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

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1 INTRODUCTION

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

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

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

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

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

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

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

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

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

(d) Analytical reports:

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

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

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

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

This is important because, the 15 Actions of the OECD BEPS Project deals with different dimensions in the international tax planning practices of multinational enterprises which could affect countries in different ways, depending on whether the country is a predominately source based country (largely attracts foreign direct

investment) or a predominately residence country (from which investments flow to other countries). South Africa's economy falls in both categories. In many respects, South Africa is a source country where activities of multinationals are being carried out as it still relies heavily on foreign direct investment. However, South Africa is also a residence state to many home grown MNEs, and it is a base country to many intermediate MNEs for further investment into the rest of Africa.

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

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

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

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

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

2.1 BEPS issues in the digital economy

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

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

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

2.2 Broader direct tax challenges raised by the digital economy

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

- The exceptions to PE status will be modified in order to ensure that they are available only for activities that are in fact preparatory or auxiliary in nature that was adopted as a result of the work on Action 7 of the BEPS Project is expected to be implemented across the existing tax treaty network in a

synchronised and efficient manner via the conclusion of the multilateral instrument that modifies bilateral tax treaties under Action 15.

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

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

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

2.3 Broader indirect tax challenges in the digital economy

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

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

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

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

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

2.5 Next steps

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

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

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

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

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

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

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

[4] PWC "Comment on DTC BEPS First Interim Report" (30 March 2015) at 9.

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

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

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

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

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

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

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5 PWC "Comment on DTC BEPS First Interim Report" (30 March 2015) at 9.

6 R Pinkernell "Internationale Steuergestaltung im Electronic Commerce" 494 (2014) *Institut Finanzen und Steuern, Schrift* at 168.

7 OECD/G20 2015 Final Report on Action 1 in Box 7.1 at 105.

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

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

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

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

- remote digital supplies to exempt businesses, and

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

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

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

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

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

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

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

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

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

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

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

- In the case of B2B transactions, the recipient vendor can only account for VAT on the imported electronic services in so far as the services are not used in the making of taxable supplies (in other words, when the recipient vendor is the final consumer). This relies heavily on the vendor's interpretation of what constitutes "in the making of taxable supplies". It is

recommended that, in the case of B2B transactions, the recipient vendor must, in terms of the reverse-charge mechanism account for VAT on all imported services irrespective of it being applied in the making of taxable supplies. The recipient vendor should claim an input VAT deduction in cases where such a deduction is allowed.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

- It is recommended that legislation around VAT branch registration and the requirement to maintain a separate independent accounting system should be revised. Foreign suppliers of electronic services should be entitled to register a VAT branch but should not be required to maintain a separate independent accounting system. A proviso should be added to this requirement to apply to foreign suppliers of electronic services, whereby,

instead of maintaining an independent accounting system, the foreign supplier or electronic services should merely be required to produce financial accounts which reflect the supplies made to residents in South Africa or where payment was made from a South African bank account.

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

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

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

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

With respect to alternative collection models:

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

2.9 Further recommendations

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

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

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

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

3 ACTION 2: NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS

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

3.1 Part I

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

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

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

3.2 Part II

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

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

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

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

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

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

- What is the impact of such a limitation on the competitiveness of home grown multinationals? If as a source state South Africa does not deny a deduction for hybrid payments, countries that chose to adopt the defensive measures

would restrict access to the associated benefits for their home grown multinationals, when multinationals from other countries may be free to enjoy these benefits.

3.4 DTC recommendations on Action 2 for South Africa

3.4.1 Recommendations on hybrid entity mismatches for South Africa

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

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

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

3.4.2 Recommendations on hybrid instrument mismatches for South Africa

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

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

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

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

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

- SARS should introduce or the revise disclosure initiatives targeted at certain hybrid mismatch arrangements. To ensure the success of such disclosure rules, it is important that the rules are clear, free of loopholes, carry sufficient penalty for non-compliance and are adequately enforced. Such rules can be effective, either insofar as reporting is concerned or as a deterrent to aggressive tax planning. To address the compliance burden on taxpayers it is important that the rules should be targeted precisely at arrangements that are of concern and not formulated so broadly that they result in arrangements that present little or no risk to the tax base having to be reported and overwhelming both taxpayers and SARS.[16]
- It should be noted however that disclosure programs are never successful and are overly burdensome from a compliance perspective.
- The hybrid debt and interest rules require attention as they are not linked to the tax treatment in the hands of the counterparty and may themselves lead to mismatches and double taxation. A rule needs to be put in place that links the hybrid rules to the treatment in foreign counties. This would prevent tax abuse in cases where there is a denial of deduction in South Africa but not in other countries.
- The rules governing the deductibility of interest need to be developed holistically and without a proliferation of too many sections within the Act. The focus should be based on a principle rule and one should not have to apply many different sections to a transaction when assessing whether or not interest is deductible. The key policy requirement is an emphasis on mismatch rather than merely attacking a particular type of instrument.
- From the analysis of the international jurisdictions, it is clear that OECD rules and in particular, the UK rules, focus on a deductibility mismatch or other clear tax leakage. This is, it is submitted, correct and is a different approach from what was adopted in sections 8E to 8FA of the Act which look purely at substance over form, without enquiring whether mischief exists. In other words, it makes no sense to alter the tax treatment of an instrument where no obvious leakage arises – such as in circumstances where a deduction is matched by a taxable receipt, or a non-deductible payment is exempt.

