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31 August 2015

Input to the Davis Tax Committee (DTC)

for the

Second Interim Report on Base Erosion and Profit Shifting (BEPS)

Introduction

The FMF is grateful for the opportunity to provide this input to assist the DTC's BEPS subcommittee with drafting its Second Interim Report on BEPS.

We agree with the DTC that South Africa already has sufficient laws to deal with BEPS. The DTC rightly says that any BEPS remedy needs to be supported by facts that shed light on how big the BEPS problem is in South Africa before legal responses follow. New research suggests that BEPS is an overstated concern.

We caution that the OECD, while saying each country is free to set up its corporate tax system and charge the rate it chooses and that non- or low taxation is not the concern, also says its BEPS Plan will impact regimes that attract foreign investors without requiring economic substance.

South Africa should continue to develop fiscal policies that encourage foreign direct investment (FDI). Evidence and logic indicate that multinational firms tend to locate greater real business activity in countries with low tax rates. We trust the DTC will not be deterred by the OECD project from assessing the benefits of economic growth and increased employment that South Africa would gain by eliminating corporate tax or reducing it in conjunction with a low flat tax for individuals as we have proposed.

Base Erosion and Profit Shifting
The DTC's Terms of Reference (TOR)[1] require it to evaluate the tax system against recent international initiatives to improve tax compliance and deal with tax base erosion. An aspect to receive specific attention is:

> A review of the corporate tax system with special reference to tax avoidance (e.g. base erosion, income splitting and profit shifting, including the tax bias in favour of debt financing).[2]

OECD
The OECD says Base Erosion and Profit Shifting are "tax planning strategies that exploit gaps and mismatches in tax rules to make profits 'disappear' for tax purposes or to shift profits to locations where there is little or no real activity but the taxes are low, resulting in little or no overall corporate tax being paid".[3]

The OECD in February 2013 issued a report about addressing BEPS which declared:

> Base erosion constitutes a serious risk to tax revenues, tax sovereignty and tax fairness for OECD member countries and non-members alike. While there are many ways in which domestic tax bases can be eroded, a significant source of base erosion is profit shifting. Whilst further work on the data related to base erosion and profit shifting (BEPS) is important and necessary, there is no question that BEPS is a pressing and current issue for a number of jurisdictions. …
>
> In order to address base erosion and profit shifting, which is fundamentally due to a large number of interacting factors, a comprehensive action plan should be developed quickly. The main purpose of that plan would be to provide countries with instruments, domestic and international, aiming at better aligning rights to tax with real economic activity.[4]

Later in 2013, the OECD issued a 15-point BEPS Action Plan to address weaknesses in current rules. The Plan calls for fundamental changes to current mechanisms.[5]

The OECD says the BEPS Action Plan is "not aimed at restricting the sovereignty of countries over their own taxes". It insists taxation is at the core of countries' sovereignty and each country is free to set up its corporate tax system and charge the rate it chooses. The Plan is said to be aimed at addressing regimes that apply to mobile activities and that "unfairly erode the tax bases of other countries". The Plan aims to end the use of shell companies to stash profits offshore or unduly claim tax treaty protection, and neutralise all schemes that "artificially shift profits offshore". The BEPS project is "not about increasing corporate taxes. Non- or low taxation is not itself the concern."[6]

But the OECD will expect low-tax countries to change their substantive tax rules to suit high-tax countries:

The OECD says the BEPS Action Plan will have an impact on regimes that seek to attract foreign investors without requiring any economic substance. A race to the bottom would ultimately drive applicable tax

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1 The Davis Tax Committee, "About Us – Our Terms of Reference" (TOR) 2013.
2 TOR item 3b.
3 OECD, Centre for Tax Policy and Administration. "BEPS – Frequently Asked Questions, Background," para 47, *http://www.oecd.org/ctp/beps-frequentlyaskedquestions.htm* (accessed 28 August 2015).
4 OECD (2013), "Addressing Base Erosion and Profit Shifting," pp 5, 8. *http://dx.doi.org/10.1787/9789264192744-en* (accessed 28 August 2015).
5 OECD (2013), "Action Plan on Base Erosion and Profit Shifting," p 13. *http://dx.doi.org/10.1787/9789264202719-en*
6 OECD, "BEPS – Frequently Asked Questions, Background" (see above), paras 60, 62, 63.

