

Withholding tax on service fees as a method to combat base erosion and profit shifting

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Remarks

The author of this research article would like to remind the reader of the following:

This mini-dissertation has been prepared in article format, in accordance with the policies of the North-West University's Faculty of Economic and Management Sciences. It consists of one research article.

The research article has been prepared in accordance with the requirements of the South African Journal of Economic & Management Sciences. The article complies with the writing style requirements of the Harvard style.

Selected journal's guidelines for authors

Requirements of the South African Journal of Economic & Management Sciences (SAJEMS):

- An introduction and/or basic literature study section(s) clearly indicating the research gap being investigated.
- A research statement and/or question that is considered to be i) of adequate actuality and research-ability to warrant publication in an ISI-indexed journal and ii) falling within the broader scope and focus of SAJEMS.
- An adequate explanation of i) the theoretical framework / research paradigm in which the article is contextualised, and ii) the research methodology in order to gauge the scientific validity of the research findings.
- An adequate and clear discussion of the research findings, any conclusions and recommendations that indicate how (or whether) the research gap has been addressed.

Format of manuscript

- All manuscript submissions should be written in either "Arial" or "Times New Roman" with a 12 point font, using 1.5 line spacing.
- The first page of the manuscript should contain a concise abstract (200 – 400 words), the JEL classification, and up to 10 keywords. The main text of the manuscript should start on the second page of the submission.
- Referencing should follow the Harvard referencing system.
- Endnotes are to be used, and not footnotes. These should be numbered sequentially and placed immediately following the text of the manuscript.
- Tables should be self-explanatory, i.e. a reader should be able to understand the table without reading the article. They should be numbered consecutively throughout the manuscript. Notes immediately following the table should explain any symbols or other useful information to the reader. The source of the table and any software used should be listed. Avoid using variable names; but rather short clear descriptions.

- Figures should be self-explanatory and numbered consecutively throughout the manuscript. Notes describing the figure should be included immediately below the figure, and should include the source and software used.
- Equations should be numbered consecutively, with these numbers appearing to the right of the equation. Theorems, lemmas, corollaries and proofs should also be numbered consecutively; however, we prefer that proofs be relegated to the appendix, in order to maintain the flow of the manuscript.

Abstract

Around the globe, including in South Africa, there has been an increasing occurrence of cross-border service fees being used by multinational enterprises to shift profits. South Africa did not have legislation to implement a withholding tax on the service fees. Because of the deductions allowed for these amounts paid when the taxable income is calculated in terms of South African taxation legislation, base erosion can occur. Research indicates that billions of rands are lost through this type of erosion. As a consequence, legislation to levy a withholding tax on service fees paid was assented. In terms of the Taxation Laws Amendment Bill released by the South African National Treasury in 2013, withholding taxes will be levied on service fees paid as part of the South African Government's attempt to protect its profit base. This legislation was assented on 12 December 2013. The effective date is however proposed to be postponed to 1 January 2017. This indicates that there are uncertainties as to the effectiveness of the legislation and whether it is the most appropriate mechanism to apply in the South African context. Owing to the possible impacts on the South African resident, the research gained insights into whether the assented legislation is fundamentally sound enough to achieve its goal.

By performing qualitative research and critical comparative analyses, the research gained an understanding of the service fees countries should be entitled to tax and the need for legislation to protect the tax base created from service fees. This article explores how the assented legislation compares to the conceptual frameworks developed by bodies involved in designing policy frameworks such as the Organisation for Economic Co-operation and Development (OECD) and the United Nations (UN). The results of the research are that the assented legislation is a combination of both the views of the UN and the OECD. The mechanism used is a withholding tax but its application is limited to service fees generated within the borders of South Africa. It was found that the assented legislation to achieve the goal intended by National Treasury is fundamentally flawed and that alternative mechanisms could be more appropriate.

Uittreksel

Diensfooie betaalbaar vir dienste wat buite die landsgrense gelewer word, word toenemend gebruik om 'n land se belastingbasis te ondermyn. Erosie van die belastingbasis kan plaasvind as gevolg van die aftrekking wat toegelaat word wanneer die belasbare inkomste bereken word in ooreenstemming met die Suid-Afrikaanse belastingwetgewing. Navorsing het getoon dat biljoene rande nie ingevorder word nie as gevolg van hierdie tipe erosie. Wetgewing was daarom goedgekeur om 'n terughoudingsbelasting op hierdie diensfooie te hef. Die Nasionale Tesourie van Suid-Afrika het in die Belastingwysingswetsontwerp van 2013 aangedui dat 'n terughoudingsbelasting op diensfooie gehef sal word in 'n poging deur die Suid-Afrikaanse regering om die belastingbasis te beskerm. Hierdie wetgewing is op 12 Desember 2013 bekragtig. Daar is egter voorgestel dat die effektiewe datum uitgestel moet word tot 1 Januarie 2017. Hierdie is 'n bewys dat daar onsekerhede bestaan oor die geskiktheid van die wetgewing en of dit die mees toepaslike meganisme is om in die Suid-Afrikaanse konteks toe te pas. Die navorsing het insig verkry oor of die goedgekeurde wetgewing fundamenteel toepaslik is om die doel te bereik weens die moontlike gevolg op inwoners van Suid-Afrika.

Deur kwalitatiewe navorsing en kritiese vergelykende ontledings uit te voer, het hierdie artikel insig behaal oor watter diensfooie lande behoort te belas en die noodsaaklikheid vir wetgewing om die belastingbasis van 'n land wat met diensfooie verband hou, te beskerm. Hierdie artikel ondersoek hoe die goedgekeurde wetgewing vergelyk met die konseptuele raamwerke ontwikkel deur instellings betrokke in die ontwerp van beleidsraamwerke. Hierdie instellings sluit in die Organisation for Economic Co-operation and Development (OECD) en die Verenigde Nasies. Die resultate van die navorsing wys dat die wetgewing 'n kombinasie is van beide die OECD en die Verenigde Nasies se sienings. Die meganisme wat gebruik word is 'n terughoudingsbelasting, maar dit word beperk tot dienste wat fisies binne die landsgrense van Suid-Afrika gelewer word. Daar is gevind dat die wetgewing fundamenteel ongeskik is vir Nasionale Tesourie om hul doel te bereik en dat alternatiewe meganismes meer toepaslik mag wees.

Keywords

Anti-avoidance legislation, base erosion, cross-border service fee payments, profit shifting, services fees, withholding tax.

Sleutelwoorden

Buitelandse diensfooi betalings, diensfooie, erosie van belastingbasis, teenvermydingswetgeving, terughoudingsbelasting, winsverskuiwing.

List of abbreviations

BEPS	Base erosions and profit shifting
MNE	Multinational Enterprises
OECD	Organisation for Economic Co-operation and Development
SARS	South African Revenue Service
SADC	South African Development Community
UN	United Nations

CHAPTER 1: INTRODUCTION

1.1 Background and Motivation of Topic Actuality

1.1.1. Phenomenon of base erosion and profit shifting

Taxation legislation is developed with the ultimate goal of collecting tax. Legislation could tax persons who are residents (as defined) in that country on their worldwide income (i.e. irrespective of the source) but it could also tax non-residents on the income originating in that country (De Koker & Williams, 2015). This is a combination of the source and the residence principle. The residence principle entails the levying of tax based on the residency of the taxpayer and disregards the source of the income. The source principle on the other hand is focused on the source of the income and where it was generated (Frenkel *et al.*, 1990:2; Hines, 1996:4; De Koker & Williams, 2015). For example, if the income is generated in South Africa, the South African legislation levies tax on this income. One of the functions of corporate tax has been described as collecting tax from the income earned domestically and in describing this function, it has been noted that it is flawed because the tax base is mobile and can be manipulated (Green, 1993:18). Manipulation of the tax base can occur through a number of methods, one of them being the payment of service fees. A concept commonly known as base erosion and profit shifting (BEPS) and the prevention thereof is something that tax authorities are struggling with.

“BEPS relates chiefly to instances where the interaction of different tax rules leads to some part of the profits of Multinational Enterprises (MNEs) not being taxed at all.

BEPS impacts on domestic resource mobilisation in developing countries. For some of the poorest countries, which rely very heavily on tax revenue from MNEs, BEPS has a particularly significant effect on vital tax revenues. The impact of BEPS on developing countries, however, extends beyond revenue. BEPS undermines the credibility of the tax system in the eyes of all taxpayers.” (OECD, 2014:3).

The tax obligation of companies can result in a large amount of cash flowing from the business and international structures are used to reduce the effective tax rate of the group of companies. An example of one such tax planning structure gaining increased

attention involves multinational companies shifting their profits to a location where it will be subject to lower tax rates. A method used to shift profit includes paying amounts classified as service fees to another company within the group of companies (OECD, 2014:15). This holding company in turn is incorporated into a jurisdiction with less stringent tax legislation, therefore allowing the group to reduce its effective tax rate.

