The relationship between transfer pricing adjustments and withholding tax on interest in South Africa

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ABSTRACT

In response to base erosion and profit shifting activities, section 31 of the Act was enacted to prevent profit shifting and base erosion brought about by the manipulation of cross-border transfer pricing practices carried out by multinational enterprises. To further protect South Africa's tax base, a withholding tax was introduced from 1 March 2015 on interest payments made to non-residents.

The objective of this study is to determine whether the tax consequences of an interest payment that is subject to a transfer pricing adjustment and a withholding tax on interest, is equitable against the base erosion and profit shifting background. The doctrinal methodology is used to conduct the research by analysing and comparing the South African legislation on transfer pricing and withholding tax on interest to the recommended practice outlined in the OECD and UN guidelines. A cross-national comparison with Morocco and Kenya is performed, to reach a conclusion on the equitability of these two provisions that are used to curb base erosion and profit shifting activities.

Based on the analysis of South Africa's tax legislation and the recommended practice of the OECD and UN, it appears that by subjecting the non-arm's length interest to both interest and dividends withholding tax, the South African legislation in this regard seems to be less equitable due to the resulting double taxation. Similar to South Africa, the non-arm's length interest is subject to both dividends and interest withholding tax in Morocco, resulting in a possible double taxation. Due to the fact that in Kenya, the secondary transfer pricing adjustment in the form of a deemed dividend was only enacted in September 2018, literature was not available to determine whether the non-arm's length interest in Kenya is subject to both interest and dividends withholding tax.

It is recommended that South Africa should consider introducing advance pricing arrangements in its legislation and amend the Dividends Tax rate that is currently imposed on secondary transfer pricing adjustments.

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LIST OF ABBREVIATIONS

Act	Income Tax Act 58 of 1962
BEPS	Base Erosion and Profit Shifting
BEPS Action 4	Limiting base erosion involving interest deductions and other financial payments, Action 4
DTA	Double Taxation Agreement
DTC	Davis Tax Committee
EC	European Commission
EY	Ernst & Young
FDI	Foreign Direct Investment
IMF	International Monetary Fund
MAP	Mutual Agreement Procedure
MNEs	Multinational Enterprises
MTC	Model Tax Convention on Income and Capital
OECD	Organisation for Economic Co-operation and Development
PwC	PricewaterhouseCoopers
SARS	South African Revenue Services
TJN	Tax Justice Network
Transfer Pricing Guidelines	OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UN Practical Portfolio	United Nations Practical Portfolio on Protecting the Tax Base of Developing Countries against Base-eroding Payments: Interest and Other Financing Expenses

DEFINITIONS OF TAX TERMINOLOGY

Tax Terminology	Definition
Arm's length	A transaction between two persons as if they were acting independently and on an equal footing with each other, without any special relationship between them, mostly used in a transfer pricing context[1].
Base erosion and profit shifting (BEPS)	Base erosion and profit shifting (BEPS) refers to tax avoidance strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations[2].
Double Taxation Agreement (DTA)	An agreement which is an international treaty concluded between two States to determine the incidence of tax in, and the application of tax laws by each State with the object of avoiding double taxation[1].
Economic double taxation	A situation where income or capital is taxed in two or more States during the same period in respect of the same transaction, but usually in the hands of different taxpayers[1].
Juridical double taxation	A situation where income or capital is taxed in the hands of the same taxpayer more than once, whether by way of different taxes or, in an international context, by different taxing authorities[1].
Multinational enterprise (MNE)	Also referred to as a multinational group of companies. It is a group of companies with business establishments in more than one country[1].
Non-resident	A person who does not have sufficient connections with a country to be liable for tax there on worldwide income and who is taxable only on income from sources in that country[1].
Tax arbitrage	Exploiting differences between the tax treatment or tax rates of taxpayers or transactions in two or more countries[1].
Tax base	The thing or amount on which the tax rate is applied, for example, corporate income, personal income, real property[3].
Transfer pricing	The adjustment of intergroup prices of goods and services charged by affiliated companies in order to take advantage of the different tax rates found in different countries[1].

Tax Terminology	Definition
Transfer pricing adjustment	A mechanism found in tax legislation which allows the tax authorities to adjust the intergroup prices of goods and services charged by affiliated companies to be in line with the arm's length principle[1].
Withholding tax	A tax levied by the source country at a flat rate on the gross amount of dividends, royalties, interest or other payments made by residents to non-residents. The tax is collected and paid to the government by the resident taxpayer[1].

1. Olivier & Honiball, 2011:838-851.

2. OECD: 2015.

3. OECD: Glossary of Tax Terms

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KEYWORDS

- Base erosion
- Interest payment
- Primary adjustment
- Profit shifting
- Secondary adjustment
- Transfer pricing
- Transfer pricing adjustment
- Withholding tax on interest

Chapter 1

1 Background to research

1.1 Introduction

Many national fiscal authorities are seeking effective ways to protect their tax bases, in response to globalisation which has opened up opportunities for multinational enterprises (MNEs) to greatly minimise their tax expenses. Globalisation has created conditions for the development of global strategies aimed at maximising profits and minimising expenses and costs, including tax expenses (Organisation for Economic Co-operation and Development (OECD), 2013a:27). By taking advantage of international differences in corporate tax systems, MNEs are able to reduce their tax expenses, by shifting profits from higher to lower tax rate countries, without moving the underlying economic activity (OECD, 2015a). These profit shifting activities can be achieved by manipulating the prices charged on intra-group, cross-border transactions or by strategically concentrating debt with interest payments that are tax deductible in high tax countries (Bartelsman & Beetsma, 2003:2227; Johansson, Skeie, Sorbe & Menon, 2016:6-7), culminating in base erosion (United Nations (UN), 2015a:12). MNEs pose a threat to jurisdictions' tax revenues by taking advantage of the fact that tax systems treat companies as separate entities, allowing deduction of expenses in one jurisdiction and accordingly a receipt of payments in another jurisdiction (Lohse, Riedel & Spengel, 2012:5).

Globally, base erosion and profit shifting (BEPS) is a serious risk to tax revenues, tax sovereignty and tax fairness (OECD, 2013a:5). For developing countries, BEPS is of major significance due to their heavy reliance on corporate income tax, especially from MNEs (OECD, 2015a). Tax policies of developing countries with emerging markets have a very sensitive role to play, especially for countries that aim at becoming integrated with the international economy (Tanzi & Zee, 2000:299). In these countries the policy of the tax authorities should aim to:

- raise enough revenue to finance essential expenditure without depending on excessive public sector borrowing;
- raise revenue in ways that are equitable and minimise disincentive effects on economic activities; and
- raise revenue in ways that do not deviate substantially from international norms.

The Davis Tax Committee (DTC)[1] acknowledges the sensitive role that tax policies play in protecting South Africa's tax base and creating an environment that will encourage foreign direct investment (FDI). The risk of making South Africa an unattractive destination for FDI based on taxation is expressed in the DTC interim report as follows:

> As South Africa takes stock of its current legislation and considers how this should be adopted or what other legislation should be enacted in order to protect its tax base from BEPS, care should be taken to adhere to the OECD's warning against countries taking unilateral action as this may result in double taxation, which could risk making South Africa unattractive as a destination for foreign direct investment (DTC, 2014a:38).

In response to BEPS activities carried out by MNEs, countries have enacted various anti-avoidance measures in their tax policies to curb tax avoidance strategies (Oguttu, 2015:521). South Africa is no exception. According to Ismail Momoniat[2], South Africa does have measures in its domestic tax law in relation to

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1 The Davis Tax Committee (DTC) was established by the Minister of Finance in 2013, to inquire into the role of the South Africa's tax system in the promotion of inclusive economic growth, employment creation, development and fiscal sustainability, by taking into account recent and local developments. The DTC is also required to address concerns relating to BEPS as identified by the OECD and G20.

2 The Deputy Director General of Tax and Financial Sector Policy for The National Treasury.

BEPS (Steyn; 2014). Evidence of this can be traced to 1995. The 1995 Explanatory Memorandum on the Income Tax Bill states that section 31 of the *Income Tax Act* (58 of 1962), (the Act), will be used to address tax avoidance schemes involving the manipulation of prices for goods and services under cross-border transactions between connected persons' (South Africa, 1995). This section is a response to prevent profit shifting and base erosion, brought about by the manipulation of cross-border transfer pricing practices by MNEs (De Koker & Williams, 2016:17).

In addition to manipulating the prices of goods and services used for international trade, MNEs also utilise loans instead of equity to finance subsidiaries in high tax countries to shift profits (Johansson *et al*., 2016:6-7; Peralta, Wauthy & van Ypersele, 2006:24-37). The rationale for using debt is that it creates an opportunity to reduce corporate income tax expense as debt produces a tax deductible interest return, while equity produces an after tax dividend (Olivier & Honiball, 2011:649; UN, 2015a:11; Webber, 2010:684).

The current provisions of section 31 of the Act requires the terms and conditions of all cross-border transactions, operations, schemes and agreements between connected persons to be based on the arm's length principle (the Act). The anti-avoidance transfer pricing provisions in the Act thus includes interest payments (as these are agreements) and is not restricted to price manipulation of inter-company international trade in goods and services. In terms of section 31(2) of the Act, payments made by a South African tax resident to a connected non-resident are only tax deductible up to the arm's length price (the Act). This limitation of interest deduction to the arm's length price is a transfer pricing adjustment referred to as the primary adjustment (Van der Zwan, 2018a:823).

The primary adjustment seeks to ensure that there is a correct allocation of taxable profit between the resident and non-resident to reflect the arm's length price (OECD, 2012:15; Wiesener, 2011:17). This adjustment is made at the taxpayer's year-end when the corporate tax expense of the resident company is calculated and has a direct impact on the corporate tax expense. The primary adjustment does not take into account the cash benefit, that is the interest which is paid in excess of the arm's length interest that is retained by the non-resident (Wiesener, 2011:17). The amount paid in excess of the arm's length price, is deemed to be a dividend consisting of a distribution of an asset *in specie* (section 31(3) of the Act) and attracts Dividends Tax of 20% (South Africa, 2017a:10). This is referred to as the secondary adjustment (Van der Zwan, 2018a:823).

In addition to the transfer pricing provisions that affect the corporate tax expense of the South African resident, a withholding tax on interest was introduced from 1 March 2015 on interest payments made to non-residents (South Africa, 2015:128) to further protect the South African tax base. Prior to 1 March 2015, the domestic tax law allowed interest payments made to non-residents to be tax deductible by the resident taxpayer. There was however no corresponding tax derived from the non-resident earning the interest income. Section 10(1)(h) of the Act exempts interest income earned by a non-resident who is in South Africa for less than 183 days from income tax (the Act) thereby shrinking the South African tax base (South African Revenue Services (SARS), 2010:Section 5.1).

The section 10(1)(h) exemption was a deviation from the tax symmetry principle. Tax symmetry according to Bradford (1996:16) is the "equal and opposite" treatment of the party and counterparty to a financial instrument, which brings about "equivalent" tax consequences to both parties. "Equivalent" means whenever a transaction has as a consequence a deduction from taxable income for one of the parties, it also has as a consequence an equal and simultaneous inclusion in the taxable income of the counterparty (Bradford, 1996:16). Although a state may have the right to impose tax on a non-resident based on source rules, it is difficult for revenue authorities to collect tax from non-residents (Olivier & Honiball, 2011:356) as they do not have a physical presence in the source country. Imposing withholding tax on payments made to non-residents is an efficient method of collecting taxes (Olivier & Honiball, 2011:356).

The withholding tax on interest is levied when the interest is paid or becomes due and payable (section 50B(2) of the Act). This means that based on the loan agreement, withholding tax can be levied on a monthly, quarterly or bi-annual basis. When there is a transfer pricing adjustment, the withholding tax on interest would have been paid on the non-arm's length amount, as the interest is deemed to have been paid on the earlier of the date on which the interest is paid or becomes due and payable (section 50B(2) of the Act). There are thus two withholding taxes levied on the non-arm's length amount, namely the withholding tax on interest paid by the non-resident and Dividends Tax on the secondary adjustment paid by the resident company (Van der Zwan, 2016:34). According to Van der Zwan (2016:34) these multiple layers of tax on a single transaction are punitive and could impact the viability of setting up operations in South Africa.

1.2 Motivation of topic actuality

The importance of transfer pricing cannot be under-estimated internationally or locally, as four of the fifteen OECD's BEPS action plans are dedicated to transfer pricing (OECD, 2013a) and locally the DTC Interim Report states that transfer pricing is the key focus area for SARS (DTC, 2014b:16).

Business, tax advisers and revenue authorities see transfer pricing as one of their biggest risks (OECD, 2012). Business fears double taxation when adjustments to taxable profits have to be made following a transfer pricing enquiry, while revenue authorities are concerned that MNEs can choose how they allocate their global profits by the way they organise their affairs and as a result they can allocate profits to low tax jurisdictions without moving the underlying economic activity (OECD, 2012).

The findings of the 2016 PricewaterhouseCoopers (PwC) Africa Tax Survey further indicates that transfer pricing and withholding taxes are very topical. The survey revealed that transfer pricing, thin capitalisation and withholding taxes were ranked as the most challenging tax areas in Africa. For the majority of the respondents transfer pricing and thin capitalisation are problematic, while over 50% of the respondents indicated that withholding taxes are at the top of their list of challenges (PWC, 2016).

In South Africa, it is the amendments to the transfer pricing legislation, current developments and areas of uncertainty that poses challenges to MNEs currently invested in or considering investing in South Africa (Miller & Joubert, 2016:5). Detailed below are some of the recent amendments that relate to transfer pricing and cross-border loans and interest payments that make the topic current.

1.2.1 *Thin capitalisation*

The transfer pricing legislation prior to 1 April 2012 specifically had a subsection 31(3) to counteract thin capitalisation[3] schemes (Bruwer, 2012:627). This subsection was not based on the arm's length principle. It was only when the Commissioner was satisfied that the financial assistance advanced was excessive in relation to the fixed capital, that interest relating to the excessive portion of the financial assistance was disallowed as a deduction (SARS, 1996). In terms of SARS Practice Note 2, taxpayers were provided with a 3:1 safe harbour rule (SARS,1996). This meant that provided the debt to equity ratio was within a 3:1 ratio, SARS would not apply the thin capitalisation anti-avoidance provision. By extending the arm's length principle to financial assistance, taxpayers now will have to ensure that their capital structure is in line with an arm's length debt to equity ratio to avoid the adverse effects of a transfer pricing adjustment (Robertson, 2013:14).

1.2.2 *Transfer pricing secondary adjustment*

Effective from 1 January 2015, the secondary transfer pricing adjustment for a resident company is deemed to be a dividend consisting of a distribution of an asset *in specie* declared and paid by the resident company (South Africa, 2015:76). Prior to 1 January 2015, the secondary adjustment was considered to be a deemed loan (National Treasury, 2014:61), on which an arm's length interest was calculated and included in the taxable income of the resident taxpayer, until the deemed loan was considered to be repaid (SARS, 2011:117). According to the Explanatory Memorandum to the Taxation Laws Amendment Bill of 2011 the secondary adjustment will not be treated as a deemed loan, to the extent that the

[3] Thin capitalisation relates to the funding of a business with a disproportionate degree of debt as opposed to equity, providing the company paying the interest, a tax benefit relating to the tax deductibility of interest payments as opposed to the non deductibility of dividends paid on equity capital (De Koker & Williams, 2016:17.54)

adjustment is repaid to the resident tax payer, by the end of the year of assessment in which the primary adjustment is made (SARS, 2011:117). A similar concession is not documented when the law was changed to deem the secondary adjustment as a dividend *in specie* (National Treasury, 2014:61-63). The secondary adjustment will thus attract Dividends Tax (section 64E of the Act) thereby expanding the South African tax base. A further tax introduced to broaden South Africa's tax base is the withholding tax on interest (SA, 2015:128).

1.2.3 Introduction of a withholding tax on interest

Effective from 1 March 2015, a 15% withholding tax on interest is levied on all interest paid or is due and payable to a non-resident (South Africa, 2015:128). The withholding tax on interest was introduced to eliminate the tax asymmetry (deduction/exemption mismatch) that was present in the legislation, where sections 11(a) and 24J of the Act allowed for interest paid to be deductible, while section 10(1)(h) exempts interest received by or accrued to a non-resident from normal income tax (National Treasury, 2013a:Section 2.6).

1.2.4 Impact of amendments

The recent changes to the secondary transfer pricing adjustment (South Africa, 2015:76), the introduction of the withholding tax on interest (South Africa, 2015:128), and the move from the "safe harbour" thin capitalisation rules to the arm's length principle, (Miller & Joubert, 2016:5-7) will have the biggest impact on a "group of companies" where the non-resident MNE provides significant financial support to resident taxpayers (Ernst & Young (EY), 2016a).

When the organisational and business structure of an MNE, is a "group of companies", with a holding company-subsidiary configuration, the group of companies is viewed as a single entity without regard for the legal or geographical boundaries of the separate legal entities (Binnekade, Koppesschaar, Stegmann, Rossouw & Wright, 2013:19). According to the Katz Commission (cited by Wilcocks & Middelman, 2014:38) a group of companies is effectively managed as a single economic unit, in the interest of the group as a whole. Therefore it can be concluded that the tax expense incurred by the single economic unit is of significance. Based on a group perspective when there is a transfer pricing adjustment on an interest payment, on which a withholding tax was levied, multiple layers of tax are identified, as a distinction is not made on what was paid separately by the resident and the non-resident but what tax was paid as a single economic unit.

Illustration

The following scenario illustrates the multiple layers of tax when an interest payment is subject to both a withholding tax and a transfer pricing adjustment from a group perspective:

A South African resident taxpayer obtains a R10 000 000 loan, which bears interest at 15% per annum from a non-resident connected person. According to the loan agreement the interest is due and payable on a monthly basis, which is R125 000 per month.

Applying the 15% withholding tax on interest rate, every month R18 750 is withheld for the benefit of SARS by the South African company paying the interest. This means that the non-resident is only entitled to R106 250, which is the gross interest income less the withholding tax paid to SARS. In the event that benchmarking studies indicate that either the loan amount or interest rate is not at arm's length the interest deduction will need to be decreased when calculating the taxable income of the South African entity. In this scenario, assume that an arm's length loan is R8 000 000. For income tax purpose, the interest deduction will decrease from R1 500 000 to R1 200 000 per annum. However, the withholding tax was not applied on the reduced interest deduction but on all interest that was paid or was due and payable during the year: that is R1 500 000. The withholding tax on interest would have been paid on the excess portion and will have to be paid again in the form of Dividends Tax on the deemed dividend *in specie* (Joubert & Isaac, 2015).

The following table depicts the difference in tax expense when there is a transfer pricing adjustment as described in the scenario above:

Table 1-1 :Transfer pricing adjustment: the difference in tax expense

	No transfer pricing adjustment	**Transfer pricing adjustment required**
Accounting profit	R1 000 000	R1 000 000
Add excess interest (Primary adjustment)		R 300 000
Taxable income	R1 000 000	R1 300 000
Tax @ 28%[1]	R 280 000	R 364 000
Withholding tax on interest @ 15%[2]	R 225 000	R 225 000
Secondary adjustment: Dividends Tax @ 20%[3]		R 60 000
Total tax expense[1+2+3]	**R 505 000**	**R 649 000**

Source: Researcher's own compilation based on the tax legislation

The withholding tax on interest imposed on non-residents serves to offset the effect of interest payments deducted by resident taxpayers (UN, 2017a:10), creating tax symmetry. It would therefore be expected tax symmetry be reciprocated when there is a transfer pricing adjustment. However, when the interest deduction is limited by a transfer pricing adjustment, the non-resident is still subject to paying the withholding tax on the full unadjusted amount. In other words the tax base of the resident company which is taxable income is increased by the transfer pricing adjustment while the tax base for interest income which is subject to the interest withholding tax remains constant. Consequently, there seems to be a deviation from the tax symmetry principle and from the tax policy to raise revenue in ways that are equitable as put forward by Tanzi and Zee (2000:299) for developing countries. Furthermore, the anti-avoidance measures adopted to protect its tax base from BEPS seem to ignore that MNEs comprise a group of companies that are managed as a single economic unit. By not acknowledging the resident company and the non-resident company as a single economic unit, the unilateral measures adopted result in multiple layers of tax for the MNE functioning as a group of companies as illustrated in Table 1-1.

1.3 Problem statement

The primary justification for imposing withholding tax on non-residents is to protect source jurisdictions from tax base erosion that occur from cross-border deductible expenses such as interest payments (Kayis-Kumar, 2015a:649; Zee, 1998:594), which reduce the resident taxpayers' corporate income tax expense (Zee,1998: 594). Tax symmetry is achieved by imposing a withholding tax on interest. However it appears when the interest deduction is limited by a transfer pricing adjustment, the tax symmetry principle seems to be violated as the tax base for corporate tax increases while the tax base for withholding tax remains constant (Source: Researcher's own).

An additional issue is that the secondary transfer pricing adjustment is deemed to be a dividend consisting of a distribution of an asset *in specie*, attracting Dividends Tax of 20% payable by the resident tax payer. However, the withholding tax on the excess interest would have been paid already, but will have to be paid again as a Dividends Tax (Joubert & Isaac, 2015). Although the withholding tax on interest is paid by a non-resident company, and the Dividends Tax by the resident company, from a group perspective, the non-resident and resident companies are viewed as a single economic entity. This single entity is taxed twice by the South African revenue authorities resulting in double taxation when there is a transfer pricing adjustment on interest payments that are also subject to withholding tax.

The problem from a group perspective is whether the tax consequences of an interest payment that is subject to a transfer pricing adjustment and a withholding tax is equitable against the BEPS background.

1.4 Research question

To address the problem raised in section 1.3, the researcher will endeavour to answer the following question:
Are the tax consequences of an interest payment that is subject to a transfer pricing adjustment and withholding tax equitable against the BEPS background?

1.5 Objectives

The following objectives are formulated to address the problem statement and to answer the research question raised in sections 1.3 and 1.4 respectively.

Primary objective

The primary objective is to determine whether the tax consequences of an interest payment that is subject to a transfer pricing adjustment and a withholding tax is equitable against the BEPS background.

Secondary objectives

The primary objective will be addressed by the following secondary objectives:

- To analyse the transfer pricing and the withholding tax provisions in the Act to determine whether the tax consequence is equitable with minimal disincentive effects on FDI when there is a transfer pricing adjustment on an interest payment that is also subject to withholding tax. This analysis will be done against the BEPS background. This objective will be addressed in chapter two.
- To analyse the OECD and UN model tax convention on income and capital (MTC) to determine how the MTC addresses transfer pricing adjustments and interest income to avoid double taxation. This objective will be addressed in chapter three.
- To analyse South Africa's transfer pricing and withholding tax provisions against the OECD and UN guidelines and reports to establish whether South Africa's legislation is equitable when compared to the recommended practice of the OECD and UN. This objective will be addressed in chapter three.
- To compare the transfer pricing and withholding tax legislation of countries that attract FDI to determine how South Africa's legislation differs and to conclude whether South Africa's tax legislation is equitable compared to the countries selected. (Please refer to section 1.6.3.3 for the selection of countries and why FDI was chosen). This objective will be addressed in chapter four.

1.6 Research design/methodology

1.6.1 Research design

According to McKerchar (2008:10), a quantitative approach is used when surveys and experiments are the main strategies of inquiry in order to prove or disprove a hypothesis. In contrast qualitative research is about discovering answers to questions and not about proving or disproving a hypothesis. The main focus in qualitative research is to understand, explain, explore, discover and clarify situations and perceptions (Kumar, 2011:104). As this research will not be testing a hypothesis, the qualitative approach will be utilised to answer the research question.

