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

(i) THE DAVIS TAX COMMITTEE

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

(ii) ACKNOWLEDGEMETS

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

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

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

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

FEDUSA	Presentation to DTC
Economic Freedom Fighters	Presentations to DTC
Business Unity South Africa	Presentation to DTC
American Chamber of Commerce in South Africa	Comment on DTC BEPS Interim Report
The Banking Association South Africa	Presentation and Report sent to DTC
Tax Justice Network	Presentations to DTC
SARS	Presentation to DTC and Technical Reports
National Treasury	Presentation to DTC and Technical Reports
South African Reserve Bank	Presentation and Technical Report
African Tax Administration Forum	Discussions with DTC
Academy for Public Finance	Presentations to DTC
OECD	Presentation to DTC
UN Economic Commission for Africa	Presentation to DTC
Webber Wentzel Attorneys	Presentation to DTC
Deloitte & Touche	Technical Report
SAIT	Presentations to DTC, comments on DTC BEPS 1st Interim Report
SAICA	Comments on DTC BEPS 1st Interim Report
KPMG	Presentation, Technical Report, Comments on DTC BEPS Interim Report
PWC	Presentation to DTC
ENS	Technical Report
Bowman Gilfillan	Technical Report
Cliffe Dekker Hofmeyr Inc	Technical Report
Peter Surtees - Norton Rose	Technical Report
Comair	Presentation to DTC
Zolani Babu (LLM Candidate - UCT)	Technical Report
Mark Hinze	Presentation to DTC
Patrick Bracher	Presentation to DTC

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

BACKGROUND INFORMATION ON BEPS AND SOUTH AFRICA'S CONCEPTUAL FRAMEWORK

1 INTRODUCTION

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

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

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

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

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

3 Ibid.

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

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

6 Ibid.

7 Ibid.

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

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

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

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

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

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8 Ibid.

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

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

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

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

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

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

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

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

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

1.1 THE GIST OF THE OECD REPORT

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

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

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

17 Ibid.

18 Ibid.

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

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

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

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

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

1.2 UNDERSTANDING MODERN BUSINESS MODELS

The OECD notes that for countries to curtail BEPS they have to understand modern business models and how MNEs operate in a globalised economy. Globalisation, the gradual removal of trade barriers, the increase in technological and telecommunication developments has caused products and operational models to evolve, changing the way modern MNEs are structured and managed and thereby creating the conditions for the development of global strategies aimed at maximising profits and minimising expenses and costs, including tax expenses. [25]

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

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

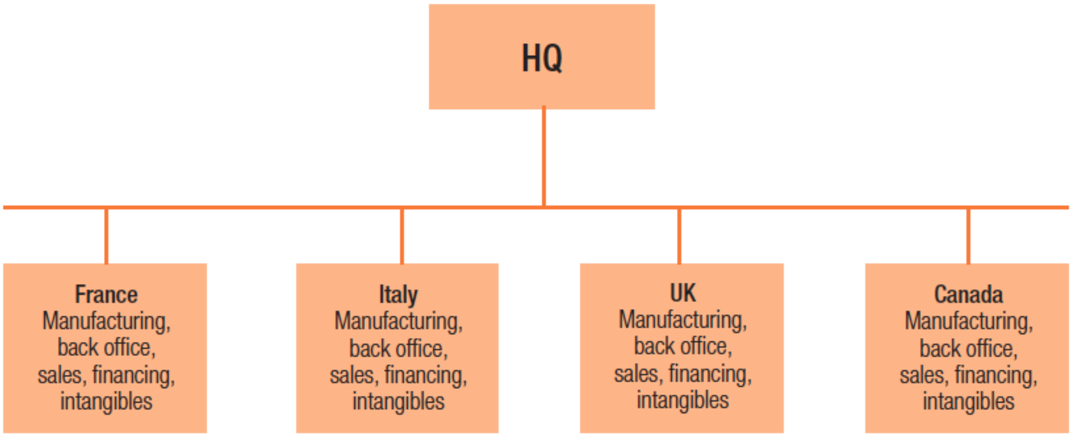
forming the group operate as a single integrated enterprise following an overall business strategy.

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

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

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

FIGURE 1: TRADITIONAL STRUCTURE OF A MULTINATIONAL ENTERPRISE



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

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

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

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

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

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

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

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

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

Beyond evidence like that by the investigations by the UK House of Lords Committee on Fiscal Affairs,[38] some non-governmental organisations have attempted to clarify the problem of tax avoidance and to provide a proxy for the scale of base erosion and profit shifting behaviour. Such include the Tax Justice Network report "The Missing Billions" which estimates that GBP12 billion of corporate income tax is lost each year due to tax avoidance by the 700 largest companies in the United Kingdom.[39] For developing countries Oxfam, a non-profit organisation, attributes a revenue loss of USD50 billion to tax avoidance by multinationals.[40] Although the question of how much revenue is lost due to profit shifting is highly interesting for the

