided to the tax administration and the lists are provided sooner rather than later. [104]

OECD recommendations on identifying scheme users

- ➢ Where a country places the primary reporting obligation on the promoter it is recommended that they introduce scheme reference numbers and require the preparation of client lists in order to fully identify all users of a scheme, and to enable risk assessment of individual taxpayers. In this context it is recommended that, where domestic law allows, client lists should automatically be provided to the tax administration. [105]

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[101] OECD/G20 2015 Final Report on Action 12 in para 168.
[102] OECD/G20 2015 Final Report on Action 12 in para 169.
[103] OECD/G20 2015 Final Report on Action 12 in para 170.
[104] OECD/G20 2015 Final Report on Action 12 in para 171.
[105] OECD/G20 2015 Final Report on Action 12 in para 172.

- Where however a country introduces a dual-reporting obligations where both the promoter and the taxpayer reports, then scheme reference number's and clients lists may not be as essential, but they are likely to aid cross-checking and allow a tax administration to quantify the risk and tax loss from specific schemes.[106]

Recommendation for South Africa

- In line with above advantages it is recommended that South Africa introduces client lists.

5.6.5 CONSEQUENCES OF COMPLIANCE AND NON-COMPLIANCE

(i) Consequences of compliance

The issue of legitimate expectation

Where an obligation to disclose is introduced, taxpayers may believe (or assume a legitimate expectation) that any disclosure to the tax authorities leads to an implicit agreement that the scheme is valid, if there is no response to the contrary from the tax authority. Disclosure does not imply any acceptance of the validity, or tax treatment, of the transaction by the tax authority.[107]

- If such a legitimate expectation were to arise it could impact on a tax authority's ability to subsequently act against a scheme and a requirement to respond to all disclosures would effectively provide a clearance mechanism for such transactions. This would be contrary to the existing practice of many countries who explicitly exclude avoidance transactions from their clearance or rulings process. [108]
- To avoid legitimate expectations from arising it is important for tax authorities to be clear that the disclosure of reportable transactions has nothing to do with the effectiveness of the transactions nor is there any automatic link to obtaining a ruling on the validity of the transaction or to the application of any anti-avoidance rules. In the UK, US, Ireland and Canada the rules make it clear that the mere reporting of any scheme does not have any bearing on whether or not a tax benefit is allowed.
- Similarly the disclosure of a tax arrangement has no effect on the tax position of any person who uses the tax arrangement. Thus, the fact that a transaction is reportable does not necessarily mean that it involves tax avoidance.
- In South Africa (as is the case in UK, the US, Ireland), the disclosure of the scheme does not affect how it is treated and the lack of response from the tax

[106] OECD/G20 2015 Final Report on Action 12 in para 173.
[107] OECD/G20 2015 Final Report on Action 12 in para 174.
[108] OECD/G20 2015 Final Report on Action 12 in para 175.

authority does not give rise to a legitimate expectation, on the part of the taxpayer, that the scheme is valid or will be accepted. [109]

- Legislation and guidance must make it clear that the disclosure of a transaction does not imply any acceptance of that transaction or any acceptance of the purported tax benefit obtained by any person.

The Issue of self-incrimination

- The information that a taxpayer is required to provide under a mandatory disclosure regime is generally no greater than the information that the tax administration could require under an investigation or audit into a tax return.
- Potential tax avoidance and tax planning transactions reported under existing mandatory disclosure regimes should not therefore give rise to any greater concern over self-incrimination than would arise under the exercise of other information collection powers.
- The argument of self-incrimination is also not valid as the types of transactions targeted for disclosure will not generally be the types of transactions that will give rise to criminal liabilities. For countries that impose criminal liabilities on taxpayers for undertaking certain tax avoidance transactions, it may be possible to simply exclude those transactions from the scope of the disclosure regime without substantially curtailing the scope of the regime.
- In addition there should not be an issue with self-incrimination where a promoter is obliged to disclose instead of a taxpayer. [110]

(ii) Consequences of non-compliance

Mandatory disclosure regimes cannot be effective unless promoters and taxpayers fully comply with the reporting requirement. Rules that are precisely articulated and clearly understood will be easier to comply with. Compliance with disclosure requirements can further be enhanced in several ways:

- The usual sanction for non-disclosure is the imposition of penalties. The structure and amount of the penalty may depend on the type of taxpayer (i.e. corporate or individual) and the type of transaction.[111]

<u>Penalties:</u> should either be monetary, non-monetary or include elements of both.
Monetary penalties: The amounts of monetary penalties will generally be an issue for each country to consider. [112] Monetary penalties could arise in a number of situations:

(i) Monetary penalty for non-disclosure of a scheme

[109] OECD/G20 2015 Final Report on Action 12 in paras 175-177.
[110] OECD/G20 2015 Final Report on Action 12 in paras 175-179.
[111] OECD/G20 2015 Final Report on Action 12 in para 180.
[112] OECD/G20 2015 Final Report on Action 12 in para 181.

(ii) Monetary penalty for failure to provide or maintain client lists
(iii) Monetary penalty for failure to provide a scheme reference number
(iv) Monetary penalty for failure to report a scheme reference number [113]

Factors to consider in structuring monetary penalties for non-disclosure:

- In setting penalty levels, jurisdictions may take into account factors such as whether there is negligence or deliberate non-compliance or penalties may be linked to the level of fees or tax benefit.
- The main aim in setting a limit and in fixing a penalty structure is to increase the pressure to comply with the law.
- Penalties should be set at a level that maximises their deterrent value without being overly burdensome or disproportionate.
- Consideration should be given to percentage based penalties based upon transaction size or the extent of any tax savings.[114]

Types of monetary penalties that can be imposed:

- Daily penalties: These put an emphasis on timely disclosure, encouraging the promoter and taxpayer to comply with the disclosure obligation as further daily penalties can be imposed if non-compliance continues (used in UK and Ireland)
- Penalty proportionate to tax savings or promoter's fee: The level of the penalty is based on the amount of the tax benefit achieved by the taxpayer or on the fees/remuneration paid to the advisor or promoter.
  - In South Africa, section 212 of the TAA provides a monthly penalty for non-disclosure of between R50,000 and R100,000 (for up to 12 months) is imposed and the penalty is doubled if the amount of the anticipated tax benefit exceeds R5 million and is tripled if the anticipated tax benefit exceeds R10 million. [115]

Non-monetary penalties

Countries come up with non-monetary penalties for non-disclosure:

- In some countries a failure to disclose could suspend the efficacy of the scheme and taxpayers can be denied any tax benefit arising from the scheme. In other countries, however, non-disclosure itself does not affect the efficacy of a scheme. This is the case in the US, the UK, Portugal, Ireland and South Africa[116].
- In the US, for example, non-disclosure will remove the ability to argue against penalties levied against additional taxes raised in respect of the scheme. It

[113] OECD/G20 2015 Final Report on Action 12 in para 182.
[114] OECD/G20 2015 Final Report on Action 12 in para 183.
[115] OECD/G20 2015 Final Report on Action 12 in para 193.
[116] OECD/G20 2015 Final Report on Action 12 in para 195.

can also extend the statute of limitations (time for Government to dispute the taxpayer's treatment).

Penalty initiatives targeting promoters

Promoters have a greater knowledge of a scheme's tax effects and are better placed to know whether a scheme constitutes tax avoidance and to be aware of any risks inherent in that scheme. For this reason tax compliance strategies, including mandatory disclosure rules, are likely to be more effective if they focus on promoters, i.e. improving tax compliance via the supply side, rather than focusing exclusively on the end user, i.e. the taxpayer. For instance under the Mexican tax code (outside the mandatory disclosure rules) a penalty is imposed on a tax advisor who provides an advisory service to a taxpayer in order to reduce or omit some federal contribution. However this penalty is not applicable if the tax advisor provides the taxpayer with a written opinion saying that the tax authority may not agree with the position taken. This type of penalty regime encourages the tax advisor to advise his clients of the risk of undertaking certain transactions and may also, more generally, encourage a tax advisor to be more careful about the advice he provides. [117]

The UK also tackles the behaviour of high-risk promoters in order to increase transparency and it has introduced new rules that make a promoter, who fails to comply with the disclosure regime, vulnerable to further action by the tax authority, including information powers and penalties designed to improve their behaviour. In its latest consultation document entitled 'Strengthening the Tax Avoidance Disclosure Regimes' published in July 2014, the UK tax administration suggests that anyone working with a non-resident promoter (such as a business partner) should be required to disclose reportable arrangements that are promoted by the offshore promoter, to deter the use of offshore promoters to circumvent the UK disclosure requirements. [118] It should also be noted that the UK introduced the Diverted Profits Tax Regime which requires a taxpayer with offshore payments to connected parties to motivate the commerciality of such payments to the HMRC. If not satisfied with this explanation a 25% tax is levied.

OECD recommendations on penalties:

In order to enforce compliance with mandatory disclosure rules, countries should introduce financial penalties that apply if there is failure to comply with any of the obligations introduced. Countries are free to introduce penalty provisions (including

117 OECD/G20 2015 Final Report on Action 12 in para 197.
118 OECD/G20 2015 Final Report on Action 12 in para 198.

non-monetary penalties) that are coherent with their general domestic law provisions.[119]

5.6.6 PROCEDURAL/TAX ADMINISTRATION MATTERS

(i) Types of information to be reported

Once a transaction is reportable, the person who is obliged to disclose (promoter or user) must provide the tax authorities with particular information about how the transaction works and how the expected tax benefit arises along with details of the promoter and scheme user.

- The information should include details of the transactions, names and the tax reference number for the promoter and scheme users.
- Sufficient information should be provided to a tax authority to enable it to understand how a scheme operates and how the expected tax advantage arises.[120]

For example:

- *Identification of promoters and scheme users:* This covers details like the full name, address, phone number and tax reference or identification number (if any) of the promoters and scheme users. This is applied in South Africa.[121]
- *Details of the provision that makes the scheme reportable*: Promoters and scheme users are required to identify all hallmarks which the disclosure is being made. This is applied in South Africa.[122]
- *Description of the arrangements and the name by which they are known (if any) – clearly explained and describing steps involved:* This is to enable a tax authority to understand how the expected tax advantage arises. This is applied in South Africa.[123]
- *Statutory provisions on which tax advantage is based:* A full reference to the legislative and regulatory provisions relevant to the tax treatment of the transactions is required. It should explain how the relevant provisions are being applied and how they allow the taxpayer to obtain the desired tax treatment. In the context of international tax schemes such information should include relevant provisions of foreign law. It is recommended that this should be applied in South Africa
- *Description of tax benefit or* advantage generated by the arrangements. This is applied in South Africa[124].
- *List of clients (promoter only).* It is recommended that this should be applied in South Africa

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119 OECD/G20 2015 Final Report on Action 12 in para 200.
120 OECD/G20 2015 Final Report on Action 12 in paras 201-202.
121 OECD/G20 2015 Final Report on Action 12 in paras 201-203.
122 OECD/G20 2015 Final Report on Action 12 in paras 201-204.
123 Section 38 of the Tax Administration Act No 28 of 2011 as amended.
124 Ibid.

- *Amount of expected tax benefit:* In South Africa the actual or expected amount of the tax benefit generated by the disclosed scheme has to be reflected on the disclosure form.[125]

(ii) Powers to obtain additional information

A tax administration may need additional legislated powers to enable it to acquire additional information i.e.:

- Enquire into the reasons for a failure to disclose;
- Enquire into the identity of promoters and intermediaries; and
- Request further follow up information in response to a disclosure. [126]

(iii) How to use the information collected

Once a mandatory disclosure regime is introduced there are several ways in which tax authorities can use the information collected to change behaviour and to counteract tax avoidance schemes. These include:

- *Legislative or regulatory change* - Quick legislative change is dependent on a country's legislative system but also requires a country to set up a process that analyses and risk assesses new schemes quickly.[127]
- *Risk assessment* - review of the arrangement plays a role in determining whether further action should be taken in the form of legislative change, audits, or more inquiries, etc. The specific internal procedure varies depending on the administrative structure of countries.
- *Communication strategy* - Tax authorities may issue publications to taxpayers as a way of providing an early warning that they have detected an arrangement in the marketplace and are currently considering its tax implications. In such publications tax authorities describe the arrangement and their concerns with the arrangement so that taxpayers are aware of the risks in undertaking the scheme – this can play an important role in influencing taxpayer's and promoter's behaviour on tax compliance. [128]

In order to use the information from a mandatory disclosure regime effectively it is recommended that tax administrations set up a small unit to risk assess the disclosures received and to co-ordinate action within and across the taxing authorities. [129]

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125 OECD/G20 2015 Final Report on Action 12 in paras 201-209 and s38 of TAA.
126 OECD/G20 2015 Final Report on Action 12 in paras 220-221.
127 OECD/G20 2015 Final Report on Action 12 in para 213.
128 OECD/G20 2015 Final Report on Action 12 in para 217.
129 OECD/G20 2015 Final Report on Action 12 in para 222.

6 ENSURING MANDATORY DISCLOSURE RULES ARE EFFECTIVE FOR INTERNATIONAL TAX SCHEMES

Action 12 specifically calls for OECD and G20 member countries to formulate recommendations for the mandatory disclosure of international tax schemes. This is intended to give countries an additional tool for tackling BEPS by providing tax administrations with real-time information on cross-border tax planning.

One of the key strengths of mandatory disclosure is its ability to provide tax administrations with current, comprehensive and relevant information on actual taxpayer behaviour. These benefits could prove particularly valuable in the context of cross-border schemes where tax administrations may otherwise find it difficult to obtain information on the facts of a scheme or a complete picture of its overall tax and economic consequences. However there are some key differences between domestic and international schemes that make such schemes more difficult to tackle from a disclosure perspective.

6.1 CHALLENGES TO MANDATORY DISCLOSE RULES IN CROSS-BORDER TRANSACTIONS

The OECD acknowledges that although the current mandatory disclosure regimes can apply to international schemes if it meets required thresholds:

- existing hallmarks used in mandatory disclosure regimes do not generally discriminate between schemes that are wholly-domestic and those that have a cross-border component; and
- Although some jurisdictions have hallmarks that specifically target cross-border schemes or may separately identify an international transaction under their rules, in practice countries receive comparatively fewer disclosures of cross-border schemes. The reason for this lower number of disclosures appears to be a consequence of the way international schemes are structured and the approach taken by these regimes in formulating the requirements for disclosure of a reportable scheme.[130]

(i) Challenges of defining a Reportable Scheme in cross border transactions

- Cross-border schemes typically generate multiple tax benefits for different parties in different jurisdictions. Thus, domestic tax benefits that arise under a cross-border scheme may seem unremarkable when viewed in isolation from the rest of the arrangement as a whole.[131]
- The nature of the tax benefits that arise in respect of cross-border tax planning means that disclosure regimes which focus exclusively on domestic

[130] OECD/G20 2015 Final Report on Action 12 in para 227.
[131] OECD/G20 2015 Final Report on Action 12 in para 228.

tax outcomes for domestic taxpayers, without understanding the global picture, may not capture many types of cross-border tax planning.

- Some disclosure regimes require reportable schemes to meet a formal threshold condition for disclosure (such as the *main benefit* or *tax avoidance* test). This threshold condition can be difficult to apply in the context of cross-border schemes that trigger tax consequences in a number of different jurisdictions.[132]
    - Some cross-border schemes may not meet the disclosure threshold if the taxpayer can demonstrate that the value of any domestic tax benefits was incidental when viewed in light of the commercial and foreign tax benefits of the transaction as a whole.[133]
    - In certain cases the foreign tax benefits of a cross-border scheme may even be returned to the taxpayer in the reporting jurisdiction in the form of a lower cost of capital or higher return. This has the effect of converting a tax benefit for a foreign counterparty in the off-shore jurisdiction into a commercial benefit for the taxpayer in the reporting jurisdiction, thereby further reducing the overall significance of the domestic tax benefits under the transaction.[134]
- Challenges in the application of certain hallmarks: Cross-border tax planning schemes are often incorporated into broader commercial transactions such as acquisitions, refinancing or restructuring. Such schemes tend to be customised so that they are taxpayer - and transaction-specific and may not be widely-promoted in the same way as a domestically marketed scheme. It may therefore be difficult to target these schemes with generic hallmarks that are primarily focussed at promoted schemes that can be easily replicated and sold to a number of different taxpayers.[135]
    - In such situations, specific hallmarks will generally be the most effective method of targeting cross-border tax schemes that raise tax policy or revenue risks in the reporting jurisdiction. Examples include leasing and income conversion schemes which can apply equally in the domestic and cross-border context. South Africa has specific hallmarks which can targeting international transactions.[136]
    - However one of the challenges in the design of specific hallmarks is to come up with a definition that is sufficiently broad to pick up a range of tax planning techniques and narrow enough to avoid over-disclosure. One approach to dealing with this issue is to focus on the kinds of *outcomes* that raise concerns from a tax policy perspective rather than the techniques that are used to achieve them. The US for example

132 OECD/G20 2015 Final Report on Action 12 in para 229.
133 OECD/G20 2015 Final Report on Action 12 in para 229.
134 OECD/G20 2015 Final Report on Action 12 in para 229.
135 OECD/G20 2015 Final Report on Action 12 in para 230.
136 OECD/G20 2015 Final Report on Action 12 in para 231.

uses the effects-based approach of extending the disclosure obligations to “substantially similar” transactions (i.e. transactions that are expected to achieve the same or similar consequences to a listed transaction and are based on the same or similar strategy).[137]

(ii) How to deal with identifying who must report in cross border transactions

- A reporting jurisdiction should only require disclosure of an international scheme where the scheme has a substantive connection with the reporting jurisdiction (i.e. the scheme results in a domestic tax consequence for a domestic taxpayer).
- A mandatory disclosure regime should avoid imposing disclosure obligations on persons that are not subject to tax in the reporting jurisdiction or on arrangements that have no connection with the reporting jurisdiction.
- Disclosure regimes should ensure that reporting obligations are not imposed in circumstances where the tax authority would have limited practical ability to enforce them.[138]
- Once the ability to require disclosure is established, further consideration needs to be given to how a taxpayer in the reporting jurisdiction would comply with additional information requirements for international tax schemes. This is because an international scheme that results in domestic consequences for a taxpayer does not necessarily mean that the taxpayer will be aware of the offshore elements of the scheme or be in a position to properly understand its effects.
- At the same time, disclosure obligations should not be framed in such a way as to encourage a taxpayer to deliberately ignore the offshore aspects of a scheme simply to avoid disclosure. [139]

(iii) Issues in describing what must be reported in cross border transactions

Once a disclosure obligation has been triggered there remains the question of what information needs to be disclosed.

- While taxpayers should only be required to disclose information that is within their knowledge, possession or control, they can be expected to obtain information on the operation and effect of an intra-group scheme from other group members.
- Outside of the group context, a reporting taxpayer should not be required to provide any more information than the taxpayer would be expected to have obtained in the course of ordinary commercial due diligence on a transaction of that nature. **[140]**

[137] OECD/G20 2015 Final Report on Action 12 in para 232.
[138] OECD/G20 2015 Final Report on Action 12 in para 233.
[139] OECD/G20 2015 Final Report on Action 12 in para 234.
[140] OECD/G20 2015 Final Report on Action 12 in para 235.

In light of the above challenges, the OECD sets out a number of recommendations on the design of mandatory disclosure regimes to make them more effective in targeting cross-border tax planning.[141] The challenge is to develop disclosure requirements that appropriately target cross-border transactions and that capture the key information tax administrations need in order to make informed policy decisions, while avoiding over-disclosure or placing undue compliance burdens on taxpayers.[142]

6.2 OECD RECOMMENDATIONS ON AN ALTERNATIVE APPROACH TO THE DESIGN OF A DISCLOSURE REGIME FOR INTERNATIONAL TAX SCHEMES

(i) No threshold requirement

The OECD notes that the function of a threshold requirement is to filter out irrelevant disclosures and reduce the compliance and administration burden by targeting only tax motivated transactions that are likely to pose the greatest tax policy and revenue risks.[143]

Thus the hallmarks for international schemes should target only arrangements that produced cross-border outcomes, which were of particular concern to a tax administration and would only require disclosure of those arrangements in circumstances where they presented a material risk to the reporting jurisdiction from a tax revenue perspective. Provided the new hallmarks give a precise description of the types of tax outcomes that are of concern to the reporting jurisdiction's tax administration and the materiality thresholds are set at level that avoids over-disclosure, there should be no need to apply a threshold requirement to filter-out irrelevant or non-material disclosures.[144]

(ii) Develop new hallmarks based on identification of cross-border tax outcomes

Countries should develop hallmarks that focus on the specific risks posed by cross-border tax planning that give rise to tax policy or revenue concerns for the tax administration in the reporting jurisdiction. These new hallmarks should be wide enough to capture different and innovative tax planning techniques designed to produce those cross-border outcomes, regardless of how those arrangements are structured.[145]

[141] OECD/G20 2015 Final Report on Action 12 in para 8.
[142] OECD/G20 2015 Final Report on Action 12 in para 228.
[143] OECD/G20 2015 Final Report on Action 12 in para 237.
[144] OECD/G20 2015 Final Report on Action 12 in para 238.
[145] OECD/G20 2015 Final Report on Action 12 in para 240.

Examples of such new hallmarks include:

- Arrangements that give rise to a conflict in ownership of an asset that results in taxpayers in different jurisdictions claiming tax relief for depreciation or amortisation in respect of the same asset or claiming relief from double taxation in respect of the same item of income.
- Deductible cross-border payments made to members of the same group that are not resident for tax purposes in any jurisdiction or that are resident in a jurisdiction that does not impose tax on income.
- Transactions that give rise to a deduction or equivalent relief resulting from a deemed or actual transfer of value for tax purposes, where that transaction is not treated as giving rise to tax consequences in the jurisdiction of the counterparty.
- Asset transfers where there is a material difference in the amount treated as payable in consideration for the asset. [146]

(iii) Broad definition of "arrangement" that includes offshore tax outcomes

Countries should develop a broad definition of arrangement that would treat any arrangement involving a domestic taxpayer as a reportable scheme where that arrangement includes a cross-border outcome (regardless of the jurisdiction where that outcome arose).

- Domestic taxpayers should be under an obligation to disclose a cross-border arrangement to the reporting jurisdiction even if they are not a direct party to the cross-border outcome.
- If disclosure of an arrangement was only required from taxpayers that were directly involved in engineering the cross-border outcome then tax planners could simply use intermediaries and back-to-back structures to avoid triggering domestic disclosure requirements. Equally, however, a reporting jurisdiction should not require disclosure of cross-border arrangements that have no substantive connection with the reporting jurisdiction and that do not give rise to any tax revenue risks. Accordingly an arrangement that gives rise to a specified cross-border outcome should only be reportable if it involves a transaction or payment that has a material tax impact on the reporting jurisdiction. [147]
- A domestic taxpayer should be treated as involved in a cross-border arrangement where the arrangement includes a transaction with a domestic taxpayer that has material economic consequences for that taxpayer or material tax consequences for one of the parties to that transaction.[148]

(iv) Limitations on disclosure

[146] OECD/G20 2015 Final Report on Action 12 in para 239.
[147] OECD/G20 2015 Final Report on Action 12 in para 241.
[148] OECD/G20 2015 Final Report on Action 12 in para 243.

In order to prevent mandatory disclosure imposing an undue burden on taxpayers, disclosure in the reporting jurisdiction should only be required where the taxpayer could reasonably have been expected to be aware of the cross-border outcome under the arrangement. [149]

A person can reasonably be expected to be aware of a cross-border outcome where the person has sufficient information about the arrangement to understand its design and to appreciate its tax effects. This will include any information obtained by a taxpayer under the obligation to make reasonable enquiries (described below) but, in the context of transactions with unrelated parties, the test should not be taken as requiring a person to gather more information than it could have been expected to obtain in the course of ordinary commercial due diligence on a transaction of that nature. [150]

(v) Enquiry and notification requirements

A taxpayer can only be expected to provide the tax administration with information that is within that person's knowledge, possession or control. Information that is within a person's control includes information held by agents and controlled entities. As is the case for domestic schemes, mandatory disclosure should not require any person to provide information that is subject to a non-disclosure or confidentiality obligation owed to a third party. [151]

Where a taxpayer enters into a transaction with a group member that has a material tax impact, then that taxpayer can be expected, at the time that arrangement is entered into, to make reasonable enquiries of those group members as to whether that transaction is part of an arrangement that includes, or will include, a cross-border outcome. In certain cases information about the scheme may be subject to confidentiality or other restrictions that prevent it from being made available to the reporting taxpayer. In these cases, where group members are unable or unwilling to provide this information within a reasonable period of time then the taxpayer should notify the tax administration of the fact that:

- It has entered into an intra-group transaction with a material tax impact.
- After making reasonable enquiries, has been unable to obtain information on whether the transaction is part of an arrangement that incorporates a cross-border outcome.

The notification should include any relevant information the domestic taxpayer has on the intra-group transaction and circumstances giving rise to the transaction. Tax administrations would be able to use this information as the basis for an information

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149 OECD/G20 2015 Final Report on Action 12 in para 249.
150 OECD/G20 2015 Final Report on Action 12 in para 250.
151 OECD/G20 2015 Final Report on Action 12 in para 251.

request under their existing exchange agreements with other jurisdictions (for example under a double tax treaty which contains an information exchange provision; the multilateral convention on mutual administrative assistance or a tax information exchange agreement). [152]

(vi) Disclosure obligation material adviser and/or taxpayer

In the case of domestic tax schemes, disclosure is normally required from the taxpayer involved in the arrangement as well as any person who is a "promoter" in relation to that taxpayer and arrangement.

- The rules that apply to domestic schemes for identifying the promoter or material adviser and for determining who has the primary disclosure obligation should also apply in the international context.
- It will, however, be important that the definition captures those who could reasonably be expected to have knowledge of the tax consequences of the arrangement, and excludes advisors or intermediaries who could not be expected to these.[153]

(vii) Information required

The information that should be required to be disclosed in respect of international tax schemes will generally be the same as the information required for domestic schemes. Such information should include information about the operation of the scheme including key provisions of foreign law relevant to the elements of the disclosed transaction.[154]

As part of the work on monitoring the outputs from the BEPS project, the OECD recommends that countries may consider whether the information required for international schemes could be standardised, in order to minimise the compliance costs that may arise from overlapping disclosure obligations imposed by different jurisdictions in respect of the same scheme. [155]

7 DISCLOSURE OF AGGRESSING TAX PLANNING IN SOUTH AFRICA

South Africa is far ahead of many countries in implementing regulations dealing with disclosing aggressive tax planning. In line with international trends, South Africa came up with reportable arrangements legislation under s 76A of the Income Tax Act 58 of 1962, introduced by the Revenue Law Amendment Act 45 of 2003. Section

152 OECD/G20 2015 Final Report on Action 12 in para 252.
153 OECD/G20 2015 Final Report on Action 12 in para 249.
154 OECD/G20 2015 Final Report on Action 12 in para 253.
155 OECD/G20 2015 Final Report on Action 12 in para 255.

76A (now repealed) was effective from 1 April 2005. The Explanatory Memorandum to the Revenue Laws Amendment Bill 2003[156] explained that it was necessary to introduce special reporting provisions for transactions that contain indicators of potential tax avoidance. Furthermore, that the purpose of this reporting system was to uncover "innovative" corporate tax products that effectively cost the tax system hundreds of millions (and perhaps even billions) of Rand annually. The Explanatory Memorandum noted that most of these innovative products stem from the Banks and other sophisticated financial institutions.[157] Essentially the rules were intended to give the SARS early warning of arrangements that were potentially tax driven. SARS would then be in a position to take appropriate action to counter abuse more quickly than would otherwise have been the case.