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

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

3.4.3 General recommendations on hybrid mismatches

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

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

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[17] GN 608 in GG 39650.

[18] No 28 of 2011.

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

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

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

4 ACTION 3: DESIGNING EFFECTIVE CONTROLLED FOREIGN COMPANY RULES

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

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

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

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

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

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

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

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

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

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

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

4.3 DTC recommendations on CFC rules for South Africa

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

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

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

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

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

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

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

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

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

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

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

4.4 Other recommendations

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

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25 KPMG Corporate Tax Rate Survey.

26 See section 9D(1) definition of "foreign business establishment".

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

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

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

Should South Africa seriously wish to embark upon a programme of attracting foreign direct investment as one of the means of fulfilling its goals, as set out under

the National Development Plan, to create employment and improve the opportunities for the poor to be uplifted, these other policy matters need first to be addressed. The tax regime will then, in its current form, naturally provide increased taxes for other social spending. In line with this overall objective, though, and once the other policies have been attended to, a more competitive tax rate and CFC regime (similar to that in the UK or Netherlands) might well support such initiatives.

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

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

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

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

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

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

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

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

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

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

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

5.2 DTC recommendations on Action 4 for South Africa

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

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

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

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

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

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

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

5.2.2 Recommendations on exchange controls

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

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

5.2.3 Recommendation on withholding tax on interest

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

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

5.2.4 Recommendation on interest deductibility

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

5.2.5 Recommendation on incurral and accrual of interest

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

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

5.2.6 Recommendations on hybrid interest and debt instruments

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

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

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

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

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

> *Revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for any preferential regime. It will take a holistic approach to evaluate preferential tax regimes in the BEPS context. It will engage with non-OECD members on the basis of the existing framework and consider revisions or additions to the existing framework.*

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

6.1 Requiring substantial activity for preferential regimes

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

undertook the core income-generating activities required to produce the type of income covered by the preferential regime.

6.2 Improving transparency

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

6.3 Review of preferential regimes

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

NOTE: The recommended OECD approach allows multinational enterprises to enjoy low (or even zero) tax on their income if (a) they carry out R&D activities that generate the income in the low (or even zero) tax country; and (b) the country is committed to exchange the rulings that it issued under such low tax regimes (as well

as other rulings) with its treaty partners. The OECD approach does not outlaw low or zero tax regimes completely. [28]

6.4 Next steps

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

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

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

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

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

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

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

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

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

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

6.6 DTC Recommendations on Action 5 for South Africa

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

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

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

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

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

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

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

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

The DTC makes the following recommendations for South Africa:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

b) For cases where a person tries to circumvent limitations provided by the treaty itself, the OECD recommends treaty anti-abuse rules, using a three-pronged approach:

   (i) The title and preamble of treaties should clearly state that the treaty is not intended to create opportunities for non-taxation or reduced taxation through treaty shopping.[38]

   (ii) The inclusion of a specific limitation-of-benefits provisions (LOB rule), which is normally included in treaties concluded by the United States and a few other countries

   (iii) To address other forms of treaty abuse, not being covered by the LOB rule (such as certain conduit financing arrangements), tax treaties should

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

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

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

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

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

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

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

The other relevant policy and practical considerations include:

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

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

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

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

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

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

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

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

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

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

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

[43] Arnold at 245

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

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

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

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

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

Feasibility of applying the PPT test in South Africa

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

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

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

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

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

48 Arnold at 245.

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

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

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

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

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

7.7 DTC recommendations on treaty shopping for South Africa

7.7.1 Treaty shopping and tax sparing provisions

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

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

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

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

51 Arnold & McIntyre at 53.

52 Weeghel at 257-260.

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

7.7.2 Low withholding tax rates in tax treaties encourage treaty shopping

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

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

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

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

55 The following withholding taxes apply in South Africa:

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

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

7.7.3 Treaty shopping: accessing capital gains benefits

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

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

7.7.4 Treaty shopping and dual resident entities

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

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

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

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

7.7.5 Treaty shopping and permanent establishment concept

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

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

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

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

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

7.7.6 Treaty shopping involving dividend transfer transactions

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

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

7.7.7 Issues pertaining to migration of companies

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

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

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

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

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

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

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

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

7.7.8 Issues pertaining to dividend cessions

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

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

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

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

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

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

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

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

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

[70] Section 5 of the Draft Taxation Laws Amendment Bill 2015.