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

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

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

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

1.5 BEPS AND ILLICIT FINANCIAL FLOWS

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

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

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

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

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

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

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

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

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

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

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

47 Ibid.

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

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

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

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

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

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

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

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

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

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

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

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

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

53 Kar & Spanjers, Global Financial Integrity "Illicit Financial Flows from Developing Countries" op cit note 78.
54 Times Live "Billions of Rands leave SA under the Radar" op cit note 85.
55 UNCTAD "Trade and Development: Global Governance and Policy Space for Development" (2014).
56 Ibid.
57 Ibid.
58 Global Financial Integrity "GFI Welcomes New US - Africa Partnership to Combat Illicit Finance" op cit note 83.
59 United Nations "Outcome document of the Third International Conference on Financing for Development: Addis Ababa Action Agenda" (13 to 16 July 2015) para 23. Available at http://www.un.org/ga/search/view_doc.asp?symbol=A/CONF.227/L.1 accessed 17 August 2015.

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

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

1.6 ACKNOWLEDGING SOUTH AFRICA'S POSITION IN AFRICA

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

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

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

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

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

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

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

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

1.7 OECD'S RECOMMENDATIONS ON HOW TO ADDRESS BEPS

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

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

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

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

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

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

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

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

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

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

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

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

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69 Ibid.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

2.1 SOUTH AFRICA'S NATIONAL SOVEREIGNTY AND CONSTITUTIONAL PERSPECTIVES

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

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

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

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

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

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

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

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

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77 K Vogel *Double Tax Conventions* (1997) in the Introduction in par 28.
78 L Olivier & M Honiball International Tax: A South African Perspective (2014) at 311-312.
79 Olivier & Honiball International Tax: A South African Perspective (2014) at 307.
80 OECD "History of the OECD". Available at http://www.oecd.org/document/63/0,2340,and_2649_201185_1876671_1_1_1_1,00 accessed 14 October 2014.
81 L Olivier & M Honiball International Tax a South African Perspective (2014) at 9.
82 *SIR v Downing* 1975 (4) SA 518 at 525 (AD).
83 53 SATC 342 at 348.

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

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

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

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

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

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

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

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

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

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

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

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

2.4.1 SARS Statistics

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

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

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

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

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

Table 1: Corporate tax statistics

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

2.4.2 National Treasury's Report

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

2.4.3 South African Reserve Bank Data

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

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

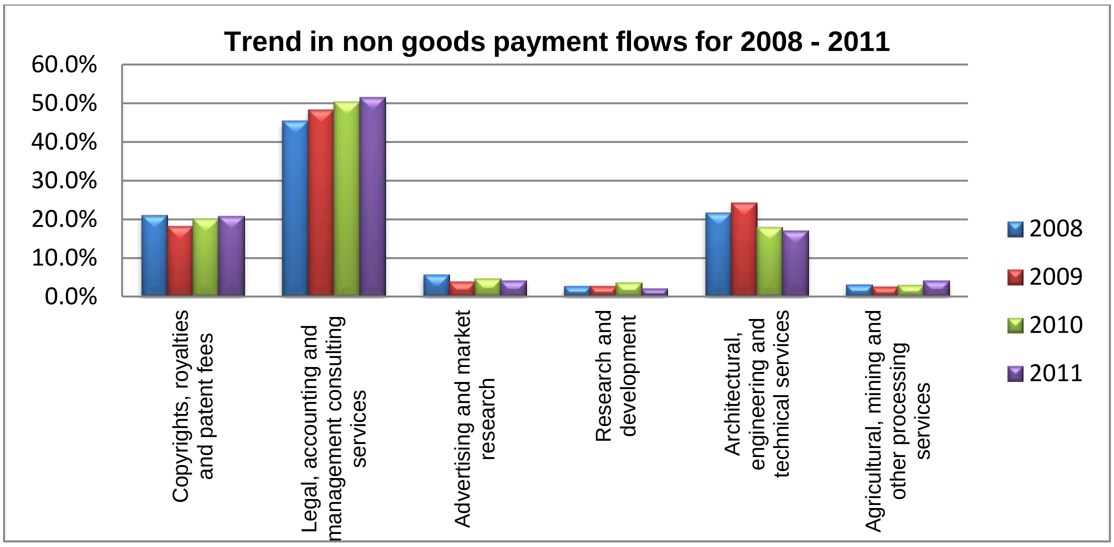
	2008 R	2009 R	2010 R	2011 R	Grand Total R
Copyrights, royalties and patent fees	9,193,024,882	9,972,557,798	10,218,632,767	11,753,572,186	**41,137,787,633**
Legal, accounting and management	19,907,138,985	26,404,401,495	25,567,916,347	29,086,527,270	**100,965,984,097**

