How is South Africa responding to growing concerns about base erosion?

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SOUTH AFRICA, INFLUENCED BY INTERNATIONAL TAX DEVELOPMENTS, HAS PROPOSED NEW MEASURES THAT SEEK TO ADDRESS PERCEIVED BASE EROSION PROBLEMS, WHILST AT THE SAME TIME IT TRIES TO POSITION ITSELF AS A 'GATEWAY TO AFRICA'.

From a tax policy perspective, base erosion becomes a concern for national tax authorities when gaps in the interaction of different tax systems, or the application of bilateral tax treaties, allow for income from cross-border activities to result in either non-taxation or unduly low taxation. The term 'base erosion' includes tax evasion, tax avoidance, tax underestimation and population flight.[1] All of these phenomena have the effect of eroding an administration's tax base, thereby limiting the revenue that the administration can allocate towards its planned objectives.

Of late, governments have become particularly concerned about corporations and multinationals being able to use tax havens and exploit loopholes or gaps in tax systems to avoid taxes or pay taxes at low effective rates – or, in some cases, pay no tax at all.[2] The OECD, a rich country think-tank, in a recent report entitled *Addressing Base Erosion and Profit Shifting*, described base erosion as a growing problem which presents a "serious risk to tax revenues, tax sovereignty and tax fairness for OECD member countries and non-members alike".[3]

In response to this perceived problem the OECD recently released and G20 finance ministers have endorsed an *Action Plan on Base Erosion and Profit Shifting*,[4] an internationally coordinated attempt to address tax avoidance in a globalised economy. The *Action Plan* identifies 15 specific actions for governments to develop (in an ambitious two-year time frame) instruments "to prevent corporations from paying little or no taxes". Our purpose is


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not to discuss the *Action Plan* in this article – it has already generated a great deal of comment, and will generate plenty more in the coming years. Our purpose is to describe South Africa's current responses to the challenges posed by base erosion.

The South African context

South Africa is a non-member with enhanced engagement with the OECD[5] and an observer to the OECD's Committee on Fiscal Affairs. It is also participating in OECD work on base erosion and profit shifting. South Africa's current Minister of Finance Pravin Gordhan was also, for a period, the elected chairman of the OECD's Forum on Tax Administration.

In his 2013 Budget Speech Minister Gordhan emphasised that the South African Revenue Service (SARS) "will continue with efforts to arrest aggressive tax planning, base erosion and profit shifting"[6]. Those efforts include the recent establishment of a Tax Review Committee, which is to conduct an extensive review of South Africa's tax system.

The Committee has been formed, in part, because of a perceived "need to address concerns about base erosion and profit shifting, especially in the context of corporate income tax, as identified by the OECD and G20".[7] And the Committee's mandate requires that, among other things, it "should evaluate the South African tax system against internationally accepted tax trends, principles and practices, as well as recent international initiatives to improve tax compliance and deal with problems of base erosion".[8]

South Africa's tax reform proposals in the 2013 Taxation Laws Amendment Bill (the Bill) also explicitly seek to address base erosion. The Bill envisages amendments to the Income Tax Act, 58 of 1962 (the ITA) to prevent opportunities for base erosion associated with debt capital and acquisition debt, and to provide for a uniform withholding tax regime, each of which we describe below.

Limitation of interest deductions: Loans between tax-exempt foreign persons and South African companies

The Bill introduces rules that, if they become law, will limit or cap the interest deductions that can be made in respect of certain loans between foreign companies and domestic (South African) companies, in instances where a 'controlling relationship' exists between the companies.

Section 23P of the Bill seeks to limit excessive interest deductions claimed by a South African resident debtor in respect of debt owed to a foreign person if that foreign creditor is both exempt from South African tax and in a 'controlling relationship' with that debtor.

A 'controlling relationship' is defined as a relationship where the creditor directly or indirectly, taking into account any 'connected person' (e.g. a company within the same group structure) in relation to that creditor, holds more than 70% of the equity shares in the South African debtor.

