SUMMARY OF DTC REPORT ON ACTION 5: COUNTER HARMFUL TAX PRACTICES MORE EFFECTIVELY, TAKING INTO ACCOUNT TRANSPARENCY AND SUBSTANCE

In 1998 the OECD issued a Report entitled *Harmful Tax Competition: An Emerging Global Issue*. This Report pointed out that tax haven jurisdictions and harmful preferential tax regimes distort financial and investment flows among countries.\(^1\) Further that the harmful tax practices of both tax haven and harmful preferential tax regimes undermine the integrity and fairness of tax structures; they discourage compliance by all taxpayers; they cause undesirable shifts of part of the tax burden to less mobile tax bases such as labour, property and consumption; and they increase the administrative costs and compliance burdens on tax authorities and taxpayers respectively.

In the 1998 Report the OECD described a tax haven as a jurisdiction with no or nominal taxation, actively making itself available for the avoidance of tax that would have been paid in high-tax countries.\(^2\) The OECD noted that tax-haven jurisdictions are characterised *inter alia* by:

- high levels of secrecy in the banking and commercial sectors.
- lack of transparency and effective exchange of information with other governments concerning the benefits taxpayers receive from the tax haven.\(^3\)

Progress Reports were issued in 2000 (listing 35 tax haven jurisdictions); 2001 (which reiterated that a jurisdiction would not be considered uncooperative if it committed to transparency and effective exchange of information.)\(^4\); 2002 (which gave rise to the principles (standards) set out in the 2002 OECD “Model Agreement on Exchange of Information on Tax Matters”); and annual progress reports thereafter on implementation of the standards. Due to countries having implemented or agreed
to implement the tax standard on exchange of information, by May 2009 no countries remained on the “tax haven list”.

The 1998 Report also described preferential regimes, which could exist even in jurisdictions with high tax rates:

(i) The regime imposes no or low effective tax rates on income from geographically mobile financial and other service activities.
(ii) The regime is ring-fenced from the domestic economy.5
(iii) The regime lacks transparency (for example, the details of the regime or its application are not apparent, or there is inadequate regulatory supervision or financial disclosure).
(iv) There is no effective exchange of information with respect to the regime.6

The eight factors determining whether such regimes are harmful are:

(i) An artificial definition of the tax base.
(ii) Failure to adhere to international transfer pricing principles.
(iii) Foreign source income exempt from residence country taxation.
(iv) Negotiable tax rate or tax base.
(v) Existence of secrecy provisions.
(vi) Access to a wide network of tax treaties.
(vii) The regime is promoted as a tax minimisation vehicle.
(viii) The regime encourages operations or arrangements that are purely tax-driven and involve no substantial activities.7

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

- Does the tax regime shift activity from one country to the country providing the preferential tax regime, rather than generate significant new activity?
- Is the presence and level of activities in the host country commensurate with the amount of investment or income?
- Is the preferential regime the primary motivation for the location of an activity?8

Although the OECD’s 1998 initiative was successful in promoting a programme of transparency and exchange of information by tax haven jurisdictions, it generally failed to accomplish what it set out to do, which is addressing harmful tax

5 The term “ring-fencing” refers to the artificial demarcation or limitation of profits or losses for tax purposes, ignoring the corporate form of the taxable or restricting the application of particular provisions to transactions inside the ring fence. See L Olivier & M Honiball International Tax: A South African Perspective 4 ed (2011) at 849.
competition. In fact, many of the OECD member countries have since enacted such regimes, especially with regard to mobile income.

The OECD 2013 Report on BEPS stated, in its commentary on Action 5, that the underlying policy concerns expressed in the 1998 Report as regards harmful tax practices (often termed the “race to the bottom”) are as relevant today as they were when the 1998 report on harmful tax completion was issued. However, nowadays it often takes less of the form of traditional ring fencing and now entails:

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

The 2013 Report thus recommended that this area should be revisited both domestically and internationally. The OECD’s previous failed attempt to shame countries into changing local laws, however, causes one to have tempered expectations for the BEPS initiative.

The 2015 Final Report on Action 5 (issued on October 2015) observes that combating harmful tax practices is an interest common to OECD and non-OECD member countries alike. However there are obvious limitations to the effectiveness of unilateral actions against such practices. Thus, the need for countries to agree on a set of common criteria to promote a co-operative framework that supports the effective fiscal sovereignty of countries over the design of their tax systems; and to enhance the ability of countries to react against the harmful tax practices of others.

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

In Action 5, the OECD has, therefore, placed priority on:

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

In addition to the above matters relating to revamping work on harmful tax practices:
3) OECD planned to take a holistic approach to evaluate preferential tax regimes in the BEPS context. The OECD also planned to engage with non-OECD members on the basis of the existing framework and consider revisions or additions to the existing framework.

The OECD’s work on substantial activity has focused in the first instance on regimes which provide a preferential tax treatment for certain income arising from qualifying Intellectual Property (“intangible regimes” or “IP regimes”). This is in line with the statements in the BEPS Action 5 that current concerns in the area of harmful tax practices may be less about traditional ring-fencing and instead relate to corporate tax rate reductions on particular types of income, such as income from the provision of intangibles. Thus all intangible regimes in OECD member countries are being reviewed. Under Action 5, the substantial activity requirement also applies to all preferential other than IP regimes.  

For the substantial activity requirement in the context of IP regimes the “nexus approach” was supported by OECD member countries and the G20. This approach allows a regime to provide for a preferential rate on IP-related income to the extent it was generated by qualifying expenditures. This is achieved by applying a formula to ensure that only qualifying expenditures relating to income from an IP asset will result in defining the income receiving tax benefits. Where the amount of income receiving benefits under an IP regime does not exceed the amount determined by the nexus approach, the regime has met the substantial activities requirement.

For the substantial activity requirement in the context of non-IP regimes to be satisfied the tax benefits may only granted to taxpayers that undertake core income generating activities that produce the type of business income covered by the preferential regime.

In addressing the second priority under Action 5 i.e. improving transparency, the report deals with 3 steps: firstly, develop a framework for compulsory spontaneous information exchange; then, consideration of whether transparency with regards to rulings (for preferential regimes and other matters) can be improved in relation to the rulings regimes in the associated countries – this concluded that the requirement to undertake compulsory spontaneous information exchange should generally cover all instances in which the absence of exchange of a ruling may give rise to BEPS

concerns, thus taking away the need for a jurisdiction to determine if a particular regime is preferential; and thirdly, develop a general best practice framework for design and operation of rulings regimes.

It is important to note that the Report requires that the obligation to spontaneously exchange rulings applies not only to future rulings, but also to past rulings i.e. those issued after 1 January 2010 and still in effect from 1 January 2014 must be exchanged. For future rulings i.e. after 1 April 2016, countries are expected to ensure they have the relevant information required, on hand.\(^\text{16}\) The report makes it clear that taxpayers have a legal right to expect that information exchanged remains confidential.

In relation to the third priority, whereby the OECD is evaluating preferential tax regimes in the BEPS context, the OECD commenced its review of member countries in late 2010. By the time of the issue of the Final Report on Action 5, forty three (43) preferential regimes had been reviewed. A list of these is provided and reflects, for South Africa, the headquarter company regime, but it notes that this is considered to be potentially harmful but not actually harmful; and the exemption of income for ships used in international shipping, with is indicated as being not harmful.\(^\text{17}\)

Further work is to be carried out on these regimes, especially in the context of substantial activities.

