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TAX

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IN THIS ISSUE

THE OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT LEADERS SHED LIGHT ON 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.

Based on the somewhat paranoid, politically driven notion that the prevailing consensus-based international tax framework was on the verge of unravelling in the wake of tax pillaging by MNEs, a rigorous BEPS Action Plan timeline was proposed for deliverables, staggered over 2014 and 2015. Naysayers considered the timeline ambitious, even unattainable. Some perhaps secretly hoped that if deadlines weren't met, the BEPS Action Plan would lose momentum and the political laser honed on MNEs as a potential source of revenue generation for cash-strapped governments would dissipate. They were wrong. On 16 September 2014, bang on schedule, after extensive consultation with government task forces, business representatives, trade unions, civil society organisations and academics from all OECD member countries, G20 and Accession countries, cumulatively representing 90% of the global economy; the seven 2014 deliverables were made available to the public, having been agreed by consensus over the preceding 12 months. The deliverables were accompanied by an Explanatory Statement, a political statement espousing the objectives of the BEPS Action Plan, summarising the achievements of the OECD/G20 BEPS Project thus far, and highlighting the way forward.

In summary, in accordance with the BEPS Action Plan, the 2014 deliverables focus on:

- designing new international standards to ensure coherent corporate income taxation at the international level through rules to neutralise hybrid mismatch arrangements (BEPS Action 2);
- realigning taxation and relevant substance to restore the intended benefits of international standards both in the domain of double taxation agreements (DTAs) by preventing treaty abuse (BEPS Action 6) and in the domain of transfer pricing (TP) by ensuring that TP outcomes align with value creation in the area of intangibles (BEPS Action 8);
- facilitating greater transparency for tax administrations and regularising requirements for taxpayers through improved TP documentation and a template for country-by-country (CBC) reporting (BEPS Action 13);
- addressing the tax challenges of the digital economy (BEPS Action 1);

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- the feasibility of developing a multilateral instrument to enable jurisdictions to implement measures agreed in the course of the BEPS work, and as a result, modify the network of existing DTAs (BEPS Action 15); and
- combating harmful tax practices more effectively, taking cognisance of transparency and substance (BEPS Action 5).

In this article, we deal with what we consider to be two of the most important 2014 deliverables, the instruments dealing with hybrid mismatch arrangements and TP documentation and CBC reporting. The remaining 2014 deliverables (ie 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) will be dealt with in a subsequent article.

1. Hybrid mismatch arrangements (BEPS Action 2)

Briefly, a hybrid mismatch arrangement is one that exploits the different tax treatment in two or more jurisdictions to produce a mismatch in tax outcomes. The mismatch either precipitates two deductions for a single economic expense or a deductible payment that is not included in income by the recipient of such payment.

The report recommends domestic law changes and changes to the OECD Model Convention with respect to taxes on Income and on Capital (MC) to deal with hybrids; the objective being to formulate clear, automatic and comprehensive rules that neutralise tax mismatches without unnecessarily disrupting the commercial or regulatory consequences of such cross-border arrangements. Further, the objective of the rules is both to reduce transaction costs and the tax risks attendant upon cross-border investment when compared to the costs and risks attendant on uncoordinated action.

Consensus has been reached on the following key issues:

1.1 Linking rules

Conceptually linking rules have been agreed upon as the appropriate mechanism to counter the adverse tax implications of hybrid mismatches. Since linking does not constitute or require cross-jurisdictional fiscal harmonisation, the proposed rules should result in minimal intervention at the domestic business level. The general rule will operate to deny a deduction (either of a payment which is not included in the income of the recipient thereof; or of a double deduction for a single economic expense).

1.2 Rule order

The hybrid mismatch is either countered by operation of the primary rule (eg denial of a deduction), or should the primary rule not operate in the relevant jurisdiction; by operation of the defensive rule (eg income inclusion). In this way the BEPS rules to neutralise hybrid mismatches operate even if not all jurisdictions subscribe to them. Further, the proposed rule order ensures that in applying the rules, one doesn't risk moving from double non-taxation to double taxation.

1.3 Scope

The perceived excessively broad scope of the rules to address hybrid mismatch arrangements has been a bone of contention for many commentators. The scope of the rules is restricted to controlled groups and structured arrangements; and to related parties in the case of hybrid instruments.

To ascertain the presence of a structured arrangement, a list of easily identifiable features indicative of the exploitation of tax mismatches precipitated by hybridity would typically include:

- an arrangement developed to exploit differences in tax treatment, marketed as a tax efficient product or marketed to investors that would benefit from tax arbitrage;
- an arrangement priced to take account of the tax benefit or potential tax benefit of a hybrid mismatch;
- the tax benefits are disproportionately significant relative to the non-tax business and financial consequences of the arrangement;
- the arrangement involves typical features of tax-driven structured products eg tax-indifferent parties or special purpose vehicles; and/or
- there are collateral arrangements or embedded terms in the instrument that amend the economic return under the instrument should the tax benefit not materialise.

Originally it was proposed that taxpayers would be considered related persons if the first person held a 10% or greater investment in the second person or a third person held 10% or more in both the first and second persons; where 'investment' meant a direct or indirect holding of 10% of the voting rights (ie right to participate in decision-making concerning distributions, change in constitution or director appointments) or equity interests (ie entitlement to profits or eligibility to participate

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in distributions) of the other person. Further it was proposed that a person would include any entity or unincorporated body of persons (including a trust).

The 10% holding has now been increased to 25% in acknowledgement of the difficulty of sourcing the requisite information to address cross-border hybrid mismatches.

