

# Base erosion & profit shifting (BEPS)

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**national treasury**

Department:  
National Treasury  
REPUBLIC OF SOUTH AFRICA

# Introduction

Important to distinguish between:

## Tax avoidance

- Using legal provisions to minimise tax liability
- Covers interventions that are referred to as *base erosion and profit shifting* (BEPS)
- Typical strategies used by multinational companies include taking on excessive debt and transfer **mis**pricing (over / under-invoicing)

## Tax evasion

- Using illegal methods to minimise tax liability
- Non declaration or under reporting of income
- Overstating expenditure
- Trade **mis**pricing

## {Other} illicit financial flows

- Criminal activities, e.g. fraud, money laundering
- Smuggling , contrabands, drug trafficking, human trafficking, etc.
- Contravention of capital flow regulations

# What is base erosion and profit shifting (BEPS)?

Tax planning strategies that exploit loopholes in domestic tax laws and mismatches in international (cross country) tax rules, resulting in profit shifting to very low tax jurisdictions and / or tax havens

Resulting in income not being taxed, or taxed at low rates (in the wrong country?)

Tax rules have not kept pace with evolving business practices:

- Blurring of distinction between debt and equity
- Ease of transferring intangibles offshore without registering patent or requiring SARB approval

# Background: Participation by G20 Leaders/ Ministers of Finance on BEPS

June 2012: G20 Leaders summit in Mexico discussed the need to prevent base erosion & profit shifting

July 2013: G20/OECD launched the BEPS action plan with 15 Action points

September 2013: G20 Leaders endorsed the BEPS Action plan and 15 Action points

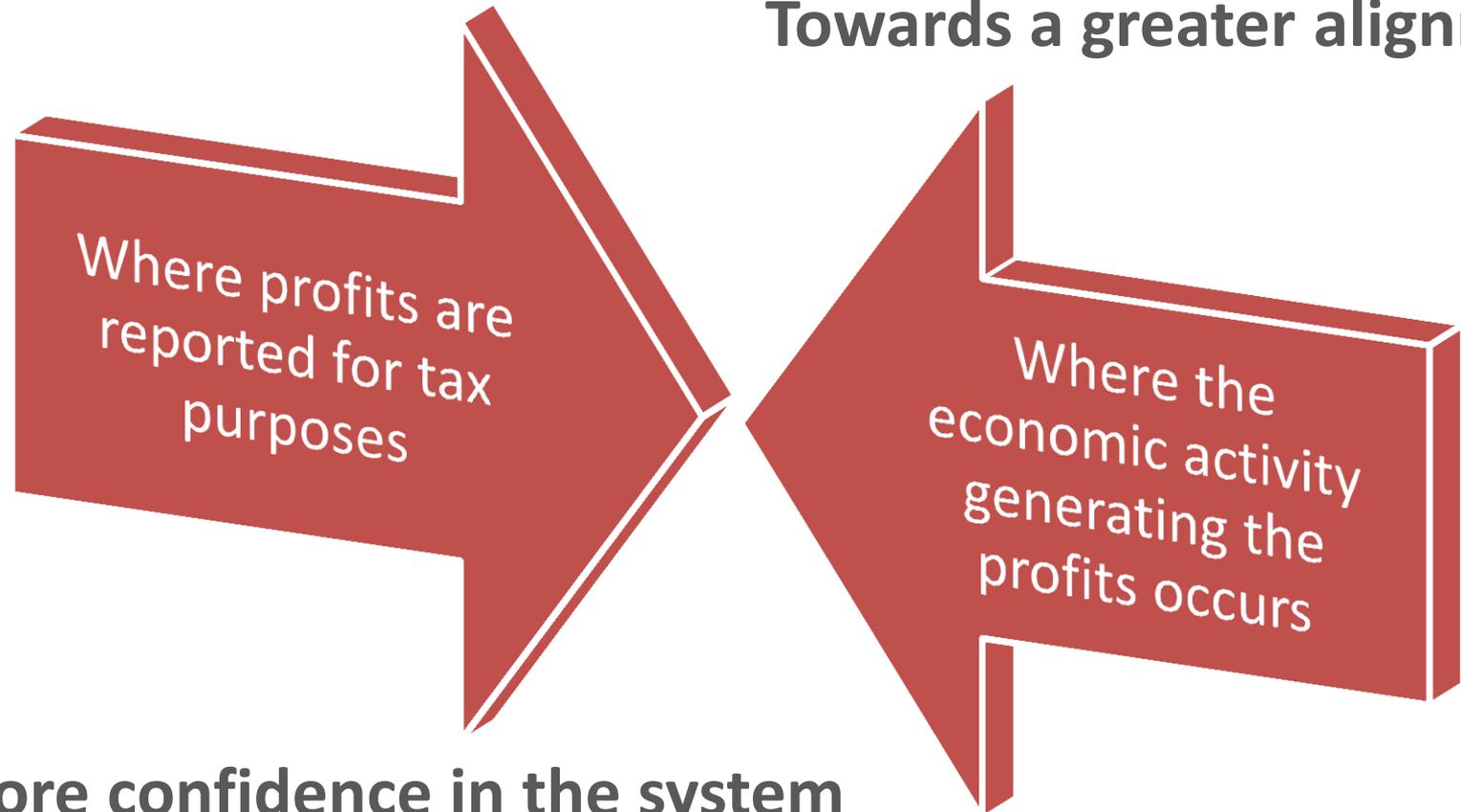
2014: Outcomes/Reports on 7 of the 15 BEPS Action plan presented to G20 and endorsed by the Ministers of Finance

