ADDRESSING BASE EROSION AND PROFIT SHIFTING IN SOUTH AFRICA
DAVIS TAX COMMITTEE INTERIM REPORT

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

1 INTRODUCTION

In 1998 the OECD issued a Report entitled *Harmful Tax Competition: An Emerging Global Issue.* This 1998 report is the foundation for the OECD's work in the area of harmful tax practices. The 1998 report was published in response to a request by Ministers of Finance of the G20 countries to develop measures to counter harmful tax practices with respect to geographically mobile activities, such as financial and other service activities, including the provision of intangibles. The nature of these types of activities makes it very easy to shift them from one country to another. Globalisation and technological innovation have further enhanced that mobility. [1] The 1998 Report divided the work on harmful tax practices into the following areas:

(i) tax havens;
(ii) preferential tax regimes in OECD member countries, and in non-OECD economies.

The1998 Report pointed out that tax haven jurisdictions and harmful preferential tax regimes distort financial and investment flows among countries.[2] Further that the harmful tax practices of both tax haven and harmful preferential tax regimes undermine the integrity and fairness of tax structures; they discourage compliance by all taxpayers; they cause undesirable shifts of part of the tax burden to less mobile tax bases such as labour, property and consumption; and they increase the administrative costs and compliance burdens on tax authorities and taxpayers respectively. In order to counter those harmful tax practices, the OECD came up with certain recommendations for countries to adopt in order to enhance the effectiveness of their domestic legislation in curbing harmful tax practices.[3]

1.1 Criteria for Identifying Tax-haven Jurisdictions in the OECD 1998 Report

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1 OECD?G20 Base Erosion and Profit Shifting Project Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance: Action 5: 2014 Deliverable (2014) at 13 (OECD/G20 2014 Report on Action Plan 5)

2 OECD "Harmful Tax Practices (1998) in par 75; Spitz & Clarke at OECD/3.

3 OECD 1998 Report at 67-71. See also AW Oguttu "A Critique on the OECD Campaign against Tax Havens: Has it been Successful? A South African Perspective" (2010) 21 No 1 *Stellenbosch Law Review* 176-177.

The OECD described a tax haven as a jurisdiction actively making itself available for the avoidance of tax that would have been paid in high-tax countries.[4] The OECD noted that tax-haven jurisdictions are characterised by:

- high levels of secrecy in the banking and commercial sectors.
- the lack of transparency and effective exchange of information with other governments concerning the benefits taxpayers receive from the tax haven.[5]

1.1.1 Progress on Tax Havens after the OECD 1998 Report

In June 2000, the OECD issued its first progress report,[6] after the 1998 Report on Harmful Tax Competition. With regards to tax havens, the June 2000 Report listed 35 jurisdictions found to have met the tax haven criteria (in addition to the 6 jurisdictions meeting the criteria that had made advance commitments to eliminate harmful tax practices). The listed jurisdictions were called upon to commit themselves to the principles of transparency and effective exchange of information or they would be regarded as uncooperative tax havens that presented a threat not only to the tax systems of developed and developing countries but also to the integrity of international financial systems.[7]

In 2001, the OECD issued another progress report entitled: "The OECD's Project on Harmful Tax Practices". This report shows a shift from harmful tax competition in its 1998 report to harmful tax practices. The 2001 Progress Report also shows a shift in focus from preferential regimes to tax havens. With respect to tax havens, the OECD focussed on transparency and exchange of information as the criteria for defining an uncooperative tax haven. Thus a jurisdiction would not be considered uncooperative if it committed to transparency and effective exchange of information.[8]

In 2002, Jurisdictions that made a commitment to reform[9] worked alongside the OECD in developing international standards of transparency and information exchange on tax matters under the direction of OECD's "Global Forum on Taxation".[10] The standards of transparency and exchange of information on tax matters that were formulated by the Global Forum require:

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4 OECD Issues in International Taxation No 1 *International Tax Avoidance and Evasion* (1987) at 20; A Ginsberg *International Tax Havens* 2 ed (1997) at 5-6; P Roper & J Ware *Offshore Pitfalls* (2000) at 5.

5 OECD 1998 OECD Report in par 79.

6 OECD: *Towards Global Tax Co-operation: Report of the 2000 Ministerial Council Meeting and Recommendations by the Committee on Fiscal Affairs: Progress in Identifying and Eliminating Harmful Tax Practices* (2000) in par 8. The list appears in par 11.

7 B Arnold & MJ McIntyre *International Tax Primer* 2 ed (2002) at 122-123.

8 M Herzfeld "News Analysis: Political Reality Catches Up With BEPS" Tax Analysts 3 February 2014.

9 OECD "Agreement on Exchange of Information on Tax Matters" para 2 of the Introduction.

10 OECD "Overview of the OECD's Work on Countering International Tax Evasion" in para 9, available at http://www.ecovis.com/fileadmin/user_upload/international/news/global/oecd-

- Exchange of information on request where it is “foreseeably relevant” to the administration and enforcement of the domestic laws of a treaty partner;
- No restrictions on exchange of information because of banking secrecy or other domestic tax interest requirements;
- Respect for taxpayer rights;
- Strict confidential information exchange.

