An evaluation of transfer pricing provisions for financial assistance granted by a foreigner to a resident

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Mini-dissertation accepted in partial fulfilment of the requirements for the degree Master of Commerce in South African and International Taxation at the North-West University

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Graduation: May 2020

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ACKNOWLEDGEMENTS

I would like to thank my supervisor, Professor Danie Schutte, for offering up his valuable time to advise me during the course of this mini-dissertation. Your contributions are sincerely appreciated.

I want to thank my father, Bartlo Oerlemans, mother, Linda Oerlemans, sister, Marissa Oerlemans and brother, Dewald Oerlemans. Your love and support throughout this study and throughout my life is a source of strength for me.

I would like to thank Ian Jannasch, who is the smartest person I know. Without your advice, optimism and constant encouragement I would not have been able to complete this mini-dissertation. Your belief in me kept me going throughout the most challenging parts of this process and for that I am more grateful than words can ever express.

Most importantly, to my Heavenly Father: Thank you for Your grace in seeing me through. I know that You were with me every step of the way.

ABSTRACT

Transfer pricing rules are anti-avoidance measures that are governed by section 31 of the South African Income Tax Act No. 58 of 1962 (Income Tax Act). Section 31(6) of the Income Tax Act provides an exemption (subject to certain requirements) from applying transfer pricing rules which allows South African holding companies to finance foreign subsidiaries with interest-free loans without worrying that the loan will be deemed to bear interest as per transfer pricing rules.

Section 31 of the Income Tax Act does not provide a similar exemption from applying transfer pricing rules in the case of a foreigner granting financial assistance to a resident. This was identified as a possible deficiency in the legislation since tax treatment that are more burdensome to a foreigner than a resident may potentially not be in line with the transfer pricing guidelines provided by the Organisation of Economic Co-operation and Development (OECD). This could indicate that the South African Revenue Service (SARS) failed to align the transfer pricing rules with the guidelines provided by the OECD, as was their announced intention with the changes made to section 31 of the Income Tax Act in 2012.

The findings of the study indicated that the absence of an exemption for a foreigner providing financial assistance to a resident from applying transfer pricing rules may be more burdensome to foreigners than residents and therefore potentially not in line with article 24 of the OECD Model Tax Convention. It was further found that the absence or implementation of such an exemption is unlikely to affect potential investors regarding investment decisions. Double Taxation Agreements (DTA) were found not to provide relief from transfer pricing liabilities (such as withholding tax on secondary adjustment deemed dividends), which further indicate that the burden on foreigners may be unfair compared to that of residents.

OPSOMMING

Oordragskostereëls is teen-vermyding wetgewing daargestel deur artikel 31 van die Inkomstebelastingwet Nr. 58 van 1962. Artikel 31(6) van die Inkomstebelastingwet verskaf 'n uitsondering (onderhewig aan sekere voorwaardes) op die toepassing van oordragskostereëls wat Suid-Afrikaanse houermaatskappye in staat stel om buitelandse filiale te finansier met rente-vrye lenings sonder om bekommerd te wees dat die lening geag sal word om rente-draend te wees ingevolge die oordragskostereëls.

Artikel 31 van die Inkomstebelastingwet maak egter nie voorsiening vir 'n soortgelyke uitsondering in die geval van finansiële bystand wat deur 'n buitelander aan 'n inwoner verleen word nie. Die afwesigheid van so 'n uitsondering is geïdentifiseer as 'n potensiële tekortkoming in die wetgewing aangesien belastingreëls wat groter druk plaas op 'n buitelander as 'n inwoner moontlik nie in ooreenstemming is met die riglyne vir oordragskostereëls soos verskaf deur die "OECD" nie. Dit mag daarop dui dat die Suid-Afrikaanse Inkomstediens nie geslaag het daarin om die oordragskostereëls in lyn te bring met die riglyne vir oordragskostereëls soos verskaf deur die "OECD" (wat die doel was van die veranderinge aangebring aan artikel 31 van die Inkomstebelastingwet in 2012) nie.

Die bevindinge van hierdie studie dui daarop dat die afwesigheid van 'n vrystelling van die toepassing van oordragskostereëls vir 'n buitelander wat finansiële bystand aan 'n inwoner verleen moontlik groter druk plaas op buitelanders as op inwoners en dus moontlik nie in ooreenstemming met artikel 24 van die "OECD" se "Model Tax Convention" is nie. Daar is verder bevind dat dit onwaarskynlik is dat die afwesigheid of implementasie van so 'n vrystelling potensiële beleggers se beleggingsbesluite sal beïnvloed. Met betrekking tot verligting verskaf deur dubbel belastingooreenkomste was die bevindinge van hierdie studie dat dit nie die bedoeling was dat dubbel belastingooreenkomste verligting van dividendbelasting op geagte dividende as gevolg van sekondêre oordragskostereël aanpassings moet verskaf nie. Dit is 'n verdere aanduiding dat die belastinglas op buitelanders moontlik swaarder is as die belastinglas op inwoners.

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CHAPTER 1: INTRODUCTION

1.1 TITLE: An evaluation of whether the South African transfer pricing provisions should include an exemption for cases where financial assistance is granted by a foreigner to a resident

1.2 KEYWORDS

The following words and terms will apply in this study:

- Transfer pricing
- International tax
- Financial assistance
- Thin capitalisation
- OECD guidelines
- Foreigner
- Resident
- Arm's length
- Taxation of companies
- South Africa

1.3 DEFINITIONS

Connected person: A connected person is defined in Section 1 of the Income Tax Act No. 58 of 1962 (the Income Tax Act) as follows:

- "In relation to a natural person, any relative and any trust (other than a portfolio of a collective investment scheme in securities or a portfolio of a collective investment scheme in property) of which such natural person or such relative is a beneficiary;

- In relation to a trust (other than a portfolio of a collective investment scheme in securities or a portfolio of a collective investment scheme in property) any beneficiary of such trust and any connected person in relation to such beneficiary;

- In relation to a connected person in relation to a trust (other than a portfolio of a collective investment scheme in property or a portfolio of a collective investment scheme in securities) includes any other person who is a connected person in relation to such trust;

- In relation to a member of any partnership or foreign partnership any other member and any connected person in relation to any member of such partnership or foreign partnership;

- In relation to a company any other company that would be part of the same group of companies as that company if the expression "at least 70 per cent of the equity shares in" in paragraphs (a) and (b) of the definition of "group of companies" in section 1 of the Income Tax Act were replaced by the expression "more than 50 per cent of the equity shares or voting rights in";

- In relation to a company any person, other than a company as defined in section 1 of the Companies Act [No. 71 of 2008] that individually or jointly with any connected person in relation to that person, holds, directly or indirectly, at least 20 per cent of the equity shares in the company or the voting rights in the company;

- In relation to a company any other company if at least 20 per cent of the equity shares or voting rights in the company are held by that other company and no holder of shares holds the majority voting rights in the company;

- In relation to a company any other company if such other company is managed or controlled by any person who or which is a connected person in relation to such company or any person who or which is a connected person in relation to a such connected person;

- In relation to a company where the company is a close corporation any member, any relative of such member or any trust (other than a portfolio of a collective investment scheme in securities or a portfolio of a collective investment scheme

in property) which is a connected person in relation to such member and any other close corporation or company which is a connected person in relation to any member or the relative or trust which is a connected person;

- In relation to any person who is a connected person in relation to any other person in terms of the foregoing provisions of the definition, such other person."

Controlled foreign company: Section 9D(1) of the Income Tax Act defines a controlled foreign company as:

- "any foreign company where more than 50 per cent of the total participation rights in that foreign company are directly or indirectly held, or more than 50 per cent of the voting rights in that foreign company are directly or indirectly exercisable, by one or more persons that are residents other than persons that are headquarter companies"

Financial assistance: Section 31 of the Income Tax Act defines financial assistance as any:

- "debt; or
- security or guarantee".

Resident: A resident is defined in Section 1 of the Income Tax Act as follows:

- "Any natural person who is ordinarily resident in the Republic;

- Any natural person who is not at any time during the relevant year of assessment ordinarily resident in the Republic, if that person was physically present in the Republic for a period or periods exceeding 91 days in aggregate during the relevant year of assessment, as well as for a period or periods exceeding 91 days in aggregate during each of the five years of assessment

preceding such year of assessment and for a period or periods exceeding 915 days in aggregate during those five preceding years of assessment.

- Any person, other than a natural person, which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic;”

- The definition does not include any person who is deemed to be exclusively a resident of another country for purposes of the application of any agreement entered into between the governments of the Republic and that other country for the avoidance of double taxation.

1.4 ABBREVIATIONS

Abbreviation	**Meaning**
BEPS	Base Erosion and Profit Shifting
CFC	Controlled Foreign Company
DTA	Double Taxation Agreement
FDI	Foreign Direct Investment
IMF	International Monetary Fund
MNE	Multi-National Enterprises
OECD	The Organisation for Economic Co-operation and Development
SARS	South African Revenue Service

1.5 INTRODUCTION

1.5.1. Background to the research area

The British novelist, Doris Lessing, was of the opinion that "borrowing is not much better than begging and lending with interest is not much better than stealing". Be that as it may, intra-group financial assistance is a reality that has to be dealt with for South African taxpayers in multi-national groups (Potgieter, 2014).

Multi-national enterprises (MNE) comprise a large proportion of global trade. Developments in the globalisation of trade, as well as the fact that intra-firm trade represents a growing portion of trade as a whole, have opened up opportunities for MNEs to minimise their tax liabilities (OECD, 2013:7). It is possible for multinational groups of companies to use the pricing of intra-group transactions as a tool to ensure that their profits are taxed in low tax jurisdictions and deductions are utilised in high tax jurisdictions (Olivier & Honiball, 2011:620). Taxpayers took advantage of these opportunities resulting from cross-border trade and mismatches in tax legislation to minimise tax burdens by moving significant amounts of profits offshore to lower tax, which resulted in tax authorities introducing anti-avoidance measures such as thin capitalisation legislation (Bredenkamp, 2015:1).

There is an ideal model for these anti-avoidance measures (such as transfer pricing and thin capitalisation rules). This ideal model is provided by the Organisation for Economic Co-operation and Development (OECD) in the form of transfer pricing guidelines, as well as a model convention with respect to taxes on income and capital. These transfer pricing guidelines address the main issues relating to transfer pricing. The OECD Transfer Pricing Guidelines and Model Convention aim to result in fair tax treatment for all taxpayers across borders and even include articles for the avoidance of double taxation (article 22) and specifically requiring non-discrimination (article 24).

In South Africa, transfer pricing and thin capitalisation rules are governed by section 31 of the Income Tax Act and was introduced in South Africa in 1995 (Olivier & Honiball, 2011:621). In the past, the thin capitalisation rules, contained in section 31(3) of the Income Tax Act, gave the Commissioner for the South African Revenue

Service (the Commissioner) the authority to disallow as deductions any interest, finance charges or other considerations relating to transactions providing international financial assistance if such assistance was deemed to be excessive in relation to the amount provided by the lender to the borrower (Musviba, 2013).

However, South African transfer pricing and thin capitalisation legislation has undergone significant developments since 2011, a number of which affect financial assistance between connected persons across borders (Potgieter, 2014). In 2010 and 2011, the South African Revenue Service (SARS) announced their intention to significantly realign the transfer pricing legislation applicable at that time with the transfer pricing rules provided by the OECD (Honiball & Delahaye, 2013:16). As a result, section 31 of the Income Tax Act was completely overhauled, with the new section 31 of the Income Tax Act coming into effect on 1 April 2012. The reason provided by SARS for the changes that were made to section 31 of the Income Tax Act, is that it wanted to bring the legislation in line with the OECD transfer pricing guidelines (Honiball & Delahaye, 2013:16).

The first substantial change applicable in respect of years of assessment commencing on or after 1 April 2012, was the removal of the thin capitalisation rules previously governed by section 31(3) of the Income Tax Act. The Taxation Laws Amendment Act No. 24 of 2011 substituted the old section 31 of the Income Tax Act with the new section 31 of the Income Tax Act (South Africa, 2011:128). However, this amendment to section 31 of the Income Tax Act did not mean that South African taxpayers no longer had to ascertain that financial assistance received was not excessive, since thin capitalisation rules were now included under a single subsection of the transfer pricing legislation. In line with the "associated enterprise' article as prescribed by the OECD Model Tax Convention, the thin capitalisation rules were combined directly into the transfer pricing rules (National Treasury, 2010:76).