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

From the angle of preserving the competitiveness of the economy, the headquarter company regime has, however, not been very successful. South Africa has been reluctant to participate in international tax competition and this has hindered its ability to fully establish itself as the gateway to Africa. There are also other factors which might affect the decision of foreign investors when deciding whether to choose South Africa as a regional headquarter location, most notably exchange controls, labour law policy, availability of guaranteed power sources, and immigration requirements (specifically the obtaining of work permits).\(^\text{18}\)

While South Africa should be concerned about preventing harmful tax competition, it should move cautiously to protect its competitiveness since many major countries

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\(^{17}\) OECD/G20 2015 Final Report on Action 5 at 64.  
\(^{18}\) PWC “Comment on DTC BEPS First Interim Report (30 March 2015) at 19.
are not willing to give up their special tax regimes, such as corporate rate reductions and patent boxes (identified in Action 5 as harmful), which are designed to attract investment so as to remain competitive. For example, the United Kingdom has reduced its corporate rate to 20% and is continuing a phased reduction.\textsuperscript{19} South Africa must, thus, take care not to be a “first mover” in terms of the BEPS reform associated with harmful tax practices.

South Africa already has regimes that are designed to encourage investment into the country in the form of urban and industrial development zones, as well as the proposed special economic zones. It would appear, however, that these will fall within the categories of low risk “disadvantaged areas”,\textsuperscript{20} which are discussed in the Final Report on Action 5. Furthermore, these are physical investments rather than mobile activities which are the concern of the OECD Report.\textsuperscript{21} Care should be taken to ensure that this remains the case and that the necessary disclosure is made to the FHTP and, if considered necessary, potentially, spontaneous exchange of information is made.

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

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

The DTC makes the following recommendations for South Africa:

- It is important that South Africa balances its international obligations not to engage in harmful tax practices with the need to preserve the competitiveness of the economy. More so, as the National Development Plan provides that South Africa should aspire to be a gateway for investment in Africa. There is potential for substantial job creation and tax revenue to the Government in the form of VAT and employees’ tax from which South Africa would benefit, as long as it ensures that it complies with the OECD’s substance requirements. The bottom line is that BEPS is both a risk and an opportunity for South Africa.

- From a tax perspective, consideration should be given to instituting a reduced corporate income tax rate for headquarter companies which meet minimum substance requirements. (It may, however, be necessary to align this rate for all companies in order for such rate not to be viewed as a harmful tax practice. However, this would need to be evaluated in terms of the DTC Reports as a whole).

\textsuperscript{19} L Shepperd “What should the OECD do about Base Erosion?” Copenhagen precise of 2013 International Fiscal Association annual Congress” 9/9/2013.
\textsuperscript{20} OECD/G20 2015 Final Report on Action 5 at 65.
\textsuperscript{21} PWC “Comment on DTC BEPS First Interim Report “(30 March 2015) at 19.
This would make South Africa more attractive as a destination for regional headquarters. While this may result in the perception that there will be a notional cost related to corporate income tax foregone, the direct and indirect spin-offs of an increased number of such companies (that would otherwise go elsewhere) which would result in increased tax revenues, as well as from increased employment taxes, consumption taxes and profit taxes of suppliers should outweigh such perceived forgone taxes.

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

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

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

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

➢ It is further recommended that South Africa’s tax authorities ensure that they do not sanction tax rulings relating e.g. to the headquarter company regime that foster harmful practices and hamper transparency. This could cover secret rulings that enable taxpayers to get tax haven results even if the country may have a tax system with an acceptable tax rate.

PWC “Comment on DTC BEPS First Interim Report” (30 March 2015) at 19.
Although not currently available in South Africa, the DTC recommends that the resources be sought to put an APA option in place, for purposes of enhancing its transfer pricing regime (in particular to provide taxpayers with certainty- see DTC reports on Actions 8-10) and thus consideration needs to be given to the practices that would need to also be put in place so as not to contravene the harmful tax practices principles set out in the OECD Action 5 Report.

The DTC furthermore recommends that SARS’ capacity be increased to enable it to satisfy the requirements of the spontaneous exchange of information whenever this should be required in terms of the conclusions reached by the forum for harmful tax practices of the OECD.

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

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

South Africa and other African countries could consider extending the automatic exchange of information arrangements currently reached to ensure a level playing field amongst them. This could be facilitated through the Africa Tax Administration Forum.
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1 INTRODUCTION

In 1998 the OECD issued a Report entitled *Harmful Tax Competition: An Emerging Global Issue*. This 1998 report is the foundation for the OECD’s work in the area of harmful tax practices. The 1998 report was published in response to a request by Ministers of Finance of the 29 OECD member countries at the time (1996), to develop measures to counter harmful tax practices with respect to geographically mobile activities, such as financial and other service activities, including the provision of intangibles. This request was endorsed by the Ministers of Finance of the G7 countries, later in 1996.\(^1\) The nature of these types of activities makes it very easy to shift them from one country to another. Globalisation and technological innovation have further enhanced that mobility.\(^2\) The 1998 Report divided the work on harmful tax practices into the following areas:

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

The 1998 Report pointed out that tax haven jurisdictions and harmful preferential tax regimes distort financial and investment flows among countries.\(^3\) Further that the harmful tax practices of both tax haven and harmful preferential tax regimes undermine the integrity and fairness of tax structures; they discourage compliance by all taxpayers; they cause undesirable shifts of part of the tax burden to less mobile tax bases such as labour, property and consumption; and they increase the administrative costs and compliance burdens on tax authorities and taxpayers respectively. In order to counter those harmful tax practices, the OECD came up with certain recommendations for countries to adopt in order to enhance the effectiveness of their domestic legislation in curbing harmful tax practices.\(^4\)

1.1 CRITERIA FOR IDENTIFYING TAX-HAVEN JURISDICTIONS IN THE OECD 1998 REPORT

The OECD described a tax haven as a jurisdiction with no or nominal taxation, actively making itself available for the avoidance of tax that would have been paid in

\(^{\ast}\) DTC BEPS Sub-committee: Prof Annet Wanyana Oguttu, Chair DTC BEPS Subcommittee (University of South Africa - LLD in Tax Law; LLM with Specialisation in Tax Law, LLB, H Dip in International Tax Law); Prof Thabo Legwaila, DTC BEPS Sub-Committee member (University of Johannesburg - LLD, ) and Ms Deborah Tickle, DTC BEPS Sub-Committee member (Director International and Corporate Tax Managing Partner KPMG).


high-tax countries. The OECD noted that tax-haven jurisdictions are characterised inter alia by:
- high levels of secrecy in the banking and commercial sectors.
- the lack of transparency and effective exchange of information with other governments concerning the benefits taxpayers receive from the tax haven.

1.1.1 PROGRESS ON TAX HAVENS AFTER THE OECD 1998 REPORT

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

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

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

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10 OECD “Agreement on Exchange of Information on Tax Matters” para 2 of the Introduction.
exchange of information on request where it is “foreseeably relevant” to the administration and enforcement of the domestic laws of a treaty partner;

- No restrictions on exchange of information because of banking secrecy or other domestic tax interest requirements;

- Respect for taxpayer rights;

- Strict confidential information exchange.

