Base Erosion, Profit Shifting and Transfer Misricing–

Joint Committee Sitting:

- Standing Committee on Finance
- Portfolio Committees on Minerals and Resources
- Portfolio Committee on Trade and Industry

Parliamentary Budget Office

PARLIAMENT
OF THE REPUBLIC OF SOUTH AFRICA

Parliament Budget Office (PBO)

Presentation Outline

- PBO and legislative Mandate
- Paper Objectives
- Taxation in context
- South Africa(RSA) approach to Base Erosion, Profit Shifting and Transfer Mispricing (BEPS)
- International Experience- Advance Price Agreement (APA)
- Impact of BEPS and other considerations
- Mining and extractive Industry
- Considerations for Oversight and Legislative process

Parliamentary Budget Office

- The PBO established in terms of the Money Bills Amendment Procedure and Related Matters Act, 2009 (Money Bills Act)
- Currently advices and provides analysis to the Finance & Appropriations Committees in both Parliament Houses
- It is intended that other Oversight Committees of Parliament will be supported in future
- The Money Bills Act provides for a procedure to amend Money Bills before Parliament

Legislative Mandate

- According to Section 15(1) of the Act, the PBO should:
  - Provide independent, objective and professional advice and analysis to Parliament on matters related to the budget and other Money Bills
- In terms of Section 15(2) of the Money Bills Act:
  - To support the implementation of the Money Bills Act by undertaking research and analysis for Committees,
  - Annually provide reviews and analysis of the documentation tabled in Parliament by the executive in terms of the Act
  - Provide advice and analysis on proposed amendments to the Fiscal Framework, Division of Revenue Bill and Money Bills and on policy proposals with budgetary implications

Legislative Mandate (cont.)

- Monitor and synthesise matters and reports tabled and adopted in a House with budgetary implications, with particular emphasis on reports by other Committees,
- Keep abreast of policy debates and developments in key expenditure and revenue areas,
- Monitor and report on potential unfunded mandates arising out of legislative, policy and budgetary proposals,
- Undertake any other work deemed necessary by the Director to support the implementation of this Act,

Paper Objectives

Key paper objectives:

- South African approach in dealing with BEPS (NB DTC's findings)
- Impact of BEPS on RSA Economy
- BEPS and Mining & extractive Industry
- Advance Pricing Agreement (APA) as BEPS combatting strategy
- Extent of BEPS in various industries in RSA
- Considerations for Oversight and Legislative process

Taxation in Context

Rationale for Taxations

Government provides good and services to citizens and other users as prescribed by the Constitution of South Africa— to address amongst other things, inequality, poverty and unemployment—

Then, many Countries (Incl. RSA) rely on tax revenue to afford goods and services to its citizens

As a result, impose direct and indirect taxes to residents and non-residents on their South African source of revenue (income earned in RSA),

Other forms of revenue generated by governments are dependent on other economic structures and bases.

Taxation in Context

Resident and Non-Resident Taxation

- RSA Residents are taxed on their worldwide generated taxable income (NB taxable income vs income), e.g.

  South African, earning taxable income from investment (interest earned) in Brazil while a resident (calc. on what resident mean)

- Non-Resident are taxed in their source of income regarded as South African, e.g.,

  Multinational Enterprises (MNEs) operating in RSA are taxed on locally source income

Taxation in Context

In South Africa context taxes are levied directly or indirectly on either of:

- Individuals and Others (e.g. Trusts)
- Corporates
- Transactions

Main taxes in terms of contribution towards tax revenue in RSA over the years on average:

- Individual taxes (33% Contribution in tax revenue)
- Value added tax (26% Contribution in tax revenue)
- Corporate taxes (22% Contribution in tax revenue)

Lets look at basic tax revenue determination from the three tax contributors:

Individual taxation (PIT)

Income earned	X XXXX
Less exemptions and deductible expenses:	
Pension contribution	(xxxx)
Medical contribution	(xxxx)
Unemployment insurance fund (UIF)	(xxxx)
And etc.	(xxxx)
Taxable income	XXXX
Then use Tax Legislation-	
Tax- table to determine taxes payable	(xxxx)
Net Income	Xxxxx

Tax table is updated annually at least,

Value Added Taxation (VAT)

