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TAX ALERT

IN THIS ISSUE

THE OECD/G20 BASE EROSION AND PROFIT SHIFTING (BEPS) PROJECT – AN INFORMED PERSPECTIVE

The OECD BEPS 15-point 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 legally but artificially shifting profits to low tax jurisdictions and eroding the tax bases of their primary high tax jurisdictions of operation.

MERGER OF CONTROLLED FOREIGN COMPANIES

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The BEPS Project involves input from the 34 member countries of the OECD, all G20 members, and more than 40 developing countries. The objective of the BEPS Project is to close gaps in international tax rules, effectively eliminating or substantially reducing BEPS; and 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.

In our October 2014 Tax Alerts, we reviewed the 2014 deliverables of the BEPS Project and speculated about whether the OECD would be able to achieve its 2015 objectives timeously.

On 5 October 2015, as promised, the OECD BEPS Project delivered its 15 final outputs, two years after its launch in 2013. Pascal Saint-Amans, Director of the Centre of Tax Policy and Administration at the OECD, stated that "the international tax system is outdated (and) we are bringing it up to date". Indeed the denouement of the BEPS Project represents the most fundamental changes to international tax rules in a century. That stated, the Project does not advocate global tax symmetry, nor does it promise a tax utopia. What it does is propose a workable framework for inter-jurisdictional cooperation at the international tax level. Cooperation at this level, particularly as between the tax authorities of different countries, was inconceivable before the global financial crisis.

The BEPS Project will precipitate changes to the OECD Model Tax Convention and the OECD Transfer Pricing Guidelines, and include recommendations for improvements to domestic legislation to better align it with the revised international tax system. These are soft law instruments which have been developed and agreed to by the governments of all participating countries. They will address double non-taxation and improve mechanisms to counter instances of double taxation.

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One of the criticisms levelled at the ambitious BEPS Project to date has been how to quantify the effect of BEPS in the absence of a monitoring body to consolidate global data on point; the exercise has facilitated the approximate quantification, albeit conservative, of revenue losses from BEPS. Extensive research done during the course of the BEPS Project indicates that between US$100 billion and US$240 billion is lost annually due to BEPS. This equates to between 4% and 10% of global revenues from corporate income tax and far exceeds the speculative estimate referenced in the

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CONTINUED

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Tax Justice Network report, "The Missing Billions"; or Oxfam's attribution of US$50 billion to lost revenue for developing countries due to MNEs engaging in tax avoidance. Given that developing countries are heavily dependent on such tax revenues, estimates of the impact on these countries, as a percentage of GDP, is even greater.

The result of the BEPS Project thus far is a comprehensive package of measures designed for coordinated domestic and treaty implementation, fortified by targeted monitoring and enhanced transparency. The measures include:

- Agreed minimum standards to level the playing field in the areas of treaty shopping, country-by-country reporting, dispute resolution and harmful tax practices. These are areas where all OECD and G20 countries have committed to consistent implementation to address situations where no action by some countries would have negative consequences for other countries. Examples of such minimum standards are:
    - the model provisions to prevent treaty abuse that will be included in the multilateral instrument that countries may adopt to implement the results of the work on tax treaty issues into their existing double taxation agreements (DTAs) without having to renegotiate each one bilaterally;
    - standardised country-by-country reporting and other documentation requirements to grant tax administrations global oversight of where MNEs' profits, tax and economic activities are reported, thereby enabling the tax authorities to assess transfer pricing and other BEPS risks;
    - a peer review process to tackle harmful tax practices, including a review of patent boxes that contain harmful features;
    - adoption of the mandatory spontaneous exchange of relevant information on taxpayer-specific rulings; and
    - a commitment to improve dispute resolution.
- Evaluation of the existing international tax standards to eliminate double taxation with the objective of curtailing abuses and closing BEPS opportunities, in particular, guidance on the agreed interpretation of the provisions of Article 9 (Associated Enterprises) of both the OECD and UN model tax conventions; modernization (in relation to intangibles) of and changes to the Transfer Pricing Guidelines to ensure that the transfer pricing of MNEs better aligns taxation of profits with economic activity, and reduces the shifting of income to 'cash boxes'; and the provision of methodology to appropriately price hard-to-value intangibles.

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THE OECD/G20 BASE EROSION AND PROFIT SHIFTING (BEPS) PROJECT – AN INFORMED PERSPECTIVE

CONTINUED

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- Amendments to the permanent establishment (PE) definition to bring the definition up to speed with the technological era and to tackle techniques employed to inappropriately circumvent the tax nexus eg through commissionaire arrangements and/or the artificial fragmentation of business activities. Follow-up work will be done to provide guidance on profit attribution to PEs and additional clarification will be forthcoming on the unintended consequences of the proposed new treaty wording, particularly with regard to the global trading of financial products.
- A common approach to align the national practices of interested countries to limit base erosion through interest expenses; and to neutralise hybrid mismatches. Recommendations for the design of both domestic and model treaty provisions have been agreed. Guidance based on best practices has also been provided for countries wishing to galvanise their domestic law pertaining to mandatory disclosure by taxpayers of aggressive transactions. In additional, the fundamentals of a sound controlled foreign company (CFC) regime form part of the proposed measures.
- Regarding the digital economy, the BEPS Project acknowledges that it is in fact the economy itself, and as such, while it may exacerbate BEPS risks, it cannot be ring-fenced for tax resolution purposes. For this reason, it is anticipated that the measures developed through the work of the BEPS Project will mitigate such risks.
- One of the most exciting measures, from a jurisprudential perspective, is the negotiation of a multilateral instrument - an innovative mechanism to update the global network of more than 3,500 DTAs. Ninety odd countries are collaborating to formulate a multilateral instrument to implement the treaty-related BEPS measures, the objective being to modify the DTAs in a synchronized and efficient manner, obviating the need to expend resources on bilaterally renegotiating each DTA. The deadline for conclusion of the multilateral instrument is the end of 2016.