These standards are now embodied in the 2002 OECD “Model Agreement on Exchange of Information on Tax Matters” and its commentary, which serves as a basis for several “Tax Information Exchange Agreements” (commonly referred to as TIEAs) entered into between countries.\textsuperscript{13} The standards are also embedded in article 26 of the OECD Model Tax Convention\textsuperscript{13} and article 26 of the United Nations Model Double Taxation Convention.\textsuperscript{14} Successive OECD Global Forum reports\textsuperscript{15} show that a number of countries originally qualifying as ‘tax-havens’ made commitments to implement the OECD’s standards of transparency and exchange of information for tax purposes. Some of these jurisdictions also signed exchange of information agreements with various OECD and non-OECD Member countries.\textsuperscript{16}

The OECD is of the view that transparency and exchange of information among countries will be helpful in preventing harmful tax practices. In 2005 the Global Forum agreed on standards on transparency relating to availability and reliability of information. Since 2006, the Global Forum has published annual assessments of progress in implementing the standards. In September 2009, the Global Forum was renamed the Global Forum on Transparency and Exchange of Information for Tax Purposes, and was restructured to expand its membership and its mandate and to improve its governance.\textsuperscript{17}

By May 2009 no countries remained on the Tax Haven list, since all had either implemented, or agreed to implement within a reasonable timeframe, the internationally agreed tax standard on exchange of information\textsuperscript{18}.

\textsuperscript{13} OECD Model Tax Convention on Income and Capital 2010 Condensed Version.
\textsuperscript{14} United Nations “Model Tax Convention Between Developed and Developing Countries”, 2011 Version.
\textsuperscript{17} OECD/G20 2014 Report on Action 5 at 18.
\textsuperscript{18} OECD “Countering Offshore Tax Evasion: Some Questions and Answers” (28 September 2009) at 12.
1.2 CRITERIA FOR IDENTIFYING PREFERENTIAL TAX REGIMES IN THE 1998 REPORT

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

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

b) Consideration of the four key criteria/factors and eight other factors set out in the 1998 Report to determine whether a preferential regime is potentially harmful:
   - Consideration of the economic effects of a regime to determine whether a potentially harmful regime is actually harmful.\(^{19}\)

\textit{a) Consideration of whether a regime is preferential}

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

(i) Firstly, apply to income from geographically mobile activities, such as financial and other service activities, including the provision of intangibles. Preferential regimes designed to attract investment in plant, building and equipment are outside the scope of the 1998 Report.

(ii) Secondly, the regime must relate to the taxation of the relevant income from geographically mobile activities. Hence, the Report is mainly concerned with business taxation. Consumption taxes are explicitly excluded.\(^{20}\)

\textit{Preferential tax treatment:} In order for a regime to be considered preferential, it must offer some form of tax preference in comparison with the general principles of taxation in the relevant country. A preference offered by a regime may take a wide range of forms, including a reduction in the tax rate or tax base or preferential terms for the payment or repayment of taxes. Even a small amount of preference is sufficient for the regime to be considered preferential. The key point is that the regime must be preferential \textit{in comparison with the general principles of taxation in the relevant country}, and not in comparison with principles applied in other countries.\(^{21}\)

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

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


(i) The regime imposes no or low effective tax rates on income from geographically mobile financial and other service activities.

(ii) The regime is ring-fenced from the domestic economy. 22

(iii) The regime lacks transparency (for example, the details of the regime or its application are not apparent, or there is inadequate regulatory supervision or financial disclosure).

(iv) There is no effective exchange of information with respect to the regime. 23

The eight other factors are:

(i) An artificial definition of the tax base.

(ii) Failure to adhere to international transfer pricing principles.

(iii) Foreign source income exempt from residence country taxation.

(iv) Negotiable tax rate or tax base.

(v) Existence of secrecy provisions.

(vi) Access to a wide network of tax treaties.

(vii) The regime is promoted as a tax minimisation vehicle.

(viii) The regime encourages operations or arrangements that are purely tax-driven and involve no substantial activities. 24

In order for a regime to be considered potentially harmful, in terms of the 1998 Report, the first key factor, “no or low effective tax rate”, must apply. This is a gateway criterion. Where a regime meets the no or low effective tax rate factor, an evaluation of whether that regime is potentially harmful should be based on an overall assessment of each of the other three ‘key factors’ and, where relevant, the other eight ‘other factors’. Where low or zero effective taxation and one or more of the remaining factors apply, a regime will be characterised as potentially harmful. 25

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

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

- Does the tax regime shift activity from one country to the country providing the preferential tax regime, rather than generate significant new activity?

- Is the presence and level of activities in the host country commensurate with the amount of investment or income?

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22 The term “ring-fencing” refers to the artificial demarcation or limitation of profits or losses for tax purposes, ignoring the corporate form of the taxable or restricting the application of particular provisions to transactions inside the ring fence. See L Olivier & M Honiball International Tax: A South African Perspective 4 ed (2011) at 849.


Is the preferential regime the primary motivation for the location of an activity?26

Following consideration of its economic effects, a regime that created harmful effects would be categorised as a harmful preferential regime. The 1998 Report recommended that where a preferential regime is found to be actually harmful, the relevant country should be given the opportunity to abolish the regime or remove the features that create the harmful effect. Other countries may take defensive measures to counter the effects of the harmful regime, while at the same time continuing to encourage the country applying the regime to modify or remove it.27

1.3 COMMENTS ON THE OECD WORK ON TAX HAVENS AND PREFERENCE TAX REGIMES AFTER THE 1998 REPORT

Although the OECD’s 1998 initiative was successful in promoting a programme of transparency and exchange of information by tax haven jurisdictions, it generally failed to accomplish what it set out to do, which is addressing harmful tax competition.28 The OECD’s initiative did not lead to the elimination of harmful preferential tax regimes and many of the OECD member countries have since enacted such regimes, especially with regard to mobile income.29

2 OECD 2013 BEPS REPORT: ACTION 5

In the 2013, the OECD issued a Report on Base Erosion and Profits Shifting (BEPS). Its Action 5, which deals with countering Harmful Tax Practices, reiterated the concerns expressed in the 1998 Harmful Tax Competition Report recognising that a “race to the bottom” would ultimately drive applicable tax rates on certain mobile sources of income to zero for all countries, whether or not this was the tax policy a country wished to pursue.30 The OECD 2013 BEPS Report on Action 5 notes that the underlying policy concerns expressed in the 1998 Report as regards the “race to the bottom” on the mobile income tax base are as relevant today as they were 15 years ago, when the 1998 report on harmful tax completion was issued. However, the “race to the bottom” nowadays often takes less of the form of traditional ring fencing and now entails:

- artificial demarcations or limitation of profits or losses for tax purposes;
- ignoring the corporate form of the taxable entities;
- restricting the application of particular provisions to transactions inside the ring fence;

29 Ibid.
across the board corporate tax rate reductions on particular types of income (such as income from financial activities or from the provision of intangibles).

To counter these harmful tax practices, the OECD 2013 Action 5 recommended that National Countries should revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for any preferential regime.

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

It should be noted that work under Action 5 focuses on preferential tax regimes and on defensive measures in respect of such regimes (other than any such measures related to a lack of exchange of information or transparency). In Action 5, the OECD is reviving its attack on harmful tax competition that it dropped over a decade ago. However, the OECD's failed attempt, over a decade ago, to shame countries into adopting changes to local law that would require a significant rethinking of substantive tax rules causes one to have tempered expectations for the BEPS initiative.31

3 OECD 2015 REPORT ON ACTION 5

Following its 2013 BEPS Report, in September 2014 the OECD issued its findings on Action 5, and in October 2015 the Final Report was issued. The 2015 Final Report observes that combating harmful tax practices is an interest common to OECD and non-OECD member countries alike. However there are obvious limitations to the effectiveness of unilateral actions against such practices. Thus the need for countries to agree on a set of common criteria to promote a co-operative framework that supports the effective fiscal sovereignty of countries over the design of their tax systems; and to enhance the ability of countries to react against the harmful tax practices of others.

