DAVIS TAX COMMITTEE NOTE ON TERRITORIAL TAXATION

WILL A MOVE FROM A WORLDWIDE TO A TERRITORIAL SYSTEM ENSURE THE EFFICIENCY OF SOUTH AFRICA'S TAX SYSTEM?

Depending on the factors at play in a given country, one of the main tax policy issues that the legislators have to grapple with is where the country ought to be on the broad spectrum that runs from a pure worldwide system to a pure territorial system. The answer to this question requires the legislators to consider whether the country's resources and administrative capacity should be used to cast the domestic tax net worldwide, so as to tax its residents' foreign investments, or whether the country's resources should be used to effectively tax income that is within their borders and encourage the competiveness of domestic enterprises to invest offshore. Generally, countries do not adhere to one of these policy objectives at the complete expense of the other, rather they gravitate towards one fiscal policy that combines elements of both objectives. On this matter, the DTC refers to Professor Annet Wanyana Oguttu's article (attached),[1] which recommended that South Africa should gravitate more towards a territorial basis of taxation alongside the worldwide system.

The DTC concurs with Prof Oguttu's views. Whilst not proposing to remove the residence-based system, the DTC recommends that South Africa considers gravitating, once again, more towards a stronger element of the territorial system in its dual system, by adopting a greater mix of the basic territorial features. Such a change would represent an improvement in terms of neutrality, efficiency and simplicity, and this would enhance the competitiveness of the economy. The following are some examples of how the South African territorial system could be strengthened.

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[1] AW Oguttu "Ensuring a right balance in applying the residence and source bases of taxation in order to protect South Africa's tax base" published in J Hattingh, J Roeleveld, C West *Income Tax in South Africa: The First 100 Years* (1914 - 2014) in Part 5, pages 245-275

(a) Strengthen domestic source rules

The source rules in section 9 of the Income Tax Act need to be revisited and strengthened

(b) Strengthen source rules in light of OECD BEPS Project

The OECD BEPS Project recommendations regarding enhancing tax treaty rules that strengthen source taxation should be adhered to, particularly those relating to preventing artificial avoidance of permanent establishment[2] status; and taxation of the digital economy – these matters were dealt with in the DTC Report on BEPS.

(c) Strengthen withholding taxes in tax treaties

The OECD Model Tax Convention (MTC) does not contain a specific article on service fees nor does it have any special treatment of services. Instead, services are treated the same way as other business activities, in that a State may only tax the foreign service provider if it qualifies as a permanent establishment in terms of article 5. [3] Under the UN Model, the services of a consultant may be taxed as "independent personal services" in article 14, if the person has a "fixed base" that they regularly use in the source state. Whether services are taxed under the PE article in or under article 14 in the UN MTC, only profits attributed to a PE or a fixed base are taxable in the source state using the arm's length principle – ALP (article 7 and 9).[4] However applying the ALP on service fees is cumbersome due to difficulties of verifying whether the fees are appropriate.[5] Besides, the OECD's authorised approached[6] of attributing profits to a PE (in article 7(2)), as discussed above, poses particular challenges for intra-group services since it recognises the internal dealings of a PE and its head office. This implies that notional management expenses from head office may be charged to the PE resulting in base

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[2] A permanent establishment is defined in section 1 of the Income Tax Act as defined in article 5 of the OECD Model Tax Convention.

[3] Para 42.11 of the Commentary on Article 5(7) of the OECD MTC

[4] BJ Arnold & MJ McIntyre *International Tax Primer* (2012) at 122.

[5] AW Oguttu "BEPS in Africa Part 2: A Critical Analysis of Some Priority OECD BEPS Action Points from an African Perspective (2016) *Bulletin for International Taxation*, vol. 70, No. 6 348-349.

[6] Article 7(2) of the OECD MTC.

erosion.[7] Despite the fact that South Africa has reserved the right not to apply the OECD's authorised approach in that, notional charges are not accepted; the OECD's approach is nevertheless often applied in practice.

The absence of a special deemed PE rule that allows a source country to tax the long-term provision of services, denies source countries the right to effectively tax such business.[8] To protect their tax bases some African countries have signed treaties with articles on management/service fees that deviate from the OECD MTC and the current UN MTC, for example, Uganda's treaty with South Africa.[9] However, there is no standard way of drafting these articles, which makes treaty negotiations difficult and creates uncertainty for taxpayers. The UN has addressed this matter by designing a "technical service fee" article which will feature in the next update of its MTC. This article will allow developing countries to levy a tax on payments made to the overseas providers of "technical services" even if there is no physical presence in the country. It is recommended that South Africa includes this article in the future tax treaties it negotiates – especially those treaties that are based on the UN Model Tax Convention.

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[7] Deloitte "ATO paper on Profit Allocation to Bank Branches". Available at http://www.deloitte.com/view/en_au/au/a79b8ba975c53310VgnVCM3000001c56f00aRCRD.htm accessed 14 June 2016.

[8] V Daurer & R Krever "Choosing between the UN and OECD Tax Policy Models: An African Case Study" (2014) 22 No. 1 *African Journal of International and Comparative Law* at 9

[9] Article 13 of the SA/Uganda DTA, entered into force 9 April 2001.