These standards are now embodied in the 2002 OECD “Model Agreement on Exchange of Information on Tax Matters” and its commentary, which serves as a basis for several “Tax Information Exchange Agreements” (commonly referred to as TIEAs) entered into between countries.[11] The standards are also embedded in article 26 of the OECD Model Tax Convention[12] and article 26 of the United Nations Model Double Taxation Convention.[13] Successive OECD Global Forum reports[14] show that a number of tax-havens have made commitments to implement the OECD’s standards of transparency and exchange of information for tax purposes. Some of these jurisdictions have also signed exchange of information agreements with various OECD and non-OECD Member countries.[15] The OECD is of the view that transparency and exchange of information among countries will be helpful in preventing harmful tax practices. In 2005 the Global Forum agreed on standards on transparency relating to availability and reliability of information. Since 2006, the Global Forum has published annual assessments of progress in implementing the standards. In September 2009, the Global Forum was renamed the Global Forum on Transparency and Exchange of Information for Tax Purposes, and was restructured to expand its membership and its mandate and to improve its governance.[16]

1.2 Criteria for Identifying Preferential Tax Regimes in the 1998 Report

The OECD 1998 Report on Harmful Tax Competition points out that, in contrast to tax havens, harmful preferential tax regimes, can occur in both tax-haven and high-tax jurisdictions. The framework under the 1998 Report for determining whether a regime is a harmful preferential regime involves three stages:

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releases-overview.pdf accessed 30 May 2013; OECD “Implementing the Tax Transparency Standards” at 9.

11 OECD “The OECD’s Project on Harmful Tax Practices: The 2004 Progress Report” in para 24 Available at http://www.oecd.org/dataoecd/60/33/30901115.pdf last accessed on 5 May 2014.

12 OECD Model Tax Convention on Income and on Capital 2010 Condensed Version.

13 United Nations “Model Tax Convention Between Developed and Developing Countries”, 2011 Version.

14 OECD “Tax Co-operation Towards a Level Playing Field: 2007 Assessment by the Global Forum on Taxation”. Available at www.oecd.org/document/29/0,3343,fr_2649_201185_39473821_1_1_1_1,00.html - 27k accessed 9 April 2014.

15 OECD “Overview of the OECD’s Work on Countering International Tax Evasion” (21 April 2009). Available at >http://www.oecd.org/dataoecd/32/45/42356522.pdf>, last accessed 5 May2014.

16 OECD/G20 2014 Report on Action Plan 5 at 18.

a) Consideration of whether a regime is preferential;
b) Consideration of the four key criteria/factors and eight other factors set out in the 1998 Report to determine whether a preferential regime is potentially harmful; and
c) Consideration of the economic effects of a regime to determine whether a potentially harmful regime is actually harmful. [17]

a) Consideration of whether a regime is preferential

To be within the scope of the 1998 Report, the regime must:

(i) Firstly, apply to income from geographically mobile activities, such as financial and other service activities, including the provision of intangibles. Preferential regimes designed to attract investment in plant, building and equipment are outside the scope of the 1998 Report.
(ii) Secondly, the regime must relate to the taxation of the relevant income from geographically mobile activities. Hence, the Report is mainly concerned with business taxation. Consumption taxes are explicitly excluded. [18]

Preferential tax treatment: In order for a regime to be considered preferential, it must offer some form of tax preference in comparison with the general principles of taxation in the relevant country. A preference offered by a regime may take a wide range of forms, including a reduction in the tax rate or tax base or preferential terms for the payment or repayment of taxes. Even a small amount of preference is sufficient for the regime to be considered preferential. The key point is that the regime must be preferential *in comparison with the general principles of taxation in the relevant country*, and not in comparison with principles applied in other countries.[19]

b) Consideration of the four key factors and eight other factors set out in the 1998 Report to determine whether a preferential regime is potentially harmful

In terms of the 1998 OECD Report, four factors are used to determine whether a preferential regime is potentially harmful are:

(i) The regime imposes no or low effective tax rates on income from geographically mobile financial and other service activities.
(ii) The regime is ring-fenced from the domestic economy. [20]
(iii) The regime lacks transparency (for example, the details of the regime or its application are not apparent, or there is inadequate regulatory supervision or financial disclosure).
(iv) There is no effective exchange of information with respect to the regime. [21]

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[17] OECD/G20 2014 Report on Action Plan 5 at 21.
[18] OECD/G20 2014 Report on Action Plan 5 at 21.
[19] OECD/G20 2014 Report on Action Plan 5 at 22.
[20] The term "ring-fencing" refers to the artificial demarcation or limitation of profits or losses for tax purposes, ignoring the corporate form of the taxable or restricting the application of particular provisions to transactions inside the ring fence. See L Olivier & M Honiball *International Tax: A South African Perspective* 4 ed (2011) at 849.

The eight other factors are:

(i) An artificial definition of the tax base.
(ii) Failure to adhere to international transfer pricing principles.
(iii) Foreign source income exempt from residence country taxation.
(iv) Negotiable tax rate or tax base.
(v) Existence of secrecy provisions.
(vi) Access to a wide network of tax treaties.
(vii) The regime is promoted as a tax minimisation vehicle.
(viii) The regime encourages operations or arrangements that are purely tax-driven and involve no substantial activities. [22]

In order for a regime to be considered potentially harmful, in terms of the 1998 Report, the first key factor, "no or low effective tax rate", must apply. This is a gateway criterion. Where a regime meets the no or low effective tax rate factor, an evaluation of whether that regime is potentially harmful should be based on an overall assessment of each of the other three 'key factors' and, where relevant, the other eight 'other factors'. Where low or zero effective taxation and one or more of the remaining factors apply, a regime will be characterised as potentially harmful. [23]

c) Consideration of the economic effects of a regime to determine whether a potentially harmful regime is actually harmful

