TAX

IN THIS ISSUE

THE FUTURE OF THE INTERNATIONAL TAX LANDSCAPE

The Organisation for Economic Co-operation and Development (OECD) Base Erosion and Profit Sharing (BEPS) Action Plan, approved by the OECD Committee of Fiscal Affairs (CFA) in June 2013 and endorsed by the G20 Heads of Government in September 2013, was formulated to combat international tax avoidance by multinational enterprises (MNEs) through artificially shifting profits to low tax jurisdictions and eroding the tax bases of their primary high tax jurisdictions of operation. The objective of the BEPS Action Plan is to secure government revenues by ensuring that profits are taxed in the jurisdiction where the economic activities generating such profits are performed and where value is created.

During September 2014, the OECD made the seven 2014 BEPS Action Plan deliverables available to the public. In our Tax Alert of 10 October 2014, we dealt with two of those deliverables: the instruments dealing with hybrid mismatch arrangements, and transfer pricing (TP) documentation and country-by-country (CBC) reporting. We turn now to the remaining 2014 deliverables:

- the final reports on the digital economy and the feasibility of a multilateral instrument;
- the interim report on harmful tax practices; and
- the instruments dealing with treaty abuse and the TP aspects of intangibles.

Final report on the digital economy (BEPS Action 1)

The report establishes by consensus that it is not possible to ring-fence the digital economy for tax purposes because the digital economy is itself, the economy. In addition, although the report does not suggest specific measures to deal with the tax issues raised by the digital economy, it does provide clarification on what was previously an area of extreme obfuscation.

In identifying the key features and business models peculiar to the digital economy that exacerbate BEPS risks, it has been agreed that such risks will be addressed by other work in the BEPS project, which will require consideration of the specific issues linked to the digital economy, in particular:

- Controlled Foreign Company (CFC) rules (BEPS Action 3) – due to the mobility of digital income;
- Artificial avoidance of permanent establishment (PE) (BEPS Action 7) – previously a confused debate because of the over-emphasis on the physical presence or lack thereof in a particular jurisdiction, when in fact the risk of artificial avoidance could be contained through re-characterisation of certain functions eg formerly preliminary functions which have now become and ought to be re-characterised as core functions, which if found to be conducted in a particular jurisdiction, would establish a PE; and
- TP (BEPS Actions 8 – 10) – to address the spread of supply chains across the globe, the mobility of intangibles, and the value of data.

The report concludes that the digital economy raises certain systemic tax challenges, both in the realm of direct taxation (eg *nexus*, characterisation, and data) and indirect taxation (eg VAT collection in the destination country for cross-border business-to-consumer transactions for which administrative mechanisms are being evolved). The possibility of modifying *nexus* rules and imposing a withholding tax on the supply of digital goods and services is considered but not finalised in the report, however the report records that agreement has been reached on a framework for evaluating the direct tax challenges precipitated by the digital economy.

Final report on the feasibility of a multilateral instrument (BEPS Action 15)

This report, approved by government representatives in the CFA, and of particular interest to public international lawyers, focusses on the feasibility of using a multilateral instrument to implement BEPS measures and modify double taxation agreements (DTAs). It concludes, based on precedents from various areas other than tax, that a multilateral instrument is not only feasible but indeed desirable to ensure the sustainability of the existing consensual DTA framework to eliminate double taxation. The report concludes that the main goal is to expedite and streamline the implementation of the measures developed to address BEPS and amend DTAs accordingly.

In January 2015, the CFA will consider a draft mandate for the negotiation of a multilateral instrument; moving swiftly from feasibility into action.

continued

Interim report on harmful tax practices (BEPS Action 5)

The interim report essentially revives and provides a progress report on the work done by the Forum for Harmful Tax Practices (FHTP), focussing on:

- the requirement of a substantial activity based on the proportionate nexus approach for all preferential regimes with particular application to intellectual property (IP) regimes;
- transparency and the establishment of a framework for the compulsory exchange of information pertaining to taxpayer specific rulings; and
- a review of member and associate regimes.

