ADDRESSING BASE EROSION AND PROFIT SHIFTING IN SOUTH AFRICA

DAVIS TAX COMMITTEE INTERIM REPORT

(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 appointed 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 interim report that sets out the DTC's position as at 30 September 2014.[2]

(ii) ACKNOWLEDGEMENTS

The DTC BEPS Sub-committee consulted with various staceholders 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 Reserve Bank, members of international bodies and academics, who have been involved through meetings were they presented their views and through submissions of technical reports on various BEPS Actions Plans.

NAME	AFFILIATION	SUBMISSION
Jasson Urbach	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 and Mr Vuyo Jack. 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: Mr Vuyo Jack (Empowerdex; Chartered Accountant with SAICA; Qualification: B.Comm Honours Taxation - Wits University).

	FEDUSA	Presentation to DTC
	Business Unity South Africa	Presentation to DTC
Johnlyn van Reenen	Tax Justice Network	Presentations to DTC
Keith Engel Lesley Isherwood Charles Makola	KPMG	Presentation and Technical Report
Kyle Mandy	PWC	Presentation to DTC
Barbra Curson Jozua Loots Marc Jardine Andrew Wes Dries Van Niekerk Tshepo Khalaki Iain Bussy Johan De La Rey Shere Peer Jenny Alence	SARS	Presentation to DTC and Technical Reports
Charles Makola Johan Lamprecht Lutando.Mvovo Hayley Reynolds Mulalo Madula	National Treasury	
Gil Marcus Lesetja Kganyago	South African Reserve Bank	Presentation and Technical Report
Lincoln Marais Logan Wort	African Tax Administration Forum (ATAF)	Discussions with DTC
Jeffrey Owens	Academy of Public Finance	Presentations to DTC
Chris Sanger	Academy of Public Finance	Presentations to DTC
Pascal Lamy Franz Tomasek	OECD	Presentation to DTC
Adv Gumbi	UN Economic Commission for Africa	Presentation to DTC
Michael Honiball	Webber Wentzel	Presentations to DTC
Nazrien Kader Billy Joubert Paul Verhoef Karen Miller Carla Van Der Merwe	Deloitte & Touche	Technical Report
Sharon Smulders	SAIT	Presentations to DTC

Zolani Buba	LLM Candidate (UCT)	Technical Report
SP Van Zyl	UNISA	Technical Report
Peter Dach	ENS	Technical Report
Wally Horak	Bowman Gilfillan	Technical Report
Lisa Brunton	Cliffe Dekker Hofmeyr Inc	Technical Report
Peter Surtees	Norton Rose	Technical Report

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(vi) ABBREVIATIONS

CFC	Controlled Foreign Company
DTC	Davis Tax Committee
ATAF	African Tax Administration Forum
FDI	Foreign 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[3] 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[4] 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 lower-taxed 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.[5] 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".[6] This message was reiterated by the UK Chancellor of the Exchequer, plus Germany and France's 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.[7] 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".[8] Responding to these concerns, in February 2013 the OECD released a Report entitled "Addressing Base Erosion and Profit Shifting"[9] (BEPS) in which it is noted that BEPS constitute a serious risk to tax revenues, tax sovereignty and tax fairness for OECD member countries and non-members alike".[10] A subsequent ambitious

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[3] 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 Net work "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).

[4] 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.

[5] Ibid.

[6] 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.

[7] OECD "Addressing Base Erosion and Profit Shifting" (2013) at 14.

[8] OECD "Addressing Base Erosion and Profit Shifting" (2013) at 14.

[9] Ibid.

[10] Ibid.

global Action Plan of the OECD with 15 comprehensive actions was released in July 2013.

There is now 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.[11]

- At the May 2013 European Union Summit,[12] the EU Council reiterated its intention to accelerate its Action Plan to strengthen the fight against tax fraud, tax evasion and aggressive tax planning.[13]
- In Australia, in order to improve the transparency of Australia's business tax system, on 3 April 2013 the Treasury released a discussion paper calling for public comment on proposals to "improve the transparency of Australia's business tax system".[14]
- On 31 July 2013, the UK House of Lords released a Report[15] 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 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.[16]
- 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

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11 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.