The then s 76A provided for the reporting of two classes of arrangement. The first class of reportable arrangement related to those that resulted in a tax benefit and were subject to an agreement that provided for the variation of, for example, interest or fees, if their actual tax benefits differed from the anticipated tax benefits. The second class of reportable arrangement related to certain hybrid debt and equity instruments. Section 76A required a company or a trust, which derived or will derive any tax benefits in terms of a reportable arrangement, to report that arrangement to the Commissioner within 60 days after the date that an amount was received by or accrued to any person or was paid or actually incurred by any person in terms of that arrangement. In terms of the provisions, the duty to report and to furnish information and documents lay on the taxpayer which derived tax benefits under the arrangement. On 1 March 2005, SARS issued a Guide on reportable arrangements.[158] Unfortunately, the number and nature of the transactions disclosed to SARS proved disappointing. Fewer than 150 transactions, most of them involving well known hybrid instruments, were reported in the 25 months in which the legislation was in force. Some taxpayers raised technical points to avoid reporting, or restructured their transactions to avoid the triggers for reporting. And some taxpayers indicated they had encountered fewer transactions that they believed would require reporting.[159]

When the General anti-avoidance rules (GAAR) under ss 80A–80L (discussed in chapter 4) were enacted in 2006, the reportable arrangements legislation was revised and linked to the factors that are indicative of a lack of commercial substance for GAAR purposes.[160] Sections 80M–80T of the Income Tax Act (now repealed) set

156 Clause 69 of the Explanatory Memorandum to the Revenue Laws Amendment Bill 2003 at 76.

157 Ibid.

158 SARS 'Reportable Arrangements Guide' (March 2005).

159 South African Institute of Chartered Accountants (SAICA) 'Tech Talk' Issue 50 (23 February 2009). Available at https://www.saica.co.za/TechnicalInformation/Publications/TechTalk/tabid/711/itemid/1211/pageid/4/language/en-ZA/language/en-ZA/Default.aspx (accessed on 13 May 2012).

160 Ibid.

out special reporting rules for transactions containing indicators of tax avoidance. In terms of the then s 80M(1) an arrangement was reportable if it qualified as a "hybrid equity instrument" as defined in s 8E and s 8F of the Income Tax Act, or if the arrangement was identified by the Minister by notice in the *Gazette* as one likely to result in any undue tax benefit. Subject to certain exclusions, the then s 80M(2) set out specific arrangements that had to be reported. Such reportable arrangements included tax benefits that would be derived by any participant with regard to 'interest' as defined in s 24J, finance costs, fees or any other charges, avoidance arrangements indicative of a lack of commercial substance, such as round trip financing, and arrangements involving an accommodating or tax indifferent party.

In terms of the provisions the duty to report an arrangement was on a "participant", defined in the provisions to include a company or a trust, which derived any tax benefits in terms of a reportable arrangement as well as a "promoter" (any person who is principally responsible for organising, designing, selling, financing or managing that reportable arrangement). On 31 March 2010, SARS issued a revised Draft Guide to Reportable Arrangements requesting public comment by 14 May 2010. The Draft Guide contained a flow chart to provide guidance in the application of the provisions. However the Draft Guide was criticised for its numerous ambiguities and discrepancies from the provisions in the Act, and it was never finalised.[161] The legislature, when drafting the reportable arrangements rules under s 80M-80T, aimed for a wide ambit, as it was felt that the previous reportable arrangement regime was toothless. This ultimately presented a problem, as the root cause of the problem with the regime under s 80M-80T was lack of precision. [162]

When the TAA was enacted in 2011, the provisions relating to "reportable arrangements" in the Income Tax Act were repealed and, instead became part of Part B of the TAA. In terms of s 34 of the Act, an "arrangement" means any transaction, operation, scheme, agreement or understanding (whether enforceable or not). This definition is the same as that in s 80L of the Income Tax Act, which deals with the GAAR. Since a number of concepts used in the reportable arrangements rules are the same as those applied in the GAAR, the meanings of those terms also apply to the Reportable arrangements, and the cases used in interpreting similar concepts under the GAAR would, thus, also apply to these rules. Thus the word "transaction" as used in the phrase "transaction, operation, scheme, agreement or understanding" refers to, for instance, a sales transaction or a leasing transaction. In *Meyerowitz v CIR*[163] the court ruled that the word "scheme" is sufficiently wide to cover a series of transactions. The word "understanding"

161 L Steenkamp & P Cramer 'A Critical Analysis of the Current SARS Model for the Disclosure of Reportable Arrangements and a Proposed Alternative' (2012) 5(2) *Journal of Economic and Financial Sciences* at 392.

162 I Louw & B Simpson (Cliffe Dekker Hofmeyer) 'The Simple Life Before Reportable Arrangement' *Tax Matters* (2010) at 3.

163 1963 (3) SA 863;25 SATC 299-300.

suggests that regardless of whether an agreement is a written or verbal understanding of proposed future conduct (such as a dealing between two or more parties), it will constitute an arrangement.[164]

8 THE FRAMEWORK OF SOUTH AFRICA'S REPORTABLE ARRANGEMENTS PROVISIONS

8.1 MEANING OF RELEVANT TERMS

In terms of s 34 of the TAA (as amended by the Taxation Laws Amendment Act 43 of 2014), a "reportable arrangement" means an "arrangement" referred to in s 35(1) or 35(2) that is not an excluded "arrangement" referred to in section 36. In terms of s 35 of the TAA, an arrangement is reportable if a "tax benefit" is or will be derived, or is assumed to be derived by any "participant".

The term "tax benefit" as used in s 35, is defined in s 34 of the TAA, to mean the avoidance, postponement, reduction or evasion of a liability for tax. This definition is the same as in s 1 of the Income Tax Act. With respect to the GAAR, it was held in *ITC* 1625[165] that the test to be applied in determining whether a transaction has had the effect of avoiding tax was to ask whether "the taxpayer would have suffered tax but for the transaction".[166] It is important to note that the definition of "tax benefit" not only refers to an actual benefit that is derived, but also a tax benefit that may be derived in future, or is assumed to be derived. In other words, even if no tax benefit is derived in the end, the transaction may still be reportable). The requirement is thus not if a tax benefit is derived in a transaction, but if it is entered into in order to avoid, escape, or prevent the tax liability. [167]

The term "participant" in relation to an "arrangement" as used in s 35, is defined in s 34 (as amended by the Taxation Laws Amendment Act 23 of 2015) to mean:

(a) a 'promoter';
(b) a person who directly or indirectly will derive or assumes that the person will derive a 'tax benefit' or 'financial benefit' by virtue of an 'arrangement'; or
(c) any other person who is party to an 'arrangement' listed in a public notice referred to in section 35(2).

[164] A De Koker & RC Williams Silke on South African Income Tax: Being an Exposition of the Law, Practice and Incidence of Income Tax in South Africa (2014) in para 19.36.
[165] (1966) 59 SATC 383.
[166] This meaning of avoiding liability was also upheld in other cases such as *Hicklin v CIR* 1964 (1) SA 324(A) and *Ovenstone v SIR* 1980(1) SA 481(A).
[167] Louw & Simpson 'The Simple Life Before Reportable Arrangement' at 3.

A “promoter”, in relation to an arrangement, means a person who is principally responsible for organising, designing, selling, financing or managing the ‘arrangement’.

A “financial benefit” is in term defined in s 34 to mean a reduction in the cost of finance, including interest, finance charges, costs, fees and discounts on a redemption amount.

8.2 CIRCUMSTANCES UNDER WHICH AN “ARRANGEMENT” WOULD QUALIFY AS A “REPORTABLE ARRANGEMENT”

Section 35 provides for two circumstances under which an “arrangement” would qualify as a “reportable arrangement”:

8.2.1 SPECIFIC REPORTABLE ARRANGEMENTS

Section 35(1) lists 5 categories of reportable arrangements. In terms of this section, an arrangement is reportable if a “tax benefit” is or will be derived or is assumed to be derived by any “participant” under the following circumstances.

(a) An arrangement is reportable if “it contains provisions in terms of which the calculation of ‘interest’ as defined in s 24J of the Income Tax Act, finance costs, fees or any other charges is wholly or partly dependent on the assumptions relating to the tax treatment of that “arrangement” (otherwise than by reason of any change in the provisions of a tax Act).”[168] In terms of s 24J, interest is defined as including:
- the gross amount of any interest or related finance charges, discount or premium payable or receivable in terms of a financial arrangement;
- the amount (or portion thereof) payable by a borrower to the lender in terms of any lending agreement as compensation for any amount to which the lender would have been entitled, but for such lending arrangement;
- the value of the difference between all amounts receivable and payable by a person in terms of a sale and lease back arrangement as contemplated in s 23G for the full terms of such arrangement.

The above is irrespective of whether such amount is calculated with reference to a fixed rate of interest or a variable rate of interest, or if it is receivable as a lump sum or in unequal instalments during the term of the financial arrangement. For purposes of the reportable arrangements provisions, the implications of the above are that if the calculation of interest is wholly or partly dependent on the assumptions relating to the tax treatment of that arrangement, other than the way that interest ought to be calculated in terms of a tax Act, then that arrangement is reportable. A typical

[168] Section 35(1)(a) of the Tax Administration Act.

example is where a financial model determines the funding cost of a transaction based on the assumed tax benefits in the hands of the participants.[169]

(b) An arrangement is reportable if "it has any of the characteristics contemplated in s 80C(2)*(b)* of the Income Tax Act, or substantially similar characteristics".[170]

Section 80C(2)(b) is a provision in the GAAR in the Income Tax Act which refers to arrangements that lack commercial substance. In terms of s 80C(1) of the Income Tax Act, an avoidance arrangement lacks commercial substance if it would result in a significant tax benefit for a party but does not have a significant effect upon either the business risks or the net cash flows of that party, apart from any effect attributable to the tax benefit that would be obtained in the absence of the GAAR. The word "significant" is however not defined in s 80C.

An objective meaning of the word would require taking into account the specific circumstances of each arrangement, since what is significant differs from person to person. In terms of s 80C(2)(b), the characteristics of an avoidance arrangement that indicates lack of commercial substance include, but are not limited to, the inclusion or presence of:

(i) round trip financing as described in s 80D; or
(ii) an accommodating or tax indifferent party as described in s 80E; or
(iii) elements that have the effect of offsetting or cancelling each other.

These elements are explained below.

Round tripping: In terms of s 80C(2)(b)(i) the characteristics of avoidance arrangements that indicate lack of commercial substance could include the presence or inclusion of round tripping. Section 80D(1) defines "round trip financing" to include any avoidance arrangement in which funds are transferred between or among the parties which would result, directly or indirectly, in a tax benefit and significantly reduce, offset or eliminate any business risk incurred by any party in connection with the avoidance arrangement. The Explanatory Memorandum to the Revenue Amendment Bill 2005 notes that the concept "round tripping" is analogous to the concept of "round robin financing" in Australia and "circular cash flows" in the United States.[171] In term of s 80D(2), the round tripping provisions apply to any round-tripped funds without regard to whether the round tripped amounts can be traced back, and ignoring the timing, sequence, means, or manner in which the round tripped amounts are transferred or received. Thus the fact that the flow of funds

169 Louw & Simpson 'The Simple Life Before Reportable Arrangement' at 4.
170 Section 35(1)(b) of the Tax Administration Act.

171 The Explanatory Memorandum to the Revenue Amendment Bill 2006 at 64.

takes place during different years of assessment is irrelevant.[172] In terms of s 80D(3), the term “funds” includes any cash, cash equivalents or any right or obligation to receive or pay the same.

<u>Accommodating or tax indifferent party:</u> Section 80C(2)(b)(iii) provides that the characteristics of avoidance arrangements that indicate lack of commercial substance include the presence or inclusion of an accommodating or tax indifferent party. The first part of the provision covers a wide a range of possible mechanisms for achieving this status, while the second part focuses upon the ways in which these parties are typically used in impermissible avoidance arrangements. Section 80E(1) provides that a party to an avoidance arrangement is an accommodating or tax-indifferent party if:

- Any amount derived by the party in connection with the avoidance arrangement is not subject to normal tax or is significantly offset either by any expenditure or loss incurred by the party in connection with that avoidance arrangement or any assessed loss; and
- Either:
- due to the participation of accommodating party:
    - an amount that would have been included in gross income of another party is now included in the gross income of the accommodating party as capital in nature;
    - a non-deductible expenditure or loss in the hands of another party would be treated as a deductible expenditure by the accommodating party;
    - an amount that would have constituted revenue in the hands of another party would be treated as capital by the accommodating party;
    - or
- The participation of that party directly or indirectly involves a prepayment by any other party.

In terms of s 80L the term “party” means “any person; permanent establishment in the Republic of a person who is not a resident; a permanent establishment outside the Republic of a person who is a resident; a partnership; or a joint venture, who participates or takes part in an arrangement”.

Thus the definition extends to parties in cross-border transactions. Section 80E(2) provides that a person may be an accommodating or tax-indifferent party whether or not that person is a connected person in relation to any party. Section 80F explains that connected persons and accommodating or tax indifferent parties are often used to give the illusion of commercial substance in a specific entity, so as to circumvent anti-avoidance rules. Accordingly, the Commissioner is empowered to combine connected persons, and disregard an accommodating or tax indifferent party or

[172] Stiglingh *et all* at 815.

combine it with another party for the purposes of determining whether an avoidance arrangement lacks commercial substance or whether a tax benefit exists.

Clearly the definition of an accommodating or tax indifferent party is extremely wide as it covers any party who is not subject to tax in South Africa. This would in principle cover all cross border transactions with non-residents[173] and any transaction in a tax-haven unless the taxpayer can prove that the sole or main purpose of the transaction was not to obtain a tax benefit.[174]

To exclude ordinary business transactions from the provisions, s 80E(3) provides two exclusions to the provisions. The first one is where income tax actually paid in other jurisdictions amounts to more than two-thirds of the income tax that would have been paid in the Republic. The second one relates to ongoing active business operations in connection with the avoidance arrangement, that is carried out through a substantial business establishment in the Republic or outside the Republic. Section 80E(4) provides that for purposes of s 80E<u>(3)(a)</u>, the amount of tax imposed by another country must be determined after taking into account any applicable double taxation treaty and any assessed loss, credit or rebate to which the party in question may be entitled or any other right of recovery to which that party or any connected person in relation to that party may be entitled.

<u>Inclusion or presence of elements that have the effect of offsetting or cancelling each other</u>*:* This indicator of lack of commercial substance, targets schemes involving complex financial derivatives that seek to exploit perceived loopholes in the law through transactions in which one leg generates a significant tax benefit while another leg effectively neutralises the first leg for non-tax purposes.[175]

(c) An arrangement is reportable if “it gives rise to an amount that is or will be disclosed by any ‘participant’ in any year of assessment or over the term of the ‘arrangement’ as:
  (i) a deduction for purposes of the Income Tax Act but not as an expense for purposes of ‘financial reporting standards’; or
  (ii) revenue for purposes of ‘financial reporting standards’ but not as gross income for purposes of the Income Tax Act”.[176]

Section 34 states that the term “financial reporting standards” means in the case of a company required to submit financial statements in terms of the Companies Act 71 of 2008, financial reporting standards prescribed by the standards that provide a fair presentation of the financial results and position of the taxpayer.

173 L Oliver & M Honiball International Tax: A South African Perspective (2011) at 533.
174 Stiglingh *et all* at 816.
175 De Koker & Williams in para 19.39.
176 Section 35(1)(c) of the Tax Administration Act.

(d) An arrangement is reportable if "it does not result in a reasonable expectation of a 'pre-tax profit' for any 'participant'".[177]

In terms of s 34, the term "pre-tax profit" in relation to an arrangement means the profit of a participant resulting from the arrangement before deducting normal tax, which profit must be determined in accordance with "financial reporting standards" (defined above) after taking into account all costs and expenditures incurred by the participant in connection with the arrangement, and after deducting any foreign tax paid or payable by the participant in connection with the arrangement.

(e) An arrangement is reportable if "it results in a reasonable expectation of a pre-tax profit for any 'participant' that is less than the value of that tax benefit to that 'participant' if both are discounted to a present value at the end of the first year of assessment when that tax benefit is or will be derived or is assumed to be derived, using consistent assumptions and a reasonable discount rate for that participant".[178]

8.2.2 ARRANGEMENTS LISTED BY THE COMMISSIONER BY PUBLIC NOTICE

Section 35(2) refers to arrangements which may be listed by the Commissioner for the South African Revenue Service ("the Commissioner") as "reportable arrangements" by public notice*,* if the Commissioner is satisfied that the "arrangement" may lead to an undue "tax benefit".

In April 2014, the Commissioner published a Draft Public Notice listing arrangements for purposes of section 35(2) for public comment. The draft notice set out a list of additional reportable arrangements that have certain characteristics that may lead to an undue tax benefit. On 16 March 2015, the Commissioner issued a finalised public notice in Government Gazette No. 38569 on 16 March 2015,[179] listing reportable arrangements and excluded arrangements for purposes of the reportable arrangement provisions of the TAA. This was followed by SARS published notice No 140 in the Government Gazette No. 39650 issued on 3 February 2016, in terms of sections 35(2) and 36(4) of the TAA, which replaces all previous notices. Paragraph 2 of the Notice lists the following arrangements that are reportable:
Paragraph 2.1: This paragraph requires the reporting of hybrid equity instrument if the prescribed period in section 8E of the Income Tax Act ('ITA') had been 10 years. The paragraph states that:

177 Section 35(1)(d) of the Tax Administration Act.
178 Section 35(1)(e) of the Tax Administration Act.
179 SARS "Public Notice Listing Arrangements for Purposes of Sections 35(2) and 36(4) of The Tax Administration Act, 2011" Government Gazette No. 38569 16 March 2015. Available at http://www.gov.za/sites/www.gov.za/files/38569_gon212.pdf accessed 23 July 2015.

> "An arrangement that would have qualified as a "hybrid equity instrument" in terms of section 8E of the Income Tax Act, 1962, if the prescribed period in that section had been 10 years, but does not include any instrument listed on an exchange regulated in terms of the Financial Markets Act, 2012 (Act No. 19 of 2012)".

Paragraph 2.2: This paragraph requires reporting where a company buys back shares for an amount in excess of R10 million and the company issued or is required to issue any shares within 12 months of the date of entering into the arrangement or of the buyback. The paragraph states that:

> "An arrangement in terms of which—
> (a) a company buys back shares on or after the date of publication of this notice from one or more shareholders for an aggregate amount exceeding R10 million; and
> (b) that company issued or is required to issue any shares within 12 months of entering into that arrangement or of the date of any buy-back in terms of that arrangement".

Paragraph 2.3: This paragraph requires reporting where a resident makes a contribution to a non-resident trust that acquires a beneficial interest in that trust and the sum of all contributions before or after that date or the value of the beneficial interest exceeds or is expected to exceed R10 million is a reportable arrangement. The paragraph states:

> "An arrangement in terms of which—
> (a) a person that is a resident makes any contribution or payment on or after 16 March 2015 to a trust that is not a resident and has or acquires a beneficial interest in that trust; and
> (b) the amount of all contributions or payments, whether made before or after 16 March 2015, or the value of that interest exceeds or is reasonably expected to exceed R10 million, excluding any contributions or payments made to or beneficial interest acquired in any—
> (i) portfolio comprised in any investment scheme contemplated in paragraph *(e)*(ii) of the definition of "company" in section 1(1) of the Income Tax Act, 1962; or
> (ii) foreign investment entity as defined in section 1(1) of the Income Tax Act, 1962."

There has however been uncertainty as to whether the use of the phrase "contribution or payment" in the above provision extends to a loan – which is the common vehicle for the transfer of cash or assets from a resident to a non-resident trust. The concern is that the terms "contribution" and "payment" are not defined in the TAA; which make it unclear as to what would qualify as a "contribution or payment". The word "contribution" is defined in the Oxford Dictionary to *inter alia* mean "a gift or payment to a common fund or collection" and the word "payment" is defined as "the action or process of paying someone or something or of being paid; an amount paid or payable". The word "pay" is defined as *inter alia* to "give someone money owed to them for work". The word "loan" is defined in the Oxford dictionary as "a thing that is borrowed, especially a sum of money that is expected to be paid back with interest; the action of lending something." Since the word "contribution" entails a gift or a payment and the word "payment" entails giving money owned; one could argue that a loan is not covered in the meaning of these words as repayment is expected. It is therefore arguable that a loan to a non-resident trust is not a reportable arrangement.[180]

- The DTC recommends that SARS clarifies the wording of this paragraph to ensure that loans are categorically covered.

The other concern is that the paragraph makes use of term “beneficial interest”, which is not defined in the TAA. [181] Even if courts could refer to the Income Tax Act (ITA) for the meaning of the term – there is no definition of the term there. Section 1 of the ITA defines the term “beneficiary” in relation to a trust to mean a person who has a vested or contingent interest in all or a portion of the receipts or accruals or the assets of that trust. However qualifying as a “beneficiary” as defined in the ITA, does not automatically infer a “beneficial interest”. An interest in a trust is usually described either as a vested interest/right, or a discretionary interest/right (a contingent right). The phrase “beneficial interest” is thus not a recognised concept in the legislation; and it is not clear if the legislator intended to refer to some other interest altogether.

If one refers to the Oxford dictionary, to determine what “beneficial interest” would imply, the dictionary defines the word “beneficial” as “having a good effect; favourable,” and the word “benefit” to *inter alia* mean an “advantage or profit gained from something”. The combination of these two definitions implies that a “beneficial interest” must be an interest of which it can be said with certainty that it is favourable, that an advantage or profit is gained. It is therefore uncertain whether a beneficiary of a discretionary trust in terms of which it is completely within the discretion of the trustees whether or not any distribution will be made to a specific beneficiary, has a beneficial interest. Unless the trustees have decided to vest any capital or income in the beneficiary, that beneficiary only has a contingent right, which is no more than a *spes* - a hope or an expectation.[182]

- It is therefore recommended that to ensure that the term “beneficial interest” is not open to an interpretation that an interest in a discretionary trust is not reportable, SARS should clearly explain what it intended by the term and whether or not it also includes any beneficial interest in a discretionary trust.[183]

The other concern about the paragraph is that the value of all contributions or payments, or the value of the beneficial interest, must exceed or be reasonably expected to exceed R10 million. Even if it is established that a person holds a beneficial interest in a discretionary trust, it is almost impossible to attribute a value

180 Technical Report submitted by STEP Cape Town to the DTC BEPS-Subcommittee (June 2016).
181 Technical Report submitted by STEP Cape Town to the DTC BEPS-Subcommittee (June 2016).
182 *Commissioner for Inland Revenue v Estate Merensky* 1959 22 SATC 343.
183 *Reportable Arrangements - 2446. Extended to foreign trusts*, Cliffe Dekker Hofmeyer, Saica Integritax Newsletter, September 2015, Issue 192, p 23 – 26, accessed 2nd June 2016: https://www.saica.co.za/integritax/Archive/Integritax_Sep_2015_Issue_192.pdf.

to that interest, as the substance of that interest is no more than a hope, and totally dependent on the discretion of the trustees. This was confirmed by the Supreme Court of Appeal in the case of *Welch v Commissioner for the South African Revenue Service*,[184] that a mere *spes* has no present inherent value.[185]

- It is therefore recommended that SARS clarifies how the value of the "beneficial' interest to be in the context of a discretionary trust will be determined.

Where reporting in the case of a trust applies, if "the value of that interest exceeds or is reasonably expected to exceed R10 million" with respect to the contributions or payments of the beneficial interest, there are also some uncertainties as to how this value is to be determined. One may not be sure when the value of such contributions or payments is likely to exceed R10 million at any point in the future, so that it becomes reportable.[186] Even if the value of the interest of a beneficiary can be established, and even if can be expected to exceed the threshold, there are numerous factors which could influence the value such as changes in the exchange rate, a decrease, decrease or crash in the markets, a discretionary distribution made to another beneficiary, *etcetera*.

- The DTC recommends that SARS provides more concrete, rather than very broad ways, of determining the value.

Paragraph 2.4: This paragraph requires reporting in the case of the direct or indirect acquisition of a controlling interest in a company with assessed losses in excess of R50 million from the year of assessment preceding the transaction, or during which the transaction is concluded is reportable. The paragraph states:

> "An arrangement in terms of which one or more persons acquire the controlling interest in a company on or after the date of publication of this notice, including by means of acquiring shares, voting rights or a combination of both, that—
>
> (a) (i) has carried forward or reasonably expects to carry forward a balance of assessed loss exceeding R50 million from the year of assessment immediately preceding the year of assessment in which the controlling interest is acquired; or
>
> (ii) has or reasonably expects to have an assessed loss exceeding R50 million in respect of the year of assessment during which the controlling interest is acquired; or
>
> (b) directly or indirectly holds a controlling interest in a company referred to in paragraph *(a)."*

Paragraph 2.5: This paragraph requires the reporting of arrangements between residents and foreign insurers if amounts that exceed or are expected to exceed R5 million have been paid or will become payable to the foreign insurer and any amount

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184 2004 2 All SA 586.

185 Supra, para 50 and para 62.

186 *SARS gazettes new list of arrangements deemed reportable,* News & Press: Tax Talk (22 September 2015). Available at http://www.thesait.org.za/news/251710/SARS-gazettes-new-list-of-arrangements-deemed-reportable-.htm accessed 9 June 2016.

payable to beneficiaries is determined mainly with reference to the value of particular assets or categories of assets held by the foreign insurer. The paragraph states:

> "An arrangement between a person that is a resident and a person that qualifies as an insurer in terms of any law of any country other than the Republic (hereinafter referred to as the foreign insurer) in terms of which—
>
> (a) an aggregate amount that exceeds or is reasonably expected to exceed R5 million has been paid or becomes payable by the resident to the foreign insurer; and
>
> (b) any amount payable on or after 16 March 2016, in cash or otherwise, to any beneficiary in terms of that arrangement is to be determined mainly by reference to the value of particular assets or categories of assets that are held by or on behalf of the foreign insurer or by another person for purposes of that arrangement."

Paragraph 2.6: This paragraph requires the reporting of services comprising consultancy, construction, engineering, installation, logistical, managerial, supervisory, technical, or training services rendered to a resident person or to a permanent establishment of a non-resident person in South Africa under certain circumstances. The paragraph states:

> "An arrangement for the rendering to a person—
>
> (a) that is a resident; or
>
> (b) that is not a resident that has a permanent establishment in the Republic to which that arrangement relates, of consultancy, construction, engineering, installation, logistical, managerial, supervisory, technical or training services, in terms of which—
>
> (i) a person that is not a resident or an employee, agent or representative of that person—
>
> (aa) was or is physically present in the Republic; or
>
> (bb) is anticipated to be physically present in the Republic, in connection with or for purposes of rendering those services; and
>
> (ii) the expenditure in respect of those services under that arrangement—
>
> (aa) incurred or to be incurred, on or after the date of publication of this notice, exceeds or is anticipated to exceed R10 million in aggregate; and
>
> (bb) does not qualify as remuneration for purposes of the Fourth Schedule to the Income Tax Act, 1962."

The above provision appears to be largely aimed at non-resident service providers who physically provide services in South Africa to residents (which may create permanent establishments of non-residents) via individual non-residents sent to South Africa. This could be the case where a foreign consulting firm sends its employees to South Africa to render consulting services. It could also be the case where a multinational corporation that has a resident subsidiary or a permanent establishment in South Africa, sends non-resident employees or agents to South Africa (e.g. managers or experts) to provide services to the resident subsidiary or permanent establishment.

Generally, a non-resident service provider would be liable to account for income tax in South Africa in respect of all income derived from a South African source. Where an international tax treaty applies, the non-resident would generally be liable to account for income tax in South Africa only to the extent that it has created a permanent establishment in South Africa and the relevant income is attributable to such permanent establishment.

Where a non-resident service provider sends non-resident employees or agents to South Africa in connection with, or for purposes of, rendering services to South African residents (or permanent establishments of non-residents in South Africa), the relevant income derived by the non-resident service provider is very likely to be taxable in South Africa.

In practice, the risk for SARS is that such non-resident service providers could fail to register as taxpayers in South Africa (whether as a permanent establishment or not), and not declare their income that is taxable in South Africa. The fiscus may then be compromised as the local recipient of the services would likely claim a tax deduction for the expenditure incurred. The non-resident service provider could potentially also become liable to register for value-added tax in South Africa to the extent that it conducts an enterprise in South Africa and makes taxable supplies of services.

Where such non-resident service providers maintain a light footprint in South Africa, SARS may find it difficult to enforce compliance. Thus, the above provision is intended to be a detection mechanism, which ensures that resident recipients of services from non-resident service providers, are forced to declare their payments to those service providers and thus give an indication of the non-resident's South African income.

The withholding tax on service fees provided for in s51A-s51H of the Income Tax Act, No 58 of 1962 was originally expected to commence on 1 January 2017. In this regard the local recipient of services would generally have to withhold 15% of the fee payable to the non-resident service provider (subject to the application of a relevant international tax treaty). However, in the 2016 Budget review it was announced that the services withholding tax is to be removed. Thus, it appears that the reporting obligation will replaced the withholding tax as a mechanism for SARS to identify where tax should be paid in South Africa by non-residents.