The choice of using the qualitative approach is supported by the philosophical assumption of how the world is viewed in relation to the research undertaken (ontology) and how knowledge is obtained (epistemology) (McKerchar, 2008:6). There are two core philosophical paradigms, namely positivism and interpretivism (McKerchar, 2008:6). In the positivist approach, the researcher follows a precise and structured process culminating in the identification of causal relationships and logical conclusions based on deductive reasoning and is most likely to adopt a quantitative approach (McKerchar, 2008:7). On the other hand, interpretivism is based on the subjective interpretation of the researcher and does not present a basis from which causal relationships can be identified and predictions made (McKerchar, 2008:7). The researcher in this paradigm is most likely to follow a qualitative approach, based on inductive reasoning and utilising creative and indirect means of collecting data. As the research is not about identifying a causal relationship between transfer pricing adjustments and withholding tax on interest, but to analyse whether the tax consequences of an interest payment that is subject to a transfer pricing adjustment and withholding tax is equitable against the BEPS background, the interpretivism paradigm is adopted.

1.6.1.1 Ontology

Ontological assumptions are concerned with the nature of reality and what there is to know about the world (Snape & Spencer, 2003:25). The ontology of the interpretivist paradigm is a relativist view of the world and knowledge. According to Guba and Lincoln (1994:110), realities take the form of multiple, intangible mental constructions that are socially and experientially based. These constructions are alterable and are not more or less true in any absolute sense but more or less informed and/or sophisticated (Guba & Lincoln, 1994:111).

1.6.1.2 Epistemology

Epistemological assumptions are concerned with ways of knowing and learning about the world and focus on issues such as how we can learn about reality and what forms the basis of our knowledge (Snape & Spencer, 2003:27). The epistemology of the interpretivist paradigm is that the researcher and the object of the research are assumed to be interactively linked so that the findings of the research are literally created as the research proceeds (Guba & Lincoln, 1994:11).

Research in the interpretivist paradigm is carried out to gain an understanding and is unlikely to prove or establish a single truth (Coetzee, Van der Zwan, Schutte, 2014). By probing into unexplored dimensions of phenomena, a wider understanding can be obtained and the outcome of the research can result in multiple findings, not just restricted to an answer that a hypothesis is true or not (Coetzee *et al*., 2014). Use of the interpretivist paradigm presents the researcher with an opportunity to obtain a wider understanding of transfer pricing, transfer pricing adjustments, withholding tax and BEPS.

1.6.2 Research methodology

1.6.2.1 Doctrinal methodology

The purpose of the research is to answer the research question raised in section 1.4 by examining the relevant domestic law provisions as well as comparing these provisions to recommended practices and guidelines established by the OECD and UN and selected countries. Accordingly, the research is conducted in the doctrinal methodology. Doctrinal research according to the Pearce Committee (cited by McKerchar, 2008:18) is described as the traditional or 'black letter law' approach and is characterised by the systematic process of identifying, analysing, organising and synthesising statutes, judicial decisions and commentary. It is typically a library-based undertaking, focused on reading and conducting intensive, scholarly analysis (McKerchar, 2008:18). This research methodology also incorporates comparative law which includes a comparative analysis of the law over time as well as comparing the legal systems of different countries (Coetzee *et al.,* 2014). According to Coetsee and Buys (2018:75) doctrinal research is firstly a description of the current law, but when opinions about the current law are provided by professionals and academics by applying the current law, it takes an interpretive role.

1.6.3 Research method and process

1.6.3.1 Analysis of domestic law

To determine whether the domestic law is equitable, the doctrinal methodology is used to analyse section 31 of the Act which deals with transfer pricing adjustments and section 50 of the Act which deals with withholding tax on interest. The focus is on section 31(3) which covers the recently amended secondary transfer pricing adjustment that triggers a Dividends Tax resulting in an additional layer of tax, section 50(B) which deals with the levying of withholding tax on interest, section 50E which addresses the withholding of withholding tax on interest by payers of interest, and section 50G which stipulates the circumstances under which a refund of the withholding tax will apply. By focusing on these sections, the researcher will obtain an understanding of the relationship between a transfer pricing adjustment and withholding tax on interest to conclude whether the domestic law is equitable. An analysis of the law over time will be performed on the secondary transfer pricing adjustment to obtain an understanding of the reasoning underpinning the change in legislation. Data obtained from the Act, documents issued by SARS and National Treasury, and reports of tax committees will be analysed to obtain an understanding of the reasoning underpinning the legislation and how the domestic law has evolved in response to BEPS. Data will also be obtained from published and non-published journal articles, theses, dissertations, books, surveys, publications produced by professional firms and professional bodies, and commentaries from leading institutions that focus on international taxation. This data will constitute the interpretations of scholars and professionals on the application of the provisions of the Act. Preference will be given to acknowledged tax experts and journal articles in accredited journals.

1.6.3.2 Analysis of domestic law against OECD and UN guidelines

Due to the fact that the OECD and UN are the driving forces for shaping rules and standards regarding international taxation (Olivier & Honiball, 2011:5; Araki, 2016:72), the researcher assumes that these standards and rules are equitable. The equitability of the domestic law will therefore be analysed against the OECD and UN publications. The researcher will analyse the OECD and UN MTCs with a focus on Articles 9 and 11 which address transfer pricing adjustments and taxation of interest income respectively, transfer pricing guidelines with a focus on secondary adjustments, and publications on interest payments. Commentaries, submissions and articles on OECD and UN publications written by leading institutions that focus on international taxation, scholars and professionals will be analysed as well.

1.6.3.3 Cross-national comparison of domestic law

Contrary to conventional thinking that tax does not play a fundamental role in investment location decisions, the 2015 United Nations Conference on Trade and Development (UNCTAD) world investment report states that tax has become a key investment factor that influences the attractiveness of a location or an economy for international investors (UN, 2015b:176-177). The growth of global value chains has made tax an important determinant in deciding on a country's attractiveness and this trend is likely to continue (UN, 2015b:177).The level of taxation and the ease with which the tax obligations can be fulfilled feature prominently in location comparisons presented to investors (UN, 2015b:177). In addition to the aforementioned reasons for carrying out cross-national comparisons for this research, Hantrais (1995) states that comparisons can lead to fresh, exciting insights and provides a deeper understanding of issues that are of central concern. According to Hantrais (1995) cross-national comparisons can lead to identification gaps in knowledge and may give possible directions that could be followed and about which the researcher may not have been aware previously. Accordingly, the researcher will compare South Africa's transfer pricing and withholding tax on interest legislation with two other countries to determine how South Africa's legislation compares with regard to equitability, and to identify any gaps in the legislation.

As transfer pricing adjustments and withholding tax on interest are in response to BEPS activities carried out by MNEs, the primary criteria used to select countries for the comparative analysis is FDI, as MNEs are associated with FDI. The secondary criteria used in the country selection is the attractiveness index as tax is an important determinant in deciding on a country's attractiveness (UN, 2015b:177).

The following statistics were obtained from EY's Africa's Attractiveness Programme published in May 2017:

- In 2016 Africa's share of global FDI capital flows increased to 11.4%, up from 9.4% in 2015, making Africa the second fastest growing destination when measured by FDI (EY, 2017:10). Due to the fact that Africa is the second fastest growing destination and South Africa is in Africa the countries selected for the comparative research are from Africa.

- South Africa, Morocco, Egypt, Nigeria, and Kenya are Africa's top recipients of FDI (EY, 2017:10); and
- based on the attractiveness index Morocco ranked number one, with South Africa and Kenya ranked number two jointly (EY, 2017:16).

The two countries selected for the comparative research are Morocco and Kenya as they seem to be South Africa's strong competitors when it comes to attracting FDI and choosing an investment location based on a country's attractiveness.

Areas of taxation to be compared are corporate tax rates as transfer pricing adjustments affect corporate tax expense, transfer pricing legislation, consistency of transfer pricing methods with OECD guidelines, secondary transfer pricing adjustment, thin capitalisation anti-avoidance legislation and withholding tax on interest. The sources to be utilised are publications by professional firms such as PwC's worldwide tax summaries and EY's worldwide corporate tax guide as these are international professional firms with a presence in Africa. Due to time constraints it will not be feasible to utilise primary data.

1.7 Overview of the chapters

1.7.1 Chapter 1: Introduction and background to research

This chapter details the background information, the problem statement, the research question, the objectives, and the research design/methodology.

1.7.2 Chapter 2: Overview and analysis of domestic law

This chapter presents an overview and an analysis of the domestic transfer pricing and withholding tax on interest provisions against the BEPS background. An analysis of the law over time on the secondary transfer pricing adjustment is included.

1.7.3 Chapter 3: Analysis of domestic law against OECD and UN guidelines

This chapter analyses South Africa's transfer pricing adjustments and withholding tax on interest legislation against the OECD and UN MTCs, guidelines and reports, to determine how South Africa's legislation differs from the OECD and UN recommended practice and guidelines.

1.7.4 Chapter 4: Cross-national comparison of domestic law

Chapter four details the comparison of the transfer pricing and withholding tax on interest legislation of Morocco and Kenya with South Africa to determine how South Africa's legislation compares with regards to equitability and to identify any gaps in the legislation.

1.7.5 Chapter 5: Conclusion

The findings, conclusion and additional research areas identified are presented in this chapter.

CHAPTER 2

2 Overview and analysis of domestic law

This chapter provides an overview and an analysis of the tax implications of transfer pricing and withholding tax on interest provisions against the BEPS background. The purpose of this chapter is to address the secondary objective detailed in section 1.5 which is to determine whether the domestic tax treatment is equitable with minimal disincentive effects on FDI when there is a transfer pricing adjustment on an interest payment that is also subject to withholding tax on interest. The chapter commences with a discussion on BEPS with a focus on the risk that BEPS poses to tax revenues, tax sovereignty and tax fairness. The analysis of the domestic law is preceded by a brief discussion on the use of debt as a profit shifting technique.

2.1 BEPS: A risk to tax revenues, tax sovereignty and tax fairness

Globalisation, together with the increasing sophistication of tax planners in identifying and exploiting legal arbitrage opportunities and boundaries of acceptable tax planning has provided MNEs with opportunities to significantly minimise their tax expense (OECD, 2013b:7-8). This type of aggressive tax planning, aimed at reducing corporate tax expense, consists of tax planning that is legal but is in contradiction to the intent of the law, and includes exploiting loopholes and mismatches between tax systems (European Commission (EC), 2017:1). Mounting attention is given to the fact that many MNEs appear to have effective tax rates well below what one would expect from the headline rates in the countries in which they operate (UN, 2015a:1). Several widely publicized cases of well-known MNEs (for example, Google, Apple, Starbucks and Microsoft) paying low or no taxes have brought the questions of tax avoidance and evasion into the public political debate (UN, 2015a:1).

In the New Zealand case of Elmiger v CIR (cited by Oguttu, 2015:520), it was held that the ingenious legal devices contrived to enable individual taxpayers to minimise or avoid their tax liabilities are often not merely sterile or unproductive in themselves (except perhaps in respect of their tax advantages for the taxpayer concerned), but that they have social consequences which are contrary to the general public interest. The consequences set out below of exploiting legal arbitrage opportunities to minimise or avoid tax liabilities that culminate in BEPS, demonstrate why BEPS is a risk to tax revenues, sovereignty and fairness.

- **Loss in tax revenue**

Many governments have to cope with less revenue and a higher cost to ensure compliance (OECD, 2013b:8). Cobham and Jansky (2017:21) estimate the annual global revenue loss from global tax avoidance by MNEs is approximately US$500 billion. In developing countries, the lack of tax revenue leads to critical under-funding of public investment that could help promote economic growth (OECD, 2013b:8). According to the EC, loss of tax revenue may have an impact on social spending for example, access to quality education, healthcare, welfare services and redistribution (EC, 2017:2). This in turn exacerbates inequalities and may fuel further social discontent (EC, 2017:2).

- **Fairness and integrity of tax system undermined**

BEPS undermines the integrity of the tax system, as the public, the media and some taxpayers deem reported low corporate taxes to be unfair (OECD, 2013b:8). Prebble and Prebble (2010:38) are of the view that tax avoidance undermines two fundamental principles of a tax system, namely the principles of horizontal equity and neutrality. The principle of horizontal equity states that people in the same economic position should be taxed at the same rate (Prebble & Prebble, 2010:38). Tax avoidance makes horizontal equity challenging to achieve, because successful tax avoidance results in some taxpayers being taxed less than others who are in the same economic position (Prebble & Prebble, 2010:38-39). In other words, taxpayers who avoid tax are not paying their fair share as calculated by their wealth (Prebble & Prebble, 2010:38-39). Furthermore, tax avoidance makes it trickier for tax systems to be economically neutral (Prebble & Prebble, 2010:39). Economic neutrality expects that tax systems distort the normal workings of the market as little as possible, that is, that people should not make decisions, either solely or partially for tax reasons (Prebble & Prebble, 2010:39).

- **Impact on taxpayer morale**

When tax rules permit businesses to reduce their tax burden by shifting their income away from jurisdictions where income-producing activities are conducted, other taxpayers in that jurisdiction bear a greater share of the burden (OECD, 2013b:8). Taxpayers who abide by their obligations and pay their taxes perceive aggressive tax planning as a breach of a social contract (EC, 2017:2). Awareness of unfair tax practices may encourage other taxpayers to stop complying with their obligations (EC, 2017:2).

- **Impact on businesses**

Businesses failing to take advantage of legal opportunities to reduce an enterprise's tax burden can place the business at a competitive disadvantage (OECD, 2013b:8). Furthermore, businesses that operate only in domestic markets, including family-owned businesses or new innovative companies, have difficulty competing with MNEs that have the ability to shift their profits across borders to avoid or reduce tax (OECD, 2013b:8). Fair competition is harmed by the distortions induced by BEPS (OECD, 2013b:8).

- **Capital flight and money-laundering**

International corporate tax avoidance sustains the offshore tax haven and secrecy system that facilitates capital flight and money-laundering (Tax Justice Network (TJN), 2014:2). Money-laundering is detrimental to the financial sector as a functioning financial sector depends on a general reputation of integrity, which money-laundering undermines (OECD, 2014a:15). Consequently, money laundering can impair long-term economic growth, harming the welfare of entire economies (OECD, 2014a:15).

In view of the induced revenue losses and distortions in the competition between MNEs and domestic firms, many countries have implemented measures to limit profit-shifting by MNEs unilaterally (Dudar, Nicolay, & Nusser, 2016:1). The view of the EC is that the fight against aggressive tax planning is essential to secure tax revenues for public investment, education, healthcare and welfare; to ensure fair burden-sharing and to preserve tax morale of taxpayers; and to avoid distortion of competition between firms (EC, 2017:1). However, the OECD cautions that unilateral and uncoordinated actions by governments responding in isolation could result in the risk of double and possibly multiple taxation for business (OECD, 2013a:8). This would have a negative impact on investment, and thus on growth and employment globally (OECD, 2013a:8). On the other hand, TJN (2007:6) is of the view that to restore public confidence in the ability of democratic forms of government to protect the rule of law and promote the equity of tax systems, it is crucial that tax avoidance practices be addressed in a comprehensive manner. According to TJN (2007:6) comprehensive action against aggressive tax avoidance will reduce incentives for corruption and increase incentives for genuine entrepreneurial activity undertaken to increase human wellbeing rather than create short-term increases in post-tax profits. TJN (2007:6) advocate that by addressing tax avoidance practices comprehensively, the additional revenues earned would offer opportunities:

- for progressive cuts in tax rates in many countries as the tax base is broadened to include sums now evaded or avoided; and
- to simplify the tax law in many countries, thereby reducing the burden of tax administration for many people (TJN, 2007:6).

It is against this background that the researcher will endeavour to answer the research question raised in section 1.4, which is " Are the tax consequences of an interest payment that is subject to a transfer pricing adjustment and withholding tax equitable against the BEPS background?"

2.2 Use of debt as a profit shifting technique

The most prominent profit shifting technique involves the strategy of using internal debt (Buettner & Warmser, 2013:63) due to the fact that the fungibility and mobility of finance allows debt to be placed in the most tax efficient jurisdiction (Burnett, 2014:5). Intra-group cross-border debt is easy to create as it merely requires a loan agreement and there is no requirement for any goods or services to physically move, or business conduct to change (Burnett, 2014:7). This profit shifting strategy involves borrowing from affiliates in low tax countries and lending to affiliates in high tax countries. The interest payment is deducted as a tax expense, reducing taxable profit in the high tax country, and the interest received in the low tax country is taxed as income received (Buettner & Warmser, 2013:63-64). In this way MNEs minimize their global tax expense without incurring any additional trade expense (Webber, 2010:684).

Kayis-Kumar (2015b:301) is of the view that international debt shifting through a phenomenon of "hidden equity capitalisation" (thin capitalisation) lies at the heart of aggressive tax planning, due to the inefficiencies in the tax treatment of debt and equity financing. Buettner, Overesch, Schreiber & Wamser (2012:931) concur that the general problem with the taxation of companies is that capital invested by a shareholder as equity is treated differently from capital that is invested by a bondholder in the form of a loan. Dividend income which is the shareholder's return from equity is paid from after-tax profits (Buettner *et al.*, 2012:931; Huizinga, Laeven & Nicodeme, 2008:81), and therefore not a deductible tax expense. In addition the dividend income may be subject to a dividend withholding tax in the subsidiary country, and in the parent company the dividend income may be subject again to corporate income tax (Huizinga *et al.,* 2008:81). On the other hand interest payments are treated as deductible expenses when computing the taxable profit of the company (Buettner *et al.*, 2012:931). Consequently, corporate taxation tends to contribute to the emergence of thinly-capitalised companies with capital mainly provided in the form of debt (Buettner *et al.*, 2012:931). In this way profits from a subsidiary can be transferred to the parent in the form of interest rather than transferring the profits as dividends which results in base erosion (Oguttu, 2013:312).

Of serious concern is the "double dip" interest deduction that occurs when a third entity (a conduit entity), residing in a low tax jurisdiction is involved. According to Mintz (2004:421) a company investing through a subsidiary in a host country can take two deductions to finance the investment in the host country. One in the host country and another in the home country as a result of indirect financing (Mintz, 2004:421). Mintz (2004:421) posits that the following essential tax attributes play a significant role in encouraging the adoption of an indirect finance structure:

- The country where the parent resides, that is the home country does not limit interest deductions taken for investments made in subsidiaries;
- The home country exempts from tax the income remitted back from the conduit entity;
- The home country exempts the income received by the conduit entity from the subsidiary in the host country from accrual taxation;
- The conduit country taxes at a low or zero rate income received by the conduit entity;
- The conduit country imposes little or no withholding taxes on income paid from the conduit entity to the parent;
- The host country does not impose a withholding tax on income paid to the conduit entity; and
- The host country does not effectively limit interest deductions taken by the subsidiary for corporate tax purposes.

Mintz (2004:422) asserts that these financing structures would not function if host countries impose relatively high withholding taxes or limit interest deductions.

South Africa is also prey to the "use of debt" profit shifting technique. National Treasury is of the opinion that one of the most significant types of base erosion in South Africa is excessive deductible interest, which is shifted as income to a no-tax or low-tax jurisdiction or converted to a different type of income in another jurisdiction (National Treasury, 2013b:1). According to Kruger (2015:13) the domestic transfer pricing provisions that limit interest deductions to an arm's length amount and the recently introduced withholding tax on interest, will provide the fiscus with some protection against aggressive debt-funding practices. The remainder of this chapter will analyse the tax consequences when this combination is utilised for interest payments made to non-residents.

2.3 Transfer pricing

“Transfer pricing” is the general term for the pricing of cross-border, inter-company transactions between related parties and refers to the setting of prices for transactions between related parties involving the transfer of property or services (UN, 2013:2). According to Olivier and Honiball (2011:620), in the absence of transfer pricing provisions in the legislation, it is relatively easy for MNEs to price intra-group transactions so that profits are taxed in low tax jurisdictions while obtaining deductions in high tax jurisdictions, as transactions within a multinational group are usually eliminated for financial accounting purposes. Hence, the transfer pricing legislation seeks to place transactions between related parties and non-related parties on equal footing, by adjusting the income and expenses of related parties if they fail to transact at arm's length (Flanagan, 2017:132). This is to ensure that those that are engaging in related party and non-related party transactions are paying the same amount of tax. In this way, the transfer pricing legislation seeks to maintain the horizontal equity principle in a country's tax system.

The tax implications of transfer pricing are found in section 31 of the Act, which is "Tax payable in respect of international transactions to be based on arm's length principle" (the Act). The arm's length principle supports an equal treatment between independent companies and companies forming part of an MNE, to avoid the possibility of utilising tax loopholes and the creation of market distortions (Lohse *et al.,* 2012:6).

Financial assistance, which includes thin capitalisation schemes between a related resident and non-resident falls under the transfer pricing rules found in section 31 of the Act (Millar, 2017:29; SARS, 2010:76). It is therefore essential that taxpayers utilise the arm's length principle to determine the amount of debt that can be borrowed from related persons (SARS, 2013a:7). The arm's length amount must be taken into account when preparing the corporate income tax return and assessing what portion of the related interest expense, if any, is not deductible under section 31 of the Act (SARS, 2013a:7).

2.3.1 Thin capitalisation

Due to the inefficiencies in the tax treatment of debt and equity financing (Kayis-Kumar, 2015b:301), MNEs are provided with an opportunity to fund investments in high-tax jurisdictions with a high debt-to-equity ratio (Webber, 2010:684). Many countries have enacted thin capitalisation rules to limit a firm’s debt-to-equity ratio to control highly leveraged financing structures (Webber, 2010:683-684). Thin capitalisation rules deny interest deductions if the borrowing entity's debt-to-equity ratio is above the so-called safe harbour debt-to-equity ratio (Buettner *et al.*, 2012:937). However, Webber (2010:703), is of the view that thin capitalisation rules may not achieve their objective of preventing profit shifting as debt-to-equity ratios do not limit absolute debt levels. If the MNE’s objective is to reduce income taxes, it can determine how much debt is necessary to shift earnings from a country, inject sufficient debt and equity to comply with limitations, and transfer profits (Webber, 2010:703). Consequently safe harbour debt-to-equity ratio may be inconsistent with the tax policy principle of efficiency (Webber, 2010:703).

Furthermore Mintz (2004:30) and Webber (2010:703) argue that thresholds are difficult to define since debt-to-equity ratios differ significantly depending on the industry type and risk. For instance, financial lenders and utilities typically have very high debt-to-equity ratios in contrast to pharmaceutical and mining companies which have much lower ones (Mintz, 2004:430). If a single threshold is used, it might be set inappropriately too high for companies that would normally have low debt-to-equity ratios while too low for companies that are typically levered (Mintz, 2004:430). Capping the debt-to-equity ratio may thus conflict with the fairness tax policy principle (Webber, 2010:703).

Due to the possible circumvention of debt-to-equity ratios and the difficulty in establishing one debt-to-equity ratio for all business types, Webber (2010:704) is of the view that the most straightforward way to preserve tax revenue is not by controlling the company's capital structure but by limiting tax-deductible interest. It seems that the South African legislators concur with this view as legislation amendments were enacted which merged the transfer pricing and thin capitalisation legislation, in order to ensure that the legislation is more effective in countering tax avoidance (Oguttu, 2013:311). The effect of this "merger" is that only the arm's length principle is applied to restrict thin capitalisation schemes (Oguttu, 2013:311; SARS, 2010:Section 5.3). Effective from 1 April 2012, section 31(3) of the Act that dealt with the safe harbour 3:1 debt-to-equity ratio was repealed. According to Wolff and Verhoosel (2014) there is an increasing number of legislators globally that are repealing thin capitalisation safe harbour rules. The abolishment of the safe harbour rules is in keeping with international trends (Wolff & Verhoosel, 2014).