International initiatives are being developed and deployed in an effort to reduce and deter such tax planning activities. One such initiative is the Organisation for Economic Co-operation and Development's (OECD) base erosion and profit shifting project, which looks at multinational companies shifting their profits to countries which differ from those in which the actual activity takes place (OECD, 2015c). Leaders at the 2013 Saint Petersburg Summit commended the progress made on the initiative and they encouraged countries to participate (G20, 2013:27). Accordingly, authorities such as the United Kingdom's HM Revenue & Customs has developed a policy to reduce tax evasion (HM Revenue & Customs, 2015).

In South Africa the Davis Tax Committee, which was appointed following an announcement by the Minister of Finance of South Africa, has set up a BEPS sub-committee to address the issue (Davis Tax Committee, 2014:1).

1.1.2. The use of withholding taxes

In order to administer the taxes and to mitigate the risk of this mobile tax base by ensuring that the taxes are collected from the amounts paid for services rendered (which has its origin in the country of which the payer is a resident) to non-residents, withholding taxes may be used (Gray & Mundial, 1989:33). In the context of South Africa, this ensures that when a person pays an amount relating to service fees to a non-resident, and this amount has its origin in the Republic, said resident will withhold and pay the relevant amount of tax to the South African Revenue Service (SARS) (National Treasury, 2013:101). However, before its introduction into the legislation through the Taxation Laws Amendment Bill of 2013, South Africa did not have effective legislation governing withholding taxes on service fees paid.

Countries, including, but not limited to the United States of America, United Kingdom, Spain, Angola and Algeria have already implemented legislation (including withholding

taxes) in an attempt to protect their own profit base and to ensure that the appropriate amount of tax is collected if in substance, the economic activities of a multinational company or resident are conducted in that country (Deloitte, 2015:6). The United States of America, Spain, Angola and Algeria have implemented a withholding tax on service fees being paid by a company operating in the respective countries to other companies in a different location. This ensures that the income is taxed in the country in which the operations are carried out and it deters the use of excessive amounts of service fees (deemed not to be commercially required) to shift profits. The excessive fees paid to shift profits are not deemed to be commercially required for the purposes of running the operations of the entity in the ordinary course of business as the intention with paying these fees are to shift the profits of the entity. These withholding rates vary from 30% (levied by the United States of America), to 24% (levied by Algeria), to 5.25% (levied by Angola) (PwC, 2014:3; IRS, 2015).

The reason for using withholding taxes as a mechanism imposed on the amounts paid to non-residents is the ease of collection of the tax if it is withheld and paid by a resident. Owing to the administrative processes which would need to be followed to recover the taxes imposed on non-residents, a withholding tax is deemed to be a simpler solution to the collection. Compliance with domestic tax legislation is also increased (Alm, 1999:760; Ger, 2015:48).

Neither the OECD nor the UN provides specific guidelines in their model tax convention on the treatment of service fees. As a result, the levying of tax on these fees is a contentious issue and warrants the development of provisions dealing with these types of fees.

1.1.3. UN's draft article on service fees

The UN's Committee of Experts on International Cooperation in Tax Matters considered a draft article and commentary relating to the taxation of technical services at its tenth session in October 2014. This article was considered for inclusion in the UN's Model Tax Convention. The article submits that the payments of technical services by a resident of one state may be taxed in both the recipient's state and in the state in which the payment is made. The draft article suggests that the tax charged by the source state should not exceed a certain percentage of the gross amount of

payments. This tax is therefore a withholding tax. The commentary on this article indicates that it is sufficient for the payment to be made by the resident of the source state for the tax to apply. It is therefore not necessary for the services to be actually rendered in the country of that resident. The reasoning behind this is that owing to technological advances, it is possible for enterprises to provide cross-border services, without being physically present in another country. This approach is different from the one applied by the OECD, as the latter requires that the services must be physically rendered in the country which will levy the tax on the service fees (United Nations, 2014).

1.1.4. South African legislation developed dealing with service fees

Before its introduction into the legislation through the Taxation Laws Amendment Bill of 2013, South Africa did not have effective legislation governing withholding taxes on service fees paid. The National Treasury of the South African Government released the Draft Taxation Laws Amendment Bill in 2013 indicating that withholding taxes would be levied on services fees paid as part of the South African Government's attempt to protect its profit base. The 2013 Taxation Laws Amendment Act (31 of 2013) was assented and it inserted Part IVC, Sections 51A to 51H (Withholding tax on service fees) in Income Tax Act (58 of 1962) (Taxation Laws Amendment Act, 2013:176). This assented withholding tax legislation is a combination of the views suggested by the UN draft article on technical fees as well as OECD's view on similar fees. The legislation provides for the withholding tax to be levied if the payment of the service fees is made by a resident of South Africa, provided that it has its source in South Africa. Therefore, South Africa is using the UN's suggestion of withholding taxes, but unlike the UN's draft article, the withholding taxes will only be levied if the source is within the Republic, that is, the services are physically rendered in South Africa; this is an OECD view (United Nations, 2014). It is still undetermined whether this legislation will become effective because of the possible cost increases, administrative burden to South African taxpayers as well as the fact that the original intention of the legislation was not the collection of tax (SAICA, 2015c:1).

1.1.5. Motivation of topic actuality

South Africa is the resident country for many multinational companies. Examples of these companies include Sasol Limited, MTN Group, Imperial Holdings Limited, Vodacom Group Limited and ArcelorMittal South Africa Limited, to name but a few (JSE, 2015). These companies are extensively involved in cross-border transactions, and some of these companies have a group head office situated abroad. It is therefore likely that certain fees (including fees for services rendered) are paid to these head office companies or other external service providers for certain services rendered.

South Africa did not have legislation to implement a withholding tax on the service fees. Because of the deductions allowed for these amounts paid when the taxable income is calculated in terms of South African taxation legislation, base erosion can occur. Research indicates that billions of rands are lost through this type of erosion (National Treasury, 2013:101). As a consequence, legislation to levy a withholding tax on service fees paid was assented.

The approved legislation is a combination of the principles stated in the UN's draft article on technical fees as well as OECD's view on like fees. Withholding tax will be levied on the payment of service fees made by a resident, but this service fee has to have its source within the Republic. This is a deviation from the UN's model which states that the tax will be levied irrespective of where the services are rendered. When the legislation becomes effective, the fees will become subject to withholding tax. At a workshop on the withholding tax on service fees, National Treasury indicated that one of its goals was to collect information on the non-resident taxpayers (Bell, 2015). This mechanism as a tool to collect information about non-residents has however been described as inappropriate (Bell, 2015). The topic is actual as there are alternative views on how to protect the tax base, collect information and how the legislation should be designed to govern service fees in order to combat base erosion and profit shifting. The withholding taxes are likely to cause increased costs to the consumer as a result of inflated fees (Bell, 2015). It has been proposed that the effective date of the legislation be postponed, likely owing to these unintended consequences.

The research gained an understanding of the service fees countries should be entitled to tax and the need for legislation to protect the tax base created from service fees.

This understanding of the need provided the starting point of the research. Global frameworks and regulations developed were analysed and compared with the South African Government's attempts to protect South Africa against base erosion and profit shifting by means of the payment of service fees. The use of withholding tax was analysed and the benefits and possible drawbacks of this mechanism was investigated. Owing to the possible impacts on the South African resident, the topic actual as the conclusion provided insights into whether the assented legislation is fundamentally sound enough to achieve its goal.

1.2 Problem Statement and Research Question

National Treasury approved legislation to withhold taxes on service fees paid to non-residents if those services were rendered in South Africa. The problem statement addressed by this paper is that this tax legislation appears to not be aligned with international developed guidelines.

The research question that this paper aims to answer is how the assented South African model to impose tax on service fees in the form of withholding taxes on the gross amount paid compare with the conceptual frameworks developed by international policy setters?

1.3 Objectives

1.3.1 Main Objective

The main objective of the research study was to critically analyse and evaluate the South African Government's assented legislation to levy withholding taxes on service fees which have their source in South Africa (as a method of protecting the tax base) against the UN's draft article on technical fees as well the OECD's views on similar fees.

1.3.2 Secondary Objectives

Secondary objectives of the research include the following:

- i. To determine what represents the tax base of South Africa in order to understand the need and reasoning for legislation to address base erosion and profit shifting from this tax base;

- ii. to investigate the risk of erosion of a tax base and to ascertain the use of service fees to achieve this goal; to explore the use of withholding tax as a mechanism to protect the tax base;
- iii. to investigate the development of the UN's draft article on technical fees as well as the OECD's views and initiatives on similar fees as a method of protecting the tax base related to service fees; and
- iv. to evaluate the assented South African withholding taxes on service fees paid from a source within the Republic against the conceptual frameworks (UN and OECD views) identified. To critically evaluate the reasoning behind charging withholding taxes on the service fees paid by residents, irrespective of where the services are rendered as opposed to only levying taxes where the services are physically rendered.