A regime that is identified as being potentially harmful based on the above factor analysis may be considered not to be actually harmful if it does not appear to have created harmful economic effects. The following three questions can be helpful in making this assessment:

- Does the tax regime shift activity from one country to the country providing the preferential tax regime, rather than generate significant new activity?
- Is the presence and level of activities in the host country commensurate with the amount of investment or income?
- Is the preferential regime the primary motivation for the location of an activity?[24]

Following consideration of its economic effects, a regime that created harmful effects would be categorised as a harmful preferential regime. The 1998 Report recommended that where a preferential regime is found to be actually harmful, the relevant country should be given the opportunity to abolish the regime or remove the features that create the harmful effect. Other countries may take defensive measures to counter the effects of the harmful regime, while at the same time continuing to encourage the country applying the regime to modify or remove it. [25]

1.2.1 Progress on preferential tax regimes after the 1998 Report

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21 OECD/G20 2014 Report on Action Plan 5 at 22.
22 OECD/G20 2014 Report on Action Plan 5 at 23.
23 OECD/G20 2014 Report on Action Plan 5 at 23.
24 OECD/G20 2014 Report on Action Plan 5 at 23-24.
25 OECD/G20 2014 Report on Action Plan 5 at 24.

In its 2000 progress report,[26] the OECD identified 47 potentially harmful regimes within OECD member countries according to the criteria contained in the 1998 Report. The second progress report released in 2001 entitled: "The OECD's Project on Harmful Tax Practices", shows a shift in focus from preferential regimes to tax havens. Of particular relevant is that the focus on criteria for "lack of real business or economic substance" with respect to preferential regimes was dropped.

The next OECD Report with regard to preferential regimes was issued in 2004. This report focused mainly on the progress made with respect to member countries. In addition to the 47 regimes identified in 2000, the 2004 Report included determinations on holding companies and similar preferential regimes. A number of regimes that had been introduced since the initial identification of potentially harmful regimes in 2000 were also considered but none of these regimes were found to be harmful within the meaning of the 1998 Report.

In 2006, the OECD issued a report on member country preferential regimes, in which it noted that of the 47 regimes initially identified as potentially harmful in the 2000 Report, 46 were abolished, amended or found not to be harmful following further analysis. Only one preferential regime was found to be actually harmful and legislation was subsequently enacted by the relevant country to abolish this regime.

1.3 Comments on the OECD work on Tax Havens and Preference Tax Regimes after the 1998 Report

Although the OECD's 1998 initiative was successful in promoting a programme of transparency and exchange of information by tax haven jurisdictions, it generally failed to accomplish what it set out to do, which is addressing harmful tax competition.[27] The OECD's initiative did not lead to the elimination of harmful preferential tax regimes and many of the OECD member countries have since enacted such regimes, especially with regard to mobile income.[28]

2 OECD 2013 BEPS REPORT: ACTION PLAN 5

In the 2013, the OECD issued a Report on Base Erosion and Profits Shifting (BEPS), its Action Plan 5 which deals with countering Harmful Tax Practices reiterated the concerns expressed in the 1998 Harmful Tax Competition Report recognising that a "race to the bottom" would ultimately drive applicable tax rates on certain mobile sources of income to zero for all countries, whether or not this was the tax policy a

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[26] OECD: *Towards Global Tax Co-operation: Report of the 2000 Ministerial Council Meeting and Recommendations by the Committee on Fiscal Affairs: Progress in Identifying and Eliminating Harmful Tax Practices* (2000) in par 8. The list appears in par 11.

[27] M Herzfeld "News Analysis: Political Reality Catches Up With BEPS" Tax Analysts 3 February 2014.

[28] Ibid.

country wished to pursue.[29] The OECD 2013 BEPS Report on Action Plan 5 notes that the underlying policy concerns expressed in the 1998 Report as regards the "race to the bottom" on the mobile income tax base are as relevant today as they were 15 years ago when the 1998 report on harmful tax completion was issued. However, the "race to the bottom" nowadays often takes less of the form of traditional ring fencing and now entails:

- artificial demarcations or limitation of profits or losses for tax purposes;
- ignoring the corporate form of the taxable entities;
- restricting the application of particular provisions to transactions inside the ring fence;
- across the board corporate tax rate reductions on particular types of income (such as income from financial activities or from the provision of intangibles).

To counter these harmful tax practices, the OECD 2013 Action Plan 6 recommends that

- National Countries should revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for any preferential regime.

On the International Front:

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

It should be noted that work under Action Plan 5 focuses on preferential tax regimes and on defensive measures in respect of such regimes (other than any such measures related to a lack of exchange of information or transparency). In Action Plan 5, the OECD is reviving its attack on harmful tax competition that it dropped over a decade ago. However, the OECD's failed attempt over a decade ago to shame countries into adopting changes to local law that would require a significant rethinking of substantive tax rules causes one to have tempered expectations for the BEPS initiative.[30]

3 OECD 2014 REPORT ON ACTION 5

Following its 2013 BEPS Report, in September 2014 the OECD issued its findings on Action 5. It noted that combating harmful tax practices is an interest common to OECD and non-OECD member countries alike. However there are obvious limitations to the effectiveness of unilateral actions against such practices. Thus the need for countries to agree on a set of common criteria to promote a co-operative

[29] OECD "Addressing Base Erosion and Profit Shifting" (2013) at 28-29.
[30] M Herzfeld "News Analysis: Political Reality Catches Up With BEPS" Tax Analysts 3 February 2014.

framework that supports the effective fiscal sovereignty of countries over the design of their tax systems; and to enhance the ability of countries to react against the harmful tax practices of others.

