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<tr>
<td>APA</td>
<td>Advance Pricing Agreement</td>
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<tr>
<td>AEoI</td>
<td>Automatic Exchange of Information</td>
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<tr>
<td>B2B</td>
<td>Business to Business</td>
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<tr>
<td>B2C</td>
<td>Business to Customers</td>
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<tr>
<td>BEE</td>
<td>Black Economic Empowerment</td>
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<td>BEPS</td>
<td>Base Erosion and Profit Shifting</td>
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<tr>
<td>BIT</td>
<td>Bilateral Investment Treaty</td>
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<td>CCCTB</td>
<td>Common Consolidated Corporate Tax Base</td>
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<td>CFC</td>
<td>Controlled Foreign Companies</td>
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<td>CIT</td>
<td>Corporate Income Tax</td>
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<td>CRS</td>
<td>Common Reporting Standard</td>
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<td>DTA</td>
<td>Double Tax Agreement</td>
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<td>DTC</td>
<td>Davis Tax Committee</td>
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<td>EU</td>
<td>European Union</td>
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<td>EXCON</td>
<td>Exchange Control</td>
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<tr>
<td>FATCA</td>
<td>Foreign Account Tax Compliance Act</td>
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<td>FI</td>
<td>Financial Institutions</td>
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<td>GAAR</td>
<td>General Anti-Avoidance Rule</td>
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<td>India-Brazil-South Africa</td>
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<td>IFF</td>
<td>Illicit Financial Flows</td>
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<tr>
<td>IFRS</td>
<td>International Financial Reporting Standards</td>
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<tr>
<td>IP</td>
<td>Intellectual Property</td>
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<tr>
<td>LOB rule</td>
<td>Limitation Of Benefits rule</td>
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<tr>
<td>MAP</td>
<td>Mutual Agreement Procedure</td>
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<td>MC-BEPS</td>
<td>Multilateral Convention of the BEPS process</td>
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<tr>
<td>MNC</td>
<td>Multinational Companies</td>
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<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
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<tr>
<td>PE</td>
<td>Permanent Establishment</td>
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<tr>
<td>PPT</td>
<td>Principal Purpose Test</td>
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<tr>
<td>R&amp;D</td>
<td>Research &amp; Development</td>
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<tr>
<td>SA</td>
<td>South Africa</td>
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<tr>
<td>SACU</td>
<td>Southern African Custom Union</td>
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<tr>
<td>SADC</td>
<td>Southern African Development Community</td>
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<tr>
<td>SARB</td>
<td>South African Reserve Bank</td>
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<td>SARS</td>
<td>South African Revenue Service</td>
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<td>SLoB rule</td>
<td>Simplified Limitation of Benefit rule</td>
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<tr>
<td>TIN</td>
<td>Taxpayer Identification Number</td>
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<td>TJN</td>
<td>Tax Justice Network</td>
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<td>TNC</td>
<td>Transnational Corporations</td>
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<td>UN</td>
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<td>VAT</td>
<td>Value-Added Tax</td>
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Executive Summary

This guide provides a comprehensive analysis of the issue of tax and wage evasion in South Africa. Not only does it build on already existing materials and studies to estimate the impact of illicit financial flows and profit shifting for South Africa and its people, but it unveils the schemes and mechanisms through which such financial flows are taking place.

More specifically, it explains how loopholes in our tax transparency framework allow for these flows to continue and grow unchallenged through gaps in our tax transparency legislation, or through abuses of our lax transfer pricing rules.

In both cases, it proposes both long-term and short-term perspectives on how to close these loopholes both theoretically and through concrete policy proposals.

"Lastly it highlights how tax treaties and trade agreements can contain harmful provisions that erode South Africa’s tax sovereignty and why these should be excluded from future negotiations.

PART I - The scale of Illicit Financial Flows

According to all available studies on the subject, illicit financial flows and the phenomenon of profit shifting are impacting all countries worldwide and their scale is increasing. However, it appears that developing countries are paying a particularly high price. The African continent in general, and South Africa in particular, are losing every year massive amounts of capital that are critical to ensuring the development of their economies and the improvement of people’s living conditions. Conservative studies estimate the annual impact for South Africa in lost revenue to be in the range of R100 billion, for trade-related illicit financial flows of goods only.

However, this first part also shows that the impacts for South Africa are not only in terms of taxes and public revenues losses; illicit financial flows also mean lower wages and chronic shortages of local savings. These two phenomena, better captured by the concept of wage evasion than tax evasion, concretely mean that South Africa economically has had to keep a low wage regime to make its endless dependence on foreign capital sustainable.
PART II - Transparency

Regarding tax transparency rules, the review of the current efforts underway internationally to curb illicit financial flows under the OECD’s initiative proves that the soon-to-come reforms, if they might bear some fruits, are structurally flawed, contain loopholes and suffer from a lack of ambition. The Automatic Exchange of Information under the new Common Reporting Standard, the country-by-country, subsidiary-by-subsidiary reporting and even the new disclosure obligations of aggressive tax planning arrangements all have weaknesses, not least the confidential essence of the information they allow to be collected.

In addition, a number of schemes that allow taxpayers to escape such new reporting obligations have stayed mostly unaddressed. The consequence is simple: citizenship-by-investment programmes as well as the use of trust or similar legal arrangements are both on the rise. Even more problematic is the fact that current transparency reforms might prevent the creation of a public registry for tax information, a real game-changer tool that appears today as the next logical step towards tax transparency.

We therefore recommend that South Africa should implement urgently a comprehensive package of tax transparency measures to empower tax authorities. In addition, civil society organisations, such as unions and tax justice organisations, have a critical role to play as watchdogs of tax and wage justice. Their role is to exercise, hand in hand with the media, independent oversight over multinational companies’ tax practices as well as over South African tax authorities, to ensure that another episode of ‘State Capture’ by the country’s elite doesn’t dismantle the sovereign capacity of South Africa to raise public resources.

Our call to the South African government is therefore for it to acknowledge the limitations of the international reforms underway, and to push up further the transparency reforms in South Africa. We therefore call on it to completely implement the ABCD of tax transparency as a minimum commitment of its fight against tax and wage evasion:

- Automatic Exchange of Information (currently underway)
- Beneficial ownership information disclosure in public registries.
- Country-by-country, subsidiary-by-subsidiary reporting standard (implemented but information not public yet)
- Disclosure of the tax returns of every South African
PART III - Profit shifting & transfer (mis)pricing methods

Coming to the core question of profit shifting and the abuse of transfer pricing rules, a similar review has been compiled in this report. It shows transfer pricing rules leave a huge space for multinational companies (MNCs) to price as they please the transactions made outside of a normal trade relation, when trading with parent companies.

The international reforms agreed on under the BEPS process are trying to shrink the room left to MNCs by imposing a stricter transfer pricing framework. They aim at making it easier for states (and MNCs) to price such transactions by setting methods to follow to price many different kinds of goods, services and intangibles, and by strengthening the capacities of states to use comparables to better assess prices.

Such rules are also trying to address the most obvious cases of transfer mispricing by capping the use of debt as a tool of profit shifting and by rendering it easier to legally locate value creation activities of digital service providers.

However, altogether, these changes don’t address the core problem: the arms-length principle as a basis of our international tax system. The reforms are indeed rendering the game of hide and seek slightly harder to play for MNCs, but ultimately the complexity of these rules, and the capacity of MNCs to mobilise huge resources of tax advising and legal firms, will prevent countries from efficiently addressing transfer pricing. On the contrary, the costs associated with tax disputes are likely to increase.

What is required now is a paradigm change towards a unitary tax system. Making irrelevant the scrutiny of each and every related-party transaction by shifting towards a system where only indicators of real economic activity (payroll, local assets, sales) matter would be a real game changer. Nevertheless, such change implies international consensus on the manner of splitting value-added rights in each sector between jurisdictions; consensus which is currently unreachable.

In the short- and medium-term, temporary solutions, as imperfect as they are, are available, and South Africa needs to urgently explore them. Not only is this an issue of tax sovereignty, but more importantly it is a matter of economic development and industrialisation strategy. The reversal of the ‘safe harbour’ rule to cap the amount of tax deductible services sourced from parent companies is one of them. The use of advance pricing agreements or of a simplified net margin method to maintain acceptable effective tax rates for MNCs is also possible.

More radically, following the Chinese example, imposing transfer of technologies by foreign investors to their local affiliates can also drastically limit the payments of royalties and intellectual property payments to foreign entities, while helping local industries to catch up to international standards. Similarly, the creation of a digital service tax is a promising tool to ensure that the e-giants (Google, Amazon, Apple, Facebook, Tencent
or Alibaba) pay their fair share of taxes, while protecting local and nascent e-companies from biased competition.

Lastly, to curb the mis invoicing of mineral exports, the creation of a state-owned compulsory mineral exporting agency must be explored in order to plug the massive hole that prevents South Africans from benefiting from natural resources.

**PART IV - Tax treaties, double non-taxation and conflict resolution**

Analysis of the issues surrounding tax and investment treaties, such as the loopholes they contain, the disputes they invoke or the opportunity to modify them, led to the following conclusions: it is fairly difficult to disregard the progress made under the BEPS Action Plan, due to the presence of the multilateral instrument embedded in the treaty that will allow most of the trade and tax treaties to be brought up to date all at once. However, it is important for South Africa to understand the limitations and risks the BEPS initiative carries.

The first risk is that it misprioritises the interests of South Africa by focusing on the implementation of extremely complex measures on treaty mismatches and inappropriate treaty benefits, whereas the benefits for South Africa will be narrow. Instead, disclosure of tax planning arrangements and debt instruments is more critical and should be prioritised because they will allow South Africa to secure its rights as a primary source country.

Then, we are critical of the fact that the G20 has tasked a rich country club, the OECD, to do the follow up of the implementation of the agreement. We believe that the UN Tax Committee is a far better forum to discuss these tax issue, because it is more inclusive. So called developing economies rely much more than industrialised economies on corporate income tax and therefore have critical and legitimate concerns to raise.

Last but not least, we want to highlight the huge risks of using arbitration as a private form of justice to deal with tax disputes. We encourage South Africa not to implement such a system in its international tax agreements and when choosing which provisions of the BEPS Action Plan it should ratify. It represents a massive loss of sovereignty to private interests. Arbitrators don't provide the same guarantees of independence as official judges and their decisions will mostly be taken secretly. Such a justice system has been used in several instances by MNCs to contest states’ sovereign power to regulate their economy, even in domains as essential as health, the environment or workers’ rights.
Introduction: What is South Africa’s position in the fight Against IFFs?

The numerous scandals of tax evasion that regularly make the headlines are slowly stirring social movements. This is happening throughout the world but, more importantly, people in developing and emerging economies are beginning to wake up to the enormity of what is happening.

South Africa is no exception, and the number of initiatives to fight illicit financial flows and tax evasion is expanding very quickly. Even the government is now pledging to implement reforms to address these attacks on our economic sovereignty and our development strategy.

This study on tax evasion in South Africa seeks to provide a comprehensive document to activists, advocacy organisations and decision-makers to understand where the battle against illicit financial flows stands. It both critically assesses reforms currently underway internationally and outlines various options that can be undertaken in the fight against illicit financial flows in South Africa.

This guide will not explore the consequences of tax evasion in terms of human rights, poverty or the daily suffering of most South Africans. It takes as a given that readers understand the benefits for a state and its citizens of having a solid and well-established tax-base and improved wages. The focus of the study will however be on the structural causes of tax evasion. We hope the readers will use the concrete proposals we offer in their general debates, as well as their engagements with our current national leadership.

Sources

This study tries to give a comprehensive overview of the gaps South Africa is suffering from or will suffer from if strong measures are not taken to address tax and wage evasion.

It expects to be both detailed enough to give the reader a solid understanding of the main loopholes allowing tax evasion in South Africa and concise and accessible enough to allow a greater number of readers to understand this information and to share its main conclusions.

In terms of research methodology, it is important to know that this guide follows extensive work from AIDC’s Economic Justice team on different cases studies. These have allowed us to acquire over time a strong understanding of how multinational corporations (MNCs) operate in South Africa to extract profits. It has of course used
amongst others, several publications and case studies produced by AIDC and its partners.

It also consistently and critically addresses, when relevant, the work undertaken by the OECD BEPS (Base Erosion and Profit Shifting) working group and the recommendations it gave when releasing the BEPS Action Plan. This part of the work appeared important to us since many of the future tax reforms the South African economy will witness are likely to fall into the framework of the so-called BEPS project.

Another important source of this document was the work of the Davis Tax Committee that gave great insights into the shortcomings of the South African tax system and of the potential for reforms.

Last but not least, it also includes ideas and analysis defended in the publications of the Tax Justice Network and its allies, particularly around the possibility of a paradigm change in the way the international tax system works.

In terms of structure, the report first tries to understand the scope of IFF and its consequences, both direct and indirect, for our economy. Then it addresses the issue of transparency and access to information by reviewing selected international transparency initiatives to point out their limits and suitable alternatives for South Africa. The core of the report, the third part, addresses the fundamental issues of transfer pricing and profit shifting. It tries to demonstrate how limiting the current international approach is in curbing those practices, and it tries to promote feasible alternatives. Lastly, the fourth part focuses on international tax treaties, the tax conflicts they can create, and the mechanisms proposed to solve such conflicts.
PART I – The scale of Illicit Financial Flows

According to the Tax Justice Network in the 2018 edition of its Financial Secrecy Index, South Africa suffers heavily from tax evasion, even though it is considered to be a minor player in providing offshore financial services.

“South Africa’s secrecy score of 56.10 is the lowest secrecy score (the lower the better) of the nine African jurisdictions included in the Financial Secrecy Index 2018. Yet its global significance [in facilitating IFF] is the greatest of any of the African countries, reflecting the relative size of South Africa’s economy.”

The Tax Justice Network argues that “secrecy undermines South Africa’s own tax base. The country’s elite, and South African and foreign multinational companies within its borders, exploit weaknesses in legislation and use other secrecy jurisdictions to reduce their tax obligations in a country with deep inequality.” However, this report will show how secrecy not only undermines the country’s tax base but also robs it of much-needed investment and local consumer demand, through the reduction/dampening of wages.

In other words, if South Africa is not a jurisdiction that facilitates tax evasion and provides a safe haven to foreign illicit financial flows, it is nevertheless suffering heavily from tax and wage evasion. The first Section below aims at both exploring the scale of such IFFs in South Africa and revealing the mechanisms that allow such flows to harm tax collection, deplete wages and limit local investments.

1 – The direct costs of IFF: main figures

1.1 - Figures worldwide

It found that profit-shifting alone cost developing countries around $100 billion a year in lost revenues. Researchers at the International Monetary Fund put the overall revenue loss for developing countries at about twice that, and the global total near $600 billion a year.

● OECD:
Considering only tax losses in terms of corporate income tax (CIT), it estimates between 4% and 10% of global CIT revenues are lost by tax authorities. That means currently

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1 Financial Secrecy Index 2018, Narrative report on South Africa, part 1, page 1
2 All references available on request. Contact AIDC: dominic@amandla.org.za
between US$100 bn and US$240 bn annually. It further notices that the effective tax rates paid by large MNC entities are estimated to be 4% to 8.5% lower than other companies.

- **High Level Panel on Illicit Financial Flows (Mbeki Panel):**
  US$ 1 trillion is lost to IFF every year worldwide.

- **Tax Justice Network:**
  A conservative estimate made in a TJN report of 2010 indicates that the range of wealth accumulated over the years in tax havens, acting as tax-free investment, from IFF, is between US$21 trillion and US$32 trillion.

1.2 - At an African level / for emerging economies

- **High Level Panel on Illicit Financial Flows (Mbeki Panel):**

![Graph of illicit financial flows from Africa, 2000-2008 (billions of dollars)](image)

  - **Global financial integrity:**
    Between US$50 billion and US$80 billion is flowing out of African countries every year. This is more than the amount of international aid received by developing countries. This makes African countries net creditors to the rest of the world.

  - **OXFAM International**
    Developing economies lose US$50bn every year.
- **Tax Justice Network**
  The elite of 139 low-middle income countries have accumulated US$7.3 trillion to US$9.3 trillion in tax havens. (By comparison, the gross external debt of these countries is US$4.1 trillion).