The remaining two deliverables are instruments, colloquially termed 'soft' legislation, which deal with the following BEPS issues:

Treaty abuse (BEPS Action 6)

The report clarifies that DTAs should avoid creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including treaty shopping, by adopting a minimum standard to prevent treaty shopping. An express statement is proposed for inclusion in DTAs that the common intention of the Contracting States is to eliminate double taxation without creating opportunities for treaty shopping. In addition a combined approach is proposed:

- A general anti-abuse rule targeting arrangements one of the main purposes of which is to obtain treaty benefits; and
- A number of specific anti-abuse rules eg:
  - a limitation-on-benefits (LOB) rule to address a variety of treaty shopping situations based on the legal nature, ownership in, and general activities, of residents of a Contracting State;
  - a minimum shareholding period to prevent dividend transfer transactions;
  - amendments to prevent transactions that circumvent the application of Article 13(4) of the OECD Model Convention on Income and on Capital (MC) in terms of which gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50% of their value directly or indirectly from immovable property situated in the other Contracting State, may be taxed in the other State;
  - changes to the tie-breaker rule for determining the treaty residence of dual-resident entities; and
  - an anti-abuse rule for PEs situated in third States.

Further work will be conducted on the treaty entitlement of various investment funds, and on the interaction between DTAs and the recommendations for new domestic anti-abuse rules that may emanate from work on other parts of the BEPS Action Plan.

TP aspects of intangibles (BEPS Action 8)

Chapter I of the TP guidelines has been expanded to discuss location savings and other local market features; assembled workforce; and group synergies. A new Chapter VI provides guidance on identifying intangibles and on determining arm's length conditions, dealing with:

- Comparability in intangibles transactions; and
- TP methods and the use of valuation techniques for intangibles transactions.

The report provides interim guidance on the allocation of returns derived from intangibles within MNEs as follows:

- legal ownership and contractual arrangements provide the departure point for TP analysis;
- but parties contributing to development, enhancement, maintenance, protection and exploitation of the intangible must be commensurately remunerated. Appropriate remuneration must also be attributed to parties performing functions, using assets, bearing risks, as well as parties controlling such activities.

This interim guidance will be finalised in 2015 taking cognisance of issues such as excessive capitalisation, ''ash-box" owners of intangibles with low functionality and the mere contractual allocation of risk, and hard to value intangibles.
We await the timeous release of the remaining eight BEPS Action Plan deliverables late in 2015.

Lisa Brunton

PROPOSED CHANGES TO SECONDARY TRANSFER PRICING ADJUSTMENT – FURTHER DEVELOPMENTS

We have previously reported on the draft Taxation Laws Amendment Bill 2014 (Bill) that was released by the National Treasury and the South African Revenue Service (SARS) earlier this year, and specifically in respect of the proposed changes to the secondary transfer pricing adjustment mechanism.

The secondary transfer pricing adjustment mechanism, contained in s31(3) of the Income Tax Act, No 58 of 1962 (Act), currently takes the form of a deemed loan in an amount equal to the difference between the arm's length amount that is taken into account for tax purposes of any resident party as a result of the primary transfer pricing adjustment and the non-arm's length amount that would have been taken into account had there been no primary transfer pricing adjustment.

For various reasons it was proposed in the draft Bill that the deemed loan be changed to a deemed dividend. Some of the criticisms raised by interested parties were that the draft Bill did not deal with:

- instances where the party deemed to pay the dividend is a holding company or a natural person;
- when the dividend is deemed to be paid;
- to whom the dividend is paid; and
- current deemed loans.

Treasury and SARS have now released a response document to the comments received from the public, as well as a final Bill (tabled in parliament on 22 October 2014), in which it has now been clarified that:

- where the party is a natural person or a trust, the amount will be deemed to be a donation by that person or trust and not a dividend – no compromise has been made in respect of where the party is a holding company (and such company therefore risks not being able to make use of any participation exemption);
- the dividend will be deemed to be paid by the resident six months after the end of the tax year in which the adjustment is made; and
- existing deemed loans will be deemed to be dividends in the case of companies and donations in respect of natural persons or trusts.

It is encouraging to see that National Treasury and SARS have taken cognisance of the public's concerns and that most of these have been addressed in the final Bill.

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