The OECD notes that its work on harmful tax practices is not intended to promote the harmonisation of income taxes or tax structures generally within or outside the OECD, nor is it about dictating to any country what should be the appropriate level of tax rates. Rather, the work is about reducing the distortionary influence of taxation on

the location of mobile financial and service activities, thereby encouraging an environment in which free and fair tax competition can take place. This is essential in moving towards a “level playing field” and a continued expansion of global economic growth.\(^{32}\)

In response to Action 5 which recommends that National Countries should revamp the work on harmful tax practices, the OECD has placed priority on:
- Requiring substantial activity for any preferential regime.
- Improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes,

In addition to the above matters relating to revamping work on harmful tax practices:
- OECD planned to take a holistic approach to evaluate preferential tax regimes in the BEPS context. The OECD also planned to engage with non-OECD members on the basis of the existing framework and consider revisions or additions to the existing framework.

The recommendations of the OECD on each of these matters in its Final 2015 Report on Action 5 are set out below.

3.1 REQUIRING “SUBSTANTIAL ACTIVITY” FOR ANY PREFERENTIAL REGIME

As noted in the analysis of the criteria for identifying preferential tax regimes in the 1998 Report, a reference to “substantial activity” is already included in the eight others factors for determining whether a regime is potentially harmful. So this is not a new concept. However the 1998 Report contains limited guidance on how to apply this factor. The substantial activity factor has been elevated in importance under Action 5, in that it has to be considered along with the first four key factors when determining whether a preferential regime is potentially harmful.\(^{33}\)

This factor requires substantial activity for any preferential regime. This requirement contributes to the second pillar of the Base Erosion and Profit Shifting (BEPS) project, which is to align taxation with substance by ensuring that taxable profits can no longer be artificially shifted away from the countries where value is created. This factor looks at whether a regime “encourages purely tax-driven operations or arrangements” and states that “many harmful preferential tax regimes are designed in a way that allows taxpayers to derive benefits from the regime while engaging in operations that are purely tax-driven and involve no substantial activities”.\(^{34}\)

\(^{34}\) OECD/G20 2015 Final Report on Action 5 at 23.
The OECD’s work on substantial activity has focused in the first instance on regimes which provide a preferential tax treatment for certain income arising from qualifying Intellectual Property (“intangible regimes” or “IP regimes”). Thus all intangible regimes in OECD member countries are being reviewed. Under Action 5, the substantial activity requirement also applies to all preferential other than IP regimes.

3.1.1 SUBSTANTIAL ACTIVITY REQUIREMENT IN THE CONTEXT OF IP REGIMES

The OECD recognises that IP-intensive industries are a key driver of growth and employment and that countries are free to provide tax incentives for Research and Development (R&D) activities, provided that they are granted according to the principles agreed by the OECD. 36

Three potential approaches were explored by the Forum for Harmful Tax Practices (FHTP) division of the OECD, but little support was given by countries to the first two-the value creation approach and the transfer pricing approach. Countries, however, supported the use of the third, “nexus approach”, to require substantial activities in an IP regime. This approach was furthermore endorsed by the G20. This approach looks to whether an IP regime makes its benefits conditional on the extent of R&D activities of taxpayers receiving benefits. The approach seeks to build on the basic principle underlying R&D credits and similar “front-end” tax regimes that apply to expenditures incurred in the creation of IP.

The nexus approach extends this principle to apply to “back-end” tax regimes, that apply to the income earned after the creation and exploitation of the IP. In essence then the nexus approach allows a regime to provide for a preferential rate on IP-related income to the extent it was generated by qualifying expenditures. This is achieved by applying a formula to ensure that only qualifying expenditures relating to income from an IP asset will result in defining the income receiving tax benefits. Where the amount of income receiving benefits under an IP regime does not exceed the amount determined by the nexus approach, the regime has met the substantial activities requirement. 37

IP regimes are generally designed to encourage research and development (R+D) activities and contribute to growth and employment, thus the principle underlying the substantial activity requirement, in this context, is to only permit taxpayers that engaged in such activities, and incurred expenditure thereon, to benefit from the regimes. 38

The Final Report thus sets out a formula for determining the “nexus ratio” for IP assets. The formula multiplies overall income from the IP asset by the ratio of qualifying expenditures incurred to develop the IP asset to the overall expenditures to develop it.\(^39\)

In applying the formula it is necessary to determine who the “qualifying taxpayer” is, and what the “qualifying” and “overall expenditures” are. Qualifying taxpayers include resident companies, domestic permanent establishments (“PE’s”) of foreign companies that are subject to tax in the jurisdiction providing benefits. However, the expenditure incurred by a PE cannot qualify income earned by the head office as qualifying income if the PE did not exist at the time the income was earned.\(^40\)

The only IP assets which, under the “nexus approach”, would qualify for tax benefits under an IP regime would be patents (in a broad sense) and other IP assets that are functionally equivalent to patents and are legally protected (subject to similar approval and registration processes). Examples are copyrighted software.\(^41\) Market-related IP assets like trademarks can never qualify under the IP regime.\(^42\)

The FHTP indicates that only taxpayers with less than EUR 50mn in global group wide turnover, and that do not themselves earn more than EUR 7.5mn per year (or the nearest equivalent in local currency) in gross revenues, from all IP assets may qualify for the IP tax benefits.\(^43\)

Other IP assets that are non-obvious, useful and novel may also qualify but jurisdictions that provide benefits to this category must advise the FHTP, with details thereof and the taxpayers concerned and volunteer such information, under the exchange of information framework set out in the Action. Such assets are to be evaluated by the FHTP and reported on by 2020.\(^44\)

“Qualifying expenditures” relate to expenditure incurred by the qualifying taxpayer directly in connection with the IP asset (and would apply in the year they are incurred). They would not, however, include interest payments, building costs or acquisition costs. The FHTP indicates an approved uplift of 30% for qualifying expenditures in terms of domestic tax rules.\(^45\)

The “overall expenditure” definition is designed to ensure that if the taxpayer incurred all the relevant expenses itself, it would qualify for a 100% of the income from the IP

asset to benefit from the preferential regime. Thus, only expenditure that is the type that would qualify as qualifying expenditure may fall into the definition of overall expenditure (e.g. it would exclude interest etc.). However, it adds related party outsourcing and acquisition costs to the overall expenditure definition.\textsuperscript{46}

Finally, “overall income” must be defined in terms of the domestic rules of the country after applying transfer pricing rules, but requiring that IP expenditures allocable to IP income and incurred in the year must be subtracted from gross IP income earned in the year. IP income would include royalties, capital gains and other income from the sale of an IP asset, and may include embedded income from the sale of products or use of processes directly related to the IP asset, provided this is clearly defined.\textsuperscript{47}

As can be seen from the formula set out, for a significant portion of the IP income to qualify from a preferential regime, a significant portion of the actual IP activities must have been undertaken by the qualifying taxpayer itself, or unrelated parties (based on the nature of IP development the FHTP views the risk of the outsourcing of significant portions to unrelated parties as being small).\textsuperscript{48}

As indicated above, where IP is acquired the FHTP considers that only costs incurred, after acquisition, for the purposes of improving the IP, should qualify as qualifying expenditure, and not the acquisition costs themselves. Acquisition costs would fall into overall expenditures.\textsuperscript{49}

