BASE EROSION AND PROFIT SHIFTING BY MULTINATIONAL CORPORATIONS AND WEAKNESSES REVEALED IN SOUTH AFRICAN INCOME TAX LEGISLATION

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ABSTRACT

This research examined the concept of base erosion and profit shifting in the context of tax schemes employed by multinational corporations. The objective of this thesis was to identify weaknesses within South Africa's income tax legislation, based on these schemes, and further to propose recommendations to counter the occurrence of base erosion and profit shifting by multinational companies. The research also comprised of a limited review of current global and South African initiatives to address the problem of base erosion and profit shifting. It was concluded that there are a number of weaknesses in the definitions and provisions of the South African income tax legislation that need to be addressed in order to reduce base erosion and profit shifting. Brief recommendations were proposed in relation to each of the weaknesses, in order to address them.

Key words:

Base erosion and profit shifting

Tax schemes

Multinational corporations

International tax consequences

Tax havens

Harmful tax practices

Tax competition

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CHAPTER 1: INTRODUCTION

1.1. THE CONTEXT OF THE RESEARCH

According to the Organisation for Economic Co-operation and Development (hereinafter referred to as the OECD), the term "base erosion and profit shifting" refers to tax planning strategies which exploit gaps and mismatches in tax legislation. This encompasses the shifting of company profits to locations where tax legislation in those countries allows for little or no corporate tax to be paid (OECD: Online).

The following extract as stated by Adam Smith (1776: 676) substantiates the premise that base erosion and profit shifting creates a problem in the context of tax equality in any state:

> The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state. The expense of government to the individuals of a great nation is like the expense of management to the joint tenants of a great estate, who are all obliged to contribute in proportion to their respective interests in the estate. In the observation or neglect of this maxim, consists what is called the equality or inequality of taxation.

Tax inequality is an aspect of what is termed the "tax gap", which is defined by the South African Revenue Service (hereinafter referred to as the SARS) as "the difference between the amount of taxes the Government should collect and the amount of taxes the Government actually collects" (National Treasury, 2013a: 183). Although the causes of the tax gap are many, it is submitted that one of the contributors is base erosion and profit shifting.

According to the latest statistics (National Treasury, 2013a: 9) available from the SARS, it is evident that the greatest contributor towards tax revenue is income tax. The collections of income tax can be further split into personal income tax and

company income tax. The breakdown in terms of the SARS statistics reflects that the major portion of Income Tax is collected from individual taxpayers. Although causal factors identified for the low contribution from companies are the decrease in company profits due to declining global and domestic demand, as well as the utilisation of assessed losses accumulated during the economic downturn (National Treasury, 2013a: 2), part of the significant imbalance in the relative contributions, could be attributable to the utilisation of complex schemes by companies to reduce their tax burden.

The phenomenon of “globalisation” has resulted in significant and rapid changes to the economic environment. The OECD defines the term “globalisation” as “increasing internationalisation of financial markets and of markets for goods and services . . .” and refers to a process of economic integration, whereby “national resources become internationally mobile while national economies become increasingly interdependent.” (OECD, 2005: 11)

From a South African economic perspective, the benefits of globalisation are evident in the form of increased foreign direct investment, which is a key factor for any developing country, as it supports growth and boosts the economy. However, the emergence of globalisation in the economic environment has led to the recognition of the need to eliminate the effects of double taxation, arising from the interaction between different tax systems across countries (OECD, 2013a: 7). Hence international tax law is considered to be an important consideration in the support of globalisation and foreign direct investment.

The growth of the global economy has led to the establishment of various multinational enterprises such as Google, Apple Inc. and Facebook. Such companies are major providers of what is known as the “digital product”, which refers to products or services supplied through the internet. This results in many companies being able to engage in trade and business activities across a vast number of countries without having a physical presence in the countries. As a result of the emergence of this “digital economy”, many multinational enterprises are able to structure their tax affairs so as to significantly minimise their tax burdens by making use of “loopholes” in international tax law. This is one aspect of base erosion and

profit shifting which is currently under scrutiny by the OECD and as a result of the recent focus on this issue, the OECD has emerged with an action plan to address base erosion and profit shifting (OECD, 2013a: 7-14).

Although South Africa does not form part of the OECD, it is a member country of the Group of 20 (hereinafter referred to as the G20), which is a forum for international economic co-operation and decision-making. On 19 June 2012, the G20 Leaders Declaration stated: "We reiterate the need to prevent base erosion and profit shifting and we will follow with attention the ongoing work of the OECD in this area" (G20, 2012: Online). Furthermore, the G20 2014 Agenda includes a focus on tax avoidance, particularly base erosion and profit shifting, in order to ensure that profits are taxed in the location where the economic activity takes place (G20, 2014: Online).

The former Minister of Finance for South Africa, Pravin Gordhan, announced in the 2013 Budget Speech, that a tax review would be initiated to assess the tax policy framework. On 17 July 2013, the terms of reference (National Treasury, 2013b: Online) for the Tax Review Committee (the Davis Tax Committee) were set out, with one area of focus being base erosion and profit shifting. The Davis Tax Committee recognises that there is an immediate need to address concerns relating to base erosion and profit shifting, in the context of corporate income tax, as identified by the OECD and the G20 (The Davis Tax Committee, 2013: Online).

It is evident that the issue of base erosion and profit shifting is one that is currently receiving worldwide attention, and it is likely that the OECD and G20 countries will work together in trying to address this problem. The implementation of any changes to legislation as suggested by the OECD will, however, have to be considered within the context of South African tax legislation, which is governed by the Income Tax Act, 58 of 1962 (hereinafter referred to as the Income Tax Act).

The SARS Strategic Plan for 2013/14 to 2017/18 (SARS: 2013b) (hereinafter referred to as the SARS Strategic Plan), states that it should be ensured that tax compliant citizens are not shouldering the tax burden of others who benefit from the country's infrastructure and resources without paying their fair share of taxes. The

SARS Strategic Plan further makes reference to the global tax environment, in which sophisticated tax schemes are on the rise, leading to a perceived unfair erosion of the tax base. The following three risks are specifically mentioned in the SARS Strategic Plan (SARS, 2013b: 18):

- Global economic uncertainty has resulted in multinational companies seeking "innovative" ways to protect profitability and their returns to shareholders by reducing their tax burden.
- The growing presence of multinational corporations in South Africa, which account for nearly seventy per cent of worldwide trade, has the greatest ability to shift profits from high tax jurisdictions to low tax jurisdictions.
- Developing countries, such as South Africa, are likely to be the most impacted by transfer pricing manipulations as the current OECD and United Nations transfer pricing frameworks are seen to favour developed countries.

A recent article published by Business Tech (2014: Online) entitled "Naspers hits out at Google over tax dodge" brought further attention to the issue of profit shifting by multinational companies. Naspers (a South African listed media company), through its subsidiary 24.com, expressed concern over Google's competitive advantage through its ability to avoid paying tax in South Africa. The article further states that the tax practices of Google have come under scrutiny in other countries such as the United Kingdom (hereinafter referred to as the UK) and France. Google's current online advertising revenue in South Africa is estimated to be between R800 million and R1 billion, and based on these figures, the article projects the lost tax revenue from Google to be around R140 million in corporate taxes, and a further R100 million in employees' tax. The complainant, 24.com, further stated that significant legislative changes are required in order for South African internet businesses to remain competitive with their global counterparts.

The focus on the above issues and the current publicity surrounding the taxation of multinational enterprises influences tax morale. If there is a perceived imbalance in the tax burden, it is submitted that compliant taxpayers are likely to be discouraged by the evident inequality in taxation. This is one of the reasons for the decision to

research the issue of base erosion and profit shifting in this thesis, specifically in relation to multinational corporations.

Although the schemes employed by multinational companies may be legal, they exploit current “loopholes” in international tax legislation, and the OECD (Online) has identified the following further impacts arising out of base erosion and profit shifting:

- Multinational enterprises are able to reduce their tax burdens, thus realising a higher net profit after tax – this gives such companies a competitive advantage over companies which operate at a domestic level.
- The occurrence of base erosion and profit shifting may lead to an inefficient allocation of resources, by influencing investment decisions towards activities that have lower pre-tax rates of return, but higher after-tax rates of return.

The discussion above illustrates how base erosion and profit shifting may impact on the tax revenues collected by tax authorities, tax morale, as well as on the economy of a country, and this further supports the need for research on this issue.

1.2. GOALS OF THE RESEARCH

The research question therefore relates to the nature of the tax structures employed by multinational corporations and how these structures reveal the underlying weaknesses in South Africa’s tax legislation, as governed by the Income Tax Act.

The primary goal of the research is to determine how the tax structures adopted by multinational companies uncover weaknesses in South Africa’s current tax legislation and to identify tax changes that will assist in reducing the occurrence of base erosion and profit shifting in relation to multinational enterprises. In carrying out the main objective of this research, the following sub-goals are addressed:

- a detailed examination of the concept of base erosion and profit shifting, including an overview of associated concepts such as harmful tax competition, tax havens and preferential tax regimes;

- a review of the provisions enacted within South African tax legislation to address international tax consequences, including a brief examination of double tax agreements;
- a study of tax structures adopted by well-known multinational companies and an illustration of the estimated loss in tax revenue (for certain countries) arising out of the profit shifting by such companies; and
- a review of current initiatives to reduce the occurrence of base erosion and profit shifting, including that of the OECD, other country-specific initiatives, as well as efforts made within South Africa.

1.3. RESEARCH METHODOLOGY AND DESIGN

An interpretative research approach has been adopted for the present research as it seeks to understand and describe (Babbie & Mouton: 2009). The research methodology to be applied can be described as a *doctrinal* research methodology. This methodology provides a systematic exposition of the rules governing a particular legal category (in the present case the legal rules relating to international tax), analyses the relationships between the rules, explains areas of difficulty and is based purely on documentary data (McKerchar: 2008). The documentary data used for the research consists of:

- South African income tax legislation and relevant case law;
- international taxing acts and associated case law;
- SARS Interpretation Notes, Regulations, Notices, Binding Rulings in relation to aspects of international tax; and
- textbooks and other writings.

The research is conducted in the form of an extended argument, supported by documentary evidence. The validity and reliability of the research and the conclusions is ensured by:

- adhering to the rules of the statutory interpretation, as established in terms of statute and common law;

- placing greater evidential weight on legislation, case law which creates precedent or which is of persuasive value (primary data) and the writings of acknowledged experts in the field;
- discussing opposing viewpoints and concluding, based on a preponderance of credible evidence; and
- the rigour of the arguments.

The multinational companies selected for further study are as follows:

- Apple Inc. – as this is the company which pioneered a popular profit-shifting scheme known as “double Irish with a Dutch sandwich”, which is commonly adopted by other multinational enterprises (Haden, 2012: Online);
- Google – due to the recent allegations made against this company, both in international (Campbell, 2014: Online) and South African (Business Tech, 2014: Online) media releases;
- Starbucks – as this company has been a recent point of focus by the tax authorities in the UK, which has revealed various tax schemes utilised by the company to avoid taxes (Bergin, 2012: Online) and
- SABMiller – as ActionAid, a global human rights organisation, published a report in 2010, revealing various tax avoidance schemes adopted by the company, mainly affecting developing African countries (ActionAid, 2010: Online).

The research does not attempt to quantify the loss in tax revenue for South Africa (arising from base erosion and profit shifting by multinational companies), as no formal quantification studies were found to have been undertaken by the South African tax authorities. Furthermore, the research does not consider any recommendations made by the Davis Tax Committee as no reports on base erosion and profit shifting were published before the completion of this research.

As all the data is in the public domain, no ethical considerations arise. Interviews are not conducted; opinions are considered in their written form. Privileged information arising in the course of the writer’s employment does not form part of this research.

1.4. OVERVIEW OF THE RESEARCH

This chapter provided an introduction to the area of research and provided a brief background to the research. The scope of the research was discussed, as well as the goals and sub-goals to be achieved. The methodology applied in conducting the research was set out, and the companies selected for the purposes of the research were identified.

Chapter Two focuses on the concept of base erosion and profit shifting, as well as other important associated issues such as harmful tax competition, tax havens and preferential tax regimes. A brief background to these issues is provided, as well as a discussion of the effects of base erosion and profit shifting.

Chapter Three provides a detailed analysis of the South African Income Tax Act in relation to international tax. This includes a review of concepts such as source, residence, controlled foreign companies, permanent establishment, place of effective management and transfer pricing, with reference to case law where necessary. Double tax agreements are also discussed.

Chapter Four reviews schemes employed by multinational companies to reduce their respective tax burdens – and the associated weaknesses that the schemes reveal in the provisions of the Income Tax Act that address international tax consequences. An illustration is provided of the estimated tax revenue that has been lost in certain tax jurisdictions, due to these schemes. Other strategies used by multinational companies to shift profits are also discussed insofar as they are not included in the case studies conducted.

Chapter Five focuses on current initiatives aimed at reducing base erosion and profit shifting. This includes a review of the OECD's action plan which addresses the tax challenges arising from multinational corporations. Current South African initiatives are also discussed, including progress made by the Davis Tax Committee in addressing the problem of base erosion and profit shifting in relation to multinational enterprises. Changes implemented or tabled by other countries (insofar as they are considered relevant in addressing the weaknesses identified) are also discussed.

Suggestions by the OECD are critically reviewed from a South African economic perspective, due to the need to maintain a balance between tax reform and attracting foreign direct investment.

Chapter Six draws on the findings of the previous chapters, and provides conclusions and recommendations in relation to potential improvements to South Africa's income tax legislation in relation to international tax issues, which would contribute towards ensuring that multinational corporations pay their fair share of income tax in the country. In addition, this chapter sets out the limitations of the research undertaken and makes suggestions for future research.

CHAPTER 2: THE CONCEPT OF BASE EROSION AND PROFIT SHIFTING

2.1. INTRODUCTION

This chapter examines the concepts of harmful tax competition, tax havens, preferential tax regimes and harmful tax practices, all of which are important issues which need to be considered in understanding the dynamic underlying base erosion and profit shifting. Once these issues are discussed in sufficient detail, base erosion and profit shifting forms the core focus of the chapter.

The chapter therefore addresses the first goal of the research: to provide a detailed examination of the concept of base erosion and profit shifting, including an overview of associated concepts such as harmful tax competition, tax havens and preferential tax regimes.

2.2. HARMFUL TAX COMPETITION

Historically, the development of tax legislation was undertaken with a focus on the requirements of the domestic economy of a country. The limited mobility of capital previously meant that the interaction of domestic tax systems between countries was not a common occurrence. However, the emergence of globalisation and its significant growth has had the effect of increasing the integration between the economies of different countries, due to the increase in the mobility of capital. This has fundamentally changed the manner and frequency of the interaction of tax systems across a number of countries. As a result of the emergence of the global economy, many governments have attempted to increase foreign investment by minimising the taxation levels and/or providing more favourable tax policies as compared to other countries (OECD, 1998: 13).

Tax competition exists when capital and/or labour can be shifted from high tax jurisdictions to low tax jurisdictions in order to reduce tax burdens (Mitchell, Online: 1). However, in the context of base erosion and profit shifting, it is submitted that tax competition also refers to competition between tax jurisdictions in order to attract investment into the country by lowering tax rates or providing other tax incentives. It

can therefore be seen as a competition between countries for taxing rights (Calich, 2011: 44). In summary, tax competition can occur through the tax strategies employed by companies to reduce their tax burdens, but can also occur through the tax policies adopted by countries in order to attract investment.

The above discussion provided a brief background to the phenomenon of tax competition. However, an important consideration is: what renders tax competition harmful? A report published by the OECD (1998: 14) highlighted the negative effects of tax competition, and stated that it potentially distorts the patterns of trade and investment, and can reduce global welfare. Tax competition can further erode national tax bases of countries. The report further clarified that investors in tax haven countries who are residents in non-haven countries benefit from public spending and the infrastructure of their resident countries, yet avoid contributing to the financing required by these countries. It is important to note that tax competition is not always harmful and in many ways, has contributed towards positive tax reform. However, for the purposes of discussing this issue in the context of base erosion and profit shifting, it is only considered necessary to explore tax competition insofar as it is considered to be harmful. Positive tax competition is considered to be beyond the scope of this thesis.

2.3. TAX HAVENS AND PREFERENTIAL TAX REGIMES

2.3.1. TAX HAVENS

The key feature of a tax haven is that its laws can be used to evade or avoid the tax regulations of other jurisdictions. Tax havens generally have laws specifically designed for the purpose of minimising a tax liability, aiming to attract financial investment, with one of the main elements of attractiveness being strong secrecy provisions which prevent the effective exchange of information (Tax Justice Network, 2007: 1). According to the OECD (1998: 21), a tax haven is generally defined as a jurisdiction where certain taxes are levied at a low rate or not at all. There are numerous features which have been identified as being indicative of a tax haven. For the purposes of this thesis, the characteristics identified by the OECD are discussed

further. The four key factors identified by the OECD (1998: 22-23) in classifying a jurisdiction as a tax haven are as follows:

a) No taxes or nominal taxes – consideration is given to whether a jurisdiction imposes no or nominal taxes and offers itself (or is perceived to do so) as a place that can be used by non-residents to escape tax in their country of residency;
b) Lack of effective exchange of information - typically this is through laws or administrative practices which protect individuals and businesses against scrutiny by foreign tax authorities;
c) Lack of transparency – this is with reference to the operation of the legislative, legal or administrative provisions of the jurisdiction; and
d) No substantial activities – the absence of substantial activity may be indicative that a jurisdiction may be attempting to attract investment or transactions that are purely tax driven.