8.3 EXCLUDED ARRANGEMENTS

Section 36 of the TAA provides for certain arrangements that are excluded from the provisions. The excluded arrangements fall under two main categories: specifically excluded arrangements (subject to certain exceptions) and arrangements excluded by the Commissioner by public notice.

8.3.1 SPECIFICALLY EXCLUDED ARRANGEMENTS (SUBJECT TO CERTAIN EXCEPTIONS)

In terms of s 36(1) excluded arrangements fall under 4 main categories discussed below:

(a) An “arrangement” is excluded if it is a loan, advance or debt in terms of which:

- (i) the borrower receives or will receive an amount of cash and agrees to repay at least the same amount of cash to the lender at a determinable future date; or
- (ii) the borrower receives or will receive a fungible asset and agrees to return an asset of the same kind and of the same or equivalent quantity and quality to the lender at a determinable future date.

An example of this exclusion is vanilla type loans (advances or debt).

(b) An “arrangement” is excluded if it is a lease:
The term ‘lease’ (not defined in the ITA or TAA) can be defined as a contract in terms of which an owner of an asset or equipment, normally referred to as the lessor, who lets the asset or equipment to be used by another person, normally referred to as the lessee.[187] Thus, the leasing contract is based on the separation of the ownership of an asset and its usage.[188] Section 23A(1) of the ITA, does however define an “operating lease” as a lease of movable property concluded by a lessor in the ordinary course of a business (not being a banking, financial services or insurance business) of letting such property to members of the general public for a period of less than a year, whereby the cost of maintaining and repairing the property are borne by the lessor and the risk of loss or destruction to the asset is not assumed by the lessee.

(c) An “arrangement” is excluded if it is a transaction undertaken through an exchange regulated in terms of the Securities Services Act 36 of 2004:

The term “transaction” is defined in s 1 of the Securities Services Act, to mean a contract of purchase and sale of securities. Section 1 of the same Act defines an “exchange” as a person who constitutes, maintains and provides an infrastructure:

- for bringing together buyers and sellers of securities;
- for matching the orders for securities of multiple buyers and sellers; and
- whereby a matched order for securities constitutes a transaction.

In terms of sections 5 and 6 of the Securities Services Act, exchange transactions are regulated by Registrar or Deputy Registrar of Securities Services in terms of Financial Services Board Act 97 of 1990. Since any person who deals in securities has to apply to the registrar for an exchange licence in respect of their securities transactions,[189] such transactions are regulated and so they are excluded from the

187 Oxford English Dictionary.

188 OECD “The Taxation of Income Derived from Leasing of Industrial, Commercial and Scientific Equipment” op cit note 1 in para 9.

189 Section 7 of the Securities Services Act 36 of 2004.

reportable arrangements provisions. This implies that preference shares traded on the JSE Securities Exchange are excluded arrangements.[190]

(d) An "arrangement" is excluded if it is a transaction in participatory interests in a scheme regulated in terms of the Collective Investment Schemes Control Act 45 of 2002:

In terms of section 1 of the Collective Investment Schemes Control Act, a "collective investment scheme" means "a scheme, in whatever form, including an open-ended investment company, in pursuance of which members of the public are invited or permitted to invest money or other assets in a portfolio, and in terms of which:

(i) two or more investors contribute money or other assets to and hold a participatory interest in a portfolio of the scheme through shares, units or any other form of participatory interest; and
(ii) the investors share the risk and the benefit of investment in proportion to their participatory interest in a portfolio of a scheme or on any other basis determined, in the collective investment scheme as authorised by any other Act.

Section 1 of the Collective Investment Schemes Control Act defines a 'participatory interest' in a collective investment scheme as "'any interest, undivided share or share whether called a participatory interest, unit or by any other name, and whether the value of such interest, unit, undivided share or share remains constant or varies from time to time, which may be acquired by an investor in a portfolio."

In terms of section 7 of the Collective Investment Schemes Control Act, transactions in participatory interests in Collective Investment Schemes are regulated by the registrar or the deputy registrar of collective investments in terms of Financial Services Board Act 97 of 1990. Since these transactions are duly regulated, they are excluded from the reportable arrangements provisions.

8.3.2 EXCEPTIONS FROM EXCLUDED ARRANGEMENTS

The above excluded arrangements are subject to certain exceptions. In terms of s 36(2), an arrangement is excluded in terms of s 36(1) only if that arrangement:

(a) is undertaken on a stand-alone basis and is not directly or indirectly connected to any other "arrangement" (whether entered into between the same or different parties); or
(b) would have qualified as having been undertaken on a stand-alone basis, were it not for a connected "arrangement" that is entered into for the sole

[190] SARS 'Reportable Arrangements Guide' (1 March 2005) at 6.

purpose of providing security and if no “tax benefit” is obtained or enhanced by virtue of the security “arrangement”.

Many loans are linked to an event that the taxpayer will undertake, or anticipates to undertake. To the extent that the loan is linked to the acquisition of an asset, the arrangement would no longer be excluded, and may need to be reported.[191]

Section 36(4) provides that the excluded arrangements set out in s 36(1) do not apply if the “arrangement” is entered into:

(a) with the main purpose or one of its main purposes of obtaining or enhancing a “tax benefit”; or
(b) in a specific manner or form that enhances or will enhance a “tax benefit”.

The meaning of the phrase “main purpose of obtaining a tax benefit” can be gleaned from the meaning of the same phrase as used in s 80G(1) of the Income Tax Act, which deals with the GAAR. In terms of this GAAR provision, the word “purpose”, as used in the context of section 80G does not refer to the intention of the taxpayer but the purpose of the arrangement. In the context of reportable arrangements, this would imply the objective effect that the arrangement is sought to achieve – the end accomplished or achieved.[192] Thus the burden of proof lies on the Commissioner to show that the main purpose or one of the main purposes of the arrangement is to obtain or enhance a tax benefit. The use of the word “or” between s 36(3)(a) and (b) seems to imply a taxpayer cannot reason that the arrangement is excluded, merely because its main *purposes* was not to obtain a tax benefit. As long as the arrangement is entered into in a specific manner that enhances or will enhance a tax benefit, it will also not fall under the excluded arrangements.

8.3.3 ARRANGEMENTS EXCLUDED BY THE COMMISSIONER BY PUBLIC NOTICE

In terms of s 36(4), the Commissioner may determine an “arrangement” to be an “excluded arrangement” by public notice, if satisfied that it is not likely to lead to an undue “tax benefit”.

As noted above, the Commissioner for SARS issued a public notice No 140 in Government Gazette (No 39650) on 3 February 2016 listing reportable arrangements and excluded arrangements for purposes of the reportable

[191] Louw & Simpson ‘The Simple Life Before Reportable Arrangement’ at 4.
[192] De Koker & Williams op cit note 5 in para 19.6.

arrangement provisions of the TAA that replaces all previous notices. In terms of this Notice the excluded arrangements are set out in paragraph 3.

Paragraph 3.1: “An arrangement referred to in section 35(1) of the Tax Administration Act, 2011, is an excluded arrangement if the aggregate tax benefit which is or may be derived from that arrangement by all participants to that arrangement does not exceed R5 million.

Paragraph 3.2: “An arrangement referred to in section 35(1)*(c)* of the Tax Administration Act, 2011, is an excluded arrangement if the tax benefit which is or will be derived or is assumed to be derived from that arrangement is not the main or one of the main benefits of that arrangement.”

8.4 DISCLOSURE OBLIGATIONS

The TAA has provisions that deal with disclosure obligations with regard to reportable arrangements. Section 37(1) thereof provides that the information in referred to in section 38 (below) in respect of a reportable arrangement must be disclosed by a person who:

(d) is a “participant” in an “arrangement” on the date on which it qualifies as a “reportable arrangement” within 45 business days after that date; or
(e) becomes a “participant” in an “arrangement” after the date on which it qualifies as a “reportable arrangement”, within 45 business days after becoming a “participant”

Section 37(3) provides that a “participant” need not disclose the information if the “participant” obtains a written statement from any other “participant” that the other “participant” has disclosed the “reportable arrangement”. :

Section 37(5) provides that SARS may grant extension for disclosure for a further 45 business days, if reasonable grounds exist for the extension.

Thus the reporting obligation is in the first instance on the promoter (who in terms of section 34 of the TAA is the person who is responsible for organising, designing, selling, financing or managing the reportable arrangement) as this is the person most likely to have insight into the whole transaction. For example, if a corporate finance firm designs a transaction, it has to report the transaction. If there is no promoter, or the promoter is a non-resident, the participants to the transaction (which only include companies and trusts) must report.[193] Essentially this provision covers reporting by participants in cross-border transactions.
Since any participant is obliged to report the relevant arrangement it follows that in terms of paragraph 2.6 of Government Gazette No. 39650 issued on 3 February

[193] Louw & Simpson ‘The Simple Life Before Reportable Arrangement’ at 3.

2016, South African residents (or non-residents having a South African permanent establishment) who conclude contracts with non-resident service providers for the provision of services, would very likely have to report the arrangement where the non-resident service provider will be sending non-resident employees, agents or representatives to South Africa in relation to the services, and the overall monetary threshold of R10 million non-remuneration income is to be exceeded.

Section 38 of the TAA provides for the information that must be submitted. The section states that:

> "The 'promoter' or 'participant' must submit, in relation to a reportable arrangement, in the prescribed form and manner and by the date specified:
>
> (a) a detailed description of all its steps and key features, including, in the case of an 'arrangement' that is a step or part of a larger 'arrangement', all the steps and key features of the larger 'arrangement';
> (b) a detailed description of the assumed 'tax benefits' for all 'participants', including, but not limited to, tax deductions and deferred income;
> (c) the names, registration numbers, and registered addresses of all 'participants';
> (d) a list of all its agreements; and
> (e) any financial model that embodies its projected tax treatment".

In terms of s 39 of the TAA, after SARS has received the information contemplated in s 38 of the same Act, it must issue a reportable arrangement reference number to each "participant" for administrative purposes only.

8.5 PENALTIES FOR NON-DISCLOSURE

Section 38 of the TAA provides that the arrangement must be disclosed in the prescribed form. Disclosing the arrangement in any other manner than with the prescribed form would therefore not constitute compliance to the TAA, and without a prescribed form it is impossible to disclose an arrangement, as it can only be done with the prescribed form.

However, the only form that can be found on SARS's website is the RA-01 form, which expressly stipulates that it is the form in which to report arrangements in terms of sections 80M – 80T of the ITA. Sections 80M – 80T were repealed by the TAA in 2011. No form exists in terms of the TAA with which to disclose reportable arrangements.

Since a reportable arrangement can only be disclosed with the prescribed form – any other manner or form of disclosure would not constitute proper disclosure or compliance with the Act. Without a prescribed form, it is therefore impossible to comply with the provisions.

Bearing in mind that the deadline for reporting any existing arrangements which became reportable on the publication date of the Notice would have expired on 15th June 2016 (calculated with an extension included), this is a major concern.[194]

- It is recommended, by the DTC, that SARS urgently provides a valid prescribed form to negate any arguments from taxpayers that the unavailability of such a form precludes their ability to comply with the Act.

8.6 PENALTIES FOR NON-DISCLOSURE

Where a person fails to disclose the information in respect of a reportable arrangement, s 212 of the TAA as amended by the Tax Administration Amendment Laws 23 of 2015 sets out penalties. The section states that:

> "(1) A person referred to in paragraph (*a*) or (*b*) of the definition of 'participant' who fails to disclose the information in respect of a 'reportable arrangement' as required by section 37 is liable to a 'penalty', for each month that the failure continues (up to 12 months), in the amount of—
> (*a*) R50 000, in the case of a 'participant' other than the 'promoter'; or
> (*b*) R100 000, in the case of the 'promoter'.
>
> (2) The amount of 'penalty' determined under subsection (1) is doubled if the amount of anticipated 'tax benefit' for the 'participant' by reason of the arrangement (within the meaning of section 35) exceeds R5 000 000, and is tripled if the benefit exceeds R10 000 000.
>
> (3) A person referred to in paragraph (*c*) of the definition of 'participant' who fails to disclose the information in respect of a 'reportable arrangement' as required by section 37 is liable to a 'penalty' in the amount of R50 000".

As indicated above, the term "participant" in relation to an "arrangement" is defined in s 34 (as to mean:

(a) a 'promoter';
(b) a person who directly or indirectly will derive or assumes that the person will derive a 'tax benefit' or 'financial benefit' by virtue of an 'arrangement'; or
(c) any other person who is party to an 'arrangement' listed in a public notice referred to in section 35(2).

From the above, there seem to be uncertainties about how the penalties apply.

- Section 212(1) stipulates that a person will be liable for penalties for non-disclosure of the arrangement. However, the conjunction "or" used between subsections 1(a) and 1(b) makes it unclear whether only one person will be held liable for the penalty, in the corresponding amount, or whether all persons will be held liable simultaneously, in the amount applicable to their role in the arrangement. It is not clear whether SARS imposes a penalty on each of the promoters or if the penalty will be imposed jointly and severally. It is suggested that the legislation be made clearer.

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194 Technical Report submitted by STEP Cape Town to the DTC BEPS-Subcommittee (June 2016).

- There are also concerns that the heavy penalties may be unfair to innocent participants. Section 34(c) of the definition of participant provides that “any other person who is a party to an arrangement” is a participant. However the TAA does not explain who is included or excluded in the term “party to an arrangement”. It is for instance not clear whether it includes beneficiaries of discretionary trusts. If the phrase “a party to an arrangement” is interpreted so widely SARS, may impose unfair and unjust penalties on innocent persons i.e. those who have no knowledge of the actions of the trust. As explained above, Action 12 of the OECD BEPS Report recommends that in structuring monetary penalties for non-disclosure:
    - Jurisdictions should take into account factors such as whether negligence, deliberate non-compliance or the tax benefit may be linked to the level of the penalty.
    - Penalties should be set at a level that maximises their deterrent value without being overly burdensome or disproportionate.
    - Consideration should be given to percentage based penalties based upon transaction size or the extent of any tax savings.[195]

  In South Africa, under section 217 of the TAA, SARS does apply discretion in the way the section 212 reportable arrangements penalties are levied. Section 217(2) provides that SARS may “remit the ‘penalty’ or a portion thereof if appropriate, up to an amount of R2000 if SARS is satisfied that:

  (iii) reasonable grounds for non-compliance exist; and

  (iv) the non-compliance in issue has been remedied”.

- The penalties in section 212(1) are: R100 000 per month of non-disclosure by the promoter, or R50 000 per month in the case of a participant other than the promoter, limited to 12 months. It would appear that “a participant” other than a promoter would include both the person falling into category (b) and the person in category (c) of the definition of participant in section 34. However section 212(3) of the penalties provision contains a separate penalty for participants in category (c) of the definition of participant. A strict reading, of the provision indicates a duplication of the penalty imposed on the person falling into category (c) of the definition of participant. Although one can through the rules of interpretation deduce that the intention was to separate all three parts of the definition of a participant, making them liable to R100 000 per month in the case of promoters in category (a), R50 000 per month in the case if participants category (b), and a once-off R50 000 in the case of participants category (c), the provision does not explicitly state so. It is recommended that the wording of this provision is made clearer.[196]

[195] OECD/G20 2015 Final Report on Action 12 in para 183.

[196] Technical Report submitted by STEP Cape Town to the DTC BEPS-Subcommittee (June 2016).

- The penalties have serious economic implications for participants and promoters. For example non-disclosure by a promoter for 12 months could amount to penalties of 1.2million (100, 000 per month). It is possible that amount could even be higher if a promoter is involved in more than one arrangement that must be reported. With such hefty penalties, it is important that SARS ensures that the provisions are well worded and clear, so that taxpayers are not left to their own devices to interpret what was meant. It is also important that SARS raises more awareness to taxpayers about the reportable arrangements provisions especially regarding the penalties for not complying with the provisions.

9 OBSERVATIONS AND RECOMMENDATIONS ON ENSURING THE EFFECTIVENESS OF SOUTH AFRICA'S REPORTABLE ARRANGEMENTS PROVISIONS

9.1 OBSERVATIONS ON ENSURING AN EFFECTIVE EARLY WARNING SYSTEM

The reportable arrangements provisions are supposed to work as an "early warning system" for SARS, allowing it to identify potentially aggressive transactions when they are entered into. This could lead to SARS countering innovative transactions as they are devised, instead of them attempting to play catch up a number of years down the line.[197]

With respect to obtaining early information about aggressive tax avoidance schemes**,** in South Africa any preference share that is redeemable within 10 years of issue is listed as a reportable arrangement. These arrangements make up the majority of transactions currently reported, and the data collected has provided an insight into how preference share funding is utilised. This understanding has informed the design of the new hybrid equity tax rules that have been recently introduced.[198]

9.2 RECOMMENDATION TO ENSURE EFFECTIVE DETERRENCE OF AGGRESSIVE TAX AVOIDANCE

The Table below from SARS[199] shows the statistics on Reportable Arrangements in South Africa for which the "Tax Avoidance and Reportable Arrangements Unit" at SARS has issued receipts since 2009. The 2016 statistics relate to the 1st quarter of the year.

197 Louw & Simpson 'The Simple Life Before Reportable Arrangement' at 3.
198 OECD May 2015 Public Discussion Draft on Action 12 in para 42.
199 Statistics adopted from SARS "Tax Avoidance and Reportable Arrangements Unit". Refer to reportable@sars.gov.za.

Year	Number
2009	151
2010	76
2011	154
2012	70
2013	91
2014	87
2015	155
2016	54
Total	**838**

The above shows that 838 arrangements have been reported to SARS since 2009 to date. This success can be ascribed to the fact that SARS has carried out successful audits where significant amounts of tax have been collected; and also to the fact that changes were made to the legislation on a more proactive basis rather than on relying on discovering arrangements through the audit process only. A further benefit of the system is that the Tax Avoidance and Reportable Arrangement Unit is able to tailor the training of its auditors for risk profilers based on its experience of reports received, thus keeping these its auditors more abreast with trends in the market.

In the majority of cases the disclosures have been made by several large companies. The majority of reports under the generic hallmarks were made during 2009 and the number of arrangements disclosed annually under those hallmarks has reduced significantly. South Africa has since extended the scope of its mandatory disclosure regime with the addition of specific hallmarks targeting transactions that are of particular concern to the South African tax administration. [200]

There were previously concerns that the reportable arrangements legislation was largely aimed at structured financial arrangements facilitated by banks; such as preference share arrangements which are legitimate. In this regard, SARS mainly received reports of vanilla type preference share arrangements which are legitimate. This left out the so-called funnel funding schemes.

Over the last two years the SARS Unit responsible for Reportable Arrangements started managing the listed Reportable Arrangements in a more proactive manner which enabled it to list five additional arrangements that are now required to be reported. This has resulted in an increase in the number of arrangements reported in line with SARS expectations, although preference share deals remain the predominant item reported. The evidence collected through reports on arrangements listed as recently as March 2015 helped to inform policy considerations on certain

200 OECD May 2015 Public Discussion Draft on Action 12 in para 54.

issues. Thus the Government Gazette No. 39650 issued on 3 February 2016 extended the scope of reportable arrangements which is hoped to make the provisions more effective in exposing tax abuses.

It appears from s 38 of the TAA that the success of the reportable arrangements rules depends on pro-active reporting[201] and the ability of the participants to fully disclose the information regarding such arrangement. Although taxpayers have in the past been able structure their affairs to avoid falling under the reportable arrangements provisions, the latest Gazette shows that much more reporting will be required of taxpayers.

9.3 COMMENT ON EFFECTIVE TIME OF DISCLOSURE

In the UK, a scheme is regarded as "made available for implementation" at the point when all the elements necessary for implementation of the scheme are in place and a communication is made to a client suggesting that the client might consider entering into transactions forming part of the scheme, it does not matter whether full details of the scheme are communicated at that time.[202] A UK a promoter must disclose a scheme within 5 working days of making a scheme available for implementation by another person. In Portugal promoters must disclose a scheme within 20 days following the end of the month in which the scheme was made available.[203]

Section 37(1) of the TAA provides that an arrangement must be disclosed by a "participant" within 45 from the date on which it qualifies as a "reportable arrangement". Further that SARS may grant extension for disclosure for a further 45 business days, if reasonable grounds exist for the extension. This time period for disclosure obligation is triggered where there is receipt or payment of money, for a transaction forming part of a reportable arrangement. This disclosure be is reasonable and in line with the OECD recommendation on the time of disclosure.

9.4 RECOMMENDATION ON EFFECTIVE IDENTIFICATION OF SCHEME USERS

The method applied to identify scheme users in South Africa is by SARS issuing a reportable arrangement reference number to each "participant" for administrative purposes in terms of s 39.

Requiring promoters to submit client lists is not a requirement in South Africa. In countries such as the USA, the UK and Canada taxpayers must include the scheme

201 Ibid.
202 OECD/G20 2015 Final Report on Action 12 in para 141.
203 OECD/G20 2015 Final Report on Action 12 in para 141.

reference number on their tax returns and lists of clients must be furnished.[204] The OECD notes that requiring the promoter to provide a client list may identify other taxpayers that participated in a scheme, but did not disclose.[205] Although this may increase compliance costs for the promoter, the fact that the user knows they will be identified either through a client list or more directly, through entering a number on their tax return, may deter some from undertaking a scheme in the first place. [206] The OECD recommends that client lists should be received by tax administrations before a tax return is submitted so they provide information about the uptake of avoidance schemes much earlier than scheme reference numbers alone. This allows compliance plans to be put in place before tax returns are received, sometimes a year in advance. Client lists also enable tax authorities to carry out early interventions such as contacting taxpayers who appear on the lists to advise them not to claim the effects of the avoidance scheme on their returns.[207]

OECD recommends that where a country places the primary reporting obligation on the promoter, they should introduce scheme reference numbers and require the preparation of client lists in order to fully identify all users of a scheme and to enable risk assessment of individual taxpayers.[208] Where however, a country has a dual-reporting obligations where both the promoter and the taxpayer reports, then scheme reference numbers and clients lists may not be as essential but they are likely to aid cross-checking and allow a tax administration to quantify the risk and tax loss from specific schemes. [209] South Africa has a dual reporting system, in term of section 38 of the TAA, the "promoter" has the primary obligation to report. If there is no promoter in relation to the "arrangement" or if the promoter is not a resident, all other "participants' must disclose the information.

- In light of the dual reporting mechanism in South Africa and in the interest of not placing administrative burdens on taxpayers to submit clients lists it is recommended that clients lists should not be introduced in South Africa. Such information could be easily accessed from the disclosures submitted by the participants in terms of section 38 of the TAA. It should also be noted that SARS Form RA 01 for Reporting Reportable Arrangements contains detailed aspects of what must be disclosed by a participate or a promoter – the information that would be provided on completion of these From is broad enough to capture what could be required from client lists. Nevertheless the Form is outdated as it is based the repealed reportable arrangements provisions under the Income Tax Act. It is important that the form is updated urgently.

204 OECD/G20 2015 Final Report on Action 12 in para 164.
205 OECD/G20 2015 Final Report on Action 12 in para 168.
206 OECD/G20 2015 Final Report on Action 12 in para 169.
207 OECD/G20 2015 Final Report on Action 12 in para 171.
208 OECD/G20 2015 Final Report on Action 12 in para 172.
209 OECD/G20 2015 Final Report on Action 12 in para 173.

9.5 RECOMMENDATION TO ENSURE THE RULES ARE EFFECTIVE TO DETERRING BEPS IN A CROSS BORDER CONTEXT

Government Gazette No. 39650 issued on 3 February 2016 which has extended the scope of reportable arrangements has the potential of making the rules more appropriate from a BEPS angle, as much of what BEPS is concerned with relates to commercial arrangements. For example, paragraph 2.3 of the Gazetted list covers any arrangement in terms of which a person that is a resident makes any contribution or payment on or after the date of publication of this notice to a trust that is not a resident and has or acquires a beneficial interest in that trust.

The reportable arrangements provisions clearly apply in a cross border context as section 37 clearly provides that if the promoter of a scheme is not a resident, all other “participants” (whether resident or non-resident) must disclose the information regarding to the arrangement to SARS. Nevertheless more needs to be done to ensure the provisions are more effective in preventing BEPS.

The OECD notes that many countries have lower numbers of disclosures of international schemes because the way international schemes are structured and the formulation of some countries’ disclosure regimes may not be effective in curtailing BEPS in a cross-border context, since such structures typically generate multiple tax benefits for different parties in different jurisdictions.[210] There is therefore need to ensure that the generic hallmarks for disclosure discriminate between schemes that are wholly-domestic and those that have a cross-border component.[211] The OECD specifically points out the ineffectiveness (in a cross-border context) of disclosure regimes that require reportable schemes to meet a formal threshold condition for disclosure (such as the *main benefit* or *tax avoidance* test) since some cross-border schemes may not meet this threshold if the taxpayer can demonstrate that the value of any domestic tax benefits was incidental when viewed in light of the commercial and foreign tax benefits of the transaction as a whole.[212]

In South Africa section 35(1) of the TAA set out a list of five specific reportable arrangements and section 35(2) sets out arrangements that are reportable if the Commissioner lists the same in a public notice. Section 36(3)(a) and (b) makes it clear that an arrangement is reportable if the main purpose or one of the main purposes of entering into the same is to obtain a tax benefit (i.e. the intention of the taxpayer); or if the arrangement is entered into in a specific manner or form that enhances or will enhance a tax benefit (i.e. even if there is no intention but the result is a tax benefit).

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210 OECD/G20 2015 Final Report on Action 12 in para 227.
211 OECD/G20 2015 Final Report on Action 12 in para 227.
212 OECD/G20 2015 Final Report on Action 12 in para 229.

- Thus both the intention to gain a tax benefit and the result of a tax benefit without intention are taken into consideration; the South African rules are not dependent on the "main purpose to obtain a tax benefit" as the l threshold condition for disclosure. Thus even though a taxpayer can reason that the value of any domestic tax benefits was incidental (not main purpose) when viewed in light of the commercial and foreign tax benefits of the transaction as a whole, the arrangement is still reportable, in light of section 36(b) if it is entered into in a specific manner or form that enhances or will enhance a tax benefit.

The OECD notes that cross-border tax planning schemes are often incorporated into broader commercial transactions such as acquisitions, refinancing or restructuring and they tend to be customised so that they are taxpayer and transaction specific and may not be widely-promoted in the same way as a domestically marketed scheme. Thus generic hallmarks that are primarily focussed at promoted schemes that can be easily replicated and sold to a number of different taxpayers may not be effective in curtailing BEPS.[213] In this regard, the OECD recommends the use of specific hallmarks to target cross-border tax schemes to address particular tax policy or revenue risks in the country. Examples include leasing and income conversion schemes which can apply equally in the domestic and cross-border context.

- Although South Africa has specific hallmarks in section 35(1) of the TAA as well as arrangements listed by the Commissioner by public notice in section 35(2) of the TAA, more international schemes need to be targeted that could cause potential loss of revenue – for example conversion, restructuring, acquisition schemes and other innovative tax planning techniques.
- In targeting more international schemes, cognisance could be taken of the challenge the OECD points out of ensuring that in the design of specific hallmarks, the relevant definition is sufficiently broad to pick up a range of tax planning techniques and narrow enough to avoid over-disclosure. To effectively deal with this challenge the OECD suggests that focus should be placed on *outcomes* that raise concerns from a tax policy perspective rather than the techniques that are used to achieve them (e.g. using the effects-based, approach of the USA that extends the disclosure obligations to "substantially similar" transactions).[214]

The OECD recommends that countries should have a broad definition of "arrangement" that includes offshore tax outcomes. The definition of "arrangement" in section 34 of the TAA states that it "means any transaction, operation, schemes, agreement or understanding (whether enforceable or not". Although this definition does not specifically refer to offshore arrangements, the use of the word "any"

[213] OECD/G20 2015 Final Report on Action 12 in para 230.
[214] OECD/G20 2015 Final Report on Action 12 in para 232.

implies that both domestic and offshore arrangements. Reference to offshore outcomes is also indicated in section 37, which provide that if there is no promoter in relation to the "arrangement" or if the promoter is not a resident, all other "participants' must disclose the information.

- Perhaps to make this offshore implication much more clearly, the legislations should consider re-drafting the definition of an arrangement to specifically state that the word "any" covers both domestic and offshore outcomes.
- The rules that apply to domestic schemes for identifying the promoter and for determining who has the primary disclosure obligation should also apply in the international context.