1.4 Research Design

1.4.1 Literature review

One of the assumptions of a literature review is that one learns, expands and builds up on what was done by others. The gaining of knowledge is a cumulative process. A literature review attempts to increase the credibility of the research. It will also result in a summary of the research which was already performed and it will stimulate new ideas for the research topic (Neuman, 2006:110).

The purpose of the literature review was to ascertain whether base erosion and profit shifting is achieved through the payment of service fees in the international taxation landscape and what taxation authorities have done to deter this phenomenon from occurring.

The National Treasury's attempt to collect an amount of tax payments made to foreign parties (specifically in the context of service fees) was determined order to provide a comparison between South Africa's legislation and international incentives/regulations. A literature review was conducted to assess whether withholding taxes have been successful to protect a country's profit base.

The assented legislation was evaluated against the UN's as well as the OECD's model.

Sources accessed during the review included (but were not limited to):

- South African legislation;
- International legislation/regulation;
- Organisation for Economic Co-operation and Development reports and action plans;
- International Monetary Fund Working Paper;
- Taxation summaries and comment of reputable professional firms including Deloitte, PwC, EY and KPMG;
- Published academic papers; and
- Taxation articles.

1.4.2 Critical analysis methodology

International policies, guidelines and initiatives have been developed and implemented in an attempt to deter base erosion and profit shifting. Foreign countries have introduced legislation specific to addressing the issue of tax not being collected in the country in which the economic activities are carried out (OECD, 2013:7; HM Revenue & Customs, 2015).

The UN and the OECD have developed model tax conventions which are used as a basis for countries when they develop and negotiate agreements addressing double tax on cross-border transactions between these countries (United Nations, 2013:1). These models are widely used as the UN and the OECD are generally accepted as the main tax policy developers of the world (Daurer & Krever, 2014:2). These international regulations and legislation was used as a framework with which the assented legislation of National Treasury to withhold tax on service fees paid was compared.

A wider understanding of the phenomenon (base erosion and profit shifting as well as the withholding tax paradigm) was obtained. Qualitative research was conducted in order to obtain deeper knowledge of the phenomenon and to attempt to identify gaps in the South African taxation legislation. This qualitative research enabled the investigation of the phenomenon without the use or analysis of numerical data (Oxford Dictionary, 2015).

1.4.3 *Paradigmatic assumptions and perspectives*

Paradigm choice is essentially an organising or disciplinary framework in which research is performed. Through research performed, it is accepted that there are two core philosophical paradigms. The choice of which paradigm to follow will be influenced by how the researcher views the world (ontology) and how the researcher perceives knowledge to be created (epistemology) (McKerchar, 2008:22).

- **Ontological assumptions**

A relativist view was followed while the research was conducted. The nature of the world is dependent on many alternatives and views. There is no absolute truth. Truth is an ambiguous term having many meanings and methods of justification (Rorty, 1990:238).

With the application of this relativist perspective to taxation and to the research, the approach followed was that legislation, initiatives and regulations must be tailored for a specific country and economic environment. No set of specific rules can be universally applied.

- **Epistemological assumptions**

In the context of the performed research, no ideal or perfect rule was suggested. The knowledge gained consists of multiple assumptions, specific limitations and should be seen as a deeper understanding of the phenomenon.

- **Methodological assumptions**

Qualitative research was conducted in an interpretivist paradigm.

Interpretivism poses to provide some clarity on social reality. It involves subjective interpretations made by the researcher. Qualitative research does not intend to prove or disprove a hypothesis, but rather to gain answers and a better understanding of the problem (McKerchar, 2008:22).

The methodological assumptions used include:

- i. Different frameworks (legislation) are comparable;
- ii. Authorities are fair and reasonable and taxes charged by different authorities are reasonable;
- iii. The payment of service fees is used to shift profits; and
- iv. Initiatives and action plans can be compared to formally implemented legislation.

1.5 Overview of Research Article Sections

Abstract

This section outlines the key elements included in the article to provide the reader with a high level summary. The abstract includes an indication of the originality and value of the research, the purpose of the research, the research design and method and a summary of the findings of the research.

1. Introduction

This section introduces the problem statement. It also includes an outline of the flow of arguments within the article to eventually conclude on the research question.

This section will outline the research question for the study performed. Additionally it gains insight on the problem statements and motivates the actuality of the study.

The methodology applied to the study and research methods used will be outlined in this section. The research paradigm in which the research was conducted is described in this section.

2. The tax base of a country and its application to service fees

This section conceptually introduces the tax base of a country by analysing the income a country should be entitled to tax. The tax base relating to service fees is also analysed and applied to the South African context.

3. Erosion of a country's tax base and the possible protection thereof

This section introduces the concept of base erosion and profit shifting. It identifies and describes the payments of service fees as a method to achieve erosion. The use of withholding taxes to mitigate this risk is analysed.

4. International developments relating to the taxing of service fees

This section introduces the UN's draft article on service fees and the development thereof. The principles applied in this article are compared with the view of the OECD on the treatment of service fees. This serve as a basis against which the South African legislation is compared.

5. Critical analysis of the South African National Treasury's assented Sections 51A to 51H to impose a withholding tax on service fees paid

This section includes a critical comparison of the assented legislation with the fundamental principles of the UN and the OECD. The consequences of using a withholding tax in a South African context are analysed.

6. Conclusion, limitations of this study and areas for further research

This section will include a summary of the findings of the research. A conclusion is reached in this section and the research question is answered in this section. Additionally, recommendations as a result of the conclusion reached on the research performed is made in this section.

Areas not covered by this study are indicated in this section. Additional research opportunities are also outlined in this section.

CHAPTER 2: RESEARCH ARTICLE

Remark

The reader is reminded that this chapter consists of the research article prepared in accordance with the writing style requirements of the Harvard style and in the format required by the South African Journal of Economic and Management Sciences.

Abstract

Around the globe, including in South Africa, there has been an increasing occurrence of cross-border service fees being used by multinational enterprises to shift profits. South Africa did not have legislation to implement a withholding tax on the service fees. Because of the deductions allowed for these amounts paid when the taxable income is calculated in terms of South African taxation legislation, base erosion can occur. Research indicates that billions of rands are lost through this type of erosion. As a consequence, legislation to levy a withholding tax on service fees paid was assented. In terms of the Taxation Laws Amendment Bill released by the South African National Treasury in 2013, withholding taxes will be levied on service fees paid as part of the South African Government's attempt to protect its profit base. This legislation was assented on 12 December 2013. The effective date is however proposed to be postponed to 1 January 2017. This indicates that there are uncertainties as to the effectiveness of the legislation and whether it is the most appropriate mechanism to apply in the South African context. Owing to the possible impacts on the South African resident, the research gained insights into whether the assented legislation is fundamentally sound enough to achieve its goal.

By performing qualitative research and critical comparative analyses, the research gained an understanding of the service fees countries should be entitled to tax and the need for legislation to protect the tax base created from service fees. This article explores how the assented legislation compares to the conceptual frameworks developed by bodies involved in designing policy frameworks such as the Organisation for Economic Co-operation and Development (OECD) and the United Nations (UN). The results of the research are that the assented legislation is a combination of both the views of the UN and the OECD. The mechanism used is a withholding tax but its application is limited to service fees generated within the borders of South Africa. It was found that the assented legislation to achieve the goal intended by National

Treasury is fundamentally flawed and that alternative mechanisms could be more appropriate.

Keywords

Anti-avoidance legislation, base erosion, cross-border service fee payments, profit shifting, services fees, withholding tax.

1

Introduction

The Davis Tax Committee of South Africa conducted an investigation into tax base erosion and the methods used to achieve this. It concluded that for the years 2008 to 2011 close to 50% of the payments made to non-residents related to legal, accounting and management consulting fees (SAICA, 2015a). As these fees could possibly be deducted for South African income tax purposes, legislation was required to ensure that tax was collected on these fees paid. The legislation assented by National Treasury has however been criticised as inappropriate to meet its objective (Bell, 2015).