The OECD notes that its work on harmful tax practices is not intended to promote the harmonisation of income taxes or tax structures generally within or outside the OECD, nor is it about dictating to any country what should be the appropriate level of tax rates. Rather, the work is about reducing the distortionary influence of taxation on the location of mobile financial and service activities, thereby encouraging an environment in which free and fair tax competition can take place. This is essential in moving towards a "level playing field" and a continued expansion of global economic growth. [31]

In response to Action Plan 6 which recommends that National Countries should revamp the work on harmful tax practices, the OECD has placed priority on:

1) Requiring substantial activity for any preferential regime.
2) Improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes,

In addition to the above matters relating to revamping work on harmful tax practices:

3) OECD planned to take a holistic approach to evaluate preferential tax regimes in the BEPS context. The OECD also planned to engage with non-OECD members on the basis of the existing framework and consider revisions or additions to the existing framework.

The recommendations of the OECD on each of these matters in its September 2014 Report on Action Plan 6 are set out below.

3.1 Requiring "substantial activity" for any preferential regime

As noted in the analysis of the criteria for identifying preferential tax regimes in the 1998 Report, a reference to "substantial activity" is already included in the eight others factors for determining whether a regime is potentially harmful. So this is not a new concept. However the 1998 Report contains limited guidance on how to apply this factor. The substantial activity factor has been elevated in importance under Action Item 5, in that it has to be considered along with the first four key factors when determining whether a preferential regime is potentially harmful. [32]

This factor requires substantial activity for any preferential regime. This requirement contributes to the second pillar of the Base Erosion and Profit Shifting (BEPS) project, which is to align taxation with substance by ensuring that taxable profits can no longer be artificially shifted away from the countries where value is created. This factor looks at whether a regime "encourages purely tax-driven operations or arrangements" and states that "many harmful preferential tax regimes are designed

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[31] OECD/G20 2014 Report on Action Plan 5 at 14.

[32] OECD/G20 2014 Report on Action Plan 5 at 27.

in a way that allows taxpayers to derive benefits from the regime while engaging in operations that are purely tax-driven and involve no substantial activities”. [33]

The OECD’s work on substantial activity has focused in the first instance on:

- Regimes which provide a preferential tax treatment for certain income arising from qualifying Intellectual Property (“intangible regimes” or “IP regimes”). This is in line with the statements in the BEPS Action Plan 5 that current concerns in the area of harmful tax practices may be less about traditional ring-fencing and instead relate to corporate tax rate reductions on particular types of income, such as income from the provision of intangibles. Thus all intangible regimes in OECD member countries are being reviewed.

Under Action Item 5, the substantial activity requirement also applies to all preferential other than IP regimes. [34]

Substantial activity requirement in the context of intangible Regimes

The OECD recognises that IP-intensive industries are a key driver of growth and employment and that countries are free to provide tax incentives for Research and Development (R&D) activities, provided that they are granted according to the principles agreed by the OECD. [35]

Countries supported the use of the “nexus approach” to require substantial activities in an IP regime. This approach looks to whether an IP regime makes its benefits conditional on the extent of R&D activities of taxpayers receiving benefits. The approach seeks to build on the basic principle underlying R&D credits and similar “front-end” tax regimes that apply to expenditures incurred in the creation of IP. The nexus approach determines what income may receive tax benefits by applying a certain calculation. Where the amount of income receiving benefits under an IP regime does not exceed the amount determined by the nexus approach, the regime has met the substantial activities requirement. [36]

3.2 Improving transparency through compulsory spontaneous exchange of information on rulings related to preferential regimes

The second priority under Action Item 5 for revamping the work on harmful tax practices is to improve transparency, including compulsory spontaneous exchange on rulings related to preferential regimes. Seen in the wider context of the work on BEPS, this requirement contributes to the third pillar of the BEPS project, which is to

[33] OECD/G20 2014 Report on Action Plan 5 at 27.
[34] OECD/G20 2014 Report on Action Plan 5 at 27.
[35] OECD/G20 2014 Report on Action Plan 5 at 28.
[36] OECD/G20 2014 Report on Action Plan 5 at 29.

ensure transparency while promoting increased certainty and predictability.[37] Lack of transparency may arise in two broad contexts:

- In the way in which a regime is designed and administered, including favourable application of laws and regulations, negotiable tax provisions, and a failure to make administrative practices widely available;
- the existence of secrecy laws and other information requirements that prevent effective exchange of information.[38]

Extensive guidance on transparency with respect to rulings is set out in the OECD, 2004 Report entitled "Consolidated Application Note: Guidance in Applying the 1998 Report to Preferential Tax Regimes" (CAN Report), which makes it clear that transparency is often relevant in connection with rulings, including unilateral Advance Pricing Agreements (APAs)[39] and certain administrative practices.[40] This is especially so "where the tax authority does not notify other tax authorities on a timely and spontaneous basis of the existence of a ruling where the tax authority is aware that it affects residents in the other country. An example is advance tax ruling or unilateral APA that provides for a downward adjustment that would not be directly reflected in the company's financial accounts.[41] A ruling "regime" could be any legislative or administrative process under which a ruling, on which a taxpayer is entitled to rely, is granted.[42] Chapter V of the CAN Report recognises that although rulings can be a useful tool for both tax administrations and taxpayers, ruling regimes can also be used to attract internationally mobile capital to a jurisdiction and they have the potential to do this in a manner that contributes to, or constitutes harmful tax practices, as explained in the 1998 Report.[43]

Action Plan 5 explicitly refers to "compulsory spontaneous exchange of information on rulings related to preferential regimes". The word "compulsory" is understood to introduce an obligation to spontaneously exchange information wherever the relevant conditions are met. The term "spontaneous exchange of information" refers to a situation in which one country is aware of information that could be of relevance to another country, but the information has not been requested by the second country.[44]

The OECD has taken forward the work on improving transparency in two steps:

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37 OECD/G20 2014 Report on Action Plan 5 at 35.