To ensure there are no undue administrative burdens on domestic taxpayers, disclosure obligations should not be placed on persons that are not subject to tax in the South Africa or on arrangements that have no connection with South Africa. At the same time, disclosure obligations should not be framed in such a way as to encourage a taxpayer to deliberately ignore the offshore aspects of a scheme simply to avoid disclosure.[215]

- Taxpayers should only be required to disclose information that is within their knowledge, possession or control. They can however be expected to obtain information on the operation and effect of an intra-group scheme from other group members. Outside of the group context, a reporting taxpayer should not be required to provide any more information than the taxpayer would be expected to have obtained in the course of ordinary commercial due diligence on a transaction of that nature.[216]

The OECD recommends that information that should be required to be disclosed in respect of domestic schemes should be the same as the information required for cross-border schemes. Such information should include information about the operation of the scheme including key provisions of foreign law relevant to the elements of the disclosed transaction.[217] Where information about the scheme is held offshore and may be subject to confidentiality or other restrictions that prevent it from being made available to the person required to make disclosure then:

- Domestic taxpayers, advisors and intermediaries should only be required to disclose the material information about the scheme that is within their knowledge, possession or control.
- In the case where the person holds only incomplete information about the scheme or is unable to disclose such information, that person should be required to the extent permitted by domestic law to:
    - identify the persons with possession or control of that information; and

215 OECD/G20 2015 Final Report on Action 12 in para 234.
216 OECD/G20 2015 Final Report on Action 12 in para 235.
217 OECD/G20 2015 Final Report on Action 12 in para 253.

- certify that a written request for that information has been sent to such persons. [218]
- SARS can then use this certificate as the basis of an exchange of information request under the relevant double tax treaty or under a Tax Information Exchange Agreement (TIEA) that may have been signed with a country.

The OECD does recommend the use of monetary thresholds set at levels that avoids over-disclosure to filter-out irrelevant or non-material disclosures. [219] In South Africa, Government Gazette No. 39650 issued on 3 February 2016, which lists reportable arrangements and excluded arrangements excludes from the rules any arrangement referred to in s 35(1) of the if the aggregate tax benefit which is or may be derived from that arrangement by all participants to that arrangement does not exceed R5 million.

- It is important that this limit is reviewed regularly taking into consideration cross-border perspectives.

9.6 UNCERTAINTY CONCERNS FOR TAXPAYERS

One of the concerns that taxpayers have had with regard to the reportable arrangements provisions is that one is not always clear when a transaction should be considered reportable.[220] However section 36(3)(a) and (b) makes it clear that an arrangement is reportable if the main purpose or one of the main purposes of entering into the same is to obtain a tax benefit (i.e. the intention of the taxpayer); or if the arrangement is entered into in a specific manner or form that enhances or will enhance a tax benefit (i.e.. even if there is no intention but the result is a tax benefit). Thus both the intention to gain a tax benefit and the result of a tax benefit without intention are taken into consideration.

9.7 CONCERNS ABOUT PROTECTION OF LEGAL PROFESSIONAL PRIVILEGE

In terms of reportable arrangements provisions, the duty to report the arrangement is on a “participant”. As explained in above, a “participant” is defined in s 34 of the TAA to mean:

- a “promoter” (a person who is principally responsible for organising, designing, selling, financing or managing the reportable arrangement;
- or a company or a trust which directly or indirectly derives or assumes that a “tax benefit” or “financial benefit” by virtue of an arrangement.

218 OECD/G20 2015 Final Report on Action 12 in para 236.
219 OECD/G20 2015 Final Report on Action 12 in para 244.
220 Louw & Simpson ‘The Simple Life Before Reportable Arrangement’ at 4.

It is common cause that many “arrangements” that could result in a “tax benefit” are designed by professionals in accounting firms and law firms who devote a lot of effort to generating complex tax shelter products.[221] However, not all tax practitioners are involved in engineering tax-avoidance schemes, many tax advisers participate in mainstream, high profile tax practice.[222] The disclosure provisions in s 37 of the reportable arrangements rules, may require a tax advisor of a taxpayer, who designs an “arrangement” to furnish information and documents in relation to the arrangement to the Commissioner, failure of which may result into penalties under s 212 of the TAA. The concern is that the reportable arrangements rules do not provide for the protection of “legal professional privilege” which is a fundamental common law principle of South Africa’s judicial system.[223] In *S v Safatsa and others,*[224] Botha AJ approved the following views expressed in the Australian case of *Baker v Campbell:*[225]

> “The law came to recognise that for its better functioning it was necessary that there should be freedom of communication between a lawyer and his client for the purpose of giving and receiving legal advice and for the purpose of litigation and that this entailed immunity from disclosure of such communications between them.... it is now established that its justification is to be found in the fact that the proper functioning of our legal system depends upon a freedom of communication between legal advisors and their clients which would not exist if either could be compelled to disclose what passed between them for the purpose of giving or receiving advice.... The restriction of the privilege to the legal profession serves to emphasise that the relationship between a client and his legal advisor has a special significance because it is part of the functioning of the law itself.... The privilege extends beyond communications made for the purpose of litigation to all communications made for the purpose of giving or receiving advice and this extension of the principle makes it inappropriate to regard the doctrine as a mere rule of evidence. It is a doctrine which is based upon the view that confidentiality is necessary for proper functioning of the legal system and not merely the proper conduct of particular litigation.... "

Zeffert [226] notes that “the confidentiality of all documents that have been communicated to legal advisors for the purpose of obtaining legal advice is protected from seizure by the authorities”. Furthermore that: “It is impossible for an advocate or attorney to advise a client properly unless he is confident that the client is holding nothing back, but such candour would be difficult to obtain if the client thought that his advisors could be compelled to reveal everything that he had told them.”[227] It is worth noting that that the Financial Intelligence Centre Act 38 of 2001 (FICA) also

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221 PC Canellos ‘A Tax Practitioner’s Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters’ (2001) 54 *SMU Law Review* at 48.

222 Canellos at 55.

223 Edward Nathan Sonnenbergs Inc ‘Reportable arrangements and legal professional privilege’ *Intergritax* Issue 102 (February 2008). Available at https://www.saica.co.za/Integritax/2008/1602_Reportable_arrangements_and_legal_professional_privilege.htm accessed 6 June 2014.

224 1988(1) SA 938 (A).

225 [1983] HCA 39; (1983) 153 CLR 52.

226 H Zeffert *The South African Law of Evidence* (1988) at 257.

227 Zeffert at 248.

places duties and obligations on accountable institutions (for example an attorney as defined in the Attorney's Act) to furnish certain information and documents to the Centre, however it protects attorney and client privilege. In terms of s 37(2) of the FICA, the restrictions on the duty of secrecy or confidentiality do not apply to the common law right to legal professional privilege between an attorney and the attorney's client in respect of communications made in confidence between:

(a) the attorney and the attorney's client for the purposes of legal advice or litigation which is pending or contemplated or which has commenced; or
(b) a third party and an attorney for the purposes of litigation which is pending or contemplated or has commenced.

In line with the FICA which protects legal professional privilege as between an attorney and the attorney's client,[228] it is recommended that a provision on protection of "legal professional privilege" between a legal advisor and his or her client, should be included in the reportable arrangement's rules. This provision should however not be limited to attorneys and their clients as is the case in the FICA but it should be extended to all legal professionals and their clients. In *Mohamed v President of the Republic of South Africa and others*[229], the court held that legal professional privilege should not be limited to legal practitioners in private practice and their clients but that it should also extend to communications by "in house legal advisors" in their capacities as such. And in *Kommissaris van Binnelandse Inkomste v Van der Heever*[230] the Supreme Court of Appeal confirmed that legal professional privilege also applies where an advocate in the employ of a firm of auditors, gave legal advice to a client.

10 CONCLUSION

Although South Africa appears to be ahead of many G20 countries on mandatory disclosure rules as discussed above, more needs to be done to make these provisions more effective especially in a cross border context.

228 Edward Nathan Sonnenbergs Inc 'Reportable arrangements and legal professional privilege' *Intergritax* Issue 102.

229 (2001) (2) SA 1145 (C).

230 1999) (3) SA 1051 (SCA)

ANNEXURE 11

DAVIS TAX COMMITTEE: SECOND INTERIM REPORT ON BASE EROSION AND PROFIT SHIFTING (BEPS) IN SOUTH AFRICA

SUMMARY OF DTC REPORT ON ACTION 14: MAKE DISPUTE RESOLUTION MECHANISMS MORE EFFECTIVE

The OECD recommends that the introduction of the measures developed to address base erosion and profit shifting pursuant to its 2013 *Action Plan on Base Erosion and Profit Shifting* should not lead to unnecessary uncertainty for compliant taxpayers and to unintended double taxation. Improving dispute resolution mechanisms is therefore an integral component of the work on BEPS issues. Article 25 of the OECD Model Tax Convention provides a Mutual agreement procedure (MAP) mechanism, independent from the ordinary legal remedies available under domestic law, through which the competent authorities of the Contracting States may resolve differences or difficulties regarding the interpretation or application of the Convention on a mutually-agreed basis. MAP is of fundamental importance to the proper application and interpretation of tax treaties, in order to ensure that taxpayers entitled to the benefits of the treaty are not subject to taxation by either of the Contracting States which is not in accordance with the terms of the treaty. Action 14 of the BEPS Action Plan, which deals with making dispute resolution mechanisms effective, aims to strengthen the effectiveness and efficiency of the MAP process. The aim is to minimise the risks of uncertainty and unintended double taxation by ensuring the consistent and proper implementation of tax treaties, including the effective and timely resolution of disputes regarding their interpretation or application through the mutual agreement procedure. Countries have agreed to important changes in their approach to dispute resolution, in particular by:

- having developed a minimum standard with respect to the resolution of treaty-related disputes,
- committed to its rapid implementation and
- agreed to ensure its effective implementation through the establishment of a robust peer-based monitoring mechanism that will report regularly through the Committee on Fiscal Affairs to the G20.

The minimum standard will:

- Ensure that treaty obligations related to the mutual agreement procedure are fully implemented in good faith and that MAP cases are resolved in a timely manner;
- Ensure the implementation of administrative processes that promote the prevention and timely resolution of treaty-related disputes; and
- Ensure that taxpayers can access the MAP when eligible.

The minimum standard is complemented by a set of best practices. The monitoring of the implementation of the minimum standard will be carried out pursuant to detailed terms of reference and an assessment methodology to be developed in the context of the OECD/G20 BEPS Project in 2016. In addition to the commitment to implement the minimum standard by all countries adhering to the outcomes of the BEPS Project, 20 OECD countries have declared their commitment to provide for mandatory binding MAP arbitration in their bilateral tax treaties, as a mechanism to guarantee that treaty-related disputes will be resolved within a specified timeframe. The OECD notes that this represents a major step forward as together these countries were involved in more than 90 percent of outstanding MAP cases at the end of 2013, as reported to the OECD.

RECOMMENDATIONS ON MAP FOR SOUTH AFRICA

For South Africa to determine the approach it will take with respect to Action 14, it has to consider its treaty partners and its stated economic policy to begin a gateway to foreign investment into Africa. MAP has not been very effective among African countries. South Africa has participated in a minimal number of MAP processes, presumably because of taxpayers have not applied for MAP and also due to capacity issues. Even though South Africa has a wide network of double tax treaties it has only 3 treaties which include binding arbitration clauses: These are the treaties with Canada,[1] Netherlands[2] and Switzerland.[3] Nevertheless, MAP is likely to become increasingly important as more treaties are concluded with less developed countries and the process becomes more accessible and reliable. As a developing country, it would be in the interest of South Africa to make use of the UN Guide to MAP under Tax treaties[4] whose primary focus is on the specific needs and concerns of developing countries and countries in transition, and would be instrumental for South Africa to follow in ensuring effective MAP. This UN Guide seeks to provide countries that have little or no experience with MAP with a practical guide to that procedure.[5]

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1 SARS "Convention Between The Republic of South Africa and Canada For The Avoidance of Double Taxation And The Prevention Of Fiscal Evasion With Respect to Taxes on Income" Government Gazette No. 17985, Date of entry into force 30 April 1997.

2 SARS "Convention Between The Republic Of South Africa And The Kingdom Of The Netherlands For The Avoidance Of Double Taxation And The Prevention Of Fiscal Evasion With Respect To Taxes On Income And On Capital" Government Gazette No. 31797, Date of entry into force 28 December 2008.

3 SARS "Convention Between The Republic Of South Africa And The Swiss Confederation For The Avoidance Of Double Taxation With Respect To Taxes On Income" Government Gazette No. 31967, Date of entry into force 27 January 2009

4 UN "Guide to Mutual Agreement Procedure in Tax Treaties" (2012). Available at http://www.un.org/esa/ffd/tax/gmap/Guide_MAP.pdf accessed 16 May 2014.

5 Ibid.

- South Africa should adopt the OECD minimum standards with respect to MAP.
- SARS needs to be more active in supporting South African taxpayers during MAP processes. This is especially so in treaties involving African countries where the MAP process is not developed and is not effectively applied. A critical need in this regard relates to cases where some African countries incorrectly claim source jurisdiction on services (especially management services) rendered abroad and yet those services should be considered to be from a South African source. These countries levy withholding taxes from amounts received by South African residents in respect of services rendered in South Africa. The withholding taxes are sometimes imposed even if a treaty between South Africa and the relevant country does not have an article dealing with management fees or and even if South African residents do not have permanent establishments in these countries. In response to the double taxation concerns that South African taxpayers face and to encourage investors to see South Africa as an attractive headquarter location, National Treasury enacted section 6*quin* which provides a rebate for management fees and technical service fees even though use of MAP in double tax treaties is the right forum that should have been employed to resolve these concerns. However South Africa residents had little success in challenging these matters with the tax authorities of the other countries and yet SARS was also not able to enforce the proper application of the treaties with these countries.[6] Although section 6*quin* ensured that South African taxpayers are not subjected to double taxation,[7] its application implied that South Africa had departed from the tax treaty principles in the OECD MTC in its treaties with the relevant countries, in that it has given them taxing rights over income not sourced in those countries. As a result, South Africa effectively eroded its own tax base as it is obliged to give credit for taxes levied in the paying country. In terms of 2015 Taxation Laws Amendment Act, National Treasury repeal of section 6*quin* from years commencing on or after 1 January 2016.[8] National Treasury explains that South Africa is the only country with a provision (like s 6*quin*) which goes against international tax and tax treaty principles in that it indirectly subsidises countries that do not comply with tax treaties and that it is a compliance burden for SARS. National Treasury also had concerns that some taxpayers were abusing the relief offered by the section. As noted above MAP under tax treaties is the forum that ought to be used to solve such problems. As a member of the African Tax Administration Forum (ATAF) which promotes and facilitates mutual cooperation among African tax administrators), South Africa should strongly advocate for ATAF to ensure that member countries enforce their treaty obligations and ensure that taxpayers can access MAP

6 PWC "Comments on DTC BEPS First Interim Report" (30 March 2015) at 22.
7 Ibid.
8 Section 5 of the Draft Taxation Laws Amendment Bill 2015.

- To ensure the effectiveness of MAP it is important that the performance measures against which officials working on MAP are measured should not be based on factors such as revenue obtained. Such officials should have a different reporting structure to that of the SARS audit team, because of the fact that, in a MAP case, a portion of tax will inevitably be given up by the competent authority. This is highlighted in the OECD Final report on Action 14 which provides that "countries should not use performance indicators for their competent authority functions and staff in charge of MAP processes based on the amount of sustained audit adjustments or maintaining tax revenue".[9]
- To ensure the effectiveness of MAP, when an application for MAP is made, it must be referred to an independent and separate unit that deals with MAP, not to e.g. the transfer pricing audit unit. This is in line with the OECD recommendation on Action 14 which states that "countries should ensure that the staff in charge of MAP processes have the authority to resolve MAP cases in accordance with the terms of the applicable tax treaty, in particular without being dependent on the approval or the direction of the tax administration personnel who made the adjustments at issue or being influenced by considerations of the policy that the country would like to see reflected in future amendments to the treaty."[10]
- Attention should be given to intensive recruitment and robust training of personnel by SARS to deal with MAP issues. This will, in turn, clearly require that funding be made available. A lack of sufficient resources (whether staff, training, funding, etc.) will inevitably result in unsatisfactory outcomes and a backlog of cases due to delays by the competent authority in processing such cases. Outsourcing could possibly be considered as a temporary solution.
- Since most MAP cases deal with transfer pricing matters, it is important for South Africa to include the Article 9(2) secondary adjustment in those tax treaties where it has not yet been included.
- Advance pricing agreements (APAs) lessen the likelihood of transfer pricing disputes. Lack of an APA program in South Africa is an inhibitor to foreign direct investment as it removes the opportunity to seek certainty on transactional pricing, particularly when Multinationals expand into the rest of Africa. It is acknowledged that there are scarce resources within the transfer pricing arena to enable a separate and independent unit to deal with APA's. A possible temporary measure could be to outsource this to recognised experts with oversight by senior SARS officials. When APA are adopted, consideration should be given to the possibility of combining MAP proceedings for a recurring transfer pricing issue with a bilateral APA with rollback. This would be in line with the OECD recommendation that "countries with bilateral advance pricing arrangement (APA) programmes should provide for the roll-back of APAs in appropriate cases, subject to the applicable time

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9 OECD/G20 2015 Final Report on Action 14 in para 28.
10 OECD/G20 2015 Final Report on Action 14 in para 27.

limits (such as statutes of limitation for assessment) where the relevant facts and circumstances in the earlier tax years are the same and subject to the verification of these facts and circumstances on audit".[11]

- SARS should not influence taxpayers to waive the right to MAP nor should taxpayers be prohibited, as part of settlement negotiations, from escalating the portion of tax suffered to the competent authority for relief from double taxation. This would amount to a unilateral decision, without due regard to the spirit of the double tax treaties or the treaty partner.
- Although South Africa has guidelines and regulations on domestic dispute resolution and litigation, there is no guidance on how to resolve disputes through the treaties. There is confusion as to how SARS approaches this, who the appropriate competent authority is in this regard and how the process should be followed. For instance some countries will suspend domestic resolution processes pending the outcome of a MAP appeal whereas other countries require the domestic remedies to be exhausted before entertaining a MAP appeal. Clear guidance on when SARS will entertain MAP needs to be given together with an appropriate process guide for taxpayers similar to the guide issued for domestic resolution. Such guidance should be clear and transparent, not unduly complex and appropriate measures should be taken to make such guidance available to taxpayers. The Guidance should contain information such as:
  - When will MAP be applied;
  - Applicable time limits in which a taxpayer can approach the Competent Authority;
  - Who the Competent Authority is;
  - What documents are required to be submitted with any application for MAP;
  - Interaction of MAP with domestic legislation;
  - Estimated timelines; and
  - Liabilities of the Competent Authority.
- Since most MAP disputes concern transfer pricing, it is important that SARS Interpretation Note on Transfer Pricing is finalised. Clear guidance should also be provided with respect to thin capitalisation rules. Other MAP disputes relating to controlled foreign company rules (CFC) and interest deductibility could be prevented by simplifying the complex CFC rules and the interest deductibility provisions.
- The current audit procedure in South Africa includes two aspects of an enquiry, a risk assessment process which is to determine whether an audit is warranted, and a full audit process. The roles and responsibilities of these two are becoming blurred in certain circumstances, which places the taxpayer in a position of uncertainty as to whether the matter is under audit or not. The respective roles and responsibilities therefore need clarifying and SARS

[11] OECD/G20 2015 Final Report on Action 14 in para 33.

should be required to inform the taxpayer as to whether their matter is under audit or not. Further the audit process often creates problems for taxpayers in that SARS often requires extremely detailed information from a taxpayer, in a relatively short period of time, without any timeline or time commitment being placed on SARS to respond resulting in an unreasonably long time passing, this needs to be addressed through better audit governance measures.

- The timing for applying for MAP needs to be clarified. Under Article 25(1) of the OECD UN MTC where a person considers that the actions of one or both contracting states results or will result in taxation that is not accordance with the provisions of the treaty, that person may irrespective of any remedies available under domestic law, present his case to the competent authorities of the contracting states in which he is resident (or the state in which he is a national). The case has to be brought to the attention of the competent authorities within three years from the first notification that the relevant tax is not in accordance with the provisions of the treaty. In South Africa, the timing is not clear and it appears that that the domestic rules govern the process and acceptance of such applications. It is understood that with scarce resources it would be inefficient to entertain a domestic appeal and competent authority application simultaneously. SARS needs to clarify the time when it will entertain a competent authority application, that is, whether it is once the taxpayer's objection has been disallowed, or at the same time as the appeal. This needs to be clarified in some form of binding, written communication. In this regard, it is recommended that SARS keeps to the time limit as is recommended in the OECD Commentary on Article 25(1). Further, to the extent the domestic appeal is suspended pending the outcome of the MAP, this should be clearly stated in the guidance, together with advice on payment suspension.
- In relation to the "Pay now, argue later" principle as applied by the SARS, if a MAP matter takes years before being resolved, SARS should be cognisant of the fact that not permitting the suspension of payment pending the outcome of MAP can be extremely detrimental to the taxpayer. The OECD recommended best practice on Action 14 to ensure taxpayers can access MAP, is that countries should take appropriate measures to provide for a suspension of collections procedures during the period a MAP case is pending. Such a suspension of collections should be available, at a minimum, under the same conditions as apply to a person pursuing a domestic administrative or judicial remedy.[12] This recommendation should be followed in South Africa.
- Many developing countries, do not consider themselves yet ready for mandatory binding arbitration in the international taxation context. India and Brazil made it clear in the BEPS discussions on the matter that they would not

[12] OECD/G20 2015 Final Report on Action 14 in para 50.

be involved in binding mandatory arbitration.[13] Developing countries are very wary of adopting binding arbitration provisions in their tax treaties, since normally in arbitration cases the winning country gets the tax revenue and the other loses. Mandatory binding arbitration is considered unfair since it entails entrusting decisions involving often millions of dollars to a secret and unaccountable procedure of third party adjudication. Developing countries hold the view that arbitration can only be effective and accepted if the rules to be applied are clear, and if the procedures are open and transparent, including the publication of reasoned decisions. As a developing country, these matters should be of concern to South Africa too. For that matter, South Africa should call for measures to be in place to make the arbitration process more transparent and it should only commit to the process if the rules are clear and transparent. Until the MAP arbitration process is made more transparent, South Africa should also be cautious about committing to an arbitration provision in the envisaged Multilateral Instrument under Action 15 of the OECD BEPS Action Plan. If South African becomes a party to the Multilateral Instrument, it should register a reservation not to commit to mandatory arbitration until the concerns regarding this process are rectified.

- Since mandatory arbitration is viewed by the OECD and taxpayers as a means of speedily resolving MAP, South Africa should call for international measures to be put in place to ensure transparency in the arbitration procedures:
  - South Africa should join the call for an international panel of arbitrators, for instance under the auspicious of the United Nations to be formed that comprises a panel of members from both developing and developed countries. Decisions of such a panel would be considered neutral and fair to the interests of all countries.
  - At regional level, South Africa should recommend that a pool of arbitrators be formed, with the necessary skills and qualifications, from among ATAF member countries. The ATAF member countries could then draw on arbitrators from that pool in cases where the MAP was between two ATAF-member countries. We note in this regard that a similar idea is successfully implemented under the EU Arbitration Convention, which pool comprises a pool of arbitrators appointed from EU member states.
  - South Africa should call for MAP results and agreements reached (even the "anonymised" versions) to be published annually, which could be in redacted manner (removing aspects that could raise confidentiality concerns) – this will provide further guidance and proactively resolve other potential future disputes.
  - Exchange of existing best practices between SARS and other revenue authorities should be strongly encouraged. South Africa should in

13 UN Committee of Experts on International Cooperation in Tax Matters "Secretariat Paper on Alternative Dispute Resolution in Taxation" (8 October 2015) in para 21.

particular adopt the OECD recommendation regarding Best Practice 1 (inclusion of Article 9(2) in its tax treaties); Best Practice 2 (adopt appropriate procedures to publish MAP agreements reached); Best Practice 5 (implement procedures that permit, after an initial tax assessment, taxpayer requests for the multiyear resolution through the MAP of recurring issues with respect to filed tax years, where the relevant facts and circumstances are the same); Best practice 6 (take appropriate measures to provide for a suspension of collections procedures during the period a MAP case is pending); Best Practice 7 (take appropriate measures to provide for a suspension of collections procedures during the period a MAP case is pending); Best Practice 8 (published MAP guidance explaining the relationship between the MAP and domestic law administrative and judicial remedies); Best Practice 9 (publish MAP Guidance which provides that taxpayers will be allowed access to the MAP where double taxation arises in the case of bona fide taxpayer-initiated foreign adjustments permitted under the domestic laws of a treaty partner); Best Practice 10 (publish guidance on the consideration of interest and penalties in the MAP).

DTC REPORT ON ACTION 14: MAKE DISPUTE RESOLUTION MECHANISMS MORE EFFECTIVE

Table of Contents

1 INTRODUCTION

Where disputes arise between taxpayers and the revenue authority, such disputes are usually resolved through the judicial and administrative remedies provided by the domestic law of the country. The judicial remedies involve resolution of tax disputes through the country's court system. Due to the complexities and amounts of monies involved, tax cases are also often settled out of court.

When a country enters into a double taxation treaty with another country, often the treaty becomes part of the domestic tax law of that country.[1] This implies that disputes that arise in a treaty context can also be resolved through the county's court system. However a taxpayer may find that a resolution of the dispute under the domestic court system may not be satisfactory due to the international nature of the dispute.

Since there is no international court to deal with disputes that could arise from tax treaties; resolution of such disputes is normally provided for under the Mutual Administration Procedure (MAP) as set out in Article 25 of relevant treaties that are based on the OECD or the UN MTC. In terms of Article 25(1), MAP is in principle available to the taxpayers in addition to their normal legal (judicial and administrative) remedies provided by the domestic law of the Contracting States. Because the constitutions and/or domestic law of many countries provide that no person can be deprived of the judicial remedies available under domestic law, a taxpayer's choice of recourse is generally only constrained by applicable time limits (such as those provided by a domestic law statute of limitation or by Article 25(1)) discussed below. There could also be constraints in circumstance where tax administrations will not deal with a taxpayer's case through both the MAP and a domestic court or administrative proceeding at the same time (*i.e.* one process will typically take precedence over the other).[2]

The MAP is administered by the "competent authorities" who are generally those named under Article 3(f) of the treaties based on the OECD MTC. Article 25 of both the OECD and UN MTC requires the competent authorities of the contracting States

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1 In South Africa for instance, section 231(2) of the Constitution of the Republic of South Africa, 1996; read together with section 108(1) of the Income Tax Act 58 of 1962, provide that as soon as the double tax agreement is ratified and has been published in the *Government Gazette*, its provisions are effective as if they had been incorporated into the Income Tax Act. See A.W. Oguttu, *Curbing 'Treaty Shopping': The 'Beneficial Ownership' Provision Analysed from a South African Perspective* XL *CILSA* (2007) at 252.

2 OECD/G20 2015 Final Report on Action 14 in para 51.

to settle “questions relating to the interpretation and application of the Convention”[3] and resolve “difficulties arising out of the application of the Convention in the broadest sense of the term.”[4] This includes procedural aspects of the application of the provisions of the treaty.

2 THE MUTUAL AGREEMENT PROCEDURE

Article 25(1) of the OECD Model Tax Convention (MTC) provides that where a person considers that the actions of one or both contracting states results or will result in taxation that is not accordance with the provisions of the treaty, that person may irrespective of any remedies available under domestic law, present his case to the competent authorities of the contracting states in which he is resident (or the state in which he is a national).

The competent authority shall endeavour, if the objection appears to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States. The case has to be brought to the attention of the competent authorities within three years from the first notification that the relevant tax is not in accordance with the provisions of the treaty. The Commentary on the OECD explains that the three year time limit is intended to protect administrations against late objections. The time limit must be regarded as the minimum so that the contracting states can agree on longer periods in the interest of the taxpayer.[5]

Article 25(2) provides that where the aggrieved person presents an objection before the competent authorities of the state in which he is resident, and the matter appears to be justified, that competent authority shall endeavour to resolve the matter. Where it cannot arrive at a satisfactory solution by itself, the matter can be resolved by mutual agreement with the competent authority of the other contacting state. In instances where domestic law could hinder the effectiveness of the MAP through domestic law time limits that may prevent a tax assessment being amended in favour of the taxpayer,[6] Article 25(2) seeks to overcome this difficulty by providing that any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the contracting states. Thus MAP provides a treaty dispute resolution mechanism irrespective of any remedies available under domestic rules.