Subsequent to the issuance of the report which listed the above factors, the OECD focus in relation to tax havens shifted (OECD, 2001: 10) to the aspect of information exchange. However, for the purpose of the understanding tax havens in relation to base erosion and profit shifting, all of the above factors are considered to be relevant.

2.3.2. PREFERENTIAL TAX REGIMES

A preferential tax regime does not have any formal definition, but refers to a tax system which has features constituting harmful tax competition (OECD, 1998: 20). The OECD (1998: 27) has also identified key features of tax regimes which suggest that they have the potential to constitute harmful tax competition. These factors are as follows:

a) No or low effective tax rates – this may arise because the relevant tax rate is very low or because of the way in which a country defines the tax base to which the rate is applicable;

b) “Ring-fencing” of regimes – this can be effected in various ways including the exclusion of resident taxpayers from participating in the regimes offered, or the prohibition of enterprises which benefit from the regime, from participating in the domestic market. Such “ring-fencing” indicates that the regime has the potential to create harmful effects, as the tax jurisdiction offering the regime needs to protect its own economy from the regime, thereby resulting in an adverse impact on foreign economies and tax bases;
c) Lack of transparency – this may arise from the way in which a regime is designed and administered. Non-transparency includes favourable application of laws and regulations, negotiable tax provisions and a number of other practices; and
d) Lack of effective exchange of information – this is a strong indication that a country is engaging in harmful tax competition.

There are a number of other factors identified by the OECD. However, for the purposes of this thesis, it is not considered necessary to discuss these additional factors. The above discussion is considered to be sufficient in creating a basic understanding of the concept of preferential tax regimes and the factors which characterise these regimes.

2.4. HARMFUL TAX PRACTICES

According to the OECD (1998: 16), the term “harmful tax practices” is the collective reference to tax havens and preferential tax regimes, which can be said to have negative effects on the tax systems of other countries. Practices which drive the effective tax rate levied on income from mobile activities significantly below the rates in other countries may cause harm by:

- distorting financial and, indirectly, real investment flows;
- undermining the integrity and fairness of tax structures;
- discouraging compliance by taxpayers;
- re-shaping the desired level and mix of taxes and public spending;

- causing undesired shifts of part of the tax burden to less mobile tax bases, such as labour, property and consumption; and
- increasing the administrative costs and compliance burdens on tax authorities and taxpayers.

(OECD, 1998: 16)

The process of identifying harmful tax practices involves a number of factors, and the extent of the harm caused will, no doubt, vary in degrees. If the effects of tax practices adopted by a particular jurisdiction are so substantial that they are concluded to be poaching the tax bases of other jurisdictions, such practices would be labelled as “harmful tax competition” (OECD, 1998: 16). This concept was discussed above, and it is submitted that the relationship between the issues discussed in this chapter have been sufficiently demonstrated to an extent that is necessary to link them to the concept of base erosion and profit shifting.

2.5. BASE EROSION AND PROFIT SHIFTING

2.5.1. BACKGROUND

The economic landscape has changed drastically over a number of years, primarily due to globalisation, which increased the integration across various economies and markets. Globalisation has resulted in increased mobility of capital and labour, the gradual removal of trade restrictions and barriers, and significant strides in technological and telecommunication developments (OECD, 2013b: 25). This has resulted in increasing levels of interaction between tax systems across different countries.

Corporate tax is levied in terms of domestic tax legislation. As stated previously, the development of tax legislation was undertaken with a focus on the requirements of the domestic economy of a country. The interaction between domestic tax systems can lead to an overlap, potentially resulting in income which can be taxed in more than one jurisdiction, which is known as “double taxation”. However, the interaction of tax systems also leaves gaps which have not been addressed by tax legislation,

thus resulting in “double non-taxation”. Corporations often exploit differences in domestic tax rules and international standards in order to reduce their tax burden (OECD, 2012a: 2).

It is considered necessary to re-iterate the definition of the term “base erosion and profit shifting” adopted by the OECD – which refers to tax planning strategies that exploit gaps and mismatches in tax legislation. This encompasses the shifting of profits to locations where the tax legislation in those countries allows for little or no taxes to be paid (OECD: Online). The gaps and mismatches referred to in this definition, arise from the failure to reform tax legislature to address the effects of the global economy that have emerged over the years. This has led to the problem of the current tax provisions being inadequate to address the global business environment under which multinational companies operate. This enables multinational corporations to create or adopt tax strategies which allow for profits to be shifted to jurisdictions where little or no tax is payable, thereby eroding the tax base of the country in which such corporation is resident.

There is a perception that substantial corporate tax revenue is lost due to base erosion and profit shifting. As discussed in Chapter One, this issue has been receiving attention on a global scale and various commitments have been made by organisations such as the OECD and the G20, as well as by specific countries, including South Africa, to address this problem.

Base erosion represents a serious risk to tax revenues, tax sovereignty, as well as tax fairness (both actual and perceived fairness) of all countries affected by this issue. There are many ways in which a country’s tax base can be eroded, but a significant cause of base erosion is profit shifting (OECD, 2013b: 5). It is submitted that the shifting of profits by companies can be achieved both through the exploitation of gaps in current tax legislation, as well as through the use of tax havens and preferential tax regimes. In some instances, companies may employ a combination of the above strategies in order to minimise their tax burden. The strategies used by multinational corporations are studied in further detail in Chapter Four of this document.

2.5.2. EFFECTS OF BASE EROSION AND PROFIT SHIFTING

The occurrence of base erosion and profit shifting has a number of adverse effects on different aspects within a country. Some of the consequences identified by the OECD (2013a: 8) are:

- Governments are harmed – this is attributable to lower tax revenues and increased costs to ensure compliance. Furthermore, the perception by the public that corporations are not paying their fair share of taxes undermines the integrity of the tax system. With regard to developing countries, the reduced tax revenue can lead to under-funding of public investment that is required for economic growth.
- Individual taxpayers are harmed – as discussed in Chapter One, individual taxpayers contribute a greater portion towards overall income tax revenue (in South Africa). In instances where this is due to the strategies employed by companies to shift income away from their country of residence and thereby reduce their tax burden, this is unfair to individual taxpayers. This has the potential to lead to a decrease in tax morale amongst individual taxpayers.
- Businesses are harmed – multinational corporations seen to be engaged in base erosion and profit shifting may suffer reputational risk. Furthermore, corporations which operate only in the domestic market may have difficulty in maintaining competitiveness in relation to multinational companies that have the ability to shift profits to reduce tax. Therefore, base erosion and profit shifting can be said to distort fair competition between businesses.

Further, it has been stated that the occurrence of base erosion and profit shifting may lead to the inefficient allocation of resources, as investment decisions are inclined towards activities that have lower rates of return before tax, but higher after-tax rates of return (OECD, 2013b: 8).

These consequences of base erosion and profit shifting indicate that this problem is potentially harmful to the economy of a country, as well as to individuals and other businesses. In addition, tax morale and investment decisions can be negatively

influenced by this issue. The potential negative impact on tax morale represents an additional challenge for the tax authorities in any country, as there are various studies which reflect that there is a significant correlation between tax morale and tax compliance, in both developing and developed countries (OECD, 2013c: 2). Therefore, a decline in levels of tax morale could result in decreased levels of tax compliance, thereby further lowering amounts of tax revenue collected by tax authorities.

2.6. CONCLUSION

To summarise, the globalisation of international trade and investment and the failure of tax legislation to take account of this, has resulted in the ability of multinational corporations to have a legal presence in a number of countries around the world, each with different tax, accounting and corporate law regimes. This has given rise to tax arbitrage and profit shifting opportunities, which are exploited by various multinational companies, resulting in the erosion of tax bases (D'Ascenzo, 2013).

The discussion of the concepts outlined in this chapter reflects that the background of tax competition is very similar to that of base erosion and profit shifting. Furthermore, it is evident that the effects of harmful tax practices are comparable to the effects of base erosion and profit shifting. It is clear that the above concepts are inter-linked and issues such as harmful tax competition and harmful tax practices have played a role in contributing to base erosion and profit shifting.

This chapter aimed to build a sufficient understanding of the concepts discussed, in order to establish a background against which the strategies employed by multinational corporations can be examined. The chapter that follows explores the current provisions of South African income tax legislation, which govern the treatment of international tax issues. This is considered important as – together with the concepts discussed in this chapter – it forms the foundation for considering the base erosion and profit shifting schemes employed by multinational corporations. This foundation is central to identifying the weaknesses of existing legislation, which is the main goal of this research.

CHAPTER 3: THE PROVISIONS OF THE SOUTH AFRICAN INCOME TAX ACT RELATING TO INTERNATIONAL TAX

3.1. INTRODUCTION

The Income Tax Act contains a number of provisions which address the treatment of international transactions. This chapter discusses a number of definitions and sections which are considered relevant in the context of base erosion and profit shifting by multinational corporations. Concepts such as source, residence, controlled foreign companies, permanent establishment, place of effective management and transfer pricing, with reference to case law where necessary, are discussed. Double tax agreements are also discussed in this chapter.

The purpose of this chapter is to create an understanding of the current income tax legislation, which is important in addressing the main goal of this research, as it is necessary to understand the provisions in order to identify gaps and shortfalls in current tax legislation, as well as to recognise the ways in which they are exploited by multinational companies.

This chapter therefore addresses the second goal of the research: to review the provisions enacted within South African tax legislation which address international tax consequences.

3.2. BASIS OF TAXATION

3.2.1. BACKGROUND

According to De Koker & Brincker (2010: §1.2), income tax is fundamentally territorial, therefore, as a result of tax competition countries may attempt to increase revenue collections by extending their tax jurisdictions as far as possible. The taxing right of any country is dependent on its fiscal jurisdiction. In *Kerguelen Sealing & Whaling Co Ltd v CIR*, 1939 AD 487, 10 SATC 363, it was held that if the natural resources of a country or the activities of its inhabitants produce wealth, that country

is entitled to a share in that wealth no matter where the recipient of the wealth may live (Emslie, Davis, Hutton & Olivier, 2001: 129).

With effect from 1 January 2001, South Africa changed its source based system of taxation to a residence based system. Under the residence basis of taxation, "residents" are subject to tax on worldwide income, irrespective of the source of such income. With respect to non-residents, only income from a source within the Republic is subject to taxation within South Africa. This is in accordance with the definition of gross income contained in section 1 of the Income Tax Act, which reads as follows:

> "gross income", in relation to any year or period of assessment, means—
>
> (i) in the case of any **resident**, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or
>
> (ii) in the case of any person **other than a resident**, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a **source within the Republic**,
>
> during such year or period of assessment, excluding receipts or accruals of a capital nature, but including, without in any way limiting the scope of this definition, such amounts (whether of a capital nature or not) as are described hereunder... (own emphasis)

As can be seen, the concepts of "source" and "residence" are important in the consideration of whether an amount is to be included in a taxpayer's gross income. These concepts form the basis upon which income tax can be levied, and in relation to international tax issues, the above concepts are considered to be of significance. However, it is important to note that although the concepts discussed above are relevant in the determination of tax jurisdiction, the provisions of a double tax agreement may override the definitions contained in the tax legislation of contracting countries to such agreements, for the purpose of avoiding double taxation (De Koker *et al.*, 2010: §12.7.3). Double tax agreements are briefly discussed later in this chapter.

3.2.2. "SOURCE" BASIS OF TAXATION

The term "source" has not been defined in the Income Tax Act, therefore it is necessary to refer to case law in order to determine the meaning and gain sufficient guidance on the application of this term.

One of the leading cases that can be consulted on the concept of "source" is *CIR v Lever Bros & Unilever Ltd*, 1946 AD 441, 14 SATC 1. In passing judgment in this case, Watermeyer CJ stated as follows:

> …the source of receipts, received as income, is not the quarter whence they come, but the **originating cause** of their being received as income and that this originating cause is the work which the taxpayer does to earn them, the quid pro quo which he gives in return for which he receives them. The work which he does may be a business which he carries on, or an enterprise which he undertakes, or an activity in which he engages and it may take the form of personal exertion, mental or physical, or it may take the form of employment of capital either by using it to earn income or by letting its use to someone else. Often the work is some combination of these… (own emphasis)

(Williams, 2009: 20)

It was further clarified by Watermeyer CJ that the source of particular amounts of income is a two-fold issue – first, to establish the "originating cause" and secondly, to establish whether that originating cause is within the Republic (Williams, 2009: 19).

Difficulties in determining source may arise where activities are performed in the Republic and in one or more other countries. In these cases, the income earned from these activities may need to be apportioned between the countries, depending on the facts surrounding the situation. Currently, there are no provisions in the Income Tax Act for apportionment or source. In the determination of the source of the income in such cases, consideration must be given to the dominant source of the income – therefore the source will lie in the country where the main activities have taken place (Stiglingh, Koekemoer, Schalkwyk, Wilcocks, Swardt and Jordaan, 2009: 55).

In *CIR v Black*, 1957 (3) SA 536(A), 21 SATC 226, it was stated that if the only true and reasonable conclusion of the facts found that the dominant or main or substantial or real and basic cause of the accrual of income was to be found in South Africa, then South Africa was the source of that income (Emslie *et al.*, 2001: 131).

In *Essential Sterolin Products (Pty) Ltd v CIR*, 1993(4) SA 859(A), 55 SATC 357, the judge made reference to the need to consider the factual matrix underlying and giving rise to the agreement in terms of which an amount becomes payable, in determining the originating cause of such amount. This principle was re-iterated in *First National Bank of South Africa Ltd v C:SARS*, 2002 64 SATC 245 (De Koker *et al.*, 2010: §2.2).

In considering the judgments in these cases, four general principles were identified in the determination of whether or not an amount was received from a source within the Republic. These principles are as follows:

- determine the originating cause of the income and once this has been determined, establish the location thereof;
- in seeking the above, regard must be given to the overall factual matrix of the circumstances;
- against the factual matrix, the originating cause of a receipt may be found to occur in different countries, in which case the dominant or main cause of the accrual on income must be determined; and
- it should always be borne in mind that the determination of the actual source of income is a difficult matter where it may be necessary to adopt a common sense approach.

(De Koker *et al.*, 2010: §2.2)

Section 9 of the Income Tax Act contains a number of provisions in relation to specific categories of income, such as royalties and interest, establishing that these types of income have been received or accrued from a South African source. There are a number of other provisions in the Income Tax Act in relation to source, such as paragraph (*n*) of the “gross income” definition and section 8E. However, these

provisions are considered to be beyond the scope of this research as, for the purposes of base erosion and profit shifting, the concept of “source” need only be considered in relation to income which is not covered by a specific provision, as it is submitted that this creates a potential gap in the income tax legislation.

It is important to note that the absence of a formal definition of “source” can be seen as an area open to exploitation, particularly in relation to entities conducting business in the global environment. This is discussed further in later chapters of this thesis.

3.2.3. “RESIDENCE” BASIS OF TAXATION

The term “resident” has been defined in section 1 of the Income Tax Act. In relation to a person other than a natural person (in other words, legal entities such as companies), paragraph (*b*) of the definition of “resident” in section 1 states the meaning as:

> [a] person (other than a natural person) which is **incorporated, established or formed** in the Republic or which has its **place of effective management** in the Republic. (own emphasis)

It is important to note that the definition further provides that the above “does not include any person who is deemed to be exclusively a resident of another country for purposes of the application of any agreement entered into between the governments of the Republic and that other country for the avoidance of double taxation.”

The definition clearly has two components, either of which will classify an entity as a resident – it is therefore necessary to discuss each of these components in more detail.

3.2.3.1. INCORPORATED, ESTABLISHED OR FORMED

The Income Tax Act does not contain a definition of “incorporated, established or formed”. However, in relation to a company, this component makes reference to the country in which the entity has been incorporated for legal purposes. Generally,

these factors can be determined through the inspection of the legal documents governing the company (De Koker *et al.*, 2010: §17.3.1).

It is submitted that the above component of the definition is not complex and has not been an area of confusion in the application of the definition; therefore further discussion is not necessary in the context of the research being undertaken.

3.2.3.2. PLACE OF EFFECTIVE MANAGEMENT

The term “place of effective management” has also not been defined in the Income Tax Act. However, some guidance is provided in SARS Income Tax Interpretation Note No. 6 “Resident: Place of Effective Management (persons other than natural persons)” dated 26 March 2002 (hereinafter referred to as Interpretation Note 6). Interpretation Note 6 (SARS, 2002: 2) states that in order to determine the intended meaning of these words, the ordinary meaning, together with international precedent and interpretation should be considered.

Interpretation Note 6 (SARS, 2002: 3) further lists three important considerations in the determination of the place of effective management as follows:

- the place where central management and control is carried out by a board of directors;
- the place where executive directors or senior management execute and implement the policy and strategic decisions made by the board of directors and make and implement day-to-day/regular/operational management and business activities; and
- the place where the day-to-day business activities are carried out/conducted.

According to Interpretation Note 6 (SARS, 2002: 4), it is recognised that no definitive rules can be laid down in determining the place of effective management, and that all relevant facts and circumstances should be considered. The following are listed as examples of facts that warrant due consideration:

- where the centre of top level management is located;
- location of and functions performed at the headquarters;
- where the business operations are actually conducted;
- where controlling shareholders make key management and commercial decisions in relation to the company;
- legal factors such as the place of incorporation, formation or establishment, the location of the registered office and public officer:
- where the directors or senior managers or the designated manager, who are responsible for the day-to-day management, reside;
- the frequency of the meetings of the entity's directors or senior managers and where they take place;
- the experience and skills of the directors, managers, trustees or designated managers who purport to manage the entity;
- the actual activities and physical location of senior employees;
- the scale of onshore as opposed to offshore operations; and
- the nature of powers conferred upon representatives of the entity, the manner in which [those] powers are exercised by the representatives and the purpose of conferring the powers to the representatives.