The current transfer pricing rules with regard to loans and other debt mean that if the terms and conditions of a particular loan or debt are not in line with what it would have been if the transaction were conducted at arm's length between two independent parties, and this discrepancy results in a tax benefit to either the borrower or the lender, then the taxpayer is obligated to calculate their taxable income based on the arm's

length terms and conditions that would have applied to that transaction. This will result in any interest or finance charges directly related to the excessive portion of the loan or debt not being allowed as a deduction when calculating the taxpayer's taxable income (Potgieter, 2014). The new transfer pricing rules also include both direct and indirect transactions, which mean that the net cast for transactions that will fall under the transfer pricing rules is even wider than under the previous rules (Olivier & Honiball, 2011:662). As a whole, section 31 of the Income Tax Act aims to be in line with OECD guidelines and to ensure that all cross-border transactions are conducted at arm's length terms.

However, there are exceptions to the application of transfer pricing rules in section 31 of the Income Tax Act. These exceptions are contained in sections 31(6) and 31(7) of the Income Tax Act and provide exemption, subject to certain conditions, from applying transfer pricing rules for transactions where financial assistance is granted by a resident to a controlled foreign company (CFC) (South Africa, 1962).

The first exemption from applying the transfer pricing rules is provided by section 31(6) of the Income Tax Act. In summary, section 31(6) of the Income Tax Act provides that transfer pricing rules in its entirety will not apply in the case of financial assistance granted by a resident to a foreigner if the following conditions apply: The resident in question owns (whether by itself or in conjunction with another company in the same group of companies) at least 10 per cent of the equity shares and voting rights in the CFC, the CFC has a foreign business establishment as defined in section 9D(1) of the Income Tax Act, and the aggregate amount of tax payable to the government of any country other than South Africa by the CFC is at least 75 per cent of the amount of normal tax that would have been payable in South Africa if the CFC had been a resident of that foreign tax year (South Africa, 1962). Section 31(6) of the Income Tax Act provides an exemption from the application of transfer pricing rules since a transaction would be regarded to be at arm's length if all the requirements of the sub-sections are met. The exemption also allows South African holding companies to finance foreign operating subsidiaries with interest-free loans without being concerned that the loan will be deemed to bear interest as a result of transfer pricing rules (Haupt, 2017:594).

The next exemption is contained in section 31(7) of the Income Tax Act and relates to equity loans. This exemption will result in the entire section 31 of the Income Tax Act not being applicable when a resident company provides financial assistance to a foreign company in which the resident owns at least 10 per cent of the equity shares and voting rights if the foreign company is not under any obligation to repay the debt in full within 30 years from receiving the assistance (South Africa, 1962). Furthermore, the repayment of the debt in full by the foreign company has to be subject to approval from all other persons to which the foreign company owes a debt or be conditional on the market value of the liabilities of the foreign company not exceeding the market value of its assets.

However, when reviewing these exceptions to applying the transfer pricing rules, it is noted that the Income Tax Act does not contain any specific provisions for exemption from transfer pricing rules in the case of financial assistance being granted by a foreign company to a resident. This means that in the case of foreign companies providing financial assistance to a resident, there is no relief from the additional burdens of tax, compliance and costs to comply with transfer pricing rules. In the absence of an exemption for foreigners providing financial assistance, the resident will have to adjustments as prescribed by transfer pricing rules. This will include both a primary adjustment of interest, which may result in withholding tax on the interest, and a secondary adjustment of a deemed dividend, which may result in withholding tax on the dividend. For the resident, it appears as if the absence of this exemption could result in double taxation (as a result of the secondary adjustment required by transfer pricing rules).

While section 31 of the Income Tax Act is an anti-avoidance provision and no relief should be given unless a transaction is a bona fide agreement for commercial purposes, section 31(6) of the Income Tax Act does provide an exemption from the application of transfer pricing rules since a transaction would be regarded to be at arm’s length if all the requirements of the sub-sections are met. That would suggest that a similar exemption to a foreigner providing financial assistance with similar requirements would still ensure arm’s length transactions.

This difference in treatment of taxpayers that are residents and taxpayers that are non-residents could also potentially not be in line with the non-discrimination guidelines provided by the OECD, which might indicate a deficiency in the current tax legislation.

As mentioned above, the application of transfer pricing rules may result in an additional tax burden, specifically with regard to withholding taxes. Sections 50A to 50H of the Income Tax Act impose withholding taxes of 15 per cent on any interest from a South African source paid to non-resident persons (South Africa, 1962). This withholding tax takes the place of normal tax on the interest. The foreign taxpayer is liable for the withholding tax, even though it is paid over by the resident. The absence of this exemption could thus result in a foreigner being liable for withholding tax.

However, on 28 May 2015, SARS issued Binding Private Ruling 192 (SARS, 2015). The ruling dealt with the issue of whether an adjustment made to taxable income under section 31 of the Income Tax Act can trigger withholding tax on interest levied under sections 50B and section 50E of the Income Tax Act. In terms of this ruling, neither the resident nor the foreigner will be liable for withholding tax on interest in terms of such an adjustment.

The ruling does not refer to possible withholding tax on the dividend as a result of the secondary adjustment. However, the ruling does lead to the question if the intention of the legislators were to collect withholding tax in these circumstances. On whether or not the deemed dividend *in specie* should be liable for withholding tax or will be subject to relief provided by a Double Taxation Agreement (DTA), the Davis Tax Committee's First Interim Report of 2014 stated that "a transfer pricing adjustment is triggered as a result of economic value being transferred from South Africa for no or inadequate consideration. This transfer of economic value results in depletion in the asset base of the South African taxpayer and a resultant potential loss of future taxable income for the fiscus. For this reason it is suggested that 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. Therefore, the secondary adjustment should result in a tax equivalent to the proposed 15 per cent withholding tax" (Davis Tax Committee, 2014:19).

No guidance is provided in the Income Tax Act, and in light of the ruling on the withholding tax on interest, it is thus unclear what the withholding tax implications are. It is also unclear if the absence of an exemption from transfer pricing implications for inward bound financial assistance is really what the legislators intended or just an anomaly or side effect of the current working of the transfer pricing rules.

Whether as a result of a side effect or intentionally excluded by legislators, it has to be considered whether the effect of the legislation as it stands is really what is intended to achieve. With the way the legislation stands currently, South Africa is imposing a heavier burden when foreigners provide funding, while residents who lend money do not get taxed in the same manner. It would appear that the system is subjecting someone who is doing something beneficial for South Africa - providing funding – to additional administrative and taxation burdens by not providing an exemption from applying transfer pricing rules. This then leads to the question of whether there should be another exception to applying the transfer pricing rules for foreigners or if efficient relief is provided elsewhere in the tax legislation.

1.5.2. Literature review of the topic/research area

From the literature review performed in this specific research area, it appears that uncertainty prevails with regard to the application of the transfer pricing rules after the legislation was amended. In 2012, SARS announced their intention to realign the transfer pricing rules that was applicable at the time with the transfer pricing guidelines as provided by the OECD. The subsequent overhaul of section 31 of the Income Tax Act, which became effective on 1 April 2012, as well as the lack of an updated supporting Practice Note provided by SARS with regard to the application of the new transfer pricing rules has resulted in much uncertainty surrounding the workings of transfer pricing rules (Honiball & Delahaye, 2013:16).

During the literature review performed, numerous references to SARS's intention to align the South African transfer pricing rules with the guidelines regarding transfer pricing as provided by the OECD were found. However, subsequent to the amendments to section 31 of the Income Tax Act as detailed above, not a lot of research appears to have been done on whether the amendments succeeded in

aligning the South African transfer pricing rules with the guidelines issued by the OECD. There has been research performed in South Africa to investigate the possibility that other sections of the Income Tax Act were in conflict with the guidelines provided by the OECD. Specifically, research was performed to investigate the possibility that section 23M of the Income Tax Act was in conflict with the OECD non-discriminatory article (Bredenkamp, 2015:3), but research to determine if the transfer pricing rules as per section 31 of the Income Tax Act is in line or in conflict with the OECD guidelines appeared to be limited. This was identified as an area in which more research was needed.

1.5.3. Motivation of topic actuality

In their first interim introductory report Addressing Base Erosion and Profit Shifting (BEPS) in South Africa, the Davis Tax Committee states that reacting to BEPS issues should not be considered as deterring foreign investment (Davis Tax Committee, 2014:37). While the report mentions BEPS, it would appear from this statement, that discouraging foreign investment is not a preferable outcome for any country.

Prior research performed in South Africa, suggested the possibility that South African tax legislation policies appear to be favouring policies that would discourage, rather than encourage, foreign investors from investing in South Africa (Bredenkamp, 2015:76).

Furthermore, after the amendments to section 31 of the Income Tax Act that were implemented in 2011, the application of transfer pricing rules in South Africa remains an area of great uncertainty, worsened by the absence of any guidance provided by SARS regarding the implementation of the new provisions, especially with regard to the new arm’s length test for thin capitalisation (Kruger, 2012:16) This uncertainty regarding the application of transfer pricing is further complicated by the fact that “Africa as a continent faces many challenges within the transfer pricing arena, the shortage of comparable data being one and another being a lack of skills and expertise in this field.” (O’Halloran, 2013:23) If the uncertainty regarding the application of transfer pricing rules and the lack of availability of comparable data are problematic for South African taxpayers, it can be assumed that foreign taxpayers will suffer the

same problems. Foreigners will in fact be affected to a worse degree than residents, since no relief is currently provided from applying transfer pricing rules for financial assistance provided to residents.

It is further submitted that transfer pricing rules that are not in line with the OECD guidelines, the application of which is uncertain with limited guidance and available data and that increases both the tax liability and compliance burden of non-resident taxpayers, would discourage foreign investment in South Africa. An evaluation of the absence of transfer pricing relief for foreigners providing financial assistance to resident against the recommendations of the OECD is thus considered to be a relevant topic for further investigation. Chapter 2 of this dissertation will be devoted to evaluating whether transfer pricing rules are in line with the OECD guidelines.

1.6 PROBLEM STATEMENT

Currently there is no exemption from applying transfer pricing rules in the case of foreigners providing financial assistance to residents in terms that are not at arm's length. Should there be such an exemption or is adequate relief already provided?

1.7 OBJECTIVES

1.7.1 Main Objective

The main objective of this study will be to evaluate the possibility that the absence of the exception from applying transfer pricing rules in the case of a foreigner providing financial assistance to a resident at terms that are not market related is a deficiency in current tax legislation. The study will consider whether there should be such an exception to ensure fair treatment of all taxpayers and if relief from both the administrative burden of applying transfer pricing rules and the possible tax implications of transfer pricing adjustments is provided elsewhere in the tax legislation.

1.7.2 Secondary Objectives

The secondary objectives of the study will aim to assist in fulfilling the main objective of the study. These objectives include the following:

- To review whether the current transfer pricing legislation is in line with the OECD guidelines for transfer pricing and the model tax convention (discussed in Chapter 2).
- To evaluate if the legislation as it currently stands is conducive to foreign investment (discussed in Chapter 3).
- To discuss the possibility that some relief from the burden of applying transfer pricing rules and the subsequent primary and secondary adjustments are provided by DTAs with other countries (discussed in Chapter 4).

1.8 RESEARCH DESIGN/METHOD

A research methodology is determined by a philosophical paradigm within which the research can be classified into (Coetzee, Van der Zwan & Schutte, 2014). A research paradigm, in turn, is a "world view underlying the theories and methodology of a particular scientific subject" (Oxford Dictionary, 2018). A research paradigm is informed by ontology and epistemology. The Oxford Dictionary defines ontology as "the part of philosophy that studies what it means to exist" and epistemology as "the part of philosophy that is about the study of how we know things" (Oxford Dictionary, 2018). Ontology is further defined as the way in which reality and knowledge is viewed (Coetzee, Van der Zwan & Schutte, 2014). The way in which reality is viewed will inform the paradigm in which research will be conducted and therefore the first thing to do is to determine how reality is viewed (in other words, to clarify the ontological assumptions).

For this study, the ontological assumption is that multiple explanations or answers to the research question may exist. Relativists do not attempt to convince that their opinions are true and no alternative explanations are possible (Anderson, 1986:157), but instead, that a fact could have multiple explanations (Bredenkamp, 2015:4). If a relativist view of the world is held the ontological assumption is that reality is influenced

by many circumstances and factors and that a situation could have multiple interpretations (Coetzee, Van der Zwan & Schutte, 2014). The first philosophical reason for the chosen research methodology is thus that the author holds a relativist view and is of the opinion that a single situation could be interpreted in many different ways. The author will review information available and reach a conclusion that may differ from another author's opinion if the same information is considered.

The next philosophical reason for the research methodology that was selected has to do with selecting the appropriate paradigm within which to conduct the research. As already mentioned, the author views reality as relativist. The research paradigm that correlates with this relativist view is the interpretivist paradigm, since this paradigm allows research to gain an understanding of unfamiliar situations (Coetzee, Van der Zwan & Schutte, 2014).