Vat levied on

- Services
- Goods
- In a transaction

Levied @

- 14 % (other than Exempt suppliers and Zero rated)
- Exempt Supplies (e.g. Residential rental accommodation
- Zero Rated 0% (e.g. Agricultural or Farming Purpose)

Corporate Taxation (CIT)

(A) Gross Income		XXXXXX
(B)Less: Exempt income		(xxxx)
E.g. R&D grants		
(C) Income **(A-B)**		XXXX
(D) Less: Cost of production (deductible)		(xxxx)
E.g. Advertising costs	XXXX	
Consulting fees	XXXX	
Wages and Salaries	XXXX	
(E) Taxable Income		XXXXX

(F) Tax payable calculated @ 28% for Non-small business

Or

Graduate taxation rate for Small Medium Business

So what is the Problem?

MNEs Unfairly Reduce RSA Tax Revenue-Tax Payable (F) by Taxable Income (E) by:

1. Inflating deductible cost of production (D)
   - Advertising Fees,
   - Management Fees
   - Interest for Foreign Loans
2. Deflating Gross Income (A)

Under-selling or delaying transaction dates

and other methods,

So what is the Problem?

Inflating Expenses and or **Under-Selling goods (Transfer-Mispricing**), is mainly done to connected person, but evidence suggest that Transfer Mispricing is also done through a third-parties,

Meaning?

- Corporates in the same group trade (Inflate expenses D and Deflating Income A) with each other on either International (more popular) and national level, (Transfer Mispricing)

e.g. Dad and a Son in a same-house do business together, then Dad sell product to son at a discounted price

- Other Corporate **(X)** engage in a international transaction with Non-Connected Person **(Y)** outside RSA. Corporate **Z (**connected to **X)** also outside RSA enjoy the benefits via **Y** (also outside the country)

South Africa's approach to BEPS

Before looking at RSA approach to combating transfer- mispricing (BEPS), lets give an understanding to some concepts:

What is Transfer Pricing(TP)?

The price at which entities within a multinational enterprise ("MNE") transact with each other for transfer of goods and services is known as a "transfer price"

Goods and services have a wide meaning; includes tangible and intangible property, granting of financial assistance, granting of guarantees, cessions, etc.

Setting transfer prices or **"transfer pricing"** is important because, according to UNCTAD, over 60% of world trade is within or involves MNEs

South Africa's approach to BEPS

But, Transfer Mispricing

Due to their relationship, entities in MNEs have the ability to distort transfer prices and ultimately profits reflected in particular jurisdictions, thereby eroding the tax base and depriving countries of their correct share of taxes

For this reason tax administrations have cause for concern where transfer prices are incorrect or mispriced

Transfer pricing is thus an essential feature of cross-border activities of MNEs and its outcomes may be perfectly acceptable but "transfer mispricing" is not!

South Africa's approach to BEPS

What is Arms' length?

If Mining **A** - in South Africa

Sell-Gold to its **Connected** Mining B- in the Singapore

@ what price would the transaction considered to be fair-representation of value **(arms' length)** of Gold being sold

Would the same price been used not **Connected**

In principle:

Price quoted in markets!!

1. But markets price fluctuates
2. Delivery time and transaction time varies (Some MNEs delays shipment of product until prices get to certain levels!!)
3. Other Products or Services don't have Markets to use as benchmark (e.g. Marketing Expenses)
4. Other similar transactions used,

But, lack of censuses in certain instances on arm's length

South Africa's approach to BEPS

- South African Tax Legislation

Sec 31 of Income Tax Act:

- TP at **Arm's Length**, SARS to adjust **(Primary adjustment)** TP in case of no arm's length followed **@ 28%**
- Over and above **Arm's Length** adjustments, benefits treated as dividends **(Secondary Adjustment)** and taxed **@ 15 %**

- Corporation tax return-ITR 14, request information from tax payer to detect potential abuse of the system
- Make use of OECD TP guidelines where necessary

South Africa's approach to BEPS

- Practice Notes, for compliance guidance to Tax Payers
- Establishment of TP Unit in SARS (Large Business Centre):
  - Focus on auditing suspected transactions or and entities
  - Recently recovered R 5.8 bil
- Tax treaties/ International agreements with other countries,

NOTED LOOPEHOLES IN THE APPROACH-RSA

But, **Is arm's length effective?**

- **Weakness in the legislations**, e.g. lack of digital economy legislation, but SARS and NT are in progress to update tax legislation e.g. Google avoid RSA tax by exploiting *'source rule'*
- **Voluntary vs Mandatory** disclosure of information (TP documentation) by Tax Payers-to apply the legislation
- **Lack** comparable arm's length prices for purpose of TP in certain goods and services
- **SARS TP Unit** lack capacity to fully monitor compliance with legislation, e.g. Small Auditing Team
- **PN/** implementation guidelines are not legally binding, but improvement in the pipeline, NT
- Does SARS data collection equipment (e.g. ITR14 and others) provide relevant and or useful information?