(SARS, 2002: 4-5)

Interpretation Note 6 (SARS, 2002: 5) further clarifies that the list is not intended to be exhaustive or specific, but serves as a guideline.

The OECD identifies the place of effective management as the "place where the key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made" (OECD, 2012b: 8). This is ordinarily where the most senior person or body of persons (such as the board of directors) makes its decisions (Haupt, 2014: 30).

It is clear that the view taken by the SARS in Interpretation Note 6 (2002) is much wider than the international view on this matter. Until recently, there has been no South African case law which provided clarity on the term "place of effective management". In *Oceanic Trust Co. Ltd. NO v C: SARS,* 74 SATC 127, the judge

applied the principles laid down in *Commissioner for Her Majesty's Revenue and Customs v Smallwood and Anor* [2010] EWCA Civ 778, in considering the meaning of the term. These principles are as follows:

- The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business are in substance made.
- The place of effective management is ordinarily the place where the most senior group of persons (e.g. – but not necessarily – a board of directors) makes its decision, where the actions to be taken by the entity as a whole are determined.
- No definitive rule can be given and all relevant facts and circumstances must be examined to determine the place of effective management of an entity.
- There may be more than one place of management, but only one place of effective management at any one time.

(Integritax, 2011: Online)

Although the judge in the *Oceanic Trust Co. Ltd* case did not conclude on whether the trust had its place of effective management in South Africa, the principles referred to above are likely to be applied in other cases relating to the place of effective management. The principles applied in the *Oceanic Trust Co. Ltd* case confirm the OECD guidelines on establishing the place of effective management. It is submitted that this can be seen as an indication that the guidelines listed in Interpretation Note 6 (SARS, 2002) may not be applied in their entirety in certain cases. Furthermore, *SIR v Downing* (1975) 37 SATC 249 confirmed that South Africa is bound to take cognisance of the content of the OECD Model Tax Convention on Income and on Capital (hereinafter referred to as the OECD Model Tax Convention) when interpreting a double tax agreement (De Koker *et al.*, 2010: §17.3.2).

SARS (2011: Online) has also issued a discussion paper on Interpretation Note 6, listing a number of criticisms of the current guidelines set out in the Interpretation Note, and suggesting proposed changes. This is further indicative that the current

Interpretation Note no longer provides relevant guidance on the issue of place of effective management. It is submitted that the lack of clarity as well as the lack of South African case law dealing with the place of effective management may lead to an increased risk of exploitation of this obvious gap in tax legislation.

3.3. CONTROLLED FOREIGN COMPANIES

3.3.1. BACKGROUND

Controlled foreign company rules were first introduced into the Income Tax Act in 1997. However, when South Africa moved from a source basis of taxation to a residence basis, the scope of these rules widened considerably (De Koker *et al.*, 2010: §3.1). The rules in relation to controlled foreign companies are governed by section 9D of the Income Tax Act, which is an anti-avoidance provision aimed at South African residents who conduct income-earning activities through a foreign company. The purpose of this section is to ensure that passive income and "diversionary income" earned offshore is taxed in the Republic (Haupt, 2014: 609).

According to Haupt (2014: 609), the term "diversionary income" refers to income which the SARS considers to arise from suspect transactions between a controlled foreign company and a South African resident. Such transactions are considered to create opportunities for transfer pricing and therefore, increase the occurrence of tax avoidance. The purpose of section 9D of the Income Tax Act is therefore to tax, in the hands of a South African shareholder, an amount equivalent to that shareholder's effective share of net income in a controlled foreign company, on an accrual basis.

3.3.2. DEFINITIONS

The following definitions are considered important in relation to the provisions of section 9D(1), in the context of base erosion and profit shifting:

> **"controlled foreign company"** means any foreign company where more than 50 per cent of the total participation rights in that foreign company are

directly or indirectly held, or more than 50 per cent of the voting rights in that foreign company are directly or indirectly exercisable, by one or more persons that are residents other than persons that are headquarter companies: Provided that—

(a) no regard must be had to any voting rights in any foreign company—

(i) which is a listed company; or

(ii) if the voting rights in that foreign company are exercisable indirectly through a listed company;

(b) any voting rights in a foreign company which can be exercised directly by any other controlled foreign company in which that resident (together with any connected person in relation to that resident) can directly or indirectly exercise more than 50 per cent of the voting rights are deemed for purposes of this definition to be exercisable directly by that resident; and

(c) a person is deemed not to be a resident for purposes of determining whether residents directly or indirectly hold more than 50 per cent of the participation rights or voting rights in a foreign company, if—

(i) in the case of a listed company or a foreign company the participation rights of which are held by that person indirectly through a listed company, that person holds less than five per cent of the participation rights of that listed company; or

(ii) in the case of a scheme or arrangement contemplated in paragraph (*e*) (ii) of the definition of “company” in section 1 or a foreign company the participation rights of which are held and the voting rights of which may be exercised by that person indirectly through such a scheme or arrangement, that person—

(*aa*) holds less than five per cent of the participation rights of that scheme or arrangement; and

(bb) may not exercise at least five per cent of the voting rights in that scheme or arrangement,

unless more than 50 per cent of the participation rights or voting rights of that foreign company or other foreign company are held by persons who are connected persons in relation to each other.

“country of residence”, in relation to a foreign company, means the country where that company has its place of effective management.

“foreign business establishment”, in relation to a controlled foreign company, means—

(a) a fixed place of business located in a country other than the Republic that is used or will continue to be used for the carrying on of the business of that controlled foreign company for a period of not less than one year, where—

(i) that business is conducted through one or more offices, shops, factories, warehouses or other structures;

(ii) that fixed place of business is suitably staffed with on-site managerial and operational employees of that controlled foreign company who conduct the primary operations of that business;

(iii) that fixed place of business is suitably equipped for conducting the primary operations of that business;

(iv) that fixed place of business has suitable facilities for conducting the primary operations of that business; and

(v) that fixed place of business is located outside the Republic solely or mainly for a purpose other than the postponement or reduction of any tax imposed by any sphere of government in the Republic:

Provided that for the purposes of determining whether there is a fixed place of business as contemplated in this definition, a controlled foreign company may take into account the utilisation of structures as contemplated in subparagraph (i), employees as contemplated in subparagraph (ii), equipment as contemplated in subparagraph (iii), and facilities as contemplated in subparagraph (iv) of any other company—

(*aa*) if that other company is subject to tax in the country in which the fixed place of business of the controlled foreign company is located by virtue of residence, place of effective management or other criteria of a similar nature;

(*bb*) if that other company forms part of the same group of companies as the controlled foreign company; and

(*cc*) to the extent that the structures, employees, equipment and facilities are located in the same country as the fixed place of business of the controlled foreign company;

(b) any place outside the Republic where prospecting or exploration operations for natural resources are carried on, or any place outside the Republic where mining or production operations of natural resources are carried on, where that controlled foreign company carries on those prospecting, exploration, mining or production operations;

(c) a site outside the Republic for the construction or installation of buildings, bridges, roads, pipelines, heavy machinery or other projects of a comparable magnitude which lasts for a period of not less than six months, where that controlled foreign company carries on those construction or installation activities;

(d) agricultural land in any country other than the Republic used for *bona fide* farming activities directly carried on by that controlled foreign company;

(e) a vessel, vehicle, rolling stock or aircraft used for purposes of transportation or fishing, or prospecting or exploration for natural resources, or mining or production of natural resources, where that vessel, vehicle, rolling stock or aircraft is used solely outside the Republic for such purposes and is operated directly by that controlled foreign company or by any other company that has the same country of residence as that controlled foreign company and that forms part of the same group of companies as that controlled foreign company;

(f) a South African ship as defined in section 12Q engaged in international shipping as defined in that section; or

(g) a ship engaged in international traffic used mainly outside the Republic.

"participation rights" in relation to a foreign company means—

(a) the right to participate in all or part of the benefits of the rights (other than voting rights) attaching to a share, or any interest of a similar nature, in that company; or

(b) in the case where no person has any right in that foreign company as contemplated in paragraph (*a*) or no such rights can be determined for any person, the right to exercise any voting rights in that company.

3.3.3. OVERVIEW OF CONTROLLED FOREIGN COMPANY RULES

Section 9D(2) of the Income Tax Act provides that an amount equal to the net income of the controlled foreign company shall be included in the income of a South African resident, in the proportion of such resident's participation rights to the total participation rights in the company. Section 9D(2A) of the Income Tax Act further defines the net income of a controlled foreign company, which is determined as if that company was a South African resident, subject to certain provisos. In other words, the net income of the controlled foreign company is imputed and taxed in the hands of the South African resident.

Certain provisos are contained in section 9D(2), in terms of which no obligation to impute part of the net income arises. These provisos can be summarised as follows:

- Section 9D(2) will not apply to the extent that a resident, together with any connected person in relation to that resident, holds less than ten per cent of the participation rights and voting rights in the controlled foreign company.
- Section 9D(2) will further not apply to the extent that the participation rights are held by a resident indirectly through another resident company – this proviso avoids the imputation of income at multiple shareholder levels.
- Section 9D(2) will not apply to the extent that the participation rights are held by a South African registered long-term insurance company in any policyholder fund, provided this is not done for tax avoidance purposes.

(De Koker *et al.*, 2010: §3.4.4)

A further proviso is contained in section 9D(2A) which states that the net income of a controlled foreign company will be nil if the amount of foreign tax is at least seventy-five per cent of the amount of normal tax that would have been payable in respect of

the taxable income of the controlled foreign company, had that company been a resident for the applicable foreign tax year (Haupt, 2014: 619).

Section 9D(9) of the Income Tax Act further provides that certain amounts must not be taken into account in determining the net income of a controlled foreign company. According to subparagraph (*b*) of this section, amounts attributable to a "foreign business establishment" (as defined) must not be imputed to a South African resident, subject to certain exclusions (De Koker *et al.*, 2010: §3.6.1). It is submitted that this is a provision that could be subject to abuse, as taxpayers could utilise foreign business establishments in order to avoid being taxed in South Africa. De Koker *et al.* (2010: §3.6.1) submits that this is the exemption most frequently relied on to avoid the imputation of the income from controlled foreign companies. This is discussed further in Chapter Four.

3.4. TRANSFER PRICING AND THIN CAPITALISATION

3.4.1. BACKGROUND

The rapid growth in globalisation has resulted in an increase in international trade. An important provision in tax legislation that governs international transactions is transfer pricing, which refers to the price at which goods, services or intellectual property are transferred between related parties across international borders. Such transactions are typically entered into in order to shift profits from a high tax jurisdiction to a low or no tax jurisdiction. Transfer pricing is therefore a strategy frequently employed by multinational companies to reduce their tax burden. Transactions between related parties are commonly not entered into on an arm's-length basis, and this gives rise to the need for provisions within the Income Tax Act to address this issue. Most tax jurisdictions have based their transfer pricing provisions on the guidelines provided by the OECD (De Koker *et al.*, 2010: §10.1).

Thin capitalisation arises when a South African taxpayer is funded either directly or indirectly by connected non-resident persons. Excessive debt granted by non-resident connected persons may result in excessive interest deductions, thereby

compromising the South African tax base. Generally, a taxpayer that has too little equity when compared to its debt, is said to be thinly capitalised (Haupt, 2014: 598).

Section 31 of the Income Tax Act was introduced in 1995 to counter transfer pricing and thin capitalisation practices. There have been a number of legislative amendments to this section of the Income Tax Act since 1 April 2012, applicable to all years of assessment commencing on or after this date. The stated objective of such amendments was to modernise transfer pricing and thin capitalisation rules in order to align these rules with the OECD and international principles of taxation (PricewaterhouseCoopers, 2012: Online). The amended legislation is discussed in further detail below.

3.4.2. DEFINITIONS

The following definitions are relevant in relation to section 31:

> **"affected transaction"** means any transaction, operation, scheme, agreement or understanding where –
>
> *(a)* that transaction, operation, scheme, agreement or understanding has been directly or indirectly entered into or effected between or for the benefit of either or both-
>
> (i) (*aa*) a person that is a resident; and
>
> (*bb*) any other person that is not a resident;
>
> (ii) (*aa*) a person that is not a resident; and
>
> (*bb*) any other person that is not a resident that has a permanent establishment in the Republic to which the transaction, operation, scheme, agreement or understanding relates;
>
> (iii) (*aa*) a person that is a resident; and
>
> (*bb*) any other person that is a resident that has a permanent establishment outside the Republic to which the transaction, operation, scheme, agreement or understanding relates; or
>
> (iv) (*aa*) a person that is not a resident; and

(*bb*) any other person that is a controlled foreign company in relation to any resident,

and those persons are connected persons in relation to one another; and

(b) any term or condition of that transaction, operation, scheme, agreement or understanding is different from any term or condition that would have existed had those persons been dealing at arm's length.

"financial assistance" includes any-

(a) debt; or

(b) security or guarantee.

"connected person" means a connected person as defined in section 1: Provided that the expression "and no holder of shares holds the majority voting rights in the company" in paragraph (*d*) (v) of that definition must be disregarded.

In this regard, section 1 of the Income Tax Act defines the term **"connected person"** in relation to a company as follows:

(i) any other company that would be part of the same group of companies as that company if the expression "at least 70 per cent of the equity shares in" in paragraphs (*a*) and (*b*) of the definition of "group of companies" in this section were replaced by the expression "more than 50 per cent of the equity shares or voting rights in";

(ii) deleted;

(iii) deleted;

(iv) any person, other than a company as defined in section 1 of the Companies Act that individually or jointly with any connected person in relation to that person, holds, directly or indirectly, at least 20 per cent of—

(*aa*) the equity shares in the company; or

(*bb*) the voting rights in the company;

(v) any other company if at least 20 per cent of the equity shares or voting rights in the company are held by that other company, and no holder of shares holds the majority voting rights in the company;

(vA) any other company if such other company is managed or controlled by—

(*aa*) any person who or which is a connected person in relation to such company; or

(*bb*) any person who or which is a connected person in relation to a person contemplated in item (*aa*); and

(vi) ....

The term **"group of companies"** as referred to in the definition of connected persons, is also of importance and section 1 sets out the definition as follows:

> ...two or more companies in which one company (hereinafter referred to as the **"controlling group company"**) directly or indirectly holds shares in at least one other company (hereinafter referred to as the **"controlled group company"**), to the extent that—
>
> *(a)* at least 70 per cent of the equity shares in each controlled group company are directly held by the controlling group company, one or more other controlled group companies or any combination thereof; and
>
> *(b)* the controlling group company directly holds at least 70 per cent of the equity shares in at least one controlled group company.

3.4.3. OVERVIEW OF TRANSFER PRICING AND THIN CAPITALISATION RULES

As stated above, transfer pricing makes reference to the pricing of goods or services outside normal commercial parameters, the result of which is some tax advantage. Therefore, section 31(2) gives the Commissioner for the SARS discretionary powers to adjust artificial prices in order to reflect an arm's length price (Stiglingh *et al.*, 2010: 583). The arm's length price is determined by reference to the price that the goods or services in question would have been had the transaction been concluded between independent, unrelated persons.

The amendments to this section as referred to previously have had the following effects:

- direct and indirect transactions may be scrutinised by the SARS;
- transfer pricing now focuses not only on the supply of goods or services, but also on any cross-border “transaction, scheme, agreement or understanding” whereby one or both parties gain a tax benefit;
- the SARS may now determine compliance with the principle of arm’s length, with reference to either profit or pricing;
- a greater burden of proof is placed on the taxpayer to demonstrate compliance with the arm’s length principle;
- a secondary adjustment mechanism has also been introduced, in terms of which the primary transfer pricing adjustment as determined, will now be deemed to be an interest-free loan, which may lead to the imputation of interest; and
- thin capitalisation rules are no longer separately addressed in the legislation as section 31(3) has been deleted – these rules are now incorporated into transfer pricing rules with the effect that the principle of arm’s length must be applied to financial assistance as well.

(PricewaterhouseCoopers, 2012: Online)

The amendment in respect of thin capitalisation, in particular, is of significance and currently no finalised guidelines have been provided by the SARS, who have (to date) issued only a draft Interpretation Note “Determination of the taxable income of certain persons from international transactions: Thin Capitalisation” (hereinafter referred to as draft Interpretation Note) in 2013 in this regard. According to the draft Interpretation Note (SARS, 2013a: 11), a taxpayer is considered to be thinly capitalised if (amongst other factors), some or all of the following circumstances are applicable:

- The taxpayer is carrying a greater quantity of interest-bearing debt than it could sustain on its own.
- The duration of the loan is greater than what it would be at arm’s length.

- The repayment or other terms are not what would normally be entered into at arm's length.

As this Interpretation Note (SARS, 2013a) is subject to change, the draft guidelines are not discussed further. The deletion of section 31(3) has further resulted in SARS Practice Note 2 "Income Tax: Determination of taxable income where financial assistance has been granted by a non-resident of the Republic to a resident of the Republic" dated 14 May 1996 (hereinafter referred to as Practice Note 2) no longer finding application in respect of thin capitalisation. SARS Practice Note 7 "Section 31 of the Income Tax Act, 1962: Determination of the taxable income of certain persons from international transactions: Transfer Pricing" dated 6 August 1999 (hereinafter referred to as Practice Note 7), previously provided guidance on the application of transfer pricing legislation in terms of section 31. However, due to the significant changes to legislation, it is submitted that the guidelines outlined in Practice Note 7 (SARS, 1999) are to a large extent, no longer applicable and accordingly, are not discussed further.