1.3 - For South Africa

- **High Level Panel on Illicit Financial Flows (Mbeki Panel):**
  4% of South Africa’s GDP is lost due to IFF. This means R186.4bn lost in 2017 alone\(^3\).

Over the period 1970-2008, the cumulative loss to IFF is around US$81.8bn (on average US$2.2bn per year, with the flows being much higher at the end of the period). The panel also calculated that, for gold trade alone, every year US$3.6bn disappeared from the UN trade database. That’s US$40bn from 2000 to 2010.

- **Global Financial Integrity Report**
  More than US$122bn was lost between 2003 and the end of 2012. According to the report, in 2012 alone US$29.1bn left the country under the radar (~R239bn at an exchange rate of US$1=R8.213 in December 2012).

- **Davis Tax Committee (SARB data on service misinvoicing)**
  In four years (2008-2011), R203bn linked to service payments left South Africa. Although part of such an amount is probably linked to real service consumption by South African economic agents, an important share of such payments is due to artificial overpricing. The data indeed shows that there was a highly suspicious and unexplained increase in such payments in 2009 (following the financial crisis). The report further notes that such payments never came back to the pre-financial crisis situation leaving the readers to assume that IFF has become a structural problem.

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\(^3\) According to Stats SA estimates of National GDP for 2017.
2 - Tax depredation mechanisms and the additional Indirect costs (wages and investments)

2.1 - How IFF impacts the national fiscus concretely: where can we see the blow?

The fiscus is hit by a phenomenon called ‘base erosion’, which is multidimensional. Essentially, the tax base of a country reflects its economic power as well as its capacity to raise resources. It represents the economic activities that it can tax (its base) at whatever level it considers appropriate. Base erosion is therefore the erosion of such a tax base, linked most of the time to tax avoidance and tax evasion.

The taxes a state can raise usually come from 3 different sources:

- Tax on revenues, linked to income creation (Personal Income Tax, Corporate Income Tax, Dividend Withdrawal Tax, etc.)
- Tax on consumption (VAT, Sin Tax, Fuel Levy, etc.)
- Tax on accumulated wealth (estate duty, inheritance tax, or wealth tax if existing)

The present report will cover initiatives and reforms on all three areas since tax evasion can impact on all of these three sources of revenues. More specifically, it will target companies’ evasion of taxes on their profits (tax on companies’ revenue). We call this ‘profit shifting’ (see Part III).

The report is also aimed at understanding losses linked to undisclosed assets and revenues of individuals that hide their money offshore (this includes tax on people’s revenue as well as on people’s accumulated wealth). It also deals with the loss of VAT revenues linked to e-companies and e-sellers, which is a side effect of profit shifting methods.

2.2 - Who are the losers of corporate tax evasion (mostly profit shifting)?

When focusing specifically on corporate tax evasion, we see all states losing money, through different schemes:

- First, as the recipient of taxes as a ‘source country’: source-based taxes are basically taxes raised by a country on foreign companies for using their resources (natural, workforce, capital, infrastructure) to produce wealth within their territory. Tax payers are therefore indiscriminately nationals and foreigners.
Most developing countries fall into this category because they rely mostly on foreign capital/companies to have a proper taxable base.

- Second, as a ‘residence country’: states can also raise taxes on the profit of their national companies, wherever this profit has been made. Developed economies rely more on this kind of tax since they are exporting a lot of capital abroad. In this case, only national companies are targeted, but this time for their global profit (not only their national profit).

This concept of residence country normally applies mostly in regard to profit shifting methods of MNCs, but it also means that individuals who are resident taxpayers might also evade taxes by hiding wealth and revenues abroad.

- Third, as a VAT collector: every state is potentially impacted here, especially with the development of online trading platforms.

South Africa falls into all three categories. With regard to corporate activities, a developing economy would fall more in the first (source country) than the second (residence country). South Africa, as an emerging economy, has a mixed corporate tax-base. It receives a lot of foreign investments (source country) but it has also started to export more and more capital to other developing countries (residence country), especially to other African countries. It therefore needs to find a balanced approach to re-establish a healthy tax-base, if it wants to be able to fund its development policies and maintain good public services.

2.3 - Is this only hurting our national fiscus? - tax evasion or wage evasion?

The most commonly accepted term when speaking about illicit financial flows is tax evasion. Not only does it have the advantage of being non-partisan, but it is also received as non-ideological, because speaking about tax justice is not speaking about class struggle or alternatives to capitalism.

This is one of the reasons why such a concept was able to gain leverage and secure support amongst people and organisations from very different backgrounds and history, and this is also why it has now become a common fight within nation states all over the world.

However, when we speak about tax evasion by MNCs, the leakage for the national economy is not only in terms of tax. The Lonmin case is extremely revealing in highlighting this (see Annex 2 for more details). Not only does tax evasion allow Lonmin to reduce its tax footprint in South Africa, it is also a great tool for reducing the company’s financial commitments towards its employees and the surrounding communities. It makes it harder to argue then that an MNC must increase wages to a
living wage level or that it must implement its commitments in terms of building housing if its South African subsidiary is showing little or no profit.

This example shows that the concept of wage evasion is integral to the phenomenon of IFF and is much bigger than just tax evasion. Not only are taxes not paid fairly by those who can pay more, but all the stakeholders are losing as a result of MNC practices, including but not limited to: citizens, since social and environmental commitments are not fulfilled; local municipalities that can’t fund their development programmes; and obviously workers that could better their living and working conditions with such money. For all these reasons, we prefer to speak about tax and wage evasion.

2.4 - The indirect consequence: the investment gap

This also means that investment could have been funded without additional foreign capital or borrowing. Altogether, this loss of both national public and private resources to invest in and for South Africa means that South Africa is now entangled in a dependency path to development and that this situation will continue unless political change happens.

Concretely, this lack of sufficient national savings means the unfulfilled need for capital is now fulfilled through foreign capital, further aggravating our current account deficit. With an increasing share of the national income leaving the country to repay both interest on debt and returns on investment, this is a vicious circle for an economy stuck in a low growth dynamic. If today our balance of payments is in such a recurrent deficit, it is not because of a trade imbalance in goods and services. It is mostly because we have accumulated a huge account deficit for too long: most of the imbalance now comes from the payment of interest and dividends to foreign investors. Tax evasion therefore doesn’t only mean less taxes and lower wages. It also means losing resources for investment. This shows the limits of the mainstream discourse that asserts that the government's task is to fill our funding gap by attracting foreign investors: too often it doesn’t look into the long-term causes of such a gap.

For an emerging economy such as South Africa, speaking about illicit financial flows is therefore not only speaking about tax justice or our current low-wage economy. It is also addressing the current dependency path on which South Africa finds itself. It’s a dependency path because with such a current account deficit, South Africa has little choice, under the current paradigm, but to please ‘the market’ and rating agencies to make sure borrowing costs are not too high. Speaking about dependency just reflects the loss of sovereignty South Africa is now experiencing when choosing its economic and trade policies.

Some might argue that this is mostly a rhetorical detail, but this reflection will be key when coming to the strategic options South Africa can envision: since multilateral reforms will still takes years to become applicable and efficient, we have to explore unilateral short- or medium-term answers to close the current gaps. It implies that when
conceiving such reforms, we should consider our tax policies as part of a bigger agenda to boost South African development.

3 – The unaccounted impact: the tax race to the bottom

3.1 - The problem worldwide

Another element often unaccounted for is the indirect impact of illicit financial flows on tax systems worldwide. The slow progress in curbing IFF has meant that many countries have started to engage in tax wars in order to attract investments and/or repatriate some economic activities that had been moved offshore. In other words, instead of seeing tax havens slowly reforming their tax system by reinstating normal tax rates and rules, we have seen more and more countries adopting tax haven-like rules and trying to compete with secrecy jurisdictions.

A perfect example of this phenomenon is the European Union, where many countries decided to engage in a tax race to the bottom as their development model. The cases of Ireland, Luxembourg, Netherlands and Malta are all competing amongst themselves by lowering standard corporate tax rates, negotiating even further, company-specific reductions and implementing rules that facilitate secrecy-based tax evasion schemes.

Large economies have now joined the tax race to the bottom. In the first half of 2018, France, for instance, has officially decided to transform temporary tax cuts into a permanent tax cut and to remove most of its wealth tax, while the US has cut its corporate tax rate to 21% from 35%.

As a result of this tax race to the bottom, between 1985 and 2018, the global average statutory corporate tax rate has fallen by more than half, from 49% to 24%.

Such cuts are a net loss for public finances globally. One has to understand that there is no winner in a tax race to the bottom: artificially increasing the attractiveness of an economy by decreasing its tax rate doesn't magically create new investments. It just diverts them from other countries. Using the tax system as a competitive, development tool will ultimately lead to a corporate income tax of zero. The only winners in this race are the corporations and their investors.

3.2 - The finance curse

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4 Public law 115-97 Tax Cuts and Jobs Act of the 115th Congress of the United States of America, 3rd of January 2017
Another problem for countries keen to become offshore financial centres – by reducing certain sets of taxes or lowering their transparency provisions – is the risk of making the country’s economy dependent on the financial sector. Just as with oil and other expensive commodities (i.e. diamonds, gold, cocoa), the financial sector can lead the country onto a dependency path in which other sectors of the economy are made to pay. This is what some call the finance curse.

This can happen through 3 mechanisms. The first is that, by creating huge profits, the financial sector crowds out the productive industries by acting as a brain-drain on key sectors such as manufacturing. Then, if a large share of national revenue comes from an oversized financial sector, the risk is a generalised price inflation. Last but not least, the easy rent the financial sector provides to the country’s elite acts as a disincentive to make the necessary reforms for the productive economy to grow.

What all this shows is that competing in the race to the bottom results in global public resource losses. Moreover, the race contributes to the ill-health of the local economy. For both these reasons, any fiscal incentives to attract financial flows and investments should be avoided, if sustainable development is the goal.

3.3 - The South African Position

The South African form of this incentive is the so-called Headquarter Tax Regime. This regime provides automatic tax relief to certain companies incorporated in South Africa. The intention is to make South Africa the most attractive country for multinational companies, operating anywhere in Africa, to base their regional/continental activity. Concretely, it does this by exempting a Headquarter Company (HQC) from tax on dividends, as well as those received by the HQC. Similarly, no capital gains tax is payable on the sale of shares in a foreign company if the HQC immediately before that disposal held at least 10% of the equity shares and voting rights in that foreign company. The Controlled Foreign Company (CFC) rules are set aside for a HQC, and it is exempt from foreign exchange control rules and regulations. Lastly, it receives relief in transfer pricing rules related to debt and financing instruments.

The Davis Tax Committee, however, is a fan of HQCs. If such a tax regime appears appealing, it is in fact the Africanisation of the tax race to the bottom.

Rather than support for HQCs, South Africa should take strong steps, within regional institutions, to avoid a tax war between African countries. In the light of the recent development of the African Free Trade Area, this question is becoming particularly acute and will need to be dealt with very soon, otherwise the spirit of pan-africanism that feeds such cooperation could fade away. No one wants to see, once again, the surge of xenophobia in Africa, and if the continent's leaders are not careful, they could simply end up following the European Union’s mistake of not providing a comprehensive and mutually-beneficial regional tax framework.
PART II - Transparency

The second part of this report focuses on the availability of information on tax related matters and the extent of that information, since such data can have a huge impact in terms of understanding companies’ tax practices, as well as how the different tax loopholes are used.

4 - Automatic Exchange of information (AEoI) and the Common Reporting Standard

Reliable documentation is key for tax authorities to be able to allocate their resources wisely and target effectively non-compliant taxpayers.

The Automatic Exchange of Information (AEoI) initiative, and its corresponding Common Reporting Standard (CRS), was one of the first initiatives taken by the OECD (February 2014) to tackle tax evasion.

Its focus is on banking information only: account holders, tax residency of such holders, amounts at stake, etc. The OECD’s objective is to make sure participating jurisdictions are able to access comprehensive sets of information on their tax residents, wherever their assets might be located around the world.

4.1 - The CRS within the Automatic Exchange of Information, a small step forward

The Automatic Exchange of Information (AEoI) started functioning in January 2017 with the first signatory participants and will allow them to access data from July 2014.

As of the 15th of May 2018, 100 jurisdictions around the world have agreed to implement the multilateral instrument for the AEoI. Some of these jurisdictions might not yet apply the AEoI but, by the 1st of January 2019, all of them should be sharing information. In between, others might join the process as well.

In terms of obligations, AEoI requires jurisdictions to follow a Common Reporting Standard (CRS) negotiated under the OECD forum. It forces every participating
jurisdiction to issue to every taxpayer a Taxpayer Identification Number (TIN), and local Financial Institutions (FIs) to collect and share them when required.

It also means participating jurisdictions have to collect data about account holders (controlling person’s name, residency, etc.). Out of this information, every jurisdiction will have to publish lists of low-risks accounts, but also to mention accounts and financial schemes excluded from reporting.

Basically, every active bank account with more than US$ 250,000 for pre-existing entity accounts or US$ 1,000,000 for pre-existing individual accounts will be registered in this system. Then, every country will automatically receive all collected information related to its own tax residents.

4.2 - Numerous loopholes in the scope of data collected

However, numerous critiques have been made of this model.

First, by focusing only on financial assets, it leaves out of the agreement many other forms of wealth, such as real estate ownership, safety deposit boxes, art, and specific assets such as gold.

Therefore, most trusts are exempt from the reporting scope of the agreement (see section 7.3).

Another problem is that the CRS threshold of 25% to establish ownership of relevant financial instruments is far too high. It should be set at 5%.

Regarding tax residency information, tax authorities have very limited obligations to follow up even obvious inconsistencies and other red flags. For instance, no further action is required in cases where the country of birth is different from the tax residency. Similarly, there is no black list of countries offering ‘residency-for-investment’ programs (see section 7.1)

Regarding the reporting obligations for financial institutions (FIs), once again there is a gap. Currently, FIs don’t even have to report that they have no reportable schemes. This makes non-reporting far too easy for those with something to hide. At the very least, they should formally declare that they have nothing to declare. This would place on record their own assessment of their reporting obligations.

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Finally, the current agreement limits the use of the data to tax matters only, whereas the data could be useful in a large number of other areas such as money laundering and corruption. This should change too.

4.3 - An automatic exchange of information … not really automatic

Beyond the weaknesses identified in the scope and use of the data collected through the CRS, another main problem exists: the automatic exchange of information is far from being automatic. There are numerous ways to limit the number of countries that supposedly benefit from the automatic receipt of the information collected.

The Model Convention rules aren’t mandatory. Any party to the agreement (signatory state) can decide not to apply the rules, if they have opted into a bilateral agreement rather than the multilateral one. In other words, individual countries have the power to decide with whom they share the information they collect. The Bahamas and Singapore for instance choose which other countries to share information with. Tax payers willing to avoid the sharing of their information will therefore just need to do some treaty shopping and decide to locate their assets in those jurisdictions that are not part of the automatic exchange of information.

Large countries, like the US, simply decided not to implement the treaty and to stick to its own legislation, the FACTA (Fair and Accurate Credit Transactions Act). FACTA covers more or less the same area as the CRS with the added advantage for the US of limiting the information it shares by negotiating one-sided bilateral agreement with smaller countries.

Even countries that have opted into the multilateral agreement (including the automatic exchange of information) can still choose which jurisdiction will receive their information. This happens in two ways. First, a country has to be able to provide equivalent information on its own entities and account holders, otherwise no information will be made available. Second, even if the country has the capabilities to collect such information, jurisdictions can refuse to share their data with them if they consider local confidentiality rules are not strong enough. This results in countries with less sophisticated tax services not benefitting from the automatic exchange of information.

4.4 - South Africa’s position on this issue
Altogether, this means the agreement still leaves a huge space for developed countries and secrecy jurisdictions not to share information with those that need it the most - developing and emerging economies.

For instance, in January 2017, at the launch of the agreement, 55 countries signed the multilateral agreement, but Argentina, one of them, was only able to get 33 AEoI agreements concluded. This was the highest number secured of all the developing countries that answered the TJN survey.