rates on certain sources of income to zero for all countries.[7] Actions to address BEPS will "restore both source and residence taxation" in cases where cross-border income would otherwise go untaxed or be taxed at very low rates.[8] "Domestic tax policy cannot be designed without taking into account the effects on other countries' policies".[9]

DTC's BEPS actions
The DTC in November 2013 called for input for its first BEPS report.[10] It released a First Interim BEPS Report in December 2014[11] which deals with the seven so-called "2014 deliverables"[12] of the OECD's 15-point Action Plan.[13]

The Report says, given the OECD's aim of coherent solutions, that the proposed measures on the seven 2014 deliverables, while agreed, are not finalised because they may be affected by decisions to be taken on the other eight actions, the "2015 deliverables". Measures will be implemented in domestic laws or bilateral tax treaties.[14]

The DTC now invites[15] input to assist its BEPS subcommittee with the Second Interim BEPS Report focussing on the 2015 deliverables (the other eight OECD actions):

Action 3: Strengthen Controlled Foreign Companies Rules
Action 4: Limit Base Erosion via Interest Deductions and Other Financial Payments
Action 7: Prevent the Artificial Avoidance of Permanent Establishment (PE) Status
Action 9: Assure that Transfer Pricing Outcomes are in Line With Value Creation /Risks and Capital
Action 10: Assure that Transfer Pricing Outcomes are in Line With Value Creation /Other High-Risk Transactions
Action 11: Establish Methodologies to Collect and Analyse Data on BEPS and the Actions to Address It
Action 12: Require Taxpayers to Disclose Their Aggressive Tax Planning Arrangements
Action 14: Make Dispute Resolution Mechanisms More Effective
Action 15: Develop a Multilateral Instrument.

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7 OECD, "BEPS – Frequently Asked Questions, Background" (see above), paras 61, 62.
8 OECD (2013), "Addressing Base Erosion and Profit Shifting" (see above) p 11.
9 OECD (2013), "Addressing Base Erosion and Profit Shifting" (see above) p 28.
10 Media Statement, 5 November 2013: The Davis Tax Committee Calls For Contributions.
11 Media Statement, 23 December 2014: Release of DTC First Interim Report on BEPS for public comment.
12 That DTC First Interim BEPS Report of December 2014 dealt with the seven OECD 2014 deliverables as follows:
(Introductory background information;
(South Africa's conceptual framework for addressing BEPS)
Action 1: Address the Tax Challenges of the Digital Economy
Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements
Action 5: Counter Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance
Action 6: Prevent Treaty Abuse
Action 8: Assure that Transfer Pricing Outcomes are in Line With Value Creation / Intangibles
Action 13: Re-examine Transfer Pricing Documentation
Action 15: Develop a multilateral instrument to enable jurisdictions that wish to do so to implement
(Summary of DTC recommendations on the OECD 2014 deliverables).
13 OECD (2013), "Action Plan on Base Erosion and Profit Shifting," *http://dx.doi.org/10.1787/9789264202719-en*
14 DTC First Interim BEPS Report, December 2014, p 16.
15 Media Statement, 21 May 2015: Call for Input for the Second Interim Report on BEPS by 31 August 2015.

The DTC requests persons giving input to, among other things,
(a) Analyse the effectiveness of South African tax legislation bearing in mind South Africa needs to attract foreign direct investment and be competitive;
(b) Provide recommendations on how tax legislation should be addressed if not effective enough to yield an optimal result for South Africa;
(c) Consider the costs of complying with the required legislation compared to its benefits and the impact it has on ease of doing business in South Africa;
(d) List affected non-tax areas in the South African economy;
(e) Comment on any other BEPS concern.

