South African
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24 August 2015

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**RE: COMMENTS CONCERNING THE DRAFT TAXATION LAWS AMENDMENT BILLS, 2015: INTERNATIONAL TAX ISSUES**

Attached are the SAIT international tax comments associated with the draft Taxation Laws Amendment Bills, 2015 (1st and 2nd). We believe that constructive private sector participation is valuable and appreciate having the workshop concerning international and business tax issues on 2 September 2015. The comments provided only cover issues of concern.

Should you have any further questions, please do not hesitate to contact me.

Yours sincerely,

**Elandre Brandt**

**Chair of the International Tax Committee**

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## I. PARTICIPATION EXEMPTION AND DISPOSALS TO CONNECTED PERSONS: PROPOSED AMENDMENT TO PARAGRAPH 64B OF THE EIGHTH SCHEDULE

### 1. Draft proposal

The Bill proposes to restrict the participation exemption when disposing of foreign shares so that the exemption no longer applies to disposals to connected persons. We understand that the purpose of the amendment is to prevent indirect tax-free corporate migrations (e.g. tax disposals by a South African company of foreign shares to a foreign holding company or to a foreign affiliate outside of the direct or CFC South African tax net, followed by the migration of the South African company outside of South Africa with little or no tax charge).

### 2. Problem

The anti-avoidance amendment goes beyond genuine avoidance situations because the "connected person" threshold is too low. Ownership, as low as 20 per cent, generally does not mean that the parties are part of the same economic unit. Ownership connections at these low levels generally mean that the economic unity between the buyer and seller is not strong enough to jointly collude against the tax system (except perhaps for significant stakes in a listed company).

> Example. Facts. Foreign Parent Holding Company holds 100% in South African Subsidiary, which in turn holds 100 per cent in CFC. South African Subsidiary also holds 25 per cent in Foreign Joint Venture Company. Foreign Joint Venture Company has a value of R100 million and is owned by four equal shareholders (no one has de facto control over the other). South African Subsidiary sells all of its shares in CFC to Foreign Joint Venture Company for R8 million worth of straight preference shares issued by Foreign Joint Venture Company.

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Outcome. Under the proposed amendment, South African Subsidiary cannot rely on the participation exemption since South African Subsidiary and Foreign Joint Venture Company are connected persons due to the 20 per cent connection despite the lack of economic unity (See paragraph d (v) of the definition of connected person in section 1). Clearly, the intention of the amendment cannot be to tax South African Subsidiary because South African Subsidiary at all times holds only minority interest in Foreign Joint Venture Company (requiring support from at least two of the three shareholders to take action).

### 3. Possible solution

The new anti-avoidance rule should be narrowed. The new anti-avoidance rule should presumably be limited to intra-group disposals (under section 1 group definition of the Income Tax Act) so that paragraph 64B of the 8th Schedule remains a closely aligned alternative to the reorganisation rules (which are limited to intra-group transactions). Alternatively, the connected person test should be limited to more than 50 per cent owners or at least exclude the paragraph (d)(iv) and (d)(v) relationships (see section 31 ("connected person" definition)). The suggested narrowing of the proposed anti-avoidance rule will not undermine the proposed attempt to prevent indirect corporate migrations (which are largely made to foreign holding companies or foreign affiliates).

## II. WITHDRAWAL OF SPECIAL FOREIGN TAX CREDITS IN RESPECT OF SERVICE FEES SOURCED IN SOUTH AFRICA: PROPOSED DELETION OF SECTION 6QUIN

### 1. Draft proposal

Section 6quin provides full relief from double taxation in the case of cross-border services. This relief is often critical for South African companies that provide services to other African and developing countries. This relief comes in the form of tax rebates that offset foreign withholding taxes imposed by certain African countries (many of which impose a withholding tax where a resident of that country pays a service fee to a non-resident, irrespective of where the services are rendered (i.e. the tax is imposed on a payments basis – not a source basis) and some of which are imposed in violation of tax treaties).



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Despite the above, it is proposed that the special tax credit for services fees be completely withdrawn. The relief currently provided is said to be a departure from international tax norms and tax treaty principles.

**2. Objection**

Although we understand that section 6quin is a departure from standard tax principles, section 6quin sought to alleviate the recurring problem of double taxation of cross-borders services, especially in Africa. The loss of this relief will be a significant problem for South Africa's banks, telecommunications, and consumer multinationals using South African management and other services to co-ordinate African operations. We note that this form of relief is far more important as a tool for the South African regional gateway initiative than the headquarter company regime. More importantly, section 6quin is a tool that assists South African home-grown companies as opposed to South African companies ultimately owned by foreign residents.