Another example is the recent Swiss debate, within its government, on the opportunity not to share the data it collects with a number of developing countries, including Brazil, Argentina and South Africa.\(^7\)

In short, and to paraphrase Andres Knobel, analyst for the Tax Justice Network, ‘this makes the multilateral agreement more like a dating game than a comprehensive system of information exchange’.\(^8\)

South African tax authorities can provide the required information to be able to tick the ‘reciprocity box’ of the multilateral agreement. It will therefore be able to access the AEoI in most cases. South Africa has also been able to negotiate, or is currently negotiating, bilateral agreements with the Bahamas, Panama, Singapore and Hong Kong\(^2\).

However, South Africa still faces a few challenges.
- Its relationship with the US is based on the FACTA agreement. This means it can access only partial information from the USA. This restriction is particularly important because the USA is the second biggest offshore financial centre, according to the Financial Secrecy Index.
- The shortcomings of the agreement previously mentioned also limit its capacity to track non-compliant taxpayers, and this is another problem.
- In regard to its strong diplomatic ties with other African countries, South Africa should question those aspects of the AEoI that limit its automatic application. It would need to do this if it wants to champion the defense of its African counterparts, which don't always have equally strong tax services and information collection capacities, and thus won't benefit from the agreement.

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\(^7\) Swiss Politicians seek to block automatic information exchange [https://www.taxjustice.net/2017/08/14/swiss-politicians-seek-block-automatic-information-exchange/](https://www.taxjustice.net/2017/08/14/swiss-politicians-seek-block-automatic-information-exchange/)

5 - Country-by-country reporting

The focus is again on transparency and more specifically on MNCs and their tax avoidance policies.

The need is for states, and ultimately the public, to understand how MNCs report their economic activities, because this has a huge impact on tax.

There are several questions MNCs need to answer: what specific activity takes place in each particular country? What detailed resources (human, financial, etc.) are involved? How much profit is generated in each jurisdiction?

Without this type of information, it is not possible to tackle the illegitimate tax avoidance strategies of MNCs. For this purpose, one needs to be able to assess whether there is a match between an MNC's actual income and its declared income. This is why accessing such information would greatly challenge the profit shifting methods of MNCs. This process will be explained in more detail in section 9 below.

Such avoidance relies on one widely recognised principle of international tax law: the arms-length principle. This allows MNCs to determine on their own (and potentially arbitrarily) the price of a transaction that takes place between two entities belonging to the same MNC. It was created for tax purposes, since no actual price negotiation takes place in such cases. For tax purposes tax authorities need to know what profits local entities are receiving. So they need a price for such transactions to determine the total costs and sales of the local affiliates of MNCs. However, such a system is extremely flexible for MNCs, which have been using illegitimate prices to artificially reduce their taxes.

However, such strategies can be challenged in three ways:

● By proving that the price chosen was not market-related (decided at 'arm's-length')
● By proving that the paid transactions had no economic substance, meaning that the questioned payment was made in exchange for nothing in terms of goods or services.
● By stopping the use of the arm's-length principle for designing a comprehensive apportionment formula that splits the profits of a MNC fairly between the different jurisdictions it is operating in (see section 15.2).

In all those cases, information is needed for two purposes: to prove the transaction was mispriced or took place for no reason other than for tax purposes (no substance), and to design a fair system that allows tax authorities to better match the tax footprint of a company to its real economic activity.
The country-by-country, subsidiary-by-subsidiary reporting is therefore a way to fill this information gap.

5.1 - Existing international recommendations and efforts on this issue

The BEPS Action Plan (See Annex 1), Action 13⁹ on country-by-country reporting is attempting to address this transparency gap.

Once ratified by a jurisdiction, Action 13 creates an obligation for any MNC with a turnover of more than €750m to make available to tax authorities:

- One master file (high-level information regarding the global business operations and transfer pricing policies of the MNC)
- One local file (detailed transactional transfer pricing information and documentation) for each jurisdiction in which a MNC operates
- One country-by-country report detailing the MNC activities in each country it is established in (amount of revenue, profit before tax, tax paid and accrued, number of employees, stated capital, retained earnings and tangible assets, as well as the type of business undertaken for comparison reasons)

Some countries could also be allowed to require additional transactional data (related party interest payments, royalty payments and, especially, related party service fees) when an implementation review will be established by the OECD in 2020.

In all those cases, information is needed for two purposes: to prove the transaction was mispriced or took place for no reason other than for tax purposes (no substance), and to design a fair system that allows tax authorities to better match the tax footprint of a company to its real economic activity.

Country-by-country, subsidiary-by-subsidiary reporting would therefore greatly help in ending such abusive practices by providing such information.

None of the above information will be made public: it is for confidential sharing between tax authorities only.

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⁹ Detailed implementation manual of Action 13 of the BEPS Process
5.2 - South Africa’s position on this issue

South Africa has no compulsory rules to force MNCs to disclose to tax authorities their transfer pricing policies (including their database of comparable transactions), but merely a set of guidelines (SARS Practice Note 7) created in 1995 and quite outdated. However, it has compulsory rules for the pricing of certain transactions. Altogether it only gives details on how MNCs should price transactions between their different related entities, within South Africa and between South African affiliates and foreign related entities, but it imposes no specific reporting procedure.

Regarding the exchange of country-by-country reports, the Multilateral BEPS instrument is not yet functioning, and South Africa has not yet implemented such standards into local norms.

It has promised it will do so in the near future, but for now there are only two bilateral agreements, with the USA and Hong Kong\(^\text{10}\), that have been signed to exchange such information. There is a new form for reporting purposes - Income Tax Return (ITR- 14) submissions. There are also guidelines for South African companies to report their tax avoidance strategies.

5.3 - The limits of Action 13 on country-by-country reporting

In spite of the evident benefits of such new international standards and its implementation in South Africa, it is important to bear in mind the limitations of such a framework.

First, the threshold for multinational companies to have to present a full CbC report under Action 13 is very high (€750 million, around R12bn). We recommend instead such a threshold should be between R1bn and R2bn annual turnover worldwide, leaving only really small businesses with the option to complete only a master and local file.

Then, Action 13 of the BEPS multilateral process carries the risk of depriving local authorities of their autonomy. It relies on the good faith of tax authorities to collect reliable files (local, master, and country-by-country) and to share them. SARS would therefore rely on the willingness of foreign tax authorities to deliver the data, whereas it could require all this data directly and unilaterally from MNCs operating within the Republic. Such a framework might also deprive SARS of information if other jurisdictions decide to water down the reporting standards when implementing them locally.\(^\text{11}\) In fact,

\(^{10}\)Link for bilateral agreement on CbC reporting (USA and Hong Kong only) http://www.sars.gov.za/AllDocs/LegalDoclib/Agreements/LAPD-IntA-EIA-CBC-2017-01%20%20Status%20Summary%20of%20all%20CBC.pdf

\(^{11}\)Comments of Nick Shaxson on how ‘lobbyists eviscerated the OECD project’ https://www.taxjustice.net/2015/09/14/country-by-country-reporting-lobbyists-eviscerate-oecd-project/
such a unilateral approach is currently being discussed by the European Union, following a request from the Netherlands to make sure the Union has the legal capacity to collect the information it considers critical. Following this complementary path, South Africa could well impose sanctions on MNCs, or, more strictly, forbid them from investing in South Africa if they refuse to comply. An alternative could also be to cancel any kind of tax deduction for a non-reporting company. There local tax bases would therefore be aligned to their local turnover (local wages taken separately).

Another problem of CbC reporting is that it could limit South Africa from requiring extra data (related party interest payments, royalty payments and especially related party service fees) if the government decides to stick too closely with the international framework, as the DTC advises it to do. South Africa can’t afford to renounce its sovereignty on this question by betting on a 2020 review process that could extend the type and scope of information required from MNCs.

Lastly, by making tax authorities the only recipients of such information, Action 13 might prevent further disclosures of such information locally. In the light of the State Capture episode in South Africa, the risk that SARS won’t use this information fully is high. The only way to really prevent MNCs from using aggressive transfer pricing methods is to expose them to public scrutiny by making this information public. Once again, if it decides to stick too closely to international standards, South Africa will miss a huge opportunity to curb tax avoidance that could be protected from scrutiny through corruption.

6 - Disclosure of aggressive tax planning arrangements

Rather than the actual behaviour of MNCs, as discussed above, Action 12, the subject of this section, focuses on their tax planning strategies for the future.

The required disclosure of aggressive tax planning arrangements is meant to allow tax authorities to better understand the stratagems, advised by tax and law firms, to reduce taxes legally. The idea is to force the disclosure of arrangements that seem borderline: in other words, the ‘aggressive’ ones. In Action 12’s own words, the intention is to oblige MNCs to ‘disclose their accounting and transfer pricing policies when such policies have tax implications’.

6.1 - The international recommendations and efforts

Action 12 of the BEPS Action Plan requires signatory jurisdictions to establish a mandatory disclosure regime to encourage better tax compliance from MNCs and ease the research of potential tax frauds.

Basically, it would entail any party to a tax arrangement to:
● Disclose the scheme - the obligation could lie both with the promoter and the taxpayer, or with either of them
● Create generic and specific triggers that would lead automatically to disclosure (e.g. requirements for confidentiality, payment of a premium fee, etc.)
● Map properly the disclosure obligations of enablers (accountants, tax-advisors, etc.) to better assess the risks (try for example to identify customers of a promoter to find users of such schemes) and require when possible a list of customers
● Introduce penalties for non-compliance.

It also requires countries to introduce special rules for cross-border schemes. Countries should therefore develop special triggers for cross-border schemes and for taxpayers entering intragroup schemes which have tax consequences.

However, this Action doesn’t have a minimum standard of implementation, meaning that every country will have to decide to what extent it wants to apply such recommendations.

Lastly, it could lead to the creation of an international platform to improve the sharing of information.

6.2 - South Africa’s position on this issue

South Africa already has reportable arrangements provisions (Part B of the Tax Administration Act 28 of 2011). According to the DTC, it is ‘ahead of many OECD members’ in this regard. SARS describes these provisions as an ‘early warning system’ allowing risks to be anticipated. Under this system, between 2009 and 2016, 838 arrangements were reported.

However, the DTC recommends that this automatic disclosure should be extended for cross-border arrangements following Action 12 recommendations.

In South Africa, the promoter of a scheme bears the primary reporting obligations. In the absence of such a promoter, the ‘participants’ in the arrangements must report the scheme.

A new form for such reporting needs to be provided, since the previous form, the RA 01 form, is now defunct, with the repealing of section 80M - 80T of the income Tax Act.
Regarding penalties for non-compliance, the current provision (Sec. 212 of the Tax Administration Act) allows the determining of liabilities, but it doesn’t adequately define who falls into the ‘party-to-an-arrangement’ category (i.e. trusts’ beneficiaries).

Current penalties amount to R50,000 for a participant and R100,000 for a promoter, per month of non-compliance. These amounts are so small as to invite non-compliance. We therefore recommend that a percentage of the annual turnover of the targeted entity needs to be considered to determine adequate an amount for future sanctions.

South Africa could also withdraw the professional licenses of non-compliant ‘enablers’, such as law firms and auditing & accounting companies, or decide to forbid auditing firms from offering to a single company both auditing services, and accounting services (tax planning strategies). This could limit the incentives for these companies to design tax avoidance schemes for their customers.

7 - Issues not covered by international initiatives: emerging loopholes

7.1 – Investment-based residency / nationality acquisition

A – What’s the problem? What’s at stake?

One of the first problems not taken into account by the work of the Davis Tax Committee, and only recently taken into account by the OECD\textsuperscript{12} - after intense lobbying from civil society groups - is the risk that exchange of tax-related data doesn’t take place under the Common Reporting Standards (CRS). More precisely, an increasing number of jurisdictions are selling their citizenship/residency to wealthy individuals.

Basically, numerous investment-for-residency programs have been created in several jurisdictions to allow individual to hide their assets from their national tax authorities. This emerging loophole work as follows: with the growing net of jurisdictions sharing information under the CRS, individuals and entities opening up a new bank account or registering a new company will have to provide more information on who owns the

money. Such information, as planned under the CRS, will then be exchanged with the country of origin/residency to allow tax authorities there to continue their oversight over their citizens, even when they store their assets abroad. However, the current requirements do not adequately cover people with dual nationality, who are under no obligation to provide all relevant information about both jurisdictions. The rapid growth of this potential loophole is not surprising given the price of a second residency or nationality starts from investments as small as €43,000. Making matters even worse, those jurisdictions often require no physical presence to apply for citizenship, even when the country is a no-tax or low-tax jurisdiction, or when it has a special tax regime for foreign individuals.

B – Additional solutions

In most cases, the problem is not the existence of these programs and schemes as such, but the absence of efficient mitigating measures that would easily curb their use in tax evasion schemes.

Easily implemented measures include, for instance, the spontaneous exchange of residency information, or the mention on such citizenship certificate that citizenship has been acquired as part of these residency or investment programmes.

It is also important for the automatic exchange of information agreements that currently exist to be amended to make sure sufficient scrutiny is exercised by banking and tax authorities worldwide. The CRS, for instance, should be amended to make sure signatory parties exercise proper due diligence processes when offering such programmes, and to incorporate the previously mentioned mitigating measures.

Then, establishing a black list could be very powerful since 'naming and shaming' campaigns are efficient tools to force secrecy havens to comply with international best practices. This list could also be used by tax authorities to better target their scrutiny work.

Lastly, for African and, more specifically, for Southern African countries, it is important to use diplomatic means and put pressure on members of regional alliances (AU, SADC, etc.) to make sure such programs are either withdrawn or strictly monitored. The fact that the Parliament of Mauritius is currently discussing the establishment of such a programme is indicative of the risk.

7.2 – The limitations of Automatic Exchange of Information initiatives: the need for registries of beneficial ownership

As mentioned previously, more and more countries are now following the CRS. Despite its shortfalls (see section 1), and subject to certain changes, its scope will soon cover most of the globalised financial flows. If the CRS is focused on banking details and tax-
related information, other initiatives are also emerging and target other types of information. For instance, there is a common declaration\textsuperscript{13} of the French, German, Italian, Spanish and English ministers (G5) of finance states that these countries will multilaterally implement the automatic exchange of beneficial ownership related information. This might look like a step forward, but it poses a risk. It might slow down the current shift that is taking place towards tax transparency.

More precisely, these initiatives between tax authorities are a step forward to curb IFF only to the extent that they provide additional information to tax authorities worldwide. But they have a huge limitation: such information is not public. The recent State Capture episode of corruption in South Africa proves that we can't always expect tax authorities to use this information wisely. It is only with public registries of beneficial ownership information that tax evasion can be curbed. It could indeed create a powerful incentive for compliance from wealthy taxpayers due to the reputational risk a scandal could have on them. More importantly, it will put pressure on tax authorities to use this information effectively. Having such information publicly available could deter politicians or politically connected persons from interfering with the work of tax authorities, since public scrutiny will shrink the space for questionable decisions to stop investigations.

Such international changes are particularly critical for South Africa. The changes are not only important for tax authorities to rebuild citizen confidence in a post-State capture era, but they would also be a powerful tool for informing the public debate on the many forms of inequality in South Africa. In addition, the extremely high wealth inequality (Gini coefficient for ownership of wealth is between 0.9 and 0.95\textsuperscript{14}), underscores the need to implement a comprehensive wealth tax, as revealed by the Davis Tax Committee\textsuperscript{15}. Such a wealth tax would ameliorate historical inequalities and strengthen the tax base in a just and sustainable way. Yet, a comprehensive mapping of asset ownership in South Africa does not yet exist. Once again, a public registry of beneficial ownership would ease the process.

To summarise, automatic exchange of Information agreements, such as the CRS or country-by-country reporting, are no more than the first of many needed steps. Public registries of beneficial ownership, while having due regard to the small amount of information that needs to be confidential, are the next urgent steps.

7.3 - Trust

A - What is the issue? What is at stake?

\textsuperscript{13}Letter of G5 of the 14 April 2016

\textsuperscript{14}Davis Tax Committee report on Wealth Tax of the 18\textsuperscript{th} of April 2018

\textsuperscript{15}Idem.
A trust is a legal vehicle originally conceived to allow asset owners (trustors) to arrange the management of their properties and assets by another person (a trustee) for the benefit of a third person (the beneficiary). It is normally limited to use for specific circumstances. For instance, if children were to inherit properties from deceased parents, they obviously can't manage such property. The solution was a trust: the asset owner would, instead of transmitting its property to his young children directly, give it to a trustee who would manage the assets for a given amount of time. That way, the beneficiaries would still be able to enjoy their property, but in between, another legal and temporary owner would manage them, on behalf of the beneficiaries. Technically the trust is not the legal recipient of the assets; it is just a contract through which the legal ownership of the assets goes temporarily to the trustee. However, such a legal entity is not recognised as a company, but merely as a legal arrangement.