[3] Paragraph 2 of the Commentary on Article 25 of the UN MTC.
[4] Paragraph 1 of the Commentary on Article 25 of the OECD MTC.
[5] Paragraph 20 of the Commentary on article 25 of the both the OECD and UN MTC
[6] United Nations, *Administration of Double Tax Treaties* at 167.

Article 25(3) provides that the competent authorities may consult each other to resolve by mutual agreement any difficulties or doubts that arising from the interpretation or application of the treaty. They may also consult together to eliminate any double taxation cases not provided for in the treaty. In terms of Article 25(4), joint commissions consisting of themselves or their representatives could also be utilised.

A factor that has been a major hindrance in the past to the effectiveness of MAP internationally has been the lack of a requirement for the competent authorities to reach agreement.[7] A conclusion could only be reached if both parties come to an agreement through their consultations. Article 25 did not provide for a mechanism of dealing with cases where no agreement is reached. This led to long procedures and a backlog of unresolved issues.

2.1 ARBITRATION UNDER THE MAP PROCEDURE

In 2004 the OECD issued a report on "Improving the Process for Resolving International Tax Disputes"[8] which proposed the development of a binding arbitration process to resolve disagreements arising in the course of a MAP case. This culminated in the inclusion of an arbitration clause in the MAP procedure, which is covered under article 25(5) of both the OECD and UN MTCs.[9] Article 25(5) of the OECD MTC states that

> Where,
>
> a) under paragraph 1, a person has presented a case to the competent authority of a Contracting State on the basis that the actions of one or both of the Contracting States have resulted for that person in taxation not in accordance with the provisions of this Convention, and
> b) the competent authorities are unable to reach an agreement to resolve that case pursuant to paragraph 2 within two years from the presentation of the case to the competent authority of the other Contracting State,
> c) any unresolved issues arising from the case shall be submitted to arbitration if the person so requests. These unresolved issues shall not, however, be submitted to arbitration if a decision on these issues has already been rendered by a court or administrative tribunal of either State. Unless a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision, that decision shall be binding on both Contracting States and shall be implemented notwithstanding any time limits in the domestic laws of these States. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this paragraph."

To improve the legal protection of their taxpayers a number of countries have re-negotiated their older treaties and have added arbitration clauses. Such treaties contain a provision which either requires the contracting states, or offers them the

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7 United Nations, *Administration of Double Tax Treaties* at 167.

8 OECD on *Improving the Process for Resolving International Tax Disputes* (2004). Available at: http://www.oecd.org/tax/treaties/33629447.pdf. The 2004 Report included 31 proposals to improve the resolution of tax treaty disputes through the MAP.

9 United Nations, *Administration of Double Tax Treaties* at 169.

opportunity, to enter into a binding arbitration process. There may or may not be a time limit whereby if agreement has not been reached, the arbitration process is triggered. The 2008 version of the OECD MTC puts this at two years.[10]

It should be noted though, that the majority of the treaties concluded by OECD member countries since 2008, do not contain an Article 25(5) arbitration provision.[11] Some of the reasons for this could be because of a footnote to the commentary on Article 25(5) which states that due to the difficulties in some countries regarding the interrelationship between MAP decisions and domestic court decisions, countries are free to exclude arbitration from their treaties. The footnotes states:

> "in some States, national law, policy or administrative considerations may not allow or justify the type of dispute resolution envisaged under this paragraph. In addition, some States may only wish to include this paragraph in treaties with certain States. For these reasons, the paragraph should only be included in the Convention where each State concludes that it would be appropriate to do so. However, other States may be able to agree to remove from the paragraph the condition that issues may not be submitted to arbitration if a decision on these issues has already been rendered by one of their courts or administrative tribunals".

The other matter is that although some countries' domestic law may give effect to MAP decisions even if they are contrary to domestic court decisions, in other countries, domestic law does not permit the MAP decision to override a court decision; which may make such states incapable of effectively implementing arbitration.[12] Paragraph 65 of the Commentary on Article 25 explains that:

> "It is recognised, however, that in some States, national law, policy or administrative considerations may not allow or justify the type of arbitration process provided for in the paragraph. For example, there may be constitutional barriers preventing arbitrators from deciding tax issues. In addition, some countries may only be in a position to include this paragraph in treaties with particular States. For these reasons, the paragraph should only be included in the Convention where each State concludes that the process is capable of effective implementation".

The OECD recommends that even where Contracting States have not included an arbitration clause in their Convention, it is still possible for them to do so (if they so wish) to implement an arbitration process for general application or to deal with a specific case, by mutual agreement.[13]

2.2 THE PROCEDURE FOR ARBITRATION

Paragraph 68 of the Commentary on Article 25(5) states that the taxpayer can request arbitration of unresolved issues in all cases dealt with under MAP on the

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[10] Angharad Miller and Lynne Oats *Principles of International Taxation* 4th edition (2014) in chapter 7

[11] OECD "Tax Conventions and Related Questions: Obstacles That Prevent Countries From Resolving Treaty Related Disputes Under the Mutual Agreement Procedure" in para 31.

[12] Para 9 of the Commentary on art 25 of the OECD MTC reproduced in para 9 of the Commentary on Article 25 of the UN MTC.

[13] Paragrah 69 of the Commentary on article 25(5) of the OECD MTC.

basis that the actions of one or both of the Contracting States have resulted in taxation not in accordance with the treaty. In terms of paragraph 63 of the Commentary on Article 25(5), the arbitration process is not dependent on a prior authorization by the competent authorities: once the requisite procedural requirements have been met, the unresolved issues that prevent the conclusion of a MAP must be submitted to arbitration. Recourse to arbitration is not automatic; the person who presented the case may prefer to wait beyond the end of the two-year period, for example, to allow the competent authorities more time to resolve the case under article 25(2).[14]

The OECD MTC sets out a "Sample Mutual Agreement on Arbitration", in terms of which:[15] an aggrieved taxpayer must make "request for arbitration" in writing regarding the unresolved issues arising from a mutual agreement case and send the same to one of the competent authorities accompanied by a written statement that no decision on the case has been rendered by a court or administrative tribunal of the States. Within 10 days of the receipt of the request, the competent authority who received it shall send a copy of the request and the accompanying statements to the other competent authority. [16] Within three months after the request for arbitration from the taxpayer has been received by both competent authorities, the competent authorities shall agree on the questions to be resolved by the arbitration panel and communicate them in writing to the person who made the request for arbitration. This is what constitutes the "Terms of Reference" for the case.[17] There after each of the competent authorities appoints one arbitrator. Within two months of the latter appointment, the appointed arbitrators are expected to appoint a third arbitrator who functions as the Chair, and makes the final decision. If any appointment is not made within the required time period, the arbitrator(s) not yet appointed have to be appointed by the Director of the OECD Centre for Tax Policy and Administration within 10 days of receiving a request to that effect from the person who made the request for arbitration.[18] Any person, including a government official of a Contracting State, may be appointed as an arbitrator, unless that person has been involved in prior stages of the case that results in the arbitration process.[19]

2.3 THE ARBITRATION DECISION

The arbitration panel does not itself formally dispose of the issue. Instead, the Competent Authorities are obliged under the treaty to dispose of the issue in conformity with the arbitration panel's decision. The decision is usually based on a

14 Par 70 of the Commentary on article 25(5) of the OECD MTC.
15 OECD *Sample Mutual Agreement on Arbitration* in the commentary on article 25 of the OECD MTC par 1.
16 Ibid.
17 OECD, *Sample Mutual Agreement on Arbitration* supra n 86 par 3.
18 OECD, *Sample Mutual Agreement on Arbitration* supra n 86 para 5.
19 OECD, *Sample Mutual Agreement on Arbitration* supra n 86 par 7.

reasoned opinion based on the arbitration panel assessment with the intention of a cohesive approach to treaty interpretation.

Since the treaty is an agreement between the contracting states, the arbitration decision is binding on both contracting states and shall be implemented notwithstanding the time limits in the domestic laws of the contracting states. The decision is final with no possibility for review or appeal by any board. This matter has been a major source of concern and a reason for some governments' general reluctance towards arbitration. This is unlike the case of bilateral investment agreements where arbitration proceedings are subject to scrutiny for example by the International Court of Arbitration.[20]

The decision of the MAP arbitration panel is however not necessarily binding on the aggrieved person who can still approach the domestic courts to settle the issue.[21] It should be noted that where the arbitrators jointly agree on a different solution, the UN Model also allows the Competent Authorities to depart from the arbitral award within 6 months after it is rendered. This is not possible under the OECD Model where the Competent Authorities are bound to implement the arbitral award.[22]

2.4 FORMS OF ARBITRATION DECISIONS

As indicated above, the generally applicable rule is that the arbitrators must give a reasoned opinion for their decision. Under the OECD Sample Mutual Agreement on Arbitration, this reasoned approach is the default approach. However both the OECD and the UN Sample Mutual Agreements on Arbitration, allow the use of "short form" arbitration. Basically under the "short form" approach, to avoid costs of arbitration and to speed up the process, each competent authority submits an offer to settle the dispute (its desired result) and the arbitrator simply picks one or the other of the two options without any reasoned opinion justifying the result. [23] The arbitrators are given only a limited time to make the decision - the one which is considered more in accordance with the treaty. The arbitrators do not give a fully written explanation of the decision but only "short reasons" explaining the choice, and the outcome is not made public.[24]

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20 http://www.iccwbo.org/products-and-services/arbitration-and-adr/arbitration/icc-arbitration-process/award-and-award-scrutiny/

21 Oliver and Honiball *International Tax*, p. 475.

22 Compare Article 25.5 (Alternative B) UN Model with Article 25 OECD Model. In both Models, the taxpayer affected by the decision may reject the decision also.

23 UN "Handbook on Selected Issues in Administration of Tax treaties for Developing Countries" (2013) at 331.

24 Paragraph 6 of the UN Sample Agreement – see Annex to the Commentary on Article 25 (5) (alternative B) of the United Nations Model Convention

In the UN Sample Mutual Agreement on Arbitration, “short form” arbitration is the default or basic arbitration approach applied.[25] The United Nations Committee of Experts on International Cooperation in Tax Matters selected this approach as it is quicker and less costly. However, the Terms of Reference may allow the competent authorities to select an “independent opinion” if they wish. The “independent opinion” approach has the advantage of providing a fuller explanation of the decision and gives the possibility for the decision being a guide to the settlement of future cases involving the same issue. If an independent opinion approach is taken, it would is possible, with the approval of both the competent authorities and the taxpayer to publish a redacted version of the decision, which would help to resolve similar cases in the future. [26]

2.5 CONCERNS ABOUT TAX ARBITRAL PROCEEDINGS

2.5.1 CONFIDENTIALITY OF TAX ARBITRAL PROCEEDINGS

Tax arbitral proceedings are currently confidential and so there are no publicly available outcomes to MAP. The secrecy of the MAP is based on the fact that businesses do not want to make their tax strategies public and that confidential proceedings allow for more flexibility for achieving a mutually acceptable result between governments without any external influences. The secrecy of MAP makes it difficult to draw from the experience or to monitor the fairness and effectiveness of the arbitration systemically. The emphasis on confidentiality over transparency is a concern for many countries as it makes it difficult to develop confidence in the system since taxpayers cannot ascertain if the same decision would be applied in other similar cases. This mechanism is a far cry from the clear procedure for arbitration under the World Trade Organisation (WTO), where there are institutional provisions in place to assist developing countries in cases involving them[27] and to ensure consistency in approaches of panels,[28] as well as an appeal system to an Appellate Body.[29] The other concern is that the OECD Model provides limited guidance in the selection of an arbitrator whereas arbitration under the WTO, provides a list of arbitrators who are appointed according to certain criteria. The list

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25 Paragraph 6 of the UN Sample Agreement – see Annex to the Commentary on Article 25 (5) (alternative B) of the United Nations Model Convention

26 UN “Handbook on Selected Issues in Administration of Tax treaties for Developing Countries” (2013) at 336.

27 WTO “Developing Countries in WTO Dispute Settlement”. Available at https://www.wto.org/english/tratop_e/dispu_e/disp_settlement_cbt_e/c11s2p2_e.htm accessed 21 October 2015.

28 WTO “The Panels”. Available at https://www.wto.org/english/tratop_e/dispu_e/disp_settlement_cbt_e/c3s3p1_e.htm accessed 21 October 2015.

29 WTO “The Appellate Body”. Available at https://www.wto.org/english/tratop_e/dispu_e/disp_settlement_cbt_e/c3s4p1_e.htm accessed 21 October 2015.

of arbitrators often includes information about the number of times an arbitrator has served in other disputes and the countries involved.

2.5.2 LACK OF EXPERIENCE

Many countries having limited experience with mutual agreement procedures could have difficulties to determine the consequences of adding arbitration in a mutual agreement procedure. The lack of expertise in many developing countries with mutual agreement procedures implies that arbitration would be unfair to them when the dispute occurs with more experienced countries.

For a country to expect a positive result out of MAP, it ought to have signed a tax treaty that protects its interest. The ability to negotiate favourable provisions depends a lot on the treaty negotiating power of the relevant country. In general, developed countries are better skilled in negotiating tax treaties than developing countries.[30] Because in treaty negotiations with developed countries the powers are not balanced and developing countries tend to be price takers, they tend to negotiate treaty provisions that are not in their favour but rather reflect the position of the other contracting state.[31] The interests of countries, which are already in the balance in their tax treaties cannot be safeguarded by private arbitrators; nor can arbitrators be expected to make up for the lack of expertise in many developing countries.

2.5.3 NEUTRALITY OF AND EXPERIENCE OF ARBITRATORS

MAP does not guarantee the neutrality and independence of arbitrators. There are very experienced arbitrators, most of whom are from developed countries who may not be considered impartial if the case involves their own country.

2.5.4 CONCERNS ABOUT TAX SOVEREIGNTY

There are also concerns that mandatory binding arbitration impacts on “tax sovereignty”. Countries are generally considered to be sovereign in their tax affairs. When countries sign tax treaties to prevent double taxation, their tax sovereignty may be limited by the treaty distributive rules that allocate taxing rights to tax the relevant income to either residence or source states. Committing to arbitration is often considered as going beyond what the treaty intended, since it requires the countries to agree to a panel of arbitrators who may be civil servants of the contracting states that are given wide discretionary powers to resolve a treaty matter.

30 PWC, EuropeAID ‘Implementing the Tax and Development Policy Agenda: Final Report on Transfer Pricing and Developing Countries’ (2011) at 21.

31 Festus Akunobela “The Relevance of the OECD and UN Model Conventions and their Commentaries for the interpretation of Ugandan Tax Treaties “ p 1089, Chapter 35 in M Lang, P Pistone, J Schuch and C Staringer *The Impact of the OECD and UN Model Tax Conventions on Bilateral Tax Treaties* (Cambridge University Press, 2012) at 1075.

Giving too much power to individuals who are third parties to decide treaty matters, without the possibility of review or challenging such decisions would impact on the states sovereignty.

2.5.5 THE COSTS OF ARBITRATION

The other reason why countries are hesitant towards arbitration is that it can also be very costly. Costs can include: costs of hiring arbitrators, facilities, hiring external advisors and counsel; costs of setting up meetings for arbitration proceedings; travelling; as well as costs for translating and preparing documents. Countries are also expected to pay their share of the salaries of arbitrators, the organization costs for the tribunal as well as the costs of representation. If there is unfamiliarity with arbitration some outside expertise might need to be brought in as well.

It is important that cost issues do not distort outcomes under the MAP against those countries least able to bear them. There is a concern that Competent Authorities from developing countries, especially the least developed, might effectively be "forced" to agree to an outcome proposed by the other Competent Authorities involved in the MAP not because they are convinced of the arguments put, but to avoid further arbitration costs. Such a situation would put to question the validity of the arbitration process, since the economic power of the relevant countries would influence the outcome of the arbitration case.

2.5.6 CONCERNS ABOUT "SHORT FORM ARBITRATION"

As explained above, a MAP decision is ideally using the approach of a reasoned decision. This approach has the advantage of providing a fuller explanation of the decision and gives the possibility for the decision being a guide to the settlement of future cases involving the same issue.[32]

The MTCs however allow the use of short form arbitration (as an alternative approach under the OECD MTC and as the main approach in the UN MTC). However, there are concerns about the short form or "baseball arbitration", [33] in terms of which, to avoid costs of arbitration and to speed up the process, the competent authorities just submit an offer to settle the dispute and the arbitrator or panel of arbitrators is allowed to choose between the two proposals - the one which is considered more in accordance with the treaty. In this form of arbitration there is generally no reasoned written decision required, and the outcome is not made public, thus causing transparency concerns. In such arbitrations cases the winning country gets the tax revenue and the other loses. This can be exemplified by the

[32] UN "Handbook on Selected Issues in Administration of Tax treaties for Developing Countries" (2013) at 336.

[33] This type of procedure is sometimes known as baseball arbitration, due to the fact that the salaries of US major league baseball players have been negotiated in this manner.

situation between the USA and Canada, in which the US Internal Revenue Service has won three of the binding arbitration decisions and Canada none.[34] Since some transfer pricing cases have billions of dollars of tax at stake, countries are concerned at the loss of revenue based on such decisions. Although the short form arbitration can offer more certainty of speedy and cost effective resolution in a particular case, it does not necessarily lead to an outcome that is in accordance with the treaty as it only allows the arbitrators to choose between one of the solutions submitted. The secrecy involved, fosters legal uncertainty as the decisions are not reasoned or published anywhere. There are concerns that decisions reached may favour those with the most experience in putting a compelling and professional looking argument over those with better underlying arguments that are nevertheless not as well presented.

3 VIEWS ON MAP GENERALLY

The above factors have affected the effectiveness of MAP in resolving treaty disputes. Treaties are designed to prevent double taxation, and many have an article for MAP for resolving issues around double taxation. But law and treaties only pronounce principles. The practical prevention of double taxation is in the hands of individual auditors and revenue administrations that decide the extent to which they wish to enforce the policies and arbitration clauses in the treaties.[35] Even the best designed laws and regulations can't prevent double taxation without effective means of dispute resolution. The issue with double taxation is not how the laws are written but how they are enforced by various governments.[36] Laws and bilateral treaties alone cannot prevent double taxation. The lack of effective means of dispute resolution is where multilateral efforts appear to be breaking down.[37]

According to the OECD statistics, the MAP caseload is rising exponentially.[38] In response, the OECD formed the Mutual Agreement Procedures Forum (MAP Forum)[39] - a meeting of competent authorities from 25 countries, which focuses on empowering competent authorities to ensure they have adequate resources, and to provide oversight over the individuals negotiating the settlements under the MAP.[40]

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[34] P Temple-West, Reuters "International Arbitration for Tax Disputes, "Baseball" Style". Available at http://www.reuters.com/article/2012/11/25/us-usa-tax-arbitration-idUSBRE8AO06T20121125 accessed 26 march 2015.

[35] M Herzfeld "Beyond BEPS: The Problem of Double Taxation" *Tax Analyst* 10 February 2014 at 1.

[36] Ibid.

[37] Ibid.

[38] OECD "Mutual Agreement Procedure Statistics" (2012). Available at http://www.oecd.org/ctp/dispute/mapstatistics2012.htm.

[39] OECD Forum on Tax Administration "Mutual Agreement Procedure Forum". Available at hyyp://www.oecd.org/site/ctpfta/ftaworkprogramme201213.htm

[40] M Herzfeld "Beyond BEPS: The Problem of Double Taxation" Tax Analyst (10 February 2014) at 1.

4 PREVIOUS OECD WORK ON MAP

The OECD has over the years carried out some work to ensure the effectiveness of MAP.

- On 27 July 2004, the OECD Committee on Fiscal Affairs released a progress report on its work on improving the resolution of cross-border tax disputes. The report was titled "*Improving the Process for Resolving International Tax Disputes*".
- On 1 February 2005, the OECD came up with "*Proposals for Improving Mechanisms for the Resolution of Tax Treaty Disputes*" was released as a public discussion draft. It included various draft changes to the OECD Model Tax Convention, dealing primarily with the addition of an arbitration process to solve disagreements arising in the course of a mutual agreement procedure, as well as a proposal for developing an online Manual on Effective Mutual Agreement Procedure[41]
- On 30 January 2007, the OECD issued a report on "Improving the resolution of tax treaty disputes"
- In 2007 the OECD developed a "Manual on effective Mutual Agreement Procedures" ("MEMAP") which contains basic information on the operation of MAP and best practices of MAP.
- In the 2012 OECD Report on dispute resolution, [42] the OECD noted that many of the obstacles to an effective MAP are of a procedural, practical or administrative nature, relating to issues such as lack of resource, empowerment of competent authorities to reach principled case resolutions and the development of competent authority relationships based on mutual trust.
- At the January 2012 OECD Roundtable on Dispute Resolution[43] practitioners raised the question of impediments to access the MAP, the ineffectiveness of the MAP in multilateral cases, the limited number of arbitration provisions included in tax treaties and MAP procedural issues.[44] The OECD recognised that effective and efficient dispute resolution mechanisms are of crucial importance for the functioning of tax treaties and that in the current international environment improving the functioning of MAP procedures, including through inclusion of arbitration as an ultimate remedy, has gained importance and urgency.[45]

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41 OECD Report: Improving the resolution of tax treaty disputes".

42 OECD Working Party 1 'Tax Conventions and Related Questions: Obstacles That Prevent Countries From Resolving Treaty Related Disputes Under the Mutual Agreement Procedure' (16 September 2013) para 16.

43 OECD "Obstacles That Prevent Countries From Resolving Treaty Related Disputes" para 7.

44 OECD "Obstacles That Prevent Countries From Resolving Treaty Related Disputes" in para 7.

45 OECD "Obstacles That Prevent Countries From Resolving Treaty Related Disputes" in para 9.

5 OECD 2013 BEPS REPORT: ACTION 14

In July 2013 OECD published its “Action Plan on Base Erosion and Profit shifting”, containing 15 Action Points. In Action Point 14: “Make dispute resolution mechanisms more effective,” the OECD noted that actions to counter BEPS must be complemented with actions to improving the effectiveness of MAP so as to ensure certainty and predictability for business.[46] Action 14 recognises that the BEPS project will change the face of international taxation. Currently multinational enterprises are not only protected from double taxation by tax treaties, but they can also design their own strategy to prevent double taxation and can even realise low or no taxation through careful tax planning, by manipulating gaps in the domestic tax systems of the tax jurisdictions in which they are involved. When these strategies are dismantled through the introduction of BEPS measures, the pressure on tax treaties to resolve double taxation will rise. Since it is difficult, if not impossible, to design rules that are open to only one interpretation, it is very likely that the pressure on the dispute resolution mechanisms that are included in tax treaties will grow significantly.[47]

Action 14 of the 2013 OECD BEPS report called on countries to:

- make dispute resolution mechanisms more effective;
- develop solutions to address obstacles that prevent countries from solving treaty-related disputes under MAP; such include:
  - the absence of arbitration provisions in most treaties; and
  - the fact that access to MAP and arbitration may be denied in certain cases.[48]

Under Action 14, the OECD undertook to work on developing solutions that address obstacles and prevent countries from solving treaty-related disputes under the MAP. It also considered supplementing the existing MAP provisions in tax treaties with a mandatory and binding arbitration provision. [49]

BEPS Action Plan Action 14 aims to improve treaty-related dispute resolution under MAPs, including the absence of arbitration provisions in most treaties and the denial of access to MAPs and arbitration in some cases. If the business community does not publicly support Action 14, the resulting double taxation problems arising from a lack of multilateral coordination on enforcement of cross-border disputes could make current concerns over stateless income appear insignificant.[50]

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46 OECD “Action Plan on Base Erosion and Profit Shifting” (2013) at 23

47 OECD “Obstacles That Prevent Countries from Resolving Treaty Related Disputes” in para 6.

48 OECD “Action Plan on Base Erosion and Profit Shifting” (2013) at 23.

49 OECD “Action Plan on Base Erosion and Profit Shifting” (2013) at 24.

50 Ibid.

5.1 FACTORS IDENTIFIED BY THE OECD THAT PRESENT OBSTACLES TO MAP

In September 2013, OECD Working Party 1 released a report on "Obstacles that Prevent Countries from Resolving Treaty-related Disputes under the Mutual Agreement Procedure".[51] The Report identified the following obstacles that may prevent countries from resolving treaty-related disputes through the MAP:

5.1.1 PRACTICAL AND ADMINISTRATIVE ISSUES

The OECD noted that many of the obstacles to an effective MAP are of a practical or administrative nature (e.g. resource issues, empowerment of competent authorities to reach principled case resolutions, development of competent authority relationships based on mutual trust, etc.). Addressing these challenges would require changes to the OECD Model Tax Convention, changes to the OECD "Manual on Effective Mutual Agreement Procedures" (MEMAP) [52] as well as changes to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the Transfer Pricing Guidelines) (in particular Chapter IV, "Administrative Approaches to Avoiding and Resolving Transfer Pricing Disputes").[53]

5.1.2 UNILATERAL DENIAL OF ACCESS TO MAP

The OECD noted that unilateral denial of access to the MAP has been a longstanding concern of OECD work to improve the effectiveness of the MAP. This was pointed out in the 2004 OECD report on "Improving the Process for Resolving International Tax Disputes"[54] referred to above, in which it was explained that notwithstanding Article 25(1), in some cases countries refuse to enter into MAP where they consider that the relevant taxpayer has engaged in fraud or certain kinds of tax avoidance in relation to the case for which MAP is sought.[55] Concerns have for instance been raised about countries like India which deny under domestic law what is available under treaty. Although Indian legislation is becoming more aligned with international norms, these changes may not always be implemented by revenue officers.[56]

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51 OECD "Obstacles that Prevent Countries from Resolving Treaty Related Disputes" in para 4.

52 OECD "Manual on Effective Mutual Agreement Procedures" (2007) Available at http://www.oecd.org/ctp/38061910.pdf accessed 16 May 2014.

53 OECD "Obstacles That Prevent Countries From Resolving Treaty Related Disputes" in para 17.

54 OECD on *Improving the Process for Resolving International Tax Disputes* (2004). Available at: http://www.oecd.org/tax/treaties/33629447.pdf. The 2004 Report included 31 proposals to improve the resolution of tax treaty disputes through the MAP.

55 OECD "Obstacles That Prevent Countries From Resolving Treaty Related Disputes" in para 19.

56 M Herzfeld "Beyond BEPS: The Problem of Double Taxation" *Tax Analyst* 10 February 2014 at 1.

To address this issue, the 2004 Report proposed that: "the circumstances in which a taxpayer should be denied access to the MAP would be analysed together with a discussion of possible appropriate practices in this regard, taking into account the differing domestic law circumstances in different countries".[57] This proposal resulted in the addition of paragraphs 26 to 29 to the Commentary on Article 25 in 2008, which explains that the fact that a charge of tax is made under an avoidance provision of domestic law does not justify a denial of access to the mutual agreement procedure. This is in line with article 27 of the Vienna Convention on the Law of Treaties which requires that justification for a denial of MAP access be found in the terms of the treaty itself, as interpreted in accordance with accepted principles of tax treaty interpretation.[58]

The OECD notes that unilateral denial of access to the MAP may be particularly problematic in the context of the work on BEPS, which, may be expected to lead to the development of a broad range of domestic law and treaty-based anti-abuse rules, many of which may be novel and/or susceptible to conflicting interpretations. The OECD Action Plan for instance indicates that the adoption of special measures in the area of transfer pricing, that go beyond the arm's length principle with respect to intangible assets (such as the proposal to use profit-splits), risk and over-capitalisation, may lead to higher risks of double taxation. [59]

The OECD committed to work on clearly articulating the circumstances under which a State – in a manner consistent with its treaty obligations and the principles of treaty interpretation set forth in the Vienna Convention on the Law of Treaties – may justifiably deny access to the MAP.[60]

5.1.3 THE CURRENT LACK OF AN ARTICLE 25(5) ARBITRATION PROVISION IN THE MAJORITY OF THE TREATIES

As explained above, the 2004 OECD report on "Improving the Process for Resolving International Tax Disputes"[61] proposed the development of a binding arbitration process to resolve disagreements arising in the course of a MAP case. This culminated in the addition of the arbitration provision (Article 5(5)), of the OECD an integral part of the OECD MAP process. However the majority of the treaties concluded by OECD member countries since 2005, do not contain an Article 25(5) arbitration provision. [62] As explained above, one of the reasons why countries may not have included arbitration in their tax treaties could have been the fact that article

[57] OECD "Obstacles That Prevent Countries From Resolving Treaty Related Disputes" in para 19.
[58] OECD "Obstacles That Prevent Countries From Resolving Treaty Related Disputes" in para 21.
[59] OECD "Obstacles That Prevent Countries From Resolving Treaty Related Disputes" in para 22.
[60] OECD "Obstacles That Prevent Countries From Resolving Treaty Related Disputes" in para 24.
[61] OECD on *Improving the Process for Resolving International Tax Disputes* (2004).
[62] OECD "Obstacles That Prevent Countries From Resolving Treaty Related Disputes" in para 31.