Based on the relativist view held by the author, the research will be conducted in the interpretivist philosophical paradigm (a subsection of qualitative research), since the research will be conducted to obtain a deeper understanding of legislation and not with the aim of confirming a specific truth or statement. The study is not likely to result in a uniform conclusion or finding but rather a number of findings that require improvement or further research. This is also in line with qualitative research (of which the interpretivist philosophical paradigm is a subsection), which is often exploratory research and used when the researcher is unsure of what to expect with regard to the outcome of the study. The goal of the study is not to achieve objectivity or to make generalisations (statistical inferences) with regard to a population as a whole. The goal is merely to obtain a deeper understanding of specific provisions with regard to transfer pricing rules for financial assistance granted by foreigners to residents.

Once the appropriate paradigm has been selected, a research methodology that falls within the selected paradigm has to be selected. Doctrinal research can be described as among others, "a research methodology that provides a systematic exposition of the rules governing a particular legal category" and "explains areas of difficulty" (McKerchar, 2008). Doctrinal research is used when legislation has to be analysed to determine how it has been developed and applied, which is the case for this study. It

is also described as the “black letter law” approach and typically has as its main aim reading and performing scholarly analyses (McKerchar, 2008).

Similar studies were reviewed to confirm the appropriateness of the selection of an appropriate research methodology. A similar study conducted by Bredenkamp in 2015, “An analysis of Section 23M in light of the OECD guidelines relating to thin capitalisation” selected doctrinal research as a research methodology. In the study it is mentioned that the methodology that was used to conduct the research was a literature review (Bredenkamp, 2015:13). Another similar study conducted by Van der Lith in 2011, “Transfer pricing: Possible implications of the amendments to the Income Tax Act” also used a literature review as a research methodology.

It appears that the most appropriate research methodology for this type of study is a doctrinal research methodology based on a literature review, after which purely theoretical research will be conducted. The literature review, the research methodology that was selected, and the paradigmatic assumptions are discussed in more detail below.

1.8.1 Literature review

A literature review will be performed as a primary strategy to consider whether the absence of specific provisions for incoming financial assistance granted by foreign companies to South African residents is in line with OECD guidelines. The literature review will also be used to determine the theoretical perspective of this study.

A wide spectrum of sources will be accessed during the course of this review, including the income tax legislation, OECD Transfer Pricing Guidelines, OECD Articles of the Model Convention, income tax text books, previous studies and articles published in publications relating to tax.

The study will be limited to the transfer pricing rules of South Africa.

1.8.2 Research methodology

As already described above, the appropriate research methodology for this study is a doctrinal research methodology, which is a research methodology in the interpretivist paradigm (Coetzee, Van der Zwan & Schutte, 2014). This type of research is also referred to as theoretical research or “black letter law” as it is exclusively derived from documentary data (Coetzee, Van der Zwan & Schutte, 2014).

Since this type of research uses data exclusively obtained from documents, the method of data collection will be the review of documents (Merriam, 1998:11). This is in line with the description of doctrinal research as a typically library-based methodology that focuses on reading and scholarly analysis (McKerchar, 2008). This reading and scholarly analysis are typically used to identify, analyse and organise judicial decisions and commentary (McKerchar, 2008).

For this study it will be used to identify and analyse the specific transfer pricing provisions relating to financial assistance granted by foreign taxpayers to residents. This method will be used due to two reasons: the first being that the general public does not possess the specified knowledge that will be required to complete a questionnaire that will provide useful information on the topic, and the second being the time constraints on the study. The literature used will be both of a primary and secondary nature.

The methodology that will be followed will be based on a literature review, followed by purely theoretical research derived from documents which will be analysed to reach a conclusion. The conclusion will be the author’s understanding of the information reviewed.

There are certain limitations on a literature review and documentary data review as a method of research which have to be considered. Information can be organised, summarised and analysed, but no new information may be produced.

1.8.3 Paradigmatic assumptions and perspectives

As already mentioned, for this study, the ontological assumptions will be that multiple explanations of answers to the research question may exist. The study will attempt to evaluate certain transfer pricing rules as described above, without concluding on a singular answer or truth to the research problem. According to Grix, ontological assumptions can be defined as the study of “claims and assumptions that are made about the nature of social reality” (cited by Mack, 2010:5). Ontological assumptions are concerned with how knowledge is viewed and in the interpretivist paradigm it means that “social reality is seen by multiple people and these multiple people interpret events differently leaving multiple perspectives of an incident” (Mack, 2010:8).

The research is conducted in a qualitative paradigm. Methodological assumptions within the qualitative paradigm assume that meaning can be determined through close interaction between the researcher and respondents. For this study, the methodological assumptions will be that answers to the research question can be obtained through theoretical research.

Epistemological refers to knowledge being acquired by investigating a phenomenon in many ways and also to what is considered knowledge. For this study, the main epistemological assumption will be that knowledge is obtained “inductively” to create a theory” (Mack, 2010:8). The theoretical research is considered as a source of evidence to form a conclusion to the research question.

1.9 OVERVIEW

The following chapters will be included in this mini-dissertation. A high-level outline of the chapters of this study is presented below.

1.9.1 Chapter 1: Introduction

Chapter 1 presents the background of the study as well as the research question (the “gap in the knowledge”) and the purpose of the study. The research objectives and research design are briefly described and an overview of the chapters in the study is given.

1.9.2 Chapter 2: Transfer pricing legislation and the OECD Guidelines

Chapter 2 will discuss the first secondary objective of reviewing whether the current transfer pricing legislation is in line with the OECD Guidelines for transfer pricing and the model tax convention. The chapter will investigate the background of the current transfer pricing legislation in South Africa as well as the background of the OECD Guidelines with regard to transfer pricing. The OECD Guidelines for Transfer Pricing and the provisions of article 24 of the model tax convention that relate to non-discrimination will also be analysed and discussed in this chapter. The absence of an exemption from applying transfer pricing rules when a foreigner provides financial assistance to a resident will be compared to the OECD guidelines and model convention, with specific regard to article 24, and discussed in an effort to identify possible discrimination, which could indicate a deficiency in the legislation as it currently stands.

1.9.3 Chapter 3: Current transfer pricing legislation as an deterrent for foreign investment

Chapter 3 will discuss the second secondary objective of evaluating whether the legislation as it currently stands is conducive to foreign investment. The chapter will investigate possible inducements as well as deterrents for foreigners to invest in a developing country such as South Africa. After identifying well-known inducements and deterrents, the possibility of tax incentives as an inducement to invest will be discussed.

Chapter 3 will then consider the possibility that the additional burden of complying with transfer pricing costs and administration for foreigners considering granting financial assistance to residents may be a deterrent for foreign investment. In other words, chapter 3 will consider the “tax protectionism” of the current transfer pricing legislation. This will assist in answering the research question since tax legislation that are detrimental to foreign investment (in the case of *bona fide* arm’s length transactions with no intention to avoid tax) could indicate a deficiency in the legislation.

1.9.4 Chapter 4: Double Tax Agreements and the possible relief for foreigners from applying transfer pricing rules

Chapter 4 will discuss the third secondary objective of discussing the possibility that the current transfer pricing legislation provides no relief from applying transfer pricing rules for a foreigner providing financial assistance to a resident in terms that are not at arm's length. However, in the case of a resident providing the same form of assistance to a foreigner, there is relief provided by section 31(6) of the Income Tax Act. As discussed earlier, it is possible that this difference in treatment is not in line with the OECD Transfer Pricing Guidelines and OECD Model Convention. Chapter 4 will thus discuss the possibility that the provisions contained in specific DTAs relating to financial assistance between South Africa and another contracting state provides some relief from the burdens resulting from transfer pricing.

To this end, this chapter will specifically review the treatment of interest and withholding tax on interest and dividends. There has already been a ruling issued by SARS stating that no withholding tax on interest is payable by a resident in the case of a primary adjustment in terms of transfer pricing rules when receiving financial assistance from a foreigner. It is possible that there is relief for the deemed dividend *in specie* (secondary adjustment) and the resulting withholding tax in DTAs. The possibility that there was an intention to provide relief from transfer pricing rules in DTAs between countries will be considered. If there is such relief, that will mitigate the burden placed on taxpayers that do not get an exemption from applying transfer pricing rules.

1.9.5 Chapter 5: Conclusion and recommendations for further studies

Chapter 5 will provide an overall summary of the research findings. The extent to which the research objectives were met will also be addressed in the form of a summary of the findings of every chapter. Limitations to the study will be identified and suggestions for further studies in the specific area of research made. A list of references will also be included after the end of this chapter.

CHAPTER 2: COMPARING CURRENT LEGISLATION WITH THE OECD GUIDELINES RELATING TO FINANCIAL ASSISTANCE

2.1. INTRODUCTION

The main objective of this study is to evaluate the possibility that the absence of the exception from applying transfer pricing rules in the case of a foreigner providing financial assistance to a resident at terms that are not market related is a deficiency in current tax legislation and to consider whether there should be such an exemption.

The first step in attempting to answer the research question, and a secondary objective of this study, was to consider whether the current legislation is in line with international transfer pricing guidelines. The OECD provides transfer pricing guidelines, as well as a model convention with respect to taxes on income and capital. It is submitted that an alignment of South African transfer pricing legislation with the ideal model and guidelines provided by the OECD would suggest an absence of a deficiency in the transfer pricing legislation.

Furthermore, in 2010 and 2011, SARS announced their intention to significantly realign the transfer pricing rules applicable at that time with the transfer pricing guidelines provided by the OECD. As a result, section 31 of the Income Tax Act was completely overhauled when the new section 31 came into effect on 1 April 2012. The reason provided by SARS for the changes that were made to section 31 of the Income Tax Act, is that it wanted to bring the legislation in line with the OECD transfer pricing guidelines (Honiball & Delahaye, 2013:16).

This chapter will compare certain aspects of the amended section 31 of the Income Tax Act, in particular the transfer pricing rules relating to assistance provided to a foreigner as set out in section 31(6) of the Income Tax Act, with applicable articles of the OECD Transfer Pricing Guidelines and the OECD Model Convention with respect to Taxes on Income and on Capital, with the aim of determining whether the amendments succeeded in aligning South African transfer pricing rules with the guidelines provided.

Article 24 of the model convention is a non-discrimination article, which states that "Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected" (OECD, 2014:37). There has already been research done on the possibility that a potential conflict could exist between thin capitalisation rules and the OECD article on non-discrimination (Elliffe, 2012). In light of the additional tax burdens as already mentioned in Chapter 1, it is submitted that there is a possibility that the absence of relief for a foreigner from applying transfer pricing rules when providing assistance to a resident, is possibly in violation of the OECD model article 24 on non-discrimination.

Before the comparison between South African transfer pricing legislation and the OECD guidelines can be made, an understanding has to be obtained of the two sets of rules. The article in the model convention on which will be particularly focused is the non-discrimination article (article 24). The article details that taxpayers of different countries should not be discriminated against based on their residency and since there appears to be a difference in treatment of residents and non-resident taxpayers by the South African tax legislation (as identified in Chapter 1), this article will be focused on.

2.1.1. Background of the OECD

The OECD is an international organisation of which the origin can be traced back to 1961 when the former Organisation for European Economic Cooperation, the United States and Canada entered into an agreement (http://www.oecd.org/about/history/). The aim of the OECD, as stated on their official website, is to promote policies that will improve the economic and social well-being, prosperity, equality and opportunity of people around the world (http://www.oecd.org/about/). It is with this mission in mind and with the aim of improving people's lives, that the organisation issues model policies, such as the Model Convention on Transfer pricing. The OECD also provides a platform for governments to work together and assist one another by sharing experiences and attempting to find solutions to common problems.

2.1.2. Background to the South African transfer pricing legislation

Transfer pricing refers to the business practice whereby a company buys or sells goods or services to a related company at a price that may be different to what the price would be if the same goods or services were sold to unrelated parties (O'Halloran, 2013:23). Transfer pricing can be utilised by multi-national groups to shift profits to be taxed to low tax jurisdictions or to countries where special tax benefits apply (Olivier & Honiball, 2011:620).

Prior to the introduction of the 1995 transfer pricing rules, the practice of shifting profits via transfer pricing could only be contested by the SARS by using the general anti-avoidance provisions in section 103 of the Income Tax Act. In an effort to more effectively curb this practice, South Africa implemented broad transfer pricing rules, which took effect on 19 July 1995 (Olivier & Honiball, 2011:621).

