Dear Vinesh

COMMENTS ON THE FIRST INTERIM REPORT ON BEPS

The South African Institute of Chartered Accountants (SAICA) appreciates the opportunity to present our collective feedback to the Davis Tax Committee (DTC) on the Interim Report entitled Addressing Base Erosion and Profit Shifting (BEPS) in South Africa.

We have set out below comments pertinent to policy as well as comments from our Transfer Pricing Committee (a Sub-Committee of SAICA’s National Tax Committee) in respect of the DTC’s reports on Action 8: Assure transfer pricing outcomes are in line with value creation with regard to intangibles, and on Action 13: Re-examine transfer pricing documentation, which relate to transfer pricing.

A. POLICY MATTERS

General

1. We agree with the DTC that an understanding of BEPS it is imperative to better understand the underlying commercial realities of modern trade. We note that BEPS is used as a very broad term in the various reports, including those of the Organisation for Economic Co-operation and Development (OECD), to deal with matters that in
principle are distinct. Not recognising the reality of the distinction will inevitably lead to decisions which negatively impact on society and will further not achieve the goals set. We have attempted to deal with some of the considerations below which we believe from a policy perspective are pertinent to creating any measures.

**Importance of facts and research**

2. The DTC report states:

   *Any BEPS remedy from the South African perspective needs to be supported by a fact base that sheds light on how big the relevant BEPS problem is in South Africa, and then legal responses can follow.*

3. We agree that making conclusions and recommendations on mere suspicion or circumstantial evidence is a perilous methodology. It is imperative that proper research should be done that is relevant to South Africa and that separately deals with whether South Africa is receiving its fair share of the valued added through either local value adding operations or subsequent flows of value. This research should also seek to identify and clarify whether the solutions are political or whether they are legislative in nature.

4. Research into unknown concepts such as the digital economy is imperative as it challenges traditional concepts and in fact seems incompatible with many of the traditional approaches. In this regard it would be appropriate that the traditional views on the determination of which country gets a right to share in the value flow (e.g. taxing rights acquired such as through permanent establishments) and what is a fair share in the digital economy should be properly explored and revisited to make informed decisions. Making hasty decisions in times of fiscal unease may not be the best approach in the long term.

**Tax avoidance vs. tax evasion**

5. Tax evasion and tax avoidance is not the same and the latter only applies to taxpayers operating within the ambit of the law. Though BEPS is defined in the context of the latter, many of the discussions seem to focus on tax evasion rather than avoidance and the concepts are not interchangeable and require very different remedies.

6. For example, at 2.4.3. the following is stated in respect of non-goods fee flows:

   “It poses a serious threat to the fiscus insofar as tax revenue, and is an indication that illicit tax base migration through avoidance schemes and practices could be taking place.”
7. The various reports allude to concepts of abuse and harmful practices which remains confusing when used in the context of taxpayers doing business within the ambit of the law as conceded in the various reports. It is unclear how global corporates can be vilified for doing business within the confines of the laws of the country’s they do business in.

8. It would seem a stretch too far to expect a taxpayer to do business not within the ambit of the law but in the “spirit” of what the relevant government of the day intends the law to be. These approaches in our mind add nothing to the debate and merely creates animosity between the various parties who should rather be working together to find a solution to the pertinent question, namely which country is entitled to share in the value flow and is a fair distribution of value done within the value add chain. This applies not only between countries but between each taxpayer and the relevant fiscus.

**Marginal tax rate as benchmark**

9. A further distinction is that commercially, the use of local tax incentives for doing business in a cost efficient manner, should not be compared directly to tax avoidance where the financial value of these operations is then extracted through the use of treaties, interposing entities or using hybrid or other mechanisms to reduce the ultimate tax charge on the flows.

10. The use of local tax incentives is a political decision as a result of each country’s sovereign right to determine its fiscal policy, as conceded in the DTC’s report. Though it has become politically expedient to merely use marginal tax rates as a benchmark for determining tax beneficial treatment for both local operations and financial flows, this approach is not illustrative of the actual rationale for doing business in a particular country or whether that particular country is less tax beneficial. For example, a country that provides fiscal incentives, grants or exemptions but has a 28% marginal tax rate could be more tax favorable than a country that provides no tax incentives but has a 15% marginal rate.

**Pricing of operations**

11. The benefit of a multinational enterprise is that the various components of a business can be attributed to a country where the cost, including tax cost, is the lowest. However, the commercial reality is that an end product that generates revenue results from this global effort, which revenue usually arises wherever the item is sold. The further reality is that a company only has actual cost to really determine what the input is to the final product, but realises the revenue as a single amount elsewhere.
12. Yet, because of the company’s global operations, local fiscal authorities in each country will require a fictional determination of the value of the goods to ensure that an “appropriate” portion of the revenue benefits are attributed to that country. What is “appropriate” becomes a debate specific to each country.