In order to determine the relevant components of the formula, the FHTP indicates that taxpayers would need to track income and expenditure per IP asset or on a particular product on an aggregated basis (the “product-based approach”).\textsuperscript{50}

Implementation of the regime is advised by the FHTP such that no new entrants will be permitted to enter into an existing regime not consistent with the nexus approach after 30 June 2016. Existing regimes are to be phased out by 30 June 2012.\textsuperscript{51}

\subsection*{3.1.2 SUBSTANTIAL ACTIVITY REQUIREMENT IN THE CONTEXT OF NON-IP REGIMES}

Action 5 requires the substantial activity regime not only for IP regimes, but for all preferential regimes. As with IP regimes, the objective is to ensure that jurisdictions only permit taxpayers to benefit from a preferential regime that fulfils the objectives

\textsuperscript{46} OECD/G20 2015 Final Report on Action 5 at 28.  
\textsuperscript{47} OECD/G20 2015 Final Report on Action 5 at 29.  
\textsuperscript{50} OECD/G20 2015 Final Report on Action 5 at 31.  
\textsuperscript{51} OECD/G20 2015 Final Report on Action 5 at 35.
of growth and employment in the relevant jurisdiction. Thus, the substantial activities requirement is only satisfied if the benefits are only granted to taxpayers that undertake core income generating activities that produce the type of business income covered by the preferential regime.\textsuperscript{52}

The determination of what constitutes core activities necessary to earn income depends on the type of regime, and the Final Report on Action 5 sets out some preferential regimes for guidance.

**Headquarter regimes** grant preference to taxpayers that provide e.g. managing, co-ordinating and controlling business activities for a group or those companies in a particular geographic area. The core income-generating activities could include key activities giving rise to specific types of service income.\textsuperscript{53}

**Distribution and service centre regimes** provide purchase and re-sell services from/to other group companies with a small percentage profit. Their core income-generating activities could include transporting and storage of goods; managing stocks and taking orders; and providing consulting or other administrative services.\textsuperscript{54}

**Financing and leasing regimes** provide preferential treatment that raise concerns regarding ring-fencing and artificial definition of the tax base. The core income-generating activities could include agreeing funding terms. Identifying and acquiring assets to the lease, monitoring and revising any agreements and managing risks.\textsuperscript{55}

**Fund management regimes** grant preferential regimes to income earned by fund managers for management of funds. The concerns lie with transparency, which can be partly dealt with through compulsory spontaneous exchange of rulings. The substantial activity to the income-generating activities of a fund manager could include taking decisions on holding or selling investments; calculating risks and reserves; taking decisions on currency and interest fluctuations and hedging positions; and preparing relevant regulatory or other reports for government authorities and investors.\textsuperscript{56}

**Banking and insurance regimes** raise concerns regarding the benefits that are provided to income from foreign activities. Substance should already be regulated by the regulatory environment ensuring that the business is capable of bearing risks and undertaking activities. Insurance, however, does not necessarily have these safeguards, due to the ability to reinsure. The core income-generating activities for banking depend on the type of banking undertaken, but could include raising of

\textsuperscript{52} OECD/G20 2015 Final Report on Action 5 at 37.
\textsuperscript{53} OECD/G20 2015 Final Report on Action 5 at 37.
\textsuperscript{54} OECD/G20 2015 Final Report on Action 5 at 38.
\textsuperscript{55} OECD/G20 2015 Final Report on Action 5 at 38.
\textsuperscript{56} OECD/G20 2015 Final Report on Action 5 at 38.
funds; managing risk, including credit, interest and currency risk, taking hedging positions and other financial services to customers; managing regulatory capital and preparing regulatory reports and returns. For insurance companies: predicting and calculating risk, insuring or re-insuring against risk and providing client services.\textsuperscript{57}

**Shipping regimes** raise concerns where they permit the separation of shipping income from the core activities that generate it. The core income-generating activities include managing the crew, hauling and maintaining the ships, overseeing and tracking deliveries and organising and overseeing voyages.\textsuperscript{58}

**Holding company regimes** comprise those that hold a variety of assets and thus earn different types of income (e.g. interest, rents and royalties) and those that apply only to equity holding companies earning only dividends and capital gains. In the former case the substantial activity requirement looks to the activities that generate the relevant type of income. In the latter case, where little activity is required, concerns revolve around transparency and beneficial ownership, treaty shopping and whether ring-fencing should apply. These concerns are addressed under other BEPS actions through exchange of information; prevention of treaty abuse (Action 6); Neutralising hybrid arrangements (Action 2); Controlled foreign companies (Action 3); Ring-fencing. The substantial activity requirement would also require that these companies have sufficient activity to manage their investments and satisfy local regulatory requirements (people and premises) that should avoid letter box and brass plate companies from benefiting from these regimes.\textsuperscript{59}

### 3.2 REVAMP OF THE WORK ON HARMFUL TAX PRACTICES: FRAMEWORK FOR IMPROVING TRANSPARENCY IN RELATION TO RULINGS

The second priority under Action 5 for revamping the work on harmful tax practices is to improve transparency, including compulsory spontaneous exchange of information on certain rulings. Seen in the wider context of the work on BEPS, this requirement contributes to the third pillar of the BEPS project, which is to ensure transparency while promoting increased certainty and predictability.\textsuperscript{60} The Final Report on Action 5 deals with this in three steps: \textsuperscript{61}

(i) Develop a framework for compulsory spontaneous information exchange.

(ii) Consideration of whether transparency with regards to rulings (for preferential regimes and other matters) can be improved in relation to the rulings regimes in the associated countries – this concluded that the requirement to undertake compulsory spontaneous information exchange

\textsuperscript{60} OECD/G20 2015 Final Report on Action 5 at 45.
\textsuperscript{61} OECD/G20 2015 Final Report on Action 5 at 45-46.
should generally cover all instances in which the absence of exchange of a ruling may give rise to BEPS concerns, thus taking away the need for a jurisdiction to determine if a particular regime is preferential. (This step recognises the work already done in the context of transfer pricing in Action 13, which requires that APA’s and advance tax rulings be disclosed in the master and local files).

(iii) Develop general best practice framework for design and operation of rulings regimes.

The OECD combines the first two steps and sets out six categories of taxpayer specific-rulings which, in the absence of compulsory spontaneous exchange of information could give rise to BEPS concerns:

(i) rulings relating to preferential regimes;
(ii) unilateral APA’s or other cross border unilateral rulings in respect of transfer pricing;
(iii) cross border rulings providing for a downward adjustment of taxable profits;
(iv) permanent establishment (PE) rulings;
(v) related party conduit rulings;
(vi) any other type of ruling agreed by the OECD that in the absence of spontaneous exchange of information gives rise to BEPS concerns.  

In this context the OECD focuses on specific instances where the absence of exchanges can give rise to BEPS concerns rather than suggesting that in all instances the country providing the ruling operates a preferential regime.

Extensive guidance on transparency with respect to rulings is set out in the OECD, 2004 Report entitled “Consolidated Application Note: Guidance in Applying the 1998 Report to Preferential Tax Regimes” (CAN Report), which makes it clear that transparency is often relevant in connection with rulings, including unilateral Advance Pricing Agreements (APAs) and certain administrative practices.

The purpose of this disclosure is to ensure that countries have the necessary information to identify BEPS risk areas, without imposing an unduly high administrative burden on the disclosing country.