However, such legal arrangements have been increasingly misused: the advantage of a trust is that it can hide the identity of the beneficial owner of the assets, since the de facto (but temporary) owner is the trustee. Wealthy individuals, in order to avoid tax, instead of owning their property directly, request a wealth manager to find someone to become trustee in terms of a trust scheme of which they will stay the ultimate beneficial owner. Tax authorities won't be able to know that such wealthy people own properties and assets, since the only name that appears is the one of the trustee. In this way, individuals can, and do, avoid taxes on income and on wealth normally linked to these assets.

If in common law such a legal arrangement is called a trust, different national legal systems use different names (i.e. Fiducie, Treuhandstiftung, fideicamisos, etc.). The common element, however, is this function of hiding the identity of the ultimate beneficial owner of the assets. The problem is that since those are understood as legal arrangements and not legal entities, they often end up left out of policy reforms internationally.

Similarly, foundations can have the same function: since the purpose of a foundation is completely up to the owners, it can be used to hide beneficial ownership, especially for disclosure purposes.

If defenders of such legal vehicles claim it would be unfair to strictly regulate such legal entities, one has to remember that, in most cases, these vehicles are not used for legitimate purposes. A good example is New Zealand: once they decided to create a compulsory registry of beneficial ownership, where all trusts would have to be registered and to provide the names of their beneficial owners, between two thirds and three quarters of existing trusts failed to meet the requirements and preferred to close¹⁶. This

is concrete proof that it’s not only a few bad apples, but that it is part of the DNA of trusts, which have lost their initial purpose and become a tool for the rich and the powerful to escape taxes. There is no surprise then to see tax activists defining trusts as weapons of mass injustice.17

In addition, it is worth mentioning that implementing reforms could once again help to achieve broader tax justice: identifying trusts’ real owners and their respective assets will be a key component in implementing a net wealth tax in South Africa.

B - What do we need to end this problem?

The first thing that is needed to tackle this problem is broad and comprehensive disclosure obligations for all Trusts operating under South African law, involving South Africa assets or beneficial owners, or using South Africa as a place of business.

A trust should therefore submit a comprehensive list of its beneficial owners if:
  ● It is incorporated in South Africa and/or according to South African law, or
  ● It owns independently, irrespective of its place of incorporation, assets in South Africa, or has any business relationships in South Africa, or
  ● Any of its beneficial owners is a South African resident, irrespective of its place of business and incorporation.

Business relationships should be defined broadly to include things as broad as having a bank account, providing or acquiring goods and services or having some kind of interest in contracts such as leases, or ownership of any assets, etc.

Then, regarding the beneficial owners, it is important to again use a broad definition such as the one chosen by the EU, as recommended by the Financial Action Task Force for Anti-Money Laundering (FATF AML) that considered all of the parties to the trust (founders, protectors, trustees, beneficiaries, etc.) as beneficial owners of the trust.

The second thing is to create a register of information publicly available as mentioned previously. This should be free of costs and in open format, as well as regularly updated by using foreign equivalent databases.

All stakeholders must have access to information:
  ● Tax authorities and regulatory bodies
  ● People and organisations with a legitimate interest
  ● People linked to a foreign company, owned by a trust
  ● The general public

available here: https://www.stuff.co.nz/business/industries/94403144/foreign-trust-numbers-plummet-after-postpanama-papers-rules-kick-in
Lastly, effective and deterrent sanctions, including financial ones, should be implemented for non-compliant trusts.

C - Additional precisions

Before going further, a few comments should be made to anticipate potential critiques of such recommendations.

It will be relatively easy to implement registration of beneficial ownership for Trusts incorporated in South Africa and Trusts undertaking business activities in South Africa. However, involvement of any South African resident as beneficial owner will obviously be harder to implement since it implies foreign cooperation.

However, with the current efforts to enhance exchange of information between countries, such a 'clause' might appear as very powerful to encourage non-compliant South African residents - who hoped to escape South African trust law by locating both their trusts and assets abroad, or who could have facilitated tax evasion for foreign taxpayers - to reveal such ownerships.

Then, to answer possible critics on the disclosure of trust and foundation information to the public, it should be highlighted that obviously tax authorities will always be the first recipient of tax information. But free access for the general public is still critical. Firstly, because so-called 'State Capture' proved to us that citizens need tools to ensure public authorities are compliant with their mandate, transparency being a powerful one. And secondly because there is a risk that journalists and civil society organisations might see their access as 'interested parties' to trust information denied or delayed through judicial processes. The use of PAIA requests today by such persons is a good example of how lengthy such processes can be.

8 - General recommendations on transparency

As explained in the second part of the report, the growing pressure on decision-makers to curb illicit financial flows is slowly bearing fruits. The Automatic Exchange of Information through the Common Reporting Standard has started to empower tax authorities, and soon country-by-country reporting will become a reality. The fact that one Action of the BEPS Action Plan specifically also deals with reportable arrangements is a good indication that the space for secrecy and illicit financial flows is shrinking.

Despite these positive steps, some powerful countries – such as the US – are refusing to be fully part of these multilateral efforts to end tax evasion and IFF.
However, South African authorities are still encouraged to implement most of these reforms. This means not waiting on international efforts to combat illicit financial flows. Indeed, the current economic crisis and austerity make these reforms all the more urgent.

**The ABCD of tax transparency is a minimum commitment** that should be applied without delay.

- **A**utomatic Exchange of Information (partially implemented already)
- **B**eneficial ownership disclosure in public registries.
- **C**ountry-by-country, subsidiary-by-subsidiary reporting standard (implemented but information not public yet)
- **D**isclosure of the tax returns of every South African.

Only the last of these – the ‘D’ – requires further elaboration. This is because recreating popular confidence in our tax authorities is absolutely essential as one of the many steps needed to get our economy moving. We therefore recommend the disclosure of the personal tax returns of all South African residents in a specific registry accessible publicly online. Not only is this possible (countries like Sweden and Norway already implement such a system), but we believe South Africa can’t take any more patch-up reform and needs something that will create a confidence boost. This is to us the best insurance that our elected representatives, the top leadership of the main state agencies and institutions, as well as the shareholders and managers of companies which benefit from public tenders, don’t misuse public money. In short, it is the best way to stop corruption, by affording a quick and free way to all South Africans to check if these people are not benefitting unduly from their position by means of corruption and other undue benefits such as IFF. This might seem radical, but this is intentional.

One can oppose this on the basis that only those previously mentioned persons should be forced to have their tax returns made public. But then there is the question of relatives and of the degree of closeness one has to be to such persons to see their tax returns made public would be difficult to establish. On the contrary, we hope that such a broad reform will create a confidence shock and be a wake-up call for South Africans to play their role as citizens more proactively, as the best defenders of public integrity.

The devil is, of course, in the details with such reforms. Effective implementation will need both commitment from decision-makers and strong oversight from civil society organisations.

Coming to the question of the costs of these transparency reforms, we have pointed out in this second part where the gaps currently lie. Closing them requires more political will than financial commitments. Of course, establishing a public registry of ownership, imposing extra-reporting requirements on big companies and financial institutions, resourcing SARS to make sure it is able to use this information effectively, or enhancing
cooperation between the different institutional holders of information (SARB, SARS, private banks, etc.), all these are not cost free.

To us, it is clear that a failure of our national leadership to implement such reforms in a short time span would mean the promises of the government and the ANC to curb illicit financial flows are not serious. It bears repeating that these reforms can be implemented quickly and unilaterally (without waiting for international efforts) and that nothing is really preventing our decision-makers from implementing them, except their own interests in using such loopholes, and the lobbying of wealthy individuals and of their affiliates (MNCs, Wealth Managers, etc.).

Lastly, we want to make it clear. We can reassure those who fear the economy will not be able to attract investments or that this will threaten our ‘competitiveness’. Only parasitic investments will depart, leaving behind the really productive and long-term ones; the ones from which we might benefit; the ones which might indeed ‘stop the bleeding’.

PART III - Profit shifting and transfer mis-invoicing methods

The third part of this document explores the question of corporate tax evasion and of multinational companies’ aggressive tax avoidance schemes. Going beyond the transparency issues pointed out in the second part of this report, we will now see that it is first and foremost the manner in which the international tax system has been designed that is playing a major role in allowing tax avoidance on an industrial scale.

In this part, we will focus first on the proposals made to reform international tax law related to corporate profits, by critically analysing such proposals, going from a general overview (section 9) to more specific issues (section 10 to 14). Then we will try to show that radical alternatives exist and could lead to a paradigm change in international tax law (section 15). We will try to demonstrate how such a paradigm shift could allow South Africa to drastically reduce illicit financial flows (IFF).
9 - Transfer pricing and value creation issues (broad perspective)

9.1 - Profit shifting, a critical issue

A - What is profit shifting?

Profit Shifting is the use of gaps and unresolved ambiguities, within the international tax rules of different jurisdictions, by international economic agents such as multinational companies (MNCs), to reduce their tax and wage obligations worldwide. Speaking of profit shifting instead of tax avoidance or tax planning simply emphasises that, in order to maximise their tax efficiency, MNCs publish accounts and financial documents that don't reflect their real economic activity worldwide. In other words, they locate their profits, not according to where they are directly made, but rather to where they choose for their tax liabilities arise.

Normally, issues such as the real production costs, the source of their inputs such as raw materials, the amount of local investments or the payroll of a company are key to determining the precise national locations of the profit of an MNC. However, for tax purposes and wage negotiations, their financial accounts might show a doctored picture. This is profit shifting, when it happens.

B - A phenomenon growing alongside the globalisation of value chains

Estimates\textsuperscript{18} show that two thirds of global trade exchanges take place between different subsidiaries of the same multinational group. It means that most world trade is free from the constraints of market conditions. In complete contradiction with neoliberal ideological fantasies, most world trade pricing therefore escapes the mechanism of the so-called invisible hand of the market.

Concretely, whenever a service or a good is traded worldwide, the company's accountants and tax practitioners have a far greater role to play in determining its price than the 'market'. This means that, in most cases, companies rely on their own pricing methods to report, selectively, to different national tax authorities the profits and revenues they claim to earn in each particular country. Acceptance of this self-pricing system provides a huge profit maximising opportunity for MNCs to shift their profits amongst their subsidiaries.

\textsuperscript{18} - UNCTAD's World Investment Report 1995 (WIR 1995)
C - Limited checks and balances

Under international tax rules, a principle has emerged to make sure such power is not misused: the arms-length principle. It emerges from the idea that, to have fair pricing methods, related companies have to trade at arms-length, meaning they will act with each other as if they were not related, or, in short, as if they were trading their products and services on a 'normal' competitive market. Governments are therefore asking them to choose fair transfer prices. This means MNCs are currently asked to price goods or services in a market-related way based on a fictional situation they should copy.

Of course, this principle, that surprisingly dates back to the mid-17th century, is highly contested and, with the rapid growth of global trade since the beginning of the 1990s, it has led to more and more disputes between tax authorities and companies. Because of the growing internationalisation of value chains, following the globalisation of our economies, and since most tax systems rely on this principle, legal tax disputes have become more and more technical. Depending on which side one is on, the challenge is to prove or disprove that the price chosen was 'market-related'. This becomes very difficult with rare products and high value-added manufactured products, and it is impossible where patents/intellectual property royalties are concerned, because they are by their nature legal monopolies. Concretely, it means disputes are increasingly technical and complex. The biggest losers in the power stakes that determine unequal international trade are countries that can’t afford the risks of costly and lengthy procedures. The result is well-known: relatively weak countries, in any particular context, witness increasing illegal and illegitimate capital outflows from their economies, making them both dependent on foreign investments and incapable of funding public investments.

D - A broader issue: the location of value creation in international value chains

Behind the technical issues of transfer pricing and profit shifting, a key problem is raised: the location of value within international value chains. It is important to remember, when reading this part of the report, that the battle at play today is around international tax rules between countries with extremely different interests. The challenge is to determine which country is going to be able to retain a bigger tax base, to the detriment of the others. On the one hand, the more powerful economies, where MNCs are mostly headquartered, defend the right of MNCs to make their subsidiaries pay fees for a multitude of services including royalties, patents, management services and insurance. By contrast, the economic interests of the less powerful countries lie in defending the value added created by the local subsidiaries, thereby reducing the abusive transfer of value to foreign headquarters. South Africa illustrates the duality of this relative power: it hosts (relatively) large foreign investments, but its companies are also increasingly investing abroad. Its interests are therefore often contradictory.
However, due to deepening globalisation and the multiplication of international value chains, countries’ interests are becoming increasingly aligned. The growing number of low and no tax jurisdictions, or so called tax havens, and of secrecy jurisdictions, now mean that the interests of competing countries are converging with the erosion of tax bases worldwide. All these countries are suffering from tax losses. This leads to a loss of economic sovereignty and to the weakening of their institutions with austerity policies they have to implement, which lead to increasing popular anger.

We must nevertheless keep in mind that there are still conflicting interests at play. The fact that the OECD and the G20 decided to take the lead on the question of base erosion and profit shifting (BEPS) is encouraging to the extent it shows the problem is now seriously considered. Nevertheless, the fact that other international institutions have been side-lined is worrying: the UN Tax Committee would have been a much better forum to discuss such tax rules considering what is at play. (See annex 2 on the BEPS Project)

9.2 - The international recommendations and efforts

Internationally, the OECD’s BEPS project addresses transfer pricing as a whole through three main Actions (8, 9 and 10).

Broadly, there is a push for international transparency: it aims at forcing MNCs to better delineate their contracts with related companies. This way, it will be easier for tax authorities to make sure the allocation of profit effectively matches the real economic activity of a company. Accounting methods will have to reflect real value creation activities, such as the presence of important functions, the economic risks taken, or the amount of contributing assets (working capital amongst others). It also incentivises tax authorities to extend their benchmarking models and databases to ease the analysis of transfer prices and guide private companies in determining their own.

One of the main points of attention, that will be discussed in detail later, is the need to change the rights associated with legal ownership of intangibles (intellectual property (IP) rights, royalties, brands, etc.). These actions point out that the owners of such assets should no longer automatically be entitled to part or all of the profit generated by their use. The OECD recommends instead to use an ‘appropriate return, reflecting the value of the asset’ as a basis for calculating a fair transfer price.

Debt instruments and other financial schemes used to manipulate the location of value creation will also come under greater scrutiny. For the OECD, the idea is to make it impossible for a funding arm of a MNC (namely a capital rich subsidiary) to claim part of the profit created elsewhere, if they don’t carry an equivalent part of the financial risks associated with such funding.
A last interesting proposal is to allow tax administrations to more easily make ex-post facto adjustments to better fix the values of intangibles (services), which is one of the hardest loopholes to close.

However, as we are now going to see in more detail, these proposals are not ambitious enough and leave unaddressed a number of substantial loopholes.

10 - Transparency and the issue of substance

In this section, the focus is on the issue of substance. The idea is to avoid the artificial localisation of profit in low-tax jurisdictions (offshore), by ensuring that a financial transfer effectively happens in exchange for a real good or service. In other words, we use ‘substance’ in cases where the problem is not the pricing per se, but more simply the absence of any real activity or service implemented in exchange for a payment. This is not limited to services, but services are the category where it is most likely to happen, especially with intellectual property regimes, royalties, sales commissions, management fees and debt-related instruments.

For a tax authority and local stakeholders (i.e. unions), the challenge, beyond accessing information (see section 5 on country-by-country reporting), is the need for adequate methods, alongside analytical and assessment capacities, to determine if there was indeed any activity (and therefore any costs) occurring in the foreign company to which the payment has been sent.

10.1 - The international recommendations and efforts

Under the OECD’s BEPS project, Action 5 on Countering Harmful Practices is being undertaken.

The main change here is the agreement over a ‘nexus approach’: one can claim tax benefit for R&D projects only to the extent that one has indeed incurred costs for such purposes in the given jurisdiction.