13. Much has been made and discussed regarding companies who abuse this value determination to secure tax benefits, however little is noted of how difficult a task it is in actually determining this fictional value attributable to each country so that each country gets its fair share (OECD Action Plan 10). As a simplistic example, if it costs R10 to generate the intellectual property pertaining to the product in country 1, R10 to source the raw materials in country 2 and R10 to assemble in country 3, then how much of a profit should go to each country if the product is sold for R40 in country 4? Is the value add the same in each country for it to be fair or is the IP, for example, a larger contributor to the ultimate value, as market forces dictate it to be so at such time or is the country where the ultimate sale price is extracted the largest contributor? Are value creation, risk and capital input really the best factors to determine “fair” as they ostensibly tend to favour the manufacturing leg of the value chain?

14. It should be acknowledged that the task of determining the fictional arm’s length price as opposed to actual cost is not a mundane one. The complexity imposed and uncertainty this complexity brings, may be a contributing factor as to why certain taxpayers are enabled to “abuse” the pricing system whereas others are just overly burdened by it. When solutions and proposals are sought to address unwanted practices, it should be done with due consideration of the complex task at hand and the principles of administrative fairness and simplicity to the taxpayer.

B. ACTION 8 – ALIGNMENT WITH VALUE CREATION

Alignment with OECD

15. Transfer pricing legislation was first introduced to South Africa in 1995. South Africa endorses the arm’s length principle as set out in the OECD’s Transfer Pricing Guidelines. Significant changes to the legislation were made in 2012, to align the South African transfer pricing legislation with the 2010 update to the OECD Transfer Pricing Guidelines and international principles.

16. However, we agree with the general comments made by the DTC and specifically agree that South Africa should align its laws and practices with the OECD guidelines going forward. The general recommendation by the DTC to ensure that section 31 of the Income Tax Act, 58 of 1962 (the Act), should refer to the OECD Transfer Pricing Guidelines directly is welcomed as it will provide clarity and consistency. Currently, Practice Note 7 on Transfer Pricing, which is, as the DTC points out correctly, mostly
outdated and does not address the amendments made to the South African transfer pricing regime with effect from 1 April 2012, refers to the OECD Transfer Pricing Guidelines, but this is not binding on the South African Revenue Service (SARS) and therefore lacks reliability.

**OECD Transfer Pricing Guidelines**

17. We submit that it should be considered to include the proposed reference to the OECD Transfer Pricing Guidelines in section 31 of the Act to address any ambiguity. The DTC also recommends (see below) that the current South African Transfer Pricing Guidance (Practice Note 7) be updated as a matter of urgency in order to be in line with and clarify the amended section 31 of the Act (refer to the “Principles of a Good Tax System” as addressed by the DTC in the General Report with specific reference to guidance/interpretation to legislation and when this should be provided). However, ambiguity may occur where the OECD Transfer Pricing Guidelines are for example updated, and the proposed updated South African Transfer Pricing Guidance is not. A rule as to which guidance should take preference should be included in the legislation for this instance. For example the guidance in the Namibian transfer pricing practice note could be followed, which states that in the case where there is a discrepancy between the OECD Transfer Pricing Guidelines and the local transfer pricing guidance, the rule contained in the OECD Transfer Pricing Guidelines shall override the local rules.

18. Of course, this raises the issue of giving the power to interpret legislation to an external body over which South Africa has no control (South Africa is still not a member of the OECD, albeit we have observer status and we are a member of the BEPS sub-committee). However, in order to ensure clarity and to foster a system on which foreign investors can rely (in line with the National Development Plan), it is submitted that following the OECD Transfer Pricing Guidelines is preferable to ensure international compatibility, clarity and consistency.

**Overly restrictive measures**

19. The final point made by the DTC is that “Care should be taken, when developing tax legislation on the transferring of intangibles, to ensure that the legislation is not so restrictive that it limits South Africa’s ambitions to be a global player in the development of IP.” It is submitted that if this is one of South Africa’s goals, this recommendation should be followed.

20. However, there is currently no indication of any support for this, and, for example, the uptake of research and development, although South Africa has quite a favourable R&D Tax Incentive in place, at least based on the legislation available, is weak.
Recent figures suggest that R&D expenditure equals only approximately 1% of GDP, whereas this is more than double for example in the European Union, and more than three times as much in Japan.

C. ACTION 13: RE-EXAMINE TRANSFER PRICING DOCUMENTATION

Update of SARS guidance

21. We agree with the comments by the DTC that the guidance on transfer pricing in South Africa (i.e. Practice Note 7) urgently needs to be updated to align with the current transfer pricing legislation and the OECD Transfer Pricing Guidelines.

Compulsory transfer pricing documentation/documentation guidelines

22. The existing uncertainty regarding whether a taxpayer should have transfer pricing documentation or not needs to be addressed. The DTC indicates in its report that maintaining documentation should be made compulsory and we agree with this recommendation. However, detailed guidance would need to be provided regarding these documentation requirements, and regarding transfer pricing documentation guidelines in general. We agree that guidance is also required regarding when documentation must be reviewed/updated, when database searches need to be updated, and the extent to which reliance can be placed on foreign benchmarking studies.