12 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.

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

14 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.

15 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.

16 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.

- 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
- G20 Leaders Meeting, 4-5 September 2013, St. Petersburg

In South Africa, the terms of reference of the Davis Tax Committee (DTC) which appointed by the Minister of Finance on 17 July 2013 required the Committee to address concerns about BEPS specially 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 Base Erosion and Profit Shifting [17] 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.[18] 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.[19] Even though there are many ways in which domestic tax bases can be eroded, a significant source of base erosion is profit shifting[20] which focuses on moving profits to where they are taxed at lower rates and expenses to where they are relieved at higher rates.[21] MNEs often argue that they have a responsibility towards their shareholders to legally reduce the taxes their companies pay. They blame governments for coming up with incoherent tax policies and designing tax systems that provide incentives for BEPS.[22]

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

- BEPS undermine competition. MNE have competitive advantages over enterprises that operate at domestic level (especially small and medium size enterprises).[23]

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17 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 7.
18 Ibid.
19 Ibid.
20 OECD "Addressing Base Erosion and Profit Shifting" (2013) at 5.
21 OECD "Addressing Base Erosion and Profit Shifting" (2013) at 39.
22 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 13.
23 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 8.

- 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 undermines the integrity of the tax system. It discourages tax morality and has encouraged a perception that the system is unfair. [24] This in turn undermines voluntary compliance by all taxpayers. [25]
- 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. [26]

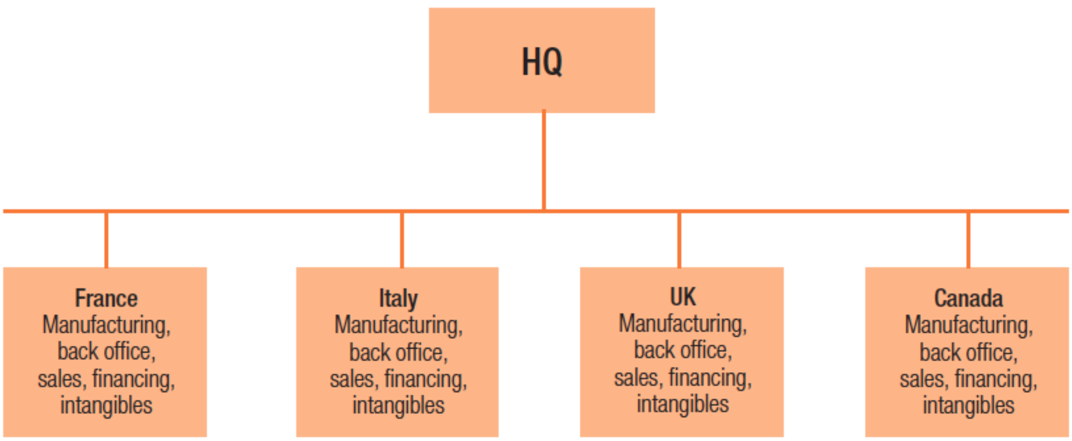
- There has been a shift from country-specific operating models to global models based on matrix management organisations and integrated supply chains that centralise several functions at a regional or global level.[27]
- There is increased growth in the service component of the economy, and of digital 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. [28]
- 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 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. [29]
- Global Value chains (GVCs), characterised by the fragmentation of production across borders, have become a dominant feature of today's global economy.[30] 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,

[24] OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 13.
[25] OECD "Addressing Base Erosion and Profit Shifting" (2013) at 8.
[26] OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 27-28.
[27] OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 25.
[28] Ibid.
[29] OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 25.
[30] OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 26.

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.[31]

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.

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.