38 OECD/G20 2014 Report on Action Plan 5 at 35.

39 An APA is a binding written contract between a taxpayer and the revenue authority. In an APA the parties agree on the best transfer-pricing method for determining the arm's length price. See AW Oguttu "Resolving Transfer Pricing Disputes: Are Advance Pricing Agreements the Way Forward for South Africa?" (2006) 18 *SA Mercantile Law Journal* 460-485; C Rolfe & A Casley 'Towards Reconciliation in Transfer Pricing' (1996) *Corporate Finance* 37.

40 OECD/G20 2014 Report on Action Plan 5 at 35.

41 OECD/G20 2014 Report on Action Plan 5 at 36.

42 OECD/G20 2014 Report on Action Plan 5 at 37.

43 OECD/G20 2014 Report on Action Plan 5 at 37.

44 OECD/G20 2014 Report on Action Plan 5 at 36.

- The first step focuses on developing a framework for compulsory spontaneous information exchange on rulings. This will enable other countries to check whether a ruling has any implications for the tax treatment of taxpayers in their country.
- The second step focuses on the application of the framework to OECD member and associate countries' preferential regimes.[45]

The framework, as currently contemplated, only requires spontaneous information exchange on taxpayer-specific rulings related to preferential regimes, i.e. rulings that are specific to an individual taxpayer and on which that taxpayer is entitled to rely (for example advance tax rulings and APAs). There is at present no such requirement for general rulings, i.e. rulings that apply to groups or types of taxpayers or may be given in relation to a defined set of circumstances or activities.[46] One reason for not currently requiring spontaneous information exchange of general rulings is that in the absence of a link between the ruling and a specific taxpayer to which the ruling applies, it would be very difficult to determine with which country or countries information should be exchanged. Spontaneous information exchange of general rulings with each country with whom a relevant tax administration has an information exchange relationship would impose a disproportionate administrative burden and is unlikely to be very effective. In addition, general rulings appear to pose less of a risk since they are often published and their conditions of applicability are normally available. Thus general rulings are not suitable for spontaneous exchange of information.[47]

Framework for compulsory spontaneous exchange on taxpayer specific rulings related to preferential regimes

The framework seeks to find a balance between ensuring that the information exchanged is relevant to other tax administrations and that it does not impose an unnecessary administrative burden on either the country exchanging the information or the country receiving it. The framework deals with the following four key design questions:

(i) When does the obligation to spontaneously exchange information on rulings arise?
(ii) Who must information be exchanged with?
(iii) What information must be exchanged?
(iv) What is the legal basis for the spontaneous information exchange?[48]

Ref (i): When does the obligation to spontaneously exchange information on rulings arise?

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[45] OECD/G20 2014 Report on Action Plan 5 at 36.
[46] OECD/G20 2014 Report on Action Plan 5 at 38.
[47] OECD/G20 2014 Report on Action Plan 5 at 38.
[48] OECD/G20 2014 Report on Action Plan 5 at 38.

To ensure that the obligation to spontaneously exchange information is sufficiently targeted, the framework applies a filter approach to determine when such an obligation arises. The filter approach seeks to reduce the level of discretion that would otherwise have to be used by a tax administration to make that determination and instead uses more mechanical filters. The first three filters limit the obligation to spontaneously exchange information to rulings related to

a) A preferential regime itself or certain aspects of it, and more broadly, rulings that concern matters that have an impact on the application of a preferential regime.
b) Regimes that firstly, relate to income from geographically mobile activities, such as financial and other service activities, including the provision of intangibles; and secondly regimes that relate to the taxation of the relevant income from geographically mobile activities
c) regimes that meet the no or low effective tax rate because the tax rate itself is very low or because of the way in which a country defines the tax base to which the rate is applied

If a ruling passes all of these three filters, additional filters apply to further target the obligation to spontaneously exchange information on rulings that are likely to be relevant to other jurisdictions. Under the filter approach, as currently contemplated, only a ruling that passes through all of the filters will be subject to compulsory spontaneous information exchange.[49]

Additional filters:

- *Is there a taxpayer-specific ruling related to a regime that meets the first three filters?*[50]
- *Is the taxpayer-specific ruling a ruling in the area of transfer pricing or another ruling?*[51]
- *For transfer pricing rulings – Is the ruling a unilateral transfer pricing ruling or a bilateral or multilateral APA?*
    - Transfer pricing rulings include APAs (whether unilateral, bilateral or multilateral) and ATRs on transfer pricing issues. Such rulings generally determine transfer pricing issues between associated enterprises engaging in cross-border transactions or the allocation of profits between a head office in one country and a PE in another country. They are therefore likely to have a direct effect on the tax base of associated enterprises, or of the head office or PE, as the case may be, in other countries.[52]
- *For rulings other than transfer pricing rulings – Does the ruling cover (i) inbound investment into the country in which the taxpayer has obtained the ruling, (ii)*

[49] OECD/G20 2014 Report on Action Plan 5 at 39-40.
[50] OECD/G20 2014 Report on Action Plan 5 at 41.
[51] OECD/G20 2014 Report on Action Plan 5 at 43.
[52] OECD/G20 2014 Report on Action Plan 5 at 43.

outbound investment from that country or (iii) transactions or a situation involving other countries?[53]

For rulings other than transfer pricing rulings, a further filter is considered necessary to make sure that the information exchanged is relevant and that the obligation to spontaneously exchange information on rulings does not impose an unnecessary administrative burden on either the country exchanging the information or the country receiving it.