91 National Treasury *Budget* (2013).

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

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

Figure 1: Trend in non goods payments



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

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

Figure 2: Non-goods contribution to overall payment flows

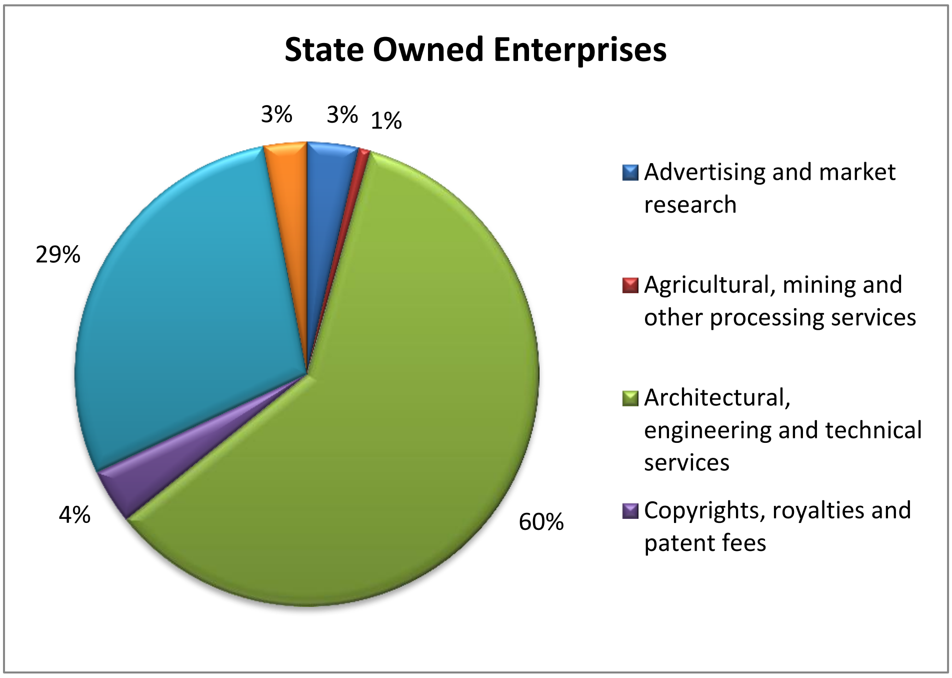
	2008	2009	2010	2011
Copyrights, royalties and patent fees	21.1%	18.3%	20.2%	20.9%
Legal, accounting and management consulting services	45.6%	48.4%	50.5%	51.6%
Advertising and market research	5.8%	3.8%	4.6%	4.2%
Research and development	2.7%	2.7%	3.7%	2.1%
Architectural, engineering and technical services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

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

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

92 UNCTAD World Investment Report (2011).

Figure 3: State Owned Enterprises' non goods payments



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

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

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

Table 4: Top non-goods payments

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

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

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

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

Summary of the data from the SARB[93]

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

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

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

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

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93 Adopted from SAIT's "Comments on DTC First BEPS Interim Report" (March 2015).

94 American Chamber of Commerce: Comments on DTC First BEPS Interim Report (March 2015) Slide 3 of Power Point Presentation.

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

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

2.4.4 The National Planning Commission's views

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

2.4.5 Recommendation on Measuring South Africa's Tax Gap

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

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

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

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

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

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

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

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

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

2.5.1 Methods of encouraging FDI

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

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

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

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

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

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

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

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

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

2.5.2 The danger to South Africa of unilateral action

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

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

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

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

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

2.5.3 The approach for developing a competitive tax policy

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

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

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

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

Equity:

118 American Chamber of Commerce in South Africa "Comments on the First DTC Interim Report on Base Erosion and Profit Shifting (March 2015) 1-2.
119 Ibid.
120 RM Sommerfeld, SA Madeo, KE Anderson & BR Jackson *Concepts of Taxation* (1993) at 10; WA Raabe & JE Parker *Taxation Concepts for Decision Making* (1985) at 14.

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

<u>Efficiency:</u>

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

<u>Certainty:</u>

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

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

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

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

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

<u>Simplicity:</u>

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

[123] Ministry of Corporate Affairs Department in India “Report of the Committee for Reforming the Regulatory Environment For Doing Business in India” (Sept 2013) in para 7.8.
[124] OECD “Fundamental Reform of Corporate Income Tax” (2007) No.16.
[125] Ibid.

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

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

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

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

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

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

127 Ibid.

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

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

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

131 Ibid.

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

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

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

2.8 THE ROLE OF EXCHANGE CONTROLS IN CURTAILING BEPS

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

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

[133] SAIT "Comments on DTC First Interim Report on BEPS" (March 2015) at 4.

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

[135] Ibid.

[136] L Olivier & M Honiball *International Tax: A South African Perspective* 4 ed (2008) at 524.

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

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

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

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

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

137 MM Katz (chairman) *Fifth Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa* (1997) ('Katz Commission Report') at 4.
138 South African Reserve Bank 'Exchange Control Manual' para E.

