



An overview

The Davis Tax Committee Interim Report

The DTC Interim Report is presented in three main parts. The first provides an introduction, including the background to the OECD report as well as the OECD's recommendations on how to address BEPS.

The second part of the DTC Report deals with the DTC's view on addressing BEPS in the light of South Africa's conceptual framework. This section of the Report is focused on the South African environment and other factors that should be taken into consideration when looking at how we, in South Africa, should be implementing BEPS actions.

The third section of the Report contains the Annexures. Each Annexure provides a summary of the draft discussion document as published by the OECD, and then provides detail on the DTC recommendations on how to address this from a South African perspective. The DTC report covers the following 7 draft reports issued by the OECD:

- Action 1: Address the tax challenges of the digital economy
- Action 2: Neutralise the effects of hybrid mismatch arrangements
- Action 5: Counter harmful tax practices more effectively, taking into account transparency and substance
- Action 6: Prevent treaty abuse
- Action 8: Assure transfer pricing outcomes are in line with value creation with regard to intangibles
- Action 13: Re-examine transfer pricing documentation
- Action 15: Develop a multinational instrument.

There is also a summary of the DTC's recommendations for South Africa.

The DTC will release a further interim report once the OECD has released its final deliverables during 2015. Once it has received comments on both interim reports, a final report will be issued.

Members of Deloitte Tax in South Africa provided technical input to the DTC with relation to Actions 8 and 13.

Of specific interest to the South African transfer pricing ("TP") environment is the points raised in respect of Action 8 and 13. We have provided below a high level summary of

the DTC Interim Report relating to Actions 1, 5, 8 and 13, focusing on the implications for the South African TP environment.

Action 1

The DTC Report indicates that there is no urgent need to amend the current rules in South Africa which provide for the taxation of e-commerce businesses conducted by SA residents. This is due to the existing CFC, TP and anti-avoidance rules being sufficient to subject the income generated by SA CFCs via e-commerce to tax in South Africa. There may be a need to amend the foreign tax credit rules and the CFC rules to cater more specifically for e-commerce. With regards to non-resident suppliers of goods and services via e-commerce, new source rules that deal with the taxation of digital economy should be enacted.

Action 5

Of importance under Action 5 is to note that the requirement for “substantial activity” should be examined in South Africa for example with respect to the headquarter company regime. This regime is a holding company regime which enables multinational enterprises (“MNEs”) to use South Africa as a conduit for passive income flows. The Report recommends that consideration be given to creating a full headquarter regime which incorporates minimum levels of substance as required by the OECD so that it is not considered a harmful tax practice. South Africa should therefore revise its criteria for headquarter companies in line with the OECD recommendations.

Action 8

Action Plan 8 of the 2013 OECD Report on BEPS notes that although in many instances the existing TP rules, based on the arm’s length principle, effectively and efficiently allocate the income of MNEs among taxing jurisdictions, in other instances MNEs have been able to use and / or misapply those rules to separate income from the economic activities that produce income and to shift it into low-tax jurisdictions. This most often results from:

- Transfers of intangibles and other mobile assets for less than full value;
- The over-capitalisation of lowly taxed group companies; and
- Contractual allocations of risk to low-tax environments in transactions that would be unlikely to occur between unrelated parties.

Profit shifting which involves the use of IP has two important characteristics – firstly it is a driver of value creation in MNEs, and secondly, due to the fact that IP is highly mobile, it plays an important role in profit shifting.

The OECD has issued in 2012 a discussion draft on the TP aspects of intangibles, which was finally incorporated into the OECD TP Guidelines in September 2014. This followed on from the work done on Action Plan 8.

The DTC report on Action 8 includes general comments on TP in South Africa, and points out that South Africa's TP rules should follow the OECD guidelines. Even though reference to the fact that South Africa's TP rules do follow the OECD Guidelines is mentioned in Practice Note 7, this Practice Note is out of date, and also not legally binding. It is therefore recommended that SARS update this Practice Note, and include a legally binding ruling to ensure that section 31 refers to the OECD Guidelines.