February 2015: G20 Ministers of Finance embrace non-G20 countries, particularly developing countries, participation in the implementation and further development of BEPS on an equal footing

October 2015: 13 reports completed

# Objectives of the BEPS Project

Towards a greater alignment



Restore confidence in the system

Build a global consensus

# 15 Actions around 3 main pillars

## Coherence

Hybrid Mismatch Arrangements (2)

CFC Rules (3)

Interest Deductions (4)

Harmful Tax Practices (5)

## Substance

Preventing Tax Treaty Abuse (6)

Avoidance of PE Status (7)

Transfer Pricing Aspects of Intangibles (8)

Transfer Pricing Risk and Capital (9)

Transfer Pricing High Risk Transactions (10)

## Transparency & Certainty

Measuring and Monitoring BEPS (11)

Disclosure Rules (12)

Transfer Pricing Documentation (13)

Dispute Resolution (14)

Digital Economy (1)

Multilateral Instrument (15)



# Hybrid Mismatch Arrangements: (Action 2)

Hybrid mismatch arrangements exploit differences in tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to achieve double non-taxation

Common approach will facilitate convergence of national tax practices through domestic & treaty rules to neutralise such arrangements

The measures proposed take the form of:

- Recommendations for linking rules that align the tax treatment of an instrument or entity with the tax treatment in the counterparty jurisdiction but otherwise do not disturb the commercial outcomes. Apply automatically with a primary and secondary rule

# Hybrid Mismatch Arrangements (cont.): (Action 2)

*South Africa: Recommendations are being incorporated into the multilateral instrument and South African domestic law has measures to limit double deductions, income exclusions where there is no corresponding deduction, and deductions with no inclusions.*

*Legislation dealing with hybrid mismatches was first introduced in 2004 in section 8E  
Hybrid mismatches were updated and modernised by introducing sections 8EA, 8F & 8FA of the Income Tax Act in 2012*

*Anti-avoidance measures aimed at deeming dividends to be interest under certain circumstances and limiting double deductions, limiting deductions where there is no corresponding income inclusion*

*2016 Budget review contained proposals relating to Hybrid mismatches to prevent base erosion and profit shifting and changes will be effected in the 2016 TLAB*

# Interest deductibility: (Action 4)

The CIT system tends to have a bias towards debt financing (debt vs. equity financing)

BEPS risks related to excessive interest payments / deductions

- Location of third party debt in high tax countries
- Using intragroup loans to generate interest deductions in excess of the group's actual third party interest expense
- Use of debt to fund tax exempt income

The recommended approach aims at ensuring that an entity's net interest deductions are directly linked to the taxable income generated by its economic activities

- Based on a fixed ratio (net interest expense / EBITDA ratio)

# Interest deductibility (cont.): (Action 4)

*South African rules follow the same approach as that recommended, but are more targeted to particular transactions (instances where the corresponding interest income is not taxable and reorganisation and acquisition transactions)*

*South Africa first introduced interest limitation rules in section 23K in 2011*

*(Section 23N replaced section 23M in 2014 with effect from 1 April 2014, and section 23M with effect from 1 January 2015)*

*Anti-avoidance rules are aimed at limiting interest deductions where the corresponding income is not taxable (e.g. non-resident receiving interest from SA) and during corporate reorganisation transactions (e.g. mergers & acquisitions)*

*Major changes made in the 2014 TLAB*

# Strengthen CFC Rules: (Action 3)

Controlled Foreign Corporation (CFC) rules seek to 'bring back' the income received by a CFC that should be attributable to the domestic entity that exerts control over the CFC

To recognise varying policy objectives among jurisdictions, not a minimum standard, but are designed to ensure those jurisdictions that choose to implement have effective rules

Recommendations provide building blocks for effective CFC rules

*South African CFC rules recommended as one of three options for countries to implement, the other two being UK and USA options.*