However, it is important to note that in relation to thin capitalisation, Practice Note 2 (SARS, 1996) previously provided companies with a safe harbour, as the provisions of section 31(3) were not applied where the financial assistance to fixed capital ratio did not exceed three to one. Practice Note 2 (SARS, 1996) therefore previously determined the excessive portion of financial assistance to be the portion that exceeded an amount equal to three times the fixed capital of the resident or recipient of the financial assistance (De Koker *et al.*, 2010: §10.14). This provided taxpayers with an assurance that if the financial assistance to fixed capital ratio was maintained at three to one, the SARS would not seek to apply the provisions of section 31(3). This safe harbour is no longer available to taxpayers and the amendments to section 31 mean that the general arm's length provisions will be used to determine whether a company is considered to be thinly capitalised (Haupt, 2014: 597).

Section 31(5) of the Income Tax Act provides that section 31 does not apply in the following instances:

- where a non-resident grants financial assistance to a headquarter company, to the extent that such financial assistance is directly applied as financial assistance to any foreign company in which the headquarter company holds at least ten per cent of the equity shares and voting rights, either directly or indirectly;
- if financial assistance is granted by a headquarter company to a foreign company in which it holds ten per cent or more of the equity shares and voting rights, either directly or indirectly, either alone or together with other companies which form part of the same group of companies of that headquarter company;
- where a non-resident grants the use of intellectual property to the headquarter company, section 31 will not apply to the royalty paid by the headquarter company, to the extent that the headquarter company gives the use of such intellectual property to a foreign company in which the headquarter company holds at least ten per cent of the equity shares and voting rights, either directly or indirectly (either alone or together with other companies which form part of the same group of companies of that headquarter company) and the headquarter company does not use the intellectual property for any other purpose; and
- the royalty paid by the foreign company (referred to above) to the headquarter company is also not subject to the provisions of section 31.

(Haupt, 2014: 600)

For years of assessment commencing on or after 1 January 2013, section 31(6) provides that section 31 will not apply in relation to the provision of financial assistance by a resident to a controlled foreign company if:

- the resident (alone or together with any other company forming part of the same group of companies as that resident) owns at least ten per cent of the

equity shares and voting rights in that controlled foreign company (however, this exemption has been deleted with effect from 1 April 2014);

- the controlled foreign company has a foreign business establishment as defined in section 9D (1); and
- the aggregate amount of tax payable to all spheres of government of any country other than the Republic by that controlled foreign company in respect of any foreign tax year of that controlled foreign company during which that transaction, operation, scheme, agreement or understanding exists is at least seventy-five per cent of the amount of normal tax that would have been payable in respect of any taxable income of that controlled foreign company had that controlled foreign company been a resident for that foreign tax year.

(Haupt, 2014: 600)

3.5. DOUBLE TAX AGREEMENTS

3.5.1. BACKGROUND

The change from a source basis of taxation to a residence basis, as well as the increase in cross-border transactions, gave rise to the problem of international double taxation. According to Haupt (2014: 631), the definition of international double taxation is generally the imposition of comparable taxes in two or more tax jurisdictions, on the same taxpayer, in respect of the same income.

Double tax in two countries may arise in the following circumstances Haupt (2014: 632):

- if one country levies tax on a source basis while the second country levies tax on a residence basis, and the source of income is in one country while the recipient of the income is a resident in the other country;
- if both countries levy tax on a residence basis but have different definitions of residence, as a result of which one person is considered to be resident in both countries;

- if both countries levy tax on a source basis but have different definitions of source; or
- if both countries tax on a residence basis for residents and a source basis for non-residents – Haupt (2014) submits that this is one of the most common causes of double taxation.

In order to address the problem of double taxation, double tax agreements were entered into between countries. According to Haupt (2014: 632), the main purpose of a double tax agreement is to resolve conflicts arising from source and residence; to determine the taxing rights between countries; and to set maximum levels of tax in situations where double tax is permitted. The provisions which authorise the conclusion of double tax agreements are found in section 108 of the Income Tax Act, which refers to the "prevention, mitigation or discontinuance of the levying, under the laws of the Republic and of such other country, of tax in respect of the same income, profits or gains, or tax imposed in respect of the same donation, or to the rendering of reciprocal assistance in the administration of and the collection of taxes under the said laws of the Republic and of such other country".

According to De Koker *et al.* (2010: §13.1), there are several issues which have not been addressed in double tax agreements concluded with a number of countries. This presents a greater risk when such agreements are with tax haven countries or countries with more favourable tax legislation. De Koker *et al.* (2010: §13.1) further submit that the double tax agreements of South Africa are old and contain a number of omissions and anomalies which could result in a loss to the South African fiscus. The following issues are considered to be part of the weaknesses of South Africa's current double tax agreements:

- Intricate financial arrangements – the definition of interest contained in South Africa's double tax agreements is not as wide as the definition contained in section 24J of the Income Tax Act. Furthermore, there are financial instruments which have not been covered by double tax agreements, as a result of which associated profits are either dealt with as business profits or other income. Therefore, as a source state, South Africa may not be able to

levy taxes on such income to the extent that the income is not linked to a permanent establishment in the Republic.

- Electronic commerce (hereinafter referred to as e-commerce) – many of South Africa's double tax agreements do not make reference to e-commerce, which is considered a significant omission considering the growth in the digital economy over the years. This can result in the failure to consider whether an entity is considered to have a permanent establishment in a country, thereby allowing for such entities to escape taxation in that country.

(De Koker *et al.*, 2010: §13.1)

It is submitted that a number of South Africa's double tax agreements, like the Income Tax Act, have failed to keep up with the pace of globalisation. It is further submitted that many double tax agreements have not kept pace with changes to the Income Tax legislation. However, certain agreements have recently been renegotiated. On 17 May 2013, South Africa and Mauritius signed a new double tax agreement. The original treaty, like many other double tax agreements, was signed at a time when South Africa had a source basis of taxation and no capital gains tax. The renegotiated agreement seeks to address the issues of dual residence for persons other than individuals, withholding taxes and capital gains (Bouwer: Online). This is indicative that the South African tax authorities are aware of the shortcomings of current agreements, and may seek to correct these weaknesses by renegotiating a number of other double tax agreements.

In considering double tax agreements in the context of base erosion and profit shifting, it is necessary to consider the concepts of "treaty shopping" and "permanent establishment".

3.5.2. TREATY SHOPPING

Treaty shopping is defined as follows:

> The practice of structuring a multinational business to take advantage of more favourable tax treaties available in certain jurisdictions. A business that resides in a home country that doesn't have a tax treaty with the source

> country from which it receives income can establish an operation in a second source country that does have a favourable tax treaty in order to minimize its tax liability with the home country...

(BusinessDictionary: Online)

The terms “treaty shopping” and “treaty abuse” may be used interchangeably and this problem has been identified by the OECD as being one of the most important sources of base erosion and profit shifting concerns (OECD, 2014a: 2).

Treaty abuse can often lead to the instance of double non-taxation, which means that items of income may go untaxed in any tax jurisdiction. This is explored in further detail in Chapter Four of this thesis. It is submitted that this was not the intended effect of double tax agreements, and such occurrences indicate that gaps in treaty provisions may exist, which need to be addressed.

3.5.3. PERMANENT ESTABLISHMENT

The term “permanent establishment” has been defined in section 1 of the Income Tax Act as follows:

> ...a permanent establishment as defined from time to time in Article 5 of the Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development...

According to De Koker *et al.* (2010: §18.1), the purpose of this concept is to outline the scope of the activities which an enterprise of the residence state must conduct in the source state, before the profits arising from its activities may be subject to tax in the source state.

The concept of permanent establishment is outlined in Article 5 of the OECD Model Tax Convention, which is to be considered in conjunction with Article 7 which provides that the profits of an enterprise may not be subject to tax in the source state unless profits were derived through a permanent establishment situated in the source state. The OECD (2012c: 1) defines the term permanent establishment as “a

fixed place of business, through which the business of an enterprise is wholly or partly carried on". Therefore, the following conditions are contained in the definition:

- the existence of a place of business;
- such place of business must be fixed (established at a distinct place with a certain degree of permanence); and
- the business of the enterprise must be carried on through this fixed place of business.

In relation to permanent establishment, the concept of "carrying on of business" is important and is an issue that has been considered by the courts in the context of the Income Tax Act. In *Estate G v COT* (1964) 26 SATC 168, the following was stated:

> The sensible approach…is to look at the activities concerned as a whole, and then to ask the question: Are these the sort of activities which, in commercial life, would be regarded as "carrying on business"? The principal features of the activities which might be examined in order to determine this are their nature, their scope and magnitude, their object (whether to make a profit or not), the continuity of the activities concerned, if the acquisition of property is involved, the intention with which the property was acquired. The list of features does not purport to be exhaustive, nor are any one of these features necessarily decisive, nor is it possible to generalize and state which feature should carry most weight in determining the problem. Each case must depend on its own particular circumstances.

(De Koker *et al.*, 2010: §18.2)

According to the OECD, the business of an enterprise is carried on mainly by the entrepreneur or persons in a paid-employment relationship with the enterprise, including employees and other persons acting on instructions from the enterprise. Whether or not such person has the authority to conclude contracts on behalf of the enterprise is not relevant if the person works at a fixed place, representing the enterprise (OECD, 2012c: 8).

The OECD has provided further clarification in respect of permanent establishment in the context of e-commerce. In summary, an internet website, which is considered to be a combination of software and electronic data, does not constitute tangible property and therefore does not have a location that can be regarded as a “place of business”. However, the server on which the website is stored and through which it is accessible, is a piece of equipment which does have a physical location. Such location may be regarded as a “fixed place of business” of the enterprise which operates the server (OECD, 2012c: 24).

The OECD (2012c: 25-26) outlines other guidelines to be considered in determining whether a permanent establishment exists, including whether the server is located at a fixed place for a sufficient period, whether the business of the enterprise is wholly or partly carried on through the server, whether the equipment could function without the involvement of personnel or whether the activities performed via the server are of a preparatory or auxiliary nature (for example, advertising).

3.6. CONCLUSION

The concepts discussed in this chapter assisted in creating a basic understanding of the provisions of the Income Tax Act that govern international transactions. This is considered to be important as multinational corporations operate across international borders and accordingly, are governed by these provisions.

It is evident from the definitions and discussions in this chapter, that terms such as “place of effective management”, “foreign business establishment” and “permanent establishment” are common to a number of the provisions in the Income Tax Act which govern the treatment of international transactions.

The legislative provisions discussed in this chapter are often complex and lengthy, and have only been discussed in as much detail as was considered necessary. Furthermore, any gaps that are evident in the current legislation have been pointed out and are expanded on in later chapters of this thesis.

As stated previously, this chapter, together with the preceding chapter aimed to provide a sufficient background understanding against which to consider the base erosion and profit shifting schemes employed by multinational corporations. The next chapter reviews the schemes employed by multinational companies to reduce their respective tax burdens – and the associated weaknesses that the schemes reveal in the provisions of the Income Tax Act that address international tax consequences.

CHAPTER 4: TAX REDUCTION SCHEMES EMPLOYED BY MULTINATIONAL COMPANIES

4.1. INTRODUCTION

According to the World Trade Organisation (Online), multinational corporations account for approximately seventy per cent of worldwide trade. This means that a significant amount of income that crosses international borders does so within the same multinational corporation. This highlights the extent to which income may be shifted in order to achieve overall tax benefits within the group.

This chapter presents a limited review of schemes employed by multinational companies to reduce their respective tax burdens – and the associated weaknesses that such schemes reveal in the provisions of the Income Tax Act which govern international transactions. Where information is available, the estimated tax revenue that has been lost in certain jurisdictions due to these schemes is provided. Other strategies that can be used by multinational companies to shift profits are also discussed insofar as they are not included in the case studies conducted. The nature and operation of the schemes discussed are public knowledge, therefore no confidentiality considerations arise.

This chapter therefore addresses the third goal of the research: to study the tax structures adopted by well-known multinational companies and where available, provide estimates of the losses in tax revenue suffered as a result of profit shifting schemes by these companies. Furthermore, the main goal of the research is also addressed: to determine the weaknesses within South Africa's current tax legislation uncovered by the tax schemes used by multinational companies in order to shift profits.

The multinational companies selected for further study are as follows:

- Apple Inc.;
- Google;
- Starbucks; and

- SABMiller.

Since many of the strategies used by these companies incorporate some of the characteristics of a scheme known as the “double Irish arrangement” and the extension of this scheme, known as the “Dutch sandwich”, it is necessary to first explain the components of these schemes before considering how they are used in respect of the multinational companies selected for further study.

4.2. THE “DOUBLE IRISH ARRANGEMENT”

In the late 1980s, Apple Inc. was among the pioneers of a scheme known as the “double Irish arrangement”, which is one of many tax avoidance strategies used by multinational corporations. This scheme uses payments between related entities in a corporate structure to shift income from high-tax jurisdictions to low-tax jurisdictions.

In order to clarify the details of this scheme, it is explained in the context of a multinational company’s tax avoidance in the United States of America (hereinafter referred to as the USA or the US). The scheme relies on the fact that Ireland’s tax laws do not include US transfer pricing rules. Irish tax legislation uses a “territorial” basis, and therefore does not levy taxes on income of subsidiaries of Irish companies that are outside the state. Typically, this arrangement allows for a company to arrange that the rights to exploit intellectual property outside the US, are owned by an offshore company. This is normally achieved through a cost-sharing agreement between the parent company in the US and the offshore company, in terms of which the offshore company is able to receive all profits from the exploitation of the intellectual property rights outside the parent company’s resident country, without paying taxes on these profits in the US until they are remitted to the parent company (Darby & Lemaster, 2007: 13).

The scheme is known as the “double Irish arrangement” as it requires two Irish companies in order to complete the structure. In order for the scheme to achieve the purpose of tax avoidance, one of these companies needs to be a tax resident of a “tax haven”, a concept which was discussed in Chapter Two of this thesis. Irish tax law provides that a company’s residency is established with reference to where its

central management and control is located, and not where such company is incorporated. This makes it possible for one of the two Irish companies in the arrangement not to be considered a tax resident of Ireland. The company resident in the tax haven country owns the international rights over the intellectual property, which is then licensed to the second company (an Irish tax resident), in return for substantial royalties or other fees. The Irish-resident company receives income from the use of the asset in international countries, but taxable income is low due to the deductibility of the substantial royalty or fee paid to the company which is a resident of the tax haven. The remaining profits of the Irish resident are taxed at a rate of twelve and a half per cent, in accordance with Ireland's corporate tax rate (Darby & Lemaster, 2007: 13).

In order for the scheme to avoid taxes in the US, it is important to ensure that the offshore companies are not subject to the controlled foreign company regulations of the US tax legislation. This is achieved by ensuring that the second Irish company is a fully-owned subsidiary of the first Irish company which is resident in the tax haven country, and then making an entity classification election for the second company to be disregarded as a separate entity from its owner, as allowed by US tax legislation. This is commonly known in the US as the "check-the-box" regime. The payments between the two Irish companies are therefore ignored for US tax purposes (Darby & Lemaster, 2007: 13).

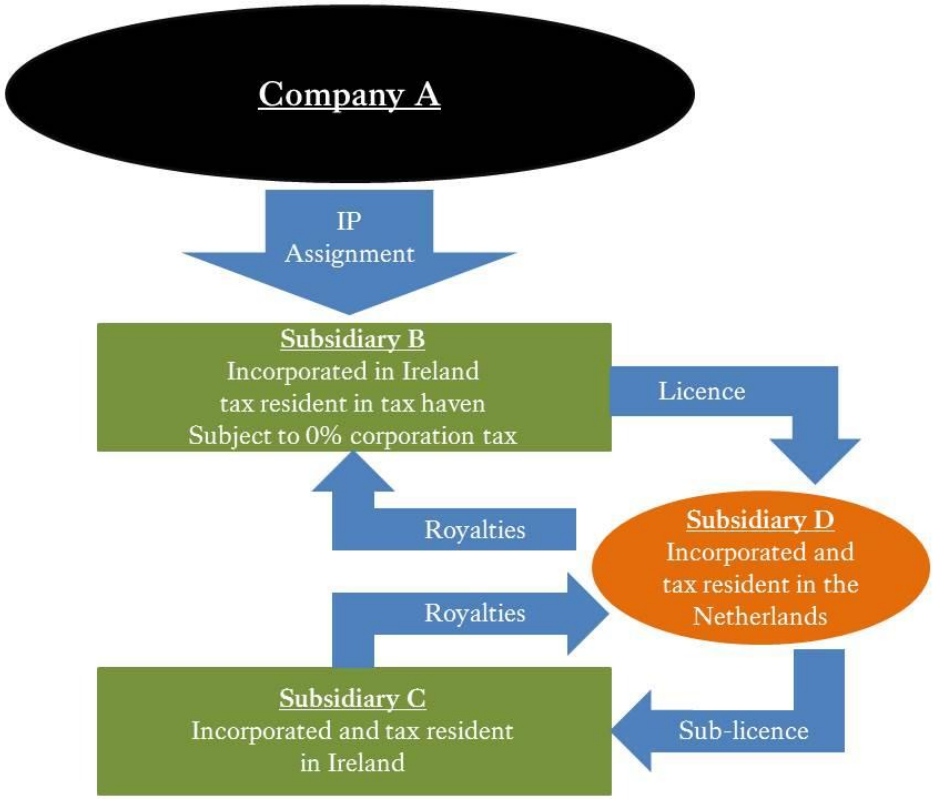
It is submitted that, for the purpose of this discussion (and the one that follows), the specific tax provisions in US and Irish legislation are not relevant as its purpose is simply to describe the nature of the scheme.