When looking at the need to address TP of intangibles in South Africa, it is important to note that South Africa already has measures in place to prevent BEPS to an extent. These measures include the current TP rules under section 31, as well as exchange control restrictions (see below). As a result, the risk of significant BEPS in relation to the payment for the use of IP from a South African perspective is probably not high.

Strict rules are in place in respect of outbound payments relating to royalty payments payable to offshore related parties. These rules are also in place for the payment of management fees, however this is not the subject of Action 8 – but important to note its role in preventing BEPS to some extent. Royalty payments are split depending on the nature of the IP - where it relates to the process of manufacturing, then approval from the Department of Trade and Industries (DTI) is required. In practice the DTI generally restricts the royalty rate to 6% of the turnover of the South African licensee. It is possible to obtain approval for a higher royalty rate, however that would need to be motivated and approved by the DTI.

For all other royalties, approval must be obtained from the South African Reserve Bank ("SARB"). Very often the SARB requests that the approval be supported by an independent TP specialist or auditor, and that evidence be provided to indicate that the royalty rate was determined with reference to the arm's length principle.

South Africa's exchange control rules also further prohibits the export of IP created in South Africa (except in special circumstances). In addition, South African based owners of IP are further required to charge their foreign related parties for the use of such IP, or the amounts are viewed as an export of capital.

It is therefore not suggested at this stage that further rules be implemented in South Africa to prevent profit shifting with regards to the payment for the use of IP. The DTC Report indicates that focus should rather be placed on the potential undervaluation of IP created in South Africa.

BEPS action 13 - Re-examine transfer pricing documentation

In its 2013 BEPS Report, the OECD indicated that a key issue in the administration of TP rules is the lack of transparency of the taxpayer's global value chain. Differences in TP Documentation requirements between tax administrations lead to a significant administrative burden for taxpayers.

The OECD recommended a three-tiered approach to TP Documentation to achieve the following three objectives:

- To ensure taxpayers can assess their compliance with the arm's length principle;
- To provide tax administrations with sufficient information to be able to perform a TP risk assessment; and
- To provide tax administrations with useful information to use in conducting a thorough TP audit.

The OECD suggested three-tiered approach to TP Documentation consists of the following:

- Master file,
- Local file, and
- Country-by country file.

The Master file should provide an overview of the Group, including the nature of the Global operations, overall TP policies, and global allocation of income and economic activity. This master file should be available to all relevant country tax administrations that form part of the Group.

The Local file should provide the detailed information relating to the material (depending on materiality threshold, if any) intercompany transactions. This is most likely to be similar to what most taxpayers currently prepare as its TP Documentation.

The Country-by Country report should provide aggregate tax jurisdiction wide information relating to the global allocation of income, taxes paid, indicators of the location of economic activity among tax jurisdictions in which the MNE Group operates. This report should be prepared annually and include revenue, profit before tax, income tax paid and accrued etc.

Various other issues are then discussed on compliance such as time frame, materiality, retention of documents, frequency of updates, confidentiality etc.

The OECD recommends that all three types of documents be updated annually. Comparability studies should be performed every 3 years, however financial data of the comparables should be updated annually.

From a South African TP perspective it was noted in the DTC Report that the revised section 31 already requires taxpayers to prepare TP Documentation to ensure

compliance with the arm's length principle. Even though it is not a legal requirement to prepare, the fact that this section now places the onus for making TP adjustments on the taxpayer, it is no longer possible to accurately do so without preparing adequate TP Documentation. Under the previous wording of section 31 only the Commissioner could make a TP adjustment.