DTC's First Interim BEPS Report
The relevant aspects of the DTC's First Interim BEPS Report are important enough to summarise here:

The Report asks if South Africa is bound to follow the OECD Plan. South Africa is not an OECD member, although it has OECD observer status and is a member of the OECD BEPS committee. The Report says OECD recommendations have become a globally accepted standard and "it is important for South Africa to work together with the international community to come up with a holistic approach to properly address the BEPS issues".[16]

Commendably, the DTC's First Interim BEPS Report stresses that South Africa's circumstances must be taken into consideration in addressing BEPS concerns. The BEPS concerns and challenges that the UK or US face may not be ones South Africa faces. Any BEPS remedy from the South African perspective needs to be supported by facts that shed light on how big the BEPS problem is in South Africa before legal responses follow.[17]

The DTC notes that the NDP[18] says South Africa should develop fiscal policies that encourage foreign direct investment (FDI). Tax policy should not prevent economic growth. It should foster an increase in tax revenues and the tax base and job creation. Tax policy should not adversely affect South Africa as a foreign investor destination. FDI is a source of economic development and employment for developing and emerging economies.[19]

The First Interim BEPS Report asks to what extent BEPS is a problem in South Africa. SARS statistics do not imply the existence or non-existence of BEPS action. The Report discusses a National Treasury budget report, Reserve Bank data, and National Planning Commission views.[20] These are all inconclusive about BEPS action in South Africa.

The First Interim BEPS Report warns that a unilateral South African introduction of domestic legislation in anticipation of global reforms could result in a less investor-friendly tax environment and place us at a disadvantage compared to other jurisdictions without BEPS legislation in attracting much-needed FDI. Competitive pressure using tax policies is evident.

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[16] DTC First Interim BEPS Report, p 18.
[17] DTC First Interim BEPS Report, pp 18 - 19.
[18] National Planning Commission "National Development Plan: Vision for 2030 (2011).
[19] DTC First Interim BEPS Report, pp 19, 26.
[20] DTC First Interim BEPS Report, pp 19 - 26.

The G7 (except the US) and BRICS countries have lowered corporate tax rates since 2000.[21]

Some countries have moved from worldwide (residence-based) to territorial (source) systems of taxing companies. The decision is a key policy issue depending on where a country wants to be on a spectrum from purely worldwide to purely territorial taxing.

There are international changes in taxing dividend income, with many European countries moving to classical or shareholder relief systems, away from imputation systems under which dividends are taxed at lower rate at the personal level. Yet many countries tax dividends at personal shareholder level at lower rates than the personal income tax rates levied on wage income. A reason for reducing the effective tax rate on dividends has been that it is potentially the rate faced by equity investors in a new business (since such a business does not have retained profits from existing activities available to reinvest).

South Africa cannot afford to proceed too hastily with the OECD Plan while other countries take a “wait and see” approach.[22]

The First Interim BEPS Report says new BEPS rules should adhere to principles of a good tax system: Equity, efficiency, certainty and simplicity: Equity entails protecting a country’s tax base by developing domestic laws that are fair and impartial. Efficiency requires minimum distortion in allocation of resources. Certainty of the tax system is important for foreign investors and goes hand in hand with low compliance costs, and should allow as much time as possible for debate of proposed BEPS rules. Simplicity requires that corporate tax laws are not too complex; complexity is caused by taxing accruals and different treatment of debt and equity; corporate tax shelters take advantage of the taxing of income only when it is realised and of the difference between debt and equity.[23]

The Report rightly says that raising tax revenues in a way broadly accepted as “fair” is more likely to achieve high levels of voluntary compliance.[24]

The First Interim BEPS Report notes that the Exchange Control Regulations have played a role against BEPS in South Africa especially with regard to transfers related to ecommerce, intellectual property and other intangibles. The Minister of Finance has directed that liberalisation of exchange controls should aim at an end result which protects the tax base.[25]

The Report concludes that over the years South Africa has made good progress in devising provisions to deal with BEPS and its legislation is comparable to or better than developed economies. Considering the competitive edge the country has to maintain, South Africa should consider whether it is necessary to tighten its laws any further.[26]

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[21] DTC First Interim BEPS Report, p 27.
[22] DTC First Interim BEPS Report, p 27.
[23] DTC First Interim BEPS Report, pp 28 – 30.
[24] DTC First Interim BEPS Report, p 30.
[25] DTC First Interim BEPS Report, p 33.
[26] DTC First Interim BEPS Report, p 33.

South Africa has anti-avoidance provisions to address BEPS including controlled foreign company (CFC) rules,[27] transfer pricing and thin capitalisation rules,[28] rules to deal with hybrid instruments, reportable arrangements rules, [29] and the Voluntary Disclosure Programme.[30] The provisions have curtailed erosion of the South African tax base.