The Final Report on Action 5 addresses:

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(i) Which rulings are covered?
(ii) Which countries information needs to be exchanged with;
(iii) Application of the framework to past and future rulings;
(iv) Information subject to the exchange;
(v) Practical implementation issues;
(vi) Reciprocal approach to exchange of information (EOI);
(vii) Confidentiality of information exchanged;
(viii) Recommendations of best practices in respect of rulings.66

Addressing these individually:

(i) Which rulings are covered:
Rulings are defined as “any advice, information or undertaking provided by a tax authority to a specific group of taxpayers concerning their tax situation and on which they are entitled to rely”.67 Rulings are generally specific to a set of facts and the framework is designed only to apply to taxpayer-specific rulings i.e. that only the specific taxpayer may rely on. It does not include agreements reached as a consequence of tax audits conducted after the filing of the tax return.68

- **Advanced tax rulings** provide the determination of the tax consequences of a proposed transaction that has not yet taken place.
- **Advanced pricing agreements** refer to agreements for the determination of the pricing of goods or services for transfer pricing purposes over a fixed period of time. Automatic exchange of information on APA’s is required, not necessarily because they are preferential, but because in the absence of transparency they can create distortions and mismatches that give rise to BEPS concerns. Furthermore, due to materiality required in transfer pricing documentation (set out in Action 13), not all APA’s will be reflected in the Master File or Local File.69
- **General rulings** apply to groups or types of taxpayers in relation to a specified set of circumstances. These are excluded from the framework but the best practises nevertheless apply.
- For **taxpayer specific rulings** Action 5 states that the FHTP has already agreed to a framework, described in the 2014 Progress Report on Harmful Tax Practices, for the compulsory exchange of information on rulings related to preferential regimes, and which sets out the filter approach to determine when there will be an obligation for spontaneous exchange of information.70

The filter approach seeks to reduce the level of discretion that would otherwise have to be used by a tax administration to make the determination of when a ruling needs

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to be exchanged, and instead uses more mechanical filters. The first three filters limit the obligation to spontaneously exchange information to rulings related to:

a) A preferential regime itself or certain aspects of it, and more broadly, rulings that concern matters that have an impact on the application of a preferential regime.

b) Regimes that firstly, relate to income from geographically mobile activities, such as financial and other service activities, including the provision of intangibles; and secondly regimes that relate to the taxation of the relevant income from geographically mobile activities.

c) regimes that meet the no or low effective tax rate because the tax rate itself is very low or because of the way in which a country defines the tax base to which the rate is applied.

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

The additional filters referred to are:

- Is there a taxpayer-specific ruling related to a regime that meets the first three filters?
- Is the taxpayer-specific ruling a ruling in the area of transfer pricing or another ruling?
- For transfer pricing rulings – Is the ruling a unilateral transfer pricing ruling or a bilateral or multilateral APA?
- For rulings other than transfer pricing rulings – Does the ruling cover (i) inbound investment into the country in which the taxpayer has obtained the ruling, (ii) outbound investment from that country or (iii) transactions or a situation involving other countries?

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

The Final Report on Action 5, however, makes it clear that the obligation to simultaneously exchange information arises for cross border taxpayer specific rulings that are (i) in the scope of the work of the FHTP; (ii) are preferential; (iii) meet

74 OECD/G20 2014 Report on Action 5 at 44.
the low or no effective tax rate factor. Thus, any such preferential regimes that will apply need not have been reviewed or identified by the FHTP, but will need to be determined by the country concerned, and in that case, or in the case of doubt, the information spontaneously exchanged immediately. Thereafter the regime can be referred to the FHTP for review.\textsuperscript{75}

\textit{Cross border unilateral APA’s and any other cross border unilateral tax rulings (such as ATRs) covering transfer pricing or the application of transfer pricing principles.} Unilateral APAs are APAs established between a tax administration of one country and a taxpayer of another. Other cross border unilateral tax rulings covering transfer pricing or the application of transfer pricing principles cover, for example, ATRs on transfer pricing issues that fall short of an APA, for instance because the ruling is limited to addressing questions of a legal nature based on facts presented by the taxpayer (as against an APA, which deals with factual issues) or is binding for a specific transaction (unlike APA’s which often deal with several transactions).\textsuperscript{76}

Transparency is required for unilateral APAs and other unilateral tax rulings not because they are preferential, but because in the absence of transparency they can create distortions and mismatches that give rise to BEPS concerns and either directly or indirectly impact the tax position in another country. Furthermore, due to materiality required in transfer pricing documentation (set out in Action 13), not all APA’s will be reflected in the Master File or Local File. In addition, the combined disclosure of rulings and Action 13 documentation permits tax authorities to cross-check information reported by taxpayers.\textsuperscript{77}

\textit{Cross border rulings providing for a unilateral downward adjustment to a taxpayer’s taxable profits that is not directly reflected in the taxpayers financial/commercial accounts} include, for example informal capital or similar rulings, and potentially provide the incentive to shift profits. Such rulings tend to recognise the contribution of capital or an asset by a related party and e.g. deem there to be an interest deduction, which reduces the company’s taxable profits to reflect an arm’s length position without a corresponding inclusion in the related party’s hands. Thus, this information is required by the corresponding tax authority.\textsuperscript{78}

Information concerning \textit{Permanent establishment (PE) rulings concerning the attribution of profits to be attributed to a PE} requires exchange with the head office country.\textsuperscript{79}

\textsuperscript{75} OECD/G20 2015 Final Report on Action 5 at 49.
\textsuperscript{76} OECD/G20 2015 Final Report on Action 5 at 49.
\textsuperscript{78} OECD/G20 2015 Final Report on Action 5 at 51.
\textsuperscript{79} OECD/G20 2015 Final Report on Action 5 at 51.
Related party conduit rulings include rulings covering arrangements involving cross border flows of funds or income through an entity in the country giving the ruling, where the funds or income flow to another country directly or indirectly. The effect is often a deduction in one jurisdiction without a corresponding income in the other.\textsuperscript{80}

Finally, the reference to any other types of rulings that in the absence of spontaneous information exchange gives rise to BEPS concerns leaves the FHTP the ability to add additional types of rulings under this heading.\textsuperscript{81}

(ii) Which countries information needs to be exchanged with: This requires that exchange of information on rulings for the six categories need to take place with:

a) The country of residence if all related parties with which a taxpayer enters into a transaction for which a ruling is granted or gives rise to income as a consequence (The related party threshold is set at 25%, but the FHTP will keep this under review);

b) The residence country of the ultimate parent company and immediate parent company (or head office for a PE as well; for conduits thee country of the paying entity and the beneficial owner are also added).\textsuperscript{82}

(iii) Application of the framework to past and future rulings: The obligation to spontaneously exchange applies not only to future rulings but also to past rulings i.e. those issued after 1 January 2010 and still in effect from 1 January 2014 must be exchanged. Thus, countries will need to be able to identify immediate and ultimate parent companies as well as related parties to a transaction. Where such information is not readily available countries are expected to use their “best efforts” to use whatever information they can find without contacting the taxpayer. For future rulings i.e. after 1 April 2016 countries are expected to ensure they have the relevant information required, on hand.\textsuperscript{83}