Before its introduction into the legislation through the Taxation Laws Amendment Bill of 2013, South Africa did not have effective legislation governing withholding taxes on service fees paid. The 2013 Taxation Laws Amendment Act (31 of 2013) was assented to by the President of South Africa on 12 December 2013 and Part IVC, sections 51A to 51H (Withholding tax on service fees) was inserted into Income Tax Act (58 of 1962), hereafter referred to as the Act (Taxation Laws Amendment Act, 2013:176). The aim of the National Treasury was to implement a mechanism which would provide some protection to the South African tax base and provide information on non-resident taxpayers. The effective date is however proposed to be postponed to 1 January 2017. This indicates that there are uncertainties as to the effectiveness of the legislation and whether it is the most appropriate mechanism to apply in the South African context.

At a workshop on the withholding tax on service fees, National Treasury indicated that one of its goals was to collect information on the non-resident taxpayers. This mechanism as a tool to collect information about non-residents has however been described as inappropriate (Bell, 2015). There are alternative views on how to protect the tax base, collect information and how the legislation should be designed to govern service fees in order to combat base erosion and profit shifting.

Owing to the possible impacts on the South African resident, the topic actual as the conclusion provided insights into whether the assented legislation is fundamentally sound enough to achieve its goal.

The research question that this study aims to answer is how the assented South African model to impose tax on service fees in the form of withholding taxes on the gross amount paid compare with the conceptual frameworks developed by international policy setters?

The article is structured as follows: Firstly, section 2 describes the tax base of a country by identifying the tax authorities that should be entitled to tax. The article explores the risks for erosion of the tax base and analyses withholding tax as a method/instrument to combat this base erosion in section 3. It goes on in section 4 to identify and explain the views of the UN and the OECD on the taxing rights related to service fees. In section 5, the South African legislation is then critically compared to these views in order to answer the research question.

A wider understanding of the phenomenon, base erosion and profit shifting, as well as the withholding tax paradigm was obtained. Qualitative research in an interpretivist paradigm was conducted in order to obtain deeper knowledge of the phenomenon and to attempt to identify gaps in the South African taxation legislation. Qualitative research and critical comparative analyses was conducted to gain an understanding of the service fees countries should be entitled to tax and the need for legislation to protect the tax base created from service fees. A relativist view was followed while the research was conducted.

2

The tax base of a country and its application to service fees

2.1 Conceptual principles relating to a country's tax base

Tax revenues are a vital source of income for various governments around the world and it is important that the tax legislation allow tax authorities to levy and collect taxes which they are entitled to (Tanzi & Zee, 2001:1). The two common bases for taxing income are:

1. the residence principle; and
2. the source principle.

The majority of tax authorities have implemented legislation following a combined approach which imposes tax on its residents' worldwide income, while non-residents are only taxed on income which has its source in that country (Daurer & Krever, 2014:1). The residence principle entails the levying of tax based on the residency of the taxpayer and disregards the source of the income. The source principle on the other hand is focused on the source of the income and where it was generated (Frenkel *et al.*, 1990:2; Hines, 1996:4; De Koker & Williams, 2015). The source principle is applied as it assists in the objective of collecting tax from the income earned domestically (Green, 1993:18; Commendatore & Kubin, 2014:4). The source principle compares to the benefit theory which states that the taxing right depends on the benefits and services provided to taxpayers by the government (Pinto, 2003:18). The government whose infrastructure, labour and public services were utilised in the production of income should be compensated (McLure, 2000:11; Pinto, 2003:18).

Another argument in support of source-based taxation is the entitlement view of taxation. The source country is the place where the income is actually or physically generated, rather than the country of residence of the person generating and collecting this income (Pinto, 2003:18). Technical experts, who were appointed by the Financial Committee of the League of Nations to study double taxation as well as tax evasion, found that there are two distinct categories of income: (i) personal taxes and (ii) impersonal taxes (Simontacchi, 2007:23). Personal taxes are regarded as taxes on the person as a result of their residence, irrespective of the source (Simontacchi, 2007:23). The impersonal taxes can be regarded as taxes on source rather than on the person. The idea of the income's origin or source was therefore recognised by these experts (Pötgens, 2006:21).

The motivation behind applying the residence principle is that it is not affected by the location in which the income is generated. It is therefore more efficient to apply as there is no requirement to determine the source of the income (Commendatore & Kubin, 2014:4). A possible result of applying the residence principle is double taxation because of both the resident and source country taxing the same amount of income. Double tax agreements were therefore required to allocate taxing rights to the respective countries.

2.2 International providers of policy frameworks

The UN and the OECD have developed model tax conventions which are used as a basis for countries when they develop and negotiate agreements addressing double tax on cross-border transactions between these countries (United Nations, 2013:1). These models are widely used as the UN and the OECD are generally accepted as the main tax policy developers of the world (Daurer & Krever, 2014:2). They form an integral part of current tax policies implemented by various tax authorities as these international norms impact the choice of policy implemented and align domestic policy to ensure that conflicts between domestic and international rules are reduced (Cortell & Davis, 1996:451; Sasseville, 2006:38).

Tax treaties do not ordinarily contain explicit rules governing the source of the income. Instead, the treaties grant taxing rights to countries depending on the nature of the income (United Nations, 2013:110). As the OECD model was created for developed countries, a model was required to protect the rights of developing countries (Kosters, 2004:4). The UN Model Convention was developed and gives preference to the source country when allocating the right to tax, thereby emphasising the economic nexus required (Lennard, 2009:4). The granting of taxing rights on income is an important factor which countries, especially developing countries, consider when they negotiate treaties. Owing to the differences in the allocation of taxing rights between source and resident countries followed by the UN and the OECD in their respective model tax conventions, a common issue when tax treaties are negotiated is whether and to what degree the source country should be provided the taxing rights on income. More often than not, a compromise is reached, whereby the source country can tax the income, and the residence country provides some relief in the form of tax credits (Lennard, 2009:4). It should however be noted that developed countries which generally apply the OECD model will not be able to ignore the effect of the UN model and will have to adapt the treaties entered into with developing countries (Kosters, 2004:4).

The guidelines provided by the UN and the OECD therefore have a substantial impact on the development of domestic legislation. The UN model is generally used by developing countries to ensure the collection of tax on income sourced in their countries as these taxes form a vital part of their government's revenue.

2.3 The South African tax base created by domestic legislation

The South African Government has implemented a taxation system combining both the residence principle and the source principle described above. This is evident from the effective legislation which states that a resident of the South African Republic will be taxed on income, irrespective of the source of this income. In contrast to this, non-residents will only be taxed on income which has its source in the Republic in accordance with the Act.

The source rules as applied by South African tax authority are currently based on a combination of legislated source rules in some instances and principles which have been adopted from case law in the absence of such rules (Robertson, 2012). A key principle in relation to source that has been established is that:

“the source of receipts, received as income, is not the quarter whence they come, but the originating cause of their being received as income and that this originating cause is the work which the taxpayer does to earn them.” (Commissioner for Inland Revenue v Lever Brothers & Unilever Ltd [1946] 14 SATC 1).

It was held further held that:

“A country that produces wealth by reason of its natural resources or the activities of its inhabitants is entitled to a share of that wealth, wherever the recipient of it may live.” (Kerguelen Sealing and Whaling Co Ltd v Commissioner for Inland Revenue [1939] 10 SATC 363).

An objective of the South African tax legislation applicable to non-residents can therefore be described as the collection of tax on the income which is generated within the Republic where the infrastructure and resources are used (Pinto, 2003:18). The location in which the key activities take place to generate the income is regarded as the origin of the income (Bosch, 2014:14). These assets and resources represent the real tax base of South Africa and should contribute to the total tax revenue of the government. The cost of providing these resources should be compensated in the form of taxes levied by the South African Government (Pinto, 2003:18).

2.4 The allocation of taxing rights and the tax base created for service fees

2.4.1 International guidelines for the allocation of taxing rights on service fees paid

There is limited guidance regarding the imposition of tax on service fees paid, which could expose the tax base of a country to possible erosion. Therefore, it was necessary for countries to negotiate taxing rights on the service fees paid. This has however been a contentious issue owing to the limited guidance. Generally, the resident country of the service provider is able to tax the income generated from services, unless the said resident receives this income from an enterprise carried on through a permanent establishment in the source country in which case the source country also has a taxing right (Arnold, 2014).

Currently, the UN Model Tax Convention provides that the rendering of certain services in a country for a period or periods aggregating more than 183 days in any 12-month period will result in that non-resident having a permanent establishment in that country (United Nations, 2011:493). The OECD does not contain a similar provision relating to services. The tax treatment of service fees under the OECD model is similar to the treatment of any business profits. The view is that the service fees should be treated in the same way as any other business activity. The OECD emphasises that economic presence in the source country is required before this source country can be allocated a taxing right on the income (Lennard, 2009:4). The OECD regards an economic presence as having a permanent establishment in a country. This is a fixed place of business, through which the business of an entity is wholly or partly carried on and it includes any premises or facilities used by the entity. The entity can also be deemed to have an economic presence simply by a certain amount of space at its disposal (OECD, 2010). The OECD has developed a nexus based on a significant economic presence test. Under this test, a business may be considered to have a taxable presence in a country based on substantial economic presence if that business generates substantial revenues from customers of that country and said business is either targeting that country's customers through digital means or considerable interaction with them (OECD, 2015a).