A further justification for the repeal of the safe harbour rules is provided in the Draft Interpretation Note issued by SARS, titled: Determination of the taxable income of certain persons from international transactions: thin capitalisation, which illustrates that an arm's length amount of debt may be nil, despite the fact that the safe harbour rules may have allowed the interest deduction:

> Taking all the relevant facts and circumstances into account, the arm's length amount of debt may be nil in circumstances where a taxpayer with a very healthy balance sheet, excess cash reserves and spare borrowing capacity borrowed from an offshore parent company when all the relevant facts indicate that there was no business or reason or commercial benefit for the additional finance. In this example independent lenders may have been prepared to lend to a person in the taxpayer's position but a person in the taxpayer's position would not have borrowed from an independent person on an arm's length basis (SARS, 2013a:7).

According to National Treasury, in a cross-border context where the debtor and creditor are connected persons, excessive interest can arise if the interest yield is driven by tax considerations as opposed to arm's length commercial reasons. (National Treasury, 2013b:2). In these cases transfer pricing adjustments can be used to eliminate debt with excessive interest or excessive debt (National Treasury, 2013b:2). In addition to section 31, sections 23M and 23N were enacted in South Africa's domestic law in 2015 and 2014 respectively, to specifically limit interest deductions, in response to National Treasury's concern regarding excessive deductible interest. The provisions of section 23M limits interest deductions in respect of debts owed to connected persons who are not subject to tax in South Africa, while section 23N limits interest deductions in respect of debts used to fund reorganisation and acquisition transactions (the Act). The interest deduction limitation for both sections 23M and 23N, which is expressed as a percentage of the tax equivalent of earnings before interest, taxation, depreciation and amortisation, will adjust up and downwards based on the prevailing repo rate (National Treasury, 2014:26). According to Kruger (2015:11) the transfer pricing provisions enacted in section 31 will be applied prior to the application of sections 23M and 23N as sections 23M and 23N rely on the determination of the taxpayer's taxable income, which can only be determined after the application of the transfer pricing provisions. The deduction of an arm's length interest expense may therefore be limited by sections 23M and 23N.

2.3.2 Primary transfer pricing adjustment

A transfer pricing adjustment is required where:

(a) any transaction, operation, scheme, agreement or understanding has been directly or indirectly entered into or effected between or for the benefit of either or both-

- *a resident and a non-resident;*
- *a non-resident and the permanent establishment of another non-resident in* South Africa*;*
- *a resident and a permanent establishment of a resident outside* South Africa*; or*
- *a person that is not a resident and a CFC of a resident*,

and those persons are connected persons in relation to one another;

and

(b) any term or condition of that transaction, operation, scheme, agreement or understanding

(i) is different from any term or condition that would have existed had those persons been independent persons dealing at arm's length; and

(ii) results or will result in any tax benefit being derived by a person that is a party to that transaction, operation, scheme, agreement or understanding,

the taxable income or tax payable of each person that is a party to that transaction, operation, scheme, agreement or understanding that derives a tax benefit must be calculated as if the transaction, operation, scheme, agreement or understanding had been entered into on terms and conditions that would have existed had those persons been independent persons dealing at arm's length (section 31(2) of the Act*)*.

The effect of the amended section 31(2) is that MNEs will no longer be able to hide behind benchmarking exercises that merely indicate that a particular transaction and the related consideration is at arm's length, while the overall transaction, operation, scheme, agreement or understanding in place, results in a profit for one of the parties that is inconsistent with the arm's length principle (Brodbeck & Gers, 2012) resulting in BEPS. However, Finke, Fuest, Nusser & Spengel *(*2014:4-5) are of the view that the possibilities for extensive profit shifting remain for intergroup interest payments despite the application of transfer pricing rules, due to the fact that in many cases no comparable transactions between independent persons exist to apply the arm's length principle. Thus an extensive range of levels of debt and corresponding interest rates may be justifiable when applying the arm's length principle (Burnett, 2014:62). This extensive range of debt levels and interest rates offer MNEs an element of electivity in creating intra-group debt and corresponding tax deductions (Burnett, 2014:62-63). With no safe harbour leverage ratio Burnett (2015:9) points out that the local subsidiary can be leveraged with related-party debt up to the maximum debt amount and interest rate which it can justify on an arm’s length basis.

Seligson (2010:12) agrees that financial assistance granted between independent financial institutions and corporate borrowers may show that financial assistance is granted where the debt-to-equity ratio is much higher than 3:1 if the assets and profitability of the borrower justify the loan amount. Thus, according to Seligson (2010:12), the impact of the new provisions may not always be favourable to SARS. This may be the case, as the arm's length principle recognises, that entities may have different levels of interest expenses depending on the circumstances (OECD, 2015b:19). This demonstrates fairness to the taxpayer as Webber (2010:703) is of the view that using a single debt-to-equity ratio for all industry types conflicts with the fairness principle. However, some countries that have experience in applying the arm's length principle express concerns on how effective it is in preventing BEPS (OECD, 2015b:20). These countries are of the view that it could be complementary to other measures (OECD, 2015b:20).

2.3.3 Secondary transfer pricing adjustment

In addition to the primary adjustment, there is a secondary adjustment. In the case of a resident company, the secondary adjustment is deemed to be a dividend consisting of a distribution of an asset *in specie* declared and paid on the last day of the 6 month period ending after the year of assessment in which the primary adjustment was made (section 31(3) of the Act). The amount of the deemed dividend is the primary adjustment amount (Van der Zwan, 2018a:824).

The secondary transfer pricing adjustment targets the tax avoidance consequences when a transaction is not at arm's length (Van der Zwan, 2018a:823). There is a possibility that a subsidiary paid an excessive transfer price (which in reality is a dividend) to the foreign parent as a means of avoiding dividends withholding tax (National Treasury, 2014:61; Weichenrieder, 1996:446). The avoidance of the dividends withholding tax can also be deduced from the profit shifting opportunities discussed in section 2.2.

According to Harmse and Van der Zwan (2016:291), in the case of a transfer pricing manipulation, the hidden profit extraction is apparent from the fact that a transaction conducted at arm’s length would have left the company with greater distributable profits. This view is shared by the DTC which states that an incorrect transfer price results in depletion in the asset base of the South African taxpayer; and a resultant potential loss of future taxable income for the fiscus (DTC, 2017:136). Hence transfer pricing adjustments are economically similar to outbound payments of dividends to foreign related parties since they represent a distribution of value from South Africa to the foreign company (DTC, 2017:136).

The concept of treating the secondary adjustment as a deemed dividend is not a novel concept in South Africa's tax legislation. Prior to the 2011 legislative amendments which introduced secondary transfer pricing adjustment rules in the form of a deemed loan, deemed dividend rules contained a provision relating to transfer pricing (National Treasury, 2014:61-62). These deemed dividend rules existed as a measure to minimise the avoidance of secondary tax on companies[4] through the transfer of certain benefits to a non-resident company without a formal declaration of a dividend (SARS, 2011:116-117). In terms of these deemed dividend rules, a deemed dividend was triggered from any additional taxable income or reduced assessed loss that resulted from a transfer pricing adjustment (SARS, 2011:116-117). The rationale behind this deemed dividend provision was to account for the removal of value from a South African company due to the company transacting with connected persons on a non-arm's length basis (SARS, 2011:116-117).

When the secondary tax on companies legislation was repealed on 1 April 2012, and replaced with the Dividends Tax, the policymakers decided that the automatically deemed dividend rules stemming from a transfer pricing adjustment would not continue into the new Dividends Tax regime (SARS, 2011:116). Instead, the transfer pricing legislation would be amended to directly cater for secondary adjustments arising from transfer pricing adjustments (SARS, 2011:117). The amount of the primary adjustment would be deemed to be an interest-bearing loan by the South African taxpayer to the non-resident and the deemed interest would be included in the South African taxpayer's taxable income (SARS, 2011:117). The rate of interest should be calculated under the arm's length principle and capitalised annually to calculate the balance of the deemed

4 Prior to 1 April 2012, when a company declared a dividend, the company was liable for 10% secondary tax on companies, on the net amount of dividends declared during a specific dividend cycle (Van der Zwan, 2018b:667). Secondary tax on companies was repealed on 1 April 2012 and replaced by Dividends Tax (Van der Zwan, 2018b:667).

loan (SARS, 2011:117). The deemed loan and the interest calculated on it would be deemed to be payable until the amount is regarded as having been repaid to the South African taxpayer (SARS, 2011:117).

The deemed dividend that was subject to secondary tax on companies, according to Miller and Joubert (2016) was simple to administer but created a cash flow burden as the secondary adjustment resulted in a cash payment of secondary tax on companies. While the secondary adjustment in the form of a deemed loan eliminated the cash flow burden linked with the secondary tax on companies charge, the deemed loan opened up a host of practical problems (Miller & Joubert, 2016). The policymakers acknowledge these practical problems as the reasons provided by National Treasury (2014:61-62) for replacing the deemed loan with a deemed dividend is as follows:

- Secondary adjustment in the form of a deemed loan is an administrative burden both for the taxpayer and the Revenue administration;
- In practice, it is impossible for the foreign company to repay the loan and the deemed interest because the loan is a deemed loan and there are no contractual legal obligations supporting the settlement of the loan;
- It also creates difficulties with the accounting treatment of the deemed loan and the relevant currency of the deemed loan and deemed interest; and
- Due to exchange control restrictions in the country of the connected person it may be impossible to repatriate the funds resulting in an ongoing interest charge for tax purposes.

It is therefore submitted that the policymakers are amenable to change when the legislation is viewed as "unfair" or when the outcome of a provision is an oversight with unintended effect. The deemed loan, a purely legal fiction, would give rise to a situation where the actual loan advanced is repaid and thus no longer in existence, but the deemed loan would seemingly continue in existence indefinitely (Warneke, 2014:15) with an arm's length interest calculated and included in the taxable income of the resident taxpayer (SARS, 2011:117).

Warneke (2014:15) is of the opinion that the repeal of the deemed loan and the introduction of a deemed dividend as a secondary adjustment is a generally well-received amendment. The deemed dividend would bring a definite end to the taxation arising from the transfer pricing adjustment when compared to the deemed loan scenario (Warneke, 2014:15).

2.3.3.1 Dividends Tax

As the secondary transfer pricing adjustment is deemed to be a dividend, the deemed dividend will be subject to Dividends Tax, levied at 20% (section 64E of the Act). A resident company that declares and pays a dividend that consists of a distribution of an asset *in specie* is liable for Dividends Tax (section 64EA of the Act). When a company declares and pays a dividend that consists of the distribution of an asset *in specie*, that dividend will qualify for a reduced rate of Dividends Tax, due to the operation of a DTA (section 64FA(2) of the Act). This reduced rate is subject to a declaration made by the beneficial owner of the dividend that if the distribution was not a dividend *in specie,* that is if it was a cash distribution, it would have qualified for a reduced rate as per the DTA agreement (section 64FA(2)(a) of the Act).

However, Strauss (2017:47) states that DTA agreements based on the OECD MTC, will not have access to reduced rates as the deemed dividend does not qualify as a dividend for Article 10 purposes of the OECD MTC. This is due to the fact that the deemed dividend does not present income from other corporate rights and is not taxed in the same manner as income from South African shares (Strauss, 2017:47). Strauss (2017:47) further states that this reduced rate denial is in line with the DTC report and is based on policy consideration that transfer pricing adjustments are anti-avoidance provisions and therefore penal in nature. Strauss (2017:48) asserts "Any relief for the tax paid in terms of these penal provisions will render them less effective in addressing the mischief sought to be addressed i.e. BEPS." It is recommended that if National Treasury wishes to adopt a more lenient and competitive policy, the provisions for domestic relief be amended to ensure that domestic relief is available for deemed dividends that result from a secondary adjustment (Strauss, 2017:48).

The question that arises is whether National Treasury wishes to adopt a more lenient and competitive policy. According to the SARS Compliance Programme Briefing Note Update, transfer pricing remains a SARS priority for the medium to long term, given the risk that transfer pricing poses regarding erosion of South Africa’s tax base (SARS, 2013b:1). The briefing note update states that during the 2012/13 financial year, the settlement of 16 transfer pricing cases with audit results of just over R3.2 billion resulted in R652 million cash collections (SARS, 2013b:1-2).

One of the premises on which the SARS Compliance Programme is based, is that by highlighting areas of high risk and non-compliance with tax and customs legislation, taxpayers and traders are encouraged to adjust their behaviour (SARS, 2012a:2). This premise ties in with a study carried out by Marques and Pinho. Using a sample of 27 278 foreign subsidiaries in Europe, in a period in which there were significant changes to transfer pricing frameworks, Marques and Pinho (2016:729) investigated the extent that profit shifting activities decreased when transfer pricing frameworks became stricter. The study revealed that the interaction between profit shifting incentives and the strictness index indicated that the stricter the transfer pricing framework of the host country, the lower the profit shifting activities (Marques & Pinho, 2016:729). The conclusion reached was that a stringent transfer pricing framework is capable of dissuading MNEs in participating in profit shifting behaviour (Marques & Pinho, 2016:729). However, a brief literature survey carried out by Finke *et al.*(2014:2) indicates that empirical studies on the impact of anti-tax-avoidance measures such as thin capitalisation rules or tighter transfer pricing policies are effective in reducing profit shifting, but they induce MNEs to invest less. This view is also supported by Bartelsman and Beetsma (2003:2246-2247). Their research findings suggest that revenues from tighter enforcement of transfer pricing rules can in principle be quite high in high tax countries at the expense of reduced net return on investments, causing real activity shifts to countries with lower taxes and/or laxer enforcement (Bartelsman & Beetsma, 2003:2246-2247).

Nevertheless, Musgrave and Musgrave (cited by Webber, 2010:686) is of the opinion that it is appropriate to use taxes to correct market inefficiencies. In the case of limiting interest deductions, the inefficiencies that tax authorities wish to address is the shifting of profits from high-tax jurisdictions in which they are earned to low-tax jurisdictions (Webber, 2010:686). An effective law should constrain companies from incurring excessive inter-company debt solely for the purpose of reducing taxes (Webber, 2010:686). Policies adopted to limit tax-efficient financing are viewed as a necessary action to limit erosion of the national corporate tax base (Mintz, 2004:428). To protect its tax base from profit shifting behaviour, many countries have enacted transfer pricing rules, thin capitalisation rules and withholding taxes (Kayis-Kumar, 2015:632; Marques & Pinho, 2016:704). Hence South Africa is not the exception to the rule. The exemptions from the tax consequences of transfer pricing discussed below indicate that the policymakers appear to consider the commercial effect that stringent transfer pricing rules may have on the economy (Brodbeck & Gers, 2012).

2.3.4 Exemptions from the tax consequences of an affected transaction under section 31 of the Act

Usually the section 31 transfer pricing adjustment rules apply to any loan provided by a South African taxpayer to a non-resident connected party irrespective of the substantive character of the loan (National Treasury, 2013a:Section 5.8). The legislation pertaining to a transfer pricing adjustment applies equally to both short-term and long-term loans as well as interest-bearing versus non-interest bearing loans (National Treasury, 2013a:Section 5.8). There are however, three exceptions to the transfer pricing adjustment rules which relate to financial assistance. These exceptions are discussed below.

2.3.4.1 Headquarter company regime exemption

The headquarter company regime is an elective regime that relaxes the requirements of the tax laws in respect of certain South African companies used by non-residents as investment vehicles into other countries (Van der Zwan, 2018a:828). To establish South Africa as a jurisdiction of choice for investment into neighbouring countries (De Koker & Williams, 2016:13.40), the headquarter company tax incentive was introduced to ensure that the tax system did not act as an obstacle to the country's attractiveness as a headquarter location (Van der Zwan, 2018a:827). One of the tax concessions of electing to be a headquarter company, is that granting of financial assistance will not be subject to the transfer pricing legislation (section 31(5) of the Act).

2.3.4.2 High taxed controlled foreign company exemption

To facilitate the expansion, global competitiveness and smooth operation of South African MNEs in other countries, a number of initiatives aimed at reducing potential double taxation for South African companies investing into Africa have been introduced (SARS, 2012b:120). One such initiative is exempting financial assistance provided by a resident company other than a headquarter company from section 31 when such financial assistance is provided to a controlled foreign company or to a company that forms part of the same group of companies as that resident company (section 31(6) of the Act). The exemption will only apply when the following requirements are met:

- the controlled foreign company has a foreign business establishment as defined in section 9D(1) of the Act; and
- the aggregate tax payable to all foreign countries by that controlled foreign company in any foreign tax year in which the transaction, operation or scheme exists is at least 75% of the normal tax that would have been payable if that controlled foreign company had been a resident for that foreign tax year (section 31(6) of the Act).

The possibility of avoidance is minimal in these circumstances as the high-taxed nature of the foreign obligor offers little overall net global tax savings if interest is understated (SARS, 2012b:121).

The rationale for the exemption is to avoid double taxation that may occur when soft-loans lacking interest and fixed dates of repayment are advanced by South African companies to controlled foreign companies for no tax reasons (SARS, 2012b:120). These soft loans are an important method of indirectly funding offshore start-up operations (SARS, 2012b:120). Unfortunately the lack of yield on these soft loans has unfavourable tax consequences (SARS, 2012b:120). The South African lender may be subject to transfer pricing adjustment, thereby being subject to tax based on a higher notional yield (SARS, 2012b:120). The foreign company borrower will often be allowed a foreign deduction only for actual cross-border payments to the South African company as opposed to a foreign deduction for the higher notional payments (SARS, 2012b:120). Consequently, this may result in double taxation that will impact on the international competitiveness of South African MNEs (SARS, 2012b:120).

2.3.4.3 Equity loan exemption

An exemption from the transfer pricing provision exists when a South African company advances an equity loan (also known as a quasi loan) to fund a foreign subsidiary. Since this type of loan is interest-free, deeply subordinated, and is often unsecured with flexible repayment terms (if any), the loan tends to resemble equity rather than debt (Van der Zwan, 2018a:826). In the case of a cross-border venture where shareholders are providing quasi loans, the South African shareholder would have to conform to the transfer pricing legislation and include an arm's length interest income in its taxable income although the loan is interest-free with equity-like features (Van der Zwan, 2018a:826). Without relief, the potential transfer pricing concerns leave the South African shareholder in a compromised tax position in relation to the South African shareholder’s multinational counterparts (National Treasury, 2013a:Section 5.8). According to Brodbeck and Gers (2012) the quasi loan was often a source of conflict between taxpayers and revenue authorities. The relief granted by section 31(7) of the Act indicate that the policymakers appear to consider the commercial effect that stringent transfer pricing rules may have on the economy (Brodbeck & Gers, 2012).

Section 31(7) of the Act states that if the following requirements are met, the loan advanced will be exempt from the transfer pricing provisions:

A transaction entered into between

- a resident company or any company that forms part of the same group of companies as that resident company, and
  a foreign company in which the resident company (alone or together with any company that forms part of the same group of companies) directly or indirectly holds at least 10% of the equity shares and voting rights;
- The transaction constitutes a debt owed by that foreign company to the resident company or any company that forms part of the same group of companies as that resident company;

- The foreign company is not obligated to redeem that debt in full within 30 years from the date on which the debt was incurred;
- The redemption of the debt in full is conditional upon the market value of the assets of the foreign company not being less than its liabilities; and
- No interest accrued in respect of the debt during the year of assessment.

A loan that meets the above criteria is in substance exposed to the same economic risk as equity and thus poses little or no risk to the South African tax base if interest is under-charged as interest should not be charged at all as an economic matter (National Treasury, 2013a:Section 5.8). According to National Treasury (2013a:Section 5.8) taxpayers should not be forced to pay tax on notional interest from a share loan that is in substance nothing more than share capital.

The above-mentioned exemptions illustrate that the policymakers are aware of the detrimental effects that double taxation may have on investment opportunities and relief from possible double taxation has been provided for in the legislation. Thus the legislation is accommodating when the risk of tax avoidance and tax arbitrage is low, when it is clear that tax considerations are not the reason for financial assistance, and when there is a reason to believe that the tax system may be an obstacle to investment opportunities.

2.3.5 Summation and conclusions on transfer pricing

In the absence of transfer pricing provisions in the legislation, it is relatively easy for MNEs to price intra-group transactions so that profits are taxed in low tax jurisdictions while obtaining deductions in high tax jurisdictions (Olivier & Honiball, 2011:620). Financial assistance, which includes thin capitalisation schemes between a connected resident and non-resident, falls under the transfer pricing rules found in section 31 of the Act (Millar, 2017:29, SARS, 2010:76).

The criticism against the repealed safe harbour debt-to-equity ratio is that it conflicts with the fairness and efficiency tax policy principles as one debt-to-equity ratio is established for all business types and it does not limit absolute debt levels. In contrast, the arm's length principle recognises that entities may have different levels of interest expenses depending on circumstances. However, some countries that have experience in applying the arm's length principle express concerns on how effective it is in preventing BEPS. According to Finke *et al.* (2014:4-5) due to a lack of non-comparable transactions to apply the arm's length principle, the possibilities for extensive profit shifting remain for inter-group interest payments, as an extensive range of levels of debt and corresponding interest rates may be justifiable. Thus some countries are of the view that the arm's length principle could be complementary to other measures.

Transfer pricing legislation seeks to place transactions between related parties and non-related parties on equal footing, by adjusting the income and expenses of related parties if they fail to transact at arm's length (Flanagan, 2017:132). The possible reasons for not transacting at arm's length could be to avoid Dividends Tax, or to exploit the advantage provided by the inefficient tax treatment of debt and equity financing. With the introduction of withholding tax on interest in South Africa, the question arises whether these reasons are still valid for excess interest payments as interest paid to non-residents are subject to a withholding tax when interest is paid or is due and payable. Furthermore, the "due and payable" provision implies that withholding tax on interest must be paid even when the interest is not yet paid by the creditor (Horn, 2017:30). This results in cash flow issues to make payment to SARS (Horn, 2017:30). Please refer to section 3.4 for a further discussion on withholding tax on interest.

Warneke (2014:15) is of the opinion that the repeal of the deemed loan and introduction of a deemed dividend as a secondary adjustment is a generally well-received amendment. The views expressed by Warneke infer that a secondary adjustment in the form of a deemed dividend is not considered to be inequitable. Value is distributed via excess non-arm's length payment and thus represents a "dividend". By re-characterising the non-arm's length amount to a dividend and by imposing a Dividends Tax, the revenue authorities are using taxes to correct market inefficiencies. The researcher cautions that this view is expressed when the transfer pricing provision is viewed in isolation and not in conjunction with the withholding tax on interest provisions.

On the issue of applying the reduced DTA rates on the deemed dividend, Strauss (2017:47) is of the view that the deemed dividend does not qualify as a dividend for Article 10 of the OECD MTC. Strauss states that the denial of a reduced DTA rate is in line with the DTC. Furthermore, relief afforded under the anti-avoidance provisions will make these anti-avoidance provisions less effective in addressing the mischief sought to be addressed, i.e. BEPS (Strauss,2017:47). Consequently, the secondary adjustment is subject to Dividends Tax of 20%.

The exemption provided to headquarter companies, high taxed CFCs and equity loans illustrates that the policymakers are aware of the detrimental effects that double taxation may have on investment opportunities and thus the legislation provides relief in these circumstances.