Certain substantive issues require further work (eg how to deal with intra-group hybrid regulatory capital, certain on-market stock-lending and repos (ie high volume transactions); the application of the imported mismatch rule to treasury centres, and how to deal with CFCs). In addition the implementation of the rules has to been dealt with cautiously. It is suggested that transitional rules may be required to ease the process and the provision of guidance on the implementation and core operation of the rules is still under consideration.

It bears mention that although some of South Africa's fiscal legislation pertaining to hybrid mismatches is operationally contradictory (eg s8E, s8EA, s8F and s8FA of the Income Tax Act, No 58 of 1962 (Act)), and the legislation limiting interest deductibility is commercially obstructive (s23M and s23N); generally South Africa has been proactive and is ahead of the BEPS curve in this regard (eg the definitions of 'foreign dividend', 'foreign partnership' and 'foreign return of capital' in s1 of the Act, s23G, the definitions of 'repurchase agreement' and 'resale agreement' in s24J etc.).

2. TP documentation and CBC reporting (BEPS Action 13)

BEPS Action 13 has generated the most commentary and response in terms of consultative input from the international business community. The major considerations covered in the report include confidentiality, timeliness, consistency, appropriate usage and whether phase-in rules may be required.

A 3-tiered approach to TP documentation has been agreed:

2.1 Master file: to provide a high level overview of the MNE group business;

2.2 Local file: containing detailed information on specific group transactions; and

2.3 CBC report: comprising aggregate, jurisdiction-wide information on the global allocation of income, taxes paid and indicators of economic activity. The CBC report is intended to be a TP risk assessment tool as well as a means of evaluating other BEPS-related risks.

The proposed CBC reporting template provides for disclosure of the following information by jurisdiction:

- Revenues (related party / unrelated party)
- Profit (loss) before income tax
- Income tax paid (cash basis) and accrued
- Stated capital and accumulated earnings
- Number of employees; and
- Tangible assets other than cash or cash equivalents;

and by constituent entity:

- Jurisdiction of organisation and incorporation (if different); and
- Main business activity

Thus final agreement has been reached on the content of TP documentation but implementation, especially filing (eg via treaty or local filing), and dissemination mechanisms for the master file and CBC report still need to be addressed.

Achieving timeous submission of the 2014 deliverables was no mean feat. The OECD/G20 BEPS Project is on track, 50% closer to the new international tax landscape; having already commenced work on the remaining eight deliverables due late in 2015. And what does that landscape look like? An indication was provided by Raffaele Russo, Head of the BEPS Project, in the live webcast broadcast from Paris on 16 September 2014. When asked what the fate would be of the "double Irish accompanied by Dutch sandwich" and similar arrangements (ie a tax avoidance strategy employed by some MNEs to reduce their corporate tax liability by shifting profits from high to low tax jurisdictions between related parties) in the post BEPS Action Plan implementation international tax landscape, he quipped, "I'm not familiar with that arrangement but I think maybe the sandwich will not taste so good!"

Lisa Brunton

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VALUE-ADDED TAX AND ENTERTAINMENT

It is well-established that, in terms of section 17(2)(a) of the Value-added Tax Act, No 89 of 1991 (VAT Act), a vendor is not entitled to deduct any amount of input tax in respect of goods or services acquired for the purposes of 'entertainment', unless certain exceptions apply.

The Tax Court recently gave judgment in the case of *AB (Pty) Ltd v Commissioner for the South African Revenue Service* (case no 1015, as yet unreported) concerning input tax deductions and entertainment expenses.

The appellant was a registered vendor that provided services in the mining industry, such as the sinking of shafts and other construction work. The fact that the services usually had to be rendered at mining sites, and that many of the appellant's employees were not from South Africa, meant that the appellant had to provide accommodation and meals for its employees while working on particular projects.

The appellant generally outsourced the provision of the said accommodation and meals by contracting with third parties operating close to the relevant mines (in this matter a particular third party). The third party was a registered vendor and levied Value-added Tax (VAT) in respect of the supply of the accommodation and meals.

The appellant claimed input tax deductions in respect of the VAT paid on the accommodation and meals. However, the South African Revenue Service (SARS) subsequently raised assessments against the appellant, disallowing the input tax deductions on the basis that accommodation and meals constitute 'entertainment'. The appellant objected, but SARS disallowed the objection, and the appellant appealed to the Tax Court.

The term 'entertainment' is defined in s1 of the VAT Act as meaning "the provision of any food, beverages, accommodation, entertainment, amusement, recreation or hospitality of any kind by a vendor whether directly or indirectly to anyone in connection with an enterprise carried on by him".

The court seemed to accept that the purpose of s17(2)(a) of the VAT Act is to prohibit input tax deductions where the supply "…involves a strong element of personal enjoyment, especially in circumstances where there is room for abuse".

The appellant's argument was essentially that, under the circumstances in question, the provision of the accommodation and meals should not be construed as 'entertainment' because there was no personal enjoyment by the appellant. Also, the employees only received basic food and accommodation and there was no intention of providing personal enjoyment. The mischief that the VAT Act intended to address by prohibiting the deduction of input tax was accordingly not present in the appellant's circumstances. A restrictive interpretation should therefore apply in respect of s17(2) of the VAT Act.

The court found the appellant's arguments to be without merit because, in the court's view, the legislature could not have intended for the provision of accommodation and meals to be categorised into basic or luxurious, and to so determine whether it should be exempt from the prohibition (presumably on the basis that luxury accommodation or meals would imply that there is an element of personal enjoyment).

The court further argued that the term 'entertainment' is defined and is unambiguous. It is clear that meals and accommodation are included in that term, and there is no problem with that interpretation that would warrant "a resort to other cannons of interpretation", presumably a purposive and restrictive interpretation.

Without elaborating on the details, the court also found that none of the exceptions to the prohibition in s17(2)(a) of the VAT Act applied.

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