23. In addition, in order to assist certain taxpayers with less involved transfer pricing transactions, rather than looking at the turnover of the relevant taxpayer when determining whether less strict rules should apply for the preparation of documentation, the significance of the cross-border connected party transactions should be considered.

24. Further, to ensure clarity regarding when a taxpayer is required to have transfer pricing documentation prepared, and following which format, this should be clarified. For example, it may not be necessary for a multinational group to prepare documentation following the Masterfile / Countryfile format if the potential risk of base erosion through profit shifting is minimal. In such cases, it may be sensible to merely require the taxpayer to prepare simplified documentation, still including the necessary components required for the tax authority (which should be prescribed).

Transfer pricing related tax return disclosures

25. The DTC points out that information relating to transfer pricing, which is required to be submitted by corporates in their annual tax return (ITR14) needs to be improved.
26. It should be noted in this regard that the guidance provided by SARS in the Tax Return Guide in respect of the relevant information is unclear and needs significant improvement. In addition, the Tax Return Guide is updated once in a while, however, taxpayers are not notified of these updates, which may result in a taxpayer completing transfer pricing related disclosure following specific guidance, but at the time the tax return is submitted via e-filing, the guidance (or even the question in the tax return) may have changed without the taxpayer being sufficiently notified of this.

27. Guidance regarding the transfer pricing related disclosures in the ITR14 should be clarified either in the Tax Return Guide, and any changes should be brought to the attention of taxpayers, or guidance should be included in the overall South African transfer pricing guidance.

**Safe harbour rules**

28. The use of safe harbour rules is often disputed. However, recent developments in the OECD have led to a change in the relevant guidance and there is globally more support for the use of safe harbour rules. Despite the concern that safe harbour rules limit the arm’s length principle in that, when applying a safe harbour rule, less focus is placed on what independent third parties would have achieved in similar circumstances.

29. Particularly, where less significant transactions are considered, the use of safe harbours may help contain compliance costs. For example, a safe harbour rule has been proposed by the OECD/G20 in terms of the BEPS initiative regarding the pricing for low value adding services. The use of safe harbours in South Africa should be considered.

**Country by country reporting - threshold**

30. The DTC suggests a group turnover threshold of R1bn making it compulsory for taxpayers above this threshold to prepare a Masterfile, Local File and to complete the Country-by-Country template. We point out that the OECD, subsequent to the release of the report on BEPS Action Point 13 published further guidance, which suggests a threshold of Euro 750 million (approximately R9.7 billion). In order to ensure consistency throughout, any South African threshold and the DTC BEPS report should be in line with the OECD’s recommendation.

**Transfer Pricing Comparables**

31. An area of great debate, particularly amongst developing countries, is the lack of local comparables for the purposes of benchmarking the pricing in respect of cross-border
connected party transactions. In 2014, the OECD released a discussion draft entitled “Transfer Pricing Comparability Data and Developing Countries”, in respect of which many comments and suggestions were submitted to the OECD. This discussion draft sets out the issue, i.e. the fact that most developing countries do not have (reliable) comparables, which could be used to benchmark the pricing in respect of transactions between connected persons.

32. However, suitable comparables are necessary to effectively administer transfer pricing. The reasons for the lack of suitable comparables vary; often there is no requirement for private companies to disclose financial information, or the financial reporting standards applied vary. Listed companies normally operate within a group and can therefore not be used as reliable comparables in that these companies are not independent, and connected party transactions may impact on their financial results.

33. The OECD, in its discussion draft, provided four possible approaches to deal with the issue, primarily suggesting a focus on improving the availability of direct comparables from local sources (expanding the range of data in commercial databases to include data from developing countries and providing such countries with access), using the available data more effectively (guidance or assistance in the use of commercial databases, adjustments etc.), relying on approaches which do not focus on direct comparable data (e.g. safe harbours, value chain analysis, use of the profit split method, sixth method), and advance pricing agreements and mutual agreement proceedings.

34. The DTC, in its DTC BEPS Interim Report, alludes to the fact that local comparables are usually the most reliable information, and it recommends that SARS should build a database for comparable information. However, the issue arises whether access to this database would be provided to taxpayers too, particularly in the context of secret comparables.

35. It is submitted that only if taxpayers have equal access to such database would this be useful. If not, then this recommendation would not be a viable option at all. In addition, and the OECD has raised this as an important point to consider, the creation of a suitable database including comparables for transfer pricing purposes will take time as multiyear comparable information is required.

36. Until the time that a local database with sufficient suitable comparables is available, it would be important for SARS to provide detailed and clear guidance regarding alternative options, i.e. ideally all four approaches mentioned by the OECD. Particularly regarding the use of databases, whether these include local or foreign comparables, it would be important that guidance regarding the use thereof from a South African perspective is provided.
Should you require any clarification of the matters raised above we would welcome any discussion on the submissions raised.

Yours sincerely

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