Ref (ii) Who must information be exchanged with?

Compulsory spontaneous exchange of information on rulings related to preferential regimes must take place with any affected country. This could include:

(a) The source country;
(b) The country of residence of the immediate parent company;
(c) The country of residence of the beneficial owner, which in most cases will be the ultimate parent company;
(d) In the case of transfer pricing rulings:
    - The country in which an associated enterprise engaged in a cross-border transaction covered by the ruling is tax resident or carries on a business through a PE;
    - In the case of a ruling allocating profits between the head office and a foreign PE, the country in which the head office is tax resident or the country in which the PE is located, depending on which country granted the ruling.
(e) For rulings other than transfer pricing rules:
    - In the case of an inbound investment into the country in which the taxpayer has obtained the ruling: the country in which the party making the investment is resident or in which it carries on a business through a PE;
    - In the case of an outbound investment from the country in which the taxpayer has obtained the ruling: the country in which the party on the receiving end of the investment is resident or carries on a business through a PE;
    - In the case of transactions or a situation involving other countries: the country in which the other party or parties to those transactions is or are resident or carries or carry on a business through a PE. [54]

Ref (iii) What information must be exchanged?

Information that must be exchanged spontaneously will depend on whether or not the relevant ruling is a transfer pricing ruling. If the ruling is not a transfer pricing ruling, it will be up to the sending country to determine the relevant. This include:

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53 OECD/G20 2014 Report on Action Plan 5 at 44.
54 OECD/G20 2014 Report on Action Plan 5 at 45.

- Information necessary to identify the taxpayer(s) and the accounting periods covered by the ruling;
- A summary of the issue(s), transactions and income covered by the ruling; and
- The tax administration's response and reasoning. [55]

If the ruling is a transfer pricing ruling, there should be a two–stage process. The first stage should involve the sending country spontaneously exchanging sufficiently detailed information about the ruling so as to enable the receiving country to decide whether a request for additional information under the second stage is appropriate. To this end, the initial spontaneous exchange should include at least:

- Information necessary to identify the taxpayer(s) and the entities involved in the cross border transaction covered by the ruling;
- Detail of the transaction(s)/business activity/situation and the period covered by the transfer pricing ruling; and
- The transfer pricing methodology applied and the price/margin agreed. [56]

<u>Ref (iv) What is the legal basis for the spontaneous information exchange?</u>

Information exchange between tax authorities requires a legal framework to enable the sending country to exchange the information and the recipient country to receive it. Examples of enabling legal instruments include:

- International instruments designed specifically for administrative assistance purposes in tax matters, such as the MAC; and,
- Domestic law provisions that provide the relevant legal basis in some countries.

Countries that currently do not have the necessary legal framework in place for spontaneous information exchange need to consider ways of putting such a framework in place to comply with their obligation under Action Plan 5. [57]

<u>Other important considerations:</u>

Time limits for compulsory information exchange: The obligation to spontaneously exchange information under Action Plan 5 requires that the countries must exchange the relevant information on a ruling with any affected country as quickly as possible and no later than 3 months after that in which the ruling becomes available to the competent authority of the country that has granted the ruling. [58]

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[55] OECD/G20 2014 Report on Action Plan 5 at 45.
[56] OECD/G20 2014 Report on Action Plan 5 at 46.
[57] OECD/G20 2014 Report on Action Plan 5 at 47.
[58] OECD/G20 2014 Report on Action Plan 5 at 47.

- *Feedback:* It is important that regular, timely and comprehensive feedback on the usefulness of the information spontaneously exchanged enables improvements to be made for future spontaneous information exchanges.[59]
- *Reciprocity:* A country that has granted a ruling that is caught by the obligation to spontaneously exchange information cannot invoke the lack of reciprocity as an argument for not spontaneously exchanging information with an affected country, where the affected country does not grant, and therefore cannot exchange information on rulings which could potentially trigger the obligation to spontaneously exchange information.[60]
- *Confidentiality of the information exchanged:* Both the country exchanging information and its taxpayers have a legal right to expect that information exchanged pursuant to the framework remains confidential. The receiving country must therefore have the legal framework necessary to protect information exchanged. All treaties and exchange of information instruments contain provisions regarding tax confidentiality and the obligation to keep information exchanged confidential. Domestic laws must be in place in the receiving country to protect confidentiality of tax information, including information exchanged. Effective penalties must apply for unauthorised disclosures of confidential information exchanged. Information exchanged pursuant to this framework may be used only for tax purposes or other purposes permitted by the relevant information exchange instrument. If domestic law allows for a broader use of the information than the applicable information exchange instrument, it is expected that international provisions and instruments will prevail over provisions of domestic law.[61]
- *Application and implementation of the framework:* Countries that do not (yet) have the necessary legal framework in place to spontaneously exchange information as required by Action Item 5 will be given an adjustment period following which the continued lack of the necessary legal framework will result in the elaborated transparency factor being triggered. Recognising the differences in countries' legislative and parliamentary processes and that the introduction of a legal framework may take some time, member and associate countries were given until the end of 2014 to initiate steps to put in place that legal framework to be able to spontaneously exchange information.[62]