31 OECD “Action Plan on Base Erosion and Profit Shifting” (2013) at 27.

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, controlled foreign corporations, treaty abuse, general anti-avoidance, anti-hybrid, tax disclosure, and transfer pricing rules. However, these piecemeal actions have often failed to keep pace with the changing business environment. [32] 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. [33]

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 legal but which take advantage of asymmetries in domestic and international tax rules.[34] Governments recognise this and also recognise that a change in this legal framework can only be achieved through international co-operation". [35]

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.[36] 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". [37]

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

32 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 47.
33 Ibid.
34 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 49.
35 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 27-28.
36 OECD "Addressing Base Erosion and Profit Shifting" (2013) at 5.
37 OECD "Addressing Base Erosion and Profit Shifting (2013) at 47.

increased segregation between the location where actual business activities and investment take place and the location where profits are reported for tax purposes.[38]

Beyond evidence like that by the investigations by the UK House of Lords Committee on Fiscal Affairs,[39] 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.[40] For developing countries Oxfam, a non-profit organisation, attributes a revenue loss of USD50 billion to tax avoidance by multinationals.[41] Although the question of how much revenue is lost due to profit shifting is highly interesting for the 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.[42]

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. 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.

38 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 15.

39 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.

40 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.

41 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.

42 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.

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

- 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 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".[45] 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 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.[46] 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.[47]

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

- Action Plan 1: Address the Tax Challenges of the Digital Economy
- Action Plan 2: Neutralise the Effects of Hybrid Mismatch Arrangements
- Action Plan 3: Strengthen Controlled Foreign Companies Rules
- Action Plan 4: Limit Base Erosion via Interest Deductions and Other Financial Payments
- Action Plan 5: Counter Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance
- Action Plan 6: Prevent Treaty Abuse
- Action Plan 7: Prevent the Artificial Avoidance of PE Status
- Action Plan 8: Assure that Transfer Pricing Outcomes are in Line With Value Creation / Intangibles

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44 OECD "Fundamental Reform of Corporate Income Tax" (2007) No.16.
45 OECD "Addressing Base Erosion and Profit Shifting" (2013) at 8.
46 Ibid.
47 OECD "Addressing Base Erosion and Profit Shifting" (2013) 7-8.

- Action Plan 9: Assure that Transfer Pricing Outcomes are in Line With Value Creation / Risks and Capital
- Action Plan 10: Assure that Transfer Pricing Outcomes are in Line With Value Creation / Other High-Risk Transactions
- Action Plan 11: Establish Methodologies to Collect and Analyse Data on BEPS and the Actions to Address It
- Action Plan 12: Require Taxpayers to Disclose Their Aggressive Tax Planning Arrangements
- Action Plan 13: Re-examine Transfer Pricing Documentation
- Action Plan 14: Make Dispute Resolution Mechanisms More Effective
- Action Plan 15: Develop a Multilateral Instrument

The 15-point Action Plan to address BEPS aims 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.

At this stage it may be difficult for countries to comprehensively address these actions until guidance has been received in the form of outcomes of the work of the OECD. It is also not known the extent to which the action plan will result in realistic action by each country's tax authorities.

1.5.1 BEPS Action Plan Time Frames

In terms of the OECD "Action Plan 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 recommends that the pace of the project must be rapid so that concrete actions can be delivered quickly. Governments also need time to complete the necessary technical work and achieve widespread consensus. It is expected that the 15-point Action Plan will be completed by 2015, with seven of those actions delivered in September 2014. 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 2014 deliverables (discussed in the annexure to this report). 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.[48] Business representatives, trade unions, civil society organisations and academics have also been very involved through opportunities to comment on discussion drafts. Given the Action Plan's aim of providing comprehensive and coherent solutions to BEPS, the proposed measures on the seven 2014 deliverables, while agreed, are not yet formally finalised since they may be affected by some of the decisions to be taken with respect to the 2015 deliverables with which the 2014 deliverable interact. The 2014 deliverables do however reflect consensus, on a number of solutions towards eliminating double non-taxation due to BEPS.[49] These measures, combined with the work to be completed in 2015, 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. The following is a summary of the BEPS Action Plan Time frame.