(iv) Information subject to the exchange: The FHTP recognises the need to balance greater transparency with the need to ensure that too great an administrative burden is not placed on tax administrations. Thus a two-step approach was developed. Firstly, a summary and basic information on the ruling is required (a template is provided which enables tax administrations to determine whether the ruling is covered by the framework and with which country it should be exchanged). The recipient tax administration can then determine whether to ask for more detail of the ruling, as the second step.\textsuperscript{84}

\begin{itemize}
\item \textsuperscript{80} OECD/G20 2015 Final Report on Action 5 at 51.
\item \textsuperscript{81} OECD/G20 2015 Final Report on Action 5 at 52.
\item \textsuperscript{82} OECD/G20 2015 Final Report on Action 5 at 52.
\item \textsuperscript{83} OECD/G20 2015 Final Report on Action 5 at 53-54.
\item \textsuperscript{84} OECD/G20 2015 Final Report on Action 5 at 54.
\end{itemize}
(v) Practical implementation issues: It was originally anticipated (in the 2014 Interim Report on Action 5) that the framework would apply following the FHTP’s 2014 autumn meeting. However, this had not (by October 2015) begun, due to the fact that the increase in the categories had substantially increased the volume of rulings that need to be exchanged. This, thus, required more consideration for past rulings (the three month requirement for future rulings remains, subject to any legal impediment that may cause delay). As a consequence, the time period for exchange of past rulings has been extended to the end of 2016. 85

(vi) Reciprocal approach to EOI: A country that has issued a ruling that is subject to obligation of spontaneous exchange of information may not use the excuse of lack of reciprocity as an argument for not exchanging that information with a country that does not grant, and therefore cannot exchange, rulings that are subject to such an obligation.86

(vii) Confidentiality of information exchanged: Both the country exchanging information and its taxpayers have a legal right to expect that information exchanged pursuant to the framework remains confidential. The receiving country must therefore have the legal framework necessary to protect information exchanged.

All treaties and exchange of information instruments contain provisions regarding tax confidentiality and the obligation to keep information exchanged confidential. Under these provisions information may only be used for specified purposes disclosed to specified persons. Information exchange partners may suspend or limit the scope of information exchange if appropriate safeguards for confidentiality are not put in place, or there has been a breach that has not adequately been resolved.

Domestic laws must be in place in the receiving country to protect confidentiality of tax information, including information exchanged. Effective penalties must apply for unauthorised disclosures of confidential information exchanged. Information exchanged pursuant to this framework may be used only for tax purposes or other purposes permitted by the relevant information exchange instrument. If domestic law allows for a broader use of the information than the applicable information exchange instrument, it is expected that international provisions and instruments will prevail over provisions of domestic law. 87

(xiii) Recommendations of best practices in respect of rulings: The Final Report to Action 5 sets out a set of best practices pertaining to”

a) the process for granting a ruling (i.e. official rules and administrative practices for rulings should be identified in advance and published; they should be retained within the limits of the domestic tax laws; they should

respect tax treaties; they should be in writing and only issued by a competent
government office or approved thereby under a prescribed procedure; they
should be binding on the tax authority; be applied for an issued in writing,
based on facts agreed with the taxpayer, with relevant reference numbers and
details of the taxpayer).

b) the terms of the ruling and audit /checking procedure (i.e. APAs
should be for a limited time period, but subject to review or extension;
taxpayers should be obliged to notify of any changes in facts; procedures
should be in place to periodically verify the facts and assumptions; and if facts
change the ruling should be subject to revocation)

c) publication and exchange of information (i.e. general rulings should be
published timeously and specific rulings should be exchanged with the
relevant tax authority within the framework for compulsory spontaneous
exchange of information).

These practices are designed to reinforce the transparency advancements made in
the OECD Framework for compulsory spontaneous exchange of information on
rulings and relate to specific and general rulings. 88

3.3 REVIEW OF OECD AND ASSOCIATE COUNTRY REGIMES

The OECD’s review of its member country regimes commenced in late 2010 with the
preparation of a preliminary survey of preferential tax regimes in member countries,
based on publicly available information and without any judgment as to the potential
harmfulness of any of the regimes included. Further regimes were subsequently
added to the review process based on member countries’ self-referrals and referrals
by other member countries. 89

As all the intangible regimes of member countries were considered together, they
were being considered not only in light of the factors as previously applied but also in
light of the elaborated substantial activity factor. As intangible regimes are just a
subset of preferential regimes, the OECD also needed to discuss and subsequently
apply the substantial activity requirement to other preferential regimes; this included
preferential regimes already reviewed provided that they were still in force and not
abolished. 90

By the time of the issue of the Final Report on Action 5, forty three (43) preferential
regimes had been reviewed. A list of these is provided and reflects, for South Africa,
the headquarter company regime, but it notes that this is considered to be potentially

harmful but not actually harmful; and the exemption of income for ships used in international shipping, which is indicated as being not harmful.91

The FHTP will carry out further work on these regimes, particularly in the context of the substantial activities, which have now been more clearly determined in the context of non-IP regimes.

The Final Report on Action 5 also makes clear the position where disadvantaged areas have preferential regimes to stimulate the economy there, and indicates that these are not considered to pose a high risk to BEPS provided that:

- The preferential tax treatment is only applicable to a small area (in terms of surface or population) selected for low level structural, economic and social development in the region relative to the country as a whole;
- The regime is mainly designed to create new jobs and attract tangible investments;
- An entity has to meet certain substance requirements to qualify for the regime;
- The country must retain relevant data relating to beneficiaries of the regime.92

3.4 FURTHER WORK OF THE FHTP

The Final Report defines what the next steps in the work of the FHTP, being (i) ongoing work, including the monitoring of preferential regimes and the application of the agreed transparency framework, (ii) further development of a strategy to expand participation to third countries, and (iii) considerations of revisions or additions to the existing FHTP criteria.93

Under the last step reference is made to the need to look at identifying harmful tax regimes that have “an artificial definition of the tax base” (i.e. where the tax base is narrowed so as to reduce the tax on income (e.g. by exempting income) rather than offering a low tax rate), and the application of the ring-fencing factor i.e. where a regime excludes residents from qualifying for the benefits, or a beneficiary of the regime may not operate in the domestic market.94

4 ADDRESSING ACTION 5 IN SOUTH AFRICA

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

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

91 OECD/G20 2015 Final Report on Action 5 at 64.
An evaluation of preferential tax regimes in OECD members and in associate countries.

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

4.1 REQUIRING SUBSTANTIAL ACTIVITY FOR PREFERENTIAL REGIMES: SOUTH AFRICA

The requirement for “substantial activity” needs to be examined in South Africa, for instance, with respect to the country’s headquarter company regime. As indicated in the Final Report to Action 5 South Africa’s headquarter company regime potentially constitutes a harmful tax practice but is not actually harmful. This is in line with the OECD 2000 Report “Towards Global Tax Cooperation”, which investigated the tax practices of holding company regimes and similar preferential tax regimes, noting that they do not constitute harmful tax practices, although such regimes may constitute harmful tax competition.

South Africa’s headquarter company regime is intended to enable the country to become a gateway for foreign investment into Africa. Consequently certain anti-avoidance rules, such as CFC rules and transfer pricing, have been relaxed with regard to headquarter companies. The headquarter regime is actually a holding company regime which enables MNEs to use South Africa as a conduit for passive income flows. The important thing for South Africa is to ensure it continues to balance its international obligations to prevent harmful tax competition, and also to ensure it preserves the competitiveness of the economy.