2.4 Withholding tax on interest

2.4.1 Background to withholding tax on interest

A mechanism used to divide taxing rights between source and residence countries is to allow the capital importing or source country to apply its domestic taxing law to income repatriated to foreign investors by imposing a ‘cap’ on the domestic taxing rights (Daurer & Krever, 2014:9). This rule is used for three types of income derived by non-resident investors, namely interest, dividends and royalties (Daurer & Krever, 2014:9). To avoid the practical difficulties that would be encountered in assessing foreign recipients of interest, dividends and royalties for tax on their receipts and then collecting tax from them when they have no assets in the source jurisdiction apart from ownership of intangible property in the form of debt, company shares or intellectual property, countries commonly collect income tax on these three types of income by the use of a withholding tax system (Daurer & Krever, 2014:9). A withholding tax is a tax levied by the source country at a flat rate on the gross amount of dividends, royalties, interest or other payments made by residents to non-residents (Olivier & Honiball, 2011:851). The tax is collected and paid to the government by the resident payer (Olivier & Honiball, 2011:851). Collecting tax in this manner ensures that the tax does not escape from the source country that it was earned in (Govan, 2014:22). Given the ongoing intense public debate on profit shifting and "aggressive" tax planning by MNEs, withholding tax is an appropriate measure to ensure MNEs pay a fair share of taxes in countries that they operate in (Fuest, Spengel, Finke, Heckemeyer & Nusser, 2013:15). To the extent that these withholding taxes are actually collected, the transactions to which they relate become less attractive as vehicles for artificially shifting profits out of the resident country (Irish, 1986:103).

Effective from 1 March 2015, any interest paid to or for the benefit of any non-resident, is subject to a 15% withholding tax, to the extent that the interest amount is regarded as having been received or accrued from a source within South Africa (section 50B(1) of the Act). National Treasury acknowledges that there is a continued need to attract foreign lending and to remain competitive in the international debt capital markets. However, the section 10(1)(h) blanket interest exemption does not achieve a fair balance between the attraction of foreign debt capital and the need to protect the tax base against potential erosion (SARS, 2010:69). The rationale behind the introduction of the withholding tax on interest is as follows (SARS, 2010:69-70):

- Section 10(1)(h) exemption of cross-border interest often results in schemes designed to undermine the tax base. At the heart of these schemes is the payment of interest to non-residents to obtain a tax deduction without a corresponding taxable income, thereby undermining the domestic tax base. These payments are then indirectly retained or controlled by the relevant parties, with the funds coming back tax-free for example as exempt dividends by utilising the participation exemption provisions in the Act;
- Section 10(1)(h) interest exemption presents foreign investors with an incentive to fund businesses with a disproportionate amount of debt as opposed to equity; and
- Section 10(1)(h) interest exemption provides foreign debt with a tax advantage over local debt, as the interest earned on local debt is fully taxable.

In addition to the afore-mentioned reasons advanced by National Treasury, further justification for the introduction of withholding tax on interest in light of BEPS activities is the possible curtailment of treaty shopping. Oguttu (2007:255) is of the view that the lack of withholding tax on interest earned by non-residents is a loophole in South African tax law that can be exploited for treaty shopping purposes. Treaty shopping is the exploitation of a country's treaty network by residents of a non-treaty country in order to obtain treaty benefits that are not available to them, by interposing a conduit company in one of the contracting states with a purpose of shifting profits (Oguttu, 2007:237). This results in a tremendous loss of tax revenue for the countries party to the treaty (Oguttu, 2007:237).

2.4.2 *Reduced withholding tax rate*

When compared to South Africa's corporate tax rate of 28%, it is noted that the rate of the withholding tax on interest of 15% is significantly lower. This 15% rate is further reduced by the operation of a DTA (section 50E(3)). According to Olivier and Honiball (2011:285), South Africa's DTAs are generally based on the OECD Model Tax Convention (MTC). The **maximum** withholding tax rate on interest income prescribed by the OECD model treaty is 10% (Daurer & Krever, 2014:17).

Low-interest withholding tax rates coupled with full deductibility of interest expenditure implies that tax savings could be realised through reasonably straightforward arbitrage transactions (Tanzi & Zee, 2000:311). Zee (1998:595) argues that the incentive for profit shifting through thin capitalisation could be eliminated by setting a withholding tax rate as high as the sum of the corporate income and dividends withholding tax rate. This high withholding tax rate would bring about neutrality between foreign debt and foreign equity financing (Zee, 1998:595). However, in practice, the international norm of interest withholding tax rate being much lower than corporate income rates is due to either treaty agreements or unilateral decisions not to impose high rates (Zee, 1998:595). The concern with high-interest withholding tax rates is the perceived detrimental effects on attracting foreign investment (Zee, 1998:595; Olivier & Honiball, 2001:4). However, by not imposing a withholding rate that is the same as the corporate tax rate, interest payments continue to offer profit shifting opportunities by taking advantage of the differences in tax rate (Irish, 1986:103).

2.4.3 *Withholding tax refunds*

There are two kinds of withholding tax, namely a creditable withholding tax and a final withholding tax (Domo & Boo, 2011:4). Under the creditable withholding tax system, the amount withheld is an estimate or a pre-payment of the tax liability

(Domo & Boo, 2011:4). The taxpayer is required to file an income tax return whereby the final tax liability is computed and the pre-paid amount is deducted from the final tax liability on assessment (Domo & Boo, 2011:4). Under this system, on assessment, the revenue authorities may be in a position where it may owe the non-resident if the pre-paid amount withheld exceeds the actual tax liability (Van der Zwan, 2018a:782).

In contrast, there is no requirement to file an income tax return by the taxpayer under the final withholding tax system (Domo & Boo, 2011:4). The withholding tax on interest enacted in South Africa's domestic law is a final withholding tax (section 50B(3) of the Act). As there is no requirement to file a return, the Act allows for withholding tax on interest to be refunded ***ONLY*** (own emphasis) under the following circumstances:

2.4.3.1 Irrecoverable interest

Section 50B(2) of the Act deems interest to be paid on the earlier of the date on which interest is paid or becomes due and payable (the Act). Where the withholding tax was paid on interest that had become due and payable, and subsequently the unpaid interest becomes irrecoverable as the outstanding debt becomes irrecoverable, the related withholding tax on the irrecoverable interest is refundable by the Commissioner of SARS (section 50G(2) of the Act). It should be noted that although section 50G(2) is deemed to have come into operation on 1 March 2015, it was only promulgated on **19 January 2017** (own emphasis) under the Taxation Laws Amendment Act 15 of 2016 (South Africa, 2017b:76). The explanatory memorandum acknowledges that there is no mechanism in the legislation to obtain relief for the tax paid on interest that becomes irrecoverable at a later stage (National Treasury, 2016:73). The oversight in the legislature was in contrast to the approach in respect of income tax where, if the non-resident is a South African taxpayer, the non-resident would have paid income tax on accrued interest but would have been able to claim a deduction in respect of any irrecoverable interest by utilising section 11(i) of the Act (National Treasury, 2016:73). To grant relief where interest withholding tax is paid on interest that becomes due and payable but is not actually paid, section 50G(2), provides a mechanism for the refund of the tax, when the interest becomes irrecoverable (the Act).

2.4.3.2 Overpayment due to the non-application of DTA rates

The only other circumstance when a refund is available on tax paid is when there is an overpayment of tax on interest, due to the fact that the non-resident did not submit the necessary declaration to the withholding agent, that either the interest is exempt from tax or qualifies for a reduced rate as determined by the relevant DTA.

It is therefore submitted that when the non-arm's length interest is re-characterised to "dividend income" under the transfer pricing provision and is also subject to withholding tax on interest, there is no relief for the non-resident in the form of a refund, nor can the non-resident submit an income tax return to claim a "refund" for the interest that is re-characterised to dividend income.

2.4.4 Summation and conclusions on withholding tax on interest

Withholding tax on interest serves a dual purpose. Firstly, it is a mechanism used to divide taxing rights between source and residence countries, thereby ensuring that MNEs pay a fair share of taxes in countries that they operate. Secondly, by subjecting interest payments to a withholding tax, they become less attractive as vehicles for artificially shifting profits out of the resident country. However, by not imposing a withholding rate that is the same as the corporate tax rate, interest payments continue to offer profit shifting opportunities by taking advantage of the differences in tax rate. The justification for a lower withholding tax rate is to eliminate the perceived detrimental effects on attracting foreign investment. Hence it appears that the legislation attempts to minimise disincentive effects on foreign investments by imposing a rate of 15%.

Of significance to the research are the circumstances when the withholding tax on interest is refunded. The legislation takes cognisance of situations that require relief for example interest payments that have become irrecoverable. From a policy point of view, the refund on irrecoverable interest indicates that when an oversight in the legislature is detected, steps are taken to rectify the oversight. It is therefore questionable whether it is an oversight of the legislation that no relief is provided when the non-arm's length interest is subject to both withholding tax on interest and Dividends Tax.

2.5 Discussion on the relationship between transfer pricing adjustments and withholding tax on interest

The research undertaken thus far indicates that the following factors justify the **co-existence** of transfer pricing provisions and withholding tax on interest to curb BEPS:

- Owing to the fact that in many cases no comparable transactions between independent persons exist to apply the arm's length principle, the possibilities for extensive profit shifting remain for inter-group interest payments despite transfer pricing rules (Finke *et al.,* 2014:4-5);
- Withholding tax by allocating taxing rights between the source and residence country is an appropriate measure to ensure MNEs pay a fair share of taxes in countries that they operate in;

- When interest payments are subject to withholding tax on interest, they become less attractive vehicles for artificially shifting profits out of the country (Irish,1986:103). However, when the withholding tax rate is lower than the corporate tax rate, interest payments continue to offer profit shifting opportunities by taking advantage of the differences in tax rate (Irish, 1986:103); and
- Low-interest withholding tax rates (as is the case of South Africa) coupled with full deductibility of interest expenditure implies that tax savings could be realised through reasonably straightforward arbitrage transactions (Tanzi & Zee, 2000:311).

Therefore, both measures are required to work in tandem to offset the limitations of each individual measure. Interest deductions must be limited to an arm's length amount to compensate for the low-interest withholding tax rate and interest payments must be subject to withholding tax to compensate for the lack of comparables to apply the arm's length principle. Consequently, these two provisions should not be viewed in isolation especially since the two taxpayers that it targets is viewed as a single entity without regard for the legal or geographical boundaries of the separate legal entities.

However, an analysis of these two provisions indicates that they run in parallel with no reference made in the transfer pricing provisions to withholding tax on interest and vice versa. Thus when the non-arm's length interest is re-characterised to dividend income in the transfer pricing provision, it retains its interest nature in the withholding tax on interest provisions and hence is subject to both Dividends Tax and withholding tax on interest. The non-arm's length amount according to the legislation is both interest income and dividend income resulting in double taxation. According to McClure (cited by Kwall, 1990:615), double taxation is criticised for being contrary to the fundamental principles of equity and efficiency (economic neutrality) of a good tax system.

An additional problem is that two taxpayers subject to a transfer pricing adjustment are not treated similarly when the underlying transaction differs in nature. For example, both sale of goods and interest payments are subject to the arm's length principle under the transfer pricing provisions. However, a comparison of the tax expense indicates that interest payments subject to a transfer pricing adjustment imposes a greater tax burden due to the double taxation on the non-arm's length interest. Table 2-1 depicts the two scenarios which illustrate that a taxpayer who is subject to a transfer pricing adjustment on the sale of goods is better off than a taxpayer who is subject to a transfer pricing adjustment on an interest payment, thereby violating the horizontal equity principle:

Table 2-1: Transfer pricing adjustment: the difference in tax expense between sale of goods and interest payments

	Transfer pricing adjustment on sale of goods	**Transfer pricing adjustment on interest payments**
Non-arm's length amount	R1 000	R1 000
Primary adjustment: Corporate income tax @ 28%[1]	R28	R28
Secondary adjustment: Dividends Tax @ 20%[2]	R20	R20
Withholding tax on interest @ 15%[3]	R0	R15
Tax expense[1+2+3]	**R48**	**R63**

Source: Researcher's own compilation based on tax legislation

The words of Kruger (2015:12) are very apt in this situation, where an interest payment is subject to both a transfer pricing adjustment and withholding tax on interest. Kruger (2015:12) states that it is unlikely that the fiscal authorities are concerned where a taxpayer pays interest, and the creditor is fully taxable on the receipt. It is only where the creditor is exempt from tax on the interest receipt, or the creditor is subject to tax at a significantly lower rate of tax on such receipt for whatever reason, that the warning bells ring loud and clear. Oguttu (2015:521) states that the cycle of continuous amendments aimed at closing loopholes in tax legislation in order to curb tax avoidance schemes has complicated most countries' corporate income tax provisions. It is therefore questionable whether the outcome of the non-arm's length amount being taxed both as interest and dividend income is intended by the legislature or an oversight and unintended effect of the legislature (Van der Zwan, 2016:34).

The withholding tax on interest imposed on non-residents serves to offset the effect of interest payments deducted by resident taxpayers (UN, 2017a:10), creating tax symmetry. It would therefore be expected that tax symmetry be reciprocated when there is a transfer pricing adjustment. However, when the interest deduction is limited by a transfer pricing adjustment, the non-resident is still subject to paying the withholding tax on the full unadjusted amount. In other words the tax base of the resident company which is taxable income is increased by the transfer pricing adjustment while the tax base for interest income which is subject to the interest withholding tax remains constant. Consequently, there seems to be a deviation from the tax symmetry principle and from the tax policy to raise revenue in ways that are equitable, as put forward by Tanzi and Zee (2000:299) for developing countries.

Tanzi and Zee (2000:310) agree that violating the tax symmetry principle leads to distortions and inequities. However, they are of the view that under certain circumstances deviation from the tax symmetry principle is acceptable provided that clear policy objectives justify the deviation. The example cited by Tanzi and Zee (2000:310), where such violation of the tax symmetry principle is justifiable is when countries find it prudent to place limits on the deductibility of capital losses in any given year or the number of years' losses of any kind can be carried forward to prevent excessive tax avoidance. Hence the justification is based on clear policy objectives to prevent excessive tax avoidance.

Except for the mutual agreement procedure (MAP) guide that was released in July 2018 by SARS, neither the legislation, nor any explanatory memorandum or any interpretation note discusses how an interest payment that is subject to both a transfer pricing adjustment and withholding tax should be treated. It is therefore questionable whether the tax symmetry deviation is justified by any clear policy objectives. This is inferred from the approach taken in the MAP guide that suggests "relief" may be granted via MAP in the case of secondary transfer pricing adjustments, withholding tax and repatriation on transfer pricing adjustments (SARS, 2018:23-24). Please refer to section 3.5 for a more detailed discussion on MAP.

Based on the analysis of the transfer pricing and withholding tax on interest provisions, it appears that the tax consequences on an interest payment that is subject to both a transfer pricing adjustment and withholding tax on interest is inequitable due to the double taxation on the non-arm's length amount. The double taxation on the non-arm's length amount may have a disincentive effect on economic activities. This is inferred by the OECD's view that double taxation can create a barrier to cross-border transactions in goods and services and the movement of capital (OECD, 2017a:15).

2.6 Chapter conclusion

The analysis of the domestic law indicates that to curb BEPS, the co-existence of transfer pricing rules and withholding tax on interest is necessary in the South

African tax legislation, in order to offset the limitations that are found in both of these anti-avoidance measures.

Evidence indicates that interest deductions in South Africa must be limited to an arm's length amount to compensate for the full deductibility of interest expenditure, coupled with a withholding tax rate of 15% that is lower than the corporate tax rate of 28%. Low-interest withholding tax rates together with full deductibility of interest expenditure implies that tax savings could be realised through reasonably straightforward arbitrage transactions (Tanzi & Zee, 2000:311) and thus continue to offer profit shifting opportunities. Owing to the fact that in many cases no comparable transactions between independent persons exist to apply the arm's length principle, the possibilities for extensive profit shifting remain for inter-group interest payments despite transfer pricing rules (Finke *et al.,* 2014:4-5). Therefore, interest payments must be subject to withholding tax to compensate for the lack of comparables to apply the arm's length principle. Consequently these two anti-avoidance provisions should not be viewed in isolation especially since the two taxpayers that it targets in most cases are viewed as a "group of companies" where the non-resident MNE provides significant financial support to the resident taxpayer. However, an analysis of these two provisions indicates that they run in parallel with no reference made in the transfer pricing provisions to withholding tax on interest and vice versa. Thus when the non-arm's length interest is re-characterised to dividend income in the transfer pricing provision, it retains its legal character of interest in the withholding tax on interest provisions. Consequently the non-arm's length interest is subject to both withholding tax on dividends and interest. The non-arm's length amount according to the legislation is both interest income and dividend income resulting in double taxation. According to McClure (cited by Kwall, 1990:615), double taxation is criticised for being contrary to the fundamental principles of equity and efficiency (economic neutrality) of a good tax system.

An additional problem identified is that two taxpayers subject to a transfer pricing adjustment are not treated equally when the underlying transaction differs in nature. A comparison of the tax expense (as presented in Table 2-1) indicates that a taxpayer who is subject to a transfer pricing adjustment on the sale of goods is in a better tax liability position than a taxpayer who is subject to a transfer pricing adjustment on an interest payment. Interest payments subject to a transfer pricing adjustment impose a greater tax burden due to the double taxation on the non-arm's length interest, that is subject to both Dividends Tax and withholding tax on interest. This unequal treatment when the underlying transaction differs in nature appears to violate the horizontal equity principle of a good tax system.

Oguttu (2015:521) is of the view that the cycle of continuous amendments aimed at closing loopholes in tax legislation in order to curb tax avoidance schemes has complicated most countries' corporate income tax provisions. It is therefore questionable whether the outcome of the non-arm's length amount being taxed both as interest and dividend income is intended by the legislature or an oversight and unintended effect of the legislature (Van der Zwan, 2016:34).

Based on the analysis of the transfer pricing and withholding tax on interest provisions, it appears that the tax consequences on an interest payment that is subject to both a transfer pricing adjustment and withholding tax on interest, violates the equity and efficiency principles of a good tax system. This inequitable result is due to the double taxation on the non-arm's length interest amount which is subject to both Dividends Tax and withholding tax on interest. The double taxation on the non-arm's length interest amount may have a disincentive effect on economic activities. This is inferred by the OECD's view that double taxation can create a barrier to cross-border transactions in goods and services and the movement of capital (OECD, 2017a:15).

Chapter 3

3 Analysis of domestic law against OECD and UN guidelines

The development of international tax rules has been left mainly to the OECD and UN (Olivier & Honiball, 2011:5). The UN has historically championed the cause of developing countries in international tax issues (Oguttu, 2015:547). The UN participates in the tax work of the OECD to provide insights into concerns peculiar to developing countries (Oguttu, 2015:547). Due to the fact that the OECD and UN are the driving forces for shaping rules and standards regarding international taxation (Olivier & Honiball, 2011:5; Araki, 2016:72), the standards, guidelines, and best practice approach of the OECD and UN will be utilised to determine how South Africa's legislation compares against international standards when an interest payment is subject to both a withholding tax on interest and a transfer pricing adjustment. Furthermore, the chapter will analyse the OECD and UN MTCs to determine how the MTCs address transfer pricing adjustments and interest income to avoid double taxation. The purpose of the analysis is to address the secondary objective set out in section 1.5.

The rationale for analysing South Africa's legislation against international standards is twofold. Firstly, Tanzi and Zee (2000:299) are of the view that the tax authorities of developing countries that wish to integrate with the international economy, should aim to raise revenue in ways that do not deviate substantially from international norms. Secondly, according to the OECD (2011:2-3) it is desirable to avoid any significant discrepancy between domestic legislation and internationally agreed principles as alignment of domestic rules with internationally accepted principles can (OECD, 2011:2-3):

- provide countries with the tools they need to fight artificial shifting of profits out of their jurisdiction by MNEs;
- provide MNEs with some certainty on the tax implications of transactions carried out in the country concerned;
- reduce the risk of economic double taxation;
- provide a level playing field between countries, which is less likely to distort the pattern of international trade and investment; and
- provide a level playing field between MNEs and independent enterprises doing business within a country.

An analysis of the OECD and UN standards, guidelines, best practice approach and MTCs will offer insights as to whether an interest payment subject to a transfer pricing adjustment and withholding tax on interest in South Africa is equitable and aligned to international standards.

3.1 OECD BEPS action plan on interest expense

Developed in the context of the OECD/G20 BEPS project, 15 action points have been formulated to equip governments with domestic and international instruments to tackle tax avoidance by emphasising that profits must be taxed where economic activities generating the profits are performed and where value is created (OECD). The BEPS package of measures represents the first significant overhaul of international tax rules in almost a century (OECD, 2015c:3). Implementation of the new measures are critical to the success of the BEPS planning strategies as strategies that rely on outdated rules or poorly co-ordinated measures will be rendered futile (OECD 2015c:3).

Due to the fact that the use of third party and related party interest expense is one of the most effortless profit shifting techniques available, the OECD's, "Limiting base erosion involving interest deductions and other financial payments, Action 4" (BEPS Action 4) of the BEPS Action Plan called for:

> [development of] recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments (OECD, 2015b:15).

Thus, BEPS Action 4 makes recommendations for best practices in the design of rules to deal with BEPS using interest and payments economically equivalent to interest, by aligning interest deductions with taxable economic activity (OECD, 2015b:18). The OECD's recommended approach is based on a fixed ratio rule which limits an entity's net deduction for interest to a percentage of its earnings before interest, taxes, depreciation and amortisation (OECD, 2015b:11). In principle sections 23M and 23N of the Act are based on the OECD's recommended approach as these two sections limits an entity's interest deduction to a percentage of its earnings before interest, taxes, depreciation and amortisation.

The best practice approach of a fixed ratio rule should offer an effective solution to BEPS involving interest payments (OECD, 2015b:27). However to combat BEPS or to attain other tax policy goals, countries are free to effect stricter rules than the best practice approach (OECD, 2015b:27). For instance, the best practice fixed ratio approach may be supplemented by additional general or targeted interest limitation rules which a country has identified as suitable to deal with the risks it faces (OECD, 2015b:27). The discussion to follow will therefore focus on the interaction of the OECD's best practice approach with withholding taxes and the arm's length test, as these are enacted in South Africa's domestic law in addition to sections 23M and 23N to combat BEPS involving interest payments.

3.1.1 Interaction of best practice approach with withholding taxes

According to the OECD, although withholding taxes is primarily utilised to allocate taxing rights to a source country, they may also be used to deter BEPS transactions (OECD, 2015b:20). However, opportunities for BEPS would remain if the withholding tax rate applied is not the same as the corporate rate (OECD, 2015b:20). In practice when applying the provisions of the relevant DTA, the withholding tax rate is reduced[5] and sometimes the rate is reduced to zero (OECD, 2015b:20). The OECD is also of the view that in some instances withholding taxes can influence BEPS behaviour, where groups enter into structured arrangements to avoid imposition of a tax or generate additional tax benefits such as multiple entities claiming tax credits with respect to the tax withheld (OECD, 2015b:20). These are some of the reasons why the OECD believes that withholding taxes would not be a suitable tool for completely addressing the BEPS risks (OECD, 2015b:20). However, countries may apply withholding tax in conjunction with the OECD best practice (OECD, 2015b:20). Furthermore, as withholding tax on interest is typically imposed to allocate taxing rights over income to a source country, it should not be impacted by the application of the best practice approach used to limit interest deduction to protect the source country from base erosion (OECD, 2015b:82). Where the best practice approach leads to an interest disallowance, there is no intention for the disallowed interest to be re-characterised for any other purpose (OECD, 2015b:82). Thus withholding tax on interest under domestic law would continue to apply to interest payments made without regard to interest deduction limitations (OECD, 2015b:82) as there is ***no re-characterisation of the disallowed interest*** (own emphasis).

[5] The reduced rate is enacted in the Act (Please refer to section 2.4.2)

The report further states that where a country re-characterises disallowed interest for example to a deemed dividend, it may continue to apply this treatment, but this re-characterisation is not part of the best practice approach (OECD, 2015b:82).

3.1.2 Interaction of best practice approach with arm's length test

According to the OECD, the arm's length test is useful to complement other rules, for example in pricing the interest income and expense of an entity before applying the interest limitation rules (OECD, 2015b:20). However, they are not considered best practice in addressing BEPS involving interest payments if they are not strengthened with other interest limitation rules (OECD, 2015b:20). The following reasons are put forward as to why the arm's length test is not considered best practice (OECD, 2015b:19-20):

- As each entity is considered separately after arrangements are entered into, the outcomes of applying a rule can be uncertain;
- Countries have experience of groups structuring intra-group debt with equity-like features to justify payments significantly in excess of those the group actually incurs on its third-party debt; and
- It does not prevent an entity from claiming an interest expense deduction on an income stream which is considered a base erosion risk.