Section 23P of the Bill imposes various changes, which will become effective in respect of interest expenditure incurred on or after July 1, 2013, namely:

- introducing an overall cap to the aggregate deductions for interest on all debt owed by a South African resident debtor to a non-resident controlling person or persons: it achieves the cap by prescribing a formula that determines the amount that the debtor will be entitled to deduct in any year of assessment; and
- excluding the rules that currently determine when interest is 'incurred' for tax purposes: a debtor who falls within the ambit of the limitation will only be entitled to an interest deduction when the amount of interest is actually paid.[9]

The formula to be applied in terms of section 23P requires a number of steps:

- First, determine the debtor's 'adjustable taxable income' in terms of a formula set out in section 23N of the Bill.

- Once the debtor's adjustable taxable income is known, the total amount of interest received by or accrued to the South African debtor, excluding any interest owed to foreign tax exempt creditors in a controlling relationship with the debtor (i.e. interest subject to the proposed limitation), should be added to 40% of the adjustable taxable income for the year of assessment in which the debt is owed.
- From the resulting amount is then deducted interest incurred in respect of debts:
  i. owed to persons who are not in a controlling relationship with the debtor; or
  ii. in respect of funding which is related to a person in a controlling relationship with the debtor; or
  iii. in respect of the funding which is guaranteed by a person in a controlling relationship with the debtor.
- After those deductions have been made, the remaining amount represents the cap or limit on interest deductions that the debtor can make in that year of assessment in respect of debt owed to exempt persons with whom it is in a controlling relationship.

Any interest expenses in excess of the cap or limit will not be deductible by the debtor in that year of assessment. Instead, excess interest may be carried forward to succeeding years of assessment, subject to certain restrictions, and will be treated on a first-in first-out basis. That is, the earlier occurring excess interest will be carried forward to successive years of assessment, while 'retaining its tainted character', and deemed to have been incurred before any excess interest that arose after such earlier excess interest. The 'tainted' interest may not be carried forward for more than 10 successive years.

Limitation of interest deductions: Acquisition debt between persons in a controlling relationship

The Bill also proposes a limitation of interest deductions in the case of company acquisition indebtedness. The use of excessive debt ('acquisition debt') to fund company acquisitions represents a tax risk, as the high levels of interest reduce the profits of the target company into the foreseeable future. SARS therefore views excessively high levels of acquisition debt in such circumstances as being indicative of tax leakage.

Currently SARS uses its discretion to determine the limits to interest deductions associated with acquisition debt by examining levels of debt to decide what is, in its own words, "acceptable versus unacceptable tax leakage".[10] This required taxpayers to request SARS to exercise its discretion to allow interest deductions in respect of acquisition debt. The proposed rules, section 23N and section 23O of the Bill, will replace this discretionary system with an interest limitation that will apply to all debt used to fund both indirect share acquisitions (facilitated through section 45 or section 47 of the ITA) and direct share acquisitions (facilitated through section 24O of the ITA).

The nature of the deductible interest limitation in section 23O is similar to that in section 23P of the Bill, described above. It will be deemed to have come into operation on July 1, 2013, and will apply to various forms of acquisition debt described in section 23O(2) of the Bill. Section 23O will impose an annual limitation on interest deductions, which is to be arrived at by way of a prescribed formula. The limitation will be triggered "if the acquiring company and acquired company are in a controlling relationship [as described above] during any 18-month period in the 36-month period preceding the period in which the debt is applied or assumed".

It is worth mentioning that Action 4 of the OECD *Action Plan* proposes the development of recommendations regarding best practices in the design of rules to prevent or limit base erosion via interest deductions and other financial payments. Going forward the OECD's work will evaluate the effectiveness of different types of limitations.[11] It is unclear to what extent South African developments will be influenced or guided by the OECD's work in this regard.

New withholding tax regime

The Bill will also introduce a "uniform cross-border withholding regime to prevent base erosion" in South Africa. Currently the country imposes withholding taxes on cross-border royalties (at 12%) and dividends payments (at 15%).

The Bill proposes that, from January 1, 2015, South Africa will levy withholding taxes not only on cross-border royalties and dividends payments, but also on cross-border service fees and interest payments – to the extent that such payments are regarded as being made from a South African source.