South Africa can also address BEPS by applying its general anti-avoidance rules and the substance over form principles, even though these general provisions are mainly applied in the domestic arena. South Africa's tax treaties also contain provisions (such as the beneficial ownership provision) which can be applied to curtail the abuse of South Africa's treaties by third country residents.

Despite these provisions, tax planners take advantage of loopholes. Legislators come up with ad hoc preventative amendments which complicate the legislation and open further loopholes.[31]

The First Interim BEPS Report stresses that the main concern of the OECD Action Plan is about addressing inbound issues which involve foreign multinationals investing in a country without paying their fair share of corporate income tax to that country. However, responding to these BEPS issues should not be seen as discouraging foreign investment. The goal is to ensure that the multinationals pay their share of tax based on amounts economically attributable to their activities in the local country.[32]

OECD Action 11: Establish methodologies to collect and analyse data on BEPS and the actions to address it

The OECD says about this:

> Develop recommendations regarding indicators of the scale and economic impact of BEPS and ensure that tools are available to monitor and evaluate the effectiveness and economic impact of the actions taken to address BEPS on an ongoing basis. This will involve developing an economic analysis of the scale and impact of BEPS (including spillover effects across countries) and actions to address it. The work will also involve assessing a range of existing data sources, identifying new types of data that should be collected, and developing methodologies based on both aggregate (e.g. FDI and balance of payments data) and micro-level data (e.g. from financial statements and tax returns), taking into consideration the need to respect taxpayer confidentiality and the administrative costs for tax administrations and businesses.[33]

We note that South Africa has institutions that can measure economic activity and which have found no material evidence of BEPS.[34]

A recent academic analysis suggests that the impact on tax revenues of BEPS is negligible: [35]

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[27] Income Tax Act 58 of 1962 s 9D.

[28] Income Tax Act s 31.

[29] Tax Administration Act 28 of 2011 ss 39 - 39.

[30] Tax Administration Act ss 225 - 233.

[31] DTC First Interim BEPS Report, p 37.

[32] DTC First Interim BEPS Report, p 37.

[33] OECD (2013), "Action Plan on Base Erosion and Profit Shifting," pp 21 – 22.

[34] See above. (The First Interim BEPS Report asks to what extent BEPS is a problem in South Africa. SARS statistics do not imply the existence or non-existence of BEPS action. The Report discusses a National Treasury budget report, Reserve Bank data, and National Planning Commission views. These are all inconclusive about BEPS action in South Africa.)

[35] James R. Hines Jr, "Policy Forum: How Serious Is the Problem of Base Erosion and Profit Shifting?" *Canadian tax journal / Revue fiscale canadienne* (2014) 62:2, 443 – 453, p 444. (Prof Hines is a research associate of the National Bureau of

How important is the problem of BEPS from the standpoint of tax collections? The statistical evidence consistently indicates that the impact on tax revenues is only modest in magnitude. Some of the latest evidence suggests that the semi-elasticity of income reporting is roughly 0.4, which means that a corporation that is located in a country with a 25 percent tax rate, and that has the opportunity to reallocate some of its taxable income to a country with a 15 percent tax rate, will typically arrange its financial and other affairs to reallocate 4 percent of its income to the lower-rate country. Other, rather more persuasive, evidence suggests that multinational firms earning profits in high-tax countries find ways to reallocate 2 percent of those profits to low-tax foreign jurisdictions. For various reasons to be discussed, even these 2 or 4 percent figures probably overstate the potential tax revenue to be had by eradicating BEPS, but on its own terms the potential tax revenue from 2 or 4 percent of pre-tax incomes of multinational corporations would make an extremely modest contribution to the government finances of most countries. The average member country of the Organisation for Economic Co-operation and Development (OECD) in 2011 raised 8.8 percent of its total tax revenue from taxes on corporate profits, only a portion of which represented taxes on multinational corporations, 2 percent of which would be two-tenths of 1 percent of tax revenue. Even if one were to double, or quintuple, this figure, it would amount to less than 1 percent of tax revenue. From this standpoint, it appears that even a complete solution to the problem of BEPS, were one available and implementable, would have little direct impact on government finances.