For the reasons set out above, the OECD is of the view that withholding taxes and the arm's length test acting on their own, do not address all of the objectives of BEPS Action 4 set out in the BEPS Action Plan (OECD, 2015b:20). Subsequently they are not considered to be best practice in addressing BEPS involving interest payments if they are not strengthened with other interest limitation rules (OECD, 2015b:20). Nevertheless, withholding taxes and the arm's length test may still have a role to play alongside the best practice approach, either in supporting the best practice approach or in fulfilling other tax policy goals (OECD, 2015b:20). Accordingly after introducing the best practice approach, a country may also continue to apply the arm's length test or withholding tax as long as these do not reduce the effectiveness of the best practice in dealing with BEPS (OECD, 2015b:20-21).

In the South African context, sections 23M and 23N of the Act are in principle based on the OECD's recommended approach in limiting the interest deduction. In addition to sections 23M and 23N, South African tax law levies a withholding tax on interest paid to non-residents and utilises the arm's length test to place transactions between related and non-related parties on an equal footing, to ensure that those that are engaged in related party and non-related party transactions are paying the same amount of tax.

The withholding tax on interest levied in South Africa may be viewed as fulfilling other tax policy goals as it was introduced to eliminate the tax asymmetry (deduction/exemption mismatch) that was present in the South African tax legislation. The deduction/exemption mismatch was due to the fact that sections 11(a) and 24J of the Act allowed interest payments made to a non-resident by a resident taxpayer to be a tax deductible expense, while section 10(1)(h) exempts interest received by or accrued to a non-resident from normal income tax (SARS, 2013:37). This deduction/exemption mismatch was shrinking the South African tax base (SARS, 2010:Section 5.1).

In South Africa, the arm's length test is embodied in the transfer pricing legislation. According to National Treasury, in a cross-border context where the debtor and creditor are connected persons, excessive interest can arise if the interest yield is driven by tax considerations as opposed to arm's length commercial reasons.

(National Treasury, 2013b:2). In these cases transfer pricing adjustments can be used to eliminate debt with excessive interest or excessive debt (National Treasury, 2013b:2). Thus the arm's length test in South Africa, is useful in pricing the interest expense of an entity before applying the interest limitation rules, thereby supporting the OECD's best practice approach.

Evidence suggest that South Africa's domestic law in limiting interest deductions is aligned to the OECD's fundamental principles as the withholding tax on interest may be viewed as fulfilling other tax policy goals as it was introduced to eliminate the tax asymmetry that was present in the legislation; and the arm's length test is useful in pricing the expense of an entity before applying the interest limitation rules, thereby supporting the best practice approach. However, the point to reflect on is that according to the OECD when applying the best practice approach, the withholding tax on interest under domestic law will continue to apply to interest payments made without regard to interest deduction limitations as long as there is no re-characterisation of the disallowed interest, for example to a deemed dividend. In other words, the OECD's view is that should the disallowed interest be re-characterised to a deemed dividend, it would lose its legal character of interest and therefore should not be subject to withholding tax on interest, as it is now considered a deemed dividend. In the South African context, there is no re-characterisation of the disallowed interest to a deemed dividend under sections 23M and 23N of the Act. Instead a re-characterisation of the disallowed interest to a deemed dividend takes place under section 31 of the Act (the transfer pricing provisions).

Section 31(2) of the Act states that payments made by South African tax residents to connected non-residents are only tax deductible up to the arm's length price (the Act). This limitation of interest deduction to the arm's length price is a transfer pricing adjustment referred to as the primary adjustment (Van der Zwan, 2018a:823). The primary adjustment seeks to ensure that there is a correct allocation of taxable profit between the resident and non-resident to reflect the arm's length price (OECD, 2012:15; Wiesener, 2011:17). The primary adjustment does not take into account the cash benefit, that is the interest which is paid in excess of the arm's length interest that is retained by the non-resident (Wiesener, 2011:17). The amount paid in excess of the arm's length price is deemed to be a dividend consisting of a distribution of an asset *in specie* (section 31(3) of the Act) and attracts Dividends Tax of 20% (South Africa, 2017a:10). This is referred to as the secondary transfer pricing adjustment (Van der Zwan, 2018a:823).

Applying the OECD's (2015b:82) assertion that withholding tax on interest under domestic law would continue to apply to interest payments made without regard to interest deduction limitations as there is ***no re-characterisation of the disallowed interest*** (own emphasis), the following may be inferred:

- The withholding tax on interest will continue to apply on interest disallowed under the transfer pricing provisions only if the disallowed interest is not re-characterised to a deemed dividend;
- Conversely, if there is re-characterisation of the disallowed interest to a deemed dividend, there should be no withholding tax on interest as the status of the disallowed interest has been changed to a deemed dividend.

However, under the South African tax law, when the disallowed interest is re-characterised to a deemed dividend under the transfer pricing provisions, the disallowed interest still retains its legal character of interest under the withholding tax on interest provisions. Thus in South Africa the disallowed interest expense is subject to both interest and dividends withholding tax, which is not part of the OECD's best practice approach in limiting interest deductions. The non-arm's length interest according to the South African legislation is both interest income and dividend income subject to interest and dividends withholding tax respectively, resulting in double taxation (Please refer to section 2.5 for a detailed discussion).

3.2 UN guidance on the limitation of interest deduction

The UN practical portfolio on Protecting the Tax Base of Developing Countries against Base-eroding Payments: Interest and Other Financing Expenses (UN Practical Portfolio), deals with the basic patterns of addressing the deductibility of interest and the treatment of cross-border interest payments that are commonly found in the domestic laws and tax treaties of many countries (UN, 2017a:5).

According to the UN Practical Portfolio, when interest payments are excessive or are exempt from, or subject to reduced withholding tax, or the related income is not subject to tax or subject to preferential tax, a country's tax base is improperly eroded and counter-measures to avert such base erosion may be apt (UN, 2017a:9). When interest is paid by a resident of one country to a related non-resident, the potential for tax avoidance and base erosion is increased. In this instance transfer pricing is a serious concern if the rate of interest charged is unreasonably high or low, or if the amount of debt on which the interest is paid is unreasonably high or low (UN, 2017a:22).

It is common practice in developing countries to impose withholding taxes on payments of interest to non-resident lenders with the view of raising tax revenue that to a certain degree offsets the tax cost of the deduction of the interest (UN, 2017a:47). In South Africa, prior to 1 March 2015, although the domestic law allowed interest payments made to non-residents to be tax deductible by the resident taxpayer, there was no tax revenue derived from non-residents. This was due to the fact that section 10(1)(h) of the Act, exempts interest income earned by a non-resident who is in South Africa for less than 183 days from income tax. Thus no tax revenue was raised from non-residents to offset the tax cost of the deduction of interest by the resident taxpayer. Effective from 1 March 2015, a 15% withholding tax on interest is levied on all interest paid or is due and payable to a non-resident (South Africa, 2015:128), to eliminate the deduction/exemption mismatch that was present in the South African legislation. By enacting a withholding tax on interest, South Africa has aligned itself with a common practice of developing countries.

The UN Practical Portfolio further states that robust transfer pricing or equivalent rules are required to ensure that interest deductions between related parties are limited to an arm's length amount, when the withholding tax rate is lower than the country's corporate tax rate or when a DTA limits the withholding tax rate (UN, 2017a:23). In South Africa, the withholding tax rate is lower than the corporate tax rate of 28% and the legislation provides for a reduced DTA rate for the withholding tax on interest (Refer to section 2.4.2 for a detailed discussion). Thus, according to the UN Practical Portfolio, South Africa is justified in limiting interest deductions between related parties to an arm's length amount as South Africa's withholding tax rate of 15% is lower than the corporate tax rate of 28% and the South African legislation provides for a reduced withholding tax rate in accordance with the applicable DTA.

According to the UN Practical Portfolio, in addition to transfer pricing rules, many countries use thin capitalisation rules or earnings-stripping rules to prevent the deduction of excessive interest (UN, 2017a:26). The UN Practical Portfolio does raise the question on the characterisation of the disallowed interest. Should it retain its legal character as interest or should it be re-characterised to dividends (UN, 2017a:38)? According to the UN Practical Portfolio this question may have significant consequences for a country’s withholding tax if the rates of withholding tax on interest and dividends differ under domestic law or the country's tax treaties (UN, 2017a:38). Although a solution is not provided in the guidelines, it does indicate that the disallowed interest cannot be subject to both a withholding tax on interest and dividends by highlighting that policymakers need to consider the impact when deciding to retain the legal character of the interest or the re-characterisation to dividend income (UN, 2017a:38). An example would be a case where a country has entered into tax treaties that limit the rate of withholding tax on interest to 15%, but the Dividends Article limits the rate of withholding tax on dividends paid to a non-resident company that owns at least 25% of the payer's share capital to 5%. Consequently, if the country's domestic law deems any disallowed interest to be a dividend, the result may be to confer an unintentional benefit on the non-resident shareholder in the form of a reduced withholding tax (UN, 2017a:38).

It is therefore evident that in terms of the UN Practical Portfolio that are based on common practices of countries, South Africa's domestic law in limiting interest deductions is aligned to international practice except for the double taxation on the disallowed interest that is re-characterised to a deemed dividend. The guideline highlights that policymakers should consider the impact of the dividends and interest withholding tax rates when determining whether the disallowed interest should retain its legal character or be re-characterised to dividend income. The UN Practical Portfolio thus suggests that the disallowed interest cannot be subject to both withholding tax on interest and dividends, as is the case under South Africa's domestic law.

3.3 Analysis of the OECD and UN Model Tax Conventions (MTCs)

International double taxation is an inherent risk in cross-border trading (Olivier & Honiball, 2011:6). The growth of MNEs presents progressively intricate taxation issues for tax administrators, as separate country rules for the taxation of MNEs cannot be viewed in isolation but must be addressed in a broad international context (OECD, 2017a:15). Relief from international double taxation may be provided under domestic law or the relevant DTA (Olivier & Honiball, 2011:6).

Both the OECD and UN have developed Model Tax Conventions (MTCs), which are used by countries as a basis for drafting individual DTAs (Olivier & Honiball, 2011:5). The main intention of the OECD MTC is to offer a means of settling on a uniform basis the most frequent problems that arise in the field of international juridical double taxation (OECD, 2017:9). The analysis to follow focuses on Articles 9 and 11 which addresses transfer pricing adjustments and interest income respectively.

3.3.1 Article 9 [6] of the MTCs: Associated Enterprise

The arm's length principle is the international standard that OECD member countries have agreed should be used for determining transfer prices for tax purposes (OECD, 2017a:23). According to the OECD, adopting the arm's length principle can be instrumental in achieving the objective of protecting a country's tax base without creating double taxation or uncertainties that could hinder FDI and cross-border trade (OECD, 2011:2). The UN concurs with this view as it

[6] Article 9 of the United Nations Model Convention reproduces Article 9 of the OECD Model Convention, except for paragraph 3 (UN, 2017b:254).

states that almost every country seeking to address transfer pricing issues has decided to adopt the arm's length approach as this approach minimizes double taxation disputes with other countries (UN, 2017c). This impacts on how a country's investment "climate" is viewed, while combating potential profit shifting between jurisdictions where an MNE operates (UN, 2017c).

The arm's length principle is embodied in paragraph 1 of Article 9 of both the OECD and UN MTC (UN, 2017b:251) which states where conditions are made or imposed between associated enterprises[7] in their commercial or financial relations which differ from those which would have been made between independent enterprises, any profits which would, but for those conditions, have accrued to one of the enterprises, but by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly (OECD, 2017b:34-35). Thus paragraph 1 of Article 9 covers adjustments made to profits for tax purposes where non-arm's length transactions have been entered into by associated enterprises, (that is parent and subsidiary companies) and companies under common control (OECD, 2017b:226). In other words, the actual arm's length taxable profits are determined and adjusted so that the correct enterprise is taxed accordingly (Olivier & Honiball, 2011:647).

Although thin capitalisation is not referred to directly in any of South Africa's tax treaties (as is the position internationally), the wording of Article 9 is so extensive that it could also apply to the testing of thin capitalisation (Olivier & Honiball,

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7 Two enterprises are associated if one of the enterprises participates directly or indirectly in the management, control or capital of the other or if the same persons participate directly or indirectly in the management, control or capital of both enterprises, that is if both enterprises are under common control (OECD, 2017a:17)

2011:658). Paragraph 3 of the OECD Commentary on Article 9 confirms this outlook which states the following (OECD, 2017b:226-227):

> a) The Article does not prevent the application of national rules on thin capitalisation insofar as their effect is to assimilate the profits of the borrower to an amount corresponding to the profits which would have accrued in an arm's length situation;
>
> b) The Article is relevant not only in determining whether the rate of interest provided for in a loan contract is an arm's length rate, but also whether a prima facie loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capital;
>
> c) The application of rules designed to deal with thin capitalisation should typically not have the effect of increasing the taxable profits of the relevant domestic enterprise to more than the arm's length profit, and that this principle should be followed in applying existing tax treaties.

Thus Article 9 provides for the reallocation of profit to be an arm's length profit and this principle must be adhered to when adjusting profits under thin capitalisation rules (Olivier & Honiball, 2011:658). Consequently the arm's length principle which is typically used to counter transfer pricing can also be used to curtail thin capitalisation schemes by deeming a loan made to related parties to be a disguised equity contribution (Oguttu, 2013:313-314). The taxpayer would then be denied any interest deduction and the loan would be adjusted to bear a zero rate of interest (Oguttu, 2013:314). It therefore appears that the merging of the thin capitalisation rules with the general transfer pricing provisions in South Africa, and the disallowance of non-arm's length interest by taking into account the interest rate of the loan is aligned with the practice of the OECD and UN.

The commentary on paragraph 2 of Article 9 acknowledges that the application of paragraph 1 of Article 9 may give rise to economic double taxation, as an entity of State A whose profits are revised upwards will be liable to tax on an amount of profit which has already been taxed in the hands of its associated entity in State B (OECD, 2017b:227). Paragraph 2 of Article 9 provides a solution to eliminate the possible double taxation that may arise, by stating that State B shall make an appropriate adjustment to the amount of the tax charged to relieve the double taxation. Thus, the commentary of paragraph 2 calls for the re-writing of transactions between the two entities so that the transactions are recorded at the arm's length price. Should a dispute arise between the parties concerned over the amount and character of the appropriate adjustment, the mutual agreement procedure (MAP) provided for under Article 25 should be implemented (OECD, 2017b:229).

The commentary of paragraph 2 cautions that paragraph 2 does not address secondary transfer pricing adjustments (OECD, 2017b:228). Hence, Article 9 does not afford a relief mechanism for double taxation arising from secondary transfer pricing adjustments (Strauss, 2017:2). Although secondary transfer pricing adjustments are not addressed in Article 9, the commentary on paragraph 2 states that nothing in the paragraph prevents such secondary transfer pricing adjustments from being made where they are permitted under the domestic laws of Contracting States (OECD, 2017b:229). Thus, Article 9 neither forbids nor requires revenue authorities to make secondary transfer pricing adjustments (OECD, 2017a:196). Please refer to section 3.4 for a detailed discussion on secondary transfer pricing adjustments.

3.3.2 Article 11 of the MTCs: Interest Income

Article 11 of both the OECD and UN MTC addresses interest income. The UN MTC replicates the provisions of the OECD MTC except for paragraphs 2 and 4, in which substantive changes have been made (UN, 2017b:281). Concerning paragraph 2, the OECD MTC provides that the tax in the country of source “shall not exceed 10% of the gross amount of the interest”, but the UN MTC leaves this percentage to be established through bilateral negotiations (UN, 2017b:283). Accordingly South Africa's domestic law of imposing a withholding tax on interest earned by non-residents is aligned to the MTCs as the MTCs does allow for interest income to be taxed at the source. Furthermore section 50E(3) of the Act takes into account the DTA tax rate as per paragraph 2 of Article 11.

The anti-avoidance provision contained in Article 11(6) is of specific significance to the research, which states that:

> Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention (OECD, 2017b:37).

According to the commentary on Article 11 the rationale of Article 11(6) is to confine the operation of the provisions concerning the taxation of interest in cases where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest paid exceeds the amount which would have been agreed upon by the payer and the beneficial owner had they transacted at arm’s length (OECD, 2017b:268). The commentary further states that to determine the taxation treatment to be applied to the excess part of the interest, the exact nature of such excess will need to be ascertained according to the circumstances of each case (OECD, 2017b:268). This is required to determine the category of income in which it should be classified to apply the provisions of the tax laws of the States concerned and the provisions of the Convention (OECD, 2017b:268). In South African domestic law, this excess interest paid is re-characterised to dividend income which is subject to Dividends Tax. By applying the principles in this paragraph, the excess should not be subject to both a withholding tax on interest and Dividends Tax. As the excess interest is subject to a withholding tax on interest with no mechanism in place to refund the withholding tax on interest when the excess interest is re-characterised to dividend income, it appears that the treatment of excess interest payments under South Africa's domestic law is not aligned to Article 11(6).

According to Millán & Roch (2015:70), "the excess will be taxed according to the laws of each State" means in the State of residence accordingly, and in the State of source without the limitation provided for in Article 11(2). Consequently due to the allocation rules in Article 11 of the MTC, Millán & Roch (2015:70), are of the opinion that there could be double taxation twice. Firstly, the borrower is not allowed to deduct the interest expense and the lender is subject to tax on the related interest income by the State of residence. Secondly, according to Millán & Roch (2015:70), the borrower is not allowed to deduct the interest expense and the lender is subject to tax on the related interest income by the State of source.

Article 23 of the MTCs addresses the issue of juridical double taxation as illustrated in the scenario above, where the lender is subject to tax on the related interest income by the State of residence and State of source. Paragraph 2 of Article 23B states that where a resident of a Contracting State earns income in accordance with the provisions of Article 11, the resident may be taxed in the other Contracting State. In such a case, the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the tax paid in that other State (OECD, 2017b:42).

The commentary on Article 11(6) concludes by stating that should the principles and rules of the two Contracting States oblige the Contracting States to apply different Articles of the Convention for taxing the excess, it will be necessary to utilise MAP provided by the Convention to resolve the conflict (OECD, 2017b:269). Please refer to section 3.5 for a discussion on MAP.

3.4 Secondary transfer pricing adjustments

To align the actual allocation of profits with the primary transfer pricing adjustment, some countries will include in their domestic legislation a constructive transaction, that is a secondary transaction (OECD, 2017a:195). The purpose of the secondary transaction is to treat the excess profit resulting from the primary transfer pricing adjustment as having been transferred in some other form and taxed accordingly (OECD, 2017a:195). Although there is no specific mention of a secondary adjustment in Article 9, the commentary to Article 9 states that there is nothing in Article 9 that prevents a country from enacting a secondary adjustment where this is allowed under the domestic laws of the contracting states (OECD, 2017b:229). The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Transfer Pricing Guidelines) states that a secondary transaction will take the form of either a constructive dividend which may give rise to a withholding tax, a constructive loan with an obligation to repay the loan with interest, or constructive equity contributions (OECD, 2017a:195).

Thus South Africa's secondary adjustment enacted as a deemed dividend attracting Dividends Tax is aligned with the recommended practice of the OECD. However, the OECD Transfer Pricing Guidelines does point out that a secondary adjustment may result in double taxation unless the other country grants a corresponding credit or some other form of relief for the additional tax liability that may result from a secondary adjustment (OECD, 2017a:196). In the case of a constructive dividend, according to the OECD Transfer Pricing Guidelines the drawback is that any withholding tax which is imposed may not qualify for any relief as there may not be a deemed receipt under the domestic legislation of the other country (OECD, 2017a:196). This statement validates the statement made by the DTC and conclusion reached by Strauss (2017:47) regarding no DTA relief (Please refer to section 2.3.3.1.for further details.)

According to the OECD Transfer Pricing Guidelines, secondary adjustments may also serve to prevent tax avoidance. For example in a country that imposes a withholding tax on dividends, the subsidiary may pay an excessive transfer price, to shift "dividends" to avoid paying the withholding tax on dividends (OECD, 2017a:196). Consequently, by applying a secondary adjustment to re-characterise the excessive price as a dividend would be an efficient way to neutralise the tax avoidance behaviour (Teixeira, 2009:451). Analysing this in the context of this study, the motive to use excessive interest to shift "dividends" to avoid paying dividends withholding tax is very remote as South Africa's domestic law imposes a withholding tax on interest when interest is paid or due and payable.

The OECD Transfer Pricing Guidelines encourages tax administrations to structure secondary adjustments in a way that minimises possible double taxation (OECD, 2017a:197). The exception to avoid or minimise double tax taxation, is when the taxpayer behaviour displays intent to disguise a dividend for purposes of withholding tax (OECD, 2017a:197). As established in the previous paragraph, the intent to disguise a dividend is very remote when interest payments are subject to withholding tax. Therefore, the researcher will analyse the constructive equity contribution option[8] proposed by the OECD Transfer Pricing Guidelines to determine whether, when it comes to excessive interest payments, this approach

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[8] Due to the fact that deemed loans have already being considered in South Africa's legislation and a conclusion on its impracticalities was discussed in chapter two, no further analysis is provided in this chapter.

would minimise possible double taxation when an interest payment is subject to a transfer pricing adjustment and a withholding tax on interest.

3.4.1 Constructive equity contribution

According to Harmse (2014:49), when the secondary adjustment takes the form of a constructive equity contribution, there are no immediate tax consequences except for the standard tax that is levied on the primary adjustment. This is attributed to the fact that an equity contribution is capital in nature and the tax consequences will only surface when the equity contribution is distributed to the owners as a return of capital (Harmse, 2014:49). In addition to simplifying the administration process for SARS and the taxpayer, the constructive equity contribution will lead to tax savings in favour of the taxpayer (Harmse, 2014:50) as there will no Dividends Tax to be paid as in the case of the constructive dividend. In the context of this study, there would be no loss to the fiscus as the withholding tax on interest would be paid on the non-arm's length interest in terms of the loan agreement. The drawback with using the constructive equity contribution option is that it can only be utilised when the non-arm's length interest is paid to the subsidiary. O'Brien and Oates (2009:21) explain that when there are parent-subsidiary transactions, the form of the secondary adjustment will depend on which entity is holding the excess cash. When the parent holds the excess cash, the secondary adjustment is a constructive dividend, and when the subsidiary holds the excess cash, the secondary adjustment is a constructive capital contribution (O'Brien & Oates, 2009:21). In the context of the research, it has already been demonstrated in chapter one that the constructive dividend utilised with the withholding tax on interest results in an additional layer of tax for a group of companies. Therefore the constructive equity contribution would not be a solution.

An option that some countries have adopted to eliminate the secondary adjustment is the repatriation of the non-arm's length amount (OECD, 2017a:197). The mechanics of the repatriation to determine whether this is an option to eliminate the additional layer of tax imposed when there is an interest payment that is subject to a transfer pricing adjustment and a withholding tax on interest, is discussed below.