4.3. THE "DUTCH SANDWICH"

The "Dutch sandwich" is an extension of the "double Irish arrangement", and consists of the establishment of a company in the Netherlands, interposed between the two Irish companies. This scheme is commonly known as the "double Irish with a Dutch sandwich". Under the "double Irish arrangement", the second Irish company (resident in Ireland for tax purposes) would pay a royalty to the first company (resident in the tax haven country). Normally, this would result in withholding tax

being payable on the royalty. By introducing a Dutch conduit company through which the royalty is routed to the tax haven resident company, multinational corporations are able to avoid the withholding tax levy, as royalties paid from Ireland to the Netherlands are tax-free under the European Union Interest and Royalty Directive, and the Netherlands does not impose withholding tax on any royalty payments, regardless of the residence state of the company receiving the royalty (Fuest, Spengel, Finke, Heckemeyer & Nusser, 2013: 5).

The Dutch company collects royalties from the second Irish company and the Irish company is able to claim a tax deduction for this payment, thereby further reducing its tax liability in Ireland. The Dutch company then pays the money to the first Irish company, which is a resident of a tax haven country and therefore not liable for tax in Ireland. Due to the introduction of the Dutch conduit company, withholding tax is completely avoided (Fuest *et al.*, 2013: 5). The following is an illustration of the "double Irish with a Dutch sandwich" scheme:



Source: IP finance, 2013: Online

Although pioneered by Apple Inc., the “double Irish with a Dutch sandwich” is a strategy employed by various other multinational corporations such as Google (Haden, 2012: Online). Furthermore, a recent report published by the US Senate Permanent Subcommittee on Investigations has detailed a tax avoidance strategy used by Apple Inc. which reveals a simpler structure than that of the “double Irish with a Dutch sandwich” (Ting, 2014: 40). This is discussed in further detail below.

4.4. APPLE INCORPORATED

4.4.1. BACKGROUND

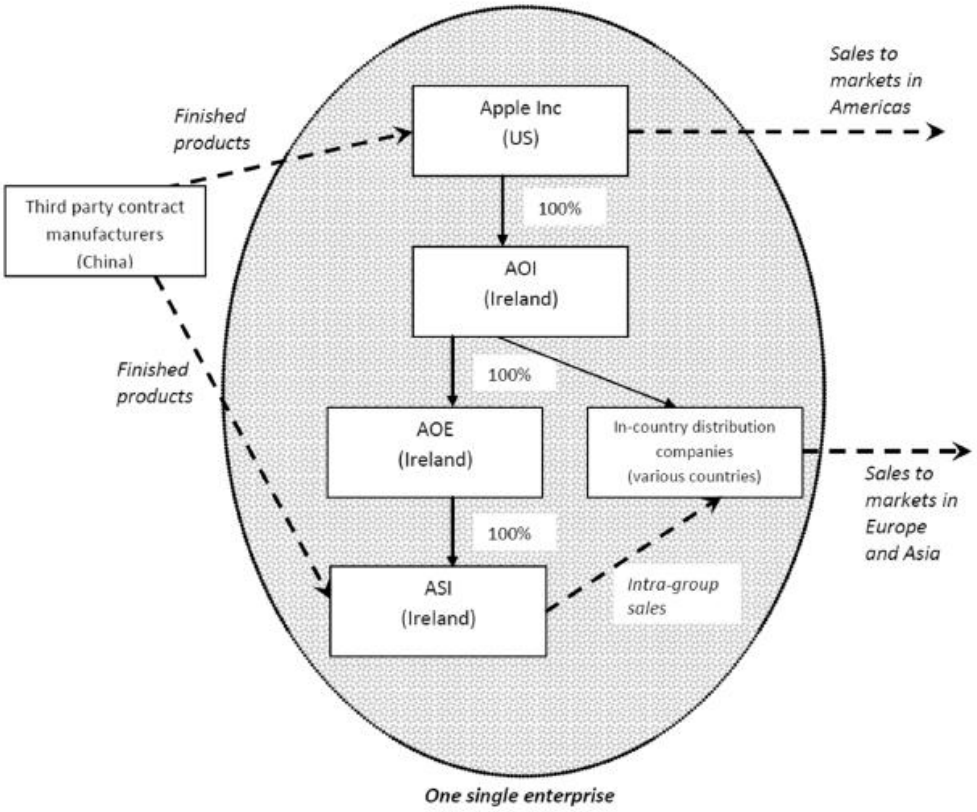
Apple Inc. is a multinational company, incorporated on 3 January 1977, which designs, manufactures and markets mobile devices, personal computers and music players and also sells related software, services, peripherals, networking solutions and third-party digital content and applications (Reuters: Online).

Since 2012, Apple Inc. has been ranked as the largest publicly traded corporation in the world by market capitalisation, and has maintained this position as of 31 March 2014 (Financial Times, 2014: Online). Apple Inc. is one of the many companies operating in the global business environment, and is one of the major providers of the “digital product”, which means that the company supplies products or services through the internet. This allows for the company to operate across various countries, without having a physical presence in these countries.

4.4.2. SCHEMES USED BY APPLE INC.

4.4.2.1. INTERNATIONAL STRUCTURE OF APPLE INC. FOR TAX PURPOSES

According to Ting (2014: 42), shortly before its listing on the New York Stock Exchange, Apple Inc. established three wholly-owned subsidiaries in Ireland – Apple Operations International (hereinafter referred to as AOI), Apple Operations Europe (hereinafter referred to as AOE) and Apple Sales International hereinafter referred to as ASI). The structure is outlined in the diagram below:



Source: Ting, 2014: 43

AOI is incorporated in Ireland, but has its central management and control in the US. It is essentially a "shell" company with no employees. In terms of Irish tax legislation, since the company is centrally managed and controlled outside Ireland, it is not regarded as a resident of Ireland. AOI is also not regarded as a resident of the US, as US tax law defines the residence of a company solely in terms of the place of incorporation (Ting, 2014: 44).

ASI is also incorporated in Ireland but on the same basis as AOI, it is not regarded as a tax resident in either Ireland or the US. The company had no employees until 2012, when 250 employees were assigned to it from its parent company, AOE. ASI engages with unrelated manufacturers in China to assemble products and sells the finished products to distribution subsidiaries in Europe and Asia. In most instances, the products do not physically transit through Ireland. ASI and the ultimate parent company, Apple Inc., are parties to a cost-sharing agreement, in terms of which ASI has the economic rights to Apple's intellectual property outside the US, while the

legal ownership of the intellectual property always remains with Apple Inc. in the US (Ting, 2014: 44). In terms of the cost-sharing agreement, ASI is obliged to pay Apple Inc. a percentage of the group's research and development costs, in proportion to the percentage of Apple's worldwide sales outside the USA.

Ting (2014: 45) submits that a review of the amounts of costs shared under the cost-sharing agreement does not appear to make commercial sense, as ASI derived significant amounts of income, which were disproportionally high in comparison to the cost-sharing payments. This has effectively resulted in a large portion of profits remaining in ASI, which as stated previously, is not considered to be a tax resident in either Ireland or the US.

According to Ting (2014: 45), Apple's tax structure is in full compliance with the tax laws of the countries involved, but the location of the profits does not reflect the location of the economic activities, such as sales and research and development. Furthermore, the profits allocated to the Irish companies are not taxable in the US, and also not taxable in the source countries where the Apple products were sold. This reflects how Apple Inc. was able to achieve double non-taxation of a large proportion of its worldwide profits.

4.4.3. ESTIMATED LOSS IN TAX REVENUE FROM APPLE INC

According to the information supplied by Apple Inc. to the US Senate Permanent Subcommittee on Investigations, in 2011, tax amounting to $3.5 billion was avoided on foreign-based sales income of $10 billion, while in 2012 $9 billion of tax was avoided on $25 billion of foreign-based sales income. Therefore, over two years, Apple Inc. was able to avoid taxes amounting to $12.5 billion (Hickey, 2013: Online).

4.5. GOOGLE

4.5.1. BACKGROUND

Google's main office is located in the USA, in the state of California. The company was incorporated in California in September 1998, and re-incorporated in Delaware

in August 2003 (Google Inc., 2013: 3). Google's revenue is earned mainly through advertising. People or companies contract with Google to have their advertisements shown to people who may be interested in the service or product offered. Google earns the advertising revenue only if the advertisement link is clicked on, therefore it is important that the advertisements are targeted at the correct audience. This is achieved through Google Analytics, which sends data to Google whenever a person visits a website. Based on this information, and other data at their disposal, Google creates a profile of a person, which provides an indication of which advertisements should be shown to that user (Google Inc., 2013: 4-5).

According to Google's consolidated income statement for the year ended 31 December 2013, approximately ninety-one per cent of the company's revenue was derived from advertising (Google Inc., 2013: 28).

4.5.2. SCHEMES USED BY GOOGLE

4.5.2.1. THE "DOUBLE IRISH WITH A DUTCH SANDWICH"

The general outline of this scheme has been discussed. Therefore, the application of the scheme in relation to Google is discussed further:

- Google licenses the rights to its intellectual property to a company called Google Irish Holdings, a company which is headquartered in Bermuda (a tax-free state).
- Google Irish Holdings owns a subsidiary called Google Ireland Limited, a company located in Dublin that sells advertising.
- Google Ireland Limited earns billions in revenue and is subject to tax at a rate of twelve and a half per cent in accordance with Irish corporate tax legislation. However, most of these earnings are sent back (in the form of royalties) to Google Irish Holdings, which is not considered to be a resident in Ireland and therefore not liable for tax in this country, other than on income from a source within Ireland.

- Payments from Google Ireland Limited are routed through Google Netherlands Holdings, an Amsterdam-based company with no employees. Therefore, no withholding tax is levied by Ireland on the royalty payment to the Dutch company, due to the European Union Interest and Royalty Directive. Furthermore, the Netherlands does not impose withholding tax on any royalty payments.

(Haden, 2012: Online)

By making use of the scheme, Google is able to ensure that a significant portion of its profits are routed to low- or no-tax jurisdictions, and the company is able to reduce its tax burden significantly.

4.5.3. ESTIMATED LOSS IN TAX REVENUE FROM GOOGLE

According to Haden (2012: Online), by adopting the tax avoidance strategy discussed, Google is able to save approximately $1 billion in taxes every year. However, it is important to note that this is merely an estimate and, to date, no formal estimates have been released by any tax authorities.

4.6. STARBUCKS

4.6.1. BACKGROUND

Starbucks is a global coffee company, based in Washington, USA and was incorporated in 1985. The first Starbucks opened in 1971 and since then the company has significantly expanded. As at 30 March 2014, the company operated a total of 20,519 stores across sixty-five countries (Starbucks, 2014: Online).

It is evident that Starbucks has an expansive global presence. Currently, South Africa does not yet house a Starbucks store. However, in 2010, Southern Sun Hotel South Africa announced that an agreement has been signed with Starbucks, enabling them to brew Starbucks coffees in selected Southern Sun and Tsogo Sun Hotels and Casinos in South Africa (Tsogo Sun, 2010: Online).

Starbucks has recently been the subject of media criticism in the UK with respect to the company's tax avoidance (Bergin, 2012: Online).

4.6.2. SCHEMES USED BY STARBUCKS

4.6.2.1. ROYALTIES ON INTELLECTUAL PROPERTY

Similar to the schemes used by Apple Inc. and Google, Starbucks houses its intellectual property in a tax haven or low-tax jurisdiction, and charges companies within the group a royalty fee for use of the intellectual property. In the case of Starbucks, a royalty at a rate of six per cent is payable to the Amsterdam-based company, Starbucks Coffee EMEA BV (Bergin, 2012: Online). This enables the multinational corporation to shift its profits from higher-tax jurisdictions to the Netherlands, where it is alleged that a lower tax rate has been agreed with the Dutch government (UKUncut: Online).

4.6.2.2. THE PROCUREMENT OF COFFEE BEANS FROM SWITZERLAND

Starbucks allegedly buys coffee beans for the UK through a Switzerland-based company, Starbucks Coffee Trading Co. The beans are then roasted at a subsidiary based in Amsterdam. According to the Chief Financial Officer of Starbucks, the tax authorities in the Netherlands and Switzerland require Starbucks to allocate some profits from its UK sales to the Dutch roasting and Swiss procurement companies. The basis of this allocation is unknown (Bergin, 2012: Online). It is submitted that this arrangement allows Starbucks to further shift profits from the UK to lower tax jurisdictions, thereby reducing its tax burden in the UK.

4.6.2.3. INTER-COMPANY LOANS

According to Bergin (2012: Online), Starbucks UK is entirely funded by debt, on which the interest rates are seen to be significantly high. This enables the company to shift profits by claiming a deduction for interest in higher-tax jurisdictions. The allegation that Starbucks UK is entirely funded by debt is indicative that the company is considered to be "thinly capitalised".

4.6.3. ESTIMATED LOSS IN TAX REVENUE FROM STARBUCKS

To date, no formal quantification process has been undertaken to determine the estimated loss in tax revenue from Starbucks.

4.7. SABMiller

4.7.1. BACKGROUND

SABMiller currently produces beers in over eighty countries. The company originated in Johannesburg, South Africa and was founded in 1895. Two years later, it became the first industrial company to list on the Johannesburg Stock Exchange (hereinafter referred to as the JSE). In 1898, the company listed on the London Stock Exchange. From the early 1900s, the company began expanding globally and made several acquisitions in emerging and developed markets. In 1999, it formed a new holding company based in the UK, and moved its primary listing to London. In 2002, Miller Brewing was acquired, and SABMiller Plc. was formed (SABMiller: Online).

4.7.2. SCHEMES USED BY SABMiller

4.7.2.1. THE USE OF A DUTCH COMPANY AS THE TRADEMARK HOLDER

According to a report published by ActionAid (2010: 8), SABMiller is able to avoid taxes through the utilisation of a company in the Netherlands. SABMiller International BV, a Rotterdam-based company, owns African brands such as Castle, Stone and Chibuku, and takes advantage of special tax rules offered by the Netherlands that enables companies to pay little or no taxes on royalties earned. In owning these brands, the company in the Netherlands earns substantial royalties from the companies in Africa, where these products are brewed and consumed. The latest Annual Report published by SABMiller Plc. (2014: 159) reflects SABMiller International BV's principal activity as "Trademark owner". Therefore it appears that the strategy identified by ActionAid is currently still being used by SABMiller.

In using the Dutch company in this manner, the companies in Africa are able to claim a substantial tax deduction for the royalties paid, while the royalties earned by the Dutch company are subject to little or no tax. Furthermore, ActionAid (2010: 23) submits that an additional motivation behind this scheme is that Dutch tax law allows for the cost of acquired trademarks to be amortised over a number of years. ActionAid (2010: 23) further concluded from its review, that in the 2009/2010 financial year, a tax reduction of £12.6 million in respect of this amortisation was claimed against an income tax liability of £12.4 million in SABMiller International BV, resulting in no taxes being paid by the Dutch company except for withholding taxes of £2.7 million.

4.7.2.2. SERVICE FEES PAID TO COMPANIES IN EUROPEAN "TAX HAVENS"

According to the ActionAid (2010: 8), the second scheme used by SABMiller to reduce their tax burden, is for the company's African and Indian subsidiaries to pay significant management service fees to companies in European "tax havens" such as Switzerland. Using this strategy, SABMiller is able to reduce the taxable income of companies paying this fee by claiming a tax deduction in respect of the management service fee. By routing these fees to "tax haven" countries, little or no taxes would be levied on the receipt of this income, thereby significantly reducing SABMiller's overall tax burden.

4.7.2.3. THE PROCUREMENT OF GOODS FROM MAURITIUS

ActionAid (2010: 9) has identified that goods are procured by Accra Brewery Ltd (a brewing company in Ghana), from MUBEX, which is a Mauritian subsidiary of SABMiller Plc. MUBEX makes a profit on this transaction. Favourable tax rates in Mauritius (a maximum rate of three per cent for global business companies) therefore ensures that the profit made by MUBEX is taxed at a lower rate as compared to a higher tax jurisdiction, while the expense claimed as a deduction in Accra Brewery Ltd lowers its taxable income which would be subject to tax at a rate of twenty-five per cent in Ghana.

4.7.2.4. THIN CAPITALISATION

ActionAid (2010: 9) has further identified that Accra Brewery Ltd has borrowed a substantial amount of money from the Mauritian incorporated MUBEX, and claims that the loan is more than seven times Accra Brewery Ltd's capital. This means that Accra Brewery Ltd is considered to be "thinly capitalised". The company is therefore able to claim a deduction of interest in respect of this loan. ActionAid (2010: 28) claims that the full interest cost appears to have been claimed by Accra Brewery Ltd, despite Ghanaian tax law which specifies a maximum debt-equity ratio, in terms of which any interest costs incurred above the maximum ratio may not be deducted from taxable profits.