These transfer pricing rules introduced in 1995 were subsequently revised with an overhaul of section 31 of the Income Tax Act that took effect on 1 October 2011 (Olivier & Honiball, 2011:621). As already mentioned, the reason provided by SARS for the changes that were made to section 31 of the Income Tax Act, is that it wanted to bring the legislation in line with the OECD transfer pricing guidelines (Honiball & Delahaye, 2013:16). The new section 31 of the Income Tax Act aims to include both direct and indirect transactions in the transfer pricing net, effectively broadening the scope and application of the legislation (Olivier & Honiball, 2011). It further adjusts the focal point of the section from separate transactions to an entity- based approach (Honiball & Delahaye, 2013:17). The new wording of the legislation seems to suggest that the arm's length principle is far more extensive than was the case previously as it is now applicable to any party to a transaction, operation or scheme. This will include big corporates that will now have to guard against obtaining an inappropriate tax benefit which is in contravention of the arm's length principle (Honiball & Delahaye, 2013:17).

In this chapter, the revised section 31 of the Income Tax Act will be discussed, since it contains the transfer pricing rules currently applicable. An understanding of the workings of section 31 is necessary before a comparison can be made to the transfer

pricing guidelines provided by the OECD to evaluate whether the South African transfer pricing legislation is in line with the OECD guidelines.

2.1.3. Background to the OECD guidelines

The role of multinational enterprises and the complex taxation matters that result from transactions between enterprises in a multi-national group have increased significantly over the last 20 years (OECD, 2010:17). The OECD issued transfer pricing guidelines that address the main issues relating to transfer pricing (OECD, 2010:22). These OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations are followed, on varying levels, by a number of countries internationally. These guidelines were originally published in 1995 and also apply in cases where domestic transfer pricing guidelines refer to the OECD guidelines, such as in South Africa (Olivier & Honiball, 2011:621). A revision of certain chapters in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations was approved in 2010 (OECD, 2010:22).

Although South Africa is not a member of the OECD, the OECD guidelines are evolving into an internationally recognised standard, since many countries that are not members of the OECD are following the guidelines. The OECD guidelines have been accepted by SARS as an important document that was compiled after comprehensive input from numerous tax practitioners and experts in the field of taxation in numerous countries (Van der Lith, 2011).

Furthermore, even though South Africa is not a member of the OECD, in 2007 the OECD council adopted a resolution that includes South Africa as one of the five key partners to the OECD. The key partners to the OECD contribute to the work done by the OECD in a sustained and comprehensive manner, which includes participating in partnerships in OECD bodies and adhering to OECD instruments (http://www.oecd.org/southafrica/south-africa-and-oecd.htm).

South Africa has a responsibility to participate as a key partner to the OECD (http://www.oecd.org/southafrica/south-africa-and-oecd.htm), the South African transfer pricing guidelines make reference to the OECD guidelines (SARS, 2013:6)

and the revenue authorities have indicated an intent to have their transfer pricing rules adjusted in line with OECD guidelines (Honiball & Delahaye, 2013:16). In light of all these factors, it would appear important that South African tax legislation is in line with the OECD guidelines.

The South African tax legislation should be investigated and compared to the guidelines to ensure that the legislation is in fact in line with the guidelines. This will start by obtaining an understanding of the workings of the South African transfer pricing legislation.

2.2. THE SOUTH AFRICAN TRANSFER PRICING LEGISLATION RELATING TO FINANCIAL ASSISTANCE

2.2.1. Transfer pricing rules currently in effect

The current transfer pricing rules is contained in section 31 of the Income Tax Act and came into effect on 1 April 2012. Section 31(2) of the Income Tax Act reads as follows:

"(2) Where –

(a) Any transaction, operation, scheme, agreement or understanding constitutes an affected transaction; and

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

  (i) is a term or condition contemplated in paragraph (b) of the definition of "affected transaction"; and

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

  the taxable income or tax payable by any person contemplated in that paragraph (b)(ii) that derives a tax benefit contemplated in that paragraph must be calculated as if that transaction, operation, scheme, agreement or understanding had been entered into on the terms and conditions that would have existed had those persons been independent persons dealing at arm's length" (South Africa, 1962).

Section 31(2)(b) of the Income Tax Act has to be read in conjunction with section 31(1) of the Income Tax Act which defines an affected transaction, and specifically section 31(1)(b) of the Income Tax Act, which defines the terms or conditions mentioned that would trigger the application of section 31(2) of the Income Tax Act as follows:

> "(b) any term or condition of that transaction, operation, scheme, agreement or understanding is different from any term or condition that would have existed had those persons been independent persons dealing at arm's length" (South Africa, 1962).

Furthermore, section 31(3) of the Income Tax Act states that:

"(3) To the extent that there is a difference between –

(a) any amount that is, after taking subsection (2) into account, applied in the calculation of the taxable income of any resident that is a party to an affected transaction; and

(b) any amount that would, but for subsection (2), have been applied in the calculation of the taxable income of the resident contemplated in paragraph (a) the amount of that difference must, for purposes of subsection (2), be deemed to be a loan that constitutes an affected transaction" (South Africa, 1962).

From these paragraphs of the Income Tax Act it is clear that there are two adjustments that need to be made in the case of a transaction that is not conducted at arm's length. These two adjustments are referred to as the primary adjustment (governed by section 31(2) of the Income Tax Act) and the secondary adjustment (detailed in section 31(3) of the Income Tax Act). Prior to 1 January 2015, the secondary adjustment resulted in a deemed loan, on which there was interest at arm's length since the deemed loan qualified as an affected transaction (Camay, 2014). The interest income that accrued at arm's length was taxable and capitalised to the balance of the deemed loan during every year of assessment. These deemed loans and interest were impractical for a number of reasons, including the fact that the administration thereof was very difficult for SARS and that the lack of obligation to settle these loans meant that the foreign companies involved seldom repaid these loans (Grant Thornton, 2016).

These practical difficulties led to an amendment of section 31 of the Income Tax Act which meant that from 1 January 2015 a secondary adjustment, if made by a company,

is treated as a deemed dividend. This deemed dividend is considered a distribution of an asset *in specie* and is subject to 15 per cent dividends tax. For taxpayers other than companies, the secondary adjustment is considered a deemed donation and results in donations tax of 20 per cent (Grant Thornton, 2016).

An important concept to consider when obtaining an understanding of section 31 of the Income Tax Act is the arm's length principle. Arm's length transactions will occur when two companies that are unrelated to each other transact with each other, since they will most often settle on a market related price for the transaction. The arm's length principle, in broad terms, refers to a price that is agreed upon between two unrelated and independent parties when concluding a transaction on the open market (Integritax, 2016).

The arm's length principle is used to deal with transfer mispricing that might occur when corporations that belong to the same multinational group transact with each other. The principle is based on the assumption that the transfer price for a transaction that occur between corporations belonging to the same multinational group should be the same as it would have been if the transaction occurred between two independent companies operating in an open market. The OECD and the United Nations Tax Committee have both recommended the arm's length principle (Tax Justice Network, 2014).

In the Draft Interpretation Note on Thin Capitalisation issued by SARS in 2013, SARS explains that when the arm's length principle is applied in terms of loans, the taxpayer should consider the loan from both the lender and the borrower's perspective when assessing if the loan occurred at arm's length terms. This means that from the lender's perspective consideration should be given to whether the borrowed amount could have been borrowed at arm's length, or in other words, if a lender would have been willing to lend that amount to that borrower. In turn, the borrower in the transaction should assess if borrowing the amount in question is in the best interest of their business (SARS, 2013:7).

From the wording of section 31(1)(b) of the Income Tax Act it is clear that it is not just the price, but also the terms of the transaction that has to be at arm's length to ensure

that the application of transfer pricing rules is not triggered. An affected transaction (a transaction concluded in terms that are not at arm's length) will result in the application of transfer pricing rules, which will require the taxpayer to calculate their taxable income based on the arm's length terms and conditions of the transaction (Integritax, 2013).

In terms of the transfer pricing rules, if a South African company provides an interest-free loan with no fixed terms of repayment (both of which are terms not normally found in an open market transaction) to a CFC, these terms that are not at arm's length will trigger section 31 of the Income Tax Act. The South African company will therefore have to calculate their taxable income as if the transaction had been conducted in terms that would have been entered into between two unrelated parties. This means that the South African company would have to make both a primary and a secondary adjustment.

The primary adjustment would result in the South African company having to include in their taxable income interest on the shareholder loan to the CFC calculated at an arm's length rate. The South African company would then have to make a secondary adjustment, which would entail a deemed dividend on which withholding tax of 15 per cent would most likely be payable.

The application of the transfer pricing rules may result in potential double taxation, since the South African company will have to include interest on both the shareholder's loan and be subject to dividends tax on the deemed dividend. The shareholder (the CFC) will in all likelihood not be entitled to a corresponding deduction for the deemed interest on the loan (Camay, 2014). To avoid the possibility of double taxation in such cases, relief from applying transfer pricing rules are provided in section 31(6) of the Income Tax Act.

The workings of the relief from applying transfer pricing rules are explained below.

2.2.2. Exception from applying transfer pricing rules currently provided for in the Income Tax Act

As defined earlier during the explanation of the current transfer pricing rules, an affected transaction means any transaction, operation, scheme, agreement or understanding that has been entered into between a resident and a non-resident that are connected persons, with terms that are different than what it would have been if the transaction occurred between independent persons dealing at arm's length. Affected transactions entered into between a South African resident and a CFC company in which the South African resident has an interest are usually also subject to the transfer pricing rules in section 31 of the Income Tax Act.

An exception from applying the transfer pricing rules in the case of financial assistance provided to a CFC is provided by section 31(6) of the Income Tax Act and came into effect on 1 January 2013. This exception states that if a transaction, operation, scheme, agreement or understanding is entered into between a South African resident and a CFC in which the South African resident has an interest, transfer pricing rules will not apply if the following requirements are met:

- The transaction should be entered into between a South African resident and a CFC of that resident or a CFC in relation to a company that forms part of the same group of companies as the South African resident.
- The transaction should entail the granting of financial assistance or the use or right of use of intellectual property.
- The CFC should have a foreign business establishment as defined in section 9D(1) of the Income Tax Act.
- The CFC should be high-taxed, which means that the aggregate amount of taxes payable by the CFC to all governments in the foreign tax year during which the transaction exists is at least 75 per cent of the normal tax that would have been payable by the CFC if it was a South African resident (South Africa, 1962).

2.2.3. Controlled foreign company as referred to above

The concept of a CFC is important from a tax perspective. Section 9D of the Income Tax Act governs the tax treatment of controlled foreign companies. While this study

is not specifically about the tax treatments as set out in section 9D of the Income Tax Act, mention is made of the section and reference is made to the concept of a CFC. It is therefore necessary to provide an explanation of the concept.

In brief, a CFC is a non-resident company that is owned by South African residents (Haupt, 2017:605). The South African residents have to own 50 per cent or more of the equity shares or voting rights in the company and residents which are headquarter companies are excluded from this definition. For the purposes of determining whether a company is a CFC, no regard is given to voting rights in a foreign company which is a listed company (Haupt, 2017:606).

2.2.4. Foreign Business Establishment as referred to above

The concept of foreign business establishment is an important concept for tax purposes. According to section 31(6) of the Income Tax Act, transfer pricing rules will not be applicable in cases where the CFC in question has a foreign business establishment. While a detailed discussion of when the foreign business establishment requirements are met is not considered to fall within the scope of this study, a brief explanation seems appropriate.

The concept of foreign business establishment is defined in section 9D(1) of the Income Tax Act and can be summarised in the following manner:

- A fixed place of business must exist and this fixed place of business must be in use for a year or more.
- The fixed place of business must be operated through one or more offices, shops, factories, warehouses or other structures.
- It must be situated in a foreign country.
- It must be staffed appropriately with employees that are on site and responsible for the main operations of the business.
- The fixed place of business must be suitably equipped with suitable facilities to conduct the business.
- The fixed place of business should not have tax avoidance through moving the business out of South Africa as its main purpose (Haupt, 2017:608).

2.2.5. Transfer pricing rules in section 31(6) of the Income Tax Act for a South African taxpayer providing financial assistance in the form of a loan to a foreigner

If the requirements as detailed in section 31(6) of the Income Tax Act are met, a South African company providing financial assistance to a non-resident shareholder, specifically a CFC, does not have to apply the transfer pricing rules.

2.2.6. Transfer pricing rules in section 31(6) of the Income Tax Act for a South African taxpayer receiving financial assistance in the form of a loan from a foreigner

Section 31(6) of the Income Tax Act, as discussed above, provides an exemption from applying the transfer pricing rules in the case of a resident providing financial relief under certain circumstances to a CFC. However, it is important to note that the section does not provide the same or similar relief to a CFC providing financial assistance to a South African taxpayer.

