31 March 2015
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Dear Davis Tax Committee members

RE: COMMENTS IN RESPONSE TO THE (FIRST INTERIM) DAVIS COMMITTEE REPORT ON BASE EROSION AND PROFIT SHIFTING (BEPS)

We thank the Davis Tax Committee ("Committee") for providing us with the opportunity to engage in terms of this report as its recommendations are being developed.

We agree with the Committee's overall cautious approach to this highly charged topic. Cross-border taxation requires a careful balance between protecting the tax base and encouraging foreign investment. Base erosion has been a growing problem for the tax base since the 1990s as economic globalisation has accelerated. Corporate income economically derived within South Africa should be fully taxed within South Africa to curtail schemes that separate the tax base from underlying income. On other hand, Government should be mindful that there are many locally-owned and foreign-owned companies that do not engage in aggressive tax practices. These companies focus on core business activities that stimulate economic growth, meaning that these companies should not become subject to unnecessary burdens that are placed on them as the result of problems that are not of their own making.

Attached is a slide presentation of our general views relating to the specific points. We are seeking to offer a long-term view that should ultimately assist the Committee in its effort to obtain a fair and sustainable resolution of the BEPS problem.

1 EUROCENTRIC VERSUS AFRO-CENTRIC FOCUS

The Committee report has performed admirably in laying out all of the OECD's concerns and action points. While BEPS is a global concern – not just a concern for Europe and Africa – the nature of BEPS is not uniform. Schemes that work to undermine the European tax base often do not coincide with the African paradigm. South Africa itself is different given its "BRICS" country status. On the one hand, South Africa has a modern economy (especially in the financial sector) with significant national corporate champions. However, South Africa is still struggling to emerge from its roots as an unequal society and is surrounded by developing countries in ranging stages of development. Hence, the Committee correctly raised the need for an African focus.

The net result for the South African tax system is a split world. South Africa has a wide OECD treaty network with developed countries around the world, which could lead one to conclude that South Africa's BEPS issues are the same as those stated by the OECD. Nonetheless, even in this world, South Africa retains a fairly strong level of Exchange Control. South Africa is also geographically distant from transactions associated with the OECD BEPS debate and has not yet attained the status of a knowledge economy. In terms of South Africa's role as a net exporter of investment capital, the rest of Africa views South Africa itself as a threat and has already taken a long-term protectionist view of the tax system that often makes local African activities non-viable. Further BEPS reform in this latter context could actually work to the detriment of South Africa as a regional gateway.

Turning to specifics, the OECD focus on intangibles appears to be misplaced based on local anecdotal history. Excessive royalties and other charges associated with intellectual property do not appear to have the same local traction in terms of audit and disputes. This lack of action may in part be due to Exchange Control (as suggested by the Committee) or due to other factors. The point is that the factual case for the OECD-style has yet to be proven in this area before action steps can be suggested (with the Committee rightly noting all the pre-existing safeguards are already in place (e.g. transfer pricing and section 23I)).

The larger issue arising in the South African and African regional context appears to be cross-border services. In this respect, we fully take note of the Committee's identification of cross-border legal, accounting and management consulting fees as a potential issue. Unfortunately, the OECD action points do not emphasise this aspect of cross-border base erosion. In terms of the service issue, it may have been more appropriate for the Committee to join the discussion on National Treasury's proposal to impose withholding taxes on certain forms of cross-border services.

We also note that cross-border interest and similar financial flows have a longer track record of risk than the risks associated with intellectual property. Many of the schemes associated with financial flows have been targeted already. The question is whether these efforts are complete (and whether the taxes associated with cross-border financial flows have to be re-examined in light of Government's growing need for external finance).

2 LACK OF DATA

We appreciate the Committee's strenuous efforts to obtain data within the introductory portion of the report. The problem is that more data is clearly needed, without which, South Africa could be undertaking major reforms solely based upon sporadic anecdotal evidence. The end-result will be a significant wastage of resources and new compliance burdens falling upon the wrong targets.

What is needed is a country-by-country analysis of outflows in the case of interest, royalties, leases and services. Payments to low-tax countries will clearly be a sign of concern, especially when those locations lack meaningful substance. Only in this way can we have some hope of aiming at the more significant targets.

To this end, a review should be conducted of all South African Revenue Service ("SARS") and South African Reserve Bank ("SARB") forms in terms of cross-border flows. SARB has a fair amount of information, but SARS will begin improving their cross-border information flow only once the new cross-border withholding tax regimes take effect. Operational control of ongoing reporting of these outflows may itself close a fair amount of avoidance, followed by more targeted legislation. We would accordingly recommend that the Committee issue a short report in this regard (perhaps with assistance from foreign revenue authorities that have successfully created a cross-border monitoring system).

3 ADDED DOCUMENTATION DOES NOT COME WITHOUT COST

As a general matter, the South African Institute of Tax Professionals ("SAIT") supports the notion of enhanced cross-border documentation. Documentation is not only needed for enhanced audit but also to ensure factual objective information can be obtained for enhanced policy making as outlined above.

However, we would suggest that any proposed documentation requirements be analysed and publicly discussed more along the lines of the current tax legislative process. Improper forms lead to excessive compliance burdens with little benefit for the Government. Requesting information for information's sake becomes a costly exercise that can actually hinder audit (with taxpayers using excessive information to flood the audit review). Form design is not easy because form design requires an understanding of technical business processes that government officials often lack. Hence, a joint Government/business collaboration would be more effective.

We would support the notion of materiality to the extent possible. Large business often use simplifying cost-plus assumptions for a variety of miscellaneous items just as a matter of administrative ease without regard to tax. Unless some form of materiality is introduced, the cost of compliance (e.g. additional employees and computer systems) will easily outweigh the cost of the underlying tax, especially for smaller items.

4 TREATY RECONSIDERATION

Many of the BEPS concerns raised globally stem from overly generous tax treaties. In the 1990s, South African government officials had a tendency to push for international agreements as a way of showing the world that South Africa was ending its long period of international isolation. The net result was the creation of certain treaties on unfavourable terms.

South Africa should accordingly utilise the BEPS era to renegotiate its "riskier" treaties with low-tax jurisdictions. Tax treaties are designed to reduce double tax – not to create a tax vacuum. The main focus of this renegotiation would be "interest" and "royalties" (and possibly a rethink at to cross-border services). To this end, South Africa should probably join the OECD effort to revise tax treaty interpretations, update treaties and join the multi-lateral instrument process so that overall weaknesses in the treaty system is corrected.

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The only note of caution should be that South Africa must take care not to be a “first mover” in terms of the BEPS reform associated with harmful tax practices. To the extent that certain tax preferences exist (with economic benefits outweighing the tax loss), these preferences should not be automatically repealed in the expectation that the OECD will follow. Many countries within the OECD continue to operate tax preferences that serve as base eroding platforms. These platforms have previously survived despite public statements to the contrary. Undoubtedly, many of these platforms will continue even after the BEPS reform is complete.

We hope and trust that our comments will serve as constructive input for the Committee as it continues with this monumental task. We look forward to further engagement with the Committee to the extent our further input proves useful.

Yours sincerely,

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