It further proposes six rulings that will have to be automatically exchanged between jurisdictions to ensure transparency. These rulings are:

● preferential regimes
● advance pricing arrangements
● downward adjustment to profits rulings
● Permanent Establishment (PE) rulings
● conduit rulings
• Any other kind of rulings

Lastly, Action 5 also reviewed 43 preferential regimes (of which 16 were specifically on Intellectual Property) to assess which ones should be amended to fit into this new nexus approach.

10.2 - South Africa’s position on this issue

Once again, the Davis Tax Committee (DTC) supports these proposals and encourages South Africa to exchange its tax rulings with foreign authorities.

The Davis Tax Committee however warned South Africa that there is a need to be careful with the implementation of Action 5 since it could have implications for the specific headquarter tax regime (see also section 3.3), as it could force South Africa to amend it.

The DTC proposes that it should be amended to create a substance test for the attribution of the regime. It also emphasises that South Africa should start exchanging information on this specific regime with foreign tax authorities for transparency purposes. However, commenting on the success of the special tax regime, the Committee notes that South Africa doesn't participate enough in tax competition to become the real gateway for foreign investments in Africa. It therefore highlights how South Africa has to be careful to make sure legal changes of this tax regime don't harm its competitiveness.

Last but not least, it highlights how South Africa should make sure that the South African Revenue Service (SARS) has the analytical and assessment capacities and capabilities to deal with this new exchange of information requirements.

11 - Thin capitalisation and interest deductions

Thin capitalisation, and more generally the use of debt (or other financial instruments) to reduce a MNC’s tax liability in a given country, represents a specific way of shifting profit. In the same way, that many intermediary consumption expenses are tax deductible for businesses when calculating their taxable income, interest paid on a debt is mostly tax deductible.

Debt can be used in two ways to achieve profit shifting. A MNC, for instance, can either put the whole burden of a third party loan onto one specific subsidiary within its group, and not compensate it properly (using intercompany loans allowing it to choose which entity will ultimately carry the burden of the debt repayment), or it can more simply overcharge a subsidiary for a loan taken out by another one of its subsidiaries (using an intercompany loan).
These techniques are often referred to as thin capitalisation techniques because, in most cases, the subsidiary from which the profits are extracted is overly indebted, especially in comparison to its equity capital. Thin capitalisation is appropriately descriptive because the preventing mechanisms focus mostly on the debt-to-equity ratio, alongside the nominal interest rate of a given loan, to determine if a company is over-abusing interest payment exemptions. In other words, international rules aim at preventing the subsidiary from being capitalised too thinly.

11.1 - International efforts and recommendations on this issue

Two main actions of the BEPS Action Plan apply.

First, Action 4 of the BEPS process on interest deductions and financial payments aims at establishing maximum indebtedness ratios to avoid thin capitalisation, as well as generalising risk assessment studies to avoid artificially high interest rates in intercompany loans.

Its main proposal is to use a fixed-ratio rule (between 10 and 30% of maximum indebtedness) to avoid thin capitalisation for a company. The additional intention is to implement a group-ratio rule for each MNC, in order to avoid too much debt being carried by one specific subsidiary.

In addition, a 'de minimis' threshold could be implemented to exclude entities which pay low interest rates from lengthy and complex validation procedures.

Action 4 also opens the way for signatory parties to forbid or cap the use of interest paid in public-benefit projects in schemes limiting the taxable base of a company benefiting from public tenders.

In summary, such proposals aim at easing the process of determining the correct price of capital (the interest rate of a loan) for tax authorities, by providing them with a stronger framework to calculate what should be a normal arms-length price for a loan or any related instrument.

The second of the aforementioned actions is Action 9 on debt-related instruments and risk-taking activities

For intra-group loan and debt-related instruments, Action 9 recommends changing the transfer pricing rules to ensure such transactions are properly delineated. In the case of such risk-taking activities, it further recommends that, unless the associated party providing such services has both the capability and the authority to undertake such risky activities, the transaction should be viewed as lacking in substance and commercial
rationality and be reassessed accordingly. This aims at preventing ‘cash boxes’ (capital rich entities without any other relevant economic activities) from claiming undue profits.

In determining the arm-length prices for such transactions, Action 9 highlights the need for TNCs to account for their total synergies when determining a fair interest rate: the benefit of synergies must benefit the whole group.

11.2 - South Africa's position on these issues

Regarding **Action 4 on interest deductions and financial payments**, the DTC made a number of recommendations:

- South Africa should align with international standards and introduce a safe harbour (under which no enquiries are made) as well as a threshold to limit costs for small investors. It indeed cautions that evaluating the right interest rate as well as the right maximum amount of debt could be too costly for small companies.
- There is a need to take into account the specificity of start-up companies that require a higher debt ceiling than more established counterparts.
- From an exchange control perspective, the DTC advice to SARB and SARS is to align their recommendations on what an acceptable interest rate is, in order to provide certainty for investors.
- In spite of the OECD recommendations, the DTC wants to keep withholding tax on interest sourced in South Africa, even if it implies that tax treaties agreed on before 2015 should be renegotiated.
- It proposes to redraft section 24J of the Income Tax Act to avoid taxing non-tax evasion scheme ('for tax purposes') and 8FA to limit tax deductibility of interests coming back to South Africa as ‘dividends’.

Regarding **Action 9 on debt related instruments and risk taking activities**, the Davis Tax Committee, beyond advising South Africa to adopt most OECD proposals, made a number of recommendations:

- To maintain and strengthen its existing capacities at SARS to better deal with Advanced Pricing Agreements (APA) in order to strengthen its transfer pricing capacities and be able to adhere to international best practices.
- For SARS and other tax authorities to systematically compare similar economic actors in order to benchmark appropriate transfer prices. This would enable SARS to tackle tax evasion more efficiently.
- To keep the safe harbour rules, a *de facto* exemption to the arms-length principle, at prime +2%, or in line with Exchange Controls when loans are lower than R100m, thereby safeguarding investors from unnecessary costs.
11.3 - Critiques

The DTC rightly points out that there is a risk that closing these specific legislative loopholes might well mean that the profits will simply be sent offshore through other mechanisms, such as royalties and technologies payments. However, this real concern does not mean South Africa should leave the door open to debt-related profit shifting methods. On the contrary, it highlights the need for a comprehensive response to profit shifting methods.

Coming to the more substantive proposals mentioned above, two main problems need to be pointed out.

First, the ratio proposal of 10% to 30% of indebtedness for a company leaves a huge space for MNCs. There is a risk that, by implementing these ratios, the government legitimises the extraction of profits through debt-related methods instead of really addressing the problem directly. It is critical to understand that giving a loan to a related company can’t bring the same kind of return as a loan from external counterparts. The risks taken are much lower in intercompany loans, since there is no asymmetry of information between the companies involved. It is therefore extremely questionable to see a parent company making a subsidiary pay a higher interest rate to its affiliates than its actual borrowing cost. The cost of funding for a member of the group should be the same as the global company (while allowing for currency fluctuations). In other words, the principle must be: one MNC, one interest rate.

The second problem is the DTC’s advice not to impose burdensome measures on investors. The danger of such a position is that it might undermine the top priority: ensuring that foreign investments really do benefit South Africa by stopping tax and wage evasion. The need to protect investors should therefore not prevent South Africa from implementing measures to stop illicit financial flows, even though this might mean going beyond current international recommendations.
12 - So-Called ‘Controlled-Foreign Companies (CFC)’ and the repatriation of offshore profits

Controlled Foreign Companies (CFC) is the misnomer MNCs are allowed to use when describing their own control over their foreign-based subsidiaries. The focus here is the headquartered MNC rather than the subsidiaries they control. The issue facing tax authorities is therefore how MNCs use such control to dodge taxes and to locate profits in low tax jurisdictions.

In some instances, such as with US MNCs, these subsidiaries facilitate long-term tax deferrals. In practice, they act as storing offshore entities where profit is not subjected to taxes anywhere. Such schemes are possible because the local tax law of the offshore entity considers the profits to be taxable in the parent entity’s jurisdiction (the US here), while the US law plans to tax such profits only once they are repatriated within the US. By simply storing their cash abroad, often in Caribbean islands, US multinational companies are de facto not paying their taxes, since they can be forever postponed. This is the way, using CFC, that companies such as Google, Facebook or Apple have been storing hundreds of billions of US dollars tax free.

If the recent tax reform implemented by the Trump administration will now subject US companies to a minimum tax rate on a share of future stored profits and has forced US multinational companies to repatriate these current profits against a massive tax break, similar schemes still exist abroad.

12.1 - International proposal and recommendations

Under the OECD’s BEPS project, Action 3 on Controlled Foreign Company rules, provides several proposals to tackle this problem by reforming international norms through 6 main initiatives:

- Properly define CFCs by setting out rules that take into account ‘sufficient influence’ over a company and not only a 50% threshold
- For exemptions and threshold requirements, the CFC rules should apply whenever the effective tax rate of such companies is much lower than normal.
- Regarding the definition of income, every country should implement a rule or a set of rules to allow easy definition of the income of such CFC.
- Regarding the computation of income, the proposal is to apply the parent company’s jurisdiction rule when there is taxable income. It also advises that losses should only apply in the jurisdiction of the CFC and not to allow computation.
• Attribution of income should be linked to the control threshold (proportionate influence meaning proportionate attribution of income).

• Lastly, to prevent and eliminate double taxation, the jurisdictions with CFC rules should allow tax deductions for tax effectively paid in the CFC’s jurisdiction.

12.2 - South Africa's position on this issue

According to the DTC, BEPS CFC rules are mostly in the interests of South Africa.

It cautions that when implementing such rules, particular attention should be given to trusts to make sure the income of a CFC, controlled through such a legal vehicle, is indeed accounted for in the total income of its parent company (following here the IFRS accounting standards).

Regarding the implementation of a tax rate threshold, the DTC notes one already exists: if the tax paid directly by the CFC is equivalent to 75% of what it would have paid in SA, then it's fine. It therefore recommends maintaining the current situation in order to cater for those more and more numerous jurisdictions that are lowering their tax rate to under 20% (i.e. UK recent tax break).

It also advises strengthening the substance requirement for CFC local activity in order to avoid a situation where a small office, with only one staff member, is able to claim a huge share of a MNC’s profits.

Coming to ancillary services, the DTC argues they should be considered as royalties for tax purposes to avoid mis-labelling, especially with intellectual property-related payments. The risk is otherwise that an increasing amount of royalty payments will be branded as ancillary services in order to benefit from more favorable tax treaty provisions.

However, it notes a couple of points that should get our attention.

First, it notes South Africa should soften its tax law regarding CFC to be more tax-competitive, following the path of the Netherlands and the UK, since it considers current CFC rules to be too complex. This is in our view problematic.

Regarding the implementation of the new international standards, it advises South Africa to protect its own interests by following, but not leading, the international changes in order not to deter foreign investments.
In both cases, we are very critical of this position since it puts South Africa’s tax competitiveness above the main objective of stopping illicit financial flows globally. These two propositions would also feed the tax race to the bottom and should therefore be discarded.

13 - Permanent establishment and VAT payments

Another key problem with collecting tax revenues is dealing with e-companies and online selling websites. It is extremely hard to make these companies pay their fair tax share for one simple reason: the nature of these businesses makes it extremely hard to assess where the value has been created and therefore what profit to tax. Collecting VAT on their local sales is similarly very challenging for tax authorities to assess and evaluate.

A very problematic notion is the one of Permanent Establishment (PE) status, which entitles local tax authorities to tax local economic activity and to recognise the company as a resident one. It is extremely problematic since PEs pre-dated e-companies. As a result, e-companies such as the GAFAs (Google, Apple, Facebook and Amazon) are known to be paying extremely low taxes by manipulating their PE status. More specifically, their tax avoidance techniques are mainly:

- The fictitious absence of a Permanent Establishment (PE): in spite of realising sales and profits in a country, a company claims it doesn't have any operating subsidiary/company there.
- The artificial fragmentation of activities and of contracts: combined with the first technique, this allow a subsidiary to declare it has no local profit / revenue by attributing those revenue generating activities to other foreign parent companies of the same MNC.
- The use of other fictitious arrangements relating to the sales of goods and services by closely related companies.
- The non-compliance with VAT related obligations (i.e. submitting regular tax filings) due to the difficulty tax authorities have in suing such non-compliant foreign entities.

Beyond the narrow definition of what is a permanent establishment, the loopholes are used in other ways.

First is the lack of oversight mechanisms making sure the accounts of e-companies indeed reflect their real economic activity.
A simple paper trail can fake the real location of the decision-making of a company, or of the realisation of high value activities in foreign countries. It means it is extremely easy for such a company to delegate to local subsidiaries/affiliates ‘only’ their customer research and promotional activities (commissionaire arrangement), and to make it look like another foreign entity ultimately sold the product (and cash in the profits).

A similar paper trail can also be used to hide the real location of where a service is performed. For instance, it is fairly easy to disguise the place where the strategic decisions of management services have been taken.

Regarding VAT, the fact that all sellers of services online don't have any office or physical addresses in South Africa makes it extremely easy to avoid paying VAT when selling items to South African residents, such as software.

In combination, these multiple loopholes mean that the effective tax rates of these multinationals companies are close to nil. Not only does this impact our national tax collection, but it is also a huge blow to local businesses who can't compete with firms and companies that pay extremely little taxes. All this means that local e-companies face unfair competition.

13.1 - International recommendations and proposals

Under Action 1 of the BEPS project on the challenges of the digital economy and Action 7 on preventing the artificial avoidance of the Permanent Establishment status, the following proposals were made:

- To enable States to raise direct taxes on e-companies (corporate income tax amongst others), a redefinition of the PE status has to take place (Action 7) to make sure only specific and narrow activities are excluded. A substantial online presence should, for instance, warrant PE status, if it is proven that this online presence specifically targets local customers (adverts, language used, etc.).

- Tax avoidance through the use of an intermediary could additionally be limited by tightening the proof required to demonstrate the intermediary is really an independent business. Absent this enhanced proof, the company would be recognised as having a taxable presence in the country. Of course, to implement such a rule, it is necessary to have a strong anti-fragmentation rule.

- Regarding VAT collection, simplification of forms and procedures for e-businesses to register as VAT collectors has been put forward.
Alternatively, imposing a withholding tax on digital transactions, or creating an equalisation levy, could be solutions to make sure the transactions mentioned previously (currently VAT free) fall into the tax net.

However, a major problem regarding the taxing of e-commerce is due to the lack of international consensus: every single existing bilateral investment treaty will need to be modified (the multilateral instrument, as planned by Action 15 of the BEPS process, won't work automatically) to properly adapt international law in regard to these two actions (1 and 7).

13.2 - South Africa's position on this issue

Unfortunately, South Africa is far from being exempt from such a problem. The DTC has done more than just pointing out the shortcomings of the current PE status. In the Committee's view, South Africa will need an alternative concept of PE. Maintaining or even expanding the current withholding of tax could therefore be a viable alternative to ensure local value creation is taxed fairly. It would mean a redefinition of section 9 of the Income Tax Act to cover all forms of the delivery of goods and services.

In parallel, the DTC points out how important it will be to force non-resident companies to complete tax returns and to make sure companies renting offices to 'representatives' do have such representatives filing tax returns. A temporary solution, according to the DTC, could be to change Section 1 of the Income Tax Act to align our PE definition to the OECD's new standards.

Another option to discourage the use of PE would be the introduction of a tax on branch profit remittances.

Regarding the non-payment of indirect taxes such as VAT, the DTC recommends the implementation of a number of clarifications within the legislation:
- Distinguishing 'Telecommunication services' from 'Electronic services'
- Creating a proper place-of-supply rule for telecommunication services
- Clarifying the rule for online advertising
- Implementing an easy system that adequately separates Business to Business (B2B) transactions that are VAT-free from Business to Consumer (B2C) transactions.
- Creating a simplified procedure for foreign sellers to declare VAT payments/sales without having an address in SA.

Broadly, these proposals follow the OECD's guidelines in reshaping our VAT compliance system to make sure it reduces compliance costs as a whole.
These various recommendations are useful to make sure e-companies finally fall into our tax net and pay their fair share of both corporate income tax and indirect taxes (VAT). However, they would still be inadequate. Service mispricing by e-companies is widely used and leads to the near absence of taxation for these e-giants. The next section will therefore give more details regarding these additional loopholes.

14 - Service mis-invoicing and intangibles - brand, copyright, patent box and innovation costs

Service mis-invoicing is one of the main problems linked to profit shifting through commercial tax evasion. Service payments are exploited by foreign companies in order to reduce the tax liability in the local jurisdiction, as these are allowable tax deductions.