<table>
<tr><th>SEPTEMBER 2014 DELIVERABLES</th><th>SEPTEMBER 2015 DELIVERABLES</th></tr>
<tr><td>Action 1: Tax challenges of the digital economy

Action 2: Hybrid mismatch arrangements

Action 5: Harmful tax practices

Action 6: Treaty abuse

Action 8: Transfer pricing work on intangibles

Action 13: Transfer pricing documentation and country by country reporting (CBCR)

Action 15: Develop a Multilateral Instrument to enable jurisdictions that wish to do so to implement</td><td>Action 3: Strengthen Controlled Foreign Corporations (CFC) rules
Action 4: Limit Base Erosion via Interest Deductions and Other Financial Payments
Action 7: Abuse of the definition of permanent establishment (PE) concept
Action 9: Transfer Pricing: Risks and Capital
Action10: Transfer Pricing: Other High-Risk Transactions
Action 11: Establish methodologies to collect and analyse data on BEPS
Action 12: Require taxpayers to disclose their aggressive tax planning arrangements
Action 14: Make dispute resolution mechanisms more effective
Action 15: Develop a Multilateral Instrument to enable jurisdictions that wish to do so to implement</td></tr>
</table>

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

2.1 South Africa's National Sovereignty and Constitutional Perspectives

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

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

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." [50] "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.[51] 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. In today's world, the interaction of countries' domestic policies becomes fundamental. [52]

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.[53] 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 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.[54] 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.[55] 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.[56]

50 OECD "Addressing Base Erosion and Profit Shifting" (2013) at 28.
51 OECD "Addressing Base Erosion and Profit Shifting" (2013) at 39.
52 OECD "Addressing Base Erosion and Profit Shifting" (2013) at 28.
53 Section 2 of the Constitution of the Republic of South Africa, 1996.
54 K Vogel *Double Tax Conventions* (1997) in the Introduction in par 28.
55 L Olivier & M Honiball *International Tax: A South African Perspective* (2014) at 311-312.
56 Olivier & Honiball *International Tax: A South African Perspective* (2014) at 307.

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.[57] The OECD often calls on non-member countries to associate themselves with its recommendations.

South Africa is not a member country of the OECD. It was, however, awarded OECD observer status in 2004,[58] 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.[59] In *ITC 1503*[60] 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 defines the "permanent establishment" concept (a matter relevant to BEPS) with reference to the OECD definition.[61] 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[62] 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.

It is 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

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

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

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

60 53 SATC 342 at 348.

61 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".

62 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.

taken. The BEPS concerns and challenges that other countries such as the UK or USA 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.

2.3 South Africa's National Development Plan: Fiscal and Economic Policy

South Africa's NDP[63] sets the country's overall economic strategy and policy. The NDP requires that the country 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. 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

SARS statistics indicate that corporate revenues in South Africa were fairly stable before 2008 and took a down turn after the 2008 global financial crisis. Although this decline may provide useful indications that perhaps BEPS are occurring, these

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

trends in the relationship of corporate income tax to GDP do not necessarily imply either the existence or non-existence of BEPS practices. The graph from SARS below shows that the contribution of corporate taxes to GDP declined over the last 6 years.

Table 1

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 Buget 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.[64]

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

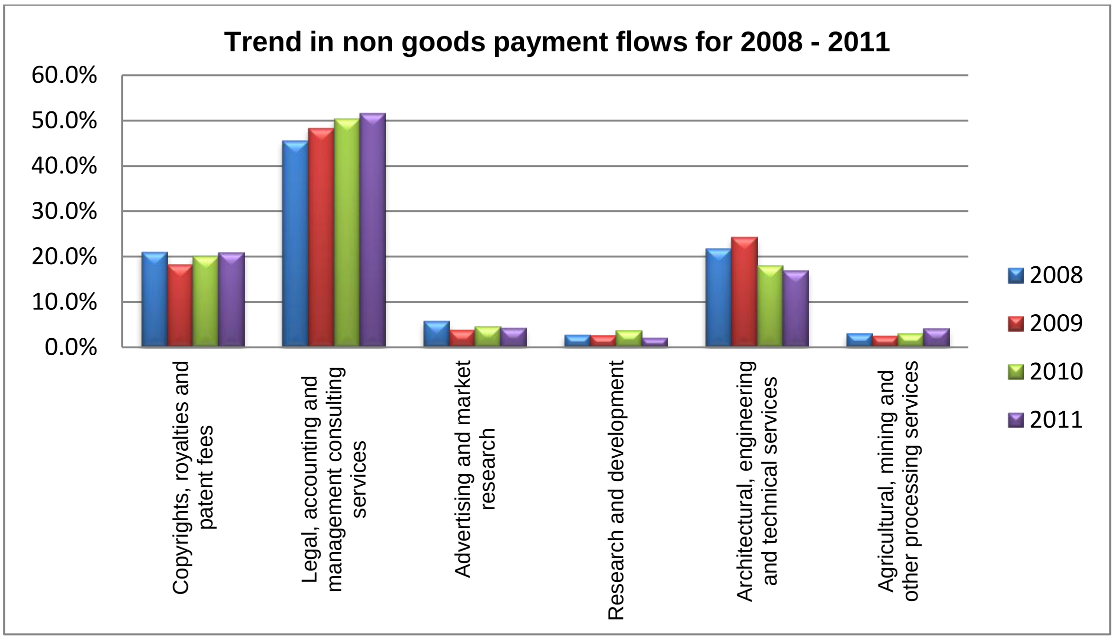
	2008 R	**2009 R**	**2010 R**	**2011 R**	**Grand Total R**
Copyrights, royalties and patent fees	9,193,024,882	9,972,557,798	10,218,632,767	11,753,572,186	41,137,787,633
Legal, accounting and management consulting services	19,907,138,985	26,404,401,495	25,567,916,347	29,086,527,270	100,965,984,097
Advertising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