3.4.2 Repatriation of non-arm's length amount

The repatriation of the non-arm's length amount effectively results in cash returned so that the accounts of the parties involved are consistent with the economic intent of the primary adjustment (Wiesener 2011:17). The OECD Transfer Pricing Guidelines states that either by establishing an account receivable, or by reclassifying other transfers, such as dividend payments where the adjustment is between parent and subsidiary, as a payment of additional price where the original price was too low or as a refund of transfer price where the original price was too high, the non-arm's length amount could be repatriated (OECD, 2017a:197). The approach of using an account receivable is identical to using a constructive loan as a secondary transaction to account for the non-arm's length amount (OECD, 2017a:198). Thus the accrual of interest could have its own tax consequences and may complicate the process (OECD, 2017a:198). A further issue is how the repatriation should be recorded in the accounting records so that both the entity and the tax authorities of that country are aware that repatriation has occurred or has been set up (OECD, 2017a:198). Currency exchange gains and losses is an additional complication when considering repatriation (OECD, 2017a:198). A drawback of repatriation according to Ryozo Himino (cited by Texeira, 2009:455) is that :

> if taxpayers are not 100% ownership relations, they may not have the authority to make repatriation. Even if the contracted price is different from the arm's length price, the original contract is still valid in terms of civil law and in court. If the taxpayers repatriate an amount for which there is no obligation to repatriate from a civil law perspective, then it would be

> an undue infringement of the interest of the minority shareholders. In such occasions, tax authorities which adopt the policy of making secondary adjustments will be compelled to make a secondary adjustment.

The reader is reminded that although the repatriation option was not legislated in South Africa's domestic law when the secondary adjustment was a deemed loan, the option was documented in the 2011 Explanatory Memorandum to the Taxation Laws Amendment Bill (Refer to section 1.2.2). Given all the complexities that accompany the repatriation option, it is possible that the repatriation omission when the secondary adjustment was amended to a deemed dividend was not an oversight by the South African revenue authorities but an informed decision. A further complication with interest payments is that if there is a repatriation option, there would have to be a refund of the withholding tax on interest that was paid on the non-arm's length amount, thereby increasing the administrative burden for both the taxpayer and the revenue authorities.

The OECD Transfer Pricing Guidelines conclude its discussion on repatriation by stating that as most OECD member countries have not had much experience with repatriation, it is recommended that agreements between taxpayers and tax administrations be discussed in the mutual agreement proceeding where it has been initiated for the related primary adjustment (OECD, 2017a:198). As the OECD commentary on both Articles 9 and 11 refers to MAP (Article 25) as a means to resolve the conflict between contracting states, an analysis of Article 25 will follow.

3.5 Article 25 of the MTCs: Mutual Agreement Procedure[9] (MAP)

Mutual Agreement Procedure (MAP) is a procedure that allows the competent authorities or designated representatives of the competent authorities from the governments of the contracting states to interact, with the intent to attempt to resolve international tax disputes (SARS, 2018a). MAP, as provided for in Article 25 of the OECD and UN MTCs, is aimed at resolving disputes arising from juridical and economic double taxation, as well as inconsistencies in the interpretation or application of a DTA (SARS: 2018b:2). The objective of Article 25 is to promote, through consultation and mutual agreement between the competent authorities of contracting states, the consistent treatment of individual cases and the same interpretation and/or application of the provisions of the Convention in both states (OECD, 2017b:430). Consequently, if there is, for example, a transfer pricing dispute over the amount and character of the adjustment between two contracting states, the MAP provided for under Article 25 should be utilised (UN, 2017b:256).

The OECD acknowledges that the interpretation and application of novel rules resulting from the BEPS Action Plan could introduce elements of uncertainty that should be minimised as far as possible (OECD, 2014b:4). The stance of the OECD is that the actions to counter BEPS must be complemented with actions that ensure certainty and predictability for business (OECD, 2014b:4). Accordingly the work on Action 14, Making Dispute Resolution Mechanisms More Effective, Action 14 – 2015 Final Report which seeks to improve the effectiveness of MAP in resolving treaty-related disputes, is a significant component of the work on BEPS

9 The UN MTC provides for two alternative versions for Article 25. Alternative A reproduces Article 25 of the OECD MTC with the addition of a second sentence in paragraph 4 but excludes arbitration as is provided for in paragraph 5 of the OECD Model Convention. Alternative B reproduces Article 25 of the OECD Model Convention with the addition of a second sentence in paragraph 4 and includes mandatory arbitration as is provided for in paragraph 5 of the OECD Model Convention but with four differences (UN, 2017b:547). Aspects that are common to both MTC's are referenced to the OECD MTC.

issues and reflects the comprehensive and holistic approach of the BEPS Action Plan (OECD, 2015c:11). In keeping up with one of the minimum standards of Action 14, namely, that countries should publish rules, guidelines and procedures to access and use MAP and take appropriate measures to make such information available to taxpayers (OECD, 2015c:18), South Africa published its Guide on Mutual Agreement Procedures[10] on 25 July 2018 which is available on the SARS website.

Although MAP applies to all Articles of the Convention, particular mention is made of the following Articles in the UN commentary on Article 25, where the measure in question leads to double taxation (UN, 2017b:555):

- taxation in the State of the payer (in case of a special relationship between the payer and the beneficial owner) on the excess part of interest under the provisions of Article 9 and paragraph 6 of Article 11; and
- cases of application of legislation to deal with thin capitalisation when the State of the debtor company has treated interest as dividends, insofar as such treatment is based on clauses of a convention corresponding for example to Article 9 or paragraph 6 of Article 11.

Thus the conflict that arises with transfer pricing adjustments that involve interest payments seems to be a global problem and is not unique to South Africa.

Paragraph 2 authorises the competent authorities to resolve by mutual agreement cases presented by taxpayers in order to avoid taxation which could otherwise

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[10] It should be noted that this guide is not an "official publication" as defined in section 1(1) of the Tax Administration Act 28 of 2011 and accordingly does not create a practice generally prevailing under section 5 of that Act. It is also not a binding general ruling under section 89 of Chapter 7 of the Tax Administration Act (SARS, 2018:i).

result from domestic laws but would not be in accordance with the Convention (OECD, 2017b:44). The requirement in this paragraph that the competent authority "shall endeavour" to resolve the case by mutual agreement means that the competent authorities are obliged to seek methods to resolve the case in a fair and objective manner, on its merits, in accordance with the terms of the Convention and applicable principles of international law on the interpretation of treaties (OECD, 2017b:429).

Of importance to the research is paragraph 3 of Article 25 which authorises the authorities of the Contracting States to resolve by mutual agreement matters presented by taxpayers in order to avoid taxation which could result from domestic laws but would not be in accordance with the Convention (OECD, 2017b:44). Regarding interest payments in South Africa to non-residents, withholding tax on interest is withheld as per the domestic law on the non-arm's length amount which is re-characterised to dividend income and subject to Dividends Tax. With no mechanism in place in South Africa's domestic law to refund the withholding tax on interest paid on the excess interest amount which according to Article 11(6) should be taxed according to the re-characterised income (which it is in terms of sections 31(3) and 64E of the Act), MAP can be utilised to resolve this conflict which is not in accordance with the Convention. This view is supported by the SARS MAP Guide which states that regarding secondary transfer pricing adjustments, withholding tax and repatriation on transfer pricing adjustments made by the contracting state, the competent authority of South Africa will seek to resolve the case by reaching a mutual understanding, taking into account the principles in the DTA, the facts of the particular case, and how those principles should be applied to the facts of the case in a way that does not result in unrelieved double taxation (SARS, 2018:23). The main drawback is that the time taken to resolve a MAP case may vary according to its complexity, but competent authorities will endeavour to resolve MAP cases within an average timeframe of 24 months (OECD, 2015c:15).

3.6 Chapter conclusion

Based on the research undertaken, it appears that South Africa's domestic law in limiting interest deductions is aligned to international practice except for the tax treatment of the non-arm's length interest that attracts both withholding tax on interest and Dividends Tax. According to both the OECD and UN publications, when there is no re-characterisation of the non-arm's length interest to dividend income, the withholding tax on interest should continue to apply. The UN Practical Portfolio does raise the question on the characterisation of the disallowed interest. That is, should it retain its legal character as interest or should it be re-characterised to dividends (UN, 2017a:38)? Although a solution is not provided in the guidelines, these do indicate that the disallowed interest cannot be subject to both a withholding tax on interest and dividends by highlighting that policymakers need to consider the impact when deciding to retain the legal character of the interest or the re-characterisation to dividend income (UN, 2017a:38). For example, if a country has entered into tax treaties that limit the rate of withholding tax on interest to 15%, while the Dividends Article limits the rate of withholding tax on dividends paid to 5%, the result may be to confer an unintentional benefit on the non-resident shareholder in the form of a reduced withholding tax, if the country's domestic law deems any disallowed interest to be a dividend (UN, 2017a:38).

When applying the best practice approach in limiting interest deduction the OECD's view is that, should the disallowed interest be re-characterised to a deemed dividend, it would lose its legal character of interest and therefore should not be subject to withholding tax on interest as it is now considered a deemed dividend. In the South African context, there is no re-characterisation of the disallowed interest to a deemed dividend under sections 23M and 23N of the Act, but instead a re-characterisation of the disallowed interest to a deemed dividend takes place under section 31 of the Act (the transfer pricing provisions).

Applying the OECD's (2015b:82) assertion that withholding tax on interest under domestic law would continue to apply to interest payments made without regard to interest deduction limitations, as there is ***no re-characterisation of the disallowed interest*** (own emphasis), it is inferred that the withholding tax on interest would continue to apply on the disallowed interest under the transfer pricing provisions only if the disallowed interest is not re-characterised to a deemed dividend. Conversely, if there is re-characterisation of the disallowed interest to a deemed dividend, there should be no withholding tax on interest as the status of the disallowed interest has been changed to a deemed dividend. However, under the South African tax law, when the disallowed interest is re-characterised to a deemed dividend under the transfer pricing provisions, the disallowed interest still retains its legal character of interest under the withholding tax on interest provisions. Thus in South Africa the disallowed interest expense is subject to both interest and dividends withholding tax, which is not part of the OECD's best practice approach in limiting interest deductions. The non-arm's length interest according to the South African legislation is both interest income and dividend income subject to interest and dividends withholding tax respectively, resulting in double taxation.

It would seem then, that by subjecting the non-arm's length interest to both interest and dividends withholding tax, the South African legislation is inequitable as it results in double taxation. However, according to Olivier and Honiball (2011:6), international double taxation is an inherent risk in cross-border transactions. According to SARS (2018b:2), disputes arising from juridical and economic double taxation as well as inconsistencies in the interpretation or application of a DTA, may be resolved by utilising MAP, as provided for in Article 25 of the OECD and UN MTCs.

Although MAP applies to all Articles of the Convention, particular mention is made of the following Articles in the UN commentary on Article 25, where the measure in question leads to double taxation (UN, 2017b:555):

- taxation in the State of the payer (in case of a special relationship between the payer and the beneficial owner) on the excess part of interest under the provisions of Article 9 and paragraph 6 of Article 11; and
- cases of application of legislation to deal with thin capitalisation when the State of the debtor company has treated interest as dividends, insofar as such treatment is based on clauses of a convention corresponding for example to Article 9 or paragraph 6 of Article 11.

Thus it appears that the conflict that arises with transfer pricing adjustments involving interest payments seems to be a global problem rather than unique to South Africa. Currently, MAP as provided for in Article 25 of the OECD and UN MTCs seems to be the only solution for a group of companies that is exposed to an additional layer of tax in the form of Dividends Tax when an interest payment is subject to both a transfer pricing adjustment and withholding tax on interest. A severe drawback of MAP is that the average timeframe to reach a resolution is 24 months.

Chapter 4

4 Cross-national comparison of domestic law

Tax has become a key investment factor that influences the attractiveness of a location or an economy for international investors (UN, 2015b:176-177). The growth of global value chains has made tax an important determinant in deciding on a country's attractiveness and this trend is likely to continue (UN, 2015b:177). The level of taxation and the ease with which the tax obligations can be fulfilled feature prominently in location comparisons presented to investors (UN, 2015b:177). Thus, chapter four analyses the tax treatment of intra-group financial transactions and transfer pricing rules of South Africa's two strong FDI and country attractiveness competitors in Africa, namely Morocco and Kenya. (Please refer to section 1.6.3.3. for justification in selecting Morocco and Kenya). The analysis will focus on corporate income tax rates, dividend and interest withholding tax rates, transfer pricing legislation, and thin capitalisation rules. The analysis is undertaken to determine the equitability of South Africa's tax legislation and to identify any gaps in the legislation when there is a transfer pricing adjustment on interest payments that are subject to withholding tax on interest. The analysis will further endeavour to provide insights as to whether South Africa is creating an environment that may be viewed as an unattractive destination for FDI when an interest payment is subject to a transfer pricing adjustment and a withholding tax. The analysis is undertaken to address the secondary objective set out in section 1.5.

4.1 Rationale for cross-national comparison

Many countries in response to BEPS activities have enacted various anti-avoidance measures in their tax policies to curb tax avoidance strategies (Oguttu, 2015:521). The OECD is of the view that it may be difficult for any single country, acting alone, to fully address the BEPS issue as several BEPS strategies take advantage of the interface between the tax rules of different countries (OECD, 2013a:8). For the BEPS issue to be appropriately addressed, a holistic approach is essential (OECD, 2013a:7). This calls for government actions to be comprehensive and to deal with all the different aspects of the BEPS issue, for example the tax treatment of intra-group financial transactions and the implementation of transfer pricing rules (OECD, 2013a:7). However, the DTC (2014a:38) states that when enacting tax avoidance legislation to protect South Africa's tax base from BEPS, care should be taken to adhere to the OECD's warning against unilateral actions that may result in double taxation as this could make South Africa an unattractive destination for FDI. Furthermore, TJN (2014:2) is of the view that the desire to attract FDI by developing countries makes it difficult for developing countries to enact and enforce tax rules to prevent BEPS. Crivelli, De Mooij and Keen (2015:4) further assert that due to the intensity of international tax competition, the possibility of mutual harm exists from the attempts of each country to make its tax system more attractive than those of others.

The rationale for the comparison is thus to determine how the South African tax treatment of intra-group financial transactions and transfer pricing rules compares to the tax rules of Morocco and Kenya, taking into account the balance required to protect a country's tax base and the desire to attract FDI. This is required to gain a deeper understanding of the central concern at hand, that is the equitability of South Africa's tax legislation when an interest payment is subject to both a withholding tax and a transfer pricing adjustment. This comparison may also identify gaps in the South African tax legislation regarding tax certainty as tax uncertainty creates a risk of discouraging investment (International Monetary Fund (IMF)/OECD, 2018:5). Tax certainty calls for clear and simple rules and regulations that minimise disputes (IMF/OECD, 2018:9) and is one of the principles of a good tax system (Bronkhorst & Stiglingh, 2018:5). Furthermore, the stance of the OECD is that the actions to counter BEPS must be complemented with actions that ensure certainty and predictability for business (OECD, 2014b:4).

4.2 Morocco

Morocco emerges as the most attractive investment destination in Africa, due to its receptive business environment, low risk profile, size of its economy (fifth largest economy in Africa), and its strong social capital factors (Quantum Global Research Lab, 2018:7). According to the African Development Bank (2019:165), Morocco has achieved remarkable economic performance over the past decade and the economy continues to demonstrate resilience. The stock of core infrastructure has grown due to an average capital investment rate of 34% during 2008-2018, compared with 29.8% in 2007, enhancing the country's attractiveness to FDI (African Development Bank, 2019:165). Furthermore Morocco is well integrated into global value chains (African Development Bank, 2019:30). Global value chains are now the dominant framework for trade (African Development Bank, 2019:111). MNEs play a vital role in the global value chain system, as global value chains coordinated by MNEs have triggered nearly 80% of the global trade of inputs and products (UN, 2016). As the growth of global value chains has made tax an important determinant in deciding on a country's attractiveness for international investors (UN, 2015b:177), an analysis of Morocco's tax legislation pertaining to corporate income tax rates, dividend and interest withholding tax rates, transfer pricing legislation, and thin capitalisation rules will now follow. This analysis will provide insights as to whether the OECD's call for governments to act comprehensively and to deal with different aspects of BEPS is given any attention in Morocco or whether the desire to attract FDI makes it difficult for a developing country like Morocco to enact and enforce tax rules to prevent BEPS.

4.2.1 Tax rates

An important amendment introduced by Morocco's 2016 Finance Law, was the introduction of progressive rates for corporate income tax, effective from 1 January 2016 (EY, 2016b). The progressive corporate income tax rates replaced the flat rate of 30%. In a progressive tax system the effective tax rate increases as the tax base increases (Bronkhorst & Stiglingh, 2018:3). In South Africa, small business corporations are afforded progressive rates for corporate income tax. Businesses that do not meet the classification requirements of a small business corporation as set out in section 12E of the Act, are taxed at a flat rate of 28% in South Africa.

According to Block (2016:6) a progressive tax system is shown to encourage entry into entrepreneurship. Block (2016:9) is of the view that entrepreneurship is important for economic development as entrepreneurs present new job opportunities. Governments can therefore, through corporate income taxation influence entrepreneurship activities by utilising progressive corporate income tax rates (Block, 2016:9). South Africa acknowledges that small businesses are key engines for job creation (South Africa, 2001:14) and have assisted small businesses with a number of concessions since 2001 (Van der Zwan, 2018b:687). Progressive corporate tax rates are one such concession granted to small businesses in South Africa (Van der Zwan, 2018b:687). Tables 4-1 and 4-2 set out below present the reader with the progressive corporate income tax rates for 2018 for Morocco and South Africa respectively.

Table 4-1: Progressive corporate tax rates for Morocco

Taxable income in Moroccan Dirhams (MAD)		**Corporate Income Tax Rate**	**Conversion[1] of Moroccan Dirhams to South African Rands (ZAR)**	
From	**To**		**From**	**To**
0	300 000	10%	0	421 111.74
300 001	1 000 000	20%	421 113.14	1 403 705
1 000 001	And above	31%	1 403 707.18	And above
1. OFX average exchange rate for 2018 calendar year: one ZAR = 0,7124 MAD				

Source: Researcher's own based on PwC's worldwide tax summaries- Corporate taxes 2018/19 (2018:1673)

Table 4-2: Progressive corporate tax rates for small business corporations in South Africa

Taxable income in South African Rands (ZAR)		Corporate Income Tax Rate (In respect of any year of assessment ending during the period of 12 months ending on 31 March 2018)
From	To	
0	75 750	0%
75 750	365 000	7% of the amount that exceeds R75 750
365 000	550 000	R20 248 plus 21% of the amount that exceeds R365 000
550 000	And above	R59 098 plus 28% of the amount that exceeds R550 000

Source: Act No. 14, 2017: Rates and Monetary Amounts and Amendment of Revenue Laws Act, 2017 (South Africa, 2017a:24)

Similar to South Africa, Morocco has a withholding tax regime on dividends and interest paid to non-residents. Dividends paid to non-residents in Morocco are subject to a 15% withholding tax (PwC, 2018:1678). This rate is lower than South Africa's dividends withholding tax rate of 20%. This rate may be reduced under an applicable tax treaty with Morocco (PwC, 2018:1678) as is the case in South Africa.

The standard withholding tax on interest paid to non-resident entities is levied at 10% unless reduced by a tax treaty with Morocco (PwC, 2018:1680). However, the Moroccan law provides that interest on loans granted in foreign currency with a maturity exceeding ten years is exempt from withholding tax on interest (PwC, 2018:1680).

4.2.2 Transfer pricing legislation

Articles 213(II) and 214(III) of the Moroccan General Tax Code (*Code Général des Impôts*) are the main legislation regulating transfer pricing in Morocco (Habachi, 2018a). Article 213(II) states that when a company has direct or indirect dependency links with companies located in Morocco or outside Morocco, the profits indirectly transferred, either by increasing or decreasing purchase or selling prices or by any other means are reported to the taxable income and/or sales reported. The profits indirectly transferred are determined by comparison with those of similar companies or by a direct assessment based on information available to the administration (Article 213(II) of the General Tax Code).

Circular Note 717 published by the Directorate General of Taxes provides that indirect transfers of profits between dependent companies can result from various practices, such as (Morocco, 2011:213):

- the increase in purchase prices of goods and services imported or acquired locally;
- the markdown sales prices of goods and services exported or sold locally;
- ***the rate of practical interest reduced or increased*** (own emphasis);
- excessive prices for royalties and other remuneration;
- excessive or fictitious management fees; and
- the write-off or waiver of revenues.

According to Habachi (2018a), Morocco has not yet introduced transfer pricing methodologies, but the law requires that transactions between related entities be performed in compliance with the arm's length principle. In practice, the Tax Administration determines an arm's length price either through the comparable uncontrolled price method or the direct assessment based on available information (Habachi, 2018a). Although Morocco is not a member of the OECD, the Moroccan Tax Administration generally accepts references to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (Habachi, 2018a).

Article 214(III) of the Moroccan General Tax Code states that for transactions carried out with companies located outside Morocco, the tax authorities may ask the taxable company in Morocco for information and documents relating to:

- the nature of the relationship between the taxable business in Morocco and that outside Morocco;
- the nature of the services rendered or products marketed;
- the method of determining the prices of the transactions carried out between the said companies and the elements justifying it; and
- the regimes and tax rates of companies located outside Morocco.

The company concerned has a period of thirty days following the date of receipt of the request to communicate to the administration the information and documents requested (Article 214(III) of the Moroccan General Tax Code). If there is no answer within the aforementioned deadline or the answer does not include the requested elements, the dependency between these companies is supposed to be established (Article 214(III) of the Moroccan General Tax Code).

Distributions considered hidden from the point of view of taxation resulting from adjustments to the tax bases of companies liable to corporation tax are subject to withholding tax (Article 13(VII) of the Moroccan General Tax Code). In other words the adjustment made to the taxable income when profits are indirectly transferred, is considered to be a company distribution and is subject to dividends withholding tax.

According to Habachi (2018b), the non-arm's length interest is subject to both dividends and interest withholding tax. This is so, as interest is subject to withholding tax when interest is paid and when a transfer pricing adjustment is made, the non-arm's length interest is subject to dividends tax. Although the tax treatment of the non-arm's length interest of both South Africa and Morocco seems to be similar, the following significant factors must be considered before a conclusion can be reached as to whether the tax consequence is equitable with minimal disincentive effect on FDI:

- Transfer pricing adjustment in South Africa is a self-assessment process. In other words the arm's length amount must be taken into account when preparing the corporate income tax return and assessing what portion of the related interest expense, if any, is not deductible under section 31 of the Act (SARS, 2013a:7). By contrast, in Morocco an adjustment is only made following a tax audit. Consequently, the taxable income of a taxpayer who is not selected for an audit will not be adjusted.
- Certainty on when the interest deduction is disallowed based on safe harbour (debt-to-equity ratio) is provided in Article 10(II)(A)(2) of the Moroccan General Tax Code which is lacking in South Africa's domestic law. (Please refer to section 4.2.3 for more details).
- The Moroccan General Tax Code makes provision for advance pricing arrangements which are absent in the South African domestic law. (Please refer to section 4.2.4 for more details).

4.2.3 Thin capitalisation

Although there are no specific thin capitalisation rules in Morocco, the tax law restricts the interest rate on debts issued by shareholders and the basis of calculating deductible interests (PwC, 2018:1677). Interest incurred is tax deductible if the shareholder’s capital is fully paid. Additionally, the sum of the shareholder loans generating deductible interest should not exceed the equity capital subscribed, and the applicable interest rate should not exceed the official rate calculated annually on the basis of six months treasury bills (Article 10(II)(A)(2) of the Moroccan General Tax Code).

The OECD (2017a:206) is of the view that safe harbours provide certainty to taxpayers, that transactions that fall within the safe harbour parameters would be accepted by the revenue authorities with a limited audit or without an audit beyond ensuring the taxpayer has met the eligibility conditions of, and complied with the safe harbour provision. By enacting thin capitalisation rules with safe harbours, Morocco seems to strike a balance between protecting its tax base from excessive interest deduction, and providing a tax system that may be viewed as favourable by MNEs by offering certainty regarding acceptable amounts of debt and interest rates.