As already mentioned in Section 9, such mis-invoicing is not limited to services only but to goods as well. The mis-invoicing of goods and services represents a useful tool to evade taxation and shift profits to tax havens and secrecy jurisdictions. Unfortunately, the estimation of IFF in the international literature only estimates trade mis-invoicing of goods due to the incomplete nature of services databases. However, it is well known that the most powerful tools to evade tax and shift profits reside in the services realm, with intangibles, including intellectual property, branding and marketing, royalties, copyrights, patenting, innovation and management fees. The issue of substance can sometimes unveil illegal tax avoidance practices (see Section 10), but most of the time, when a service is indeed provided, it is the price chosen that is problematic.

While it is feasible with goods trading to find similar products for comparison, finding similar services is extremely complicated. Unless tax authorities have extremely well-trained staff, comprehensive databases and sufficient human and financial resources, it is nearly impossible, financially, to sustain a large number of tax disputes against MNCs. MNCs are indeed extremely well-resourced and well-versed in the tax loopholes of international tax law. They can therefore easily delay and contest tax adjustments.

Beyond this issue, another main challenge is to determine the real worth of any claimed intellectual property. It is indeed extremely complex. In theory, when one subsidiary of a MNC develops a new concept, a new production method or more simply an innovation, it can, following the international copyright and patent rules, claim against other parent companies using such innovation, fee, or share of their profits. The problem is that, for tax purposes, such patents can be artificially overcharged to the rest of the group's companies.

A related problem with brand rights and royalty related payments, or with the use of specific kinds of IP such as algorithms, is the issue of the localisation of the value creating activity. Currently, MNCs often use 'patent box' (letter box subsidiaries located
in low tax jurisdictions) to store and claim fees for their brand rights and royalties. The problem is, however, whether these 'patent boxes' are the legitimate ones to claim the value creation. It is indeed very difficult to know which of the subsidiaries is the rightful owner of the intellectual property.

Sometimes, the value creation entity is the subsidiary that hosts the Research and Development (R&D) department and its engineers. However, in most cases, the answer is not as straightforward. For instance, who, precisely, gives value to the related brand? The communication team is definitely one, as is the local customer services. Similarly, the employee of an international fast-food chain, by representing the brand to local customers, is also instrumental in expanding the brand. The question is how to apportion the royalties between the different contributions made by the different components of a company?

Similarly, for intellectual property, the engineers behind algorithms, for instance, are not the only ones creating value. What about the users of social media and online search engines? The algorithms would never have been built if billions of requests, behavior patterns and personal data weren't registered first by these platforms. In other words, without the unpaid value creation of its users, most social media and search engines would never be able to offer such efficient algorithms. Why, then, require the South African subsidiaries of these e-companies to pay for an intellectual property they have participated in creating through their unrecognised staff, as well as the South African users?

To summarise, the current system to assess the correct value of a service or an intangible is currently inadequate, and this is especially relevant for e-companies whose core business is the use and trade of such immaterial assets and services. The nature of these activities is such that it makes it extremely hard to locate the real place of value creation. It means there is currently a legal vacuum leading to a phenomenon of 'stateless income' and the notion of virtual state. This means the already established businesses can easily benefit from such a vacuum. The risk is not only in terms of tax base. It also means that it is now extremely hard for new entrants in the digital economy to compete on a level playing field with these more established players. The latter have accumulated huge financial power over the years by not paying taxes, thus making it impossible to compete with these conglomerates. In other words, it is not only a tax and wage issue. The current legal vacuum is increasingly an obstacle to innovation.

14.1 - International recommendations and efforts

Under the BEPS process, three actions are trying to solve these issues: Action 1 of the BEPS process on the challenges of the digital economy, Action 8 on transfer pricing for intangibles and Action 10 on Management fees and low value intra-group services and commodities.
All of them recognise there is an urgent need to reform transfer pricing rules regarding intangibles, but they also agree to discourage countries from implementing unilateral solutions to tax e-companies (in relation to intangibles) by designing alternative methods not reliant on the arms-length principle.

Their proposals follow two principles:

- The allocation of profit should match the effective economic activity (important functions, economic risks taken, contributing assets, etc.) to stop abuses such as the existence of letter box subsidiaries (‘Patent box’)
- The legal ownership of intangibles (intellectual property (IP) rights, brands, etc.) won’t automatically entitle MNCs to claim parts or all of the profit generated by their use. Instead the notion of ‘appropriate return’ should be privileged to reflect the real value of an asset.

However, regarding royalties, no substantial proposal appears in the BEPS action plan.

14.2 - South Africa's position on this issue

According to the DTC, the proposals of Action 1 of the BEPS project on the challenges of the digital economy, Action 8 on transfer pricing for intangibles and Action 10 on Management fees and low value intra group services and commodities should be adopted.

First, in relation to Action 10 on management fees and low value intra group services and commodities, it advises SARB to price intra-group services by using their real costs +5% (as the OECD proposal) and to add a maximum threshold. However, it recommends scrapping the Service Withholding Tax that currently limits the overpricing of intra-group services.

For commodities, OECDs guidelines should, according to the committee, be followed to establish benchmarks and dialogues with MNCs, initiated to better understand their pricing methods.

Lastly, the DTC recommends South Africa not to try to develop its own guidelines on the Transactional Profit Split Method (last resort methods) but to follow the OECD ones. In its view, it should not be used too widely in order not to deter foreign investments.

Then coming to the more complex issues of intangibles and the digital economy, the detailed recommendations of the DTC regarding Action 8 and Action 10 are as follows:

- Use of the ‘cost contribution method’ to assess which part of the new intellectual property patent developed should lie in South Africa as taxable, when such patent has been developed internationally. It points out that any patent developed internationally, but involving SA contributions, should be considered as South African for tax purposes. It
further says, in term of oversight, that resourcing SARS will be key to implementing properly Cost Contribution Arrangements.

- Greater transparency of the exchange control rules to make sure a consistent application of the rule applies.

However, the DTC advises South Africa to retain a right to review the recommended methods over time. It especially points out that the recommended EXCON standards on intellectual properties could have bad transfer pricing implications.

It also notes a big shortcoming: the absence of reforms regarding the payments of services and royalties made to parent companies. This is a big loophole where South Africa will have to implement rules on its own.

In our opinion such recommendations make sense within the current international paradigm of the arms-length principle. It is however problematic to see the DTC not taking a stronger stance regarding the loopholes linked to service mispricing and intangibles. As mentioned previously, when speaking about the rapidly growing e-economy (but not only) and its tax implications, heterodox short-term solutions must also be debated. We will therefore try in the next section to show what alternatives are possible to comprehensively address transfer pricing issues.

15 - The need for a paradigm change - exploring heterodox solutions

15.1 - The arms-length principle, an obsolete concept

Looking at all the existing loopholes that allow transfer pricing reveals one similarity. All of them rely on the possibility of reducing their taxable income in the country where the economic activity takes place and where the tax liability is higher, by shifting profits to lower tax jurisdictions. Since companies are not taxed on their revenues but on their taxable income (more or less equivalent to the common idea of profit) it is fairly easy for corporate entities, especially for e-companies, to dodge the tax system.

Concretely, MNCs can use different channels to drastically reduce their tax obligation:
- Claiming additional, fictional or more simply inflated expenses will artificially reduce their local profits through such artificial increases of import prices (import over-invoicing)
- Lowering export prices to artificially limit local profits by reducing sales revenues (export under-invoicing)
- Limit custom duties by artificially lowering the price of foreign inputs (import under-invoicing)
- Over-evaluate foreign sales to benefit from higher VAT refunds (export over-invoicing)

A combination of these different methods can heavily reduce the tax liability of a MNC. Why then pay taxes?

Of course, as we have seen, the BEPS project is underway to try to address these issues:
- it will be harder to overprice inputs and to underprice outputs
- it will be harder to justify that some transactions have any real economic substance
- it will become more complicated to claim that only auxiliary activities took place in South Africa for e-companies; and
- it will limit the costs the GAFAs can legitimately claim over brand and intellectual property use.

However, it is very clear that such practices won’t stop. Maybe the game of hide and seek of MNCs will become slightly harder, maybe it will ease a little bit the hardship of our tax authorities in stopping the profit shifting schemes, but, altogether, it doesn’t comprehensively address the real issue: the fair allocation of value creation internationally between the different entities of a multinational company.

In other words, profit shifting still takes place simply because the principle on which the whole architecture of the international tax system is based, the arms-length principle, is flawed. Flawed because such a principle is based on a distorted conception that two entities of the same MNC would act with each other as if they were two competing firms trying to get the best out of a faked market competition. Why believe they won’t take into account the tax impacts their choices will have?

The OECD’s attempt to fix an international tax system, rotten to its core, is therefore highly questionable. Of course, the implementation of the BEPS reforms will help to reduce some of the space left to MNCs to artificially chose their transfer prices, and this is the least people expect after 20 years of growing political pressure from civil society organisations worldwide. But all this is still far from answering the real challenges raised by these illegal and illegitimate methods.
15.2 - The ideal alternative: a unitary tax system

The question is therefore not if such a system can be fixed, but how it can be replaced. Luckily, there are already indications within federal states of what a unitary tax system could look like. But the principle at the core of such a system bears restating: corporate profits must be taxed wherever they are made, not where corporations contrive to make them appear to be made. In other words, at the centre of such an alternative is the need to tax corporations according to their real economic activity.

The main alternative to a tax system based on the arms-length principle is the creation of a global apportionment formula. Instead of relying on the fiction that a market-like relation exists between the different entities of the same MNC, an apportionment formula would take into account different criteria to apportion the global benefits of a whole international group between the different countries where it operates. This way, instead of relying on corporate accounting methods and trying to adapt their tax system to fix loopholes and other opportunities for profit shifting, states would simply have to decide on what level to tax the share of the profit that was considered to be made locally.

To establish such a formula, the following criteria should be considered:

- The payroll (number of employees and amount of their wages)
- The assets (amount of capital and investments made in each jurisdiction)
- The amount of sales and market size (could be the number of users for online services).

Other criteria could be considered. These include the risks taken in each country by a company, or the national effort of every country in funding public fundamental research (contributing de facto to future innovations). However, no matter what the criteria may be, we have to keep in mind that the simpler the formula, the easier and cheaper it will be for companies to comply and for tax authorities to curb frauds.

The question is then, is it really unfeasible or unrealistic to apply such a system as many have argued?

Well, there is an already existing apportionment formula: the US Corporate Tax system. Although, internationally, US companies use (and abuse) the current tax system based on the arms-length principle, within the US itself, each individual state has to establish the particular contribution of every company operating in the US that was made locally. Why? Simply to be able to split fairly the fruits of US corporate tax between federated states, according to their real contribution in the realisation of such benefits. The result is a functioning system, easy to understand, that drastically limits tax avoidance within the US.
Also encouraging is the proposed establishment of a Common Consolidated Corporate Tax Base (CCCTB) within the EU. Following the idea that the current tax race to the bottom between EU members was detrimental to all members and to the quality of the welfare state services each of them can provide, discussions started around the implementation of such a unitary tax system. Not only would it stop the dangerous tax competition from taking place within the EU, but it would also avoid, within this economic area, the need for the complex BEPS-driven homogenisation of tax rules that could lead to more tax arbitrage. The capacity of each member state to deal with these new rules is uneven. This means the concrete application of the standards would be uneven. The CCCTB would not only harmonise tax rules, it would also simplify them. In spite of such advantages, some members are currently blocking the initiative (consensus is the rule on tax matters according to EU founding treaties), but the idea is slowly gaining ground. The fact that the European Commission is now fighting aggressively the secret tax rulings concluded between companies and certain member states to grant them tax exemptions, is proof of the Commission’s willingness to act for a fiscal convergence between EU members.

In spite of such powerful examples, proving both the desirability and the feasibility of such a paradigm shift, one major obstacle remains. There needs to be an international consensus around this approach for it to be applicable. The risk for a country applying this method unilaterally would be to expose corporations operating within its jurisdiction to double taxation. Currently, the international tax system works in such a way that profits or income taxed in one jurisdiction are exempted from being taxed again in another jurisdiction. In the event of a country moving unilaterally to the apportionment formula system, such exemptions would likely not be granted anymore, and many companies would suffer from double taxation.

Even if it seems that such a unitary tax system won’t be applied internationally in the near future, it is however important to keep in mind the recognition of such an alternative. Not only do we have to push the South African government to commit to the implementation of this alternative, but, more importantly, South Africa must promote this innovative solution, within international organisations and regional alliances. Developing and emerging economies are those that are suffering the most from the current international tax system. This is sufficient reason for them to take the lead in arguing for such a change. South Africa is a key country in this process, if only because of the capacity and financial difficulties the other countries have dealing within their current tax rules, whilst also being the countries that rely the most on corporate income tax to fund their development policies. South Africa is a key country in this instance. This group of countries should be at the forefront of this battle simply because the composition of their tax-base makes them rely the most on corporate income tax revenues.
15.3 - Temporary solutions for South Africa

A - Reversing the Safe Harbour rule

A first step towards moving away from the arms-length principle could be to rely on approaches that don’t use it currently. For instance, the safe harbour rule allows companies involved in inter-related companies’ trade to use the safe harbour threshold to make sure their transfer pricing won’t lead to tax disputes with tax authorities. However, currently the threshold, fixed at 2% for insurance and management fees, has not prevented profit shifting in South Africa through such mechanisms. The notorious Lonmin case reveals that such a threshold wasn’t sufficient to avoid large amounts of money being shipped abroad. (See annex 2).

A possible alternative could be to reverse the rule, using it as a cap instead of a safe harbour: whatever is over the threshold should be forbidden, or at least presumed to be overpriced by tax authorities (and taxed accordingly), and whatever is under such threshold could be investigated, especially in term of substance, to avoid artificial transfer pricing.

B - Implement advance pricing agreements for key industries

Another method to fight tax avoidance and profit shifting could be to rely on one of the proposed methodologies of the OECD (in a section on ‘Advance Pricing Agreements (APA)’ in its 2014 discussion draft ‘Transfer Pricing Comparability Data and Developing Countries’). More precisely, the implementation of sectoral advance pricing agreements could be interesting for South Africa as a medium-term solution.

For instance, Mexico concluded with the USA an APA to tax the maquila sector at its border, following one of two criteria: 6.9% of the assets used, or 6.5% of operating expenses. Such an APA could therefore be another way to design safe harbour agreements but on a comprehensive basis. This has the advantages of being both very predictable and easily manageable by tax authorities. It was, in this case, a good way of closing PE and transfer pricing loopholes.

Another more interesting approach was the Dominican example, where the hotel-tourism industry was scrutinised from a worldwide perspective by tax authorities. Following the principles of an apportionment system, they checked the amount of assets and revenues of the different subsidiaries of the hotel companies to adapt their transfer pricing policies. Once these investigations were made, Dominica’s tax authorities used them to negotiate favourable APAs. This was allowed by a prior modification of the local tax rules empowering the tax authorities to exercise such scrutiny. In this case, the APAs were signed because hotel owners feared a comprehensive apportionment formula being applied if they didn’t agree to the APAs. As a result, the massive loopholes used by
these companies – such as the use of marketing-related companies to locate most of the profit in tax havens – were closed.

**C - Simplified net margin methods - the Brazilian case**

Another option is the Brazilian tax rules that offer an interesting alternative principle for taxation: instead of letting foreign companies rely on transfer pricing rules, Brazilian authorities decided to opt for a fixed margin method to calculate the local tax-base of MNCs. In cases where such a safe harbour approach wouldn’t work well, alternatives were also provided. However, because of its simplicity, such an approach was largely adopted.

A close alternative, as advocated by the Tax Justice Network, would be to apply a Simplified Net-Margin Method (SNMM) which relies on the ‘ability to pay’ principle. Instead of using the same assumed profit rate for all companies, this method relies on the global profitability of a MNC and determines its local tax base according to the total income of the local entity, and not its net income (no deductions allowed). However, to make sure such a profit rate is acceptable for the MNC, only a fraction of it would be used to determine the local tax base in accordance with the locally generated income.