[71] Explanatory Memorandum to the Taxation Laws Amendment Bill, 2015.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

8.3 Splitting of contracts to avoid PE status

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

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

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

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

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

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

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

8.6 DTC recommendation regarding Action 7 for South Africa

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Notably, however, no additional measures were proposed to deal with the deductibility of base erosion payments such as services and royalties. Existing guidelines on intra-group services (and the conditions for disregarding intra-group service charges) were re-produced without significant changes in their scope. Thus,

it is unclear whether the OECD recommendations would have any impact on the base erosion opportunities of foreign multinationals in this regard.[78] From these perspectives, South Africa may have to consider:

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

9.2 General on transfer pricing in South Africa

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

If the terms or conditions made or imposed by the connected persons differ from the terms and conditions that would have otherwise existed between independent persons acting at arm's length, and the difference confers a South African tax benefit on one of the parties, the taxable income of the parties that have benefitted must be calculated as if the terms and conditions had been at arm's length. To determine an arm's length price South Africa makes use of the methods set out in the OECD Transfer Pricing Guidelines,[80] which are also set out in SARS Practice Note 7.[81] This process is designed to combat the shifting of profits which should rightly be taxed in South Africa, to elsewhere.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(a) Low value added services

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

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

(b) Commodities

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

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[87] Deloitte submission to DTC July 2015 at 6.

[88] E.g. Bureau van Dijk's Amadeus; Thompson Reuters; Royaltysource; Lexisnexis; Onesource; (all commonly used by taxpayers and tax authorities globally).

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

11 ACTION 11: MEASURING AND MONITORING BEPS

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

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

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

11.1 OECD six indicators of BEPS

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

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

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

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

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

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

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

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

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

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

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

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

future must take into account the need to protect the confidentiality of taxpayer information and minimise the administrative burden for governments and taxpayers.[98]

11.2 DTC recommendations for South Africa with respect to Action 11

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

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

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

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

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

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

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

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

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

12.1 Design principles and key objectives of a mandatory disclosure regime

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

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

12.2 Key design features of a mandatory disclosure regime

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

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

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

12.3 Coverage of international tax schemes

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

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

12.4 Enhancing information sharing

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

13 ACTION PLAN 14: MAKE DISPUTE RESOLUTION MECHANISMS MORE EFFECTIVE

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

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

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

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

The minimum standard will:

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

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

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

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

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

13.2 DTC recommendations to ensure effective MAP for South Africa

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

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

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

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

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

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

[117] Ibid.

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

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

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

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

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

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

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

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

- Since most disputes concern transfer pricing, it is important that SARS Interpretation Note on Transfer Pricing is finalised. Clear guidance should also be provided with respect to thin capitalisation rules. Other MAP disputes relating to controlled foreign company rules (CFC) and interest deductibility could be prevented by simplifying the complex CFC rules and the interest deductibility provisions.
- The current audit procedure in South Africa includes two aspects of an enquiry, a risk assessment process which is to determine whether an audit is warranted, and a full audit process. The roles and responsibilities of these two are becoming blurred in certain circumstances, which places the taxpayer in a position of uncertainty as to whether the matter is under audit or not. The respective roles and responsibilities therefore need clarifying and SARS should be required to inform the taxpayer as to whether their matter is under audit or not.
- Further the audit process often creates problems for taxpayers in that SARS often requires extremely detailed information from a taxpayer, in a relatively short period of time, without any timeline or time commitment being placed on SARS to respond resulting in an unreasonably long time passing, this needs to be addressed through better audit governance measures.
- The timing for applying for MAP needs to be clarified. Under Article 25(1) of the OECD UN MTC where a person considers that the actions of one or both contracting states results or will result in taxation that is not accordance with the provisions of the treaty, that person may irrespective of any remedies available under domestic law, present his case to the competent authorities of the contracting states in which he is resident (or the state in which he is a national). The case has to be brought to the attention of the competent authorities within three years from the first notification that the relevant tax is

not in accordance with the provisions of the treaty. In South Africa, the timing is not clear and it appears that that the domestic rules govern the process and acceptance of such applications. It is understood that with scarce resources it would be inefficient to entertain a domestic appeal and competent authority application simultaneously. SARS needs to clarify the time when it will entertain a competent authority application, that is, whether it is once the taxpayer's objection has been disallowed, or at the same time as the appeal. This needs to be clarified in some form of binding, written communication. In this regard, it is recommended that SARS keeps to the time limit as is recommended in the OECD Commentary on Article 25(1). Further, to the extent the domestic appeal is suspended pending the outcome of the MAP, this should be clearly stated in the guidance, together with advice on payment suspension.

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

[124] OECD/G20 2015 Final Report on Action 14 in para 50.

[125] UN Committee of Experts on International Cooperation in Tax Matters "Secretariat Paper on Alternative Dispute Resolution in Taxation" (8 October 2015) in para 21.

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

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

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

14 ACTION 15: DEVELOP A MULTINATIONAL INSTRUMENT

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

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

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

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

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

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

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

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

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

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

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

14.2 DTC recommendations for South Africa regarding the multilateral instrument

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

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

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

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

129 Ibid.

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

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

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

131 Ibid.

132 Croome op cit note 220 at 1.

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