25 of the OECD Model contains a footnote stating that countries are free to exclude arbitration from their treaties. The OECD committed to examine:

- Whether and to what extent the views reflected in the footnote to article 25(5) still reflect the position of OECD countries. As States have become more familiar with arbitration, the considerations reflected in the footnote and Commentary may be no longer seen as a hindrance to including arbitration provisions in tax treaties; [63]
- The reasons why OECD member countries have failed to include mandatory binding arbitration provisions in their recent tax treaties; [64]
- The MAP cases to be covered by arbitration. Article 25(5) currently provides that cases eligible for arbitration are cases arising under Article 25(1) which are based on the claim that the actions of one or both of the Contracting States have resulted in taxation not in accordance with the Convention; [65]
- The circumstances under which States may, consistent with their obligations under Article 25 of the OECD Model and international law, justifiably deny a taxpayer access to arbitration with respect to an Article 25(1).[66] These would result in clarifications and/or amendments to paragraph 5 of Article 25; [67] and
- Appropriately consider the best way of ensuring that arbitration is included in bilateral treaties, which would include consideration of whether an arbitration provision should be included in the multilateral instrument that is proposed to be developed pursuant to Action 15 of the Action Plan. [68]

The OECD notes that in developing instruments and approaches to address obstacles to MAP, the differences in the dynamics between MAP with and MAP without arbitration need to be recognised. As access to arbitration automatically means that the double taxation will be resolved, it may be warranted to more carefully and clearly define the circumstances in which access to MAP including arbitration is permitted. It was also necessary to identify types of MAP cases where governments do not want to unconditionally commit to providing a resolution with respect to the taxation not in accordance with the Convention. For access to the MAP where an arbitration procedure is excluded, more unconditional access to MAP may be warranted, as competent authorities only need to endeavour to reach a solution. [69]

On 18 December 2014 the OECD released a Public Discussion Draft on Action 14, this culminated in the final report on MAP in 2015 (which is summarized below).

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[63] OECD "Obstacles That Prevent Countries From Resolving Treaty Related Disputes" in para 34.

[64] OECD "Obstacles That Prevent Countries From Resolving Treaty Related Disputes" in para 35.

[65] OECD "Obstacles That Prevent Countries From Resolving Treaty Related Disputes Under the Mutual Agreement Procedure" in para 36.

[66] OECD "Obstacles That Prevent Countries From Resolving Treaty Related Disputes" in para 36.

[67] OECD "Obstacles That Prevent Countries From Resolving Treaty Related Disputes" in para 37.

[68] OECD "Obstacles That Prevent Countries From Resolving Treaty Related Disputes" in para 38.

[69] OECD "Obstacles That Prevent Countries From Resolving Treaty Related Disputes" in para 10.

6 SUMMARY OF THE OECD REPORT IN ACTION 14: MAKING DISPUTE RESOLUTION MECHANISMS MORE EFFECTIVE, 2015 FINAL REPORT

The OECD Final Report on Action 14 reiterates that the actions to counter BEPS must be complemented with actions that ensure certainty and predictability for business and that improving the effectiveness of MAP in resolving treaty-related disputes, is an integral component of the work on BEPS issues.[70] The Report notes that the interpretation and application of novel rules resulting from the BEPS project could introduce elements of uncertainty that should be minimised as much as possible.[71] In response to Action 14 which requires that countries make dispute resolution mechanisms more effective, to develop solutions to address obstacles to MAP, to address the absence of arbitration in most treaties and the denial of access to MAP in certain cases; the OECD issued its final report on “Making Dispute Resolution Mechanisms More Effective” in 2015. This report reflects:

- A commitment by countries to implement a minimum standard on dispute resolution, consisting of specific measures to remove obstacles to an effective and efficient MAP.
- Agreement by countries to establish a peer-based monitoring mechanism to ensure that the commitments contained in the minimum standard are effectively satisfied. [72]

The minimum standard constitutes specific measures that countries will take to ensure that they resolve treaty-related disputes in a timely, effective and efficient manner. The elements of the minimum standard have been formulated to reflect clear, objective criteria that will be susceptible to assessment and review in the monitoring process. [73] The elements of the minimum standard are intended to fulfil three general objectives:

- Countries should ensure that treaty obligations related to the MAP are fully implemented in good faith and that MAP cases are resolved in a timely manner;
- Countries should ensure that administrative processes promote the prevention and timely resolution of treaty-related disputes; and
- Countries should ensure that taxpayers that meet the requirements of Article 25(1) can access MAP. [74]

The specific measures that are part of the minimum standard will result in certain changes to the OECD Model Tax Convention to be drafted as part of the next update

70 OECD/G20 2015 Final Report on Action 14 in para 2.
71 OECD/G20 2015 Final Report on Action 14 in para 2.
72 OECD/G20 2015 Final Report on Action 14 in para 3.
73 OECD/G20 2015 Final Report on Action 14 in para 6.
74 OECD/G20 2015 Final Report on Action 14 in para 4.

to the OECD Model Tax Convention in order to reflect the conclusions of this Report.[75]

6.1 THE ELEMENTS OF A MINIMUM STANDARD TO ENSURE TIMELY, EFFECTIVE AND EFFICIENT RESOLUTION OF TREATY-RELATED DISPUTES

I) <u>Countries should ensure that treaty obligations related to MAP are fully implemented in good faith and that MAP cases are resolved in a timely manner:</u>

Since MAP forms an integral and essential part of the obligations assumed by a Contracting State in entering in to a tax treaty,[76] the OECD recommends that:

a) **Countries should include Articles (25)(1) – (3) in their tax treaties. They should provide access to MAP in transfer pricing cases and implement the resulting MAP (e.g. by making appropriate adjustments to the tax assessed):**
   - Countries should thus provide access to MAP in transfer pricing cases Failure to grant MAP access a view to eliminating the economic double taxation that results from transfer pricing adjustments will frustrate a primary objective of tax treaties. [77]
   - Countries should provide access to MAP with regards to article 9(2) if their domestic law enables them to provide for a corresponding adjustment. The competent authorities should consult with each other to determine the appropriate amount of that corresponding adjustment with the aim of avoiding double taxation. [78]

b) **Countries should provide** MAP **access in cases where there is a disagreement between the taxpayer and the tax authorities making the adjustment with respect to whether the conditions for the application of a treaty anti-abuse provision have been met or as to whether the application of a domestic law anti-abuse provision is in conflict with the provisions of a treaty:**
   - Paragraph 26 of the Commentary on Article 25, provides that in the absence of a special provision, there is no general rule denying MAP access in cases of perceived abuse.
   - In cases of treaty abuse, paragraphs 9.1 to 9.5 of the Commentary on Article 1 states that there is an obligation to provide MAP access in cases of abuse. Paragraph 9.5 provides that treaty benefits may be denied through the application of an anti-abuse provision to ensure

75 OECD/G20 2015 Final Report on Action 14 in para 5.
76 OECD/G20 2015 Final Report on Action 14 in para 9.
77 OECD/G20 2015 Final Report on Action 14 in para 11.
78 OECD/G20 2015 Final Report on Action 14 in para 13.

treaty benefits are gained contrary to the object and purpose of the relevant treaty provisions. For example, Action 6 will ensure that tax treaties incorporate general anti-abuse rule based on the principal purposes test or "PPT" rule, according to which the benefits of a tax treaty should not be available where one of the principal 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. The interpretation and/or application of that rule would clearly fall within the scope of the MAP. [79]

c) **Countries should commit to a timely resolution of MAP cases and they should commit to resolve MAP cases within an average timeframe of 24 months (depending on the complexity of each case). Countries' progress toward meeting that target will be periodically reviewed on the basis of the statistics prepared in accordance with the agreed reporting framework:**

- This reporting framework will include agreed milestones for the initiation and conclusion/closing of a MAP case, as well as for other relevant stages of the MAP process.
- Work to develop the reporting framework will seek to establish agreed target timeframes for the different stages of the MAP process. [80]

d) **Countries should enhance their competent authority relationships and work collectively to improve the effectiveness of the** MAP **by becoming members of the Forum on Tax** A**dministration** MAP **Forum** (FTA MAP Forum):

- The FTA Forum, a subsidiary body of the OECD Committee on Fiscal Affairs, currently brings together Commissioners from 46 countries to develop on an equal footing a global response to tax administration issues in a collaborative fashion.
- The FTA MAP Forum is a forum of FTA participant country competent authorities created to deliberate on general matters affecting all participants' MAP programmes that has developed a multilateral strategic plan to collectively improve the effectiveness of the MAP in order to meet the needs of both governments and taxpayers and so assure the critical role of the MAP in the global tax environment. [81]

e) **Countries should provide timely and complete reporting of** MAP **statistics, pursuant to an agreed reporting framework to be developed in co-ordination with the FTA MAP Forum:**

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79 OECD/G20 2015 Final Report on Action 14 in para 11.
80 OECD/G20 2015 Final Report on Action 14 in para 18.
81 OECD/G20 2015 Final Report on Action 14 in para 19.

- Since 2006, the OECD has collected and published MAP statistics from OECD member countries and from non-OECD economies that agree to provide these statistics.
- These statistics provide transparency with respect to each reporting economies' MAP programme as well as a comprehensive picture of the overall state of the MAP in all of the economies reporting statistics.
- In the context of the work on Action 14, MAP statistics should be expected to provide a tangible measure to evaluate the effects of the implementation of the minimum standard and an important component of the monitoring mechanism.
- Countries should accordingly provide a timely and complete reporting of MAP statistics, pursuant to an agreed reporting framework that will be developed in co-ordination with the FTA MAP Forum.
- The reporting framework will include agreed milestones for the initiation and conclusion/closing of a MAP case, as well as for other relevant stages of the MAP process. [82]

f) Countries should commit to have their compliance with the minimum standard reviewed by their peers in the context of the FTA MAP Forum:

- The OECD recommends that countries should become members of the FTA MAP Forum and commit to have their compliance with the minimum standard reviewed by their peers through an agreed monitoring mechanism that will be developed in co-ordination with the FTA MAP Forum.
- Such monitoring is essential to ensure the meaningful implementation of the minimum standard. [83]

g) Countries should provide transparency with respect to their positions on MAP arbitration:

- Mandatory binding MAP arbitration has been included in a number of bilateral treaties following its introduction in Article 25(5) of the OECD MTC in 2008. However a footnote to paragraph 5 notes that national law, policy or administrative considerations may not allow or justify this type of dispute resolution and that States should only include the provision in the Convention where they conclude that it would be appropriate to do so. [84]
- Based on the footnote it is unnecessary for countries to enter reservations (in the case of OECD member countries) or positions (in the case of non-OECD economies) on the provision. As a consequence,

[82] OECD/G20 2015 Final Report on Action 14 in para 20.

[83] OECD/G20 2015 Final Report on Action 14 in para 21.

[84] Based on the factors described in paragraph 65 of the Commentary on Article 25. See OECD/G20 2015 Final Report on Action 14 in para 22.

however, there is a lack of transparency as to countries' positions with respect to MAP arbitration. [85]

- In order to provide transparency with respect to country positions on MAP arbitration, the OECD notes that the above mentioned footnote will be deleted and paragraph 65 of the Commentary on Article 25 will be appropriately amended when the OECD MTC next updated to include in particular suitable alternative provisions for those countries that prefer to limit the scope of MAP arbitration to an appropriately defined subset of MAP cases. [86]

II) <u>Countries should ensure that administrative processes promote the prevention and timely resolution of treaty-related disputes:</u>

- The OECD notes that appropriate administrative processes and practices are important to ensure an environment in which competent authorities are able to fully and effectively carry out their mandate to take an objective view of treaty provisions and apply them in a fair and consistent manner to the facts and circumstances of each taxpayer's specific case.
- The elements of the minimum standard are intended to address a number of different obstacles to the prevention and timely resolution of disputes through the MAP that are related to the internal operations of a tax administration and the competent authority function, as well as to the transparency of procedures to use the MAP and to the approaches used by competent authorities to address proactively potential disputes. [87]

a) Countries should publish rules, guidelines and procedures to access and use the MAP and take appropriate measures to make such information available to taxpayers:

- Countries should ensure that their MAP guidance is clear and easily accessible to the public (*e.g.* made available on the websites of the tax administration and/or ministry of finance). This should include guidance on how taxpayers may make requests for competent authority assistance.[88]

b) To promote the transparency and dissemination of the MAP programme, countries should publish their country MAP profiles on a shared public platform (pursuant to an agreed template to be developed in co-ordination with the FTA MAP Forum).

- A "country MAP profile" is a document providing competent authority contact details, links to domestic MAP guidelines and other useful country-specific information regarding the MAP process.

[85] OECD/G20 2015 Final Report on Action 14 in para 23.
[86] OECD/G20 2015 Final Report on Action 14 in para 23.
[87] OECD/G20 2015 Final Report on Action 14 in para 24.
[88] OECD/G20 2015 Final Report on Action 14 in para 25.

- The OECD will develop a template for the content of the country MAP profiles in co-ordination with the FTA MAP Forum. [89]

c) Countries should ensure that the staff in charge of MAP processes have the authority to resolve MAP cases in accordance with the terms of the applicable tax treaty, in particular without being dependent on the approval or the direction of the tax administration personnel who made the adjustments at issue or being influenced by considerations of the policy that the country would like to see reflected in future amendments to the treaty:[90]

d) Countries should not use performance indicators for their competent authority functions and staff in charge of MAP processes based on the amount of sustained audit adjustments or maintaining tax revenue.

- The performance of their competent authority functions and staff in charge of MAP processes should not be evaluated based on the amount of sustained audit adjustments or the maintenance of tax revenue.
- These internal procedures should instead provide that competent authority functions and staff in charge of MAP processes will be evaluated based on appropriate performance indicators, such as the number of MAP cases resolved; principled and consistent manner of applying to MAP cases of same facts and similarly-situated taxpayers; and time taken to resolve a MAP case (which may vary according to its complexity and that matters not under the control of a competent authority).[91]

e) Countries should ensure that adequate resources are provided to the MAP function:

- Personnel, funding, training and other programme needs should be provided to the MAP function, in order to enable competent authorities to carry out their mandate to resolve cases of taxation not in accordance with the provisions of the Convention in a timely and effective manner. [92]

f) Countries should clarify in their MAP guidance that audit settlements between tax authorities and taxpayers do not preclude access to MAP:

- If countries have an administrative or statutory dispute settlement/resolution process independent from the audit and examination functions and that can only be accessed through a request

89 OECD/G20 2015 Final Report on Action 14 in para 26.
90 OECD/G20 2015 Final Report on Action 14 in para 27.
91 OECD/G20 2015 Final Report on Action 14 in para 28.
92 OECD/G20 2015 Final Report on Action 14 in para 29.

by the taxpayer, countries may limit access to the MAP with respect to the matters resolved through that process.

- Countries should notify their treaty partners of such administrative or statutory processes and should expressly address the effects of those processes with respect to the MAP in their public guidance on such processes and in their public MAP programme guidance.

g) Countries with bilateral advance pricing arrangement (APA) programmes should provide for the roll-back of APAs in appropriate cases, subject to the applicable time limits (such as statutes of limitation for assessment) where the relevant facts and circumstances in the earlier tax years are the same and subject to the verification of these facts and circumstances on audit.

- Situations may arise in which the issues resolved through an APA are relevant with respect to previous filed tax years not included within the original scope of the APA.
- The "roll-back" of the APA to these previous years may be helpful to prevent or resolve potential transfer pricing disputes, in cases where the relevant facts and circumstances in the earlier tax years are the same.[93]

III) <u>Countries should ensure that taxpayers that meet the requirements of Article 25(1) can access MAP:</u>

Countries should keep their obligation to provide MAP access. The elements of the minimum standard are intended to ensure that taxpayers that meet the requirements of paragraph 1 of Article 25 have access to the mutual agreement procedure.[94]

a) Both competent authorities should be made aware of MAP requests being submitted and should be able to give their views on whether the request is accepted or rejected.

- In order to achieve this, countries should either amend paragraph 1 of Article 25 to permit a request for MAP assistance to be made to the competent authority of either Contracting State, or where a treaty does not permit a MAP request to be made to either Contracting State, implement a bilateral notification or consultation process for cases in which the competent authority to which the MAP case was presented does not consider the taxpayer's objection to be justified (such consultation shall not be interpreted as consultation as to how to resolve the case).[95]

93 OECD/G20 2015 Final Report on Action 14 in para 33.
94 OECD/G20 2015 Final Report on Action 14 in para 34.
95 OECD/G20 2015 Final Report on Action 14 in para 35.

b) **Countries' published MAP guidance should identify the specific information and documentation that a taxpayer is required to submit with a request for MAP assistance. Countries should not limit access to MAP based on the argument that insufficient information was provided if the taxpayer has provided the required information.**
   - The published guidelines and procedures for MAP should include guidance on how taxpayers may make requests for competent authority assistance.
   - The FTA MAP Forum will develop guidance on the specific information and documentation required to be submitted with a request for MAP assistance. [96]

c) **Countries should include in their tax treaties the second sentence of Article 25(2) that: "Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States"**
   - Countries that cannot include this sentence in their tax treaties should be willing to accept alternative treaty provisions that limit the time during which a Contracting State may make an adjustment pursuant to Article 9(1) or Article 7(2), in order to avoid late adjustments with respect to which MAP relief will not be available.[97]

6.2 MAP BEST PRACTICES RECOMMENDED BY THE OECD

The work on Action 14 also came up with conclusions that reflect the agreement that certain responses to the obstacles that prevent the resolution of treaty-related disputes through MAP are more appropriately presented as best practices. Unlike the elements of the minimum standard, these best practices have a subjective or qualitative character that could not readily be monitored or evaluated or because not all OECD and G20 countries are willing to commit to them at this stage. These best practices relate to the three general objectives of the minimum standard but they are not part of the minimum standard

<u>With respect to minimum standard 1:</u> "Countries should ensure that treaty obligations related to the mutual agreement procedure are fully implemented in good faith and that MAP cases are resolved in a timely manner", the OECD recommends the following best practice.

<u>Best practice 1</u>:
- Countries should include Article 9(2) in their tax treaties.

96 OECD/G20 2015 Final Report on Action 14 in para 37.
97 OECD/G20 2015 Final Report on Action 14 in para 43.

- Most countries consider that the economic double taxation resulting from the inclusion of profits of associated enterprises under Article 9(1) is not in accordance with the object and purpose of tax treaties and falls within the scope of the MAP under Article 25.
- Some countries, however, take the position that in the absence of a treaty provision based Article 9(2), they are not obliged to make corresponding adjustments or to grant access to the MAP with respect to the economic double taxation that may otherwise result from a primary transfer pricing adjustment. Such a position frustrates a primary objective of tax treaties – the elimination of double taxation – and prevents bilateral consultation to determine appropriate transfer pricing adjustments.
- The minimum standard will ensure that access to MAP is provided for in such transfer pricing cases. However, it would be more efficient if countries would also have the possibility to provide for corresponding adjustments unilaterally in cases in which they find the objection of the taxpayer to be justified.[98]

With respect to minimum standard 2: "Countries should ensure that administrative processes promote the prevention and timely resolution of treaty-related disputes", the OECD recommends the following best practices.

Best practice 2:

- Countries should have appropriate procedures in place to publish agreements reached pursuant to the authority provided in Article 25(3) "to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention" that affect the application of a treaty to all taxpayers or to a category of taxpayers (rather than to a specific taxpayer's MAP case). Such agreements could provide guidance that would be useful to prevent future disputes and where the competent authorities agree that such publication is consistent with principles of sound tax administration.[99]

Best practice 3:

- Countries should develop the "global awareness" of the audit/examination functions involved in international matters through the delivery of the Forum on Tax Administration's "Global Awareness Training Module" to appropriate personnel. [100]

Best practice 4:

- Countries should implement bilateral APA programmes.[101]

98 OECD/G20 2015 Final Report on Action 14 in para 44.
99 OECD/G20 2015 Final Report on Action 14 in para 45.
100 OECD/G20 2015 Final Report on Action 14 in para 46.
101 OECD/G20 2015 Final Report on Action 14 in para 48.

Best practice 5:

- Countries should implement appropriate procedures to permit, in certain cases and after an initial tax assessment, taxpayer requests for the multiyear resolution through the MAP of recurring issues with respect to filed tax years, where the relevant facts and circumstances are the same and subject to the verification of such facts and circumstances on audit. Such procedures would remain subject to the requirements of Article 25(1). Thus, a request to resolve an issue with respect to a particular taxable year would only be allowed where the case has been presented within three years of the first notification of the action resulting in taxation not in accordance with the Convention with respect to that taxable year.

With respect to minimum standard *3:* "Countries should ensure that taxpayers that meet the requirements of Article 25(1) can access MAP, the OECD recommends the following best practices:

Best practice 6:

- Countries should take appropriate measures to provide for a suspension of collections procedures during the period a MAP case is pending.
    - Where the payment of tax is a requirement for MAP access, the taxpayer concerned may face significant financial difficulties: if both Contracting States collect the disputed taxes, double taxation will in fact occur and the resulting cash flow problems may have a substantial impact on a taxpayer's business, for as long as it takes to resolve the MAP case.
    - A competent authority may also find it more difficult to enter into good faith MAP discussions when it considers that it may likely have to refund taxes already collected.
    - Countries should accordingly take appropriate measures to provide for a suspension of collections procedures during the period a MAP case is pending.
    - Such a suspension of collections should be available, at a minimum, under the same conditions as apply to a person pursuing a domestic administrative or judicial remedy. [102]

Best practice 7:

- Countries should implement appropriate administrative measures to facilitate recourse to the MAP to resolve treaty-related disputes, recognising the general principle that the choice of remedies should remain with the taxpayer.[103]

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102 OECD/G20 2015 Final Report on Action 14 in para 50.
103 OECD/G20 2015 Final Report on Action 14 in para 51.

Best practice 8:

- Countries should include in their published MAP guidance an explanation of the relationship between the MAP and domestic law administrative and judicial remedies. Such public guidance should address, in particular, whether the competent authority considers itself to be legally bound to follow a domestic court decision in the MAP or whether the competent authority will not deviate from a domestic court decision as a matter of administrative policy or practice.

Best practice 9:

- Countries' published MAP guidance should provide that taxpayers will be allowed access to the MAP so that the competent authorities may resolve through consultation the double taxation that can arise in the case of bona fide taxpayer-initiated foreign adjustments – i.e. taxpayer-initiated adjustments permitted under the domestic laws of a treaty partner which allow a taxpayer under appropriate circumstances to amend a previously-filed tax return to adjust (i) the price for a transaction between associated enterprises or (ii) the profits attributable to a permanent establishment, with a view to reporting a result that is, in the view of the taxpayer, in accordance with the arm's length principle. For such purposes, a taxpayer-initiated foreign adjustment should be considered bona fide where it reflects the good faith effort of the taxpayer to report correctly the taxable income from a controlled transaction or the profits attributable to a permanent establishment and where the taxpayer has otherwise timely and properly fulfilled all of its obligations related to such taxable income or profits under the tax laws of the two Contracting States.

Best practice 10:

- Countries' published MAP guidance should provide guidance on the consideration of interest and penalties in the MAP.

Best practice 11:

- Countries' published MAP guidance should provide guidance on multilateral MAPs and advance pricing arrangements (APAs).

6.3 A FRAMEWORK FOR A MONITORING MECHANISM

The OECD came up with the following framework for implementing the minimum standards:

1) All OECD and G20 countries, as well as jurisdictions that commit to the minimum standard will undergo reviews of their implementation of the minimum standard. The reviews will evaluate the legal framework provided by a jurisdiction's tax treaties and domestic law and regulations, the jurisdiction's

MAP programme guidance and the implementation of the minimum standard in practice.[104]

2) The core output of the peer monitoring process will come in the form of a report.
3) The report will identify and describe the strengths and any shortcomings that exist and provide recommendations as to how the shortcomings might be addressed by the reviewed jurisdiction. The core documents for the peer monitoring process will be the *Terms of Reference* and the *Assessment Methodology*.
    - *The Terms of Reference:*
        - will be based on the elements of the minimum standard Report and will break down these elements into specific aspects against which jurisdictions' legal frameworks, MAP programme guidance and actual implementation of the minimum standard are assessed.
        - will provide a clear roadmap for the monitoring process and will thereby ensure that the assessment of all jurisdictions is consistent and complete.
    - *The Assessment Methodology:*
        - will establish detailed procedures and guidelines for peer monitoring of OECD and G20 countries and other committed jurisdictions by the FTA MAP Forum and will include a system for assessing the implementation of the minimum standard.
4) Both the *Terms of Reference* and the *Assessment Methodology* will be developed jointly by Working Party No. 1 and the FTA MAP Forum by the end of the first quarter of 2016.
5) The peer monitoring process conducted by the FTA MAP Forum, reporting to the G20 through the OECD Committee on Fiscal Affairs, will begin in 2016, with the objective of publishing the first reports by the end of 2017.[105]

6.4 COMMITMENT TO MANDATORY BINDING MAP ARBITRATION

The agreement to a minimum standard that will make tax treaty dispute resolution mechanisms more effective is complemented by the commitment, by a number of countries, to adopt mandatory binding arbitration. The OECD notes that the business community and a number of countries consider that mandatory binding arbitration is the best way of ensuring that tax treaty disputes are effectively resolved through MAP.

- There is however currently no consensus among all OECD and G20 countries on the adoption of mandatory binding arbitration as a mechanism to ensure the timely resolution of MAP cases.

[104] OECD/G20 2015 Final Report on Action 14 in paras 60-61.
[105] Ibid.

- However, a significant group of countries has committed to adopt and implement mandatory binding arbitration.[106] The countries that have expressed interest in doing so include Australia, Austria, Belgium, Canada, France, Germany, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Poland, Slovenia, Spain, Sweden, Switzerland, the United Kingdom and the United States. The OECD notes that this represents a major step forward as together these countries are involved in more than 90 percent of outstanding MAP cases at the end of 2013, as reported to the OECD. [107]
- The OECD states that a mandatory binding MAP arbitration provision will be developed as part of the negotiation of the multilateral instrument envisaged by Action 15 the BEPS Action Plan.
- The countries in this group will, in particular, be required to consider how to reconcile their different views on the scope of the MAP arbitration provision. Whilst a number of the countries included in this group would prefer to have no limitations on the cases eligible for MAP arbitration, other countries would prefer that arbitration should be limited to an appropriately defined subset of MAP cases.[108]

7 OVERVIEW OF MAP FOR SOUTH AFRICA

The latest summary of treaties, on SARS website as at 21 July 2015, shows that South Africa has an extensive treaty network and has DTA's with 73 countries. In terms of section 108 of Income Tax Act read together with section 231 of the Constitution, a tax treaty becomes part of the Income Tax Act after it has been negotiated and published in the Government gazette.

Even though South Africa is a member of the OECD BEPS Committee and also a member of the G-20, adoption of the OECD recommendations such as those on MAP must take into consideration the special economic and socio geo-political circumstances of the country and its position on the African continent. For South Africa to determine the approach it will take with respect to Action 14, it has to consider its treaty partners and its stated economic policy to begin a gateway to foreign investment into Africa. A policy decision should be considered about the position to be taken regarding accepting the OECD and/or UN recommendations, where there are divergent approached or guidelines. Many African countries with source based tax systems prefer to sign treaties based on the UN MTC which is more favourable to source countries rather than the OECD Model that favours residence countries. Although MAP has not been very effective among African countries, many of them largely adopt the UN approaches to treaty issues such as the UN Transfer Pricing guidance.

106 OECD/G20 2015 Final Report on Action 14 in para 8.
107 OECD/G20 2015 Final Report on Action 14 in para 62.
108 OECD/G20 2015 Final Report on Action 14 in para 63.