# Strengthen CFC Rules (cont.): (Action 3)

*South Africa first introduced CFC rules in section 9D of the Income Tax Act in 1997 (when South Africa had source based system of taxation)*

*In 2001: CFC rules reviewed due to South Africa moving from source based to resident based system of taxation.*

*Anti-avoidance measures aimed at preventing South African residents from shifting tainted forms of taxable income offshore by investing through a CFC. The net income of a CFC is attributed to and included in the taxable income of South African shareholders.*

*South African CFC rules recommended as one of three options for countries to implement*

*Changes in the legislation to ensure that these rules meet policy objectives. Big changes made in the 2015 TLAB and minor changes will be made in 2016 TLAB*

# Transfer Pricing: (Actions 8 – 10)

Transfer pricing rules are used to determine the conditions, including the price, for transactions within an MNE group

Ensures that transfer pricing rules secure outcomes that better align operational profits with the economic activities that generate them

Existing standards in this area have been clarified and strengthened with

- guidance on the arm's length principle
- an approach to ensure the appropriate pricing of hard-to-value-intangibles has been agreed upon within the arm's length principle
- guidance on transactions involving cross-border commodity transactions
- guidance on low value-adding intra-group services

The latter two areas were identified as critically important by developing countries

- Guidance will be supplemented with further work mandated by the G20 Development Working Group

# Transfer Pricing (cont.): (Actions 8-10)

*No policy change is required . SARS is updating the Practice Note on Transfer Pricing to include the new Guidance*

*South Africa first introduced Transfer Pricing Rules in section 31 of the Income Tax Act in 1995*

*Most recent amendments were made in the TLAB in 2011 and 2014*

*Draft public notice requiring large corporates with cross border transaction with connected persons to maintain specific transfer pricing documentation released by SARS for public comment in December 2015*

# Transfer Pricing Documentation: (Action 13)

Improved & better-coordinated TP documentation will increase quality of information provided to tax administrations & limit the compliance burden

Large multinationals will be required to submit reports for each country in which they do business to the tax authority where their head office is located

Tax authorities will share this information starting in 2018

*In 2015, changes were made in the Tax Administration Act to extend the definition of “International Tax Standard” to include country by country reporting*

*This legislative enables SARS to exchange and receive information from other jurisdictions*

*SARS will have access to country-by-country information on all large multinationals operating in South Africa and its multinationals operating in other countries*

# Transfer Pricing Documentation (cont.): (Action 13)

*This will include information on revenue, profit, income tax paid and accrued, number of employees, stated capital, retained earnings and tangible assets in each tax jurisdiction MNEs with a group revenue of R10 billion or more.*

*South Africa signed multilateral competent authority agreement on exchange of country -by -country reports in 27 January 2016, closely modelled on legislation related to country -by -country reporting published in the Action 13 Final report*

*Draft regulations released by SARS for public comment in 11 April 2016*

# Digital Economy: (Action 1)

Impossible to ring-fence the digital economy for tax purposes

Digital economy has key features and fosters business models that raise related but different issues, and exacerbates BEPS concerns

- Addressed across the BEPS Project, including within the work on permanent establishment, transfer pricing and CFC rules

# Digital Economy (cont.): (Action 1)

*VAT has also become a challenge given the increase in sales of e-services. South Africa has implemented measures requiring foreign companies selling e-services to customers in South Africa register for VAT purposes*

*This ensures that there is a level playing field both local and foreign suppliers' customers are required to pay VAT on their purchases*

*Legislation dealing with electronic services introduced in the VAT Act in 2013*

*Regulations dealing with foreign businesses supplying specified electronic services in South Africa required to register as VAT vendors were issued in 2014*

*Regulations are currently being updated.*

# Multilateral Instrument: (Action 15 – tax treaties)

100 countries are working together to develop the multilateral instrument, which aims at preventing treaty abuse

The multilateral instrument incorporates recommendations of Actions 2, 6, 7 and 14.

*South Africa is working together with other countries (including other African countries such as Kenya and Nigeria) in developing the multilateral instrument*

# Preventing Treaty Abuse: (Action 6 – tax treaties)

Treaty abuse, in particular treaty shopping, is one of the most important sources of BEPS

Treaty shopping can involve a MNE with operations in two countries setting up a conduit in a third country purely to obtain treaty benefits (e.g. low or no withholding taxes)

Minimum standard on preventing abuse including through treaty shopping

New flexible rules that provide a minimum level of protection against treaty abuse, including treaty shopping

# Preventing Treaty Abuse (cont.): (Action 6 – tax treaties)

*South Africa currently has about 76 Tax Treaties*

*South Africa participates in the negotiation of multilateral instruments (Action point 15) which aims at preventing treaty abuse*

*New treaties that South Africa enters into will be aligned with the minimum prescribed standards, while existing treaties will be taken care of through the multilateral instrument*