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

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

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

2.8.1 Examples of how exchange controls have been applied in South Africa to counter various BEPS schemes

Foreign loans: All loans coming into South Africa are subject to thin capitalisation rules as is the case with tax i.e., interest is capped at prime +2% for related party loans and prime +3% for third party funding. Our loan policy, which states that South African entities with offshore subsidiaries may not establish entities back into South Africa, assists in preventing the South African entity from moving its tax base to a foreign jurisdiction.

Imports: A general exchange control requirement is that all import transactions must be substantiated by documentary evidence including evidence to the effect that goods have in fact been cleared through Customs at some point in time. It is the responsibility of the ADs to ensure import transactions are executed in a manner compliant with permissions granted and upon presentation of documentary evidence.

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

In this regard, miss-invoicing/under-invoicing of goods at Customs is a matter that execrates BEPS. The 2014 UNCTAD "Trade and Development"[140] Report notes that illicit flows of capital through developing countries due to trade mis-invoicing is one of the most pressing challenges facing policymakers, since it costs these countries billions of dollars in revenue. The report showed that under-invoicing of imports and over-invoicing of exports, where buyers or sellers falsify the value of trade to be less than the actual market value can be used to disguise foreign investment and avoid capital controls. The UNCTAD recommends that in order to prevent channel financing, governments need to resort to capital management measures, including capital controls.[141]

South Africa's Reserve bank's investigations show that under-invoicing takes place in order to circumvent the payment of import duties and that fraudulent documentation is presented to ADs in order to effect payment for imports. In recent cases freight payments were used to disguise the settlement of import payments. In all the cases under investigation documentation was forged or falsified. Research has revealed that there is substantial discrepancy between the value of outward payments for imports and value of goods declared to Customs by the entities under investigation. The Reserve Bank also suspects that in some instances outward payments declared as import or freight payments have been used to exit funds from South Africa, which funds may be the proceeds of other criminal activities. Many of the transactions under investigation were cash funded (i.e. the ZAR leg) which raises suspicion as to the origin of the funds as well as whether such funds were properly declared for income tax purposes. Certain of the transactions also appear to have the makings of money laundering schemes which involve multiple entities and individuals.

In an effort to curb the submission of false documentation to ADs, FinSurv introduced the Imports Verification System (IVS). Essentially this system allows the relevant AD to verify the authenticity of a South African Revenue Service ("SARS") Customs Release by validating a unique Movement Reference Number (MRN) as annotated on the relevant Customs Release. The current system, however, does not validate the document in terms of the Customs Value indicated thereon.

Loop structures: Loop structures are tax-avoidance and exchange control schemes whereby South African residents invest in offshore trusts that, in turn, reinvest funds in South African businesses in which the original investors have a stake.[142] Loop

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

141 Ibid.

142 L du Preez 'No Sign of Extension to Amnesty Yet' (8 November 2003). Available at http://www.persfin.co.za/index.php?fSectionId=&fArticleId=280017 accessed on 20 March 2007. Wiseman Khuzwayo, Business Report 'FirstRand's loop legal – Dippenaar' (September 9, 2007). Available at http://www.busrep.co.za/index.php?fArticleId=4023192 accessed on 20 March 2009.

structures are considered to be in breach of exchange control regulations as capital is essentially exported through the subsequent growth in value of the company. The regulations prohibit South African residents from holding their local assets via offshore structures or from placing their legal foreign assets at the disposal of another South African resident.[143]

Individual remittances via ADLAs: The Reserve bank's investigations into transactions in terms of which foreign nationals remit funds abroad through ADLAs in respect of income earned from their employment in South Africa have revealed various exchange control contraventions. The fact that many of these transactions were funded by way of cash deposits (in many cases amounts of up to Rand 500 000) into the client accounts of ADLAs raised further concerns regarding possible money laundering as well as tax evasion by the individuals involved. It also became clear during investigations that almost none of the individuals conducted bank accounts in South Africa, which FinSurv finds strange, taking into account the fact that many of them remitted substantial amounts abroad claiming it was part of their South African earnings.

2.8.2 Actions from an Exchange Control Perspective to Address the BEPS Concerns in South Africa

- FinSurv monitors cross-border flows and shares information with SARS and the Treasury on a regular basis.
- The Treasury has introduced various policies to encourage South African individuals, corporates and institutional investors to use South Africa as a base for diversifying through domestic channels. One example of this being the Holdco regime (Treasury Management Company), which brings flows back into South Africa from all offshore entities, which would have previously been transferred to tax havens such as Mauritius, Isle of Man or some other jurisdictions.

2.8.3 How the Reserve Bank Works Together with other Government Agencies to Monitor Financial and Capital Flows

- FinSurv works closely with the Tax Policy Unit at the Treasury when it receives requests for corporate restructures to ensure that the tax base is protected when making decisions.
- FinSurv normally receives comprehensive reports from various South African corporates with financial statements of all their offshore entities. It is thus able

[143] Exchange Control reg 10(1)*(c);* Exchange Control Circulars D417 and D405. For details see generally AW Oguttu "Curbing Offshore Tax Avoidance: The Case of South African Companies and Trusts" (2007, UNISA LLD Thesis) chapter 9.

to report various forms of cross-border information to the Treasury because it is in a position to monitor financial and capital flows in and out of South Africa.