4.7.3. ESTIMATED LOSS IN TAX REVENUE FROM SABMiller

ActionAid (2010: 8) estimates that developing countries have lost a total of approximately £20 million in 2010 due to the schemes employed by SABMiller to reduce its tax burden. However, it is submitted that this estimate is based on the information at the disposal of ActionAid, and may not be accurate. In estimating this figure, ActionAid reviewed the accounts of eight SABMiller subsidiary companies in Ghana, Mozambique, Tanzania, South Africa, Zambia and India.

No quantification of the losses in tax revenue has been formally published by any of the revenue authorities in these countries.

4.8. WEAKNESSES IN TAX LEGISLATION REVEALED BY THESE SCHEMES

The schemes discussed exploit weaknesses in tax legislation. These weaknesses are discussed below and a comparison to the equivalent provisions in the Income Tax Act of South Africa is made in order to identify similar gaps or reveal other potential gaps in South African tax legislation.

4.8.1. ARBITRAGE BETWEEN CORPORATE RESIDENCE DEFINITIONS

As discussed, Ireland's definition of residence in relation to corporate entities is in terms of central management and control. The US definition of corporate tax residence is in terms of place of incorporation. A company incorporated in Ireland but centrally managed and controlled in the US, would therefore not be resident of either country. The Irish company would be liable for taxation in Ireland only on income sourced in the country, under the source basis of taxation. Any income sourced outside Ireland would not be subject to Irish taxes due to the non-residence of the company. It is evident that schemes such as the "double Irish arrangement" exploit the differences in the definitions of corporate residence between the two countries, as well as the source basis of taxation. As a result, the benefit of double non-taxation is enjoyed by Apple Inc. on a large portion of its income (Ting, 2014: 46). The same applies to other multinational corporations using the same or similar schemes in order to shift profits.

In comparing these aspects of US tax legislation with that of South Africa's, it is evident that the South African definition of residence in relation to corporate entities is wider than that of the US, as the definition includes entities "incorporated, established or formed" in South Africa, as well as those whose "place of effective management" is in South Africa. However, as pointed out previously, the lack of formal definitions of the above terms, as well as the criticisms of Interpretation Note 6 (SARS, 2002) indicates a potential gap which can be exploited by multinational companies.

Furthermore, the lack of a formal definition of "source" can also be seen to be a gap within income tax legislation. In order to prevent the non-taxation of non-resident multinational companies on income from sources within South Africa, it is submitted that the term should be clearly defined, especially in relation to the digital economy. In instances where a double tax treaty exists with the company's resident country, the concept of "permanent establishment" would be considered more important. This is discussed in further detail later in this chapter.

4.8.2. TRANSFER PRICING RULES ON INTANGIBLES

According to Ting (2014: 47), a key component of Apple Inc.'s scheme is the transfer of the economic rights of the company's intellectual property to ASI under the cost-sharing agreement. As a result of the intra-group contract entered into, ASI owns the production and marketing rights of Apple Inc.'s products for Europe and Asia. Furthermore, ASI does not pay royalties to Apple Inc. due to the split economic ownership of the intangible assets. The cost-sharing regime was introduced in the US in the early 1990s, under which a US parent company may enter into an agreement with a foreign subsidiary to share the research and development costs of developing the intellectual property. Based on the percentage of cost-sharing agreed upon, the foreign subsidiary is entitled to a percentage of the profits earned from the intangible asset, even if the research and development activities take place wholly in the US.

It is submitted that the use of these provisions in the US tax legislation by multinational corporations in order to shift profits and avoid taxes is indicative of the presence of a tax loophole.

The OECD has recognised that the regulations on transfer pricing on intangibles is an area of weakness, and it has been identified as part of the OECD's Action Plan on Base Erosion and Profit Shifting (2013a: 20). This will be discussed in further detail in Chapter Five of this thesis.

It is important to note that South African tax legislation currently contains an anti-avoidance provision with respect to intellectual property in terms of section 23I of the Income Tax Act. The effect of section 23I is to prohibit the deduction of royalties paid in respect of intellectual property which was created in South Africa, then sold to a non-resident, and then licensed back to the South African company which created the intellectual property. Such an arrangement would render the intellectual property as "tainted intellectual property", which a defined term. A classification as "tainted intellectual property" would render any expenditure incurred for the use or right of use of or permission to use tainted intellectual property, non-deductible for tax purposes, to the extent that it does not constitute income to a South African resident

or does not constitute part of the imputed income of a controlled foreign company in terms of section 9D of the Income Tax Act (Integritax, 2012: Online). However, where such expenditure is subject to withholding tax of at least ten per cent in South Africa, allowances are made in terms of section 23I(3), which provides that one-third of such expenditure is allowed as a deduction if the withholding tax is payable at a rate of ten per cent, while one half of the expenditure is allowed as a deduction if withholding tax is payable at a rate of fifteen per cent.

It is submitted that by introducing such an anti-avoidance provision, South Africa would be in a stronger position to prevent the shift of profits in respect of intellectual property, than countries which do not contain such provisions in tax legislation. However, cost-sharing arrangements are currently accepted in South Africa, as the country follows Chapter VIII of the OECD Guidelines. Multinationals in South Africa may therefore make use of cost-sharing arrangements to shift profits out of the country. However, payments made by a South African company may be subject to exchange control approval (Deloitte, 2014: 179).

4.8.3. TRANSFER PRICING RULES ON INTER-COMPANY CHARGES

A number of the schemes discussed comprise of payments between group companies, which are generally considered to be excessive, with the intention behind the scheme being to shift profits from a high tax jurisdiction to a low tax jurisdiction or tax haven. According to Sikka & Willmott (2010: 9), globalisation has created new complexities with respect to transfer pricing, as corporations are able to easily establish subsidiaries, affiliates, joint ventures, special purpose entities and trusts in more favourable tax jurisdictions. Since the allocation of costs and overheads are considered to be subjective, companies have the discretion to allocate them to particular products, services or geographical locations, thereby allowing such companies the opportunity to minimise their tax burdens (Sikka & Willmott, 2010: 3).

It is submitted that the subjectivity involved in determining arm's length prices represents an additional problem for tax authorities, especially where the goods or services in question do not have comparable market prices and are not widely

traded. Transfer pricing can therefore be considered to be an area that is subject to a significant amount of abuse by multinational corporations. Companies often use inter-company charges such as management fees to shift profits between entities within the group.

The schemes used by Starbucks and SABMiller also reflect the use of inter-company transactions to shift profits – Starbucks allegedly procures coffee beans through a Swiss company, which are roasted at a subsidiary based in Amsterdam. Although the prices at which these transactions take place are not known, there is a possibility that these prices are not considered to be arm's length, as inflated prices would allow for Starbucks to reduce profits in the UK by shifting money to its subsidiary in Switzerland, where commodities such as coffee are taxed at five per cent (UKUncut: Online).

Similarly, SABMiller allegedly procures goods for its Ghanaian company from a company in Mauritius, a jurisdiction which levies tax at a maximum rate of three per cent for global business companies. Furthermore, the African and Indian group companies of SABMiller pay significant management fees to companies in Switzerland.

It is evident that the use of transfer pricing arrangements and non-arm's length prices enable multinational corporations to shift profits between tax jurisdictions in a manner that allows for the overall tax burden of the multinational company to be significantly reduced. South African transfer pricing legislation has recently been considerably revised in order to align with the OECD and international principles of taxation (PricewaterhouseCoopers, 2012). The amended provisions of section 31 of the Income Tax Act place a greater burden of proof on the taxpayer to demonstrate compliance with the arm's length principle. However, as stated in Chapter Three of this thesis, no guidelines have been released by the SARS regarding the implementation of this section. Therefore, it is submitted that due to the lack of clarity and guidance in this regard, this is an area of income tax legislation that may still be subject to abuse. Furthermore, the application of transfer pricing legislation and arm's length principles are complex and subjective, and require specialised skills within the SARS in order to ensure compliance with legislation. Due to the significant

changes to section 31 of the Income Tax Act, it is submitted that the SARS would have to ensure that the relevant staff are appropriately trained in order to review the application of transfer pricing regulations within multinational corporations.

4.8.4. CONTROLLED FOREIGN COMPANY RULES

The US controlled foreign company rules contain a provision known as “check-the-box” – which effectively allows taxpayers to elect the classification of an entity either as a corporation or a pass-through entity. In electing the classification as a pass-through entity, intra-group transactions are ignored (Ting, 2014: 51-52).

In relation to Apple Inc., Ting (2014: 52) illustrates how the “check-the-box” provision allows the company to use hybrid entities to avoid taxes. ASI sells products to other group distribution companies, which sell the products to customers in Europe and Asia. Using this structure, Apple Inc is able to shift a substantial portion of the profits made through sales in those countries, to ASI. Ordinarily, the profits in ASI would be subject to the controlled foreign company rules of US tax legislation. However, by “checking the box” for all subsidiaries of AOI, these subsidiaries are deemed to be part of AOI for US tax purposes. AOI is therefore regarded as having derived sales income directly from the end customers of ASI. Furthermore, the intra-group sales between ASI and the group distribution companies are effectively ignored (Ting, 2014: 52).

South African tax legislation does not contain an equivalent for the US “check-the-box” provision. However, it is submitted that should a multinational corporation in South Africa with a similar structure as Apple Inc.’s wish to avoid the controlled foreign company rules in the Republic, the use of “foreign business establishments” could be relied on. In a structure similar to Apple Inc., the multinational corporation would merely need to ensure that the companies incorporated in Ireland meet the definition of a “foreign business establishment” as outlined in section 9D of the Income Tax Act. Within a multinational structure, it is submitted that this would not be difficult, as the definition of “foreign business establishment” contained within section 9D, allows for the employees, equipment and facilities of other companies within the

group, located in the same country, to be taken into account in determining if there is a fixed place of business.

4.8.5. THIN CAPITALISATION RULES IN RESPECT OF INTER-COMPANY LOANS

The discussion of schemes employed by Starbucks and SABMiller revealed that companies within multinational groups are alleged to be thinly capitalised. This means that these companies make use of high levels of debt to claim a significant deduction for interest, thereby reducing taxable income in high tax jurisdictions. Generally, the loans are obtained from group companies located in low or no tax jurisdictions, allowing for the movement of profits to a company that would not be taxed on the corresponding interest income, or taxed at a lower rate (Buettner & Wamser, 2013: 63).

As discussed in Chapter Three of this thesis, thin capitalisation was previously dealt with in section 31(3) of the Income Tax Act, and Practice Note 2 (SARS, 1996) previously provided a safe harbour for companies. However, the amendments to section 31 have deleted the provisions of section 31(3) and rendered Practice Note 2 no longer applicable. The current provisions of section 31 now incorporate thin capitalisation rules into transfer pricing rules, with the effect that the arm's length principle must be applied to financial assistance as well. This means that in relation to South African companies, any interest paid on loans obtained from related parties will have to be shown to be computed at an arm's length basis. Any excessive interest charges will therefore be disallowed as a deduction. In addition, the draft Interpretation Note (SARS, 2013a: 7) clarifies that the arm's length principle applies to the amount of the debt as well. Taxpayers are therefore required to determine the amount of debt that could have been borrowed and would have been borrowed at arm's length from an independent party and assess what portion of the related expenditure may not be deductible in terms of section 31 (SARS, 2013a: 7). However, as mentioned previously, there are currently no finalised guidelines from the SARS in this regard. To date, the draft Interpretation Note (SARS, 2013a) outlines, *inter alia*, the factors to be considered in determining whether a company is thinly capitalised. The lack of finalised guidelines are submitted to be a weakness in

relation to South Africa's Income Tax Act, as without clarity on the application of the new provisions of section 31, it is possible that this section is more open to abuse by taxpayers.

4.8.6. DOUBLE TAX AGREEMENTS – TREATY SHOPPING

The scheme known as the "double Irish arrangement" is an example of an arrangement which reflects an element of "treaty shopping", a concept which was briefly discussed in Chapter Three of this thesis.

In order to successfully implement this scheme, a multinational company would have to ensure that the companies located in Ireland are not considered to be Irish residents for tax purposes. According to Thorne (2013: 8), an Irish company will not be treated as a tax resident even though it carries on trade in Ireland, if it is classified as a "relevant company". In order to obtain the classification as a "relevant company", it must be controlled by a European Union resident, or by a company residing in a country that has a double tax treaty with Ireland. In the case of Apple Inc. and Google, this classification is successful as Ireland and the US have a double tax agreement in force (Thorne, 2013: 9). This reveals how multinational corporations use the existence of double tax agreements for the ultimate purpose of tax avoidance. This exploitation of the existence of a double tax agreement between two countries is further extended by the arbitrage between the definitions of corporate residence in the two countries, which has been previously discussed in this chapter.

It is submitted that the use of Dutch companies as trademark holders, as outlined in the scheme used by Starbucks and SABMiller, further illustrates an element of treaty shopping. For example, if a South African company within the SABMiller group pays royalties to the Dutch company, the tax treaty between South Africa and the Netherlands does not allow South Africa to levy a withholding tax on royalties beneficially owned by a resident of the Netherlands (SARS, 2009: Article 12). Similarly, the double tax treaty between the UK and Netherlands treats royalties in the same manner (HM Revenue & Customs, 2011: 18). By ensuring that the companies which hold the trademarks within the group are residents of the

Netherlands, multinational corporations such as Starbucks and SABMiller are able to ensure a further reduction in tax as withholding taxes do not apply in terms of the tax treaties.

4.8.7. AVOIDANCE OF CLASSIFICATION AS A PERMANENT ESTABLISHMENT

In terms of tax treaties based on the OECD Model Tax Convention, taxing rights are normally granted to the state of residence, unless business is carried on through a permanent establishment in the other contracting state, in which case profits attributable to the permanent establishment may be taxed in the source state (Lamers, Mcharo & Nakajima, 2014: 18).

Apple Inc. and Google are two multinational corporations which operate in the "digital economy". The sales made by these companies escape taxation in the source countries – by avoiding the classification as a permanent establishment. According to Lamers *et al.* (2014: 18), the concept of permanent establishment as defined in Article 5 of the OECD Model Tax Convention is no longer appropriate to determine whether taxing rights exist in the source state, as within the digital economy, an enterprise is able to conduct business in one or more states outside its resident state without creating a permanent establishment in those states. According to Fuest *et al.* (2013: 5) multinationals using the "double Irish with a Dutch sandwich" scheme often provide services and sell goods via the internet. Using the structure explained in the discussion of this scheme, the Irish resident company acts as the contractual partner of non-US customers, therefore no physical presence is created in the country of consumption. In the case of Google, it is Google Ireland Limited which acts as the contractual partner.

As discussed in Chapter Three, the OECD has provided guidelines to clarify the concept of permanent establishment in the context of e-commerce. These guidelines make reference to the physical location of the server (OECD, 2012c: 24), as well as the extent of the business carried on through the server, the involvement of personnel and whether the activities performed via the server are of a preparatory or auxiliary nature.

Lamers *et al.* (2014: 18) further submit that the status of permanent establishment is avoided by multinational corporations by artificially fragmenting their operations, in order to make use of the exception in terms of Article 5(4) of OECD Model Tax Convention, which excludes activities of a preparatory or auxiliary character from being classified as a permanent establishment. South Africa adopts the OECD definition of permanent establishment, therefore any weaknesses and loopholes identified in relation to the OECD definition, means that South Africa will be subject to similar tax schemes which exploit these weaknesses. Although beyond the scope of this thesis, it is considered relevant to note that the Value-Added Tax Act, 89 of 1991 (hereinafter referred to as the VAT Act) now requires foreign suppliers of e-commerce to register as Value-Added Tax (hereinafter referred to as VAT) vendors. Under the previous provisions of the VAT Act, suppliers of electronic services with no physical presence in South Africa were not required to register for VAT. Due to the difficulty in establishing a place of supply for e-commerce transactions, payment from a South African bank account or customer residence in South Africa will serve as the proxies to determine the place of supply (Watson, 2014: 16).

4.9. CONCLUSION

The significant rate of the growth of globalisation has facilitated an increase in the mobility of capital, resulting in an increase in the interaction between the economies of different countries. This has led to an increase in tax competition, a concept which was discussed in Chapter Two. Furthermore, the existence of tax havens and preferential tax regimes creates opportunities within global organisations to engage in tax arbitrage and profit shifting with the intention of reducing the overall tax burden of the organisation. It is submitted that the failure of tax legislation to keep up with the pace of globalisation has further resulted in increased opportunities for profit shifting. Chapter Two and Chapter Three of this thesis presented a detailed discussion of concepts associated with base erosion and profit shifting, and the legislative provisions within the Income Tax Act which address international transactions.

The purpose of this chapter was to conduct a limited review of profit shifting schemes used by multinational corporations and use the components of these

schemes in order to identify the provisions within income tax legislation which were used by these companies to obtain tax benefits. In relation to South African income tax legislation, the weaknesses identified in this chapter can be summarised as follows:

- the lack of formal definitions with respect to “source” and determining corporate residence, specifically with regard to the “place of effective management” as a determinant of residence;
- the acceptance of cost-sharing arrangements as outlined in Chapter VIII of the OECD Guidelines, without the incorporation of corresponding specific provisions in transfer pricing legislation to prevent such arrangements from being used to shift profits;
- the lack of guidelines in respect of the practical application of the amended section 31, which provides for transfer pricing and the lack of finalised guidelines in respect of thin capitalisation rules;
- the perceived inability of legislation to counter the use of the “foreign business establishment” exemption to circumvent controlled foreign company rules in terms of section 9D of the Income Tax Act;
- outdated double tax agreements; and
- the lack of legislative provisions to prevent the avoidance of classification as a permanent establishment due to the lack of a physical presence in respect of the digital economy and the use of the exception to Article 5(4) of the OECD Model Tax Convention, which excludes activities of a preparatory or auxiliary nature from classification as a permanent establishment.