**D - Limiting foreign investments in key sectors of the economy and imposing technology transfers**

In the two previous examples, the tactics to curb profit shifting rely mostly on alternatives to the arms-length principle. The solution explored here is to limit foreign investors’ access to specific sectors of our economy and/or to force them to transfer their technologies (IPs, Brands, Patents, etc.) to limit MNCs’ opportunities to shift profits.

First, let us explore the advantages of imposing local control (>50% local ownership) for key sectors of our economy. Mining is a good example. Currently, and in spite of the BEE requirements, in any mining joint venture, a foreign company is likely to have kept its control. Since the control of the firm is foreign, it is possible for such a foreign company to use transfer pricing methods to reduce at once its local tax-base and its local profits potentially available for wage increases, and to confiscate from its local BEE associates a share of the profit effectively made in South Africa. To do so, it simply needs to transfer the profits to a foreign subsidiary where the BEE partner has no ownership rights through profit shifting methods.

At first sight, it can seem unlikely that minority shareholders will let their foreign partner rob them of part of the profit. But, since the balance of power is unequal, both locally in the equity shares, and internationally in terms of control of global value chains, it is very likely that BEE business people can’t prevent such schemes.
Forcing key industries (mining, industry, commercial farming, etc.) to be nationally controlled, by capping the percentage of foreign ownership to 49%, could help South Africa stop the most predatory practices of MNCs that hamper local workers, the fiscus and also local businesses.

Another method to limit the room for transfer pricing is to require MNCs to transfer to their local affiliates the IP their local counterpart will need in the production process. Doing so not only ensures that royalties and other related payments don't illegitimately lead to capital flight, but also helps local companies bridge their technological gap.

A mix of the two approaches could also be experimented with. This approach was chosen by China to protect its tax base: requiring MNCs to transfer intellectual property to local companies, and forcing MNCs to associate themselves with local majority partners, would allow local economic agents to catch-up with international manufacturing standards, while avoiding predatory transfer pricing schemes.

Of course, South Africa doesn’t have the same market size that would provide it with the same leverage as China. However, this approach has its merits, and targeted measures should be considered for critical industries such as mining and key manufacturing sectors.

**E - State-owned selling agency to address mineral trade mis-invoicing**

Another possibility, designed to avoid specific commodities from being under-invoiced, is to create a state-owned selling agency. The ‘High Level Panel on Illicit Financial Flows’ chaired by Thabo Mbeki revealed that South Africa is suffering highly from trade mis-invoicing when it comes to mining exports. South Africa could restrict mining companies to a mining-extractive role while leaving a mineral-selling state agency to handle export markets with little or no commission. This would ensure that a fair price is paid to the local affiliates of multinational mining companies and therefore ensure the right amount of taxes are paid locally and that wage negotiations are not affected by artificially depleted resources. At the same time, this would make sale commissions paid to foreign headquarters an obsolete transfer pricing method.

This could also help South Africa better regulate the supply of specific minerals - those where South Africa is the dominant producer (i.e. platinum) - in order to ensure the long-term stability of the industry. In other words, South Africa could use this state agency to maintain decent prices for specific sectors.

Of course, such an agency would need to have strong anti-corruption safeguards to avoid mismanagement. However, it could be a powerful tool in protecting our tax base, even if such tools wouldn’t address all the loopholes related to service mispricing previously described.
F - Specific taxes for e-companies - the EU example

Last but not least regarding e-companies, we strongly urge South Africa to move away from the arm’s-length principle in order both to rebuild its tax base and to make sure our local e-companies can grow in an empowering environment. An interesting approach is the European Union’s recent discussion on its ability to tax e-companies: France has been pushing in the EU to establish a tax on e-companies of **between 2% and 5% of their revenues**: the **digital service tax**. Moving to taxing revenues and not profits is considered to be a huge break from tax orthodoxy.

However, the veto of countries where e-companies are well-established (Ireland, Estonia, etc.) is currently leading the reform to a dead-end. This highlights the challenge of properly taxing e-companies: even a powerful trade giant, the European Union, struggles to tax them efficiently. It now considers it can’t deal efficiently with e-companies’ tax evasion methods and has resorted to taxing their revenues instead.

For South Africa, to go into such heterodox policy on its own could be risky in term of trade retaliations. However, the fact that the EU is now fearing that it may become a US e-colony and the growing possibility that it will implement such a reform, shows there will be in the near future a space for South Africa to follow a similar path. In addition, South Africa could explore ways regionally to implement such an agenda in order both to protect the regional tax base, and to enable a regional ecosystem of e-industries to emerge and ultimately to be able to compete with much bigger US and Chinese e-giants.
PART IV - Tax treaties, double non-taxation and conflict resolution

This last part will focus on the role of international tax treaties in allowing tax avoidance schemes. It will also explore the usefulness of conflict resolution mechanisms that might be implemented following the BEPS Action plan.

16 - Tax treaty mismatches and inappropriate treaty benefit

Treaty mismatches basically mean that, during the process of trading, the two relevant countries might classify the same transaction differently. These mismatches can lead to double non-taxation. They are also closely linked with inappropriate treaty benefits that allow taxpayers to avoid paying taxes in both jurisdictions by being tax free and/or tax deductible in both of them and for the same payment or income. This is linked to the fact that tax residents and non residents are taxed differently.

Normally, two rules apply. The primary rule states that a taxpayer can claim deductions for taxes they are able to show will be paid in another jurisdiction. The secondary rule, also called the defensive rule, states that if taxes are not levied as planned by the other jurisdiction, the first country can deny the deductibility of the payment from the taxable income.

However, these systems are far from perfect and allow taxation avoidance through the lack of harmony of classification of goods and services between jurisdictions, on the one hand, and through the practice of what’s called treaty shopping (the abuse of the multiplicity of existing tax treaties with no matching real economic activity to back such legal claims), on the other hand.

For instance, these mismatches can sometimes apply when determining the tax-residence of an entity. By playing around, (tax exemption given to resident/non-resident, together with being misleading, declared resident/ non-resident in both countries), a MNC can avoid paying a tax that is specifically meant to be levied by the resident country.
16.1 - International recommendations and efforts on this issue

To tackle these problems, the BEPS Action Plan incorporates Action 2 on Hybrid Mismatch Arrangements and Action 6 on Inappropriate Treaty Benefit.

These Actions lay the basis for a general harmonisation of classifications to avoid mismatches. More specifically, to address treaty shopping loopholes, they put forward two options:

- All tax treaties to better define the purposes and circumstances allowing reduced taxation or non-taxation (LOB rule – limitation of benefit), in addition to a more general anti-abuse rule.
- The creation of a PPT (Principal Purpose Test) to help identify treaty hopping/abuse.

Lastly, they encourage all tax treaties to be modified (following the multilateral instrument, see section 18) to integrate a tipping rule to determine the real residence of an entity in case of double/non residence problems.

16.2 - South Africa's position on this issue

South Africa already has rules in place to avoid treaty mismatches and undue treaty benefit. The Davis Tax Committee however recommends reforming the foreign partnership section of the Income Tax Act to catch up with international standards and to reform anti-abuse clauses of old tax treaties. OECD recommendations should be regarded as a basis for such reforms.

Overall, and behind very technical measures and details, the objective is still to try to simplify existing rules that deny benefits in case of hybrid mismatches (align on OECD) and to consolidate them into a unique tool. According to the DTC, the aim is to boost compliance, while making sure taxpayers are not overly burdened by tax compliance duties.

In terms of principle, the DTC recommends moving from a transaction-based rule to a principle-based rule to be able to catch more transactions in the net. It also advises the government to look at the UK ‘manufactured payments’ approach that focuses on applying a matching principle when updating such rules.

Addressing undue treaty benefits, the Committee recommends clarifying the definition and implication of the 'beneficial ownership' rule and clarifying Article 1 of the Income Tax Act.
Regarding the determination of what is an undue treaty benefit, currently two sets of rules exist: the Limitation of Benefits (LOB) that clearly states forbidden uses, and the Principal Purpose Test (PPT) that analyses the intention of the taxpayers. The DTC advises updating the provisions of the PPT, which South Africa currently uses, to make it harmonise with international standards.

The main existing loopholes attracting the DTC’s attention include:

- The withholding tax in its different forms to limit the room for tax avoidance, but updating the framing of such provisions. However, it points out the SA-Netherlands tax treaty has to be renegotiated urgently as it contains one of the main loopholes (dual resident entities) for dividend transfer transactions.

- Foreign revenues going to South Africans working for foreign companies in South Africa are currently tax-free. The current rule relies on foreign authorities taxing these revenues. This should be replaced by an automatic taxation of such revenues with the possibility of claiming a rebate if it can be shown that the tax has already been paid abroad.

- The Special Foreign Tax Credit. The DTC recommends designing this tax credit that allows foreign governments to claim taxes unlawfully imposed on South African companies abroad. Since the South African companies don’t object but instead expect automatic tax exemption from South Africa, SARS effectively ends up subsidising foreign tax authorities. The DTC points out that the government should also start discussions with foreign authorities to make sure such unlawful taxes are not claimed anymore.

17 - Binding mechanisms for dispute resolution

The question of dispute resolution mechanisms raises the problem of conflicts between tax authorities or between tax authorities and foreign taxpayers. The issue is how to solve them effectively and timeously. Quick dispute resolution improves and secures tax collection; it also facilitates the closing of existing loopholes.

17.1 - International recommendations and efforts

Under Action 14 of the BEPS process on Dispute Resolution Mechanisms, there is a proposal to establish a Mutual Agreement Procedure (MAP) Countries would have to agree to:

- Developing a minimum standard to resolve treaty related disputes to ensure that:

Obligations of the MAP are fully implemented and in good faith
Administrative processes are implemented
Taxpayers can access the MAP when eligible.
- A rapid implementation of the minimum standards
- Creation of a peer-based monitoring mechanism (which reports to the G20)

Some countries have already committed to MAP binding arbitration mechanisms.

17.2 - South Africa's position on this issue

The Davis Tax Committee (DTC) questions the value of binding arbitration within the MAP process. Currently, SA has only 3 treaties with binding arbitration: Canada, Switzerland and Netherlands. According to the Committee, SA should follow the OECD on MAP but choose the minimum standards.

Speaking more specifically of binding arbitration provision, the Committee advises South Africa to commit to such mechanisms only if the rules are clear and transparent. Unless such conditions are provided, SA should reserve the right to apply Action 15 (see next section). But, at the same time, it should push for more open and transparent arbitration processes.

Regarding the role of SA tax authorities, the DTC suggests that mechanisms should be created to support SA taxpayers during MAP processes, to make sure non-cooperative countries don’t take advantage of the Special Tax Credit.

More generally, a specific unit should be created to deal with MAP processes. Such a unit should design clear guidelines to help claimants understand their rights and opportunities. Similarly, this unit could create an APA (Advance Pricing Agreement) programme to decrease anticipated tax disputes.

18 – Applying the BEPS multinational instrument

Currently, the international tax system relies mostly on bilateral tax and investment treaties. Implementing the reforms of the BEPS Action Plan could therefore be overly burdensome and lengthy. To avoid separately updating each and every bilateral investment treaty (there are thousands of them in use currently), using a multinational instrument could ease the process by automatically updating all existing treaties.
18.1 - International recommendations

Under Action 15 of the BEPS process on Developing a Multinational Instrument, such a multilateral tax agreement is planned. It is meant to review and simultaneously update all existing treaties as soon as all parties to the pre-existing treaties have opted in to the multilateral agreement.

In addition, Action 15 has led to the creation of an open group of interested countries to push for the adoption of such a multilateral agreement and follow up on progress. South Africa is now part of that group.

18.2 - South Africa's position on this issue

The Davis Tax Committee has encouraged South Africa to join such a group since it will be able to gather experience on the functioning of the multilateral instrument. It regards the multilateral instrument as an interesting tool but warns South Africa to be careful when choosing what standards and actions it commits to implement, since they could have huge consequences, not least the imposition of a private justice system (international arbitration).

19 – Remarks and critiques

When analysing the international efforts to solve issues surrounding tax and investment treaties, such as the loopholes they contain, the disputes they invoke or the opportunity to modify them further, it is fairly difficult to disregard the progress already made under the BEPS Action Plan. Few people would deny that most of the proposals are going in the right direction, or that the possibility to update all existing treaties simultaneously is extremely appealing.

Moreover, to see that a South African expert panel has been able to point out many of the current limits and deficiencies of our tax system (of which only a few are reported here) is encouraging. It is a positive sign that South Africa has the capacity to deal with tax evasion and illicit financial flows if the real political will to address that problem exists. Of course, as mentioned many times by the DTC, SARS and other regulatory bodies need to build up their capacities in these specific areas of expertise.

However, and even if we support some of this analysis, it is also important to understand the limitations and risks the BEPS initiative (and its future implementation in SA) bears.

Here are a few selected ones that seems particularly important to raise.
• Regarding Actions 2 and 6 on treaty mismatches and inappropriate treaty benefit, we need to mention that these 2 Actions, which seek to address important loopholes, should not be considered as South Africa's first priority. These measures are very technical, and therefore very resource-consuming to apply, whereas the positive impact for South Africa will be limited at first: the loopholes they address impact mostly the right of ‘residency’ countries (mostly developed economies).

• South Africa needs instead to focus on Actions that aim at defending its interest as a source country. For instance, Actions 4 and 12 (disclosure of tax planning arrangement and debt instrument) are more critical, since their expected outcomes have more potential. South Africa should therefore focus on implementing Action 2 and 6 only to the extent that it doesn't prevent it from securing its right as a primary source country.

• Regarding these two actions, the BEPS process plans that State parties to the agreement will report to the G20 the achievements and difficulties related to the provisions of Action 2 and Action 6. In spite of the presence of South Africa as a member of this 'club', we believe the G20 is not the appropriate forum to discuss tax matters while the main losers of the current international tax system are the so-called developing economies. The UN Tax Committee is a better forum.

• Regarding dispute resolution, we want to highlight the risks of arbitration as a private form of justice. We encourage South Africa not to implement such a system within its international tax agreements and when choosing which provisions of the BEPS Action Plan it should ratify.

Originally, arbitration as a justice mechanism was conceived to ease dispute resolution between states when none of their respective justice systems would have sufficient guarantees of neutrality and independence. The solution was to use a private justice system, where each party chooses one arbitrator who would then agree on a third one. This way, the arguments of both parties can be heard fairly and more decisively resolved.

However, this represents a massive loss of sovereignty to private interests. Arbitrators don't provide the same guarantees of independence as official judges, and their decisions are mostly taken secretly. In many investment treaties, arbitration provisions
have been used by MNCs to contest states’ sovereign power to regulate their economy, even in domains as essential as health, the environment or workers’ rights. The recent case of Chevron vs Ecuador is only one warning lesson: the sovereign right of the Ecuadorian government to sanction Chevron for its environmental damage was ultimately revoked.

We therefore strongly disagree with the Davis Tax Committee when it advises the government to adopt such a mechanism. Even if sufficient guarantees are given on the independence of arbitrators, we believe such provision constitutes a loss of sovereignty for South Africa. Unless a proper international justice system is created and allows for real popular and democratic oversight, such binding provisions should be rejected.
Conclusions and final recommendations

1 - IFF, a national emergency for our economic sovereignty and the capacity to lead South Africa towards an inclusive and low-carbon development path

As we have seen in this report, not only are illicit financial flows a problem, but they appear more and more to be a national emergency. This is not only because they deprive our state of extremely precious financial resources, but also because the issue is further leading our economy on a dependency path in relation to foreign capital.

This impacts both our national and local budgeting processes by depriving us of precious tax resources and is leading to an unprecedented socio-economic crisis. In the light of the findings of the different studies highlighted in this report, it also appears that the question of illicit financial flows can't be disconnected from the issue of low wages and unemployment. Curbing these flows must therefore be a national priority.

2 - Immediate reforms to boost transparencies

In light of the findings of the second part of this report, and bearing in mind the main recommendations of the Mbeki Panel on IFF, it is critical to highlight once again what is already all too well known: government promises to end illicit financial flows are not sufficient. People want action, and they want it quickly. Not only is this possible, but the way forward is clear: the requirement for curbing IFF is enhanced transparency. This must become the new normal at all level of the economy and the government; from asset ownership, to companies’ tax policies. The disclosure of decision-makers’ tax returns will also be critical.