The UN also issued a Guide to MAP under Tax treaties.[109] The Guide's primary focus is on the specific needs and concerns of developing countries and countries in transition, and would be instrumental for South Africa to follow in ensuring effective MAP. The UN Guide considers different possible ways to improve the MAP (including advance pricing agreements, mediation, conciliation, recommended administrative regulations and prescribed obligations) for the taxpayer applying for mutual agreement procedure. This UN capacity-building initiative seeks to provide countries that have little or no experience with the mutual agreement procedure with a practical guide to that procedure. Whilst this Guide draws on the OECD Manual on Effective Mutual Agreement Procedures (MEMAP), it is based on the provisions of the UN Model Double Taxation Convention between Developed and Developing Countries (update 2011) and seeks to present the various aspects of MAP from the perspective of countries that have limited experience with that procedure.[110]

The statistics of MAP cases for South Africa as listed on the OECD website for the period 2006-2014[111] is as follows

Year MAP case was initiated	Case with OECD Member country	Case with OECD Non-member country	Cases completed during reporting period (including cases carried over from previous year)	
			OECD country	Non-OECD country
2008	3	1	3	1
2009	1	0	0	0
2010	2	3	1	1
2011	1	4	0	3
2012	1	2	1	2
2013	1	1	2	0
2014	4	0	2	0

The above table shows that South Africa has participated in a minimal number of MAPs presumably because of taxpayers have not applied for MAP and also due to capacity issues. So the MAP process in South Africa is generally not that developed and there is a general lack of capacity and even capability to practically manage the MAP process. It appears that when an application for MAP is made to the competent authority, the application is referred back to the same audit team involved in the original dispute. This is clearly an issue of concern for taxpayers due to there being a risk of a lack of objectivity of the audit team.

There is also little awareness amongst South African multinational companies of the MAP process and the role played by SARS. The MAP process is supposed to be initiated by the taxpayer. However, since the process normally takes long, taxpayers

109 UN "Guide to Mutual Agreement Procedure in Tax Treaties" (2012). Available at http://www.un.org/esa/ffd/tax/gmap/Guide_MAP.pdf accessed 16 May 2014.
110 Ibid.
111 OECD "Mutual Agreement Procedure Statistics 2006-2014: South Africa". Available at http://www.oecd.org/ctp/dispute/map-statistics-2006-2014.htm accessed 4 April 2016.

often avoid initiating MAP. Nevertheless, MAP is likely to become increasingly important as more treaties are concluded with less developed countries and the process becomes more accessible and reliable.

Even though South Africa has a wide network of double tax treaties it has only 3 treaties which include binding arbitration clauses: These are the treaties with Canada, [112] Netherlands[113] and Switzerland.[114]

Treaty disputes can arise as a result of overly complex CFC rules, interest deductibility rules which are difficult to administer and enforce for SARS and problematic for taxpayers to comply with. Most disputes that require MAPs relate to transfer pricing disputes. However in South Africa, the Transfer Pricing Draft Interpretation Note issued by the SARS exacerbates the feeling of uncertainty for taxpayers. Clear guidance is required in order to provide taxpayers with certainty, which is a fundamental cornerstone for the encouragement of greater cross-border investment into a country. These concerns are further augmented by the fact that South Africa does not have an Advance Pricing Agreement (APA) programme in place, which is usually beneficial in preventing transfer pricing disputes. Bilateral APAs provide an increased level of certainty for taxpayers. Thus lack of APAs in South Africa could inhibit foreign direct investment into South Africa.

8 RECOMMENDATIONS ON MAP FOR SOUTH AFRICA

- South Africa should adopt the OECD minimum standards with respect to MAP.

- SARS needs to be more active in supporting South African taxpayers during MAP processes. This is especially so in treaties involving African countries where the MAP process is not developed and is not effectively applied. A critical need in this regard relates to cases where some African countries incorrectly claim source jurisdiction on services (especially management services) rendered abroad and yet those services should be considered to be from a South African source. These countries levy withholding taxes from amounts received by South African residents in respect of services rendered in South Africa. The withholding taxes are sometimes imposed even if a treaty

112 SARS “Convention Between The Republic of South Africa and Canada For The Avoidance of Double Taxation And The Prevention Of Fiscal Evasion With Respect to Taxes on Income” Government Gazette No. 17985, Date of entry into force 30 April 1997.

113 SARS “Convention Between The Republic Of South Africa And The Kingdom Of The Netherlands For The Avoidance Of Double Taxation And The Prevention Of Fiscal Evasion With Respect To Taxes On Income And On Capital” Government Gazette No. 31797, Date of entry into force 28 December 2008.

114 SARS “Convention Between The Republic Of South Africa And The Swiss Confederation For The Avoidance Of Double Taxation With Respect To Taxes On Income” Government Gazette No. 31967, Date of entry into force 27 January 2009

between South Africa and the relevant country does not have an article dealing with management fees or and even if South African residents do not have permanent establishments in these countries. In response to the double taxation concerns that South African taxpayers face and to encourage investors to see South Africa as an attractive headquarter location, National Treasury enacted section 6*quin* which provides a rebate for management fees and technical service fees even though use of MAP in double tax treaties is the right forum that should have been employed to resolve these concerns. However South Africa residents had little success in challenging these matters with the tax authorities of the other countries and yet SARS was also not able to enforce the proper application of the treaties with these countries.[115] Although section 6*quin* ensured that South African taxpayers are not subjected to double taxation,[116] its application implied that South Africa had departed from the tax treaty principles in the OECD MTC in its treaties with the relevant countries, in that it has given them taxing rights over income not sourced in those countries. As a result, South Africa effectively eroded its own tax base as it is obliged to give credit for taxes levied in the paying country. In terms of 2015 Taxation Laws Amendment Act, National Treasury repeal of section 6*quin* from years commencing on or after 1 January 2016.[117] National Treasury explains that South Africa is the only country with a provision (like s 6*quin*) which goes against international tax and tax treaty principles in that it indirectly subsidises countries that do not comply with tax treaties and that it is a compliance burden for SARS. National Treasury also had concerns that some taxpayers were abusing the relief offered by the section. As noted above MAP under tax treaties is the forum that ought to be used to solve such problems. As a member of the African Tax Administration Forum (ATAF) which promotes and facilitates mutual cooperation among African tax administrators), South Africa should strongly advocate for ATAF to ensure that member countries enforce their treaty obligations and ensure that taxpayers can access MAP.

- To ensure the effectiveness of MAP it is important that the performance measures against which officials working on MAP are measured should not be based on factors such as revenue obtained. Such officials should have a different reporting structure to that of the SARS audit team, because of the fact that, in a MAP case, a portion of tax will inevitably be given up by the competent authority. This is highlighted in the OECD Final report on Action 14 which provides that “countries should not use performance indicators for their competent authority functions and staff in charge of MAP processes based on the amount of sustained audit adjustments or maintaining tax revenue”.[118]

115 PWC “Comments on DTC BEPS First Interim Report” (30 March 2015) at 22.
116 Ibid.
117 Section 5 of the Draft Taxation Laws Amendment Bill 2015.
118 OECD/G20 2015 Final Report on Action 14 in para 28.

- To ensure the effectiveness of MAP, when an application for MAP is made, it must be referred to an independent and separate unit that deals with MAP, not to e.g. the transfer pricing audit unit. This is in line with the OECD recommendation on Action 14 which states that "countries should ensure that the staff in charge of MAP processes have the authority to resolve MAP cases in accordance with the terms of the applicable tax treaty, in particular without being dependent on the approval or the direction of the tax administration personnel who made the adjustments at issue or being influenced by considerations of the policy that the country would like to see reflected in future amendments to the treaty."[119]

  We acknowledge that it is not every SARS transfer pricing auditor who may be affected by their lack of independence if presented with a MAP matter, and we also acknowledge the difficulty in achieving this complete separation as the officials involved will need to be chosen from a relatively small pool of appropriately skilled people, however, this is a crucial step not only to ensure the effectiveness of MAP, but also to obtain the co-operation and trust of taxpayers. The same level of independence should exist between the audit teams and the teams considering APA's similar to the current separation between audit and advanced rulings.

- Although the SARS transfer pricing team has grown significantly in both size and expertise, there remain significant constraints due to the lack of skilled resources in South Africa. It is therefore important that attention must be given to intensive recruitment and robust training of personnel by SARS. This will, in turn, clearly require that funding be made available. A lack of sufficient resources (whether staff, training, funding, etc.) will inevitably result in unsatisfactory outcomes and a backlog of cases due to delays by the competent authority in processing such cases. Outsourcing could possibly be considered as a temporary solution.

- It is important for South Africa to include Article 9(2) in those DTAs where it has not yet been included. This is to ensure that the position in the South African treaties are in accordance with the commentary on Article 25. This is, however, not a "deal breaker" as Article 25(3) in any event permits discussions between the respective competent authorities in situations of double taxation not covered by the DTA. Secondary adjustments, for interest and penalties should be dealt with under the MAP process simultaneously. Further, interest to be levied in relation to a period of time caused by an unreasonable delay in either the domestic process or the MAP process, could

119 OECD/G20 2015 Final Report on Action 14 in para 27.

be waived subject to SARS' discretion and potentially align to a suspension of payment.

- SARS should not influence taxpayers to waive the right to MAP not should taxpayers be prohibited, as part of settlement negotiations, from escalating the portion of tax suffered to the competent authority for relief from double taxation. This would amount to a unilateral decision, without due regard to the spirit of the double tax treaties or the treaty partner.

- Advance pricing agreements (APAs) lessen the likelihood of transfer pricing disputes. Lack of an APA program in South Africa is an inhibitor to foreign direct investment as it removes the opportunity to seek certainty on transactional pricing, particularly when Multinationals expand into the rest of Africa. It is acknowledged that there are scarce resources within the transfer pricing arena to enable a separate and independent unit to deal with APA's. A possible temporary measure could be to outsource this to recognised experts with oversight by senior SARS officials. When APA are adopted, consideration should be given to the possibility of combining MAP proceedings for a recurring transfer pricing issue with a bilateral APA with rollback. This would be in line with the OECD recommendation that "countries with bilateral advance pricing arrangement (APA) programmes should provide for the roll-back of APAs in appropriate cases, subject to the applicable time limits (such as statutes of limitation for assessment) where the relevant facts and circumstances in the earlier tax years are the same and subject to the verification of these facts and circumstances on audit".[120]

- Although South Africa has guidelines and regulations on domestic dispute resolution and litigation, there is no guidance on how to resolve disputes through the treaties. There is confusion as to how SARS approaches this, who the appropriate competent authority is and how the process should be followed. For instance some countries will suspend domestic resolution processes pending the outcome of a MAP appeal whereas other countries require the domestic remedies to be exhausted before entertaining a MAP appeal. Clear guidance on when SARS will entertain MAP needs to be given together with an appropriate process guide for taxpayers similar to the guide issued for domestic resolution. Such guidance should be clear and transparent, not unduly complex and appropriate measures should be taken to make such guidance available to taxpayers. The Guidance should contain information such as:
  - When will MAP be applied;
  - Applicable time limits in which a taxpayer can approach the Competent Authority;

[120] OECD/G20 2015 Final Report on Action 14 in para 33.

- Who the Competent Authority is;
- What documents are required to be submitted with any application for MAP;
- Interaction of MAP with domestic legislation;
- Estimated timelines; and
- Liabilities of the Competent Authority.

For purpose of providing examples to which South Africa could refer when drafting such guidance, reference could be had to:

- The HMRC's "*Statement of Practice, SP1/11*";
- The "*Mutual Agreement Procedures (MAP) Operational Guidance for Member Countries of the Pacific Association of Tax Administrators (PATA"),*[121]
- The OECD "*Manual on Effective Mutual Agreement Procedures" ("MEMAP")* ; and
- The UN "*Guide to the Mutual Agreement Procedure under tax treaties*":

➢ Since most disputes concern transfer pricing, it is important that SARS Interpretation Note on Transfer Pricing is finalised. Clear guidance should also be provided with respect to thin capitalisation rules. Other MAP disputes relating to controlled foreign company rules (CFC) and interest deductibility could be prevented by simplifying the complex CFC rules and the interest deductibility provisions.

➢ The current audit procedure in South Africa includes two aspects of an enquiry, a risk assessment process which is to determine whether an audit is warranted, and a full audit process. The roles and responsibilities of these two are becoming blurred in certain circumstances which places the taxpayer in a position of uncertainty as to whether the matter is under audit or not. The respective roles and responsibilities therefore need clarifying and SARS should be required to inform the taxpayer as to whether their matter is under audit or not. Further the audit process often creates problems for taxpayers in that SARS often requires extremely detailed information from a taxpayer, in a relatively short period of time, without any timeline or time commitment being placed on SARS to respond resulting in an unreasonably long time passing, this needs to be addressed through better audit governance measures.

➢ The timing for applying for MAP needs to be clarified. Under Article 25(1) of the OECD UN MTC where a person considers that the actions of one or both contracting states results or will result in taxation that is not accordance with the provisions of the treaty, that person may irrespective of any remedies available under domestic law, present his case to the competent authorities of

121 PATA is an inter-country affiliation between Australia, USA, Canada and Japan.

the contracting states in which he is resident (or the state in which he is a national). The case has to be brought to the attention of the competent authorities within three years from the first notification that the relevant tax is not in accordance with the provisions of the treaty. In South Africa, the timing is not clear and it appears that that the domestic rules govern the process and acceptance of such applications. It is understood that with scarce resources it would be inefficient to entertain a domestic appeal and competent authority application simultaneously. SARS needs to clarify the time when it will entertain a competent authority application, that is, whether it is once the taxpayer's objection has been disallowed, or at the same time as the appeal. This needs to be clarified in some form of binding, written communication. In this regard, it is recommended that SARS keeps to the two year time limit as is recommended in the OECD Commentary on Article 25(1). Further, to the extent the domestic appeal is suspended pending the outcome of the MAP, this should be clearly stated in the guidance, together with advice on payment suspension. The UK's clarification on this matter can be emulated, as set out in the HMRC's Statement of Practice 1, 2011. Paragraph 21 thereof states: "*The UK follows the approach adopted by most countries and described in the Commentary on Article 25 at Paragraph 76. Under this approach a person cannot pursue simultaneously the MAP and domestic legal remedies. Thus a case may be presented and accepted for MAP while the domestic remedies are still available. In such cases, the UK competent authority will generally require that the taxpayer agrees to the suspension of these remedies or, if the taxpayer does not agree, will delay the MAP until these remedies are exhausted.*"

In Australia, the Australian Taxation Office ("ATO") considers concurrently a case presented to the competent authority and the objection lodged by the taxpayer under domestic provisions.

- In relation to the "Pay now, argue later" principle currently applied by the SARS, if a MAP matter take years before being resolved, SARS should be cognisant of the fact that not permitting the suspension of payment pending the outcome of MAP can be extremely detrimental to the taxpayer. The OECD recommended best practice on Action 14 to ensure taxpayers can access MAP, is that countries should take appropriate measures to provide for a suspension of collections procedures during the period a MAP case is pending. Such a suspension of collections should be available, at a minimum, under the same conditions as apply to a person pursuing a domestic administrative or judicial remedy. [122] This recommendation should be followed in South Africa. The UK example could be emulated. In the UK, a taxpayer

[122] OECD/G20 2015 Final Report on Action 14 in para 50.

may apply to the HMRC to defer the payment.[123] In the UK, each case is decided on its own merits, with consideration of factors including, but not limited to, the size of the tax liability, the capacity of the taxpayer to discharge the tax liability and the risks to the revenue. Deferral may be subject to review on a periodic basis, a requirement for partial payment, the provision of security by the taxpayer, or other such arrangements which minimise the risk to the revenue authority. It is recommended that measures such as those in the UK should be adopted in South Africa.

- Many developing countries, do not consider themselves yet ready for mandatory binding arbitration in the international taxation context. India and Brazil made it clear in the BEPS discussions on the matter that they would not be involved in binding mandatory arbitration.[124] Developing countries are very wary of adopting binding arbitration provisions in their tax treaties, since normally in arbitration cases the winning country gets the tax revenue and the other loses. Mandatory binding arbitration is considered unfair since it entails entrusting decisions involving often millions of dollars to a secret and unaccountable procedure of third party adjudication. Developing countries hold the view that arbitration can only be effective and accepted if the rules to be applied are clear, and if the procedures are open and transparent, including the publication of reasoned decisions. As a developing country, these matters should be of concern to South Africa too. For that matter, South Africa should call for measures to be in place to make the arbitration process more transparent and it should it only commit to the process if the rules are clear and transparent. Until the MAP arbitration process is made more transparent, South Africa should also be cautious about committing to an arbitration provision in the envisaged Multilateral Instrument under Action 15 of the OECD BEPS Action Plan. When South African becomes a party to the Multilateral Instrument, it should register a reservation not to commit to mandatory arbitration until the concerns regarding this process are rectified.

- Since mandatory arbitration is viewed by the OECD and taxpayers as a means of speedily resolving MAP, South Africa should call for international measures to be put in place to ensure transparency in the arbitration procedures:
    - South Africa should join the call for an international panel of arbitrators, for instance under the auspicious of the United Nations to be formed that comprises a panel of members from both developing and developed countries. Decisions of such a panel would be considered neutral and fair to the interests of all countries.

123 HMRC Taxation Ruling TR 2000/16, paragraphs 4.50 – 4.51

124 UN Committee of Experts on International Cooperation in Tax Matters “Secretariat Paper on Alternative Dispute Resolution in Taxation” (8 October 2015) in para 21.

- At regional level, South Africa should recommend that a pool of arbitrators be formed, with the necessary skills and qualifications, from among ATAF member countries. The ATAF member countries could then draw on arbitrators from that pool in cases where the MAP was between two ATAF-member countries. We note in this regard that a similar idea is successfully implemented under the EU Arbitration Convention, which pool comprises a pool of arbitrators appointed from EU member states.
- South Africa should call for MAP results and agreements reached (even the “anonymised” versions) to be published annually (this could be in redacted form – removing matters that are confidentiality concern) – this will provide further guidance and proactively resolve other potential future disputes.
- Exchange of existing best practices between SARS and other revenue authorities should be strongly encouraged. South Africa should in particular adopt the OECD recommendation regarding Best Practice 1 (inclusion of Article 9(2) in its tax treaties); Best Practice 2 (adopt appropriate procedures to publish MAP agreements reached); Best Practice 5 (implement procedures that permit, after an initial tax assessment, taxpayer requests for the multiyear resolution through the MAP of recurring issues with respect to filed tax years, where the relevant facts and circumstances are the same); Best practice 6 (take appropriate measures to provide for a suspension of collections procedures during the period a MAP case is pending); Best Practice 7 (take appropriate measures to provide for a suspension of collections procedures during the period a MAP case is pending); Best Practice 8 (published MAP guidance explaining the relationship between the MAP and domestic law administrative and judicial remedies); Best Practice 9 (publish MAP Guidance which provides that taxpayers will be allowed access to the MAP where double taxation arises in the case of bona fide taxpayer-initiated foreign adjustments permitted under the domestic laws of a treaty partner); Best Practice 10 (publish guidance on the consideration of interest and penalties in the MAP).

ANNEXURE 12

DAVIS TAX COMMITTEE: SECOND INTERIM REPORT ON BASE EROSION AND PROFIT SHIFTING (BEPS) IN SOUTH AFRICA*

SUMMARY OF REPORT ON ACTION: 15: DEVELOP A MULTINATIONAL INSTRUMENT

Globalisation has exacerbated the impact of gaps and frictions among different countries' tax systems. The endorsement of the 2013 OECD *Action Plan on Base Erosion and Profit Shifting* by the Leaders of the G20 in Saint-Petersburg in September 2013 shows unprecedented political support to adapt the current international tax system to the challenges of globalisation. Many of the principles that underpin international tax principles are imbedded in the tax treaties which are based on a set of common principles designed to eliminate double taxation that may occur in the case of cross-border trade and investments. However, the principles in the current network of bilateral tax treaties were developed back in the 1920s when the first soft law Model Tax Convention developed by the League of Nations was developed. Although both the OECD and the UN model tax conventions have been subsequently updated over the years, some of the contents of those model tax conventions as reflected in thousands of bilateral agreements among jurisdictions, have been superseded by developments in globalisation. As a result, some features of the current bilateral tax treaty system facilitate base erosion and profit shifting (BEPS) and need to be addressed.

Beyond the challenges faced by the current tax treaty system on substance, the sheer number of bilateral treaties makes updating the current tax treaty network highly burdensome.[1] Even where a change to the OECD Model Tax Convention is consensual, it takes a substantial amount of time and resources to introduce it into most bilateral tax treaties. As a result, the current network is not well-synchronised with the model tax conventions, and issues that arise over time cannot be addressed swiftly. Without a mechanism to swiftly implement them, changes to models only make the gap between the content of the models and the content of actual tax treaties wider. This clearly contradicts the political objective to strengthen the current system by putting an end to BEPS, in part by modifying the bilateral treaty network. Doing so is necessary not only to tackle BEPS, but also to ensure the sustainability of the consensual framework to eliminate double taxation. For this reason, governments have agreed to explore the feasibility of a multilateral instrument that

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1 OECD "Action Plan on Base Erosion and Profit Shifting" at 24.

would have the same effects as a simultaneous renegotiation of thousands of bilateral tax treaties.

Action 15 of the BEPS Action Plan provides for an analysis of the tax and public international law issues related to the development of a multilateral instrument to enable countries that wish to do so to implement measures developed in the course of the work on BEPS and amend bilateral tax treaties. On the basis of this analysis, interested countries will develop a multilateral instrument designed to provide an innovative approach to international tax matters, reflecting the rapidly evolving nature of the global economy and the need to adapt quickly to this evolution. The goal of Action 15 is to streamline the implementation of the tax treaty-related BEPS measures. This is an innovative approach with no exact precedent in the tax world, but precedents for modifying bilateral treaties with a multilateral instrument exist in various other areas of public international law. Drawing on the expertise of public international law and tax experts, the OECD Report on Action 15 explored the technical feasibility of a multilateral hard law approach and its consequences on the current tax treaty system. It identified the issues arising from the development of such an instrument and provided an analysis of the international tax, public international law, and political issues that arise from such an approach. The Report also concluded that a multilateral instrument is desirable and feasible, and that negotiations for such an instrument should be convened quickly. Based on this analysis, a mandate for the formation of an ad hoc Group to develop a multilateral instrument on tax treaty measures to tackle BEPS was approved by the OECD Committee on Fiscal Affairs and endorsed by the G20 Finance Ministers and Central Bank Governors in February 2015. The ad hoc Group is open to participation from all interested countries on an equal footing and is served by the OECD Secretariat. The ad hoc Group begun its work in May 2015 with the aim to conclude its work and open the multilateral instrument for signature by 31 December 2016. Participation in the development of the multilateral instrument is voluntary and does not entail any commitments to sign such instrument once it has been finalised.

RECOMMENDATIONS FOR SOUTH AFRICA

As a G20 country and as a member of the OECD BEPS committee, South Africa is supportive of the OECD work developing a multilateral instrument that is intended to amend numerous bilateral treaties via a single instrument. South Africa is one of over 80 countries that form the ad hoc Group created for the development of the multilateral instrument.[2]

- It is in the interest of South Africa to participate in the development of the Multilateral Instrument as the country will gain experience as to how the multilateral instrument is intended to work. This experience will enable the

[2] OECD "Multilateral instrument for BEPS tax treaty measures: the Ad hoc Group". Available at http://www.oecd.org/tax/treaties/multilateral-instrument-for-beps-tax-treaty-measures-the-ad-hoc-group.htm accessed 4 April 2016.

country to give special consideration to which provisions in the instrument it can reservations on.

- Before South Africa signs the multilateral instrument, it should take cognisance of its economic and socio-geopolitical special circumstances. Cognisance should also be taken of the fact that South Africa has signed treaties with some countries that are based on the OECD MTC and others based on the UN MTC. The OECD MTC embodies rules and proposals by developed capital exporting countries so it favours capital exporting countries over capital importing countries. Treaties based on the OECD MTC normally eliminate double taxation by requiring the source country to give up some or all of its tax on certain categories of income earned by residents of the other treaty country.[3] The UN MTC favours capital importing countries over capital exporting countries and it generally imposes fewer restrictions on the tax jurisdiction of source countries.[4] It is not clear how these diverging interests will be protected in a multilateral instrument (despite the op-in/opt-out proposals); and whether the interests of developing countries will be addressed in the multinational instrument. It would therefore be worthwhile for South Africa to adopt a "wait and see" approach as it gauges how other developing and emerging economies are proceeding on the matter. The UN is currently working on a revised MTC to be released in 2017 that would take into perspective the BEPS implications. It will be worthwhile for South Africa to first consider the UN recommendations as to how developing countries should respond to the changes.
- The OECD notes that countries have gained some experience in the working of multilateral instruments through the Multilateral Convention on Mutual Administrative Assistance in Tax Matters,[5] which was open to developing countries in 2011.[6] Although there has been an increase in the number of countries that have signed the Multilateral Convention, significant work in administrative capacity building is still required for many developing countries, before they can be admitted as parties to the Convention.
- Administrative capacity will once again be a major hindrance for many developing countries to be part of the BEPS Action 15 multilateral instrument. On 3 November 2011, South Africa signed, but has not yet ratified the Multilateral Convention on Mutual Administrative Assistance in Tax Matters.[7] South Africa has therefore not gained experience from this

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3 BJ Arnold and M.J. McIntyre, *International Tax Primer* (Kluwer Law International, 2002), p. 109.

4 Ibid.

5 OECD 'Convention on Mutual Administrative Assistance in Tax Matters'. Available at http://www.oecd.org/tax/exchange-of-tax-information/conventiononmutualadministrativeassistanceintaxmatters.htm (accessed on 9 May 2013).

6 Ibid.

7 Croome op cit note 220 at 1.

multilateral instrument. There are however other regional multilateral instruments South Africa has signed. South Africa is a member of the African Tax Administration Forum (AFAF) which promotes and facilitates mutual cooperation among African tax administrators. ATAF has come up with an African Agreement on Mutual Assistance in Tax Matters - a legal instrument to allow African Tax Administrations to assist each other in tax matters.[8]

- South Africa is also a party to the SADC Agreement on Assistance in Tax Matters signed in 2012 and dealing exclusively tax administration matters. It is important that South Africa gauges its experience from its involvement in these regional instruments to determine whether it is ready to sign the multilateral instrument. As much as it is important for South Africa as a member of G20 and OECD BEPS Sub-committee to be associated with the BEPS initiatives, protection of South Africa's economic interests in light of its special circumstances as developing country is of paramount importance.

[8] ATAF "Twenty one African Countries finalise Mutual Assistance Agreement in collecting taxes" (2 August 2012). Available at http://content.ataftax.org/Ataf/KodiKaticontentWeb.nsf/0/B4357C40821E9FDA42257AC9004DBE61?OpenDocument accessed 14 March 2014.

DTC REPORT ON ACTION 15: DEVELOP A MULTINATIONAL INSTRUMENT

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1 BACKGROUND

The OECD notes that globalisation has exacerbated the impact of gaps and frictions among different countries' tax systems. As a result, some features of the current bilateral tax treaty system facilitate base erosion and profit shifting (BEPS) and need to be addressed. The delivery of the actions included in the BEPS Action Plan will result in a number of outputs. Some actions will result in:

- recommendations regarding domestic law provisions;
- changes to the Commentary to the OECD Model Tax Convention (OECD MTC);
- changes to Transfer Pricing Guidelines; and
- changes to the OECD MTC. Such as:
  - the introduction of an anti-treaty abuse provision;
  - changes to the definition of permanent establishment;
  - changes to transfer pricing provisions; and
  - introduction of treaty provisions in relation to hybrid mismatch arrangements.[1]

The OECD explains that changes to the OECD MTC are not directly effective without amendments to bilateral tax treaties.[2] Beyond the challenges faced by the current tax treaty system on substance, the sheer number of bilateral treaties makes updating the current tax treaty network highly burdensome. Even where a change to the OECD MTC is consensual (after having been agreed upon multilaterally), it takes a substantial amount of time and resources to introduce that change into most bilateral tax treaties. Indeed, renegotiating a country's treaty network takes decades. As a result, the current network is not well-synchronised with the model tax conventions. Since the actual treaties are many years behind the models on which they are based, any multilaterally-agreed changes to the models take a generation to be implemented[3] and issues that arise over time cannot be addressed swiftly.[4] Furthermore, the version of the commentary and convention that applied when the treaty was signed is generally viewed as being the one that applies (i.e. as agreed) and, thus, many treaties are not suitable for the prevailing business environment.