All of these withholding taxes will operate in much the same way, and will be levied at a rate of 15%, for example:

- The withholding tax on interest will be calculated at a rate of 15% of "the amount of any interest paid by any person to or for the benefit of any foreign person" to the extent that such amount is regarded as having been received or accrued from a South African source (i.e. a source within the Republic in terms of section 9(2)(b) of the ITA).[12]
- The withholding tax on cross-border service fees is to be imposed at a rate of 15% of "the amount of any service fee that is paid by any person to or for the benefit of any foreign person to the extent that the service fee is regarded as having been received by or accrued to that person from a source within [South Africa]".[13]

The foreign person receiving the payments – be they interest, dividends, service fees or royalties – would be liable for the withholding tax, but the liability to actually withhold the tax and to pay it to SARS would fall with the person making the payment (the payor). The payment of the withholding tax to SARS by the payor discharges the liability of the foreign payee.

All of the proposed withholding taxes will be a final tax.

Increasing cooperation between SARS and foreign tax authorities

On top of proposing changes to its domestic laws, South Africa has also recently been party to a number of tax treaty amendments which allow for increased, and increasing, cooperation between SARS and foreign tax authorities. South Africa has signed a number of Protocols to its tax treaties with various countries, which include rules allowing for mutual assistance between the respective countries' tax authorities in the collection and enforcement of tax debts.[14] This adds another dimension to SARS' efforts to address base erosion practices.

The recent UK Court of Appeals judgment of May 23, 2013 in *Ben Nevis (Holdings) Limited v Commissioners for HM Revenue & Customs* [2013] EWCA Civ 578 is an important example of mutual assistance between tax authorities in the enforcement of tax debts. It involved a request by SARS to Her Majesty's Revenue & Customs (HMRC), the UK tax authorities, for assistance in the collection of a debt which SARS regarded as owing to it by Ben Nevis (Holdings) Limited (Ben Nevis). Ben Nevis is a company registered in the British Virgin Islands, which is owned and controlled by a South African resident businessman and/or his trustees.

In 2010, SARS obtained judgment against Ben Nevis in a South African court for an amount of some R[15]2.6bn (about £222m). Subsequent to that judgment, SARS learned that moneys had flowed from Ben Nevis to a related company's London bank account. SARS requested HMRC to assist in collection of the tax debt in the UK, and HMRC obliged.

Without notice to Ben Nevis or the related company, HMRC applied for, and obtained, an order freezing the funds in the London bank account and granting it permission to serve proceedings in the UK. Ben Nevis and the related company applied to set aside the order and to strike out the proceedings; HMRC in turn claimed judgment against Ben Nevis and relief against Ben Nevis and the related company under certain provisions of UK's Insolvency Act, 1986 that deal with transactions defrauding creditors. The appeal judgment turns on issues relating to the temporal scope of the mutual assistance provisions between UK and RSA, which do not concern us here. What is important for our purposes is that Ben Nevis provides a clear illustration of the increased enforcement powers that SARS can call on as it attempts to address and prevent base erosion – and it is just one example of a trend of continued broadening of SARS' enforcement powers.

Preventing base erosion whilst seeking to attract foreign investment

South Africa has to try to balance measures that seek to curb base erosion, like the sort described above, with tax proposals and other initiatives that seek to attract foreign direct investment to the country[16] – especially given the increasing foreign interest in Africa as an investment destination.

To this end, the Minister of Finance has proposed a number of measures "to relax cross-border financial regulations and tax requirements on companies, making it easier for banks and other financial institutions to invest and operate in other countries".[17] Similar measures are to be introduced to apply to foreign companies wanting to invest in African countries using South Africa as their regional headquarters.[18] All of these measures will accompany outward investment reforms as part of an overall scheme to make South Africa an attractive 'Gateway to Africa'.[19]

One example is the creation of a so-called 'Gateway subsidiary'. South Africa's National Treasury has proposed the creation of a special type of holding company, which is to be registered with the Financial Surveillance Department of the Reserve Bank. Each Johannesburg Stock Exchange-listed entity will then be entitled to establish one subsidiary to hold African and offshore operations, and that entity (HoldCo) will not be subject to foreign exchange restrictions. It is envisaged that, among other things, a HoldCo must be a South African tax resident, incorporated and effectively managed and controlled in South Africa. A HoldCo will be allowed to:

- receive transfers from its parent company, up to R750m per year;
- freely raise and deploy capital offshore, provided such funds are without South African guarantees;
- operate as cash management centres for South African multinationals, with cash pooling allowed without any restrictions;
- freely transfer income generated locally from cash management; and
- choose its functional currency or currencies, and operate foreign currency accounts and a rand-denominated account for operational expenses.