3.3 Status on the OECD's approach to evaluate preferential tax regimes member countries and progress on the review of preferential regimes of associate countries

The OECD's review of its member country regimes commenced in late 2010 with the preparation of a preliminary survey of preferential tax regimes in member countries,

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[59] OECD/G20 2014 Report on Action Plan 5 at 48.
[60] OECD/G20 2014 Report on Action Plan 5 at 48.
[61] OECD/G20 2014 Report on Action Plan 5 at 55.
[62] OECD/G20 2014 Report on Action Plan 5 at 49.

based on publicly available information and without any judgment as to the potential harmfulness of any of the regimes included. Further regimes were subsequently added to the review process based on member countries' self-referrals and referrals by other member countries.[63]

As all the intangible regimes of member countries are being considered together, they are being considered not only in light of the factors as previously applied but also in light of the elaborated substantial activity factor. As intangible regimes are just a subset of preferential regimes, the OECD will also need to discuss and subsequently apply the substantial activity requirement to other preferential regimes; this could include preferential regimes already reviewed provided that they are still in force and not abolished.[64]

4 ADDRESSING ACTION PLAN 5 IN SOUTH AFRICA

As noted above, OECD Action Plan 5 requires countries to revamp the work on harmful tax practices with a priority on:

- Requiring substantial activity for any preferential regime.
- Improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes,
- An evaluation of preferential tax regimes in OECD members and in associate counties

These factors are considered below from a South African perspective. It should be noted that South Africa is associate country to the OECD BEPS project.

4.1 Requiring substantial activity for preferential regimes: South Africa

The requirement for "substantial activity" has got to be examined in South Africa for instance with respect to the country's headquarter company regime. As to whether South Africa's headquarter company regime[65] constitutes a harmful tax practice, the OECD 2000 Report "Towards Global Tax Cooperation"[66] investigated the tax practices of holding company regimes and similar preferential tax regimes, noting that they do not constitute harmful tax practices, although such regimes may constitute harmful tax competition. Until South Africa's headquarter company regime is reviewed and found wanting in terms OECD September 2014 Report on Action 5, South Africa's endeavours in creating such a regime would not be in conflict with

63 OECD/G20 2014 Report on Action Plan 5 at 48.
64 OECD/G20 2014 Report on Action Plan 5 at 48.
65 In terms of section 1 of the Income tax Act, as amended by the Taxation Laws Amendment Act 24 of 2011, a 'headquarter company' is defined as any company which has made an election in terms of section 9I.
66 OECD Towards Global Tax Cooperation – Report on the 2000 Ministerial Council Meeting and Recommendations by the Committee on Fiscal Affairs: progress in Identifying and Eliminating Harmful Tax Practices (2000) in para 12

international expectations.[67] South Africa's headquarter company regime is intended to enable the country to become a gateway for foreign investment into Africa. Consequently certain anti-avoidance rules, such as CFC rules and transfer pricing, have been relaxed with regard to headquarter companies.[68]

The headquarter company regime has, however, not been very successful. South Africa has been reluctant to participate in international tax competition and this has hindered its ability to fully establish itself as the gateway to Africa. On the African continent, Botswana, Ghana and Mauritius have tax regimes that could make them better bases for investment into Africa.[69]

It should be noted that although the OECD recommends that work on preferential regimes should be revamped, it appears many major countries are not willing to give up their special tax regimes which are designed to attract investment. Action 5 identifies corporate rate reductions and patent boxes as harmful. However, many countries have now reduced their corporates tax to remain competitive. For example, the United Kingdom has reduced its corporate rate.[70]

4.1.1 Recommendations

- It is important that South Africa balances its international obligations not to engage in harmful tax practices with the need to preserve the competiveness of the economy. More so, as the National Development Plan provides that South Africa should aspire to be a gateway for investment in Africa. There is potential for substantial job creation and tax benefits in the form of VAT and employees tax from which South Africa would benefit as long as it ensures that it complies with the OECD's substance requirements. The bottom line is that BEPS is both a risk and an opportunity for South Africa.
- The headquarter regime is actually a holding company regime which enables MNEs to use South Africa as a conduit for passive income flows. Consideration should be given to creating a full headquarter regime which incorporates minimum levels of substance as required by the OECD so that it is not considered a harmful tax practice. It is therefore important that South Africa revises its criteria of for headquarter companies in line with the OECD recommendations.

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67 AW Oguttu "Developing South Africa As A Gateway For Foreign Investment In Africa: A Critique Of South Africa's Headquarter Company Regime" (2011) 36 *South African Year Book of International Law* at 68; Olivier & Honiball at 703.

68 Oguttu "Developing South Africa As A Gateway For Foreign Investment In Africa" 61; P Surtees "Transfer Pricing Amendments Would Aid South African Companies Funding Offshore Expansion" *Tax Analayst* 4 November 2013.

69 AW Oguttu "Developing South Africa As A Gateway For Foreign Investment In Africa: A Critique Of South Africa's Headquarter Company Regime" (2011) 36 *South African Year Book of International Law* 68-71.

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

- Care should also be taken to ensure South Africa's provisions relating to Special Investment Zones to attract investment comply with the OECD's substance requirements.