In revealing the ways in which multinational corporations exploit the provisions of the tax legislations of the various countries in which they operate, weaknesses within South African tax legislation were able to be identified. It is submitted that this is of significant importance in the global movement to address base erosion and profit shifting, as without this understanding, proper mechanisms to reduce the occurrence of profit shifting cannot be implemented. The next chapter outlines the current initiatives towards addressing the problem of base erosion and profit shifting, from both a global and a South African perspective.

CHAPTER 5: CURRENT INITIATIVES TOWARDS REDUCING BASE EROSION AND PROFIT SHIFTING

5.1. INTRODUCTION

The previous chapters of this thesis focussed on important concepts in relation to base erosion and profit shifting, as well as the provisions contained within the Income Tax Act which govern international tax consequences. Furthermore, certain schemes used by multinational corporations were reviewed in Chapter Four, the purpose of which was to identify weaknesses and loopholes in income tax legislation.

This chapter addresses the fourth goal of the research: to review the current initiatives to address base erosion and profit shifting, both within South Africa and from a global perspective. This chapter discusses the OECD's action plan and other global initiatives to address base erosion and profit shifting (insofar as they are considered to be relevant to the schemes and legislative weaknesses identified in this thesis), as well as South Africa's initiatives towards addressing the problem of base erosion and profit shifting. The fact that South Africa is a developing country necessitates that due consideration be given to foreign direct investment, as it is important that South Africa is seen as an attractive investment country. Therefore this chapter also includes a brief discussion on the potential impact of efforts to address base erosion and profit shifting, on levels of foreign direct investment into South Africa.

5.2. OECD INITIATIVE TOWARDS ADDRESSING BASE EROSION AND PROFIT SHIFTING

The OECD's project on base erosion and profit shifting resulted in the release of an action plan in July 2013, which entails addressing key elements of the international tax consequences which govern multinational corporations (Picciotto, 2013: 1105). The OECD (2013a: 11) has recognised that fundamental changes are required to prevent double non-taxation and stresses that coherence of corporate income tax at an international level is required, as unilateral action taken by countries may result in

uncertainty and unrelieved double taxation. The OECD action plan consists of fifteen actions aimed at addressing base erosion and profit shifting, which are based on three core principles: coherence, substance and transparency (OECD: Online). In addition, the action plan contains two further actions which fall outside the above core principles – one in relation to the digital economy, and the other relating to a multilateral instrument. Since the focus of this thesis is limited to income tax, the fifteen actions are discussed briefly below without reference to indirect tax considerations. Furthermore, the discussion of each action includes a brief update in respect of the progress made, as well as any shortcomings identified.

Action One: Address the tax challenges of the digital economy

The purpose of this action is to identify the main difficulties created by the digital economy, within income tax legislation. Issues include, *inter alia*, the ability of a company to have a significant digital presence in a country without being liable for taxes in that country due to the lack of nexus under current tax legislation, the attribution of value created from the generation of location-relevant data, the characterisation of income and the application of related source rules. The OECD (2013a: 15) submits that this will require a detailed analysis of the various business models in this sector.

It is submitted that this action is of importance in relation to multinational corporations, as many are operating within the digital economy, such as Apple Inc. and Google, as discussed in Chapter Four. Furthermore, it is submitted that schemes such as the "double Irish with a Dutch sandwich" work particularly well within the digital economy, due to the lack of a physical presence, thereby allowing such corporations to escape taxation in the source countries in which the income arises.

This action constituted one of the seven deliverables in 2014 according to the anticipated timelines of the action plan (OECD, 2013a: 29-34). In this regard, the OECD (2014b: 8) has stated that it has been agreed that since the digital economy is fast becoming the economy within which many countries and organisations operate, it would be difficult to ring-fence the digital economy from the rest of the economy for tax purposes. However, it is acknowledged that the features of the digital economy

represent risks in relation to base erosion and profit shifting, and therefore need to be addressed. According to the Explanatory Statement: OECD/G20 Base Erosion and Profit Shifting Project (hereinafter referred to as the Explanatory Statement) issued by the OECD (2014b: 8), it is anticipated that other actions included in the action plan will address the risks represented by the digital economy, and these actions, where applicable, should specifically address any issues related to the digital economy.

Actions which fall within the core principle of coherence of corporate income taxation:

Action Two: Neutralise the effects of hybrid mismatch arrangements

This action addresses the mismatches in the way entities and instruments are treated by different tax jurisdictions, which allows companies to claim multiple deductions for the same expense or cause taxable income to "disappear" through the use of hybrid entities (OECD: Online).

The OECD (2014b: 5) has released recommendations in this regard as part of its 2014 deliverables. These recommendations relate to changes in domestic tax legislation and tax treaty provisions which would eliminate mismatches, and include a recommendation to link domestic rules, which effectively means that the treatment of an amount in one jurisdiction would be linked to the treatment in the other jurisdiction (Musviba, 2014: Online). The OECD report further recommends the addition of a new provision to Article 1 of the OECD Model Tax Treaty, which would address the income of fiscally transparent entities (Musviba, 2014: Online). The detailed recommendations outlined in the report are beyond the scope of this thesis.

Action Three: Strengthen controlled foreign company rules

This action addresses the concern that income is routed through offshore entities in order to escape taxation. The OECD (Online) is of the opinion that strong controlled foreign company rules can address this issue by including the income of the offshore entities in the parent company's income on a current basis.

Action Three forms part of the 2015 deliverables of the OECD (2013a: 30), and accordingly no recommendations have been released to date. According to Picciotto (2013: 1106), when controlled foreign company rules first emerged, Switzerland's authorities argued that since tax treaties define and allocate taxing rights, a residence country cannot use anti-avoidance provisions to tax income of foreign affiliates incorporated in treaty-partner states. The decentralisation and multi-tier structures of multinational corporations, as well as the operation within the digital economy have made controlled foreign company rules increasingly difficult to implement (Picciotto, 2013: 1107).

From a South African tax perspective, it is submitted that the complexity of current controlled foreign company rules, as well as the complex structures within multinational corporations, makes the application of the anti-avoidance provisions of section 9D difficult. Picciotto (2014: 6) submits that controlled foreign company rules would be more effective if they were co-ordinated and targeted against preferential tax regimes. It is submitted that since South Africa is considered to be a developing country, it would benefit from stronger controlled foreign company rules, as this would discourage the diversion of investments by South African resident companies into foreign affiliates in order to obtain tax benefits.

Action Four: Limit base erosion via interest deductions and other financial payments

This action addresses the use of excessive interest deductions by companies to reduce their taxable profits, by obtaining a loan from a related entity which benefits from a low-tax regime, thereby avoiding a corresponding interest income inclusion in the taxable income of the lender. Furthermore, a company may use debt to finance the production of exempt or deferred income, while claiming a current deduction for interest (OECD, 2013a: 17). The OECD recommends that the rules relating to the deductibility of such interest should take these schemes into account. The action plan proposes the evaluation of the effectiveness of different limitations of such deductions and suggests that transfer pricing guidance will be developed in this regard (OECD, 2013a: 31).

Picciotto (2014: 6) submits that the limitation of such deductions could reduce tax losses within countries, but that many developing countries have been reluctant to

adopt such measures for fear of discouraging inward investment. However, it is submitted that South Africa does not display such reluctance, as the Income Tax Act already contains provisions which govern thin capitalisation – which is dealt with under section 31. The amended provisions of this section already require that thin capitalisation be considered within transfer pricing rules. According to the Explanatory Memorandum on the Taxation Laws Amendment Bill (National Treasury, 2010: 75), the aim of the amendments to section 31 of the Income Tax Act was to align with OECD guidelines. It is therefore submitted that South Africa is likely to implement any further guidelines issued by the OECD in this regard.

Action Five: Counter harmful tax practices more effectively, taking into account transparency and substance

The OECD (2013a: 18) proposes to refocus on past work done to address harmful tax practices, and to prioritise improving on transparency, including compulsory spontaneous exchange on rulings relating to preferential tax regimes. Furthermore, non-OECD members will be engaged in addressing this action.

As part of its 2014 deliverables in terms of the action plan, the OECD (2014b: 9) has released an interim report on this action. This report states that the focus will be on requiring substantial activity to access the benefits of preferential tax regimes, improving transparency and the compulsory exchange of information on rulings for preferential regimes and reviewing member and associate country regimes (Musviba, 2014: Online). It is submitted that the detailed contents of the interim report are beyond the scope of this thesis. However, based on the discussion in Chapter Two on harmful tax practices, it is evident that this action is considered to be important in the context of reducing base erosion and profit shifting.

Actions which fall within the core principle of the alignment of taxation and substance:

Action Six: Prevent treaty abuse

The OECD (2013a: 19) aims to develop model treaty provisions and recommendations regarding domestic tax rules to prevent the granting of treaty benefits in inappropriate circumstances. The OECD (2013a: 18) submits that treaty

anti-abuse clauses, together with the exercise of taxing rights under domestic tax legislations will help to restore source taxation to a large extent. The OECD aims to clarify the tax policy considerations that countries should take into account before entering into a tax treaty.

The OECD Explanatory Statement (2014b: 6) states that all countries have agreed that anti-treaty abuse provisions should be incorporated into tax treaties. It has further been acknowledged that the work on addressing treaty abuse may impact existing business structures and this may require improvements to existing policies in order not to negatively affect investments, trade and economic growth (OECD, 2014b: 6). Chapter Four of this thesis discussed the abuse of double tax agreements by multinational corporations. It is submitted that the adoption of anti-treaty abuse provisions within such agreements, could effectively counter tax avoidance schemes which contain treaty shopping components. Chapter Three of this thesis outlined a number of weaknesses within tax treaties of South Africa. It is therefore submitted, that in addition to the introduction of anti-abuse provisions within tax treaties, the weaknesses identified should be addressed.

Action Seven: Prevent the artificial avoidance of permanent establishment status

According to the OECD (Online), in terms of treaty rules, a country may not tax business profits of a foreign company unless the company has a permanent establishment in that country. If the company is not taxed on those profits in its country of residence, double non-taxation arises. The OECD (2013a: 19) proposes to change the definition of permanent establishment to prevent the artificial avoidance of permanent establishment status.

This action is expected to be met with a deliverable in 2015 (OECD, 2013a: 32). However, there are a number of concerns regarding the apparent lack of intention of the OECD to reconsider the “separate entity” principle first implemented in 2008 through changes to the commentary to Article 7 to the OECD Model Tax Convention, and by amending the Article itself in 2010 (Picciotto, 2013: 1109). This approach was rejected by the United Nations tax committee and by many developing countries (including South Africa), and some OECD-member countries, due to the complexity of the implementation of such changes, as well as possible conflicts with domestic

tax legislation (Picciotto, 2013: 1110). Effectively, this change to Article 7 treats a permanent establishment as a separate legal entity and applies transfer pricing rules to such establishments (Oguttu, 2009: 773). Picciotto (2014: 6) submits that without a reconsideration of these issues, it is unlikely that adequate solutions can be found, especially in relation to the problems posed by the digital economy. It is submitted that this could result in unilateral action by countries, which is not in keeping with the need for coherence on an international basis in order for base erosion and profit shifting to be addressed effectively.

The discussion in Chapter Four regarding schemes used by multinational companies that avoid classification as a permanent establishment supports the need to address this problem in order to reduce base erosion and profit shifting. This problem is further exacerbated by the operation of certain companies within the digital economy and the ability of multinational companies to artificially fragment operations (Lamers *et al.,* 2014: 18). It is therefore submitted that changes to the concept of permanent establishment should take these problems into account.

Actions Eight, Nine and Ten: Assure that transfer pricing outcomes are in line with value creation

The OECD (Online) states that the purpose of transfer pricing rules is to allocate income earned by a multinational corporation among the countries in which it operates. In some cases, multinational companies have misapplied the rules to separate income from the economic activities that produce such income. This is achieved through transfers of intangibles or other mobile assets, over-capitalisation of group companies and contractual allocations of risk. The actions outlined by the OECD aim to develop rules to prevent the base erosion and profit shifting mechanisms outlined above.

The OECD 2014 deliverables include a report on action eight, which is to assure that transfer pricing outcomes are in line with value creation with specific reference to intangibles (OECD, 2013a: 32). Deliverables in respect of actions nine and ten are expected in 2015. According to Picciotto (2014: 7), the OECD Guidelines on Intangibles indicates a move away from the attribution of profits derived from intangible assets on the basis of ownership or provision of finance, which allowed

multinational corporations such as Google to accumulate significant profits in low-tax jurisdictions such as Bermuda – this has been discussed in Chapter Four of this thesis. In terms of the guidelines, profits would be attributed based on each entity's contribution to "value creation" through functions performed, assets used and risks assumed. Picciotto (2014: 7) further submits that the draft guidelines of the OECD do not provide clear guidance in terms of how these contributions to value creation can be assessed. The tax schemes discussed in Chapter Four indicate that transfer pricing is a common scheme used to shift profits, and such schemes contribute to tax avoidance in South Africa. Therefore, it is submitted that these actions contemplated by the OECD are important from a South African tax perspective. South Africa has recently amended its transfer pricing legislation to align with the OECD guidelines (National Treasury, 2010: 75) and therefore any further guidelines issued by the OECD are likely to be followed by South Africa, However, it is submitted that it is important that the OECD guidelines are clear and outline the application of transfer pricing provisions, as the effectiveness of this legislation is dependent on the enforcement of its provisions. Furthermore, as mentioned previously, no guidelines in relation to the amended transfer pricing legislation have been released by the SARS to date.

Actions which fall within the core principle of ensuring transparency, while improving certainty:

Action Eleven: Establish methodologies to collect and analyse data on base erosion and profit shifting and the actions to address it

According to the OECD (Online), further work is required in order to measure the scale and effects of base erosion and profit shifting, and to monitor the effectiveness and impact of the actions taken to address this issue.

This is one of the actions expected as a deliverable in 2015. It is submitted that the aim of this action is to establish a reliable way in which to measure the effects of base erosion and profit shifting and to regularly monitor these measures in order to establish whether actions undertaken in the plan to address this problem have the intended effect of reducing the occurrence of base erosion and profit shifting. It is further submitted that this action is important as it can assist in providing an

indication as to whether actions implemented are successful or whether further changes are necessary. However, it appears that the monitoring of such measures is not anticipated to yield reliable data unless proposed actions to address base erosion and profit shifting are coherently implemented on a global level. It is submitted that unilateral measures taken by countries could distort any measurements to establish the effectiveness of actions taken.

Action Twelve: Require taxpayers to disclose their aggressive tax planning arrangements

The OECD (2013a: 22) plans to develop recommendations regarding the design of mandatory disclosure requirements for aggressive tax planning arrangements or structures. One area of focus will be international tax schemes, where the work will explore using a wide definition of “tax benefit” in order to capture such transactions. Other potentially useful measures include co-operative compliance programmes between taxpayers and tax administrations, in order to enhance information sharing.

Recommendations by the OECD in this regard are expected during 2015. It is submitted that any disclosure requirements imposed on taxpayers may be met with opposition from multinational corporations. It is further submitted that disclosure requirements for taxpayers should not be made unduly onerous.

Action Thirteen: Re-examine transfer pricing documentation

The aim of this action is to develop rules regarding transfer pricing documentation which would enhance the transparency for tax administrations, while taking into account the costs of compliance for business. The rules will include a requirement that multinational corporations provide all relevant governments with information on their global allocation of income, economic activity and taxes paid among countries, based on a common template (OECD, 2013a: 23).

In relation to this action, the OECD has released a report comprising guidance on transfer pricing documentation and country-by-country reporting (Musviba, 2014: Online), which sets out revised standards for tax administrations to take into account with respect to transfer pricing documentation, and sets out a template for country-by-country reporting of income, earnings, taxes, and certain measures of economic

activity. The implementation of the guidelines provided in this report will be addressed by the OECD in the near future, taking into account factors such as the protection of the confidentiality of this information (Musviba, 2014: Online).

Action Fourteen: Make dispute resolution mechanisms more effective

The actions identified to counter the occurrence of base erosion and profit shifting will need to be complemented with actions to ensure the certainty and predictability needed in order to promote investment (OECD: Online). This action aims to ensure that solutions are developed in order to address obstacles that prevent countries from solving treaty-related disputes, including the absence of arbitration provisions in most treaties (OECD, 2013a: 23).

According to Picciotto (2013: 1113), although arbitration provisions have been introduced into many treaties, a number of states are reluctant to include such provisions, especially developing countries. Since this action forms part of the 2015 deliverables, it is submitted that it remains to be seen what the recommendations are from the OECD in this regard, and whether all countries involved in the base erosion and profit shifting project are able to achieve consensus in this regard.

Actions that address the need for swift implementation of the measures:

Action Fifteen: Develop a multilateral instrument

Many of the actions identified could result in changes to the OECD Model Tax Convention, which will not be effective without corresponding amendments to bilateral tax treaties. The OECD (2013a: 24) recognises that if these changes are undertaken on a treaty-by-treaty basis, the process of implementation would be prolonged. A multilateral instrument to amend bilateral treaties has been identified as a possible solution to this problem.