64 National Treasury *Budget* (2013).

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 crises 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%). Consumption increases during the aftermath of a global financial crisis 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 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.

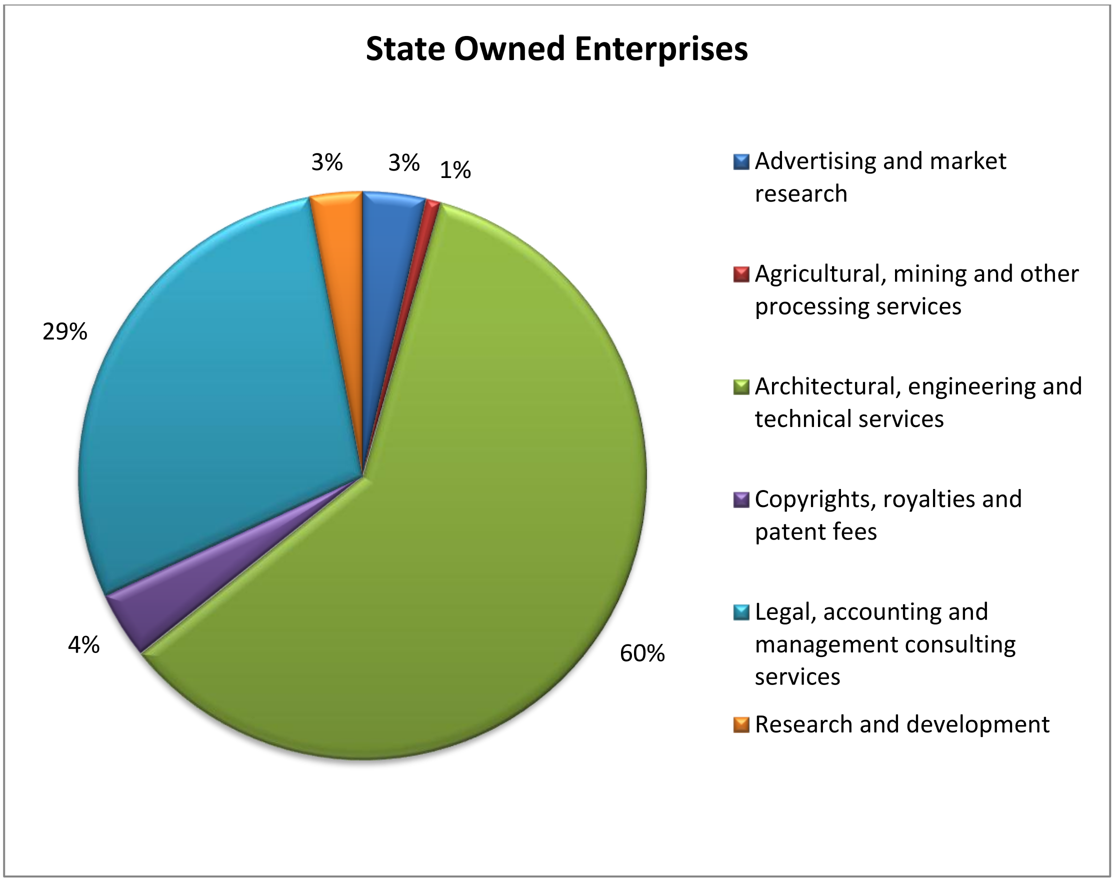
Figure 2: Non goods contribution to overall payment flows

	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 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 are 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.