A HoldCo may also be able to benefit from a tax incentive which is being mooted to allow a HoldCo to use foreign functional currency for tax accounting purposes. This would ensure that a HoldCo is not taxed on foreign currency gains and losses that arise in the course of foreign functional currency treasury operations.[20]

Conclusion

South Africa's responses to base erosion are being influenced, and will continue to be influenced, by the OECD's plans to address problems associated with base erosion.

South Africa is also introducing initiatives that are intended to make it an attractive gateway into Africa for both South African and foreign businesses.

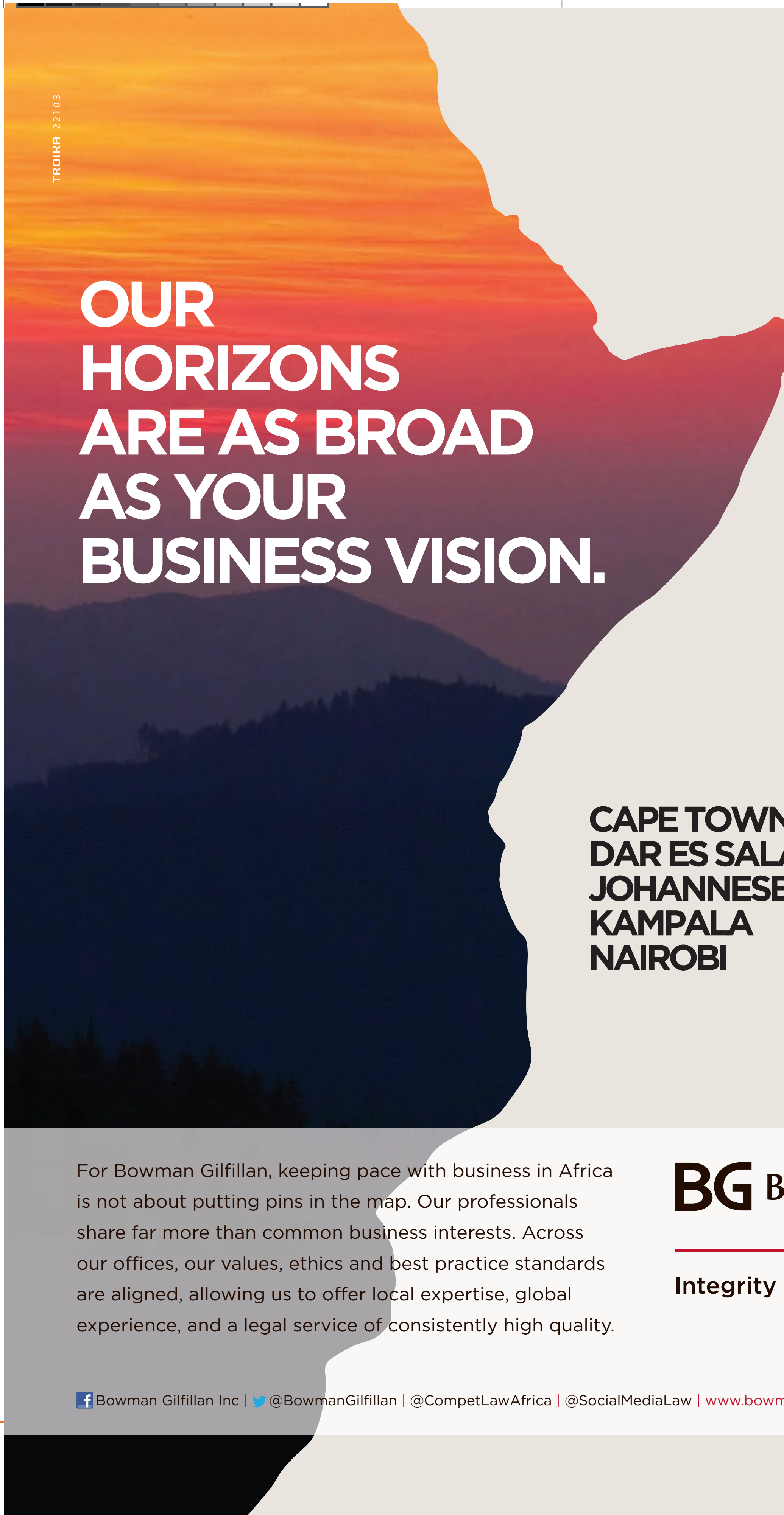
The proposed legislative measures to combat base erosion are still in draft format and will be subject to debate and revision going forward. The measures are likely to be influenced by the OECD's *Action Plan*.