- When FinSurv relaxes controls or grants approvals outside of policy, it works closely with the tax authorities. Where gaps in policy are identified, FinSurv makes recommendations to the tax authorities.
- As exchange controls are relaxed, FinSurv ensures that it has discussions with the Tax Policy Unit at the Treasury and with SARS to highlight any reforms that could potentially have implications for the South African tax base.
- FinSurv provides various forms of cross-border information, so it is in a position to monitor financial and capital flows, in and out, of South Africa. FinSurv is, however unable to identify what component, if any, of BEPS may be contained in the various categories of transactions.
- It is recommended that a review be conducted of all SARS and SARB forms in terms of cross-border flows. SARB has a fair amount of information, that SARS can make use of in improving cross-border information flow especially once the new cross-border withholding tax regimes take effect. Operational control of ongoing reporting of these outflows may itself close a fair amount of avoidance, followed by more targeted legislation. It is therefore recommended that SARS should get assistance from foreign revenue authorities that have successfully created a cross-border monitoring system.[144]

2.8.4 Recommendations on how the SARB can assist in the efforts against BEPS

- The production of a Tax Clearance Certificate be made compulsory for certain types of high risk transactions involving individuals e.g. gifts above a certain threshold etc.
- Urgent steps are taken to improve efforts to prevent the circumvention of rules, which efforts would require closer and pro-active collaboration between SARS and FinSurv.
- Various types of schemes that are used by corporates i.e. hybrids, foreign tax generalisation etc. be disclosed to FinSurv, to assist with the detection of such schemes when approving requests.

Although some of the recommendations above may be construed to be a tightening of exchange controls or creating red tape, it must be noted that BEPS is not illegal, nor does it necessarily amount to a contravention of the exchange control regulations for the relevant transaction to be deemed invalid.[145] This was confirmed in the Supreme Court of April case of Oilwell v Protec[146] where it was held that:

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144 SAIT "Comments on DTC First Interim BEPS Report" (March 2015) at 3.

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

146 (295/10) [2011] ZASCA 29 (18 March 2011).

> "The Regulations are, accordingly, for the public interest and not to protect any private interests. They were adopted for the sake of The Treasury and not for the sake of disgruntled or disaffected parties to a contract. This is apparent from the penalty provision. But more importantly, it appears from regs 22A, 22B and 22C. They provide that any money or goods in respect of which a contravention has been committed may be attached by The Treasury; these may be forfeited to the State; and any shortfall may be recovered by The Treasury from not only persons involved in the commission of the offence but also from anyone enriched or who has benefited as a result thereof. *To add irremediable invalidity to the transaction would amount to overkill* and as Kriek J said, it would lead to 'greater inconveniences and impropriety'". (our emphasis)

2.9 OVERVIEW OF MEASURES IN PLACE TO CURTAIL BEPS IN SOUTH AFRICA

It has to be acknowledged that over the years, South Africa has made good progress in devising tax laws to deal with BEPS. South Africa's legislation in this regard is comparable to many developed countries; in fact, in many respects South Africa has done better than many developed economies. This has been augmented by the fact that:

- National Treasury and SARS are regularly engaged in international tax debates which have ensured that South Africa's tax policy is in line with internal norms. This ensures predicable tax results for MNE operating in the country.
- South Africa has an annual legislative cycle that ensures annual amendments to the Act, which enables businesses to plan for these changes and to make comment on the same.
- South Africa's e-filing system ensures an efficient filing of tax returns and payment of tax liabilities. SARS continued use of technology will ensure an efficient revenue collection mechanism

Considering all the legislation in place and the competitive edge the country has to maintain, South Africa may wonder whether it is necessary to tighten its laws any further or introduce new laws:

(i) Efforts to curtail BEPS can be traced back to the Katz Commission,[147] appointed in 1997 to inquire into the ability of the tax structure of South Africa to deal with the consequences of the globalisation of trade. The Commission recommended the introduction of the residence basis of taxation.[148] This basis of taxation, which was implemented in 2000, has been instrumental in curtailing erosion of the tax base, especially in light of South Africa's re-entry into the global economy after its first democratic elections in 1994.

(ii) South Africa has in place various specific anti-avoidance provisions to address

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

[148] Ushered in by the Revenue Laws Amendment Act 59 of 2000 (the Amendment Act) which amended the Income Tax Act.

BEPS. These include: the controlled foreign company (CFC) rules,[149] transfer pricing and thin capitalisation[150] rules, rules to deal with hybrid instruments, reportable arrangements [151] rules, and the Voluntary Disclosure Programme.[152] These provisions have been instrumental in curtailing erosion of the South African tax base.

(iii) In addition, South Africa can address BEPS by applying its general anti-avoidance rules and the substance over form principles, even though these general provisions are mainly applied in the domestic arena.