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
- 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
	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 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, and is an indication that illicit tax base migration 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 off shore service providers.

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.[65] The existence of the uncompetitive markets has led to relatively high profit margins for enterprises but very little new

65 National Planning Commission *National Development Plan 2030* (2012).

investment or innovation. Authors Aghion et al[66] 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 South African manufacturing industry and employment creation.[67] Clearly this shows 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

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,[68] 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.[69] 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.[70]

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 strengthen and/or comes up with measures to prevent the base erosion and profit shifting as identified in the OECD BEPS Action Plan. However, these measures should not be adopted without taking into consideration the need to encourage foreign direct investment (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.

Tax competition, like other forms of competition, requires governments to provide a tax environment that is conducive to economic growth.[71] In practice, most taxes (not just the corporate income tax) can have an impact on competitiveness. [72] In

66 P Aghion, M Braun & F Fedderke "Competition and Productivity Growth in South Africa" (2008) 16(4) *Economics of Transition* at 741-68.
67 Ibid.
68 IMF "United Kingdom: Technical Assistance Report - Assessment of HMRC's Tax Gap Analysis" (August 2013).
69 Ibid.
70 HMRC "Measuring tax gaps 2012, Tax gap estimates for 2010-11
71 J Owens "What is meant by a Competitive Tax Environment?" Presentation before Davis Tax Committee (19 September 2013).
72 Ibid.

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. [73] 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 on the return on investment, particularly their corporate income tax rate. [74] The revenue derived from corporate taxes in most developing countries is largely contributed to by taxes from FDI. Developing countries and emerging economies acknowledge that FDI is a source of economic development and modernisation, income growth and employment.[75]

2.5.1 Methods of encouraging FDI

Two common methods of encouraging FDI are 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.[76] 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.[77]

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

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73 Ibid.

74 Ibid.

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

76 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

77 Best 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).

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). [78]
- 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. [79] Making the 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. [80]
- 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). [81]

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, South Africa's legislators should:

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

79 Ibid.

80 Ibid.

81 Ibid.

- 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. 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.

2.6 Addressing BEPS Requires Adhering to the Principles of a Good Tax System

Designing tax rules prevent BEPS requires that those rules comply with the principles of a good tax system. These principles are: equity, efficiency, certainty and simplicity.[82]

Equity:

- 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" [83] or "capital export neutrality". [84] South Africa

[82] 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.

[83] 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.

[84] 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.

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.

Efficiency:

- 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.

Certainty:

- 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 effect of creating major uncertainties in the business environment and constituting a significant disincentive for persons wishing to do business.[85] 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.

Simplicity:

Excessively high withholding taxes on dividends, interest and royalties paid to non-residents are likely to discourage foreign investment.

85 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

- 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. [86] 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, the tax rules with respect to business restructurings and the tax rules with respect to the transfer of business assets. Corporate tax shelters take advantage of the fact that income is taxed only when it is realised and of the difference between debt and equity. [87]
- 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.

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. [88]

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. [89] The

86 OECD "Fundamental Reform of Corporate Income Tax" (2007) No.16.
87 Ibid.
88 J Owens "What is meant by a Competitive Tax Environment?" Presentation before Davis Tax Committee (19 September 2013).
89 Ibid.

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.[90] 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. [91]

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. [92]

To achieve this, it is important for SARS to build its administrative capacity by recruiting and maintaining high quality staff. A tax administration is only as good as its staff.[93] 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. [94]

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. [95] The intention was protect South Africa's foreign exchange reserves. [96] During the apartheid era, exchange controls on residents were tightened in response to the large-scale capital outflows.[97] Strict exchange controls applied to prevent the flow of funds from South Africa. However, since 1997 the exchange controls have been

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90 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.