This absence of a similar exemption from applying transfer pricing rules for foreigners providing loans to residents may result in a possible non-conformation to the OECD transfer pricing guidelines. Foreign taxpayers providing assistance to residents remain obligated to apply the transfer pricing rules. In addition, the South African taxpayer receiving the financial assistance may be required to apply transfer pricing rules if the terms and conditions of the loan (such as interest on the loans received not charged at a market related rate) are not market related. The application of transfer pricing rules may result in an additional burden on taxpayers that are not provided relief from applying these rules. The possibility of an additional burden that comes with having to apply transfer pricing rules will be discussed in more detail in the remainder of the chapter.

It is evident that there is a difference in the transfer pricing rules for a resident and a foreigner. Consideration should be given to whether the different treatment results in a burden that is higher for the non-resident providing financial assistance than for the resident.

2.2.7. Assessing whether the relief for South African taxpayers providing assistance is justified

When considering whether the relief for South African taxpayers providing assistance from applying transfer pricing rules is justified or not, the possible reasons for the relief should be considered. One reason provided for the granting of this relief, is the fact that a high-taxed CFC will save only marginally on worldwide tax by understating interest. The opportunity for tax avoidance by understating interest and obtaining a tax saving by including understated interest in taxable income is therefore considered to be very small (Camay, 2014).

It is also important to consider that the exception is only available for controlled foreign companies. Income earned by a CFC may, subject to the provisions of section 9D of the Income Tax Act, be taxed in the hands of the resident who has participation interest (either in the form of shares or votes) in the CFC (Haupt, 2018:570).

2.3. BURDEN PLACED ON FOREIGN TAXPAYERS BY THE CURRENT LEGISLATION

As mentioned in the introduction to this chapter, the transfer pricing rules relating to assistance provided to a foreigner as set out in section 31(6) of the Income Tax Act will be compared to the transfer pricing guidelines provided by the OECD to determine if the South African legislation is in line with the OECD guidelines. As will be discussed in more detail later on in this chapter, article 24 of the OECD Model Convention is a non-discrimination provision that refers to taxation treatment of nationals of a contracting state which is other or “more burdensome” than the taxation treatment of nationals of the other contracting state in the same circumstances (OECD, 2014:37). The following paragraphs will outline the additional burden on foreign taxpayers as a result of transfer pricing rules.

2.3.1. Assessing the additional burden placed on foreign taxpayers by the current legislation

As mentioned in the introduction to this chapter, the transfer pricing rules relating to assistance provided to a foreigner In order to determine if the current legislation indeed places an additional burden on foreign taxpayers for whom there is no relief from applying the legislation, the possible burdensome effects of complying with the legislation must be considered. This will be done in the paragraphs below.

2.3.2. Additional burden as a result of increased tax liability

The first and most significant aspect of the increased burden is that of the additional tax payable in cases where the transfer pricing rules have to be applied. A significant number of South African companies have suffered from double taxation as a result of revenue authorities not being satisfied with their commercial pricing (O'Halloran, 2013).

If no relief was provided from applying transfer pricing rules in the case of financial assistance, the transfer pricing implication would be as follows:

If a South African company provides a shareholder loan to a CFC that bears no interest and has no fixed terms of repayment, the transfer pricing rules will be triggered (since these terms are not market related) and the South African company will have to make both a notional primary and a notional secondary adjustment on which it will be liable for tax. At the same time, the CFC will most likely not be granted a deduction for these notional primary or secondary adjustments. The net result of the primary and secondary adjustments and the disallowance of the deduction will potentially result in double taxation (Camay, 2014).

Foreign taxpayers providing financial assistance to local taxpayers suffer from this additional burden in the form of possible double taxation, since no relief is provided. Since relief is provided from applying transfer pricing rules in section 31(6) of the Income Tax Act, South African taxpayers providing financial assistance do not suffer from this additional burden (double taxation) as described above. However, if the

South African company receives funds on which no interest is charged (assuming that they are provided relief from applying transfer pricing rules even if the funds are not received at market related terms) the South African taxpayer will not have an interest deduction against any additional revenue generated by the additional funds available. This could possibly result in the South African company being liable for more income tax. A higher amount of income tax payable is in itself an additional burden. The next paragraph will therefore consider the additional burden placed on taxpayers not in the form of additional taxes payable but in the form of additional costs to apply the transfer pricing rules.

2.3.3. Additional burden due to the costs involved in applying the transfer pricing rules

The changes made to section 31 of the Income Tax Act places a burden of additional costs on taxpayers as a result of a significant responsibility being placed on the taxpayer when assessing whether financial assistance is provided at terms that are at arm's length. Prior to the changes made to transfer pricing rules, applicable to tax years commencing on 1 April 2012 and following years, financial assistance granted by or to foreigners was governed by the thin capitalisation rules contained in section 31(3) of the Income Tax Act.

Thin capitalisation consists of the funding of a CFC with an excessive amount of debt in relation to equity so as to provide the foreign investor the benefit of having the interest income derived therefrom exempt. The aim of thin capitalisation rules was to limit the deduction of interest incurred on excessive funds. Guidance on the workings of the thin capitalisation rules was provided by SARS in Practice Note 2 (titled 'Determination of taxable income where financial assistance has been granted by a non-resident of the Republic to a resident of the Republic') which provided 'safe harbours' that could be used to assess excessive financial assistance and arm's length interest rates. Practice Note 2 included simple rules to determine whether a company was thinly capitalised (excessively financed), such as using a formula to determine the ratio of fixed capital to debt and provided a 'safe harbour' of 3:1 debt to fixed capital. This meant that if a company's debt to fixed capital ratio fell into this 'safe harbour'

ratio, that company was allowed to fully deduct the interest they paid on the debt from their taxable income (Integritax, 2011).

The thin capitalisation rules were deleted and replaced by the general rules for transfer pricing, which meant that Practice Note 2 became obsolete (Potgieter, 2014). Since taxpayers no longer had guidance on the application of thin capitalisation rules, SARS issued a Draft Interpretation Note titled 'Determination of the taxable income of certain persons from international transactions: Thin capitalisation'. The purpose of this document is to explain how thin capitalisation rules now fit in with the general transfer pricing provisions. Instead of the safe harbours provided in Practice Note 2, the Draft Interpretation Note requires taxpayers to assess whether financial assistance is excessive and interest rates are considered at arm's length with reference to both the lender's and the borrower's positions (Potgieter, 2014).

This requirement of taxpayers by the Draft Interpretation Note leads to a significant responsibility for the taxpayer, since considering whether the financial assistance occurred on market related terms will for all intents and purposes require the same evaluation procedures as that of a bank considering providing financial assistance (Potgieter, 2014). Companies that are not financial service providers will naturally not be equipped to do this type of vetting and will have to incur costs to follow this process.

Another problem that arises with the new transfer pricing rules, is the availability of comparable data to assess whether the terms of a transaction is at arm's length. In an effort to address the difficulties of obtaining comparable information, SARS makes mention in the Draft Interpretation Note of the fact that they are "investigating the availability and appropriateness of a third party-provided South African-focussed database" and that "the databases being considered are used in conjunction with credit risk models from a quantitative perspective and scorecard models from a quality perspective" (Potgieter, 2014). Such a database will assist taxpayers in assessing whether they are negotiating transactions at market related terms by providing comparable information.

The costs to obtain access to such a database will, however, most probably be extremely high, possibly even to the point of preventing taxpayers from using the

database. These costs will be considered even higher if only one or two loans are to be assessed for market comparability (Potgieter, 2014). The high costs of such a database will further add to the additional burden of complying with transfer pricing rules.

The burden due to the costs of applying the transfer pricing rules is further worsened by the lack of guidance provided by SARS, since paying for experts in the area to provide guidance will further increase costs of compliance. Guidance on the application of section 31 of the Income Tax Act has been lacking since the transfer pricing rules were amended in 2012. In 2013, Honiball and Delahaye wrote in an article that the – at that time – recent changes to the South African transfer pricing legislation resulted in uncertainty regarding the application of the new transfer pricing rules. They also mention that the uncertainty is worsened by the absence of an updated Practice Note from SARS regarding the application of the new rules. Currently, in 2019, an updated Practice Note to guide taxpayers in applying the transfer pricing rules have still not been released.

The lack of guidance with regard to documentation and submission requirements as mentioned above also increases the administrative burden placed on taxpayers, which will be discussed below.

2.3.4. Administrative burden placed on taxpayers having to apply the transfer pricing rules

According to a Transfer Pricing Tax Authority survey performed by Ernst & Young in 2012, the documentation burden related to transfer pricing is increasing (O'Halloran, 2013). Since then, South African taxpayers have been bombarded with an ever increasing number of additional requirements to remain compliant in the area of transfer pricing (Joubert, 2018). These changes to what was previously required were implemented to be in line with the requirements as per the OECD Transfer Pricing Guidelines and include compulsory documentation that have to be kept, compulsory submission of Country-by-Country reports as well as burdensome supplementary record keeping requirements (Joubert, 2018).

Furthermore, SARS issued a Draft Public Notice on 15 December 2015 that prescribes additional record-keeping requirements for transfer pricing. This Draft Public Notice does not make mention of the Master File and Local File documentation requirements as recommended by the OECD in BEPS Action Plan 13 and SARS is thus not in line with the OECD recommendations (Integritax, 200:27). Additional documentary requirements will increase the efforts and work needed by the taxpayer to comply, which will increase costs to the taxpayer (Integritax, 200:25). This additional burden of costs to comply will only be applicable to foreign taxpayers providing financial assistance to residents, since there is relief for resident taxpayers providing cross-border intra-group financial assistance.

This administrative burden is even more pronounced for smaller taxpayers. According to Lewis (cited by O'Halloran, 2013:23), who wrote an article recommending safe harbour tax legislation for smaller taxpayers, it is important to note that smaller taxpayers do not possess the resources required to justify their transfer pricing strategies to revenue authorities.

Mention was previously made of a database of comparable information to aid taxpayers in assessing whether a certain transaction is indeed conducted at arm's length. It would be very useful if SARS could provide access to such a database free of charge to taxpayers aiming to adhere to the transfer pricing rules (Potgieter, 2014). Based on the above it appears that the current legislation places a heavy administrative burden on taxpayers having to apply transfer pricing rules.

2.3.5. Summative observations of considering the possible additional burden

From the paragraphs above it seems as if the application of transfer pricing rules could possibly result in an additional burden for the taxpayer having to apply these rules, both financially and administratively.

While it was not considered in great detail in this study, there is a possibility that an additional burden, either financially or administratively, could have a detrimental effect on the tax compliance of taxpayers in South Africa. Complex tax laws and high rates of tax have been identified as factors that decrease tax compliance (Williams,

2017:30). It is submitted that the absence of relief for foreigners providing assistance to residents could possibly increase the risk of non-compliance to transfer pricing legislation since applying transfer pricing rules are potentially both complex and costly (as discussed above). While it will most likely be almost impossible to weigh losses in tax revenue as a result of non-compliance against gains in tax revenue due to transfer pricing rules preventing tax avoidance, non-compliance with tax legislation should be avoided.

2.4. THE OECD TRANSFER PRICING GUIDELINES

SARS has historically held some views that have not been in line with the views of the OECD. For example, strict adherence to the legal interpretation of legislation has led to the concept of economic substance being a rather disputed concept in South Africa, while the OECD holds the view that the economic circumstances of related party transactions between companies in different countries should be taken into account (Kruger, 2012).

It has been discussed previously that it is important for South African tax legislation to be in line with the OECD guidelines. Specific paragraphs of the OECD Transfer Pricing Guidelines will be compared to the exception in the South African transfer pricing rules that provides relief from applying transfer pricing rules in the case of residents granting financial assistance to controlled foreign companies under specific circumstances and the absence of similar relief in the case of foreign companies granting financial assistance to resident companies.

2.4.1. Preface to the OECD Transfer Pricing Guidelines

Paragraph 4 of the preface to the OECD Transfer Pricing Guidelines states that countries need to determine which profits of a taxpayer can legitimately be taxed as a result of originating within that country without the same income being taxed by more than one tax authority. It further states that such “double or multiple” taxation can act as a deterrent for transactions between taxpayers in different countries (OECD, 2010:17). Furthermore, paragraph 7 of the preface to the OECD Transfer Pricing

Guidelines mentions that the principles that have been chosen by the members of the OECD aims to assist with allocating the appropriate tax base to each tax authority and to avoid double taxation (OECD, 2010:18).

Paragraph 12 of the preface to the OECD Transfer Pricing Guidelines also warns against double taxation by explaining that the international aspects of transfer pricing are complicated to deal with since more than one tax authority is involved. If an adjustment to a transfer price is made by one tax authority, a correlating adjustment should also be made by the other tax authority. However, if the other tax authority is not willing to accept the same adjustment, the taxpayer will be taxed twice on the same amount of profits (OECD, 2010:20).