Therefore, under the UN's model, which favours the source country, a permanent establishment is recognised sooner and without the requirement to consider the facts of the specific business.

The requirement of a physical presence or a fixed place of business has however been described as inappropriate for income from services in the modern business model because services can be rendered without the need for a fixed place of business or permanent establishment (Arnold, 2010:18). Guidelines were therefore required to provide protection for the source country against the loss of tax income on these service fees.

Articles 7 and 14 in the 2011 update of the United Nations Model Tax Convention are being used at present by developing countries to determine and allocate the taxing rights on the income from service fees (Arnold, 2010:18). Article 7 deals with the taxation of business profits. This article states the following:

“The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein.” (United Nations, 2011:493)

Article 14 on the other hand governs independent professional services. It states that income derived by a resident of one of the contracting states in respect of professional services or other activities of an independent character shall be taxable only in that contracting state. There are however exceptions that will result in the latter not applying. This happens when the resident has a fixed base in the other country or when the resident stays in the other country for a period exceeding 183 days in aggregate during a 12-month period (United Nations, 2011:493).

The above articles are however not specific to professional services and it is unclear whether it applies to companies as well. The requirement for a fixed base is also not described which could lead to incorrect applications (Committee of Experts on International Cooperation in Tax Matters, 2009:3).

The lack of specific guidance on service fees, in particular technical and consulting fees, can cause uncertainty among both taxpayers and tax authorities (Arnold, 2014). On the one hand, the UN model does not have specific guidance other than a deemed

permanent establishment created if services continue in a country for a period aggregating more than 183 days in any 12-month period (United Nations, 2011:493). On the other hand, the OECD requires that the services be physically rendered in a country. This uncertainty could result in amounts being taxed twice or not being taxed at all. Consequently, the UN is in the process of developing an article that will provide specific guidance on how to tax service fees. The South African Development Community (SADC), which was established to achieve economic development in southern African countries, also issued a model tax convention including an article dealing with technical fees (SADC, 2015). It indicates that both the resident country and the source country may tax the technical fees, but the source country should tax the income on a gross basis up to a maximum percentage. This model deems the technical fees to arise in the country where the payer is a resident or where the permanent establishment bearing the payment is situated. It therefore disregards where the services are actually rendered (SADC, 2013).

2.4.2 The South African tax base relating to service income

In South Africa, case law is currently consulted to determine the source of income in the form of service fees. According to South African legislation and case law relating to services, non-residents will be taxed on the fees if the fees have their source in South Africa. This approach is more aligned with the OECD model as some physical presence is required.

According to the Shein case:

“It now seems settled law that generally the source of such income is the place where the services for which the salary is paid are rendered.” (Commissioner of Taxes v Shein [1958] 2 All SA 438)

However, in some instances, the principles established by case law are limited and therefore reliance is placed on treaties. The lack of legislation creates opportunities for the exploitation of the South African tax base relating to service fees. This is possible, as in terms of the section 11(a) of the Act, a deduction for the purposes of calculating normal income tax can be obtained from income if the foreign sourced service fees are paid by a resident to a non-resident in the production of income.

Erosion of a country's tax base and the possible protection thereof

3.1 Risk of erosion of a country's tax base

In applying the source principle, it was noted that this approach is flawed where the tax base is mobile and can be manipulated (Green, 1993:18). The result of globalisation is a virtual global economy that enables certain services to be rendered from a remote location. The tax base relating to service fees has therefore become movable and created opportunities for reducing tax liabilities (Ibrahim, 2005:8; OECD, 2013:7).

The OECD describes a concept known as base erosion and profit shifting (BEPS) as occurrences in which the interaction of different tax rules leads to some part of the profits of organisations not being taxed.

“BEPS exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity, resulting in little or no overall corporate tax being paid.” (OECD, 2015b)

BEPS bring into question the reliability, effectiveness and credibility of the legislation and tax collection process of the country (OECD, 2014:3). Tailored legislation is required to ensure that tax is collected on income earned using the domestic resources (McLure, 2000:11; Pinto, 2003:18). This is especially required for cross-border trade transactions and agreements.

Globalisation has enabled companies to expand their operations to various parts of the world. This expansion can be driven by operational reasons such as labour, capital, natural resources or infrastructure (OECD, 2013:7). The positioning of group companies could however also be based on tax planning initiatives to reduce the overall amount of tax payable by a person or multi-national organisation (Gupta & Mills, 2002:118). As globalisation has resulted in trading activities taking place across the world, transactions will occur in multiple tax jurisdictions, each with its own implication (Mintz, 1999:389). These mismatches in taxing regulations create opportunities for the reduction of the tax liability through sophisticated tax planning, for example, where the principle of matching the deduction of an amount from taxable income in one jurisdiction with the taxing of said amount in another jurisdiction does not occur (OECD, 2013:9; OECD, 2015c). This risk is exacerbated by certain double

tax agreements, which could prevent certain source countries from taxing such payments (United Nations, 2014).

A concept of integrated markets, economies and trading activities has resulted in a virtual global economy which is not bound by location (Ibrahim, 2005:8). This, together with the development of global trade, has enabled multinational organisations to change operating models to global models with integrated management functions and supply chains. This eliminates certain duplicated functions at a divisional or local level in order for these services to be rendered from a globalised level (OECD, 2013:7). This is especially relevant for the rendering of services, which is now possible without the resident of one country who is rendering the services having to be present in the other country. Although this change in structure does have commercial validity as it results in streamlined operations and reduced costs, the global structure creates the opportunity to artificially shift profits to companies located in countries with a less stringent tax jurisdiction. This is done by paying a fee, referred to either as a service, management or technical fee, to the company rendering the services.

As a result of this, source countries are exposed to the risk that tax on the payments for services is not collected. The tax base is generally created under the benefit theory which imposes taxes on the income earned using the domestic country's resources. However, this theory does not cater for the fact that income can be earned in a country without using that country's resources. This mismatch in turn creates opportunities for exploitation whereby funds can be moved from one jurisdiction to another jurisdiction with less stringent tax laws (OECD, 2015b). For the purposes of calculating normal income tax, the service fee payments are usually deductible from the payer's income if the payer is a resident of the country or a non-resident with a permanent establishment or fixed base in the country (United Nations, 2014). Owing to the deduction in one country not being matched with the taxing of the same amount in the other country, the overall tax liability is reduced.

A further risk is that the payment of these fees might be excessive and not based on the actual value of the service received. Legislation, such as section 31 of the Act, relating to transfer pricing adds protection against excessive payments as it requires adjustment of the payments to amounts approximating arm's length (Neighbour, 2008; South Africa, 1962). The use of a fixed percentage of tax on a gross amount could

also discourage excessive fees as more tax is levied if the fee is increased. However, service fees at an arm's length price could still be used to achieve base erosion.

In some instances, the payments for services are not made with the intention to shift profits but rather in the ordinary course of business. However, owing to limited legislation and guidance on service fees, the payment of these amounts might be made without the tax authorities being notified and the taxes on these fees will not be collected. This relates to an administrative risk of the non-reporting of the payment of service fees and the subsequent non-collection of taxes (FIRS, 1995).

In South Africa, the payment of service fees as a method to shift profits has been acknowledged by the Davis Tax Committee of South Africa. It was noted that management and technical fees pose a great threat to the South African tax base because a deduction is allowed in terms of the South African legislation. (Engel, 2015). An additional burden is placed on the SARS to locate the non-resident in order to levy the appropriate tax on the income sourced from South Africa. As such, outbound service fees pose a risk to South Africa as they could erode the South African base from which essential tax revenues could be collected. A mechanism to assist in the protection of the South African tax base was therefore required.

3.2 Withholding tax as an instrument used to enforce source taxing rights and protection of the tax base

One of the methods used by tax authorities to collect tax at the source is the implementation of withholding taxes; this provides an effective way of implementing the principle of source-based taxation (Huizinga & Nielsen, 2002:40). Withholding taxes are used by a number of tax authorities and have a number of benefits including addressing the issue of tax evasion/base erosion. The implementation of withholding taxes provides fairness in the allocation of the taxing rights while ensuring administrative simplicity. It also promotes compliance with domestic legislation (Zee, 1998:587; United Nations, 2013:177).