(iv) South Africa's tax treaties also contain provisions (such as the beneficial ownership provision) which can be applied to curtail the abuse of South Africa's treaties by third country residents.

(v) The Exchange Control rules are also instrumental in curtailing BEPS.

Despite all of these provisions, tax planners constantly seek to be one step ahead of tax administrations, coming up with various schemes that take advantage of the loopholes in the law. To curtail these schemes, the legislators often come up with *ad hoc* amendments, which have complicated the tax legislation and have unsuspectingly opened up further loopholes - and the cycle goes on.

It must be made clear that the main concern of the OECD BEPS Action Plan is about addressing in-bound issues which involve foreign multinationals investing in a country without paying their fair share of corporate income tax to that country. However, responding to these BEPS issues should not be seen as discouraging foreign investment. The goal is to ensure that the multinationals pay their fair share of tax, based on amounts that are economically attributable to their activities in the local country. It should also be noted many of BEPS concerns have been dealt with previously by the OECD and in some respects there is nothing new in the rules, but what is new is their application and that the rules need to be implemented in the way that was intended. The need to enforce these rules has also necessitated the proposals for significantly increase in exchange of information in tax matter and also mandatory disclosure rules to enable tax authorities to monitor the implementation.

Countries can ensure the preservation of the taxable income base of inbound investment, either by limiting local deductions (interest, dividends and royalty fees) and curtailing incentives by quantifying the real benefit. Although the issues pertaining to out-bound investments (for instance the Action Plan to strengthen CFC legislation) are connected to the BEPS in-bound concerns, outbound investments are not the main focus of the BEPS Action Plan. It is thus necessary to ensure a balance between *revenue collection* and *growth*. It is vital that South Africa, while

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149 Section 9D of the Income Tax Act 58 of 1962 as amended.
150 Section 31 of the Income Tax Act 58 of 1962 as amended.
151 Sections 34-39 of the Tax Administration Act 28 of 2011.
152 Sections 225-233 of the Tax Administration Act 28 of 2011.

ensuring that it collects its fair share of taxes on inbound investment, also creates the right environment to encourage foreign investment. In particular it is important to take note of the following:

- In adopting the OECD recommendations on BEPS, it is necessary that the envisaged legislation be first evaluated to ensure effectiveness of South Africa's tax environment.
- Care needs to be taken not to introduce fragmented and uncoordinated tax measures that address specific tax issues instead of dealing with the fundamental tax concerns. This can result in creating uncertainties and complicating the tax laws. A consistent tax policy must be maintained, instead of the trend over the last few years of introducing provisions and then withdrawing the policy position a few years later. This hampers confidence in the tax system. An example is the recent announcement in the 2015 Budget speech to tighten CFC rules and the withdrawal of the withholding tax on service fees. It is important that SARS is not seen to be "auditing legislation" rather than maintaining a predicable tax policy framework.[153]

2.10 OTHER FACTORS THAT SHOULD BE TAKE INTO CONSIDERATION TO ENSURE COMPREHENSIVE PROTECTION AGAINST BEPS IN SOUTH AFRICA

Comprehensive protection against BEPS in South Africa must occur at multiple levels.

2.10.1 BEPS protection at policy level

(a) Clear policy on tax incentives

South Africa has seldom offered tax holidays, preferring the tax incentive option. Studies by the IMF, the World Bank and the OECD show that tax holidays are a less effective way to generate new investment than incentives in the form of tax credits.[154] The subject of tax incentives in not dealt with in the OECD BEPS Actions however as alluded to in paragraph 2.5.1 above, some tax incentives can provide more opportunities for BEPS to occur. South Africa offers quite a few tax incentives to foreign investors. Tax incentives entail "any tax provision granted to a qualified investment project that represents a favourable deviation from the provisions applicable to investment projects in general."[155] The economic theory is that tax

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153 American Chamber of Commerce in South Africa "Comments on the First DTC Interim Report on Base Erosion and Profit Shifting (March 2015) at 4.

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

155 Fleischer, (2002).

incentives act as a tool for encouraging foreign investments. However, it has been observed that tax incentives distort resource allocation leading to some sub-optimal investment decisions and are therefore harmful to long term growth, since the country loses out in revenue foregone. It is also argued that tax incentives are not the primary determinants of the decision to invest. Most investors base their investment decisions not only on economic and commercial factors but also on institutional and regulatory factors. Despite these concerns, internationally there has been not much attention given to developing guidelines on tax incentives.

It is encouraging to note that in 2014 the G20 has called upon the IMF, OECD, UN and World Bank Group to work jointly to present a report in on options for low income countries on the efficient and effective use of tax incentives for investment.[156] It is therefore important that South Africa follows up on these developments and considers the best practice guidelines in the design of tax incentives.[157] Developing a clear tax policy on the use of tax incentives will be instrumental in preventing any resultant BEPS.