According to the OECD Transfer Pricing Guidelines, international agreement is needed on how transfer prices for cross-border transactions should be determined for tax purposes, since this will reduce the risk of double taxation as mentioned above (OECD, 2010:20). It seems that the OECD regards double taxation as a risk that should be minimised as far as possible. It is therefore submitted that being taxed on both the primary and the secondary adjustment as a result of the same loan that qualifies as an affected transaction is not in line with the OECD guidelines, since this effectively means being taxed twice on the same amount.

2.5. THE OECD MODEL CONVENTION

The OECD Transfer Pricing Guidelines is not the only document providing guidelines for international taxation. Further guidelines are also found in the OECD Model Convention with Respect to Taxes on Income and on Capital. The Transfer Pricing Guidelines make reference to the OECD Model Convention and paragraph 8 of the preface to the OECD Transfer Pricing Guidelines (as discussed above), specifically state that the principles applicable to the taxation of multinational entities are contained in the OECD Model Tax Convention on Income and on Capital (OECD, 2010:18). Since the OECD Transfer Pricing Guidelines refer to the OECD Model Convention, some of the articles of the Model Convention will also be assessed against South African transfer pricing guidelines in the paragraphs below.

2.5.1. Article 24 of the OECD Model Convention

Article 24 of the Model Convention contains a special non-discrimination provision that stipulates the following in paragraph 1:

"Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected. This provision shall, notwithstanding the provisions of Article 1, also apply to persons who are not residents of one or both of the Contracting States" (OECD, 2014:37).

2.5.2. Other or more burdensome

In the OECD Commentaries on the Model Tax Convention paragraph one of the commentary on article 24 states that the taxpayers of one of the contracting states may not be subjected to terms that are less favourable than the terms would be for taxpayers of the other contracting state in the same situation (OECD, 2010:333). The Oxford Dictionary defines favourable as "to the advantage of someone or something" (Oxford Online Dictionary, 2019). From a tax perspective, a tax benefit is defined as "avoidance, postponement, reduction or evasion of a liability for tax" (Haupt, 2017:989). It is submitted that being subjected to tax terms that result in an additional burden will not be to the advantage of foreign taxpayers. The possible implications of these tax terms that are not to the advantage of foreign taxpayers could have a negative effect on foreign investment into South Africa. This possible implication will be discussed in a next chapter in this study.

2.6. SUMMARY

In the introduction to this chapter it is mentioned that the first step in attempting to answer the research question, and a secondary objective of this study, is to consider whether the current legislation is in line with the OECD Transfer Pricing and the OECD

Model Tax Convention. In order to consider that, this chapter compared the current legislation to the guidelines provided by the OECD with regard to transfer pricing.

Based on the findings detailed in this chapter with regard to the additional burden as a result of applying the transfer pricing rules, both with regard to costs and administration, it appears as if not allowing for relief from applying transfer pricing rules is in fact more burdensome. That would suggest that a different treatment for foreigners providing financial assistance to residents than for residents providing financial assistance to foreigners is potentially not in line with the OECD Model Convention and that the South African transfer pricing legislation as it stands may not be in line with the OECD transfer pricing guidelines and model convention. This could potentially be considered a deficiency in the legislation, especially considering the intention of SARS to align the South African transfer pricing rules with that of the OECD.

The next chapter will discuss another secondary objective that was formulated as the second step in attempting to answer the research question. Since the South African transfer pricing legislation may not be in line with the OECD Model Convention, which could potentially be considered a deficiency in the legislation, the next chapter will assess whether the current legislation is conducive to investments from foreigners. If the current legislation is not conducive to investment from foreigners, that could potentially be another possible deficiency in the current legislation.

CHAPTER 3: ASSESSING WHETHER THE CURRENT LEGISLATION IS CONDUCIVE TO INVESTMENTS FROM FOREIGNERS

3.1. INTRODUCTION

The international tax goals set by the OECD, have as an aim both to secure the appropriate tax base in each country and to avoid double taxation. According to the OECD Transfer Pricing Guidelines, this will reduce conflict between tax jurisdictions and encourage international trade and investment (OECD Transfer Pricing Guidelines, 2010:18).

Chapter two discussed whether or not the current legislation is in line with the above mentioned OECD guidelines. As stated above, the OECD guidelines aim, among other things, to promote international investment. If the OECD guidelines are formulated to serve as an encouragement to international investment, it stands to reason that tax legislation that is not in line with the OECD guidelines runs the risk of acting as a deterrent to international investment.

In research conducted by Bredenkamp (2015:76), the possibility is discussed that section 23M of the Income Tax Act, could be seen as tax legislation that impedes foreign investors from investing in South Africa. Such hindrances to foreign investment could have a negative impact on economic growth. If section 23M of the Income Tax Act does in fact encourage tax protectionism, the argument could be made that South African tax policies have a propensity to deter foreign investors rather than enticing them to invest in South Africa. According to Bredenkamp, the National Treasury stated in 2013 that a balance is needed between attracting foreign capital and protecting the tax base of a country against base erosion.

This chapter investigates second secondary objective of the study, which is the possibility that the current legislation might not be conducive to international investments. As a starting point, factors that encourage foreign investment, specifically in South Africa, will be addressed.

3.2. BACKGROUND OF FOREIGN DIRECT INVESTMENT

Since the early 1980s, worldwide foreign direct investment (FDI) has increased exceptionally, with a corresponding increase in the global market in contending for such investment (Asafo-Adjei, 2007:7). According to Pugel (cited by Asafo-Adjei, 2007:7), FDI is the process during which residents of one country obtain possession of foreign assets with the purpose of controlling the production, distribution and other undertakings of a company in another country. It can also be considered as an expansion of corporate control over international boundaries other than that of a home or source country (Asafo-Adjei, 2007:7).

The International Monetary Fund (IMF) (2003) defines FDI as a type of international investment that “reflects the objective of a resident in one economy (the direct investor) obtaining a lasting interest in an enterprise resident in another economy (the direct investment enterprise)”. The continuing interest ensures the existence of a long-term relationship between the investor and the investment business, as well as a substantial amount of influence by the investor on the daily operations of the business (IMF, 2003:6). FDI transactions are mainly entered into by multinational enterprises (MNEs) and occurs as an effort by the investing entity to protect or expand its capacity to receive profits as a result of its control over intangible assets. This effort to protect its profits can be the result of continuous competition in their resident country, as well as in other countries, and is driven by the ability to receive higher profits on undertakings in the foreign country (Asafo-Adjei, 2007:8).

For developing countries, FDI is an indispensable source of private external funding (Asafo-Adjei, 2007:10) and according to the Global Investment Report 2018 it is still the largest external source of funding for developing countries (UNCTAD, 2018:xii). In 2017, global flows of FDI decreased by 23 per cent from 2016. In developed and transition economies cross-border investment decreased severely and in developing economies the growth was practically non-existent. Policymakers globally should be concerned with this downward trend in FDI, since only a very modest recovery is predicted for 2018, and especially since international investment is crucial for the sustainable industrial development in developing countries (UNCTAD, 2018:iii).

As mentioned above, from 2016 to 2017 global FDI flows fell by 23 per cent (from a revised $1.87 trillion to $1.43 trillion). To developed economies and economies in transition, FDI flows decreased significantly, while FDI flows to developing economies remained constant. As a result of this decline of FDI flows to developed economies and economies in transition, developing economies comprised an increasing portion of global FDI inflows in 2017 (47 per cent of the total, compared with 36 per cent in 2016) (UNCTAD, 2018:2). However, while developing countries are receiving a growing share of global FDI inflows, the distribution of these inflows are unequal. According to the report, in 2017 Africa's share in the world's FDI inflows was 2.9 per cent (UNCTAD, 2018:38), while Asia received 33.3 per cent (UNCTAD, 2018:44) and Latin America and the Caribbean received 10.6 per cent (UNCTAD, 2018:50). FDI flows to Africa slumped to $42 billion in 2017, a 21 per cent decline from 2016 (UNCTAD, 2018:40).

3.3. SOUTH AFRICA AS A DEVELOPING MARKET

From the figures above, it is clear that when discussing investment, there should be distinguished between developed countries and developing countries since the circumstances under which investment occurs in developing countries differ greatly from that of developed countries. This is especially true with regard to non-tax factors such as market stability, labour skills and availability, infrastructure, political stability and tax administration procedures (Van Parys, 2012:132). The World Investment Report 2018, issued by the United Nations Conference on Trade and Development (UNCTAD), states that developing countries with small markets are experiencing increased pressure on their investment policies, due to the fact that potential investor companies are increasingly often searching for investment locations that possess optimal conditions and potential to deliver new and high-quality products promptly (UNCTAD, 2018:iv).

FDI has been a significant factor in the growth of South Africa's economy, but has remained at fairly low levels in the past in comparison to FDI in other emerging market countries (Arvanitis, 2005:64). Even though advances have been made in overall macroeconomic conditions and despite South Africa's favourable market size and

natural resources, there is a reluctance from foreign investors to acquire, create or expand domestic ventures (Arvanitis, 2005:64). In more recent years, this appears to remain the case, as confirmed by the World Investment Report 2018 which states that foreign investment to South Africa continues to underperform (UNCTAD, 2018:40). The report indicates that FDI to South Africa decreased by 41 per cent to $1.3 billion, as a result of the country being plagued by an underachieving commodity sector and political uncertainty (UNCTAD, 2018:42).

The IMF’s World Economic Outlook Database issued a list of developing countries during April 2018 which includes South Africa as a developing country. This status as a developing country means that investing in South Africa may not be as attractive as investing in a developed country with an attractive investment climate. According to research done previously, it is also possible that changes to tax rates are not as effective an incentive for investment in developing countries as in developed countries (Van Parys, 2012:136).

Research has suggested that investment is more affected by the tax rates in countries with positive investment climates. This is possibly due to the fact that investors may not be interested in further improving an investment climate by paying higher taxes (which can in turn be utilised to fund further improvement of the investment climate) if the investment climate was good to begin with (Van Parys, 2012:136). In his research, Van Parys (2012:136) found that in general FDI had a negative reaction to the marginal effective tax rate. This negative reaction became more negative as the investment climate became better. Furthermore, FDI was not affected negatively by higher marginal effective tax rates in countries with a very inferior investment climate (Van Parys, 2012:136).

The findings of this research seem to indicate that investors are less disapproving of higher tax rates in countries where the higher taxes paid is used to fund improvement of the investment climate, which in turn plays a part in the productivity of capital. It is therefore possible that a reduced tax liability or burden in countries with a poor investment climate is not very effective (Van Parys, 2012:136).

That being said, there is a possibility that tax competition is more vigorous in developing countries than in developed countries if the regulators feel that a decrease in the tax rate can be used as compensation for a worse investment climate. However, reducing tax rates while the investment climate is still not a desirable one will not necessarily have any effect if foreign investors need fundamental investment conditions to be in place before they will invest. This is especially true when considering that firms do not simply make investment decisions based on possible tax burdens, but also consider factors such as the availability of public goods funded by the taxes collected (Van Parys, 2012:132).

This chapter will discuss factors that encourage foreign investment and will then focus on discussing investment in a developing or emerging market country.

3.4. FACTORS ENOURAGING FOREIGN INVESTMENT

The OECD conducted studies in the MENA (Middle East and North African) region on factors that encourage foreign investment. The majority of international studies in this area indicated that general economic conditions are much more likely to influence the amount and quality of investment into a country than tax incentives. This being said, incentives are considered more simple to implement and can in some cases reduce the negative effect of market failures. It is also often viewed as effective policy tools to drive a country's economic and social goals (OECD, 2007:3).

The international studies referred to above all agree on the fact that the most important factors influencing foreign investment are: (i) market size and real income levels, (ii) skill levels in the host country, (iii) the availability of infrastructure and other resources, (iv) trade policies and (v) political and economic stability of the host country. While the most important factors that influence foreign investment are not tax related, there are some tax factors that do have an influence on foreign investment. These are transparency, simplicity, stability and certainty in the application of tax legislation and tax administration, tax rates and tax incentives (OECD, 2007:3). Furthermore, foreign investment may be affected by incentives given by government such as reduced corporate tax rates, grants and preferential loans to multinational companies and market preferences or exclusive control rights (OECD, 2007:4).

Survey analysis data indicate that a country's tax and international investment incentives have a limited effect on foreign investment and furthermore that simplicity, stability, transparency, certainty in the application of tax legislation and administration and the management of government finances are frequently noted by investors as more important to their investment decision than tax incentives (OECD, 2007:4).