91 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).

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

93 Ibid.

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

95 Exchange Control Manual para C; BK Spitz *Exchange Control Encyclopedia* (2002 Service Issue 4) at Part at 2-1.

96 Exchange Control Manual para C; BK Spitz *Exchange Control Encyclopedia* (2002 Service Issue 4) at Part at 2-1.

97 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.[98]

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.[99] The Regulations prohibits 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 states 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. 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. is not listed on a formal exchange). Similarly it is not always possible to determine whether a specific transaction takes place on an arm’s length basis and reliance is 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.

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98 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.

99 South African Reserve Bank ‘Exchange Control Manual’ para E.

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.[100] 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 Africa 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 finical 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.

In this regard, miss-invoicing/under-invoicing of goods at Customs is a matter that execrates BEPS. The 2014 UNCTAD "Trade and Development"[101] Report notes that illicit flows of capital through developing countries due to trade miss-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

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[100] AW Oguttu *Curbing Offshore Tax Avoidance: The Case of South African Companies and Trusts* (2007) UNISA LLD Thesis at 431.

[101] UNCTAD "Trade and Development: Global Governance and Policy Space for Development" (2014).

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.[102]

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 suspected that in some instances outward payments declared as import or freight payments were 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 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.[103] Loop structures are considered to be in breach of exchange control regulations. The regulations prohibition South African residents from holding their local assets via offshore

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102 Ibid.

103 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 (last 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 (last accessed on 20 March 2009).

structures or from placing their legal foreign assets at the disposal of another South African resident.[104]

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 evasions by the individuals involved. It also became clear during investigations that nearly 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 Work 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 receive comprehensive reports from various South African corporates with financial statements of all their offshore entities I is thus able to report various forms of cross-border information to the Treasury

[104] 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.

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.

2.8.4 Recommendations on how the Reserve Bank 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.
- A general provision inserted into the Regulations to the effect that transactions concluded with the purpose of BEPS are void *ab initio,* i.e. treated as invalid from the outset.
- 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.

It should, however, be noted that some of the measures mentioned above may be construed to be a tightening of exchange controls or creating red tape.

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 provisions 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. Considering all the legislation in place and the competitive edge the country has to maintain, South Africa should consider 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,[105] 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.[106] 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 BEPS. These include: the controlled foreign company (CFC) rules,[107] transfer pricing and thin capitalisation[108] rules, rules to deal with hybrid instruments, reportable arrangements [109] rules, and the Voluntary Disclosure Programme.[110] 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 share of tax, based on amounts that are economically attributable to their activities in the local country.

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105 MM Katz (chairman) *Fifth Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa* (1997) at 4.

106 Ushered in by the Revenue Laws Amendment Act 59 of 2000 (the Amendment Act) which amended the Income Tax Act

107 Section 9D of the Income Tax Act 58 of 1962 as amended.

108 Section 31 of the Income Tax Act 58 of 1962 as amended.

109 Sections 34-39 of the Tax Administration Act 28 of 2011.

110 Sections 225-233 of the Tax Administration Act 28 of 2011.

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 ensuring that it collects its fair share of taxes on inbound investment, also provides incentives to support incoming investment. Comprehensive protection against BEPS in South Africa must occur at multiple levels.

- At a policy level,
  - Strengthening the source basis of taxation to effectively deal with inbound investments
  - Ensuring the effectiveness of withholding taxes
  - Taking into account the impact of treaties
  - Considering the impact of exchange control (bearing in mind the Finance Ministry's intended phase-out of exchange controls over time).
- At an administrative level, the use of proper forms and withholding process must be considered as well as the impact of treaties in terms of exchange of information.

2.10 Conclusion and Remarks on Annexure discussing the BEPS Action Plans

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 annexure that analyse the OECD BEPS Action Plans (specifically the September 2014 deliverables - the others will be dealt with when they are delivered in 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;
- A discussion as to whether the relevant BEPS concern 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 concern and in light of international developments regarding the concern, recommendations are made as to how South Africa should position itself to effectively address that concern, as it awaits the OECD’s on-going work on that particular concern.