# Artificial avoidance of PE status: (Action 7)

Business profits of a foreign enterprise are generally taxable in a State only to the extent that the enterprise has a Permanent Establishment (PE) in that State to which profits are attributable

Address techniques used to inappropriately avoid the tax nexus

Changes to the definition of PE in Article 5 of the OECD Model Tax Convention, which is widely used as a basis for negotiating tax treaties

*Like other countries, SA treaties have a PE concept contained in Article 7 of the tax treaties  
South Africa's tax treaty model will be updated to incorporate the BEPS Action 7 recommendation dealing with fragmentation of activities and splitting of contracts*

# Mandatory Disclosure Rules: (Action 12)

Tax authorities face a lack of timely, comprehensive and relevant information on aggressive tax planning which can be addressed by mandatory disclosure rules

MDR requires disclosure, often before returns are filed, of certain transactions, by promoters, taxpayers or both

Not a minimum standard, but 3 key outputs for countries wishing to adopt MDR

- Framework for design of rules that are flexible to country specific risks and needs
- Special recommendations for rules that focus on international tax schemes
- Enhanced models of information sharing using the JITSIC network as a platform

# Mandatory Disclosure Rules (cont.): (Action 12)

*South Africa has committed to implementing the Common Reporting Standard (CRS) at the beginning of 2017*

*South Africa first introduced Reportable Arrangements rules in section 76A of the Income Tax Act in 2003. These rules were revised in 2008 and reintroduced in section 80M to 80T of the Income Tax Act. In 2011, these rules were transferred from the Income Tax Act to section 34 to 39 of the Tax Administration Act.*

*These rules require disclosure of reportable arrangements to SARS within 45 Business day of qualifying as a reportable arrangement*

*SARS generally publishes a list of reportable arrangements by notice in the government gazette, with the last notice published on 3 February 2016*

*Benchmark country for work on Action 12*

# Dispute Resolution: (Action 14)

Improving dispute mechanisms is an integral component of the work on BEPS so that unnecessary uncertainty for compliant taxpayers and unintended double taxation are avoided

Measures developed aim to strengthen the effectiveness and efficiency of the mutual agreement procedure (MAP) process

*South Africa participates on Forum on Tax Administration MAP WORK*

*Similar to other developing countries participating in the OECD/G20 BEPS project, South Africa has not committed to mandatory binding MAP*

# Harmful Tax Practices: (Action 15)

Addresses preferential regimes and improves transparency in connection with certain rulings

Minimum standard based on agreed methodology to assess whether substantial activity in a preferential regime

- “Nexus” approach was developed in the context of intellectual property (IP)
- Allows a taxpayer to benefit from an IP regime only to the extent that the taxpayer itself incurred qualifying research and development (R&D) expenditures that gave rise to the IP income.
- Uses expenditure as a proxy for activity because IP regimes are designed to encourage R&D activities and to foster growth and employment,

# Measuring & Monitoring BEPS: (Action 11)

## Measuring & monitoring BEPS

- Assessment of data
- A 'dashboard of indicators'
- Economic analysis
- Recommendations for new tools and data

## Key recommendations

- The OECD to work with governments to:
  - publish a new regular Corporate Tax Statistics publication, including statistical analyses of Country-by-Country report data
  - refine BEPS indicators and produce periodic reports on the estimated revenue impacts of proposed and enacted BEPS countermeasures
- More research is needed on MNEs, including collaboration with academic researchers
- Better data and refined analyses will improve the measurement and monitoring of BEPS and countermeasures in the future

*Micro-tax data will assist in more analysis on BEPS and BEPS countermeasures*

# Scale and impact of BEPS?

More than 100 empirical studies report evidence of BEPS

OECD research finds a global net annual revenue loss of 4-10% of CIT (US\$ 100-240 billion) at 2014 levels

BEPS creates many economic distortions

- ETRs of large MNEs are 4-8½ % points lower than similar domestic firms
- Favours intangible investments, companies locating debt in high-tax countries and distorts the location of FDI
- Creates negative tax spillovers across countries

Anti-avoidance rules are effective in preventing BEPS in individual countries, but coordinated measures could be more effective

# Quantification of BEPS in South Africa?

## *Quantification of the impact of BEPS:*

- Most studies either attempt to estimate BEPS on a global scale, or
- They focus on particular BEPS activities (e.g. interest limitation rules) in the U.S. and Germany, where a rich micro-data set that identifies ownership links for MNEs is available

## *National Treasury initiatives:*

- Access to the CIT micro-data
- UNU Wider has recently awarded two research teams with funding to assist with an analysis of the data to gain a better understanding of scope of BEPS in South Africa
- The projects are envisaged to be completed by November 2016