Further evidence of the consideration given to tax legislation by investors making an investment decision was reflected by a survey of investors in South East Europe (OECD, 2007:4). According to the survey, instability and unpredictability of a tax system were the most significant hindrances when considering whether or not to invest. Opportunistic investors did not list tax issues as hindrances in the process of deciding whether to invest or not (OECD, 2007:4).

The results of the same survey referenced above also indicate that special tax incentives did not specifically stimulate direct foreign investment. Instead, the tax incentives either were not considered at all when foreigners decided to invest or were discouraging to investment where tax incentives were burdensome to keep record of, difficult to understand or to comply with or created situations conducive to corrupt actions by tax officials (all circumstances that increase costs and uncertainty for foreign investors) (OECD, 2007:4).

These findings are also supported by other studies. The OECD framework, while acknowledging that the corporate tax policy is important, highlights the importance of costs to comply with tax legislation to investors. According to the OECD (cited by Van Parys, 2012:131) the decision to invest is influenced by the burden to comply with tax legislation, as well as the complexity, transparency and predictability of tax legislation.

Tax incentives are deployed by many developing countries to lower the tax liability of foreign investors (Van Parys, 2012:134). According to Van Parys (2012), however, there are few theoretical studies investigating complicated tax systems that include tax incentives, since most models are aimed at determining the effect that the corporate tax rate has on investment.

The problem with these models are that they make the assumption that a reduced tax burden will be an automatic enticement for investment, but they do not take into consideration the subsequent tax compliance costs, or information costs relating to tax incentives. These additional costs could potentially counteract any benefit derived from a reduced tax benefit (Van Parys, 2012:134).

It is submitted that if tax incentives that are difficult to comprehend, keep record of or to comply with are considered a discouragement to investment, tax legislation (although not in the form of an incentive) that is difficult to comply with will also serve as a discouragement to investment.

In a study conducted by Van Parys (2012), the following results are noted: "In countries with a very poor basic investment climate, capital does not react negatively to higher marginal effective tax rates. FDI also rises as the investment climate becomes better." The study notes that these results would suggest that investors are not deterred by higher corporate tax rates in countries, if the additional revenue collected from the higher tax rates is used to improve the investment climate (which in turn will add to the productivity of capital). It is possible that a reduction in tax liabilities will be ineffective in countries with a poor investment climate (Van Parys, 2012:136).

An African study was also conducted where the effect of tax incentives on investment, the effect of the transparency and intricacy of tax systems and the significance of legal protection for foreign investors were investigated. The study found that higher transparency and security for investors were ranked higher as considerations when making investment decisions than a reduced tax burden. This is further confirmation that the investment environment of a country is more important to potential investors than tax incentives (Van Parys, 2012:138). It is submitted that the investment climate of a country will be more important to potential investors than reduced tax burdens, since tax incentives will most likely reduce as a result of reduced tax burdens.

There are very few modern economists who commend the benefits of tax incentives. In fact, more often economists warn against using tax incentives (Calitz, Wallace & Burrows, 2013:1). Even though tax incentives are being used more often and are enjoying increased popularity, they are often unnecessary and ineffective. The

application of tax incentives increases the complexity of tax legislation and often do not achieve the goal for which they were instated (Bird, 2009:9). Tax incentives are widely used, even though there is only highly inconclusive empirical evidence on the cost-effectiveness and ability of tax incentives to encourage investment (Calitz, Wallace & Burrows, 2013:1). A report on incentives in Indonesia found meagre evidence of the effectiveness of incentives in encouraging investment without very high cost (Calitz, Wallace & Burrows, 2013:1).

The economic workings related to various tax incentives are fairly simple. If the incentives are aimed at investment the "user cost of capital concept" illustrates the fact that tax incentives could potentially lower the cost of capital (either directly or indirectly) and this could in turn act as an incentive for investment (Calitz, Wallace & Burrows, 2013:5). The user cost of capital is the cost incurred to use a capital asset for one period. Profits are maximised when capital assets are obtained so that the value of the marginal product of capital equals that of the user cost. Factors that affect the user cost of capital, such as tax rates, depreciation, treatment of capital gains and tax subsidies also affect the level of investment. For example, tax incentives specifically targeted at decreasing the cost of labour could potentially increase hiring (Calitz, Wallace & Burrows, 2013:5).

If tax incentives could in fact increase investments, the question to be asked is why many economists and other authorities remain unenthusiastic about the use of tax incentives. This disapproval of tax incentives is partly due to the fact that they skew preferences and allocative efficiency and is partly due to the fact that tax incentives suggest that tax officials are better equipped than private investors to determine the best types and means of production (since increased production is needed to improve economic results). This strategy of "picking winners" is further criticised because empirical evidence from prior research on the subject suggests that decisions to invest are not influenced only by tax related matters (Calitz, Wallace & Burrows, 2013:7). Other factors that are unrelated to tax, such as economic factors, noneconomic factors and social policy factors play an important part in the investment decision. A better way of encouraging investment will be to determine the root of the reluctancy to invest and seeking to correct the root problem, rather than attempting to lure investment through the use of tax incentives (Calitz, Wallace & Burrows, 2013:7).

Further empirical research has shown that while tax incentives may encourage investment to a certain degree, as a rule they are not cost effective and the general economic and investment climate of a country may be more significant in determining the success or failure of any specific industry in that country (Calitz, Wallace & Burrows, 2013:8). This is in line with the findings of other studies already discussed in this chapter. It appears that a stable economic and political climate and certainty regarding the application of tax law is a bigger incentive for foreign investment than tax incentives that may result in tax savings. After considering factors that encourage foreign investment in general, the focus is narrowed to factors encouraging investment in developing countries, specifically the use of tax incentives as an encouragement to investment.

3.5. FACTORS ENCOURAGING INVESTMENT IN DEVELOPING COUNTRIES

The application and effect of tax incentives have to be given consideration when research is done regarding corporate taxation in developing countries. Tax incentives can be defined as "measures that provide for a more favourable tax treatment of certain activities or sectors compared to what is granted to the general industry" (Klemm, 2009:3). Since tax incentives do not make use of government funds, they are often preferred by developing countries over financial incentives (such as subsidies and grants). Tax incentives are not exclusively used in developing countries, but some incentives are commonly used in developing countries to decrease tax burdens for foreign investors (Van Parys, 2012:134).

Even though tax incentives are used in developing countries to entice investment, it appears that in developing countries, as in developed countries, tax incentives are not the main factor that investors consider when deciding where to invest. The empirical evidence of the effect of tax incentives on investment in developing countries remain elusive (Calitz, Wallace & Burrows, 2013:3). However, evidence suggests that the restricted benefits of tax incentives have resulted in investors often considering possible tax incentives irrelevant compared to other considerations when making investment decisions. The evidence suggests that investors mainly investigate a country's economic climate and institutional situation when making an investment

decision. These firms are attracted to the potential markets and relatively low costs of labour in developing and transitional countries (Calitz, Wallace & Burrows, 2013:8). There are negative factors that will prevent potential investors from investing - such as uncertainty in government policy, political instability and the rudimentary state of the legislation governing the economy – that cannot be negated by tax incentives. The positive factors that will contribute to an investor's decision to invest, such as the tax base, tax rates, stability, consistency, predictability and transparency, are more likely to entice investors to make an investment in a country than tax incentives (Calitz, Wallace & Burrows, 2013:8).

In South Africa, SARS has recognised that a tax authority's position on prices that are considered at arm's length can affect the way companies carry on cross-border activities, which can in turn have an effect on how competitive that company can be in a global market (Van der Lith, 2011:63). This is in line with the findings mentioned above that suggest that there are factors (such as tax rates and transparency) that may affect an investor's investment decision. With regard to developing countries, potential investors may be enticed rather by the potential markets and relatively low cost of labour than by tax incentives, since the negative factors that could deter foreign investment may not be prevailed over by tax incentives (Calitz, Wallace & Burrows, 2013:8). This is the same as the findings of factors that encourage foreign investment in general.

3.6. SUMMARY

3.6.1. Additional burden and lack of certainty as a result of current legislation

Chapter two of this study already concluded that there exists an additional burden both in the form of amounts payable and lack of certainty with regard to the application of the tax legislation as it currently stands. As mentioned earlier in this chapter, stability and certainty in the application of tax legislation and tax administration ranked higher as a factor that could potentially sway an investor's decision to invest than a lower tax burden (OECD, 2007:3). It would therefore appear as if the legislation as it stands currently, especially with regard to the complexity and uncertainty when applying transfer pricing rules, is not necessarily conducive to foreign investment.

3.6.2. Effect of tax incentives on foreign investment

The main factors affecting foreign investment are agreed on in literature with the main factors listed as market size, skills levels, infrastructure and resources available in the country in which the investment is to be made, trade policies and political and economic stability in the country receiving the investment (OECD, 2007:3). In turn, survey analysis has indicated that the role of tax incentives is very limited when it comes to foreign investment patterns (OECD, 2007:4). With regard to the second secondary objective of whether the current legislation is conducive to foreign investment, it appears that the current tax legislation may not be conducive to foreign investment.

When assessing the correlation between corporate investment and corporate taxation, an important consideration is the fact that investors contemplate many factors other than taxation when making an investment decision (Van Parys, 2012:132). This is especially true for countries with a poor investment climate. In the studies conducted by Van Parys, the impact of tax incentives on investment in Africa was considered insignificant. A possible reason provided for this was that the investment environment was so inferior that tax incentives were not considered adequate compensation to entice investors to invest (Van Parys, 2012:137). Since South Africa is a developing country in Africa, it is submitted that the current unstable investment climate cannot be mitigated sufficiently by tax incentives and reduced tax burdens to be the direct reason that investors decide to invest.

Therefore, while the current tax legislation may not be conducive to foreign investment, it does not automatically mean that amending the legislation will increase foreign investment. It appears that factors other than tax considerations are much more important to the investment decisions made by potential investors.

CHAPTER 4: INVESTIGATING POSSIBLE TRANSFER PRICING RELIEF PROVIDED BY DOUBLE TAX AGREEMENTS

4.1. INTRODUCTION

As discussed in previous chapters, the current legislation does not provide an exemption from applying transfer pricing rules in the case of a foreign company providing financial assistance to a South African company at terms that are not at arm's length. However, in the case of a resident providing the same form of assistance to a foreigner, there is some relief provided by section 31(6) of the Income Tax Act.

Chapter two reviewed the possibility that this difference in treatment is not in line with the OECD Transfer Pricing Guidelines and OECD Model Convention, which could potentially indicate a deficiency in the current legislation. This chapter will address the third secondary objective which is to consider the possibility that some relief from the burden of applying transfer pricing rules and the subsequent primary and secondary adjustments are provided by DTAs with other countries. If DTAs do provide some form of relief that may mitigate the difference between the treatment of foreigners and residents. The chapter will not include analysing specific DTAs but instead will be considering whether it is possible that relief from the burden can be provided by double tax treaties.

To determine if relief is provided, it must first be determined what the specific burdens are from which relief is needed. In Chapter two, the additional burden as a result of applying transfer pricing rules was discussed. In this chapter, the focus will be on the specific burdens of interest as a result of the primary adjustment and the deemed dividend as a result of the secondary adjustment when transfer pricing is applied in cases where the resident receives funding (which should lead to interest being paid on the funds received).

Both interest and deemed dividends may lead to a withholding tax liability in terms of sections 50A to 50H and 64D to 64N of the Income Tax Act. The primary adjustment will be interest, on which sections 50A to 50H of the Income Tax Act levy a withholding tax of 15 per cent. This withholding tax is levied on South African source interest paid

to non-resident persons (Haupt, 2017:597). Secondary adjustments in the case of a company is treated as a deemed dividend, which will consist of a distribution of an asset *in specie* and will be subject to dividends tax at 15 per cent (Grant Thornton, 2016). Dividends tax is levied by sections 64D to 64N of the Income Tax Act (Haupt, 2017:467) and is considered a withholding tax since the company paying the dividend is responsible for withholding the tax at a rate of 15 per cent (Haupt, 2017:474).

The possibility that there is relief from the above-mentioned burdens provided by DTAs are reviewed in this chapter. The two adjustments, primary and secondary, are reviewed separately.

4.2. PRIMARY ADJUSTMENT RESULTING IN INTEREST AND WITHHOLDING TAX ON INTEREST

4.2.1. The primary adjustment

Section 31 of the Income Tax Act requires that the taxable income of any party to the affected transaction who received a tax benefit must be calculated as if the affected transaction had been entered into on the terms and conditions that would be expected between parties transacting with each other on an arm's length basis (Honiball & Delahaye, 2013:17). This condition essentially does away with the ability of the Commissioner to make a transfer pricing adjustment at his discretion and instead places the responsibility to voluntarily declare a transfer pricing adjustment on the respective parties to the transaction (Honiball & Delahaye, 2013:17).