4.2.4 Advance pricing arrangements

Countries agree that measures developed to address BEPS should not lead to unnecessary uncertainty for compliant taxpayers and unintended double taxation (OECD, 2015c:9). One of the best practices recommended in BEPS Action 14 to minimise uncertainty and unintended double taxation is the implementation of advance pricing arrangements (OECD, 2015c:30).

An advance pricing arrangement is defined as an arrangement that determines in advance, of controlled transactions, an appropriate set of criteria for example methods, comparables and appropriate adjustments thereto for the determination of the transfer pricing of those transactions over a fixed period of time (OECD, 2017a:23). Several countries have implemented advance pricing arrangements in their legal or administrative procedures as a bilateral resolution mechanism to avoid double taxation (UN, 2017c:356) and Morocco is no exception.

Legislation dealing with advance pricing arrangements in Morocco is found in Article 234 of the General Tax Code. Article 234a of the General Tax Code states that companies directly or indirectly dependent on companies located outside Morocco may request the tax authorities to reach a preliminary agreement on the method of determining the prices of the transactions referred to in Article 214-III, for a period not exceeding four fiscal years. The administration cannot question the method of determining the prices of transactions referred to in Article 214-III which have been the subject of a prior agreement with an enterprise, in accordance with the provisions of Article 234a (Article 234b of the General Tax Code). Thus a transfer pricing adjustment can be eliminated when the taxpayer has an advance pricing arrangement with the revenue authorities and the possible double taxation on the non-arm's length interest is also eliminated.

An advance pricing arrangement according to the OECD (2017a:219) can assist taxpayers by eliminating uncertainty through enhancing the predictability of the tax treatment of international transactions. Due to the certainty provided by an advance pricing arrangement, a taxpayer may be in a better position to predict its tax liabilities, thereby providing a tax environment that is favourable for investment (OECD, 2017a:219-220). A further advantage of an advance pricing arrangement is that it may prevent costly and time-consuming examinations and litigation of major transfer pricing issues for both taxpayers and revenue authorities (OECD, 2017a:220).

Evidence suggests that the non-arm's length interest is potentially subject to both dividends and interest withholding tax in Morocco, upon the conclusion of a tax audit, if it is found that a transfer pricing adjustment is required on interest payments made. However, this double taxation on the non-arm's length interest does not appear to be as punitive as in South Africa, as the Moroccan taxpayer is able to predict and eliminate this double taxation due to the country's "thin capitalisation rules" and advance pricing arrangements, both of which are lacking in the South African tax legislation. Morocco's thin capitalisation rules and advance pricing arrangements provide certainty to the taxpayer regarding acceptable amounts of debt and interest rates. By providing the taxpayer with certainty as to when an interest payment will be disallowed based on acceptable amounts of debt and interest rate, the taxpayer is in a better position to predict its tax liabilities and this results in an environment that is favourable for investment.

4.3 Kenya

Kenya is East Africa’s anchor economy and Sub-Saharan Africa's fourth largest economy (EY, 2017:12). While economic activity faltered following the 2008 global economic recession, growth has resumed in the last three years reaching 5.8% in 2016, placing Kenya as one of the fastest growing economies in Sub-Saharan Africa (The World Bank, 2018). Based on EY's Africa Attractiveness Index, Kenya ranked number two jointly with South Africa as a destination to invest in Africa (EY, 2017:16). The World Bank (2018) is of the view that Kenya has the potential to be one of Africa’s success stories based on its growing youthful population, a dynamic private sector, highly skilled workforce, improved infrastructure, a new constitution, and its pivotal role in East Africa. The Kenyan Capital Nairobi hosts a number of MNEs that use Nairobi as a hub for the East African region (Rödl & Partner, 2016). According to Waris (2017:8-12) Kenya has an active international trade and investment network with many countries and was among the first countries in Africa that attempted to strengthen its enforcement of international taxation, including transfer pricing rules. As noted in chapters one and two, South Africa has also enacted various anti-avoidance measures to strengthen its enforcement of international taxation. An analysis with a focus on Kenya's corporate income tax rates, dividend and interest withholding tax rates, transfer pricing legislation, and thin capitalisation rules will follow to determine how South Africa's legislation compares with Kenya's legislation. This analysis will provide insights as to whether the OECD's call for governments to act comprehensively and to deal with different aspects of BEPS is given any attention in Kenya or whether the desire to attract FDI makes it difficult for a developing country like Kenya to enact and enforce tax rules to prevent BEPS.

4.3.1 Tax rates

Unlike South Africa, where the corporate income tax rate for resident and non-resident companies are taxed at the same rate of 28%, a differentiated corporate income tax rate is applied in Kenya for resident and non-resident companies. In Kenya, the corporate income tax rate for a resident is 30% while branches of a non-resident company and permanent establishments are taxed at 37.5% (PwC, 2018:1282). Although branches of non-resident companies and permanent establishments are taxed at a higher rate than resident companies in Kenya, it is noted that there is no further taxation on the distribution of branch profits (PwC, 2018:1293) while the distribution of profits by resident companies is subject to a dividends withholding tax.[11]

Kenya, similar to South Africa, has a withholding tax regime on dividends and interest paid to non-residents. Dividends paid to non-residents and any overseas holding company attract a 10% withholding tax in Kenya (PwC, 2018:1294). This is significantly lower than South Africa's Dividends Tax rate of 20%.

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[11] When a resident company distributes dividends in Kenya, the effective tax rate for the shareholder of the resident company is 37%. This rate takes into account the two levels of taxation, namely the corporate income tax rate of 30% and dividends withholding tax of 10% that is levied on the distribution of after tax profit (which is 10% of after tax profit of 70%). Thus, effectively, the branches of non-resident companies are not at a disadvantage as there is no further taxation on the distribution of branch profits.

Unlike South Africa, where there is only one withholding tax rate of 15% on interest paid to non-residents, Kenya imposes a 15% withholding tax on interest arising from a two-year Government bearer bond and 25% on interest-bearer instruments other than two-year Government bearer bonds. All other interest paid to non-residents is subject to a 15% withholding tax (PwC, 2018:1297).

Interest payments made by a permanent establishment to its head office are not subject to withholding tax on interest (PwC, 2018:1293. However, there are certain restrictions to the tax deductibility of interest payments made by a permanent establishment to non-resident related parties (PwC, 2018:1293). Please refer to sections 4.3.2. and 4.3.3 for further details on these restrictions.

As in South Africa, lower rates may apply to non-residents where there is a DTA in force (PwC, 2018:1297). The withholding tax on both dividends and interest is a final tax for non-residents (PwC, 2018:1297).

4.3.2 Transfer pricing legislation

The Kenyan transfer pricing legislation was incorporated into the Income Tax Act in 2006 with the purpose of providing guidelines to be applied by related enterprises, in determining the arm's length prices of goods and services in transactions they are involved in (Rödl & Partner, 2016). The legislation confers on the Commissioner of Domestic Taxes powers to adjust the profits of a resident person who carries on business in Kenya with a related non-resident person where the business is so arranged as to produce to the resident person either no profits or less than ordinary profits (Rödl & Partner, 2016).

Section 18(3) of the Kenya Income Tax Act CAP.470 which is the transfer pricing legislation states that (Kenya, 2014):

> Where a non-resident person carries on business with a related resident person or through its permanent establishment and the course of that business is such that it produces to the resident person or through its permanent establishment either no profits or less than the ordinary profits which might be expected to accrue from that business if there had been no such relationship, then the gains or profits of that resident person or through its permanent establishment or from that business shall be deemed to be the amount that might have been expected to accrue if the course of that business had been conducted by independent persons dealing at arm's length.

To guide the application of section 18 (3) of the Income Tax Act, Kenya introduced The Income Tax (Transfer Pricing) Rules in 2006 (Waris, 2017:18) which was brought into effect by Legal Notice no.67 of 2006. Waris (2017:18) asserts that the Transfer Pricing Rules in effect follows the principles set out in the OECD Transfer Pricing Guidelines. The purpose of the Transfer Pricing Rules is (Kenya, 2006):

- to provide guidelines to be applied by related enterprises in determining the arm’s length prices of goods and service in transactions involving them; and

- to provide administrative regulations, including the types of records and documentation to be submitted to the Commissioner by a person involved in transfer pricing arrangements.

The transactions subject to adjustment of prices detailed under Rule 6 of the Transfer Pricing Rules shall include (Kenya, 2006):

- the sale or purchase of goods;
- the sale, purchase or lease of tangible assets;
- the transfer, purchase or use of intangible assets;
- the provision of services;

- ***the lending or borrowing of money*** (own emphasis); and
- any other transactions which may affect the profit or loss of the enterprise involved.

Prior to 1 January 2019, Kenya's tax law did not impose a secondary transfer pricing adjustment. A significant amendment to the dividend definition introduced by Kenya's Finance Act of 2018 has a direct impact on Kenya's transfer pricing legislation. Effective from 1 January 2019, an amount shall be deemed to be a dividend, where the amount represents additional taxable income or reduced assessed loss of that company by virtue of any transaction with the shareholder or related person to such shareholder, resulting from an adjustment (Kenya, 2018:166). Consequently, transfer pricing adjustments that result in additional income or reduced losses will be deemed to be a dividend (EY, 2018) subject to a dividends withholding tax of 10%. According to the Kenya's Transfer Pricing Rules the borrowing and lending of money is subject to transfer pricing adjustments. Thus, as from 1 January 2019, the non-arm's length interest will not be tax deductible when computing the entity's tax liability and in addition will be subject to a dividends withholding tax of 10%.

The Kenyan transfer pricing legislation appears to be similar to South Africa's transfer pricing legislation based on the fact that all related party cross-border transactions should be concluded at an arm's length price to eliminate a transfer price adjustment and in the case of a transfer pricing adjustment, the non-arm's length amount will be deemed to be a dividend subject to dividends withholding tax.

Kenya's Finance Act of 2018 does not provide any guidance as to whether a refund or credit is available for the interest withholding tax levied on the non-arm's length interest. It is therefore unclear at this stage, whether the non-arm's length interest when re-characterised to dividend income in the transfer pricing provision, still retains its "interest" nature in the withholding tax on interest provisions. If this is the case, the non-arm's length interest will be subject to both dividends and interest withholding tax. Due to the fact that the dividends withholding tax is levied at 10%, while the interest withholding tax is levied at 15%, it appears that by re-characterising the non-arm's length interest to a deemed dividend, an unintentional benefit is conferred on the non-resident in the form of a reduced withholding tax, unless the non-arm's length interest is subject to both dividends and interest withholding tax as is the situation in both South Africa and Morocco.

4.3.3 Thin capitalisation

When a non-resident person controls a company in Kenya alone, or with four or fewer other persons, interest deduction restrictions or ‘thin capitalisation’ rules apply (PwC, 2018:1295). A company is subject to thin capitalisation rules in Kenya, if all of the following occur (PwC, 2018:1296):

- The company is controlled by a non-resident person alone or together with four or fewer persons;
- The company is not a bank or financial institution; and
- The highest amount of all loans held by the company at any time exceeds the sum of three times the revenue reserves (including accumulated losses) and the issued and paid up share capital of all classes of shares of the company.

A company that is subject to thin capitalisation rules in Kenya cannot claim a deduction on the interest expense incurred by the company on loans in excess of three times the sum of revenue reserves and issued and paid-up capital of all classes of shares of the company (PwC, 2018:1295). In other words, if the debt-to-equity ratio exceeds 3:1, the interest deduction will be disallowed. For companies in the extractive sector, when the debt-to-equity ratio exceeds 2:1, the interest deduction will be disallowed (PwC, 2018:1295). The company also cannot claim a deduction for any foreign exchange loss realised by the company with respect to any loans from its shareholders in the period that the company remains subject to thin capitalisation rules (PwC, 2018:1295).

Furthermore, the Kenyan tax legislation gives the Commissioner for Domestic Taxes the discretion to ‘deem interest’ on interest-free borrowings received by foreign-controlled entities in Kenya (PwC, 2018:1295). The ‘deemed interest’ is based on the Commissioner’s prescribed rates. This means that withholding tax is due on the ‘deemed interest’ as if this was an actual finance charge (PwC, 2018:1295).

4.4 Discussion of cross-national comparison

The rationale for the cross-national comparison is to determine how South Africa's tax treatment of intra-group financial transactions and transfer pricing rules compares to the tax rules of Morocco and Kenya, taking into account the balance required to protect a country's tax base and the desire to attract FDI. The salient factors that have emerged from the cross-national comparison are listed in Table 4-3 and a discussion on each factor follows.

Table 4-3: Salient facts from cross-national comparison

	South Africa	Morocco	Kenya
Corporate Income Tax rate	28%	31%	30%
Interest Withholding Tax rate	15%	10%	15-25%
Dividend Withholding Tax rate	20%	15%	10%
Transfer pricing legislation	Yes	Yes	Yes
Secondary transfer pricing adjustment	Yes	Yes	Yes
Form of secondary transfer pricing adjustment	Deemed Dividend	Deemed Dividend	Deemed Dividend
Advance pricing arrangement	No	Yes	No
Thin capitalisation (Safe Harbour Rules)	No	Yes	Yes

Source: Researcher's own compilation based on facts uncovered during the research

4.4.1 Corporate income tax rates

According to De Mooij and Ederveen (2008:680), corporate taxes influence business behaviour in numerous ways. For example, companies exploit tax arbitrage opportunities between legal forms, companies switch between debt and equity or reduce investment in response to tax rates, and MNEs can choose to allocate income in foreign affiliates or modify their location decisions based on differential tax rates (De Mooij & Ederveen, 2008:680). De Mooij and Ederveen (2008: 681) are of the view that if profit shifting and discrete location are relatively important, policies that reduce statutory tax rates are likely to be more efficient. The question thus arises: how do the corporate income tax rates of South Africa, Morocco and Kenya compare globally?

In a systematic empirical-based study undertaken by Crivelli *et al.* (2015:4) where the objective of the study was to determine whether base erosion, profit shifting and international tax competition really matter for developing countries, the mean statutory corporate income tax rate over the period 1980 to 2013 is recorded as 32%. The study involved the tax rates of 173 countries, with a particular focus on developing countries which included South Africa, Kenya and Morocco (Crivelli *et al.,* 2015:13). South Africa, Morocco and Kenya with corporate income tax rates of 28%, 31% and 30% respectively are all below the mean statutory corporate tax rate of 32%.

Desai and Hines Jr. (2001:7) are of the view that tax policies are capable of affecting the volume and location of FDI, since all other considerations being equal, higher tax rates reduce after-tax returns, thereby reducing incentives to commit investment funds. Based on the mean statutory rate of 32%, it appears that South Africa's corporate income tax rate of 28% places South Africa in a more favourable light if a decision has to be made by an MNE based solely on corporate income tax rate.

4.4.2 Withholding tax on interest

Given the ongoing intense public debate on profit shifting and "aggressive" tax planning by MNEs, withholding tax on interest is an appropriate measure to ensure MNEs pay a fair share of taxes in countries that they operate in (Fuest *et al*., 2013:15). According to the OECD, although withholding taxes is primarily utilised to allocate taxing rights to a source country, they may also be used to deter BEPS transactions (OECD, 2015b:20). To the extent that these withholding taxes are actually collected, the transactions to which they relate become less attractive as vehicles for artificially shifting profits out of the resident country (Irish, 1986:103). Evidence as provided in sections 2.4, 4.2.1 and 4.3.1 for South Africa, Morocco and Kenya respectively, indicate that in all three countries, interest income paid to non-residents is subject to a withholding tax on interest. Consequently, by levying a withholding tax on interest income earned by non-residents, it appears that South Africa, Kenya and Morocco have made interest payments less attractive for artificially shifting profits out of the respective countries.

As in South Africa, the withholding tax rate is much lower than the corporate tax rate in Kenya and Morocco. According to Zee (1998:595), internationally interest withholding tax rates are much lower than corporate income rates, as high-interest withholding tax rates are perceived to have detrimental effects on attracting foreign investment. Thus, it appears that South Africa, Kenya and Morocco by levying a withholding tax on interest lower than their corporate tax rates is in keeping with international norms.

Although Table 4-3 illustrates the withholding tax rate for South Africa, Kenya and Morocco as 15%, 15-25% and 10% respectively, it should be noted that in all three countries the withholding tax rate may be reduced under the applicable DTA. The **maximum** withholding tax rate on interest income prescribed by the OECD MTC is 10% (Daurer & Krever, 2014:17). Consequently, in all three countries if the DTA is based on the OECD MTC, the maximum withholding tax rate is 10%. Thus, if the respective country's DTA is based on the OECD MTC, the withholding tax on interest imposed on non-residents may not play a significant role when an investment decision has to be made between South Africa, Kenya and Morocco, as the withholding tax on interest will be capped at 10%.

4.4.3 Dividend withholding tax

Dividend income earned by non-residents in South Africa, Kenya and Morocco is subject to dividends withholding tax. Although South Africa's dividends withholding tax rate of 20% is significantly higher than Kenya's (10%) and Morocco's (15%), it should be noted that in all three countries the rate may be reduced under an applicable DTA. According to Daurer and Krever (2014:15), DTAs commonly distinguish between small passive investments in local companies, commonly referred to as 'portfolio' investments, as they are assumed to be part of the foreign shareholder's investment portfolio, and the more substantial non-portfolio direct investments in local operating companies.

The OECD MTC stipulates a maximum 5% withholding tax for dividends to non-portfolio investors and a maximum 15% withholding tax rate for dividends to portfolio investors (Daurer & Krever, 2014:16). Thus countries whose treaties are based on the OECD MTC pay the capped rate as stipulated in the respective DTA and not the rate as stipulated in the respective country's tax legislation.

The reason for the differing rates between portfolio and non portfolio investments is that the profits of a business owned through a locally incorporated subsidiary, is potentially subjected to two layers of tax, namely corporate income tax when the business profits are taxed and dividends tax when the after-tax profits are distributed to shareholders (Daurer & Krever, 2014:15). As the study is focussed on anti-avoidance measures to curb BEPS activities carried out by MNEs and the impact they have on FDI, the dividend tax rate of non-portfolio investments is of significance, as the MNEs are carrying on business through locally incorporated subsidiaries. As South Africa's DTAs are generally based on the OECD MTC (Olivier & Honiball, 2011:285), the dividend withholding tax rate for non-portfolio investments will be reduced to 5%. The same reduced rate of 5% will also apply to Kenya's and Morocco's DTAs that are modelled on the OECD's MTC. It therefore appears that the withholding tax rate on dividends may not play a significant role when an investment choice is to be made between South Africa, Kenya and Morocco, as the dividend tax rate for non-portfolio investment is capped at 5% if the DTA is based on the OECD MTC.

However, in the case of a secondary transfer pricing adjustment which takes the form of a deemed dividend, any withholding tax which is imposed may not qualify for DTA relief as there may not be a deemed receipt under the domestic legislation of the other country (OECD, 2017a:196). Consequently the reduced rate offered by the applicable DTA may not apply and the dividends withholding tax rate imposed on a secondary transfer pricing adjustment will be the rate legislated in the respective country's domestic law. This finding is very significant to the study as South Africa, Kenya and Morocco impose a secondary transfer pricing adjustment which takes the form of a deemed dividend. In the case of a transfer pricing adjustment, the dividends withholding tax rate levied in South Africa, Kenya and Morocco are 20%, 10% and 15% respectively.

The table below illustrates the impact of the corporate tax rates and dividends tax rates when there is a transfer pricing adjustment in South Africa, Morocco and Kenya.

Table 4-4: Transfer pricing adjustment: tax cost

	South Africa	**Morocco**	**Kenya**
Corporate Income Tax rate	28%	31%	30%
Dividend Withholding Tax rate	20%	15%	10%
Total nominal rate	**48%**	**46%**	**40%**

Source: Researcher's own compilation based on facts uncovered during the research

Due to South Africa's high Dividends Tax rate, it appears that South Africa has the highest transfer pricing adjustment tax cost of 48%, compared to Morocco and Kenya at 46% and 40% respectively. A brief literature survey carried out by Finke *et al.*(2014:2) indicates that although tighter transfer pricing policies are effective in reducing profit shifting, they do induce MNEs to invest less. Based on the Finke *et al*. study, it appears the combined corporate income tax rate of 28% and Dividends Tax rate of 20% when there is a transfer pricing adjustment may induce MNEs to invest less in South Africa when compared to the lower combined income tax rate and Dividends Tax rate of Morocco and Kenya.

4.4.4 Transfer pricing legislation

By taking advantage of international differences in corporate tax systems, MNEs are able to reduce their tax expenses by shifting profits from higher to lower tax rate countries without moving the underlying economic activity (OECD, 2015a). By manipulating the prices charged on intra-group, cross-border transactions (commonly referred to as transfer mispricing), MNEs are able to shift profits from higher to lower tax rate countries (Bartelsman & Beetsma, 2003:2227; Johansson, Skeie, Sorbe & Menon, 2016:6-7), resulting in BEPS.

In the absence of clear regulatory requirements, related parties may have incentives to engage in transfer mispricing (Cooper *et al.,* 2016:5). Regulation of transfer pricing for tax purposes commonly involves the prescription of standards or methodologies, which must be complied with when determining transfer prices (Cooper *et al.,* 2016:4). Transfer pricing regulations, for example, usually require that transfer prices for transactions between related parties be determined in accordance with the arm's-length principle (Cooper *et al.,* 2016:4). Non-compliance with these regulations will often result in adjustments to the tax liability (Cooper *et al.,* 2016:4).

Sections 2.3, 4.2.2 and 4.3.2 of this study provide evidence that South Africa, Morocco and Kenya respectively, have a regulatory framework to prevent transfer mispricing. These sections show that in all three countries an adjustment should be made to taxable profit when cross-border transactions with related parties are not based on an arm's length price. This adjustment in most cases will increase the taxable income of the resident taxpayer and thereby increase the income tax expense. Furthermore, all three countries deem the non-arm's length amount to be a dividend that is subject to dividends withholding tax. Thus Morocco's and Kenya's transfer pricing legislation seems to be very similar to South Africa's, as in all three countries, a primary transfer pricing adjustment is made to taxable income when related parties do not adhere to the arm's length principle and all three countries impose a secondary transfer pricing adjustment in the form of a deemed dividend that is subject to dividends withholding tax.

Transfer pricing legislation is frequently linked with double taxation, high compliance costs, increased discretion for tax administrations and, as a result, heightened levels of uncertainty for taxpayers, all of which can have a negative effect on FDI (Cooper *et al*., 2016:22).To strike a balance between protecting a country's tax base without having a detrimental effect on FDI, many countries have introduced transfer pricing legislation based on the arm’s-length principle with the view that this approach will reduce instances of double taxation and prevent MNEs from having to manage contrasting compliance obligations and associated costs (Cooper *et al*., 2016:17). By legislating the arm's length principle for all cross-border transactions between related parties, it appears that South Africa, Kenya and Morocco are committed to protecting their tax bases from artificial shifting of profit by the use of transfer mispricing, without having a detrimental effect on FDI. Furthermore, by enacting transfer pricing rules, it seems as if South Africa, Morocco and Kenya are heeding the OECD's call for governments to address BEPS holistically. The reason for the holistic approach is that it may be difficult for any single country acting alone to fully address the

BEPS issue as several BEPS strategies take advantage of the interface between the tax rules of different countries.