The government’s minimum commitment in the immediate future must be to ABCD:

● **Automatic Exchange of Information**
● **Beneficial ownership disclosure in public registries.**
● **Country-by-country, subsidiary-by-subsidiary public reporting by MNCs**
● **Disclosure of tax returns of every South African, starting with elected representatives and high-ranked public officers.**

3 - A critical need to resource SARS

Another major point, highlighted multiple times in this report but also repeatedly mentioned by the Davis Tax Committee, is the need to make it possible for SARS, the SARB, the Financial Intelligence Centre and other regulatory bodies to do justice to their role of gatekeepers. The recent report of the Parliamentary Monitoring Group highlighted
the fact that the “sharp fall in the number of staff employed by the SARS had limited its ability to curb illicit financial flows, which drain billions of rand from the economy every year. The exodus of employees meant the staff complement of the tax authority had declined from over 14 000 a few years ago to about 12 600 now. If SARS does not invest in this, delivery might suffer”. In addition, the hearings of the Nugent Commission have underlined both this deep weakening of SARS and how long and costly it will be to rebuild such a critical institution.

It bears repeating: unless we equip our tax authorities with the resources they need to pursue aggressively tax avoidance and tax evasion schemes in all their existing forms, we will not be able to combat IFF efficiently. Hand in hand with our advocated transparency reforms, greater accountability by these institutions and oversight of them will be needed. The promises of the government to curb IFF will therefore be seen in this light as well.

4 - A strong commitment to the long-term paradigm shift on profit shifting

In addition to these short-term changes, this report highlights how the current international tax system limits our national efforts to curb IFF. By equipping national tax authorities with tools too complex to deliver quick results and tools such as international arbitration that could further restrict our national sovereignty, there is a huge risk the promises of the BEPS Action Plan won’t be fulfilled. As demonstrated in the third part of this document, the problem lies within the core principle of our international tax system, the arms-length principle, a principle based on a fiction.

It is important for the South African leadership to understand that relying only on international efforts to curb IFF will not lead to any concrete results unless a paradigm shift takes place towards a unitary tax system.

Realistically, a new tax system is unlikely to be implemented soon. This means South Africa must advocate the unitary solution internationally and regionally in order to muster support. Unless this is done, both IFF linked to transfer pricing methods, and the tax race to the bottom will continue, and this is unacceptable for the overwhelming majority of South African citizens.

5- A pragmatic but ambitious approach for the medium-term

In the meantime, South Africa must implement pragmatic solutions that allow for the fixing of the main loopholes of our tax system. As highlighted in this report, many heterodox alternative tax reforms exist, and it simply depends on the South African government’s willingness to implement them.
For practical purposes, we recommend South Africa to focus first on two main industries: mining, and the digital economy. Mining first, because it has historically been a major source of IFF from South Africa and still represents a very big component of our exports. There are two reasons for focusing on the digital economy: its rapid growth is likely to become a major source of IFF. Then, there is a window of opportunity internationally that is being opened by the European Union’s focus on the tax obligations of the tech giants.
Annexures

Annex 1: Wage evasion case study: Lonmin - summary of findings (Bermuda Connection)

Part 1 The competitiveness of rock drill operator wages paid by Lonmin prior to the protest in 2012.

Part 1 of the report examines the competitiveness of Rock Drill Operator (RDO) wages at Lonmin. This implies a comparison with RDO wages at Anglo Platinum (Amplats) and Impala Platinum (Implats) before August 2012. In July 2012, Lonmin managers made the comparison themselves and drew the conclusion that Lonmin RDO wages were lower than at the other two big platinum companies and had to be increased.

The actual number of permanently employed workers in RDO roles and cost calculations might be confused because of Lonmin’s use of contracted labour. On 16 August, 34 mine workers were shot down by police. The payroll data of 28 of the workers was made available to the Marikana Commission, but the other 6 individual records were missing, possibly because they were contract workers.

The documentation shows that, compared to Amplats and Implats, Lonmin was late in introducing special RDO allowances. After examining documents from June 2012 onwards, there is still an unanswered question on whether the implementation of the RDO allowances was made from 1 October 2012, or earlier from 1 July as recommended in a Lonmin memorandum, or in August, which was the impression created in a SAPA (SA Press Agency) release on 25 August. This was never clarified by the Commission in its cross examination of Lonmin.

After August 2012, a public discussion started about economic stress caused by so called “Garnishee orders” that oblige companies to make deductions from workers’ wages for all kind of debts, despite many of these orders being fraudulent, outdated or questionable for other reasons. The sparse records of 28 deceased Marikana workers’ pay slips show that mine workers’ indebtedness to the company itself, through advance payments that are rolled over, were even more serious.

Part 1 of this report was never used in the cross examination of Lonmin on its finances that took place at the Marikana Commission on 16 and 29 September 2014.
Parts 2 & 3 cover the affordability for Lonmin of the increases demanded by the rock drillers and the financial capacity of Lonmin to provide decent work and living conditions for its employees.

Part 2 describes, through the analysis of financial statements and other documents, the consequences for affordability of two transfer pricing arrangements. The first involves a subsidiary in Bermuda, which allegedly marketed and sold the Lonmin Group’s platinum group metals (PGM) for a commission.

The second is a service arrangement with Lonmin Management Service (LMS) – the South African branch of the UK based Lonmin Plc – rendering a range of services for which Western Platinum Ltd (WPL) was paying management fees. Both the commissions and the fees were based on a percentage share of the revenue of Western Platinum Ltd. Investigation shows that from 2006 commissions and fees were substantially higher than the 2% and 1.9% of WPL’s revenue that was stipulated in the inter-company agreement, possibly due to a double accounting error.

Lonmin’s Mr Mohamed Seedat gave another explanation for the anomaly during cross examination at the Commission on 29 September, which doesn’t concur with other data. In addition, CFO Simon Scott’s written testimony of 29 September, when untangled, shows that Lonmin Management Services (LMS) in turn paid “management fees” of between 20% and 37% of its revenue to Lonmin Plc in UK to the amount of R429m between 2007-2010.

The inter-company exchange of actual services should be examined in transfer pricing arrangements. The issue of “substance” concerns whether the service paid for is really provided or if its commercial value is being exaggerated (or understated). Terminating the Bermuda profit shifting arrangement could have released R3 500-R4 000 extra per month for wages for every RDO. In its contrafactual (“what if”) examples, the report has also arbitrarily taken 28% of the transfer payments to provide additional financing of Lonmin’s South African subsidiaries’ Social Labour Plan (SLP) commitments, which they seriously neglected.

Collapsing the Bermuda arrangement, and cutting back on fees to LMS to a reasonable amount, would have allowed the Lonmin subsidiaries – the actual employers of Lonmin’s workers – to meet the 2012 RDO demands for a basic wage of R12 500 after tax, even after allocating 28% of resources to meet their SLP commitments. This would have been possible if pension costs and other “knock-on effects” like medical benefits hadn’t been added in full to the increase, mimicking the platinum strike agreement of June 2014, in which a part of the wage increase was agreed to be “non-pensionable”. To this should be added huge extra incomes given to managers in the form of share-based payments, costing the key subsidiary WPL R100 million per annum in 2010-2012. or R2000 per Rock Drill Operator.
The cost of the profit shifting arrangements to workers, to mining communities, to BEE shareholders in the subsidiaries and to South African society at large, is estimated to be well over R400 million per year. A public argument broke out in September 2014 over Lonmin’s claim that the “Bermuda connection” was terminated during FY2008 and that WPL paid 100% of both the commissions and fees to LMS from October 2008, which is when the 2009 financial year (FY) starts. This is contradicted by all WPL’s annual financial statements 2008-2012, except for the FY2011 Special Purpose AFS.

Lonmin paradoxically denied that this was the case and its auditor KPMG supported Lonmin’s position, in an email to this author. Whether WPL’s payments are made to Bermuda or to the head office company LMS makes no difference to the depletion of its funds. It does however have importance for taxation in SA. The taxable profits of an external company like LMS were taxed at a rate of 33% before 2013, but there are of course no taxes paid to SA from Bermuda.

Furthermore, no taxes have to be paid on profits in Bermuda and Lonmin paid nil in taxes in UK, 2000-2013. Chapter 4 also speaks to a 2006 once-off transfer of R758 million when one SA Lonmin subsidiary bought all the shares in Messina Ltd and the Messina platinum mine from Lonmin Plc after taking out a loan. This inter-company acquisition has no meaning from the point of view of corporate power. WPL is controlled by Lonmin Plc. It has had importance, however, from a tax planning point of view. Between 2008-2012, WPL every year gave a loan to Messina and then declared the loan impaired in the same financial year (to impair a loan is to declare it as valueless, assuming that it will never be paid back). WPL’s taxable profit was the reduced by that amount in its books.

Two general insights should be highlighted:

- Firstly, profit shifting starts at the domestic level and should be studied from the point of view of stakeholders in subsidiaries. The subsidiaries of transnational mining companies hire and pay workers and pay tax on profits. They hold the mining licenses as well as the SLP obligations. It is also in the subsidiaries that BEE partners hold shares from which they receive dividends. It is the subsidiaries’ funds that are depleted by exaggerated intercompany invoicing in the first link of a chain of transactions. To combat such abuse, full disclosure of these domestic finances to the public is imperative. Transfer pricing is not only a cross border arrangement.

- Secondly, when profits are shifted from subsidiaries out of the country, the effect on wages is bigger than the effect on tax revenues. Schematically: if the
Corporate income tax is 28%, a company has to move R100m to a tax haven in order to avoid R28m in taxation. In this way, R100m is effectively moved from the stakeholder table in SA. Hence we have coined the concepts ‘wage evasion’ and ‘wage avoidance’; ‘evasion’ refers to illegal arrangements and ‘avoidance’ to legal. To only estimate how much tax a company evades or avoids is misleading. We must look at the total value that every year is moved out of reach of domestic stakeholders through transfer pricing, or in other ways.

In the Lonmin case, the affordability of wage demands and social obligations under the Mining Charter was about a choice of what to afford and Lonmin chose not to afford these obligations. Affordability is a matter of choice.

Chapter 5 examines Lonmin’s reporting on employment equity to the Department of Labour (DOL) and income disparities in the company. Reports on equity were submitted on EEA4 forms for 2003-2012 and in a separate report from April 2012 when DOL made an audit. This part discusses what measures the 1998 Employment Equity Act (EEA) obliged Lonmin and the DOL to take to ensure equity and whether either party took such measures. The statistics are used to examine wage disparities between high and low paid employees in the year before August 2012. Huge gaps in income emerge above the 95th and again above the 99th percentile. There are 75 individuals at the very top of the company’s income hierarchy. These employees are probably also the beneficiaries of the share-based payment expenses of R100m per year, mentioned above. Twelve directors and the 45-50 employees of LMS with very high salaries are excluded from the equity reports to DOL.

The chapter raises questions about social reasonableness, fairness, and contribution to political stability and whether Lonmin, by flattening the wage curve, could not have distributed its production of monetary wealth more equitably.

The documentation showed that the DOL was in breach of Section 27 of the EEA (1998). This is reinforced by the very manner in which the Employment Equity report form (EEA4) is designed.

Lonmin has been informed by the DOL to focus only on income equality between the apartheid categories and between men and woman within the same wage band or category, as opposed to focusing on widening gaps between bands, i.e. between ordinary workers and higher paid employees, like managers and supervisors. It is not a concern of DOL to compare the wages of so-called semi and unskilled workers in general and RDO wages in particular with higher paid groups.
The average wage is the simplest concept to employ when making earnings comparisons between groups of employees, but average wage levels in the different groups demarcated by the EEA report forms do not allow for such reporting and consequently Lonmin was not asked to do this by DOL.

Contract workers are outside the moral and political realm of the equal pay for equal work regime upheld by the EEA. Blue collar contract workers at Lonmin earned about 55% of an established (permanent) blue collar worker’s earnings in 2011 (the ratio is about the same for the whole platinum mining industry). Statistics submitted by Lonmin to the DMR on contract workers’ wages were highly unreliable, but Lonmin effectively reported exactly the same average wage between 2009-2013.

This means a real wage loss of about 22% over that period.
Annex 2: The OECD’s BEPS Process

A - What is the BEPS project? Why is it important?

Basically, the BEPS process is a process initiated by the OECD to tackle tax evasion. It is a package of different measures (actions) meant to target specific loopholes of actual international tax agreements and rules. BEPS stands for Base Erosion and Profit Shifting.

B - What is in the BEPS Action Plan?

BEPS Action Plan contains 15 different actions. Each one plans to tackle one specific loophole of the international tax system.

- Actions 1, 4, 6 and 7 are meant to strengthen the capabilities of source countries (countries where the wealth is produced) to benefit from such economic activities.
- Actions 2, 3, 5, 8, 9 and 10 on the contrary try to address problems that impact the capacities of home countries of MNCs to tax the profits made by their national companies abroad (residence countries).
- Actions 11 aims at evaluating the BEPS process, and Action 15 targets the development of an international and multilateral tax instrument.
- Last but not least, Actions 12, 13 and 14 are simply expected to strengthen information exchanges between jurisdictions.

C - What has it led to so far?

A first part of the work achieved by the OECD has been to propose leads and paths in each one of these fields for national authorities to reform their national tax system.

The other main one was to propose the implementation of an international tax treaty that would lead to the reform of every existing DTA (double tax agreement) or BIT (Bilateral Investment Treaty) if adopted fully. This approach is quite interesting in that it would lead to a quick harmonisation of tax treaties worldwide without having to renegotiate, one by one, every one of them.

On 1st July 2018, the treaty came into force for ratifying parties. It will modify existing tax treaties from 1st January 2019.
D - What is the balance between the potential benefits of this project and its risks?

A broad coalition of tax justice organisations (BEPS Monitoring Group) has published a critical analysis of the BEPS project. It raised criticisms on both the process (involving developing and emerging economies only at a very late stage of the discussion) and on the forum (OECD is a rich-country club now claiming it can act on behalf of developing economies as well) which should have been the UN instead.

However, regarding the outcome they are more positive: ‘Overall, we consider that most of the provisions would be improvements on existing tax treaty rules’. They should ‘help to restore some source country taxation powers and strengthen the general powers of tax authorities to control tax avoidance’.

If altogether they still seem to be mere ‘patch up remedies’, the proposals seem to go in the right direction and should ‘reduce the space for tax planning strategies’. For instance, it might allow the re-establishment of the right of jurisdictions, even if it’s a minimalist approach, to tax income as a source (the opposite of most double tax agreements).

A big criticism is however of the legalised dispute resolution system (international binding arbitration mechanism) that could be implemented. Since international tax rules are subjective and discretionary, especially on allocation of MNC’s profits, accepting the decision of unaccountable arbitrators is highly anti-democratic!

Another one is the absence of any provision clearly stating that the overall objective is to treat MNCs in accordance with the economic reality that they operate as a single firm.

Lastly, the monitoring group points out that translations should be made in different languages, especially non-European ones.

In conclusion, they say that developing countries which have tax treaties currently in force should sign the BEPS Multilateral Convention to benefit from improvements in existing tax treaty rules but retain existing flexibility to use their own approach to transfer pricing by making reservations (i.e. article 17.3.b.ii).

For the monitoring group, a uniform adoption of the multilateral convention should be pursued to make sure it doesn’t add another layer of complexity to existing tax treaties through multiple reservations (especially from G20 countries).

E - How will the multilateral convention work?

The multilateral convention follows an opt-out system: every signatory state is considered as accepting all the provisions of the convention, unless they make specific reservations to opt out of specific provisions. However, some provisions are considered
minimum standards and can't be the subject of an opt out (core commitment when ratifying the convention). The only exception is part VI on binding arbitration for which every country will need to opt in.

A major drawback the monitoring group is pointing out, however, is that since most articles have opt-out options, some countries, such as the US, could be part of the treaty only to benefit from Part V and VI that provide more effective tax conflict resolution mechanisms. It could mean that, without changing the substance of their double tax agreements, some countries could still benefit from those mechanisms.

South African Tax Authorities as well as the government will therefore have to decide to what extent they want to follow the recommendations of the BEPS project and to decide if they want to join the Multilateral Convention to renew all tax treaties at once (and if so, to see which provisions to opt for and which ones to reject).
Alternative Information Development Centre (AIDC)
129 Rochester Road, Observatory, Cape Town
P.O Box 12943, Mowbray 7705, South Africa
Tel: 021 447 5770 Fax: 021 447 5884