The function of tax administration has been described as having three legs: namely, identification, assessment, and collection. When withholding taxes are used the tax administration function becomes more effective as the risk of non-compliance with local legislation is mitigated (Alm, 1999:760; Bird & De Jantscher, 1992:37). The UN

have indicated that one of the primary reasons for the use of withholding taxes is to ensure that non-residents comply with the domestic tax rules of the countries. Compliance with the domestic legislation is improved because of easier application by tax authorities of the following factors:

1. Identification of the taxpayer;
2. gathering and reporting of information; and
3. the collection of tax levied (United Nations, 2013:174-177).

The information required depends on the person paying the tax to the tax authority. When the payments are made by a resident to a non-resident, the information about the non-resident is less relevant owing to the tax being withheld by the resident taxpayer. Under the normal tax regime, information is gathered by requiring non-residents to file tax returns. However, this could be burdensome for the local tax authorities. By using withholding taxes, the required information about the non-resident, and the nature and amount of the payment are provided by the resident taxpayer.

Because of the administrative processes that would need to be followed to recover the taxes imposed on non-residents, a withholding tax is deemed to be a simpler solution for the collection (Ger, 2015:48; United Nations, 2013:176). The risk that no tax will be collected owing to the non-resident having no tangible assets following the outflow of funds arising from the fees in the source country is reduced (Daurer & Krever, 2014:9). It mitigates this risk by providing a convenient manner in which the taxes are collected from the amounts paid to non-residents (Gray & Mundial, 1989:33). It is easier to collect the taxes first and then to identify the taxpayers than it is to identify the taxpayer and then collect the taxes. Withholding taxes are therefore used to enforce the established source rules and as such provide protection to the tax base of the country in which the income-generating activity takes place.

The use of withholding taxes does however have certain disadvantages. The imposition of withholding taxes on the service fees paid increases the costs of doing business in a country. The net amount received by the service provider is lower as a result of the tax withheld and in order to restore the service provider to the same financial position, the amount charged is often grossed up. This results in an increased cost for the resident consumer of the services (Bell, 2015). The local tax authorities

will essentially be collecting taxes from the residents and not the non-residents as intended. The person making the payment will, in addition, have to incur additional cost and time in order to meet his or her obligation in terms of the legislation (PwC Tax Services, 2013). This could result in profit margins being reduced to a point where they are no longer commercially viable.

The use of withholding taxes to collect information about the non-residents is also criticised as not being the most appropriate method to achieve such a goal. This is based on the above-mentioned disadvantages together with the fact that most countries have alternative information collection mechanisms at their disposal. It is possible for countries to utilise their foreign currency exchange control regulators to collect the required information. The resident who is making the payment to the non-resident could also be required to report the required information to the local tax authority (Bell, 2015).

The use of withholding taxes therefore has both satisfactory and undesirable consequences that depend on the intended goal. Neither the Model Tax Convention of the UN nor that of the OECD includes any information providing guidance on how to tax the payment of service fees and the mechanism to use. The risk of erosion in using these fees has resulted in countries requiring guidelines on how to collect taxes on these fees.

4

International developments relating to the taxing of service fees

4.1 The United Nations' draft article on service fees

Owing to the increased use of service fees together with the limited guidance on the taxing of service fees, a policy providing clear guidelines on the taxing of these fees was required. The UN has made extensive efforts to draft an article specifically dealing with service fees. Three main areas were considered in the development of this draft article. These areas were:

1. The determination of what would constitute and fall within the ambit of "technical services";
2. whether there is a need for physical presence in the source country; and

3. whether the payment of service fees by a resident or permanent establishment in a country was sufficient to justify the allocation of taxing rights to that country (Arnold, 2013:1,4).

At the tenth session of the Committee of Experts on International cooperation in Tax Matters in Geneva during October 2014, a Draft Article and Commentary on Technical Services was presented by the coordinator of the Subcommittee on Tax Treatment of Services. The article proposes the requirements to be included in the UN's model tax convention to deal specifically with the tax treatment of service fees. The article is applicable to fees of a managerial, technical or consultancy nature and the objective is to increase the source-country's taxing rights. The purpose of the article is to counter the possible erosion of the source country's tax base caused by the payment of service fees (Arnold, 2013:1,4).

The proposed article allows for the person who renders the services to be taxed in the country of his, her or its residence. It furthermore allows the tax authorities of the country from which the payment is made to tax the payments on a gross basis (limited to an agreed rate) if it originated from:

1. residents of the country; or
2. costs borne by permanent establishments or fixed bases of a non-resident in the country.

The provisions are not dependent on where the actual services are rendered and the rate at which these fees can be taxed should be negotiated by the tax authorities.

During the development of this draft article on service fees, three alternatives were proposed:

1. Alternative A: This alternative allows a tax to be imposed on all of the service fee payments made by either a resident of a country or a permanent establishment of a non-resident in the same country.
2. Alternative B: This alternative suggests that withholding taxes should only apply to the extent that the services are performed in the source country.
3. Alternative C: This alternative allows for the taxing of the income only if the services have been carried out in the country for a minimum period of time.

The income under this alternative is also taxed on a net basis (Arnold, 2013:1,4).

Various comments were received during the development of the provisions. It was indicated that the new article should mirror the principles applied to the taxing of royalties found in the current model tax convention and that both the resident and source country should be able to tax the income. The source country should tax the income at a maximum percentage on a gross basis. Caution was however given that if withholding taxes were used, it should be purely a collection mechanism as the net basis was preferable (Kaeser, 2014:3).

It was also indicated that there should be no requirement that the services should be rendered in the source country before said country could tax the amount. A tax levied on a gross amount was supported as it would be easier to apply and would reduce administrative costs. This commentary did not support the use of alternative C (Arnold, 2012:13). It was also indicated that the existing model already contained provisions for physical presence as a deemed permanent establishment could be created (Arnold, 2012:13). Alternative B was not suited for the purpose of the article because of the possibility created to render services in a country without being physically present in that country (Arnold, 2014). With the development of global trade and technology a virtual global economy had been created which enabled certain services to be rendered from a remote location without a fixed base or permanent establishment (Ibrahim, 2005:8; OECD, 2013:7).

Alternative A was selected by the UN as the most appropriate option and the draft article therefore disregarded where the actual income-generating activities took place and placed the emphasis on the source of the payment. It was argued that as the connection between base erosion and the payment for services under Articles 15 and 16 respectively was sufficient to warrant source taxation, a similar principle could be applied to the service fees (Arnold, 2014).

4.2 Differences between the UN article and the OECD's view on service fees

The OECD considers that as part of the core principles dictating the OECD's Model Tax Convention, the recipient of income should be taxed exclusively in the country of residence, unless there is a sufficient economic nexus with the other country (i.e. an economic presence as explained in section 2.4.1). Although in some instances,

countries impose taxes on services rendered outside their jurisdiction, the OECD argues that this should not be the case (OECD, 2012:115; Louw, 2015). It considers the true source of the income when allocating taxing rights between countries. Additionally, the OECD argues that the income should be taxed on a net basis, rather than a gross basis as the article proposes. This is based on the commentary provided on Article 5 of the OECD Model Tax Convention. Paragraph 42.19 of this commentary notes that for non-employment services, only the profits (therefore, after the appropriate deductions) should be taxed (OECD, 2012:115). The view is that costs are usually incurred on any income generated and should be taken into account when taxing a person. By levying taxes on a net basis rather on a gross basis, the inflation of fees to compensate the service providers for the increased tax as described in section 3, is avoided. Withholding taxes are therefore used only as a possible collection mechanism by the OECD.

The application of tax on a net basis, however, makes the collection of the tax imposed on the fees more difficult. The allocated taxing rights should not result in unnecessarily onerous burdens for the taxpayer to comply and it should also be possible for developing countries, with less established tax administration functions, to implement these allocated taxing rights (Arnold, 2010:18). The different views of the OECD are expected considering that the development of these provisions rarely includes significant participation by representatives of developing countries (Christians, 2010:19-40). The committee however concluded that as the UN's model used by various developing countries, which does not necessarily have the required administrative capacity and skills to collect the taxes on the income, a withholding tax was the best method to collect the taxes.

The OECD therefore argues that persons should be taxed on a net basis and only by countries in which they have a sufficient economic presence. The UN on the other hand supports taxation from any source and the use of withholding taxes in this regard owing to the ease of applying this mechanism.

Critical analysis of the South African National Treasury's assented sections 51A to 51H to impose a withholding tax on service fees paid

The Davis Tax Committee of South Africa was appointed following an announcement by the Minister of Finance of South Africa to set up a BEPS sub-committee to address the issue of erosion of the South African tax base (Davis Tax Committee, 2014:1). This committee investigated the impact of base erosion and profit shifting on South Africa and the methods used to achieve this. It concluded that for the calendar years 2008 to 2011 close to 50% of the payments made to non-residents (other than payments made for the supply of goods) related to legal, accounting and management consulting fees (SAICA, 2015a). As these service fees could possibly be deducted for South African tax purposes, a risk for the possible erosion of the tax base existed unless an alternative method such as withholding taxes ensured the imposition of taxes. Legislation dealing with the taxing of service fees was therefore required (National Treasury, 2013:101).