NOTED LOOPEHOLES IN THE APPROACH-RSA

BUT, **Sanctions for non-compliance**:

Entity

- Primary adjustment in TP and levy tax @ 28%
- Secondary adjustment (dividends in species) in TP and levy @ 15%

Natural Person or Trust

- Primary adjustment in TP and levy tax @ maximum 40 %
- Secondary adjustment in TP and levy on Donation tax

Impact of BEPS and other considerations

In the context of the paper, impact is consider in the loss of tax revenue as a result of BEPS,

There is currently no conclusive evidence to substantiates and provide sources to accurately quantify the revenue loss in South African context, -as result of transfer mispricing (BEPS)

Evidence exist that, some discourses about BEPS' impact on revenue losses often takes into account both Legal and Illegal practices (flows),

Though various interpretation on this (legal vs Illegal flows), this paper focus mainly on Legal flows— also considered to be morally wrong—

Separating the Legal and Illegal Flows e.g.

Impact of BEPS and other considerations-

Legal Flows

- Transfer Pricing (Mispricing)
- Tax abuse
- Regulatory abuse

- **Illegal Flows**

- Drug trafficking
- Human trafficking
- Bribery of officials
- Theft of state assets

Impact of BEPS and other considerations

Loss of Income

- **2015 African Union Report/ Global Financial Integrity (GFI)**

On average $ 12 000 bil per year past 12 years by 2014

Figures includes both Illegal and Legal flows

In case of Corporates, maximum of 43 % (28% +15%)