(b) Clear treaty negotiation policy

Improper use of tax treaties can be a major source of BEPS. South Africa has a wide network of double tax treaties, some of which are with low tax jurisdictions and can be a major source of BEPS. The list of double tax treaties on the SARS' website as at 30 May 2015 shows that South Africa has entered into 75 double tax treaties (DTT), which have been published in the Government Gazette, 21 of these DTTs are with African countries. Another 36 treaties are in the process of negotiation or have been finalised but not yet signed.[158]

Many of the BEPS concerns raised globally stem from overly generous tax treaties. In the 1990s, South African government officials had a tendency to push for

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156 G20 Development Working Group "Domestic resource Mobilization: G20 Response to 2014 base Erosion and Profit Shifting and Automatic Exchange of Information for Developing Economies" (2014) at 7. Available at https://g20.org/wp-content/uploads/2014/12/16%20G20%20response%20to%202014%20reports%20on%20BEPS%20and%20AEOI%20for%20developing%20economies.pdf accessed 1 April 2015.

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

158 SARS "Double taxation agreements (DTAs) & protocols". Available at Visit http://www.sars.gov.za/Legal/International-Treaties-Agreements/DTA-Protocols/Pages/default.aspx accessed 5 March 2015.

international agreements as a way of showing the world that South Africa was ending its long period of international isolation. The UN has advised that the ability to negotiate favourable treaty provisions depends a lot on the treaty negotiating power of the relevant country. In general, developed countries are better skilled in negotiating tax treaties than undeveloped countries.[159] The United Nations notes that:

> "Developing countries, especially the least developed ones, often lack the necessary expertise and experience to efficiently interpret and administer tax treaties. This may result in difficult, time-consuming and, in a worst case scenario, ineffective application of tax treaties. Moreover, skills gaps in the interpretation and administration of existing tax treaties may jeopardize developing countries' capacity to be effective treaty partners, especially as it relates to cooperation in combating international tax evasion. There is a clear need for capacity building initiatives, which would strengthen the skills of the relevant officials in developing countries in the tax area and, thus, contribute to further developing their role in supporting the global efforts aimed at improving the investment climate and effectively curbing international tax evasion".[160]

It is important that South Africa has a clear policy on treaty negotiation and that it ensures that the knowledge and technical capacity of its treaty negotiators are sufficient so that it avoids concluding treaties that are not in its favour, because they reflect the position of the other contracting state. There are two main Models employed internationally in the drafting of treaties: the OECD Model Tax Convention (OECD MTC) and the UN Model Tax Convention between Developed and Developing Countries (UN MTC). The OECD MTC embodies rules and proposals by developed capital exporting countries. It thus favours capital exporting countries over capital importing countries. Treaties based on the OECD MTC normally eliminate double taxation by requiring the source country to give up some or all of its tax on certain categories of income earned by residents of the other treaty country.[161] The UN MTC favours capital importing countries over capital exporting countries. It generally imposes fewer restrictions on the tax jurisdiction of source countries. For instance, it does not contain specific limitations on withholding tax rates on dividends, interest, and royalties imposed by the source country.[162]

South Africa also has a model tax treaty that is used as a basis for negotiating its treaty position. This model treaty is a template used as a starting point when embarking on a treaty negotiation.[163] Nevertheless, most of South Africa's treaties are largely based on the OECD MTC. In some treaties, the Contracting states have negotiated some treaty provisions that are based on the UN MTC. Since South Africa

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159 PWC, EuropeAID 'Implementing the Tax and Development Policy Agenda: Final Report on Transfer Pricing and Developing Countries' (2011) at 21.
160 United Nations 'Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries' (United Nations, 2013) at iii.
161 B.J. Arnold and M.J. McIntyre, *International Tax Primer* (Kluwer Law International, 2002), at 109.
162 Ibid.
163 Oliver & Honiball at 272; Mazansky "South African Treaty Network – Why is South Africa the Meat in the Sandwich? (2009) Bulletin for International Tax 48.

is generally a net capital importing counties, it is generally within its interest to sign treaties based on the UN MTC.

South Africa should accordingly utilise the BEPS era to renegotiate its “riskier” treaties with low-tax jurisdictions. Tax treaties are designed to reduce double tax – not to create a tax vacuum. To this end, the DTC recommends that South Africa joins the OECD effort to revise tax treaty interpretations, update treaties and cautiously monitor other countries moves on the multi-lateral instrument process (under Action 15) so that overall weaknesses in the treaty system is corrected.

2.10.2 BEPS Protection at Administrative level

At an administrative level, the use of proper forms should be attended to, to ensure proper detection of BEPS.