We note that many African countries formally (and informally) deviate from the OECD paradigm in terms of services. Many countries treat the payment by a local African company as locally sourced even if paid in respect of services rendered outside the country. Some South African tax treaties mitigate this result while others do not. In some cases, there are not treaties. Even if treaties create relief, certain African revenue authorities ignore treaty relief as a practical matter. It is stated that competent authority is a possible remedy, but we note that treaties only override certain local practices (as previously mentioned). The regular and continuous nature of services on a small scale basis also means that the cost of competent authority relief often outweighs the added tax of separate services. Even in ideal conditions, the competent authority process is slow and expensive. Most African competent authority processes are far from this ideal.

Although easier said than done for certain large corporates, the only effective remedy is to shift shared services offshore to other locations (e.g. Dubai, Mauritius or now even the United Kingdom). The short answer is that sometimes international competitiveness comes before purity of tax principles. We further note that section 6quin is not a tax incentive – merely a tool to alleviate cross-border double taxation. This African trend of claiming African paid services on a payor basis is set to continue and even increase (see Note from the Coordinator of the UN Subcommittee on Tax treatment of Services: Draft Article and Commentary on Technical Services (2014) (drafted by Brian Arnold)).

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Note: The Explanatory Memorandum suggests that the section 6quin rebate is subject to avoidance with certain taxpayers claiming the rebate for foreign royalties and interest. However, from a distance, this argument seems questionable because these amounts paid by foreign taxpayers are largely foreign source (under South African and OECD principles) and should be eligible for section 6quat credits.

Note: The Explanatory Memorandum notes that there is a significant compliance burden placed on the SARS in administering section 6quin. We suggest that the burden can be overcome by providing for less frequent submission of withholding tax certificates and placing a de minimus reporting requirement on taxpayers. For example, taxpayers could be required to submit their withholding tax certificates on a less frequent basis (e.g. in batches every 4 months instead of within 60 days) and only withholding tax certificates exceeding a certain amount should be filed but with the taxpayer being required to retain all certificates irrespective of amount for the normal documentation retention period in support of all amounts claimed.

## 3. Alternative solution

Part of the difficulty is that the current rules contained within section 6quat are theoretically more pure than the OECD tax credit rules and tax credit rules of other developed countries. The OECD tax treaty (Section Article 23B of the 2014 OECD Model Tax Convention) allows taxpayers to claim tax credits without regard to source. Source applies only in terms of the general limitation (meaning that all credits can be aggregated against all foreign source income). However, section 6quat prohibits all tax credits in respect of foreign taxes stemming from South African sourced activities. We would request that foreign taxes be pushed into this OECD paradigm (or at least the tax falling on cross-border services).

In addition, foreign taxes paid should be deductible if incurred or paid (with payments being deductible regardless of the "proved to be payable" concept). Internationally, the "proved to be payable" concept is limited to tax credits. The concept does not apply to deductions because deductions only represent partial relief from double taxation, thereby creating an implicit incentive for the taxpayer to dispute the issue with the local authorities.

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## III. REINSTATEMENT OF THE CONTROLLED FOREIGN COMPANY DIVERSIONARY INCOME RULES: PROPOSED AMENDMENTS TO SECTION 9D

### 1. Draft Proposal

This Bill proposes that both the diversionary rules in respect of CFC outbound sales and CFC inbound sales be reinstated in their pre-1 April 2012 form. We understand from the Explanatory Memorandum that the purpose of the amendment is to combat BEPS because the existing transfer pricing rules leaves the domestic tax base “vulnerable” to offshore profit shifting. The CFC rules are intended to operate as simple mechanical method of eliminating BEPS without resorting to the complexity of transfer pricing.

### 2. Concern

The mechanical nature of the reinstated tests was the policy reasons for their removal. Certain countries (mainly in Europe) operate as centralised distributors or purchasers of goods with various nearby country clients / product providers. We also note that various schemes emerged that essentially undercut the effectiveness of these diversionary rules with taxpayers interposing CFCs between South Africa and the low-taxed CFC at issue. The connected person rule has consistently been limited to South African connected persons because the CFC rules are designed only to protect the South African tax base (not the tax base of other countries).

Example. Basic Concept: SA Company owns Dubai CFC. If SA Company purchases goods from the Dubai CFC (low tax jurisdiction), and Dubai CFC purchases the goods with a bulk discount from Italian Company (which may or may not be a CFC). Dubai CFC presumably keeps the discount and sells at a much higher price to SA Company. Under this scenario, Dubai CFC has section 9D imputed income under the newly proposed rules.