No clarity in terms of accuracy of the figures

But, not alternative figures to dispute

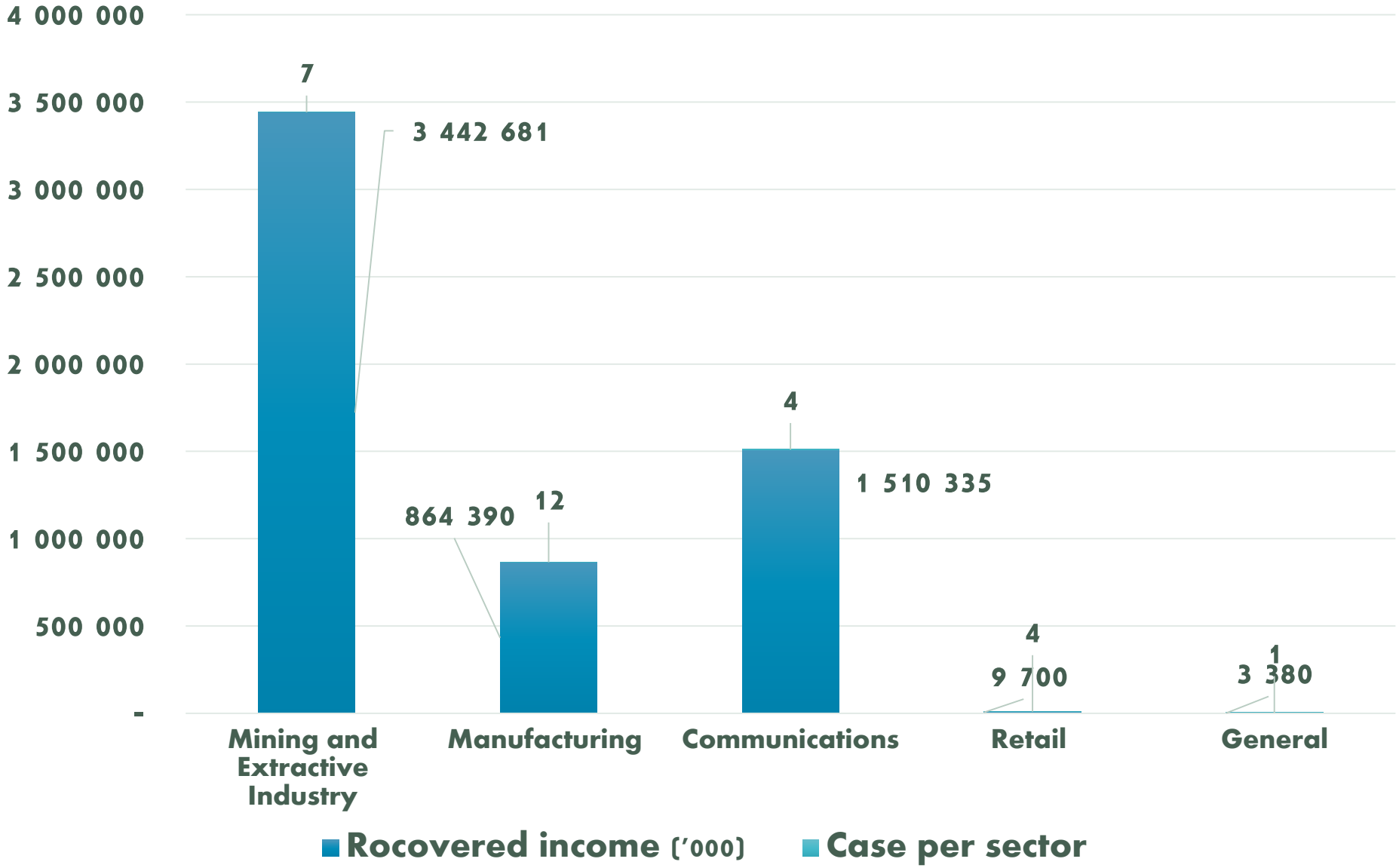
- **South African Revenue Services**

Recovered R 5,8 bill (R 20 bill assessment) in 3 years (2011-2014) audits in specific cases,

Loss recovered in various industries, with high prevalent in **Mining and extractives Industry**, with more than 55 % of recovered money,

Concerns about the Financial Services Sector,

Cases previously Audited by SARS



Impact of BEPS and other considerations

There is already sacrifice in revenue or government expenditure programs to provide various incentives to business:

Business Incentives:

- Incentives for research and development
- Incentives for capital expenditure
- Incentives for enhanced competitive advantage
- Incentives for specific industries

For the purpose of oversight:

What has been impact on growth, employment, inequality taking into account BEPS

International Experiences

Transfer Mispricing is experienced by other countries—including both developing and developed countries—

RSA, approach to combatting BEPS is considered amongst the best Internationally, in particularly developing nations

But other countries, more so those aligned OECD make use of Advanced Pricing Agreement (APA) to deter Tax Payers from practices of BEPS,

South Africa does not currently have APA as an deterrent to BEPS,

BUT APA is been considered as an approach to complement the current approach in South Africa,

International Experiences

Advance Pricing Agreement (APA):

An APA is an agreement between a tax payer and tax authority, transfer pricing methodology (for pricing the tax payer's international transactions for future period).

Some of countries adopted principles of APA:

Australia, Austria, Canada, Chile, Denmark, Finland, Germany, Hungary Italy, Japan, Korea, Mexico, Netherlands, Poland, Portugal, Slovak Republic, Republic of Slovenia, Spain, Sweden, Turkey, United Kingdom United States

International Experiences -APA

APA Benefits:

- Certainty with respect to tax outcome of the tax payer's international transactions
- Removal of an audit threat (minimize rigours of audit), and deliverance of a particular tax outcome based on the terms of the agreement
- Substantial reduction of compliance costs over the term of the APA; and
- For tax authorities, an APA reduces cost of administration and also frees scarce resources

Advanced Price Agreement (APA)

Potential weakness for APA- In RSA

In South African context

- Effectiveness of the current system or approach (what is the real problem?),
- Loss of income already (currently), APA involve sacrifice of tax revenue as incentives to deter MNE (inherent limitations),
- APA not a *silver bullet*, countries with mechanism experiencing BEPS too,
- More burden to the already incapacitated agencies (e.g. SARS)
- Costs vs Benefits Considerations