- Currently the IT14 Company Tax Form makes no distinction between a local company versus a foreign company operating in South Africa, except a box checkmark. It is important that SARS divides the two into separate audit tracks.
- Instead SARS has implemented form IT14-SD which has resulted in additional compliance costs for MNEs.[164]
- Forms should also be created for all cross-border withholding taxes.
    - There is a form in progress for outgoing interest
    - A form is need for outgoing royalty

2.11 OECD VIEWS ON HOW BEPS RECOMMENDATIONS ARE TO BE IMPLEMENTED

The OECD notes that a better understanding of how the BEPS recommendations are implemented in practice could reduce misunderstandings and disputes between governments. Greater focus on implementation and tax administration is mutually beneficial to governments and business. [165]

The OECD BEPS Project culminated in a comprehensive package of measures which are designed to be implemented domestically and through treaty provisions in a coordinated manner, supported by targeted monitoring and strengthened transparency. The implementation of the BEPS package will better align the location of taxable profits with the location of economic activities and value creation, and

[164] American Chamber of Commerce in South Africa: Comments on DTC First Interim BEPS Report (March 2015).

[165] OECD BPS Project “Addressing the Tax Challenges of the Digital Economy” (2015 Final Report) at 4.

improve the information available to tax authorities to apply their tax laws effectively.[166]

(a) Minimum standards

Minimum standards were agreed in particular to tackle issues in cases where no action by some countries would have created negative spill overs (including adverse impacts of competitiveness) on other countries. [167] Thus all OECD and G20 countries (which includes South Africa) have committed to consistent implementation of minimum standards in the following Action Points:

- Harmful tax practices (Action 5)
    - A revitalised peer review process will address harmful tax practices, including patent boxes where they include harmful features, as well as a commitment to transparency through the mandatory spontaneous exchange of relevant information on taxpayer-specific rulings which, in the absence of information exchange, could give rise to BEPS concerns.
- Preventing treaty shopping (Action 6)
- Country-by-country reporting (Action 13)
    - Standardised Country-by-Country Reporting and other documentation requirements will give tax administrations a global picture of where MNE profits, tax and economic activities are reported, and the ability to use this information to assess transfer pricing and other BEPS risks, so they can focus audit resources where they will be most effective
- Improving dispute resolution (Action 14)
    - For mutual agreement procedures (MAP), agreement on a minimum standard to secure progress on dispute resolution has been reached.

(b) Common approaches and best practices for domestic law

In other cases countries have common approaches, which will facilitate the convergence of national practices in interested countries. In these areas, countries have agreed on certain best practices. Countries are expected to converge over time through the implementation of the agreed common approaches, thus enabling further consideration of whether such measures should become minimum standards in the future. Action points with best practices are:

- hybrid mismatch arrangements (Action 2)
    - domestic legislation and related treaty provisions where necessary to neutralise hybrid mismatches which undermine their tax base or the tax base of their partners.

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166 OECD OECD/G20 Base Erosion and Profit Shifting Project Explanatory Statement (2015) in para 11.

167 Ibid.

- Controlled foreign company rules (Action 3)
    - Building blocks for effective CFC rules
- Limiting base erosion through Interest expenses, for example via intra-group and third party loans that generate excessive deductible interest payments (Action 4)
- Mandatory disclosure of aggressive tax planning (Action 12)
    - Guidance based on best practices for countries which seek to strengthen their domestic legislation relating to mandatory disclosure by taxpayers of aggressive or abusive transactions, arrangements, or structures.

(c) Action points that reinforce international standards to eliminate double taxation, in order to stop abuses and close BEPS opportunities

This translates into a set of agreed guidance which reflects the common understanding and interpretation of provisions based on Article 9 of both the OECD and UN model tax conventions. Under this category fall:

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

(d) Analytical reports

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

2.12 CONCLUSION AND REMARKS ON DETAILED ANNEXURES DISCUSSING THE BEPS ACTION POINTS

As South Africa takes stock of its current legislation and considers how this should be adopted or what other legislation should be enacted in order to protect its tax base from BEPS, care should be taken to adhere to the OECD's warning against countries taking unilateral action as this may result in double taxation, which could risk making South Africa unattractive as a destination for foreign direct investment. Unilateral measures may also create further opportunities for avoidance.

Attached to this main introductory report are annexures that analyse the OECD BEPS Action Plans (issued in final form on October 5 2015) from a South African perspective. The structure of discussion of each Action Plan in the relevant annexure is as follows:

- Background information about the BEPS concern that the Action Plan addresses;
- A description of the OECD Action Plan regarding that BEPS concern;
- Previous and ongoing OECD work/recommendations on how to address that BEPS concern;
- An overview of how other countries have addressed the concern, where relevant;
- A discussion as to whether the relevant the specific BEPS practice is an issue in South Africa and the effectiveness of the legislation in place (if any) to address the concern.
- In light of the OECD's recommendations on how to address the relevant BEPS practice, and in light of international developments regarding the practice, recommendations are made as to how South Africa should position itself to effectively address it.
- Once again it is reiterated that the DTC recommends that South Africa, other than where it is committed to adopt BEPS Action proposals, takes a very cautious approach to BEPS. It should be a follower that monitors the trends and developments on the international scene regarding BEPS rather than be a leader that pioneers BEPS provisions that have not been tested in any other country.[168]

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