4.2 Improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes: Recommendations for South Africa

With respect to tax rulings in South Africa, Chapter 7 of the Tax Administration Act 28 of 2011 (TAA), sets out provisions dealing with "advance rulings". Section 75 of the TAA defines an advance ruling to mean 'a binding general ruling, a binding private ruling or a binding class ruling'. In terms of s 75 of the Tax Administration Act, a "binding general ruling" is defined as a written statement issued by SARS regarding the application of a tax Act to a specific 'class' of persons in respect of a "proposed transaction". A "binding private ruling" means as a written statement issued by SARS regarding the application of a tax Act a specific 'class' of persons in respect of a 'proposed transaction'. Basically these categories of advance rulings allow taxpayers to obtain clarity and certainty on the Commissioner's interpretation and application of the tax laws on proposed transactions. They are intended to promote clarity, consistency and certainty regarding the interpretation and application of a tax Act on proposed transactions by creating a framework for issuance of the advance rulings.[71] The OECD's framework covers only spontaneous exchange of information on taxpayer specific rulings. In the South African context these would encamps binding private rulings.

- It is recommended that in line with the OECD Recommendations on exchange of information regarding tax rulings, that SARS notifies other tax authorities on a timely and spontaneous basis of the existence of a binding private ruling where SARS is aware that it affects residents in the other country. This is especially so where such where a ruling provides for a downward adjustment that would not be directly reflected in the company's financial accounts)".
- South Africa's tax authorities should ensure that they do not sanction tax rulings that foster harmful practices and hamper transparency. This could cover secret rulings that enable taxpayers to get tax haven results even if the country may have a tax system with an acceptable tax rate.

It should however be noted that section 80(1)*(a)*(iii) of the TAA provides that:

> 'SARS may reject an application for an advance ruling if the application requires or requests the rendering of an opinion, conclusion or determination regarding the pricing of goods or services supplied by or rendered to a connected person in relation to the applicant or a class member'

[71] Section 76 of Tax Administration Act. See also SARS 'Comprehensive Guide to Advance Tax Rulings' at 6.

This implies that transfer-pricing transactions are potentially excluded from South Africa's advance rulings system.[72] In this regard, APAs which are normally entered into by taxpayers with tax authorities in order to resolve transfer-pricing disputes are currently not in use in South Africa and SARS has declared that APAs will not be made available to South African taxpayers in the foreseeable future.[73]

To ensure spontaneous exchange of information on tax rulings, the OECD recommends that its member and associate countries that do not (yet) have the necessary legal framework in place to spontaneously exchange information as required by Action Plan 5 will be given an adjustment period of up to end of 2014 to initiate steps to put in place that legal framework to enable spontaneously exchange information.

- It is recommended that in line with the above OECD recommendation, South Africa should come up with a provision in the Tax Administration Act that provides for the legal framework to ensure spontaneous exchange of information regarding tax rulings with other countries' tax authorities.

The other forum that can be used in South Africa to ensure spontaneous exchange of information on rulings is double tax treaties since they also ensure transparency and exchange of information in tax matters, specifically under article 26 of treaties based on the OECD Model Tax Convention. The standard of exchange of information under double tax treaties provides for information exchange to the widest possible extent. This includes: upon on request, automatically, spontaneously, and by using other techniques such as simultaneous examinations, tax examinations abroad and industry-wide exchange of information.

Although the Tax Information Exchange Agreements (TIEAs) that South Africa has signed with some countries (especially tax haven jurisdictions that do not normally have a double tax treaty is not in place),[74] currently the standard of exchange of information in the TIEAS is not spontaneous; it is only "upon request".[75] The effectiveness of exchange of information upon request is hampered by the fact that the requesting state's taxation procedures must first be exhausted before a request for information is made to the other state. Due to the inherent restriction of this

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[72] AW Oguttu 'Resolving Transfer-pricing Disputes: Are 'Advance Pricing Agreements' the Way Forward for South Africa?' 2006) 18 *SA Mercantile Law Journal* 147.

[73] SARS *Practice Note 7* in para 6.2; see also D Clegg *Income Tax in South Africa* (May 2005) in para 24.12.1; Olivier & Honiball *International* at 501.

[74] This is because most tax havens do not levy income tax taxes, so they often do not sign double tax treaties. See M Keen & JE Ligthart "Information Sharing and International Taxation: A Primer" 13 (2006) *International Tax and Public Finance* at 92. In 2010, South Africa signed Tax Information Exchange Agreements, in line with the OECD standards, with the Bahamas, Bermuda, Cayman Islands, Guernsey, Jersey and San Marino. See SARS "International Treaties - Tax Information Exchange Agreements." Available at http://www.sars.gov.za/home.asp?pid=53079 accessed 10 August 2010.

[75] M Stewart "Transnational Tax Information Exchange Networks: Steps Towards a Globalised, Legitimate Tax Administration" (June 2010) *World Tax Journal* at 162.

approach, intentional exchanges of information upon request are relatively small and are based on reciprocity.[76] The OECD has recommended that the standard for exchange of information in TIEAs should be automatic.

The September 2014 OECD report on Action 5 calls for confidentiality of the information exchanged. It recommends that provisions must be in place in the receiving country to protect the confidentiality of the information that is exchanged.

- In the case of South Africa, Chapter 6 of the TAA provides detailed provisions relating to "confidentiality of information". These provisions can be applied to ensure confidentiality with respect to exchange of information on tax rulings in South Africa.

[76] Keen and Ligthart at 95; Oguttu "A Critique on the Effectiveness of 'Exchange of Information on Tax Matters" at 11.