In Morocco evidence indicates that when there is a transfer pricing adjustment on an interest payment, the non-arm's length interest is subject to both interest and dividends withholding tax, resulting in double taxation, which is similar to the South African legislation. However, the Moroccan transfer pricing legislation does not appear to be as punitive as South Africa when there is a transfer pricing adjustment on an interest payment for the following reasons:

- Transfer pricing adjustment in South Africa is a self-assessment process. In other words the arm's length amount must be taken into account when preparing the corporate income tax return and assessing what portion of the related interest expense, if any, is not deductible under section 31 of the Act (SARS, 2013a:7). In contrast, in Morocco a transfer pricing adjustment is only made following a tax audit. Consequently, the taxable income of a taxpayer that is not selected for an audit will not be adjusted.
- The Moroccan General Tax Code makes provision for advance pricing arrangements which are absent in South Africa's tax legislation. (Please refer to section 4.2.4 for more details). The risk of a transfer pricing adjustment is mitigated when the taxpayer has an advance pricing arrangement with the revenue authorities. Consequently, the possibility of subjecting the non-arm's length interest to both interest and dividends withholding tax is eliminated as the dividends withholding tax is only imposed when there is a transfer pricing adjustment.
- If the Moroccan taxpayer does not have an advance pricing arrangement with the revenue authorities and a transfer pricing adjustment is made on an interest payment following a tax audit, the dividends tax rate of 15% levied on the non-arm's length is 5% lower than South Africa's dividends tax rate of 20%.

In Kenya, the recent introduction of a secondary transfer pricing adjustment in the form of a deemed dividend leaves it unclear at this stage whether the non-arm's length interest is subject to both a dividends and interest withholding tax. Kenya's Finance Act of 2018 (which introduced the secondary transfer pricing adjustment in the form of a deemed dividend), makes no reference as to whether a refund or credit is available for the interest withholding tax levied on the non-arm's length interest. In Kenya, dividends withholding tax is levied at 10%, while the interest withholding tax is levied at 15%. It therefore appears that by re-characterising the non-arm's length interest to a deemed dividend, an unintentional benefit is conferred on the non-resident in the form of a reduced withholding tax, unless the non-arm's length interest is subject to both dividends and interest withholding tax as is the situation in both South Africa and Morocco.

4.4.5 Thin capitalisation rules

An in-depth understanding of financial transactions and markets, as well as access to specialized market data is required to ensure that intra-group financial arrangements are in accordance with the arm’s length principle (Cooper *et al*., 2016:210). Consequently, the compliance costs for entities, particularly with respect to smaller loans can be significant and potentially disproportionate (Cooper *et al*., 2016:210). According to Cooper *et al*. (2016:210) simplification measures such as safe harbour rules (debt-to-equity ratios) for loans may be appropriate in these circumstances. It should be noted that the OECD (2015c:21), acknowledges that although the safe harbour rules (debt-to-equity ratios) are not included as part of the best practice approach to deal with BEPS, it does not suggest that the safe harbour rules cannot play a role within an overall tax policy to limit interest deductions.

Tax certainty calls for clear and simple rules and regulations that minimise disputes (IMF/OECD, 2018:9) and is one of the principles of a good tax system (Bronkhorst & Stiglingh, 2018:5). According to the OECD (2017a:206), safe harbours provide certainty to taxpayers that transactions falling within the safe harbour parameters will be accepted by the revenue authorities with a limited audit or without an audit beyond ensuring the taxpayer has met the eligibility conditions of, and complied with the safe harbour provision. By enacting thin capitalisation rules with safe harbours (which are lacking in South Africa), it appears that both Kenya and Morocco are reducing compliance costs as well as providing certainty to the taxpayer regarding acceptable amounts of debt and interest rates.

As discussed in section 2.2, the most prominent profit shifting technique involves the strategy of using internal debt. The primary objective of thin capitalisation rules is to prevent BEPS by denying interest deductions if the borrowing entity's debt-to-equity ratio is above the so-called safe harbour debt-to-equity ratio (Buettner *et al.*, 2012:937). As tax certainty is one of the principles of a good tax system (Bronkhorst & Stiglingh, 2018:5), Morocco and Kenya, by enacting thin capitalisation rules with safe harbours, seem to strike a balance between protecting their tax base from excessive interest deduction, and providing a tax system that may be viewed as favourable by MNEs.

According to the IMF/OECD (2018:5), tax uncertainty creates a risk of discouraging investment. The DTC (2017:33) recognises that inbound investors require tax certainty as it makes a recommendation that at least one legally binding General Ruling should be enacted in section 31 of the Act. The binding General Ruling according to the DTC (2017:34) should define a safe harbour (debt-to-equity ratio) as well as an interest rate for inbound loans. Consequently, inbound investors will obtain the certainty they need regarding loan requirements without having to expend significant amounts of money to determine an arm’s length amount for loans (DTC, 2017:133).

4.5 Chapter conclusion

Evidence indicates that Morocco and Kenya are as committed as South Africa to protecting their tax bases from BEPS as they have transfer pricing rules that discourage transfer mispricing, thin capitalisation rules that limit interest deductions, and dividends and interest withholding taxes that are levied on dividends and interest payments made to non-residents. By enacting these anti-avoidance measures it appears that South Africa, Morocco and Kenya are heeding the OECD's call for governments to address BEPS holistically. The reason for the holistic approach is that it may be difficult for any single country acting alone to fully address the BEPS issue as several BEPS strategies take advantage of the interface between the tax rules of different countries. The anti-avoidance measures enacted in South Africa, Morocco and Kenya to curb tax avoidance strategies, appear to contradict TJN's view that the desire to attract FDI by developing countries makes it difficult for developing countries to enact and enforce tax rules to prevent BEPS.

Countries agree that measures developed to address BEPS should not lead to unnecessary uncertainty for compliant taxpayers (OECD, 2015c:9). According to the OECD (2017a:206), safe harbours provide certainty to taxpayers that transactions that fall within the safe harbour parameters, will be accepted by the revenue authorities with a limited audit or without an audit beyond ensuring that the taxpayer has met the eligibility conditions of, and complied with the safe harbour provision.

By enacting thin capitalisation rules with safe harbours (which the South African legislation lacks), Kenya and Morocco are affording certainty regarding acceptable amounts of debt and interest rates, as well as reduced compliance costs. According to the IMF/OECD (2018:5), tax uncertainty creates a risk of discouraging investment. The certainty regarding acceptable amounts of debt and interest rates afforded by Kenya's and Morocco's tax system may thus be viewed as favourable by MNEs. The DTC (2017:33) recognises this certainty, which is required in South Africa by inbound investors, as it makes a recommendation that at least one legally binding General Ruling should be enacted in section 31 of the Act. The binding General Ruling according to the DTC (2017:34) should define a safe harbour (debt-to-equity ratio) as well as an interest rate for inbound loans.

Evidence indicates that the transfer pricing legislation of Morocco and Kenya seems to be very similar to South Africa's, as in all three countries, a primary transfer pricing adjustment is made to taxable income when related parties do not adhere to the arm's length principle and all three countries impose a secondary transfer pricing adjustment in the form of a deemed dividend that is subject to dividends withholding tax. In Morocco the non-arm's length interest is subject to both interest and dividends withholding tax, resulting in a possible double taxation, as is the case in South Africa

Due to the recent introduction of a secondary transfer pricing adjustment in the form of a deemed dividend in Kenya, it is unclear whether the non-arm's length interest is subject to both a dividends and interest withholding tax. Kenya's Finance Act of 2018 (which introduced the secondary transfer pricing adjustment) makes no reference as to whether a refund or credit is available for the interest withholding tax levied on the non-arm's length interest. In Kenya, dividends withholding tax is levied at 10%, while the interest withholding tax is levied at 15%. It therefore appears that by re-characterising the non-arm's length interest to a deemed dividend, an unintentional benefit is conferred on the non-resident in the form of a reduced withholding tax, unless the non-arm's length interest is subject to both dividends and interest withholding tax, resulting in double taxation as is the situation in both South Africa and Morocco.

Countries agree that measures developed to address BEPS should not lead to unnecessary uncertainty for compliant taxpayers and unintended double taxation (OECD, 2015c:9). One of the best practices recommended in BEPS Action 14 to minimise uncertainty and unintended double taxation is the implementation of advance pricing arrangements (OECD, 2015c:30). Several countries including Morocco, have implemented advance pricing arrangements as a bilateral resolution mechanism to avoid double taxation (UN, 2017c:356).

The research undertaken suggests that although the non-arm's length interest is subject to both dividends and interest withholding tax in Morocco, it is not as punitive as in South Africa, as the Moroccan taxpayer is in a better position to predict and eliminate this double taxation due to the country's "thin capitalisation" rules and advance pricing arrangements (which are lacking in South Africa's tax legislation).

Chapter 5

5 Conclusions

The findings, conclusions, recommendations, limitations and further research areas are presented in this chapter.

The primary objective of the study as detailed in section 1.5 was to determine whether the tax consequences of an interest payment that is subject to a transfer pricing adjustment and withholding tax on interest is equitable against the BEPS background.

The following secondary objectives were formulated to address the primary objective:

- To analyse the transfer pricing and the withholding tax provisions in the Act to determine whether the tax consequence is equitable with minimal disincentive effects on FDI when there is a transfer pricing adjustment on an interest payment that is also subject to withholding tax. This objective is addressed in chapter two.
- To analyse the OECD and UN model tax convention on income and capital (MTC) to determine how the MTC addresses transfer pricing adjustments and interest income to avoid double taxation. This objective is addressed in chapter three.
- To analyse South Africa's transfer pricing and withholding tax provisions against the OECD and UN guidelines and reports to establish whether South Africa's legislation is equitable when compared to the recommended practice of the OECD and UN. This objective is addressed in chapter three.

- To compare the transfer pricing and withholding tax legislation of African countries that attract FDI to determine how South Africa’s legislation differs and to conclude whether South Africa’s tax legislation is equitable compared to the countries selected. This objective is addressed in chapter four.

The findings and conclusions of the respective chapters, in which the above objectives are addressed, are outlined below.

5.1 Findings and conclusions:

5.1.1 Chapter 2: Overview and analysis of domestic law

The analysis of the domestic law indicates that to curb BEPS, the co-existence of transfer pricing rules and withholding tax on interest is necessary in the South African tax legislation, in order to offset the limitations that are found in both of these anti-avoidance measures (Please refer to section 2.5).

The study however, indicates that these two provisions run independently of each other with no reference made in the transfer pricing provisions to withholding tax on interest and vice versa. Thus when the non-arm's length interest is re-characterised to dividend income in the transfer pricing provision, it retains its legal character of interest in the withholding tax on interest provisions. Consequently the non-arm's length interest is subject to both withholding tax on dividends and interest. The non-arm's length amount according to the legislation is both interest income and dividend income, resulting in double taxation. According to McClure (cited by Kwall, 1990:615), double taxation is criticised for being contrary to the fundamental principles of equity and efficiency (economic neutrality) of a good tax system.

An additional problem identified is that two taxpayers subject to a transfer pricing adjustment are not treated equally when the underlying transaction differs in nature. For example, both sale of goods and interest payments are subject to the arm's length principle under the transfer pricing provisions. However, a comparison of the tax expense (as presented in Table 2-1) indicates that interest payments subject to a transfer pricing adjustment impose a greater tax burden due to the double taxation on the non-arm's length interest. Thus a taxpayer who is subject to a transfer pricing adjustment on the sale of goods is in a better tax liability position than a taxpayer who is subject to a transfer pricing adjustment on an interest payment. This discrepancy in the tax treatment appears to violate the horizontal equity principle of a good tax system.

Based on the analysis of the transfer pricing and withholding tax on interest provisions, it appears that the tax consequences on an interest payment that is subject to both a transfer pricing adjustment and withholding tax on interest, violates the equity and efficiency principles of a good tax system. This inequitable result is due to the double taxation on the non-arm's length interest amount which is subject to both Dividends Tax and withholding tax on interest. The double taxation on the non-arm's length interest amount may have a disincentive effect on economic activities. This is inferred by the OECD's view that double taxation can create a barrier to cross-border transactions in goods and services and the movement of capital (OECD, 2017a:15).

5.1.2 Chapter 3: Analysis of domestic law against OECD and UN guidelines

Evidence indicates that South Africa's tax legislation in limiting interest deductions is aligned to international practice except for the non-arm's length interest that attracts both withholding tax on interest and Dividends Tax. Both the OECD and UN indicate that the withholding tax on interest should continue to apply when there is no re-characterisation of the non-arm's length interest to dividend income. Please refer to section 3.1 and 3.2.

The question of the characterisation of disallowed interest is raised by the UN Practical Portfolio. That is, should it retain its legal character as interest or should it be re-characterised to dividends (UN, 2017a:38)? Although a solution is not provided in the guidelines, they do indicate that the disallowed interest cannot be subject to both a withholding tax on interest and dividends by highlighting that policymakers need to consider the impact when deciding to retain the legal character of the interest or the re-characterisation to dividend income (UN, 2017a:38).

Based on the recommended practice of the OECD and UN it appears that by subjecting the non-arm's length interest to both interest and dividends withholding tax, the South African legislation in this regard is not equitable due to the resulting double taxation. According to SARS (2018b:2), disputes arising from juridical and economic double taxation as well as inconsistencies in the interpretation or application of a DTA, may be resolved by utilising MAP, as provided for in Article 25 of the OECD and UN MTCs.

Currently, MAP as provided for in Article 25 of the OECD and UN MTCs seems to be the only solution for a group of companies that is exposed to an additional layer of tax in the form of Dividends Tax when an interest payment is subject to both a transfer pricing adjustment and withholding tax on interest. Please refer to section 3.5 for a detailed discussion. A severe drawback of MAP is that the average timeframe to reach a resolution is 24 months.

5.1.3 Chapter 4: Cross-national comparison of the domestic law

This chapter outlines the corporate income tax rates, dividend and interest withholding tax rates, transfer pricing legislation and thin capitalisation rules of South Africa's two strong FDI and country attractiveness competitors in Africa, namely Morocco and Kenya.

Evidence indicates that the transfer pricing legislation of Morocco and Kenya seems to be very similar to South Africa's transfer pricing legislation, as in all three countries, a primary transfer pricing adjustment is made to taxable income when related parties do not adhere to the arm's length principle and all three countries impose a secondary transfer pricing adjustment in the form of a deemed dividend that is subject to dividends withholding tax (Please refer to Table 4.3). In Morocco the non-arm's length interest is subject to both interest and dividends withholding tax, resulting in a possible double taxation, as is the case in South Africa.

In Kenya, it is unclear whether the non-arm's length interest is subject to both a dividends and interest withholding tax. Kenya's Finance Act of 2018 (which introduced the secondary transfer pricing adjustment) makes no reference as to whether a refund or credit is available for the interest withholding tax levied on the non-arm's length interest. In Kenya, dividends withholding tax is levied at 10%, while the interest withholding tax is levied at 15%. It therefore appears that by re-characterising the non-arm's length interest to a deemed dividend, an unintentional benefit is conferred on the non-resident in the form of a reduced withholding tax, unless the non-arm's length interest is subject to both dividends and interest withholding tax resulting in double taxation, as is the situation in both South Africa and Morocco.

Based on the research findings although the non-arm's length interest is subject to both dividends and interest withholding tax in Morocco, it is not as punitive as in South Africa as the Moroccan taxpayer is in a better position to predict and eliminate this double taxation due to the country's "thin capitalisation" safe harbour rules and advance pricing arrangements, which are lacking in South Africa's tax legislation.

5.2 Recommendations

5.2.1 Advance pricing arrangements

Countries agree that measures developed to address BEPS should not lead to unnecessary uncertainty for compliant taxpayers and unintended double taxation (OECD, 2015c:9). One of the best practices recommended in BEPS Action 14 to minimise uncertainty and unintended double taxation is the implementation of advance pricing arrangements (OECD, 2015c:30). According to the UN (2017c:356), several countries have implemented advance pricing arrangements in their legal or administrative procedures as a bilateral resolution mechanism to avoid double taxation. Due to the certainty provided by an advance pricing arrangement, a taxpayer may be in a better position to predict its tax liabilities, thereby providing a tax environment that is favourable for investment (OECD, 2017a:219-220). It is therefore recommended that South Africa should consider introducing advance pricing arrangements in its legislation to minimise uncertainty and eliminate possible double taxation that arises from transfer pricing adjustments.

5.2.2 Amend Dividends Tax rate imposed on secondary transfer pricing adjustment

When the transfer pricing provision is viewed in isolation from and not in conjunction with the withholding tax on interest provisions, re-characterising the non-arm's length interest amount to a dividend and imposing Dividends Tax seems justifiable. It is justifiable as there is a possibility that a subsidiary paid an excessive transfer price (which in reality is a dividend) to the foreign parent as a means of avoiding dividends withholding tax (National Treasury, 2014:61; Weichenrieder, 1996:446; OECD, 2017a:196). Applying a secondary adjustment to re-characterise the excessive price as a dividend would be an efficient way to neutralise the tax avoidance behaviour (Teixeira, 2009:451). In the context of this study, the motive to use excessive interest to shift "dividends" to avoid paying dividends withholding tax is very remote as South Africa's domestic law imposes a withholding tax on interest when interest is paid or due and payable.

The UN Practical Portfolio indicates that the disallowed interest cannot be subject to a withholding tax on both interest and dividends (UN, 2017a:38), as is the case in South Africa. It highlights that policymakers need to consider the impact of deciding either to retain the legal character of the interest or to re-characterise it to dividend income by reviewing the respective withholding tax rates (Please refer to section 3.6). The withholding tax rates are reviewed to eliminate any unintentional benefit to the non-resident in the form of a reduced withholding tax that either the dividends or interest withholding tax may provide, when the rates are not the same (UN, 2017a:38). For example, if South Africa's tax treaties were to limit the rate of withholding tax on interest and dividends to 10% and 5% respectively, South Africa would confer an unintentional benefit in the form of a reduced withholding tax if the non-arm's length interest is re-characterised to dividend income.

In South Africa, due to the fact that Dividends Tax is levied at 20% (with no treaty relief for a secondary transfer pricing adjustment) and withholding tax on interest is levied at 15% (which may be reduced in terms of an applicable DTA), the re-characterisation of the non-arm's length interest to dividend income appears to be justifiable as the rationale is to neutralise any perceived tax avoidance behaviour.

To overcome the issue that withholding tax on interest may have been paid already on the non-arm's length interest and to eliminate the resulting double taxation on the non-arm's length interest, it is recommended that the Dividends Tax payable on the non-arm's length should be the difference between 20% (the current Dividends Tax rate) and the withholding tax on interest rate levied when the interest was paid. Using the information that was used in section 1.2.4 to illustrate the difference in tax expense when there is a transfer pricing adjustment, Table 5-1 depicts the difference in tax expense under the current legislation and the recommended amended legislation.

Table 5-1: Transfer pricing adjustment: difference in tax expense using the recommended reduced Dividends Tax rate

	Transfer pricing adjustment not required	**Transfer pricing adjustment under section 31 of the Act**	**Transfer pricing adjustment using the recommended reduced Dividends Tax**
Accounting profit	R1 000 000	R1 000 000	R1 000 000
Add excess interest (non-arm's length interest)		R 300 000	R 300 000
Taxable Income	R1 000 000	R1 300 000	R1 300 000
Tax @ 28%[1]	R 280 000	R 364 000	R 364 000
Withholding Tax on interest @ 15%[2]	R 225 000	R 225 000	R 225 000
Dividends Tax @ 20%[3]		R 60 000	
Dividends Tax @ 5%[4] (Difference between current Dividends Tax rate and Withholding Tax on interest rate)			R 15 000
Total tax expense[1+2+3]	**R 505 000**	**R 649 000**	
Total tax expense[1+2+4]			**R 604 000**

Source: Researcher's own compilation based on information uncovered during the research

5.3 *Limitations of the study*

Literature could not be obtained to determine whether the non-arm's length interest in Kenya is subject to both interest and dividends withholding tax, resulting in double taxation, as is the case in South Africa and Morocco. The non-availability of literature is possibly due to the fact that in Kenya, the secondary transfer pricing adjustment in the form of a deemed dividend was only enacted in September 2018, with the effective date being 1 January 2019.

5.4 *Further research areas*

5.4.1 Quantitative research

The qualitative approach was utilised to answer the research question which is "Are the tax consequences of an interest payment that is subject to a transfer pricing adjustment and withholding tax equitable against the BEPS background?"

Based on this qualitative approach, it appears that the tax consequences on an interest payment that is subject to both a transfer pricing adjustment and withholding tax on interest, results in the double taxation on the non-arm's length interest amount. This double taxation violates the equity and efficiency principles of a good system and is therefore inequitable The OECD's view is that double taxation can create a barrier to cross-border transactions in goods and services and the movement of capital. Further research utilising the quantitative approach could be undertaken to measure the extent to which MNEs are affected by the double taxation of the non-arm's length interest and the impact thereof of FDI in South Africa.

5.4.2 Exploring the effectiveness of MAP to eliminate double taxation

MAP as provided for in Article 25 of the OECD and UN MTCs is aimed at resolving disputes arising from juridical and economic double taxation. Currently MAP seems to be the only solution for resolving disputes arising from double taxation for a group of companies, when an interest payment is subject to both a transfer pricing adjustment and withholding tax on interest. Exploring MAP to determine how effective it is in South Africa in resolving conflicts that arise from double taxation, could be an area for further research.

5.4.3 Develop a framework

An additional problem identified is that two taxpayers subject to a transfer pricing adjustment are not treated equally when the underlying transaction differs in nature. For example, both sale of goods and interest payments are subject to the arm's length principle under the transfer pricing provisions. However, a comparison of the tax expense (as presented in Table 2-1) indicates that interest payments subject to a transfer pricing adjustment impose a greater tax burden due to the double taxation on the non-arm's length interest. Thus a taxpayer who is subject to a transfer pricing adjustment on the sale of goods is in a better tax liability position than a taxpayer who is subject to a transfer pricing adjustment on an interest payment. This discrepancy in the tax treatment appears to violate the horizontal equity principle of a good tax system.

A further research area would be to develop a framework that would assist in eliminating:

- the double taxation that arises when interest payments are subject to transfer pricing adjustments and withholding tax on interest; and

- the violation of the horizontal equity principle when the underlying transaction that is subject to a transfer pricing adjustment differs in nature.

5.5 *Chapter conclusions and recommendations*

Based on the analysis of South Africa's tax legislation and the recommended practice of the OECD and UN it appears that by subjecting the non-arm's length interest to both interest and dividends withholding tax, the South African legislation is less equitable due to the resulting double taxation. According to McClure (cited by Kwall, 1990:615), double taxation is criticised for being contrary to the fundamental principles of equity and efficiency (economic neutrality) of a good tax system The double taxation on the non-arm's length interest amount may have a disincentive effect on economic activities. This is inferred by the OECD's view that double taxation can create a barrier to cross-border transactions in goods and services and the movement of capital (OECD, 2017a:15).

Based on the findings of this research, although the non-arm's length interest is subject to both dividends and interest withholding tax in Morocco, it is not as punitive as in South Africa, as the Moroccan taxpayer is in a better position to predict and eliminate this double taxation due to the country's "thin capitalisation" safe harbour rules and advance pricing arrangements. One of the best practices recommended in BEPS Action 14 to minimise uncertainty and unintended double taxation is the implementation of advance pricing arrangements (OECD, 2015c:30). By enacting thin capitalisation rules with safe harbours, transfer pricing legislation and advance pricing arrangements, Morocco seems to strike a better balance between protecting its tax base from excessive interest deductions and affording a tax system that may be viewed as favourable by MNEs by providing certainty regarding acceptable amounts of debt and interest rates, as well as reduced compliance costs, which is lacking in the South African legislation.

To offer a tax system that will possibly minimise the disincentive impact on FDI and thus be viewed as favourable by MNEs the following recommendations are put forward:

- South Africa should consider introducing advance pricing arrangements in its legislation; and
- To address the more serious issue of double taxation on the non-arm's length interest that is subject to both dividends and interest withholding tax, it is recommended that the dividends tax rate on the secondary transfer pricing adjustment be amended. To overcome the issue that withholding tax on interest may have been paid already on the non-arm's length interest and to eliminate the resulting double taxation on the non-arm's length interest, it is suggested that the Dividends Tax payable on the non-arm's length should be the difference between 20% (the current Dividends Tax rate) and the withholding tax on interest rate levied when the interest was paid.

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