Mining and Extractive Industry

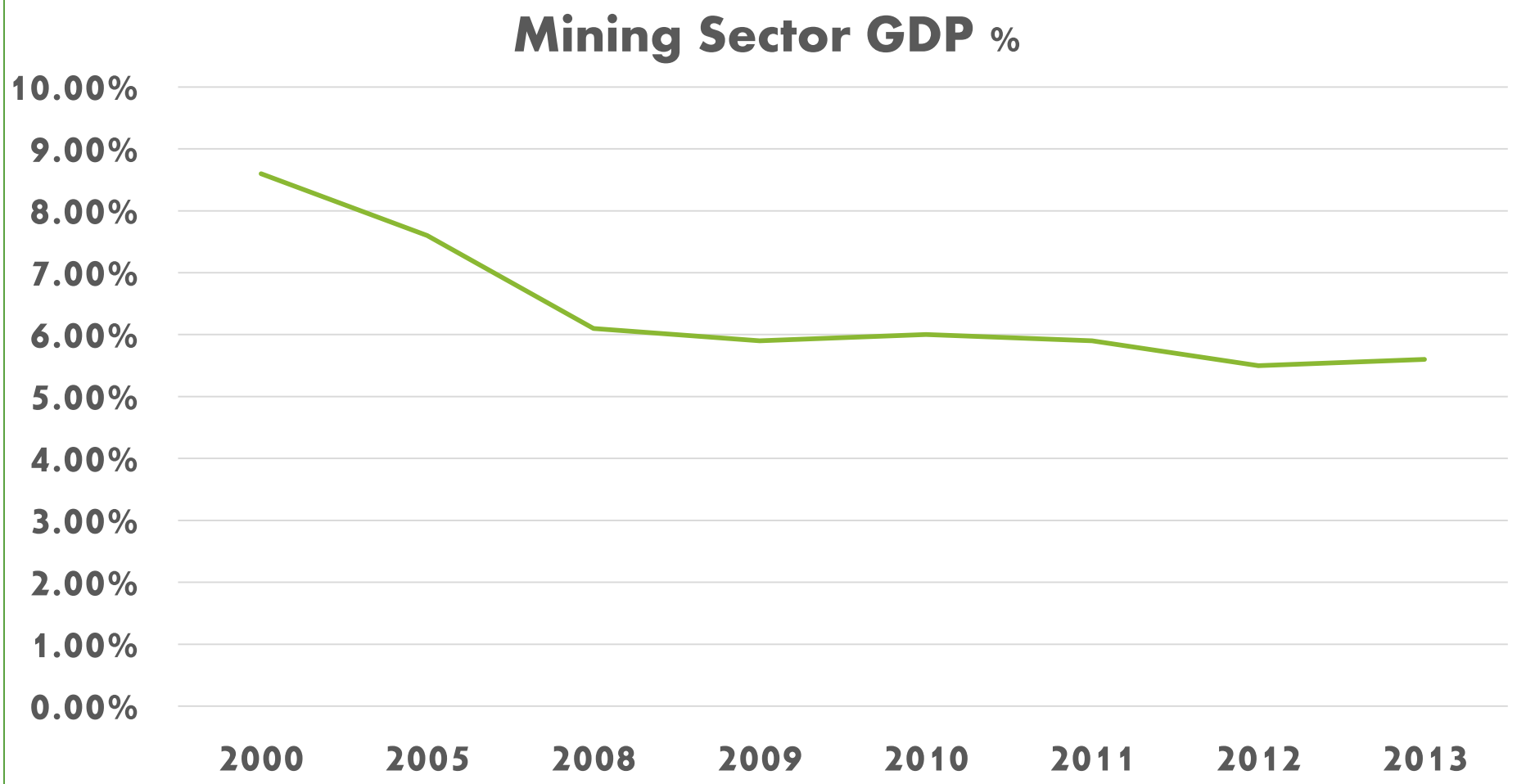
Mining and Extractive Industry experiences high volume transactions involved in BEPS in RSA,

Studies internationally also shows that Mining and Extractive Industries have high prevalence of BEPS,

But there is also concern of production decline in the Mining and Extractive Industry,

Mining and Extractive Industry

Tax Revenue decline GDP contribution over the years



Mining and extractive Industry-Sector Views

Though criticised for lack of inclusivity in the discourses,

Some of the pointers from 2015 **Mining Indaba** held F**ebruary 2015**:

- Sector concerned about the decrease in various commodities prices globally– trends expected to continue— affecting the profit margins
- Decline in demand for commodities, e.g. China' s recent developments
- Contributions directly and indirectly into the economy, effects of recent 5 months prolonged industrial action led to various sectors been affected though not in Mining Industry
- Mining Houses working and willing to work with Government to help solve some of social ills (i.e., health care, educations, infrastructure and etc.) – this does not mean they takeover government's responsibility
- Considerations given for more technology to be used in certain areas in the sectors, in particular in risky areas
- Lack of tax and other legislation predictability in the sector (affects compliance and so on- certainty about policies)
- Opportunity for partnerships and coordination between local government and mining houses to improve service delivery (Collaboration)
- Lack of policy and or legislation coordination affecting the Industry,

Mining and Extractive Industry

Surveyed shareholding of JSE listed Mining Houses,

The survey considered shareholding interests on a local vs foreign ownership proportion

An outlook is that majority of shareholding in the JSE Listed Mining Houses are Locally (RSA) Controlled,

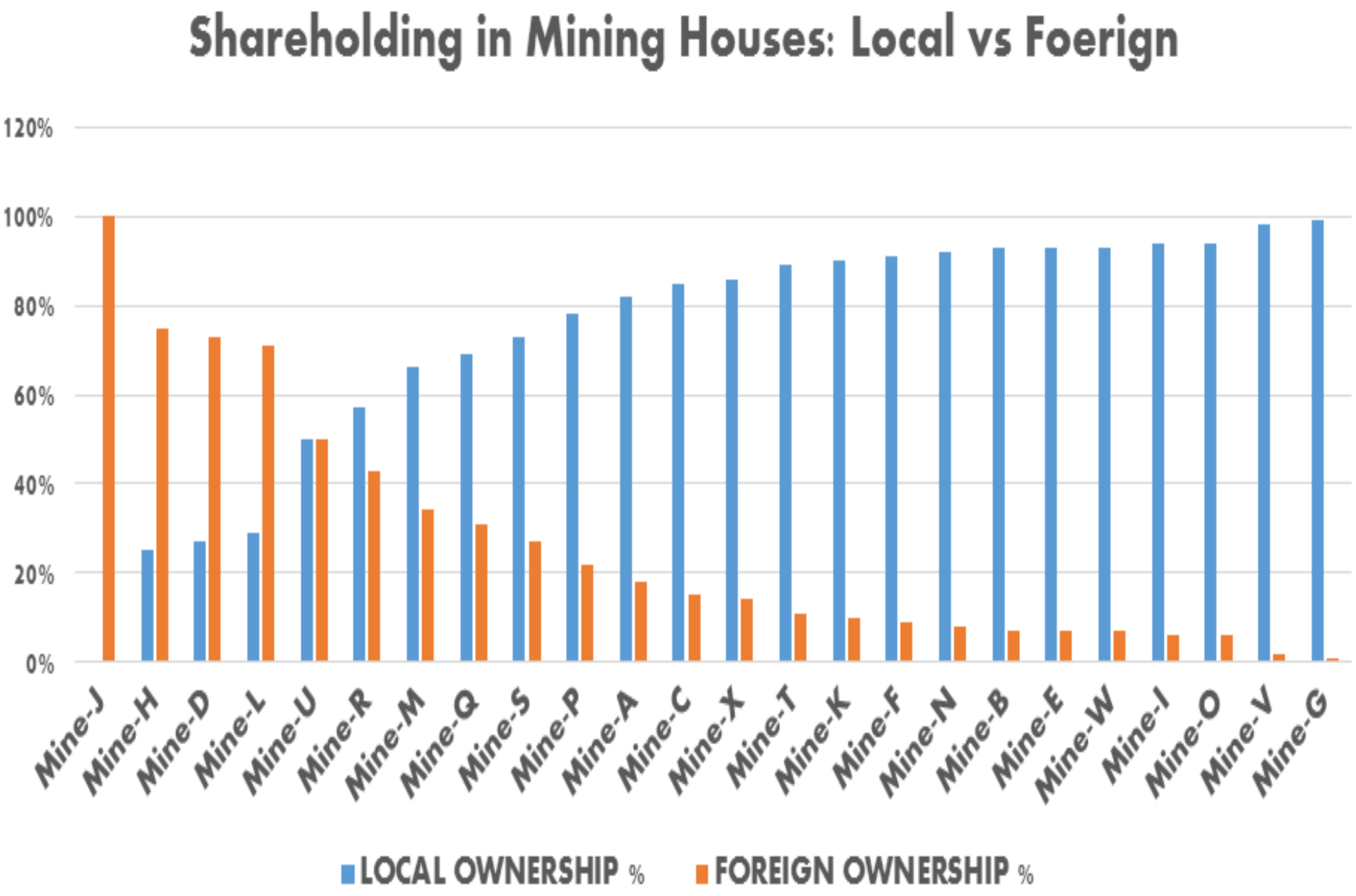
- **79%** (19 out of 24) RSA controlled (> 50% shareholding by RSA)