From the angle of preserving the competitiveness of the economy, the headquarter company regime has, however, not been very successful. South Africa has been reluctant to participate in international tax competition and this has hindered its ability to fully establish itself as the gateway to Africa. On the African continent, Botswana, Ghana and Mauritius have tax regimes that make them better bases for investment into Africa, especially with respect to their tax rates. There are also other factors

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95 In terms of section 1 of the Income tax Act, as amended by the Taxation Laws Amendment Act 24 of 2011, a ‘headquarter company’ is defined as any company which has made an election in terms of section 9I.
96 OECD/G20 2015 Final Report on Action 5 at 64.
which might affect the decision of foreign investors when deciding whether to choose South Africa as a regional headquarters location, most notably exchange controls, labour law policy, availability of guaranteed power sources, and immigration requirements (specifically the obtaining of work permits).\(^{100}\)

While South Africa should be concerned about preventing harmful tax competition, it should move cautiously to protect its competitiveness since many major countries are not willing to give up their special tax regimes, such as corporate rate reductions and patent boxes (identified in Action 5 as harmful), which are designed to attract investment so as to remain competitive. For example, the United Kingdom has reduced its corporate rate to 20% and is continuing a phased reduction.\(^{101}\) South Africa must, thus, take care not to be a “first mover” in terms of the BEPS reform associated with harmful tax practices.

South Africa already has regimes that are designed to encourage investment into the country in the form of urban and industrial development zones, as well as the proposed special economic zones. It would appear that these will fall within the categories of low risk “disadvantaged areas”\(^{102}\) discussed in the Final Report on Action 5. Furthermore, these are physical investments rather than mobile activities which are the concern of the OECD Report.\(^{103}\) Care should be taken to ensure that this remains the case and that the necessary disclosure is made to the FHTP and, if considered necessary, potentially, spontaneous exchange of information is made.

Thus, to the extent that certain tax preferences exist (with economic benefits outweighing the tax loss), these preferences should not be automatically repealed in the expectation that the OECD will follow up on them. Many countries within the OECD continue to operate tax preferences that serve as base eroding platforms. These platforms have previously survived, despite public statements to the contrary. Undoubtedly, many of these platforms will continue even after the BEPS reform is complete.\(^{104}\)

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

4.1.1 RECOMMENDATIONS

- It is important that South Africa balances its international obligations not to engage in harmful tax practices with the need to preserve the competitiveness

\(^{100}\) PWC “Comment on DTC BEPS First Interim Report (30 March 2015) at 19.

\(^{101}\) L Shepperd “What should the OECD do about Base Erosion?” Copenhagen precise of 2013 International Fiscal Association annual Congress” 9/9/2013.


\(^{103}\) PWC “Comment on DTC BEPS First Interim Report *(30 March 2015)* at 19.

\(^{104}\) SAIT: Comments on DTC First Interim BEPS Report (March 2015) at 4.
of the economy. More so, as the National Development Plan provides that South Africa should aspire to be a gateway for investment in Africa. There is potential for substantial job creation and tax revenue to the Government in the form of VAT and employees’ tax from which South Africa would benefit, as long as it ensures that it complies with the OECD’s substance requirements. The bottom line is that BEPS is both a risk and an opportunity for South Africa.

- From a tax perspective, consideration should be given to instituting a reduced corporate income tax rate for headquarter companies which meet minimum substance requirements. (It may, however, be necessary to align this rate for all companies in order for such rate not to be viewed as a HTP. However, this would need to be evaluated in terms of the DTC Reports as a whole).

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

It is, however, important that any revised headquarter regime be bundled with a package of measures to address all of the impediments and externalities associated with the choice of South Africa as a location for regional headquarters, including with respect to exchange control (although there is relief for headquarter companies, better alignment with the tax regime is required), labour law policy, availability of power and immigration.105

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

4.2 IMPROVING TRANSPARENCY, INCLUDING COMPULSORY SPONTANEOUS EXCHANGE ON RULINGS RELATED TO PREFERENTIAL REGIMES: RECOMMENDATIONS FOR SOUTH AFRICA

With respect to tax rulings in South Africa, Chapter 7 of the Tax Administration Act 28 of 2011 (TAA), sets out provisions dealing with “advance rulings”. Section 75 of the TAA defines an advance ruling to mean ‘a binding general ruling, a binding private ruling or a binding class ruling’. In terms of s 75 of the Tax Administration
Act, a “binding general ruling” is defined as a written statement issued by SARS regarding the application of a tax Act to a specific ‘class’ of persons in respect of a “proposed transaction”. A “binding private ruling” means as a written statement issued by SARS regarding the application of a tax Act a specific ‘class’ of persons in respect of a ‘proposed transaction’. Basically these categories of advance rulings allow taxpayers to obtain clarity and certainty on the Commissioner’s interpretation and application of the tax laws on proposed transactions.

They are intended to promote clarity, consistency and certainty regarding the interpretation and application of a tax Act on proposed transactions by creating a framework for issuance of the advance rulings.\(^{106}\) The OECD’s framework covers only spontaneous exchange of information on taxpayer specific rulings. In the South African context these would include binding private rulings.

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

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

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

This implies that transfer-pricing transactions are potentially excluded from South Africa’s advance rulings system.\(^{107}\) In this regard, APAs which are normally entered into by taxpayers with tax authorities in order to resolve transfer-pricing disputes are currently not in use in South Africa and, although the DTC recommendations contained in the discussions on Actions 8-10 and 13 recommend that SARS administrative capacity be increased to facilitate this, SARS has declared that APAs

\(^{106}\) Section 76 of Tax Administration Act. See also SARS ‘Comprehensive Guide to Advance Tax Rulings’ at 6.

will not be made available to South African taxpayers in the foreseeable future. However, the use of the word ‘may’ in s 80(1)(a)(iii) implies that the Commissioner has the discretion to reject or approve the granting of an advance ruling relating to transfer pricing. To date the Commissioner has not exercised discretion in this regard. It is regrettable that South Africa is lagging behind international trends with regards to introducing APAs.

- As mentioned above, the DTC does, however, recommend that the resources be sought to put such an APA option in place, for purposes of enhancing its transfer pricing regime (in particular to provide taxpayers with certainty- see DTC reports on Actions 8-10) and thus consideration needs to be given to the practices that would need to also be put in place so as not to contravene the Harmful Tax Practices principles set out in the OECD Action 5 Report.

- The DTC furthermore recommends that SARS capacity be increased to enable it to satisfy the requirements of the spontaneous exchange of information whenever this should be required in terms of the conclusions reached by the FHTP.

To ensure spontaneous exchange of information on tax rulings relating to preferential regimes, the OECD recommended that its member and associate countries that do not (yet) have the necessary legal framework in place to spontaneously exchange information, as required by Action 5, were to be given an adjustment period of up to end of 2016 to initiate steps to put in place that legal framework to enable spontaneously exchange information.

- In line with the above OECD recommendation, South Africa has inserted provisions into the Tax Administration Act that provide for the legal framework to ensure spontaneous exchange of information regarding tax rulings that relate to *inter alia* the headquarter company with other countries’ tax authorities.

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

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

109 See section 1 definition of International Reporting Standard read with Section 3, as amended by the 2015 Administration Laws Amendment Act.
Although South Africa has signed Tax Information Exchange Agreements (TIEAs) with some countries (especially tax haven jurisdictions that do not normally have a double tax treaty in place), currently the standard of exchange of information in the TIEAS is not spontaneous; it is only “upon request”. The effectiveness of exchange of information upon request is hampered by the fact that the requesting states’ taxation procedures must first be exhausted before a request for information is made to the other state. Due to the inherent restriction of this approach, intentional exchanges of information upon request are relatively small and are based on reciprocity. The OECD has recommended that the standard for exchange of information in TIEAs should be automatic. The Common Reporting Standard for automatically exchanging information pertaining to South African bank accounts owned by residents of other countries is an example of this.

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

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

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112 Keen and Ligthart at 95; Oguttu “A Critique on the Effectiveness of ‘Exchange of Information on Tax Matters” at 11.