5.1 South African legislation governing the taxing of service fees paid

On 12 December 2013, the 2013 Taxation Laws Amendment Act (31 of 2013) was assented to by the President of South Africa and it inserted sections 51A to 51H (Withholding tax on service fees) in the Act (Taxation Laws Amendment Act, 2013:176). The effective date of the approved legislation was originally set as 1 January 2016. However, it has been proposed in the 2015 Draft Taxation Laws Amendment Bill that it should be postponed until 1 January 2017 (National Treasury, 2013:101; National Treasury, 2015; SAICA, 2015b). In terms of this assented legislation, a tax will be imposed at a rate of 15% on the amount of service fees paid by a person to a non-resident. This withholding tax will only apply to the extent that the amount (which accrues to the non-resident) is considered to be from a source within the Republic (Taxation Laws Amendment Act, 2013).

As the proposed tax is in the form of a withholding tax, any person making payment of any service fee for the benefit of a foreign person must withhold the tax so imposed. This withholding tax will be a final withholding tax (National Treasury, 2013:101). It will therefore not be taken into account in the calculation of normal income tax as it will not

be regarded as a prepayment of normal tax. In terms of section 51D(1) of the assented legislation, there are exemptions available such as when the non-resident is a natural person and physically present in South Africa for a period exceeding 183 days during a 12-month period. It also does not apply when the payment is effectively connected with a permanent establishment which is a registered taxpayer or when the service fee constitutes remuneration to an employee. The legislation makes it clear that the withholding taxes only apply to the extent that the service fee has its source in South Africa. There is no specific guidance currently provided on what the source of the service fees might be. As described in section 2.4, the source of the fees is where the services are rendered.

National Treasury indicated that the legislation was not developed with an intention to create another source of revenue. The purpose was rather to identify non-resident taxpayers and to gather information on these taxpayers (National Treasury, 2013:101). SARS is struggling with the gathering of information to identify permanent establishments of non-residents as they do not file their required tax returns. These non-residents are thereby completely avoiding South African tax (National Treasury, 2013:101; Bell, 2015). The legislation enables SARS to collect information about non-residents from the residents making the payment of service fees. By using withholding taxes as a mechanism to collect these taxes, compliance with domestic legislation and the enforcement of the source rules could be improved as explained in section 3.2.

The requirements and implications of this assented legislation will now be compared to the international frameworks provided by the UN and the OECD in order to highlight key similarities and differences between the legislation and said frameworks. This will be done in order to consider the effectiveness of the legislation conceptually.

5.2 Fundamental principles adopted in the approved legislation

The key differences in the views of the UN and the OECD on service fees as analysed in section 4.2 are the requirement of where the services should be rendered and the mechanism used to collect taxes. These different views will be compared to the adopted legislation.

5.2.1 The source of the service fees

The UN's draft article does not require that the services be physically rendered in a country from which the payment is made for the tax to be levied (Arnold, 2014). This view was followed after criticism of the requirement of physical presence owing to the risk of erosion that it poses. As indicated in section 3, it is possible in the modern economy to render services without having a presence in a country. The OECD model on the other hand states that the source country should only be allocated taxing rights if it has a physical presence in that country (OECD, 2012:115). The assented legislation (sections 51A to 51H), in line with the views of the OECD, requires the services to be rendered within the Republic. This is in accordance with the benefit theory as described (McLure, 2000:11; Pinto, 2003:18). The legislation therefore appears to follow an approach similar to that in Alternative B, which was rejected by the UN owing to the inherent risk of the mobile tax base. This method falls short in that it allows for no protection when the services are paid by a resident but rendered outside of the Republic. The tax base can still be eroded using this type of scheme despite the imposition of a withholding tax.

In addition to the fact that the risk of a mobile tax base not appropriately mitigated, another shortcoming of the legislation, is that it does not provide explicit guidance on what the source of the service fees should be. The tax base of South Africa relating to service fees will still be based on case law. The person making the payment of the service fees will have to establish the true source of the service fees. Without clear guidance, these determinations could be arbitrary. It is furthermore not clear how SARS will treat the services rendered partially in the Republic of South Africa and partially in a foreign country. The resident might also not be able to determine the services rendered in South Africa (Bell, 2015). This lack of guidance could derail the effectiveness of the legislation (SAICA, 2015a). If the services are rendered in the Republic, it could cause the non-resident to have a permanent establishment. If a non-resident has a permanent establishment in South Africa, the legislation will not apply which renders the withholding tax provisions ineffective.

5.2.2 The mechanism used to collect taxes

The UN's draft article proposed a mechanism similar to withholding taxes as the tax authority would apply a set rate to the gross amount paid. Sections 51A to 51H provide for the same method of taxing. This is different from the view of the OECD that income should be taxed on a net basis. The OECD possibly uses withholding taxes only as a prepayment mechanism and not as a final tax imposition as indicated in section 4.2. It was explained in section 3.2 that the tax administration function becomes more effective and the ease of the collection of taxes on the service fees is increased (Bird & De Jantscher, 1992:37).

Withholding taxes provides enforcement of the source principle, thereby ensuring some protection of South Africa's tax base. However, owing to the uncertainties involved in determining whether the services are rendered in the Republic as explained above, the withholding taxes are likely to be ineffective.

The cost of providing services in South Africa may increase as a result of the withholding taxes. The service provider will receive an amount net of tax. These providers might require that the total fee be grossed up in order to ensure that they are not disadvantaged by the withholding taxes. For example, if the service provider requires a net cash income of R100 and a withholding tax of 15% is imposed, the actual service charge will be R117,65. This effectively is a 17.6% increase in the service fees. These additional costs together with the cost and time in order to comply with the legislation, may negatively impact South African resident taxpayers (PwC Tax Services, 2013). The legislation also does not make distinction between service fees that are commercially necessary and service fees that are used in a scheme to shift profits. By applying this legislation to all service fees paid by residents the commercially justifiable and necessary services may also become more expensive. Fees are deemed to be commercially justifiable when it is incurred for the purposes of running the operations of the entity in the ordinary course of business.

The imposition of withholding taxes may result in a reduction of foreign investments in South Africa, especially from developed countries. The OECD model tax convention does not include a provision for the withholding of taxes on the service fees and it generally follows the taxing of amounts on a net basis as explained in section 4.2. South Africa has been described as a preferred gateway for investors looking to

expand their operations into Africa (Games, 2012:1). These multinational operations usually require managerial services and the imposition of an additional tax on the payment for these services may further reduce foreign direct investments. With the legislation, South Africa could be perceived as moving against the international norms. This in turn may lead to less investment in and the reduced use of South Africa as a trading position (PwC Tax Services, 2013).

The use of the assented sections 51A to 51H as an information collection mechanism is deemed to be inappropriate. SARS could utilise the South African Reserve Bank's authorised dealers to report the information when a payment of service fees to a non-resident is made. Alternatively, legislation could be implemented which requires the resident who is making the payment to report the required information to SARS. This would be similar to a reportable arrangement imposed on taxpayers in terms of the Tax Administration Act (28 of 2011) (Bell, 2015; SAICA, 2015a). Non-resident companies, trusts or other juristic persons are already required to submit an income tax return to SARS if they receive service fees from a source in South Africa. This obligation was implemented through Notice 506 on 25 June 2014 (South Africa, 2014:3).

6

Conclusion, Limitations of this study and areas for further research

6.1 Conclusion

The legislation is a modified version of the UN's draft article on service fees as it follows a view similar to that of the OECD, meaning that only services physically rendered within South Africa will be taxed. The legislation adds only a specified rate of tax and does not provide guidance on what the source of the services is. Case law therefore still has to be consulted. It is submitted that the legislation essentially adopted a model which contains elements rejected by both the UN and the OECD. It is in contrast with the OECD that favours a model of taxation based on the net basis while the legislation provides for taxation on a gross basis at a specified rate. In addition, it does not follow the draft UN model which rejected the requirement that the fees should have a sufficient nexus to a source country in order to be taxed as the legislation specifies that the source should be within the Republic, a concept still determined on an OECD-like basis.