What is clear is that there are likely to be significant changes to corporate tax in the coming years; just what those changes will be remains unclear.

Notes:

1 Detroit, Michigan is a case in point. A 2011 census showed that the city's population plunged 25% in a decade: http://www.nytimes.com/2011/03/23/us/23detroit.html?_r=0. In July 2013 Detroit filed for the largest municipal bankruptcy in US history.

2 Google, Starbucks, Apple and Microsoft have all come under increased scrutiny from multiple government authorities. A recent article in the *Guardian* suggests that HMRC, the UK tax authority, has no taxing rights on profits generated by Amazon's £4.2bn annual sales in the UK, which rely on a network of eight mega-warehouses across Britain, and are routed through Luxembourg; see: Simon Bowers and Patrick Wintour 'Amazon told: time is up for tax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3 OECD (2013), *Addressing Base Erosion and Profit Shifting*, OECD Publishing. http://dx.doi.org/10.1787/9789264192744-en.

4 OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing. http://dx.doi.org/10.1787/9789264202719-en.

5 See OECD Council Resolution on Enlargement and Enhanced Engagement, adopted on 16 May 2007, available at http://www.oecd.org/brazil/oecdcouncilresolutiononenlargementandenhancedengagement.htm.

6 See 2013 Budget Speech delivered on February 27, 2013 by Minister of Finance, Pravin Gordhan, available online at http://www.treasury.gov.za/documents/national%20budget/2013/speech/speech.pdf, at 62.

7 See http://www.treasury.gov.za/TaxReviewCommittee/Terms%20of%20Reference.pdf, at 2.

8 Above, note 7 at 4.

9 The deeming provision, section 23M(2) of the Bill, will not apply to any expenditure incurred in respect of the acquisition of trading stock – see section 23M(3).

10 SARS Draft Explanatory Memorandum to the Bill, at 34. Available online at http://www.treasury.gov.za/legislation/draft_bills/default.aspx.

11 See OECD *Action Plan*, above note 4, at 17.

12 See sections 49A to 49H of the Bill.

13 See sections 51A to 51H of the Bill. Section 51A defines "service fees" as "any amount that is received or accrued in respect of technical services, managerial services and consultancy services but (sic) does not include services incidental to the imparting of or the undertaking to impart any scientific, technical, industrial or commercial knowledge or information, or the rendering of or the undertaking to render any assistance or service in connection with the application or utilisation of such knowledge or information".

14 See, for example, the mutual assistance provisions in the Protocols to the Double Taxation Agreements entered into between South Africa and the United Kingdom (entry into force, October 13, 2011) and Australia (entry into force, November 12, 2008).

15 South African rand.

16 See, for example, OECD (2007), *Tax Effects on Foreign Direct Investment: Recent Evidence and Policy Analysis* – OECD Tax Policy Studies No. 17, available online at http://www.oecd.org/tax/tax-policy/39866155.pdf.

17 2013 Budget Speech, above note 6, at 13.

18 The 2013 Budget Review suggests that between 2007 and 2011, South African companies undertook nearly 1000 new investments into 36 African countries, including Nigeria, Zambia, Mozambique, Zimbabwe, Kenya, Botswana and Angola.

19 *Ibid*.

20 See 2013 Budget Review, Annexure W3, at 1-2. Available online at http://www.treasury.gov.za/documents/national%20budget/2013/review/Annexure%20W3.pdf.