The DTC Report recommends the following under Action 13:

- SARS should provide guidance on whether it would require taxpayers to prepare TP Documentation based upon the suggested three-tiered approach.
- The current guidance in Practice Note 7 is out of date, and it is also recommended that SARS update this Practice Note with the detailed TP Documentation requirement. Should the three-tiered approach be adopted by SARS, it would also be necessary to include detail on what would be required in the Country-by-country reporting – South Africa, as an emerging market country, may require additional information to be included in this report, in line with OECD recommendations.
- On other matters it is recommended that SARS considers the various other recommendations of the OECD under Action 13. For example, it should investigate the use of materiality thresholds for the preparation of TP Documentation, for smaller groups, where it may not be practical to prepare TP Documentation based upon the three-tiered approach, a different approach to Documentation could be considered.
- Compliance matters – the OECD suggested that tax administrations should put rules in place to ensure that taxpayers do not spend disproportionately high cost in relation to the value of its related party transactions in the preparation of TP Documentation. SARS has already indicated in the Addendum to Practice Note 2 that SARS acknowledges that the preparation of TP Documentation is time-consuming and expensive, and that taxpayers should weigh up the risk of not providing TP Documentation. Furthermore, if a taxpayer in South Africa provides full detail of its related party transactions, for example in its agreements, it would not be regarded as non-disclosure. The addendum does note that a taxpayer choosing not to prepare TP Documentation is at risk and it may be more difficult to prove to SARS that it transacted at arm's length with its related parties.
- It is recommended that SARS clarifies time frames by when TP Documentation, whether in the three-tiered approach or not, should be finalised by taxpayers.
- In South Africa the Tax Administration Act already includes details on retention of documents, and therefore no further recommendations to SARS on this is currently proposed.
- It is also recommended that SARS indicates, possibly in its updated Practice Note 7, how often it would require taxpayers to update its TP Documentation, of whether it would be in line with the OECD recommendations of annual updates

- The OECD recommended that tax administrations do not impose a documentation related penalty for failing to submit data to which the MNE Group did not have access to. Furthermore the OECD also recommends compliance incentives, to encourage taxpayers to fulfil the TP Documentation requirements. From a South African perspective the current penalties include the deemed loan that has been replaced recently by the deemed dividend. Further penalties as per the tax administration act under the general penalty regime also applies to TP. The DTC recommends that SARS considers implementing an incentive programme to encourage compliance on TP Documentation.

Should SARS agree to the three-tiered approach, it would assist in creating a consistent approach for taxpayers operating as part of a MNE.

The detailed DTC Report is available for public comment on the DTC website www.taxcom.org.za. Alternatively if you would like to send us your comments we will collate and submit to the DTC.

Should you have any other questions or would like to discuss the recommendations of the DTC with us, please contact us.

Director Head Transfer Pricing (JHB)



Billy Joubert
Tel/Direct: +27 (0)11 806 5352
Fax: +27 (0) 86 522 2908
Email: bjoubert@deloitte.co.za

Transfer Pricing Leader (WC)



Karen Miller
Direct: +27 (21)427 5484
Main: +27 (21)427 5300
Fax: +27 (21)441 1057
Email: karmiller@deloitte.co.za

Associate Director(JHB)



Carla van der Merwe
Tel/Direct: +27 (0)11 806 5230
Fax: +27 (0)11 388 3051
Email: cavandermerwe@deloitte.co.za

Associate Director (WC)



Philip Fouche
Tel/Direct: +27 (0) 21 427 5488 Fax: +27 (0)
21 413 2826
Email: pfouche@deloitte.co.za

Associate Director(JHB)



Steven Breslin
Direct: +27 (0)11 806 5772 Fax: +27
(0)11 806 5333
Email: stbreslin@deloitte.co.za

Lead Director – Cross Boarder Taxes (JHB)



Amo Bosman
Tel/Direct: +27 (0)11 209 8404 mobile +27 (0)
11 806 5304
Email: ambosman@deloitte.co.za

Senior Manager(JHB)



Chantel Venter
Tel/Direct: +27 (0)11 806 5000
Fax: +27 (0) 11 806 5304
Email: cventer@deloitte.co.za

Senior Manager (JHB)



Dan Zaidman
Tel/Direct: +27 (0)11 209 8744
Fax: +27 (0)11 388 3180
Email: dzaidman@deloitte.co.za