SO, WHERE TO FROM HERE?

The BEPS Action Plan notes that:

> "The emergence of competing sets of international standards, and the replacement of the current consensus based framework by unilateral measures, could lead to global tax chaos marked by the massive re-emergence of double taxation."

Given this potential risk, it is submitted that consistent, coordinated implementation and application are critical. There has been a shift in the international tax paradigm for governments, tax administrations and taxpayers (particularly MNEs) since the global financial crisis, the best of which is evidenced by the overwhelming cross-jurisdictional participation and collaboration in the BEPS Project; and embodied in the Project's measures. It has been observed that South Africa has developed certain sophisticated and robust measures to protect its tax base from erosion over time, so why should

THE OECD/G20 BASE EROSION AND PROFIT SHIFTING (BEPS) PROJECT – AN INFORMED PERSPECTIVE

CONTINUED

We operate within the global community and as SAICA commented, with reference to another international tax issue, South Africa is "too small an economy in the world to be out of step with the general consensus view".

we concern ourselves with what happens beyond our borders? Well, simply because we operate within the global community and as SAICA commented, with reference to another international tax issue, South Africa is "too small an economy in the world to be out of step with the general consensus view". I submit that SAICA's observation is relevant here too. The objectives of the BEPS Project may be lofty, but how can that be viewed as a shortcoming? They make practical sense in both the domestic and international tax arenas. And who knows? Perhaps South Africa's active involvement in the BEPS Project, and its commitment to consider the proposed measures, provided they align with the NDP, will operate as a notional extra-jurisdictional sanction on the perceived willingness of South African corporate taxpayers and MNEs conducting business in South Africa, to invest substantial amounts of time, money and resources on domestic tax avoidance. This could be to the South African Revenue Service's (SARS's) advantage, particularly given that domestic tax morality is under threat due to inefficient government spending and corruption; inchoate e-tolling pronouncements; and SARS's rapacious collection methods, all of which have caused the "trust deficit between taxpayers and government" to increase.

Lisa Brunton

MERGER OF CONTROLLED FOREIGN COMPANIES

SARS ruled that the proposed transaction would constitute an amalgamation transaction in terms of paragraph (c) of the definition of 'amalgamation transaction' in s44(1) of the Act.

The South African Revenue Service (SARS) released Binding Private Ruling No 207 (Ruling) on 7 October 2015. The Ruling dealt with the merger of two controlled foreign companies (CFCs) for purposes of s9D of the Income Tax Act, No 58 of 1962 (Act).

A South African incorporated and resident company (Applicant) had two subsidiaries that were incorporated and resident in foreign countries, and were CFCs. The first subsidiary (CFC 1) was a listed passive holding company. The second subsidiary (CFC 2) was a privately held intermediate holding company.

In order to consolidate some of the group's investments, it was proposed that all the assets and liabilities of CFC 1 be transferred to CFC 2 by way of a merger. As a result of the merger, the assets and liabilities of CFC 1 would become that of CFC 2 by operation of law, and CFC 1 would automatically cease to exist.

CFC 2 would issue a single ordinary share at nominal value, ranking pari passu with all other issued ordinary shares, to the Applicant as consideration for the transfer of the assets and liabilities.

SARS ruled that the proposed transaction would constitute an amalgamation transaction in terms of paragraph (c) of the definition of 'amalgamation transaction' in s44(1) of the Act.

The definition refers to a transaction:

"(c) (i) in terms of which an amalgamated company which is a foreign company disposes of all of its assets (other than assets it elects to use to settle any debts incurred by it in the ordinary course of its trade) to a resultant company which is a foreign company, by means of an amalgamation, conversion or merger;

(ii) if -

(aa) immediately before that transaction -

(A) that amalgamated company and that resultant company form part of the same group of companies (as defined in section 1);

(B) that resultant company is a controlled foreign company in relation to any resident that is part of the group of companies contemplated in subitem (A); and

(C) any shares in that amalgamated company that are directly or indirectly held by that resultant company are held as capital assets; and

(bb) immediately after that transaction, more than 50 per cent of the equity shares in that resultant company are directly or indirectly held by a resident (whether alone or together with any other person that is a resident and that forms part of the same group of companies as that resident); and

(iii) as a result of which the existence of that amalgamated company will be terminated."

CFC 1, and therefore the Applicant, would enjoy roll-over relief in respect of the transfer of the assets and liabilities (s44(2) and (3) of the Act).

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CONTINUED

SARS also ruled that s24BA of the Act, which attempts to curb value mismatches in transactions where assets are transferred in return for the issue of shares, would not apply.

The Applicant would also enjoy roll-over relief in respect of the disposal of its shares in CFC 1, and would establish a base cost in the consideration share issued by CFC 2 equal to the base cost it had in its shares in CFC 1. The issue of the consideration share would also not be treated as a dividend in respect of the shares in CFC 1 (s (6)(c) of the Act).

Since the proposed transaction would constitute an 'amalgamation transaction' as defined, s9H(6)(a) of the Act would also apply to provide relief from any exit charge that could arise as a result of CFC 1 ceasing to be a CFC.

SARS also ruled that s24BA of the Act, which attempts to curb value mismatches in transactions where assets are transferred in return for the issue of shares, would not apply. Unfortunately it is not clear on what basis SARS ruled that s24BA of the Act would not apply, and specifically whether it was because there would be no value mismatch, the parties would transact at arm's length, or one of the exemptions in s24BA(4) would apply.

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