Example. Added Intermediary CFC. However, if a Namibian CFC is added to the mix with Dubai CFC selling to Namibia CFC at an elevated price, the new regime still applies to Namibian CFC but only creates nominal gain in terms of the Namibian CFC. This gain only falls on Namibian CFC even though the gain was artificially trapped in Dubai CFC (and the gain may also fall under the 75-per cent taxed exemption).

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### 3. Possible solutions

It is recommended that the reinstatement of the diversionary rules be postponed in favour of the Davis Committee reports so that the shortcomings of the CFC rules be addressed more comprehensively (if desired). However, if the amendment is to proceed, we would suggest that indirect transactions with a South African resident be taken into account (without going so far as to target all connected CFC transactions so as to be tighter than most global CFC regimes). We would also recommend relief for perceived diversionary CFCs that have a permanent establishment and that are subject to a more than 50% effective rate vis-à-vis South Africa (see the current limited diversionary rules of section 9D(9A)(a)(i)).

## IV. DEFINITION OF INTEREST FOR WITHHOLDING TAX PURPOSES: PROPOSED AMENDMENTS TO SECTION 50A

### 1. Draft Proposal

Section 50A does not contain a definition of the term "interest," meaning that the common law definition probably applies. However, the lack of a general definition arguably creates uncertainty and probably means that certain forms of implicit section 24J interest can arguably escape the cross-border interest withholding regime.

### 2. Overall view

We largely support the amendment. Section 24J interest should be added as a general matter.

- Suggestion for a slightly narrower definition

However, we would suggest that the core definition should apply as opposed to certain more indirect forms. Under this approach, the interest definition should be limited to paragraph (a) of the section 24J(1) "interest" definition. This definition is most likely to be consistent with the forms of interest eligible for treaty relief; it is unclear whether the other forms of section 24J qualify for tax treaty relief (see Article 11(3) of the 2014 OECD Model Double Tax Convention).

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➢ Effective date

The proposed amendment needs to be prospective – not retroactive. Local payors subject to withholding cannot be forced to make payment retroactively in respect of overall sums that already have been paid (i.e. when the underlying cash payment is already gone). Given that the withholding system is relatively new and systems are still being adjusted, we recommend the effective date be deferred until 1 January 2016.

## V. CROSS BORDER WITHHOLDING FOR SERVICES DEFERRED / REPORTABLE ARRANGEMENTS PENDING (CLAUSE 141 OF THE TAXATION LAWS AMENDMENT BILL, 2015)

We note the postponement of the cross-border services withholding for one year. We presume that the issue has been postponed pending the outcome of whether the reportable services arrangement system will suffice.

## VI. NEW POWERS OF SARS TO COLLECT FOREIGN INFORMATION FROM CONNECTED PERSONS: PROPOSED SECTION 46 OF THE TAX ADMINISTRATION ACT

### 1. Draft proposal

The proposed amendment seeks to provide SARS with greater powers in obtaining information from group foreign affiliates of the South African company taxpayer at issue. This information must be obtained in 90 days. If the information is not so obtained (presumably within the required time-period), the taxpayer cannot generally use the material for the taxpayer's benefit in any subsequent proceedings.

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2. **Initial view**

While the possible need for extending SARS's power to include information from foreign affiliates appears reasonable, it is unclear why this class of information is singled out for harsher treatment. We also question why the time period is set at 90 days versus the more open-ended approach used for other information requests.

## VII. EXTENDED PRESCRIPTION PERIODS FOR TRANSFER PRICING AUDITS AND OTHER MATTERS: PROPOSED AMENDMENT TO SECTION 99 OF THE TAX ADMINISTRATION ACT

1. **Draft proposal**

The proposed amendment provides SARS with a series of grounds for extending the statutory prescription period. One ground is the existence of an audit or investigation relating to transfer pricing (or a matter of analogous complexity). However, this ground for extension can only be for a further three years.

2. **Concern**

The proposal effectively provides SARS with the unilateral power to extend the time period with little more than an ongoing audit or investigation. Indeed, SARS will be able to merely start an "audit or investigation" shortly before the prescription date solely to extend the prescription date. The net effect of this amendment is to extend the statutory period from three years to six years.

3. **Possible solutions**

We strongly recommend that this amendment be entirely scrapped. If SARS is in the middle of a serious investigation or audit, we note the current ability to extend the prescription date by joint agreement (which is often effectively "forced upon" taxpayers in practice). If SARS needs further powers, SARS at least should be forced to go to the High Court and seek an extension on the basis that the taxpayer has unduly obstructed the audit or investigation (or some other equivalent independent safe guard needs to be in place).

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