Without a mechanism to swiftly implement them, changes to model treaties only make the gap between the content of the model treaties and the content of actual tax

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1 OECD "Action Plan on Base Erosion and Profit Shifting" at 24.

2 OECD "Action Plan on Base Erosion and Profit Shifting" at 23.

3 OECD/G20 2015 Final Report on Action 15 in para 5.

4 OECD/G20 2015 Final Report on Action 15 in the Executive Summary.

treaties wider. This clearly contradicts the political objective to strengthen the current system by putting an end to BEPS, in part by modifying the bilateral treaty network. Doing so is necessary not only to tackle BEPS, but also to ensure the sustainability of the consensual framework to eliminate double taxation.[5]

The OECD BEPS report notes that there is a need to consider innovative ways to implement the measures resulting from the work on the BEPS Action Plan.[6] The OECD recommends that a multilateral instrument to amend bilateral treaties is a promising way forward in this respect.[7] In terms of Action 15, a "multilateral instrument" is a treaty concluded between more than two parties. The OECD makes reference to the Vienna Convention on the Law of Treaties (VCLT), which defines a treaty in article 2(1)(a) as:

> "an international agreement concluded between States in written form and governed by international law, whether embodied in a single instrument or in two or more related instruments and whatever its particular designation."[8]

It is proposed that the "multilateral instrument" would have the same effect as a simultaneous renegotiation of thousands of bilateral tax treaties.

The OECD is of the view that such a multilateral instrument would not be a far-fetched idea as countries have gained some experience through the Multilateral Convention on Mutual Administrative Assistance in Tax Matters,[9] which was initially only open to members of the OECD and through the Council of Europe in 1998. In 2009, the G20 called for action to make it easier for developing countries to secure the benefits of transnational tax administrative co-operation.[10] In 2011, the OECD and the Council of Europe developed a Protocol that amended the Multilateral Convention on Mutual Administrative Assistance in Tax Matters thereby opening it up to developing countries.[11] Since then there has been increase in the number of countries that have signed the Multilateral Convention.

The OECD undertook to analyse the tax and public international law issues related to the development of a multilateral instrument so as to enable jurisdictions that wish to do so to implement measures developed in the course of the work on BEPS and amend bilateral tax treaties.[12] On the basis of this analysis, interested countries will develop a multilateral instrument designed to provide an innovative approach to

5 OECD/G20 2015 Final Report on Action 15 in the Executive Summary.

6 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 24.

7 OECD "Action Plan on Base Erosion and Profit Shifting" at 24.

8 OECD/G20 2015 Final Report on Action 15 in para 6 of Annexure A.

9 OECD "Convention on Mutual Administrative Assistance in Tax Matters". Available at http://www.oecd.org/tax/exchange-of-tax-information/conventiononmutualadministrativeassistanceintaxmatters.htm (accessed on 9 May 2013).

10 Ibid.

11 Ibid.

12 OECD/G20 2015 Final Report on Action 15 in the Executive Summary.

international tax matters, reflecting the rapidly evolving nature of the global economy and the need to adapt quickly to this evolution. [13]

The goal of Action 15 is to streamline the implementation of the tax treaty-related BEPS measures. This is an innovative approach with no exact precedent in the tax world, but precedents for modifying bilateral treaties with a multilateral instrument exist in various other areas of public international law.[14] Drawing on the expertise of public international law and tax experts, the OECD explored the technical feasibility of a multilateral hard law approach and its consequences on the current tax treaty system. It identified the issues arising from the development of such an instrument and provided an analysis of the international tax, public international law, and political issues that arise from such an approach. [15]

In 2014 the OECD issued a report in which it also concluded that a multilateral instrument is desirable and feasible, and that negotiations for such an instrument should be convened quickly. Based on the analysis in the 2014 report, a mandate for the formation of an ad hoc Group ("the Group") to develop a multilateral instrument on tax treaty measures to tackle BEPS was approved by the OECD Committee on Fiscal Affairs and endorsed by the G20 Finance Ministers and Central Bank Governors in February 2015. The Group is open to participation from all interested countries on an equal footing and is served by the OECD Secretariat. The Group began its work in May 2015 with the aim to conclude its work and open the multilateral instrument for signature by 31 December 2016. Participation in the development of the multilateral instrument is voluntary and does not entail any commitments to sign such an instrument once it has been finalised. [16] In 2015, the OECD issued its Final Report on report on Action 15. Below is a summary of the Report.

2 FINAL REPORT ON ACTION 15: DEVELOPING A MULTILATERAL INSTRUMENT TO MODIFY BILATERAL TAX TREATIES - 2015

2.1 SUMMARY OF THE OECD'S VIEWS ON A MULTILATERAL INSTRUMENT

a) The OECD notes that there is strong political support to eliminate BEPS.[17]
b) The current system of bilateral tax treaties focuses on the elimination of double taxation.[18]
c) Some features of the current tax treaty system facilitate BEPS.[19]

13 Ibid.
14 Ibid.
15 Ibid.
16 Ibid.
17 OECD/G20 2015 Final Report on Action 15 in para 1.
18 OECD/G20 2015 Final Report on Action 15 in para 2.
19 OECD/G20 2015 Final Report on Action 15 in para 3.

d) Change is needed to eliminate the opportunities the current tax treaty system creates for double non-taxation.[20]

e) The sheer number of bilateral treaties makes updates to the treaty network, burdensome and time-consuming, limiting the efficiency of multilateral efforts.

f) The need for change is urgent, and this is both a challenge and a unique opportunity. To address BEPS in a reasonable timeframe, a mechanism to facilitate swifter implementation is hence required. [21]

g) A multilateral instrument can address treaty-based BEPS issues while respecting sovereign autonomy in tax matters.
   - As BEPS results from the interactions of multiple countries' laws and treaties, governments need to collaborate more intensively through a hard law multilateral instrument both to prevent the tax treaty network from facilitating BEPS and to protect their tax sovereignty. Recognising the tax sovereignty concern, the report focuses on implementing treaty measures, even though a multilateral instrument could in principle also be used to express commitments to implement certain domestic law measures. [22]

h) A multilateral instrument facilitates speedy action and innovation. It will implement agreed treaty measures over a reasonably short period and at the same time it would preserve the bilateral nature of tax treaties. This innovative approach has at least three important advantages:
   - It would help ensure that the multilateral instrument is highly targeted;
   - It would allow all existing bilateral tax treaties to be modified in a synchronised way with respect to BEPS issues, without a need to individually address each treaty within the 3000+ treaty network; and
   - It responds to the political imperatives driving the BEPS Project in that it allows BEPS abuses to be curtailed and governments to swiftly achieve their international tax policy goals without creating the risk of violating existing bilateral treaties that would derive from the use of unilateral and uncoordinated measures. [23]

i) Overcoming traditional obstacles to swiftly implement agreed tax treaty measures requires political willingness to act. [24]

j) The OECD report on Action 15 concludes that a multilateral instrument is desirable and feasible, and that negotiations should be convened quickly. Negotiations would be convened through an International Conference open to G20 countries, OECD members and other interested countries under the aegis of the OECD and the G20. [25]

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[20] OECD/G20 2015 Final Report on Action 15 in para 4.
[21] OECD/G20 2015 Final Report on Action 15 in para 6.
[22] OECD/G20 2015 Final Report on Action 15 in para 7.
[23] OECD/G20 2015 Final Report on Action 15 in para 8.
[24] OECD/G20 2015 Final Report on Action 15 in para 9.
[25] OECD/G20 2015 Final Report on Action 15 in para 10.

2.2 THE OECD'S VIEWS AS TO WHY A MULTILATERAL INSTRUMENT IS DESIRABLE

The OECD is of the view that the multinational instrument is desirable because: the benefits are numerous, while burdens can be addressed or avoided:

a) Changes to the OECD MTC are intended to ultimately produce changes to the network of bilateral tax treaties that form a key component of the broader international tax architecture: [26]

b) A multilateral negotiation can overcome the hurdle of cumbersome bilateral negotiations and produce important efficiency gains: [27]
   - Given the decades-long process for bilateral treaty negotiations, a multilateral instrument represents the only way to address treaty-based BEPS concerns in a swift and co-ordinated manner;
   - The current network of bilateral treaties involves substantial complexity because each treaty is a legally distinct instrument, and its relationship to other bilateral treaties is undefined. As a result, lawyers, tax administrators, and courts spend a lot of energy interpreting each individual treaty, especially when treaties differ in small ways;
   - This problem would become more severe if varied anti-BEPS measures were included in thousands of new bilateral protocols to existing treaties;
   - The multilateral instrument will instead produce synchronised results that would save resources and improve the clarity of BEPS-related international tax treaty rules; and
   - Only a multilateral instrument can overcome the practical difficulties associated with trying to rapidly modify the 3000+ bilateral treaty network.[28]

c) The multilateral instrument can provide developing countries with the opportunity to fully benefit from the BEPS Project: [29]
   - Developing countries find it more difficult than developed countries to conclude double tax treaties, and to get the interest of other countries in tax treaty re-negotiation. This is because their tax treaty negotiation expertise is often more limited than that of developed economies.
   - A multilateral instrument therefore offers the best opportunity to ensure that developing countries reap the benefits of multilateral efforts to tackle BEPS.
   - In a multilateral negotiation, similarly-minded developing governments may co-operate, pooling their expertise to be efficacious in the negotiating process. [30]

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[26] OECD/G20 2015 Final Report on Action 15 in para 11.
[27] OECD/G20 2015 Final Report on Action 15 in para 12.
[28] OECD/G20 2015 Final Report on Action 15 in para 12.
[29] OECD/G20 2015 Final Report on Action 15 in para 13.
[30] OECD/G20 2015 Final Report on Action 15 in para 13.

d) Some issues are much easier to address multilaterally than in bilateral instruments:
  - o The bilateral treaty architecture was not originally designed to address high levels of factor mobility and global value chains brought about globalisation, this substantially increases the need to resolve resultant multi-country tax disputes.
  - o Although the multilateral mutual agreement procedure (MAP) can be used to resolve such multi-country disputes, some countries foresee legal constraints in the absence of a hard law instrument authorising multilateral MAP. Other countries do not believe they can use MAP to resolve cases that touch on issues not explicitly addressed in their existing bilateral tax treaties in the absence of an international law instrument that provides that authority.
  - o These and other legal obstacles that arise in implementing multilateral MAP can easily be addressed in the context of the multilateral instrument.[31]

e) A multilateral instrument can increase the consistency and help ensure the continued reliability of the international tax treaty network, providing additional certainty for business:
  - o Having a single text, instead of thousands of similar but slightly varying texts would be more likely to produce consistent interpretation across jurisdictional boundaries.
  - o A common international understanding would develop about the meaning of the text of the provisions of the multilateral instrument.
  - o By addressing a number of contested questions surrounding international tax rules in a definitive way, a multilateral instrument can restore clarity and ensure future certainty for the status of a variety of important rules that business relies upon to be able to invest with confidence cross-border. [32]

f) Flexibility, respect for bilateral relations, and a targeted scope are key to success:
  - o The multinational instrument provides benefits of swift implementation, improved consistency, certainty, and efficiency. These benefits can only be achieved if bilateral specificities and tax sovereignty are fully respected.
  - o Countries can be allowed to tailor their commitment under the instrument in pre-defined cases to help address these concerns.
  - o Parties could commit to a core set of provisions as part of a multilateral instrument, but then have the possibility to opt-out, opt-in or choose between alternative – and clearly delineated – provisions with respect to other issues covered by the instrument.

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31 OECD/G20 2015 Final Report on Action 15 in para 14.

32 OECD/G20 2015 Final Report on Action 15 in para 15.

- Negotiations would thereby accommodate bilateral specificities, reinforce governmental policy goals, and reassert tax sovereignty in the face of globalisation. [33]

g) A level playing field will require broad participation:
   - Some provisions of the treaty-based portion of the BEPS Project require broad participation in order to successfully address BEPS concerns.
   - To ensure a level playing field and fairly shared tax burdens; flexibility and respect for bilateral relations will need to be balanced against core commitments that reflect new international standards that countries are urged to meet and for which the multilateral instrument is a facilitative tool.[34]

2.3 OTHER ADVANTAGES OF THE MULTINATIONAL INSTRUMENT

a) The multilateral instrument provides an innovative approach to address the rapidly evolving nature of the global economy and the need to adapt international rules quickly.[35]

b) Some of the measures developed in the BEPS Project are multilateral in nature (such as those below) and would be much more effective if implemented through a multilateral instrument. These include:
   - Multilateral MAP;
   - Addressing dual-residence structures;
   - Addressing transparent entities in the context of hybrid mismatch arrangements;
   - Addressing "triangular" cases involving PEs in third states: where income of a tax treaty resident is attributed by the country of residence to a PE in a third State and exempt from tax in the residence State, often together with low taxation in the State of the PE; and
   - Addressing treaty abuse.[36]

c) Some tax treaty provisions that may implicate BEPS concerns are bilateral in nature, and for these provisions flexibility can be provided within certain boundaries. For instance, a multilaterally agreed provision which introduces changes to the definition of PE may need to provide for some flexibility to tailor the level of commitment towards all the other parties depending on the partner country.

d) Flexibility has to be within certain boundaries to ensure consistency and administrative feasibility.[37]

33 OECD/G20 2015 Final Report on Action 15 in para 16.
34 OECD/G20 2015 Final Report on Action 15 in para 17.
35 OECD/G20 2015 Final Report on Action 15 in para 30.
36 OECD/G20 2015 Final Report on Action 15 in para 33.
37 OECD/G20 2015 Final Report on Action 15 in para 32.

e) The precise content of a multilateral instrument is yet to be defined but the sense of direction is clear.[38] OECD and G20 governments are working towards agreement on substantive treaty-based measures to counter BEPS.

f) A multilateral instrument to implement BEPS outputs is an effective and innovative solution. This feasibility study concludes that despite potential challenges, a multilateral instrument is a promising way to quickly implement treaty-related BEPS measures. [39]

g) A multilateral instrument should be conceived in a dynamic way.[40]

2.4 THE OECD'S VIEWS AS TO WHY A MULTILATERAL INSTRUMENT IS FEASIBLE

The OECD is of the view that the multilateral instrument is feasible because legal mechanisms are available to achieve a balanced instrument that addresses the technical and political challenges.

a) The technical legal challenges that arise in modifying the international tax treaty architecture by means of a multilateral instrument will require careful attention. Nevertheless, an analysis of precedents in other areas of international law and the specifics of various proposed changes to the model tax conventions illustrate that developing a multilateral instrument to rapidly implement agreed changes is completely feasible from a legal point of view. [41]

b) The multilateral instrument would coexist with the existing bilateral tax treaty network:
   - Like existing tax treaties, this instrument would be governed by international law and would be legally binding on the parties.
   - A multilateral instrument will modify a limited number of provisions common to most existing bilateral treaties, and would, for those treaties that do not already have such provisions, add new provisions specifically designed to counter BEPS.
   - It could also clarify the compatibility with tax treaties of other anti-BEPS measures developed in the course of the BEPS Project.
   - The multilateral instrument could be accompanied by an explanatory report to facilitate the implementation of the provisions contained therein.[42]

c) The approach of a multilateral instrument is highly targeted and efficient:
   - The OECD considered other options, but a multilateral instrument that coexists with bilateral tax treaties was identified to be more appropriate

38 OECD/G20 2015 Final Report on Action 15 in para 33.
39 OECD/G20 2015 Final Report on Action 15 in para 34.
40 OECD/G20 2015 Final Report on Action 15 in para 35
41 OECD/G20 2015 Final Report on Action 15 in para 18.
42 OECD/G20 2015 Final Report on Action 15 in para 19.

than other approaches because it is more efficient and more targeted. Other options evaluated included:

- The use of a "self-standing instrument" that would wholly supersede bilateral tax treaties, governing the relationship between all the parties, whether or not they have concluded bilateral tax treaties amongst themselves. A "self-standing instrument" was however viewed to be overbroad given the importance of bilateral relations in international tax affairs and the importance of preserving tax sovereignty.
- An instrument whose sole purpose would be to operate like a bundle of "amending protocols", precisely amending the varying language of each of the 3000+ tax treaties. However the use of a bundle of "amending protocols" was viewed as less appealing than a coexisting multilateral instrument because it would be both more technically complex and less efficient. This approach was viewed as being too cumbersome and time consuming to satisfy the central purpose of the multilateral instrument, which is to implement treaty-related responses to BEPS quickly.[43]

d) A multilateral instrument would follow established negotiating processes, and ratification would require conventional domestic procedures, pursuant to national laws:

- o The intent of this multilateral instrument would be to ensure the effective and efficient implementation of the outputs of the BEPS Project that bear a relationship to the operation of tax treaties.
- o Once the implications of this innovative solution have been fully considered and addressed, an International Conference would negotiate the content and actual text of the multilateral instrument, which would then be subject to the regular ratification procedures by each party.
- o Therefore, this multilateral instrument would follow traditional negotiating processes, and ratification would take place according to national laws. [44]

e) The relationship between parties to a multilateral instrument that are not parties to a bilateral tax treaty between themselves generally would not be affected:

- o In some instances, parties to a multilateral instrument would not yet have concluded a bilateral tax treaty between themselves.
- o The multilateral instrument would only govern the relationship between parties that have concluded bilateral tax treaties amongst themselves.
- o One exception to this general rule could be a multilateral dispute resolution mechanism which operates among all parties to the multilateral instrument, including in cases where certain parties to the instrument lack bilateral treaty relationships with one another.

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43 OECD/G20 2015 Final Report on Action 15 in para 20.
44 OECD/G20 2015 Final Report on Action 15 in para 21.

- A separate question to be examined by the treaty negotiators at the International Conference is whether this multilateral instrument would impose any obligation on the parties to the instrument with respect to a situation in which two States conclude a bilateral tax treaty covering the same issue for the first time at a date after they each become parties to the instrument. In this regard, the OECD recommends that from a legal point of view the relevant provisions could be crafted to apply in such a case, and therefore a decision will have to be taken at the political level. [45]

f) Technical challenges arising from the interaction between a multilateral instrument and bilateral tax treaties can be addressed:
   - Variations in scope between similar provisions of existing bilateral treaties can be successfully resolved.
   - Variations in the wording of similar provisions of existing bilateral treaties can be addressed through superseding language in a multilateral instrument.
   - Addressing variations in the numbering of provisions simply requires careful drafting.
   - The timelines for signature and entry into force can be calibrated for flexibility.
   - Solutions for other technical issues, such as questions of language and translation, are readily available.[46]

g) In general, a flexible approach will be paramount for the multilateral instrument:
   - As is the case with the existing network of bilateral tax treaties, parties to a multilateral instrument may have tax policies that differ from one another and could not be harmonised amongst all the parties to the instrument. They may not be ready to accept the same precise commitments vis-à-vis all other parties.
   - One of the main challenges for negotiators of a multilateral instrument will therefore be to ensure flexibility regarding the extent of the rights and obligations established by the treaty vis-à-vis all the other parties, as well as the level of commitments towards certain parties, while at the same time maintaining consistency, in order to create a level playing field, and transparency, in order to provide certainty.[47]

h) There are ample legal means for providing flexibility to modulate, within agreed boundaries, parties' commitments:
   - A multilateral instrument could allow for the tailoring of the level of certain commitments towards all the other parties and/or depending on the partner country.
   - There are a number of tools to ensure flexibility and a number of relevant precedents in this regard.

[45] OECD/G20 2015 Final Report on Action 15 in para 22.
[46] OECD/G20 2015 Final Report on Action 15 in para 23.
[47] OECD/G20 2015 Final Report on Action 15 in para 24.

- It should be recognised that some provisions may require consistent adoption among the parties to a multilateral instrument for reasons of technical administrability.[48]

i) The relationship with other multilateral instruments should be closely examined.[49]

j) Negotiation of the multilateral instrument must be speedy to avoid uncertainty.[50]
   - This is necessary so that business may adjust to the new reality and continue to support growth, create jobs, and foster innovation.
   - To avoid the fact that putting some issues in a multilateral instrument may slow the ability to address BEPS, a targeted multilateral instrument will be set with a well-defined scope and a precise timetable for negotiation.[51]

k) The BEPS Project is intended to result in shared principles to shore up the clarity and predictability of the tax treatment of cross-border activities.[52]

2.5 SCOPING THE INTERNATIONAL CONFERENCE

- The development of a multilateral instrument requires framework provisions related to its entry into force, language, etc. and more importantly agreement on the substance of the tax treaty measures required to respond to BEPS.[53]
- The OECD convened an International Conference to develop the multilateral instrument in November 2015.
- The International Conference was open to all interested countries, under the aegis of the OECD and the G20.[54]

2.6 SUMMARY OF THE TOOLBOX FOR THEORETICAL OPTIONS IN THE DEVELOPMENT OF A MULTILATERAL INSTRUMENT

The multilateral instrument offers an expansive and adaptable toolkit to ensure:

a) A multilateral instrument can implement BEPS measures and modify the existing network of bilateral tax treaties.
   - The bilateral tax treaties would remain in force for all non-BEPS related issues.
   - It would be preferable, for reasons of efficiency and transparency, to define this relationship through the inclusion of compatibility clauses in the multilateral instrument.
   - There are several options in order to ensure consistency in the interpretation and implementation of the multilateral instrument. Solutions

[48] OECD/G20 2015 Final Report on Action 15 in para 25.
[49] OECD/G20 2015 Final Report on Action 15 in para 26.
[50] OECD/G20 2015 Final Report on Action 15 in para 27.
[51] OECD/G20 2015 Final Report on Action 15 in para 27.
[52] OECD/G20 2015 Final Report on Action 15 in para 28.
[53] OECD/G20 2015 Final Report on Action 15 in para 36.
[54] OECD/G20 2015 Final Report on Action 15 in para 37.

also exist with regard to the dates of entry into force of different provisions and logistical issues including differences in the authentic languages of the multilateral instrument and bilateral tax treaties.[55]

b) A multilateral instrument can provide appropriate flexibility for stakeholders in their level of commitment in order to move towards a level playing field.
   - Flexibility can be defined as to the level of commitment of the parties vis-à-vis all or certain parties can be achieved through the use of:
     - opt-out mechanisms allowing parties to exclude or modify the legal effects of certain provisions;
     - a choice between alternative – and clearly delineated – provisions; and
     - opt-in mechanisms offering parties the possibility to take on additional commitments.

   The level of commitment of parties can also be modulated through the language used in the multilateral instrument (strong or soft wording) and types of obligations (of results and/or means).[56]

c) A multilateral instrument can ensure transparency and clarity for all stakeholders. Mechanisms are available to ensure clear and publicly accessible information as regards, on the one hand, the interaction between the multilateral instrument and bilateral tax treaties and, on the other hand, the use of the mechanisms for flexibility set up by the multilateral instrument.[57]

As with the development of any new instrument, there are technical issues but they can be solved through well-tested solutions drawing on treaty law and practice. International tax experts and public international law experts will need to continue working hand in hand as this project moves forward.[58]

3 CONCLUDING REMARKS AND RECOMMENDATIONS FOR SOUTH AFRICA

The signing of the multilateral agreement seems to be the pinnacle upon which one can judge if the BEPS project will succeed or fail. [59]

As a G20 country and as a member of the OECD BEPS committee, South Africa is supportive of the OECD work on multilateral instrument that is intended to amend numerous bilateral treaties via a single instrument. A Mandate to set up an ad hoc for the Development of a Multilateral Instrument on Tax Treaty Measures to Tackle BEPS[60] was developed by the OECD Committee on Fiscal Affairs and endorsed by

55 OECD/G20 2015 Final Report on Action 15 in para 2 of Annex A.
56 OECD/G20 2015 Final Report on Action 15 in para 2 of Annex A.
57 OECD/G20 2015 Final Report on Action 15 in para 4 of Annex A.
58 OECD/G20 2015 Final Report on Action 15 in para 5 of Annex A.
59 Ibid.
60 OECD/G20 Base Erosion and Profit Shifting Project “Action 15: A Mandate for the Development of a Multilateral Instrument on Tax Treaty Measures to Tackle BEPS” (2015). Available at

the G20 Finance Ministers and the Central Bank Governors at their February 2015 Meeting. South Africa is one of over 80 countries that form the ad hoc group created for the development of a multilateral instrument.[61] Work on the development of the Multilateral Instrument begun on 27 May 2015 and South Africa participates in forums to discuss the working and crafting of the multilateral instrument.

- It is in the interest of South Africa to participate in the development of the Multilateral Instrument as the country will gain experience as to how the multilateral instrument is intended to work. This experience will enable the country to give special consideration to which provisions in the instrument it can make reservations on.
- Before South Africa signs the multilateral instrument, it should take cognisance of its economic and socio-geopolitical special circumstances. Cognisance should also be taken of the fact that South Africa has signed treaties with some countries that are based on the OECD MTC and others based on the UN MTC. The OECD MTC embodies rules and proposals by developed capital exporting countries so it favours capital exporting countries over capital importing countries. Treaties based on the OECD MTC normally eliminate double taxation by requiring the source country to give up some or all of its tax on certain categories of income earned by residents of the other treaty country.[62] The UN MTC favours capital importing countries over capital exporting countries and it generally imposes fewer restrictions on the tax jurisdiction of source countries.[63] It is not clear how these diverging interests will be protected in a multilateral instrument (despite the op-in/opt-out proposals); and whether the interests of developing countries will be addressed in the multinational instrument. It would therefore be worthwhile for South Africa –; to adopt a “wait and see” approach as it gauges how other developing and emerging economies are proceeding on the matter. The UN is currently working on a revised MTC to be released in 2017 that would take into perspective the BEPS implications. It will be worthwhile for South Africa to first consider the UN recommendations as to how developing countries should respond to the changes.
- The OECD notes that countries have gained some experience in the working of multilateral instruments through the Multilateral Convention on Mutual Administrative Assistance in Tax Matters,[64] which was open to

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http://www.oecd.org/ctp/beps-action-15-mandate-for-development-of-multilateral-instrument.pdf accessed 4 April 2016.

61 OECD “Multilateral instrument for BEPS tax treaty measures: the Ad hoc Group”. Available at http://www.oecd.org/tax/treaties/multilateral-instrument-for-beps-tax-treaty-measures-the-ad-hoc-group.htm accessed 4 April 2016.

62 BJ Arnold and M.J. McIntyre, *International Tax Primer* (Kluwer Law International, 2002), p. 109.

63 Ibid.

64 OECD ‘Convention on Mutual Administrative Assistance in Tax Matters’. Available at http://www.oecd.org/tax/exchange-of-tax-information/conventiononmutualadministrativeassistanceintaxmatters.htm (accessed on 9 May 2013).

developing countries in 2011.[65] Although there has been an increase in the number of countries that have signed the Multilateral Convention, significant work in administrative capacity building is still required for many developing countries, before they can be admitted as parties to the Convention.

- Administrative capacity will once again be a major hindrance for many developing countries to be part of the BEPS Action 15 multilateral instrument. On 3 November 2011, South Africa signed, but has not yet ratified the Multilateral Convention on Mutual Administrative Assistance in Tax Matters.[66] South Africa has therefore not gained experience from this multilateral instrument. There are however other regional multilateral instruments South Africa has signed. South Africa is a member of the African Tax Administration Forum (AFAF) which promotes and facilitates mutual cooperation among African tax administrators. ATAF has come up with an African Agreement on Mutual Assistance in Tax Matters - a legal instrument to allow African Tax Administrations to assist each other in tax matters.[67]
- South Africa is also a party to the SADC Agreement on Assistance in Tax Matters signed in 2012 and dealing exclusively tax administration matters. It is important that South Africa gauges its experience from its involvement in these regional instruments to determine whether it is ready to sign the multilateral instrument. As much as it is important for South Africa as a member of G20 and OECD BEPS Sub-committee to be associated with the BEPS initiatives, protection of South Africa's economic interests in light of its special circumstances as developing country is of paramount importance.

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65 Ibid.
66 Croome op cit note 220 at 1.
67 ATAF "Twenty one African Countries finalise Mutual Assistance Agreement in collecting taxes" (2 August 2012). Available at http://content.ataftax.org/Ataf/KodiKaticontentWeb.nsf/0/B4357C40821E9FDA42257AC9004DBE61?OpenDocument accessed 14 March 2014.