The OECD has released a Multilateral Instrument Report which concludes that a multilateral instrument is feasible (based on non-tax precedents) and desirable as it would ensure the sustainability of the consensual framework to eliminate double taxation on cross-border transactions (Musviba, 2014: Online). An international convention to begin negotiations for a multilateral instrument is to be set up in 2015,

and Musviba (2014: Online) submits that such an instrument is likely to co-exist with existing bilateral treaty networks. Furthermore, the Convention on Mutual Assistance in Tax Matters, which is an example of a multilateral instrument to counter global tax avoidance and to allow revenue authorities to co-operate and assist each other in the collection and recovery of taxes, has been signed by sixty-six countries (Musviba, 2014: Online), including South Africa.

5.3. OTHER GLOBAL INITIATIVES

5.3.1. THE UNITED NATIONS

In October 2013, the United Nations Committee of Experts on International Co-operation in Tax Matters established a subcommittee on base erosion and profit shifting issues for developing countries (United Nations: Online). This subcommittee is mandated to draw on its experience and engaged with other bodies, such as the OECD, with a view to monitoring developments in relation to base erosion and profit shifting issues, and communicating on such issues to officials in developing countries. The aim of establishing this subcommittee is to help to keep developing countries informed and to help facilitate the input of developing countries into the OECD/G20 action plan on base erosion and profit shifting (United Nations: Online). However, based on the literature review undertaken for this thesis, no significant outcomes or reports from this committee were found.

5.3.2. IRELAND

As discussed in Chapter Four, one of the tactics used by multinational corporations is the arbitrage between corporate residence definitions across different tax jurisdictions. An example of a scheme which uses this tactic is the “double Irish arrangement”. In order to address this problem, Ireland has amended its corporate residence rules to ensure that an Irish-incorporated company can no longer be used to exploit this loophole. The amendment provides that if an Irish-incorporated company is managed and controlled in a treaty-partner country and such company would not be regarded as a tax resident in any jurisdiction due to the mismatch in corporate residence definitions between Ireland and the treaty-partner country, then

such company will be regarded as a tax resident in Ireland (Mayer Brown Practices, 2014: 8).

The amendment was effective from 24 October 2013 for companies incorporated on or after that date and from 01 January 2015 for companies incorporated before 24 October 2013. However, this amendment will not affect the tax residence of Irish companies managed and controlled in non-treaty partner jurisdictions, such as the Cayman Islands (Mayer Brown Practices, 2014: 8). Therefore it is submitted that the amendment to Irish tax legislation does not fully address schemes such as the "double Irish arrangement", where no tax treaty exists between Ireland and the tax haven state chosen for the company within the scheme. Google's "double Irish with a Dutch sandwich" scheme, for example, would still be effective, as no tax treaty exists between Ireland and Bermuda. However, it appears that Apple Inc.'s double non-taxation of profits under the tax structure discussed in Chapter Five could be affected by Ireland's change in legislation, as the US and Ireland have a tax treaty in force. It is submitted that the negotiation of tax treaties between Ireland and the tax haven countries (those which have not yet entered into a double tax agreement with Ireland) seems to be a way in which the "double Irish arrangement" can be rendered ineffective in the context of base erosion and profit shifting.

5.4. INITIATIVES UNDERTAKEN BY SOUTH AFRICA

5.4.1. INVOLVEMENT IN THE OECD ACTION PLAN

As mentioned in Chapter One, South Africa is not an OECD-member country. However, South Africa does form part of the G20, which was involved in the work undertaken by the OECD to address base erosion and profit shifting, and all G20 countries participated in the meeting of the Committee of Fiscal Affairs at which the first set of deliverables in terms of the action plan was adopted (OECD, 2014b: 4). It appears that all G20 countries, including South Africa are in agreement with the action plan and 2014 deliverables of the OECD. The Explanatory Statement (OECD, 2014b: 3) states that the proposed measures in respect of seven of the actions outlined in the action plan have been agreed upon and reflect consensus. However, certain measures have not been finalised as they may be affected by 2015

deliverables in terms of the action plan timelines. The seven 2014 deliverables include two final reports on Action One and Action Fifteen, one interim report on Action Five, and four reports containing draft recommendations on Actions Two, Six, Eight and Thirteen (OECD, 2014b: 9). The OECD (2014b: 4) states that developing countries and other non-OECD/G20 economies have been extensively consulted in the process of drafting recommendations.

It appears that, based on South Africa's involvement in the base erosion and profit shifting project through its membership of the G20, current recommendations of the OECD are consistent with South Africa's overall intention to reduce base erosion and profit shifting. South Africa is also a member of the African Tax Administration Forum, and through its membership of this organisation – which has urged African countries to provide input to the OECD – also demonstrates a commitment towards addressing base erosion and profit shifting (South African Institute of Tax Professionals, 2014: Online). However, the extent of South Africa's intention to adopt the recommendations of the OECD is not yet known. It is submitted that once all the deliverables of the OECD action plan have been issued, and recommendations finalised, all countries would be in a better position to make a decision regarding potential changes to legislation and tax treaties. Furthermore, it is submitted that the work of the Davis Tax Committee (see below) will affect the outcome of the base erosion and profit shifting project, from a South African perspective.

5.4.2. SOUTH AFRICA'S DAVIS TAX COMMITTEE

The former Minister of Finance, Pravin Gordhan, initiated a tax review in 2013, and the terms of reference (National Treasury, 2013b: Online) for the Davis Tax Committee includes a focus on base erosion and profit shifting. On 30 June 2014, the Davis Tax Committee submitted an interim report on base erosion and profit shifting to the Minister of Finance (The Davis Tax Committee, 2013: Online). The contents of this interim report have not been published, but it is an indication that the issue of base erosion and profit shifting currently still forms part of the main focus within South Africa. To date, the extent of the work undertaken by the Davis Tax Committee with respect to base erosion and profit shifting and any findings in relation to the problem are not known to the public.

5.5. CONSIDERATION OF FOREIGN DIRECT INVESTMENT INTO SOUTH AFRICA

Foreign direct investment is defined as an investment made by a company or entity in one country, into a company or entity based in another country (Investopedia: Online). It is submitted that since South Africa is considered to be a developing country, an important consideration from an economic perspective, is that of foreign direct investment into the country. It is possible that imposing stricter rules in the Income Tax Act in relation to international tax issues may result in less investment into South Africa by multinational companies. However, tax legislation is not considered to be the main driver behind foreign direct investment. Therefore, in order to assess the possible impact of changes in tax legislation, it is necessary to establish the extent to which it is considered to affect investment decisions.

According to Terhoeven (2011: 62) a comparison between Brazil, Russia, India, China and South Africa revealed that there does not seem to be a significant relationship between tax policies and foreign direct investment into these countries. However, other studies discussed by Terhoeven (2011: 62) indicate that factors such as lower corporate tax rates, tax holidays and the existence of double tax agreements with other countries do influence levels of foreign direct investments and can increase the attractiveness of a country as an investment opportunity.

According to the International Monetary Fund (2014: 24) addressing tax avoidance by multinational corporations may discourage investment into a country. However, in the context of a developing country, there are factors that could be seen to be more important, such as infrastructure and labour costs which attract investment into countries. It is submitted that the loss of tax revenue from multinational companies, and the negative effect that the imbalance of tax burdens borne by taxpayers can have on tax morale, are considered to be of significance. Furthermore, judging by the quantum of the estimated losses in tax revenue due to schemes used by multinational corporations, it is submitted that any reduction in inward investment into the country may be offset, at least partially, by an increase in tax revenue arising from a decrease in tax avoidance schemes. Furthermore, it is submitted that due to the current media focus on base erosion and profit shifting, initiatives by tax

jurisdictions to address this problem can assist to increase taxpayer morale, as it reflects a tax authority's commitment to fairness. The International Monetary Fund (2014: 24) further submits that the impact of tax avoidance initiatives on investment within a country can be reduced if the number of countries participating in such initiatives is significant. This supports the view of the OECD (2013a: 11), which has emphasised the importance of coherence at an international level, and stressed that unilateral actions taken by countries could have negative consequences. It is submitted that the views of the International Monetary Fund and the OECD in this regard reflect the fact that consideration has been given to foreign direct investment within the context of addressing base erosion and profit shifting and accordingly, any recommendations should take this factor into account, especially given that South Africa and other developing countries appear to have adequate representation and involvement in the base erosion and profit shifting project.

5.6. CONCLUSION

Chapter Four of this thesis set out a review of the schemes commonly used by multinational corporations and the associated weaknesses in tax legislation which these schemes exploited. The aim of this chapter was to discuss the current initiatives designed to address the problem of base erosion and profit shifting, in order to establish whether the weaknesses identified in Chapter Four are being adequately addressed. Based on the initiatives discussed above, it is submitted that although the OECD action plan takes into account many of the weaknesses of tax legislation that are exploited by multinational companies, at this stage the strength of any recommendations cannot be determined conclusively, as the project will only deliver expected outputs on all actions by 2015. It is submitted that many of the actions within the action plan are inter-dependent and can only be finalised once the base erosion and profit shifting project has met all deliverables. However, based on the discussion in this chapter of the initiatives to address base erosion and profit shifting, it is evident that many proposals and recommendations contain weaknesses as they fail to consider certain aspects of the schemes used by multinational corporations – for example certain components of the "double Irish arrangement" have not been addressed. Furthermore, although the actions set out within the OECD action plan seem to address many weaknesses in tax legislation, it appears

that currently there are insufficient guidelines regarding the implementation of recommendations made to date.

It is therefore submitted that the base erosion and profit shifting project has a substantial amount of work still to be done in order to provide a cohesive report on how this problem can be addressed at an international level. Furthermore, the extent of the implementation of OECD recommendations by different tax legislation remains to be seen. However, based on South Africa's involvement in the movement to address base erosion and profit shifting, it appears that South Africa will follow OECD guidelines to a large extent.

CHAPTER 6: CONCLUSION AND RECOMMENDATIONS

6.1. INTRODUCTION

This chapter concludes the study and makes recommendations in respect of the research undertaken by drawing on the findings of previous chapters. This is achieved through restating the goals of the research, followed by a discussion of how these goals were achieved, including recommendations on possible amendments to South African income tax legislation to address the challenges of base erosion and profit shifting. A brief discussion of the limitations of the research undertaken follows, and finally, areas for further research are identified.

6.2. THE GOALS OF THE RESEARCH

The goal of the research was to undertake a study of tax avoidance schemes employed by multinational corporations, which contribute to base erosion and profit shifting, and to examine the components of these schemes in order to identify weaknesses within South Africa's income tax legislation in relation to the provisions that govern international transactions. The goal was further extended to the identification of potential amendments to legislation, using the weaknesses uncovered in the research, which may assist in reducing the occurrence of base erosion and profit shifting.

6.3. HOW THE RESEARCH GOALS WERE ACHIEVED

Firstly, a review of the concept of base erosion and profit shifting, as well as associated issues such as harmful tax competition and harmful tax practices (which is the collective reference to tax havens and preferential tax regimes) was considered necessary. This was addressed in Chapter Two which concluded that the background and effects of these practices are similar and that harmful tax competition and harmful tax practices are contributing factors to base erosion and profit shifting. This inference was important in the context of addressing the main goal of the research, as the schemes used by multinational corporations reflected that the issues and concepts discussed in Chapter Two are employed as

components of tax avoidance schemes. Furthermore, the discussion of base erosion and profit shifting in this chapter provided an insight into the overlap between domestic tax legislations that are prey to such schemes, due to increased cross-border transactions. This provided a basis against which to consider the actual tax schemes of multinational companies, as these schemes demonstrated such overlaps.

Secondly, in order to identify how base erosion and profit shifting schemes exploit gaps in tax legislation, it was considered necessary to discuss the provisions within the Income Tax Act which govern international transactions. Chapter Two demonstrated that base erosion and profit shifting is a problem which emanates from the exploitation of gaps and mismatches in tax legislation. Therefore Chapter Three was aimed at providing an understanding of the definitions and provisions in South African tax legislation, which are relevant to cross-border transactions.

Chapter Four of this thesis comprised of a review of schemes used by four multinational companies – Apple Inc., Google, Starbucks and SABMiller. The components of these schemes were linked to the underlying gaps in tax legislation that were exploited in order to reduce the tax burdens of these companies. These gaps were subsequently reviewed from a South African perspective with reference to the provisions of South African tax legislation discussed in Chapter Three. This enabled the identification of gaps and loopholes within South Africa's Income Tax Act.

Finally, Chapter Five presented a discussion of the current global and South African initiatives aimed at addressing the problem of base erosion and profit shifting. The purpose of this chapter was to establish what recommendations have been made in relation to the legislative weaknesses identified in Chapter Four and to identify any shortcomings in these recommendations. Furthermore, considerations from a South African perspective were suggested and a brief discussion of foreign direct investment into South Africa was included. The purpose of this chapter was to justify the submission of recommendations in respect of the weaknesses identified in Chapter Four. This therefore addressed the extended goal of this research.

In addressing the main goal, the following weaknesses in South African tax legislation were identified and discussed in Chapter Four:

- the lack of formal definitions with respect to “source” and determining corporate residence, specifically with regard to the “place of effective management” as a determinant of residence;
- the acceptance of cost-sharing arrangements as outlined in Chapter VIII of the OECD Guidelines, without the incorporation of corresponding specific provisions in transfer pricing legislation to prevent such arrangements from being used to shift profits;
- the lack of guidelines in respect of the practical application of the amended section 31, which provides for transfer pricing and the lack of finalised guidelines in respect of thin capitalisation rules;
- the perceived inability of legislation to counter the use of the “foreign business establishment” exemption to circumvent controlled foreign company rules in terms of section 9D of the Income Tax Act;
- outdated double tax agreements; and
- the lack of legislative provisions to prevent the avoidance of classification as a permanent establishment due to the lack of a physical presence in respect of the digital economy and the use of the exception to Article 5(4) of the OECD Model Tax Convention, which excludes activities of a preparatory or auxiliary nature from classification as a permanent establishment.

6.4. RECOMMENDATIONS

The following submissions are made in relation to each of the weaknesses identified:

- Interpretation Note 6 (SARS, 2002) should be revised (or replaced) in order to provide clear guidelines in respect of the term “place of effective management”, taking the OECD guidelines into consideration, particularly in light of the principles applied in the *Oceanic Trust Co. Ltd* case. In addition, a clear definition of “source” is required. Furthermore, the application of these terms within the digital economy should be addressed.

- With regard to cost-sharing agreements, it is submitted that the OECD recommendation that these arrangements should be aligned with value creation is adopted in South Africa. However, based on the discussion in Chapter Five, it appears that the OECD guidelines in this regard are not clear, therefore prior to implementation in South Africa, it should be ensured that that these guidelines are extensively reviewed in terms of their relevance and clarity; and that any shortcomings have been addressed.
- In respect of transfer pricing, in addition to the submission in respect of cost-sharing agreements, it is further recommended that concise guidelines with reference to section 31 of the Income Tax Act are provided in order to minimize the risk of uncertainty in applying the provisions of this section. This can be in the form of an interpretation note or practice note issued by the SARS.
- With regard to thin capitalisation, it is submitted that the existing draft Interpretation Note (SARS, 2013a) should be finalised as a matter of urgency, with due consideration to the OECD guidelines, in view of the fact that thin capitalisation is now incorporated into South Africa's transfer pricing rules in an effort to align them with OECD principles.
- The "foreign business establishment" exclusion in section 9D of the Income Tax Act should be revised to restrict the use of the employees, equipment and facilities of other group companies located in the same country for the purpose of the determination of the presence of a fixed place of business, due to the ease with which multinational corporations are able to meet the requirements to be classified as a foreign business establishment.
- Double tax agreements should be updated to take factors such as e-commerce into account. Furthermore, as suggested by the OECD, an anti-treaty abuse provision may be introduced into these agreements, to counter schemes which lead to double non-taxation through treaty shopping.
- It is submitted that the OECD definition of "permanent establishment" should be amended to provide for the digital economy. In this regard, more consideration than is currently given to e-commerce is necessary, since the current guidelines do not appear to be strong enough to prevent the artificial avoidance of classification as a permanent establishment.

6.5. LIMITATIONS OF THE RESEARCH

For the purposes of this research, an interpretative approach was adopted and the research was conducted in the form of an extended argument, supported by documentary evidence. The studies conducted in respect of schemes used by multinational corporations were limited to a review of information currently within the public domain and the quantification of losses in tax revenue was also limited in this regard. No empirical studies were conducted or reviewed in respect of the tax losses suffered from base erosion and profit shifting. Furthermore, the weaknesses within income tax legislation identified were limited to the schemes discussed in relation to the multinational companies selected for further study. The review of current initiatives and the recommendations outlined in this research were limited to the weaknesses identified. Therefore there are potentially other provisions which govern international transactions within the Income Tax Act which require amendments to counter those avoidance schemes that have not been discussed within the ambit of this thesis. Due to the fact that the initiatives to address base erosion and profit shifting are still a work-in-progress, the strengths and weaknesses thereof could not be conclusively identified in this research.

6.6. FURTHER RESEARCH

Considering the limitations of the research undertaken, it is submitted that further research can be conducted in respect of the schemes used by other multinational corporations and how the associated legislative weaknesses in the Income Tax Act can be addressed in relation to these schemes. In addition, the OECD action plan can be further analysed, with detailed consideration being given to the OECD deliverables and whether the detailed recommendations contained therein are suitable from a South African tax perspective. A critical analysis of the OECD recommendations (once they are finalised) can be undertaken in order to establish whether they would effectively curb base erosion and profit shifting, or whether multinational corporations could simply uncover further loopholes in the amended legislation to exploit in order to reduce their tax burdens.

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