The author warns against overreacting to BEPS:[36]

If firms were able to arrange their affairs in ways that would easily reallocate pre-tax income earned in high-tax locations to alternative locations with zero or very low tax rates, then most would surely do so, and even those corporations without an international business presence would quickly establish operations in low-tax foreign locations in order to reduce their tax obligations. That corporations persist in paying taxes to governments of high-tax countries does not reflect lack of imagination or insufficient profit motive; it reflects the fact that enforcement makes tax avoidance difficult and costly.

Further evidence is available from the location of foreign business activities. Studies consistently find that multinational firms locate more employment, property, plant, and equipment in low-tax locations, and less in high-tax locations, than the structures of these economies would ordinarily warrant. This business activity pattern is itself a form of base erosion from the standpoint of high-tax countries, albeit of a rather mundane form, since it is hardly surprising that high tax rates discourage business activity, whereas low tax rates attract it.

[…] In fact, this is not what firms do: the evidence consistently indicates that multinational firms tend to locate greater real business activity in countries with low tax rates than would otherwise be expected. […]

It is questionable whether radical reforms are justified by the very modest size of the BEPS problem. Accordingly, it is to be hoped that any actions undertaken by the international community will reflect thoughtful consideration of the magnitude of BEPS and the costs and benefits of possible reforms.

Economic Research, and research director of the International Tax Policy Forum. Univ of Michigan, Law Faculty biographies, *https://www.law.umich.edu/FacultyBio/Pages/FacultyBio.aspx?FacID=jrhines* (accessed 30 August 2015).

36 James R. Hines Jr *Canadian tax journal / Revue fiscale canadienne* (2014) 62:2, 443 – 453, pp 445, 453.

Non- or low taxation is not an OECD concern
We welcome the OECD's assertion mentioned above that its BEPS project is not about increasing corporate taxes. Non- or low taxation is not the concern.

We have pointed out to the DTC previously[37] that corporate taxes constitute an additional tax on income that is ultimately borne by individuals. Taxes may be levied on corporations but *ordinary people* pay taxes in their roles as employees, consumers and shareholders. Most studies show that a part of corporate tax is passed on to workers in the form of lower wages and benefits. Corporate taxes also result in less money being available for companies to invest in research and development (R&D). Without this investment in R&D it would not be possible to expand business and hire more people.

Reducing or eliminating corporate tax would boost economic growth, increase South Africa's competitiveness and attractiveness as an investment destination and raise future wages. Future wages are adversely affected by high corporate tax rates because corporate taxes retard capital formation and decrease the overall level of investment, which negatively affects future labour productivity and wages.

We have urged the introduction of the Hall/Rabushka flat tax system with a low tax rate that would broaden the tax base and make tax evasion more difficult and less lucrative. Companies should be taxed at the same low flat rate as individuals.[38]

South Africa must retain its sovereignty and be free to adopt policies that increase our global competitiveness and attractiveness as a viable investment destination if it is ever to enjoy in increased economic growth and provide opportunities that will enable all South Africans to prosper.

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Consultant to FMF

The Free Market Foundation
The Free Market Foundation (FMF) is an independent non-profit public benefit organisation founded in 1975 to promote and foster an open society, the rule of law, personal liberty, and economic and press freedom as fundamental components of its advocacy of human rights and democracy based on classical liberal principles. It is financed by membership subscriptions, donations and sponsorships.

Most of the work of the FMF is devoted to promoting economic freedom as the empirically best policy for bringing about economic growth, wealth creation, employment, poverty reduction and human welfare. As a think-tank the FMF's fundamental approach to policy questions is consumer-based. Individual consumer choice is placed at the centre of any policy recommendations that the FMF espouses. Consumer satisfaction is generally achieved by an absence of barriers to entry into the provision of goods and services, allowing consumers a choice between the offerings of freely competing providers, and the absence of regulations that impose avoidable costly burdens on the providers of goods and services.

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[37] Free Market Foundation, Submission to the Davis Tax Committee: Base Erosion and Profit Shifting (BEPS), January 2014.
[38] Free Market Foundation, Submission to the Davis Tax Committee [Hall/Rabushka flat tax system etc], January 2014.