Certain JSE listed Mining Houses are fully Foreign Controlled, though its minority mining houses

- **13% (** 3 out of 24) Foreign controlled (> 50% shareholding by Foreign)
- **4%** (1 out of 24) Fully Foreign controlled (100% shareholding by Foreign)

- Almost all JSE listed Mining Houses have proportion of both Local and Foreign interests

Mining and Extractive Industry



Mining and Extractive Industry

Mining shareholding points to consider for oversight and legislative process:

- Majority of listed Mining Houses are locally controlled- Is this root cause for BEPS-
- But JSE listed Mining Houses are subsidiaries to MNEs though mostly locally controlled-
- Does this hinder process of combatting BEPS- Perpetuate a problem-
- If indeed Foreign Controlled—Parent Entity— does this mean RSA locals are Fronting for MNEs as a result there lack of combatting problem?

Mining and Extractive Industry

Some of concerns from other commentators:

- Is there a need to review the current Royalty Bill as a reflection on the current transfer pricing practices-
- Capital allowance against tax liability in Mining Industry in a year of acquisition problematic?
- No VAT on exports, but claim refunds
- Is the Mining Tax regime **progressive**?
- Do economic models like, Marginal Effective Tax Rates (MERT) and Average Effective Tax Rates (AETR), suggest that RSA Mining taxations regime too **lenient**
- Arm's length as it is currently is not practical effective, perhaps need for other methods to either replace it or supplement it,

Considerations for oversight and legislative process

	National Level	International level	Mining and Extractive Sec
	1. Need for tax legislation implementation guideline, 2. Co-ordination between various institutions for BEPS, 3. Appropriate level of tax levies by sectors, 4. Appropriate level of tax levies by sectors, 5. Level of disincentives and deterrents, 6. Rationale for Advanced Pricing Agreement and 7. Incentives for complying with TP rules, 8. Tax Treaties - reviewed for BEPS consideration, 9. Disclosure of information requirement vs voluntary 10. RSA-Resident' subsidiary financial reports to reflect inter-company transaction with all information 11. Mandatory reporting on, Taxes, Levies, Licence fees and rates paid by Business	1. Co-ordination between various institutions for BEPS 2. Level of disincentives and deterrents 3. Pro-active Legislative International Co-ordination Alternatives approaches to arm's length 4. 5. Tax Treaties - reviewed for BEPS consideration, 6. Disclosure of information requirement: compulsory vs voluntary 7. Collaboration with African Countries vulnerable BEPS	1. Need for tax legislation implement 2. Co-ordination between various ins 3. Appropriate level of tax levies by s 4. Alternatives approaches to arm's l 5. Level of disincentives and deterre 6. Rationale for Advanced Pricing Ag Incentives for complying with TP ru 7. Tax Treaties - reviewed for BEPS co 8. Disclosure of information requirem vs voluntary 9. RSA-Resident' subsidiary financial r inter-company transaction with all 10. Mandatory reporting on, Taxes, Le fees and rates paid by Business 11. Alternatives approaches to arm's l 12. Rationale for capital allowance a income in Mining and Sectors with
tio	1. Capacity building at SARS TP Unit 2. Strengthening of Exchange Controls and Role of Exchange Controls Surveillance- SARB		
nd	1. Co-ordination between various institutions for BEPS 2. Legislation implications for other Business (than those involved in BEPS) 3. Parliament oversight process, (and ability to reflect on effectiveness of BEPS combating measures) 4. Collaboration with African Countries vulnerable BEPS	1. Legislation implications for other Business (than those involved in BEPS) 2. Collaboration with African Countries vulnerable BEPS	1. Legislation implications for other B those involved in BEPS) 2. Parliament oversight process, (and on effectiveness of BEPS combatin 3. Collaboration with African Countri BEPS

THANK YOU TO ALL CONTRIBUTORS AND FOR YOUR TIM

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