In assessing the effectiveness and appropriateness of the assented withholding taxes on service fees as a method to combat base erosion from a South African perspective it is argued that the legislation is fundamentally flawed as it contains provisions such as the exemption on permanent establishments which will result in no taxes being received at all. Where the taxes are levied, this will result in increased costs. The ambiguity caused by the unclear source rule could also render it impractical to implement. The use of withholding taxes is inappropriate if the main intention of National Treasury was to obtain information about the non-residents performing activities in South Africa as it could result in increased costs and administrative burden on South African resident taxpayers. Additionally, without guidance on what the source of services is, the legislation could be rendered ineffective. These adverse implications are likely the cause of the uncertainty as to whether this legislation will become effective or not (SAICA, 2015c).

The legislation does not protect the South African base from profits shifted using services rendered outside the Republic and is therefore not effective to provide complete protection of the South African tax base. Before this legislation is implemented, National Treasury will have to assess the real intention behind the legislation and whether it should be revised in order to avoid adverse impacts.

The payment of service fees is likely to stay in the modern economy. The use thereof to achieve a reduction of a person's overall tax liability is generally recognised. Based on the analysis performed, the use of withholding taxes in this regard will only partially mitigate the risk of erosion of the South African tax base and additional groundwork will have to be performed.

It is therefore recommended that the National Treasury explore other methods to provide protection for its tax base. Recommendations in this regard are:

1. Change the current assented legislation so that the tax withheld from the fees paid is a prepayment of taxes rather than a final tax. As a result, non-residents will be able to utilise the taxes so withheld as a reduction of the assessed tax liability due to a portion already been paid to SARS. This could incentivise and provide an opportunity for non-residents to submit a tax return to SARS. This will further assist in the information collection which National Treasury wants to achieve.

2. For the legislation to be more effective for the purposes of addressing the risk of base erosion and profit shifting, the model should be more aligned with that of the UN. Taxes should be withheld on all service fees paid by residents and not only on the services fees with its source in South Africa. This will mitigate the risk of payments made by residents for services rendered outside of the Republic.
3. If the intention of National Treasury is to collect information on the non-residents, The South African Reserve bank can be utilised. Before the payment is released, information about the payment and its recipient could be submitted to SARS. The resident who is making the payment to the non-resident could also be required to report the required information to the local tax authority.
4. Legislation similar to the diverted profits tax implemented in the United Kingdom could be implemented. This will impose tax where a foreign company has artificially avoided having a taxable presence (permanent establishment) in South Africa or where a group has a South African company and there is a tax advantage as a result of transactions that lack economic substance.

6.2 Limitations of this study

The research is subject to the following limitations:

1. The research does not conclude on the appropriateness of either the UN's or the OECD's view on the taxing of service fees.
2. The research does not conclude on the use of either the UN's or OECD's model in a developing country's economy.
3. The research does not explore whether authorities are fair and reasonable in the allocation of taxing rights.

6.3 Further research opportunities

Further research opportunities include the comparison of the legislation to alternatives such as diverted profit taxes implemented in the United Kingdom. A model to tax the service fees, suitable for South Africa, could also be developed as part of additional research on the subject matter.

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CHAPTER 3: SUMMARY OF FINDINGS, OVERALL CONCLUSION AND RECOMMENDATIONS

3.1 Objectives of research article

The main objective of the research performed was to critically analyse and evaluate the South African Government's legislation to levy withholding taxes on service fees against the UN's draft article on technical fees as well the OECD's views on similar fees.

To achieve the above stated objective, it was required to determine:

- i. what represents the tax base of a country and how the South African tax base relating to service fees is established;
- ii. the risk of erosion of a tax base and the use of service fees to achieve this goal. The use of withholding tax as a mechanism to protect the tax base was also investigated; and
- iii. the principles applied in the UN's draft article on technical fees as well as the OECD's views and initiatives on similar fees as a method to protect the tax base related to service fees.

3.2 Findings of research

From the research conducted, the tax base is concluded to be represented by that income which the source country is entitled to tax. In accordance with the source principle, which is supported by the benefit theory, government whose infrastructure, labour and public services were utilised in the production of income should be compensated for the use of these resources. The income so generated represents the tax base of a country as it has its source in that country and it is this income which should be taxable. Furthermore, it was concluded that the tax base in South Africa related to service fees is created by services physically rendered in South Africa.

Due to globalisation, a virtual global economy was created which enables certain services to be rendered from a remote location. The tax base relating to service fees have therefore become movable and created opportunities to reduce tax liabilities. MNEs have changed their operating models to global models with integrated

management functions and supply chains. Commercial reasons for this restructuring includes cost saving, efficient administration, centralised control and planning, all of which are done in the ordinary course of business. These considerations are necessary for any business in order to maintain competitiveness. Although this restructuring could be motivated by commercial reasons, it could also be based on tax planning initiatives. A risk for erosion of the tax base was therefore identified, as the payment of fees, referred to either as a service, management or technical fees, are used to shift the tax base. Payments are made for services not physically rendered in that country, which is now possible as described above and in accordance with the benefit theory, the country should then not be able to tax the amount. Without any legislation in place to tax these payments, the country's tax base could be eroded.

Withholding taxes were identified as a method to collect the taxes on these amounts paid. The results of the research were that the withholding tax legislation enforces the source principle, it ensures administrative simplicity and increased compliance with domestic legislation. Additionally, it simplifies the collection of the taxes. It does however have drawbacks in that it could result in inflated fees to compensate for the additional taxes levied.

The UN developed a draft article dealing with the taxing of service fees. The article allows for a tax to be imposed at a fixed rate on the gross amount of service fees paid, irrespective of where the services were rendered. The fixed withholding was selected due to the benefits of using withholding taxes described above. As one of the objectives of the article is to protect the tax base of a company, all payments, and not just those for services physically rendered in a country will be subject to the tax. This approach taken differs from the view followed by the OECD. The latter requires a sufficient economic presence (as described in section 2.4.1) in a country before that country should be able to have taxing rights on the income. Furthermore, the OECD does not support the use of a withholding tax applied to a gross amount. It recommends that a person should be taxed on profits (i.e. after the deduction of costs incurred to generate the income).

It was noted that the assented South African legislation (Sections 51A to 51H) levies a withholding tax at 15% on service fees paid. The services should however be from a source within the Republic (based on case law, this will be the case if the services

are physically rendered in South Africa). It therefore adopted a model which contains elements rejected by both the UN and the OECD. It is in contrast with the OECD which favours a model of taxation based on the net basis as the legislation provides for taxation on a gross basis at a specified rate. As the legislation specifies that the source should be within the Republic, it does not follow the draft UN model which rejected the requirement that the fees should have a sufficient nexus to a source country in order to be taxed. In this regard, it follows a concept still determined on an OECD-like basis.

3.3 Overall conclusion

In assessing the effectiveness and appropriateness of the assented withholding taxes on service fees as a method to combat base erosion from a South African perspective it is argued that the legislation is fundamentally flawed as it contains provisions such as the exemption on permanent establishments which will result in no taxes being received at all. The ambiguity caused by the unclear source rule could also render it unpractical to implement. Furthermore, the use of withholding taxes is inappropriate if the main intention of National Treasury was to obtain information about the non-residents performing activities in South Africa as it could result in increased costs and administrative burden on South African resident taxpayers. These adverse implications are likely the cause of the uncertainty as to whether this legislation will become effective or not (SAICA, 2015c). The legislation does not protect the South African base from profits shifted using services rendered outside the Republic and is therefore not effective to provide complete protection of the South African tax base.

3.4 Recommendations

It is recommended that the National Treasury explore other methods to provide protection for its tax base. Recommendations in this regard are:

1. Change the current assented legislation so that the tax withheld from the fees paid is a prepayment of taxes rather than a final tax. As a result, non-residents will be able to utilise the taxes so withheld as a reduction of the assessed tax liability due to a portion already been paid to SARS. This could incentivise and provide an opportunity for non-residents to submit a tax return to SARS. This will further assist in the information collection which National Treasury wants to achieve.

2. For the legislation to be more effective for the purposes of addressing the risk of base erosion and profit shifting, the model should be more aligned with that of the UN. Taxes should be withheld on all service fees paid by residents and not only on the services fees with its source in South Africa. This will mitigate the risk of payments made by residents for services rendered outside of the Republic.
3. If the intention of National Treasury is to collect information on the non-residents, The South African Reserve bank can be utilised. Before the payment is released, information about the payment and its recipient could be submitted to SARS. The resident who is making the payment to the non-resident could also be required to report the required information to the local tax authority.
4. Legislation similar to the diverted profits tax implemented in the United Kingdom could be implemented. This will impose tax where a foreign company has artificially avoided having a taxable presence (permanent establishment) in South Africa or where a group has a South African company and there is a tax advantage as a result of transactions that lack economic substance.

3.5 Further research opportunities

Further research opportunities include the comparison of the legislation to alternatives such as diverted profit taxes implemented in the United Kingdom. A model to tax the service fees, suitable for South Africa, could also be developed as part of additional research on the subject matter.

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