Loans can create thin capitalisation issues, typically in situations where South African taxpayers received loans from non-resident connected persons. The new section 31 of the Income Tax Act does not refer specifically to thin capitalisation but instead states that market related terms, or arm's length provisions should be considered when assessing if a taxpayer is thinly capitalised (Haupt, 2017:590). The requirement that the terms and conditions of all cross-border transactions must be as if entered into between independent parties transacting at arm's length is the most significant difference between the previous section 31 and the new section 31 of the Income Tax

Act. This requirement was not included in the old section 31 of the Income Tax Act (Olivier & Honiball, 2011:665). The change is a development towards the method of dealing with thin capitalisation used by some foreign tax jurisdictions (Haupt, 2017:590). The amendment complies with international best practice, while at the same time adhering to the suggestions made in the OECD Model Tax Convention and in the OECD Transfer Pricing Guidelines (Olivier & Honiball, 2011:665). It changes section 31 of the Income Tax Act from an adjusting provision to a taxing provision and only becomes an adjustment provision if a transaction is entered into at terms that are not considered at arm's length. At that point, the provision will require SARS to re-evaluate the transaction at arm's length terms (Olivier & Honiball, 2011:665).

As discussed above, according to the revamped section 31 of the Income Tax Act, all cross-border transactions entered into between connected persons must be evaluated as if the transaction was entered into at arm's length terms (Olivier & Honiball, 2011:665). This means that when a loan is provided by a foreign company to a South African company the first step in determining if the South African company is thinly capitalised will be to determine if the foreign company is a connected person in relation to the South African company, instead of considering the correlation between the amount of the loan and the fixed capital attributable to the lender (Haupt, 2017:590). If it is established that the parties involved in the loan transaction are connected, the next step will be to determine if a tax benefit has arisen (Haupt, 2017:590). If a tax benefit has in fact arisen, the interest that the South African company will be allowed to claim as a deductible expense will be limited to an amount that is equal to an arm's length rate of interest. Furthermore, this deductible interest is only allowed to be based on an amount that an independent lender would have lent the South African company at arm's length terms (Haupt, 2017:590). SARS will not allow interest expenditure that arises from an amount of debt that is not at arm's length, which means that both the debt and the interest rate charged on the debt must be at arm's length (Haupt, 2017:591).

Since the new section 31 of the Income Tax Act does not have thin capitalisation rules, there has to be referred to the OECD guidelines with regard to when thin capitalisation occurs (Haupt, 2017:591). SARS issued a Draft Interpretation Note in 2013 with the subject Determination of the taxable income of certain persons from international

transactions: Thin Capitalisation, that deals with thin capitalisation as per section 31 of the Income Tax Act.

There are a few points made in the Draft Interpretation Note that add useful insights, such as that in situations where a taxpayer is thinly capitalised, no tax deduction is allowed in terms of the interest on the portion of the funds received that is considered excessive (SARS, 2013:4). This can be illustrated by the following example: If a South African subsidiary borrows R60 million bearing interest at 15 per cent from their foreign holding company at terms that are not at arm’s length (in the example it is stated that arm’s length terms would have been a loan of R40 million bearing interest at 10 per cent), two adjustments must be made. Firstly, the South African taxpayer will not be allowed to claim a deduction on the excessive portion of the debt (R20 million). Secondly, a deduction will also not be allowed for the excessive interest (5 per cent) on the arm’s length portion (R40 million) of the debt (Haupt, 2017:591).

However, a binding private ruling by SARS suggests that there are cases where the primary adjustment results in deemed interest, instead of a limitation on the available deduction of interest. The ruling provided clarity on the question of whether or not withholding tax should be paid on that interest and will be discussed in the paragraph below.

4.2.2. Relief from withholding tax on interest

The situation that is investigated in this study is that of a foreigner granting a loan to a South African taxpayer. A ruling issued by SARS was found that addresses this situation.

On 28 May 2018, SARS issued the Binding Private Ruling: BPR 192, with the subject “Cross-border interest-free loan and withholding tax on interest”. The summary of the ruling states that it was issued with regard to the question of whether an adjustment to taxable income or tax payable in terms of section 31 of the Income Tax Act can result in a withholding tax on interest being payable. The type of transaction to which the ruling would be applicable is described as a company that is a resident of a foreign

country (which does not carry on business through a permanent establishment in South Africa) that advances a loan to a company that is a resident of South Africa and a connected person to the foreign company. The loan described is one that is interest-free, unsecured and repayable on demand (therefore not at market related terms).

According to the ruling (BPR 192) that was made with regard to a loan transaction as described above, if an adjustment in accordance with section 31 of the Income Tax Act is made to taxable income or tax payable, no withholding tax will be payable by the foreign company and the resident company will not be required to withhold an amount of withholding tax on the interest. This ruling is valid for 5 years from 11 May 2015.

This ruling therefore provides relief from withholding tax in the case of an adjustment made in accordance with section 31 of the Income Tax Act to taxable income or tax payable.

4.3. SECONDARY ADJUSTMENT RESULTING IN DIVIDENDS AND WITHHOLDING TAX ON DIVIDENDS

4.3.1. The secondary adjustment

The OECD defines a secondary adjustment as an "adjustment that arises from imposing tax on a secondary transaction in transfer pricing cases" (Grant Thornton, 2016). The secondary adjustment in South African tax legislation has undergone a number of changes. Before 1 January 2015, the secondary adjustment was treated as a deemed loan. The taxpayer also had to account for interest at an arm's length rate on the deemed loan if the loan was not repaid in the same year as the year during which the primary adjustment was made (Grant Thornton, 2016). This income as a result of the arm's length interest adjustment was taxable and capitalised to the balance of the deemed loan for each year of assessment (Grant Thornton, 2016).

The deemed loan with the corresponding arm's length interest adjustment was very impractical to be governed by SARS and due to various reasons, including that there

existed no actual obligation to repay the deemed loan, these loans were very seldom repaid by foreign entities (Grant Thornton, 2016). As a result of this, the secondary adjustment was changed from 1 January 2015.

The new secondary adjustment requires that the secondary adjustment takes the form of either a deemed dividend *in specie* (distribution of an asset *in specie*) in the case of a company or a deemed donation in the case of persons other than companies. The deemed dividend will be subject to dividends tax while the deemed donation will be subject to donations tax (Grant Thornton, 2016).

There is a possibility of withholding tax on both interest and dividends, but earlier in the chapter a ruling was discussed that appears to provide relief from withholding tax on the interest. The next paragraph will consider whether there is possibly any relief from the dividends tax provided in DTAs.

4.3.2. Relief from dividends tax

The Davis Tax Committee was of the opinion that no DTA relief for dividends tax would be available. The Committee reported that transfer pricing adjustments are the result of economic value that is shifted from South Africa to another country for insufficient or in some cases no compensation, regardless of the relationship between the South African taxpayer and the other person or entity involved in the transaction (Grant Thornton, 2016).

Transactions of this nature that transfer economic value lead to an exhaustion of the South African asset base as well as a potential loss in future taxable income. The Committee was therefore of the opinion that transfer pricing adjustments are similar in nature to outward dividend payments to foreign related parties, considering that they both constitute a transfer of value from South Africa to a foreign entity (Davis Tax Committee, 2014:19). As a result of this similarity, the secondary adjustment should be subject to a tax that is comparable to the suggested 15 per cent withholding tax. The example provided by the Committee was a tax that resembles the old secondary tax on companies. Due to the fact that the South African company, rather than the foreign related party, will be liable for a tax of this nature, no relief would be available

from a DTA (Grant Thornton, 2016). Even though the Davis Committee is not binding from a legal perspective, SARS may take guidance regarding the interpretation and application of the amendments from the report (Grant Thornton, 2016).

There exists further evidence of the absence of any DTA relief for dividends tax on the secondary adjustment. Earlier in this chapter, mention was made of the old secondary tax on companies. Secondary tax on companies was replaced by dividends tax, which came into effect on 1 April 2012 (Haupt, 2017:453). At the same time, the definition of dividend in section 1 of the Income Tax Act was also amended.

Section 1 of the Income Tax Act provides a definition of a dividend as an amount transferred or applied by a South African resident company for the benefit, or on behalf of, any person in respect of any share in that company by way of a distribution made (South Africa, 1962). The person receiving the benefit does not have to be a shareholder, but there must be a link between the payment and the share in issue.

As already discussed, in 2015 amendments were made to the secondary transfer pricing adjustment. The amendments made provision for a company that has to make a secondary transfer pricing adjustment to deem the amount to be a dividend in the form of a distribution of an asset *in specie* declared and paid to the non-resident connected person by the resident company. Such a deemed dividend *in specie* is currently subject to dividends tax at a rate of 20 per cent, which will have to be paid by the company (Haupt, 2018:589).

There exists a potential intersection in the current tax legislation between the treatment of a dividend as defined by section 1 of the Income Tax Act and the treatment of an amount deemed to be a dividend as per the requirements of the transfer pricing rules in section 31 of the Income Tax Act. As a result of this intersection, it is possible that a deemed dividend *in specie* that resulted from a secondary transfer pricing adjustment may also meet the definition of a dividend as contained in section 1 of the Income Tax Act (pursuant to the specific circumstances of the case). If the deemed dividend *in specie* meets the definition of a dividend as given in section 1 of the Income Tax Act, this overlap may have the unintentional result of tax treaty relief being available for this amount.

The proposed amendments in the Tax Laws Amendment Bill of 2018 suggest that it was never the intention that double tax treaty relief should be available for deemed dividends as a result of secondary transfer pricing adjustments. In the 2018 Draft Explanatory Memorandum on the 2018 Draft Tax Law Amendment Bill, the proposal is made that in an attempt to address the above mentioned anomaly, there should be specific mention of the fact that an amount deemed as a dividend *in specie* that resulted from a secondary transfer pricing adjustment as per section 31 of the Income Tax Act is excluded from the dividend definition as provided in section 1 of the Income Tax Act (Draft Explanatory Memorandum on the Taxation Laws Amendment Bill, 2018:37).

Ensuing from the above amendment, an amendment should also be made to section 64 of the Income Tax Act (which relates to dividends tax) to specifically include an amount that is a deemed dividend *in specie* resulting from a secondary transfer pricing adjustment as a dividend that is subject to dividends tax. (Draft Explanatory Memorandum on the Taxation Laws Amendment Bill, 2018:37).

4.4. SUMMARY

At the start of the research, it was expected that the answer to whether or not relief is available from DTAs will be found by reviewing specific tax agreements. However, it appears that other legislation either prevents any DTA relief from being applicable or provides the necessary relief, and therefore the DTAs were not reviewed.

Relief from withholding tax on interest in the case of any adjustments made in accordance with section 31 of the Income Tax Act to taxable income or tax payable (in the case where a foreigner grants a loan to a resident) is already provided by Binding Private Ruling: BPR 192. Further relief is therefore not required from a DTA.

As far as treaty relief for dividends tax, it appears as if it was not the intention that treaty relief should be available for dividends tax on deemed dividends resulting from a secondary transfer pricing adjustment. The proposed amendment to the legislation further supports this opinion. Within the scope of this study, it does not appear as if

any treaty relief is available for dividends tax on deemed dividends as a result of a secondary transfer pricing adjustment.

The possibility that the difference between the tax treatment of foreigners and residents could potentially indicate a deficiency in the current tax legislation does not appear to be mitigated through relief provided by DTAs.

CHAPTER 5: CONCLUSION

5.1. INTRODUCTION

The main objective of this study was to evaluate the possibility that the absence of the exception from applying transfer pricing rules in the case of a foreigner providing financial assistance to a resident at terms that are not market related is a deficiency in the current tax legislation. The study considered whether there should be such an exception to ensure fair treatment of all taxpayers and if relief is provided elsewhere in the tax legislation.

To assist in achieving the main objective, which was also the problem statement of this study, the following secondary objectives were formulated:

- To review whether the current legislation is in line with the OECD guidelines for transfer pricing and the model convention.
- To discuss if the legislation as it currently stands is conducive to foreign investment.
- To discuss the possibility that some relief from the burden of applying transfer pricing rules and the subsequent primary and secondary adjustments are provided by DTAs with other countries.

5.2. CURRENT LEGISLATION IN LINE WITH OECD GUIDELINES FOR TRANSFER PRICING AND THE MODEL CONVENTION

The first secondary objective of assessing whether the current legislation is in line with OECD guidelines for transfer pricing and the model convention, was addressed in chapter 2. In an effort to curb the practice of shifting profits via transfer pricing, South Africa implemented broad transfer pricing rules which came into effect on 19 July 1995. These transfer pricing rules contained in section 31 of the Income Tax Act was subsequently completely overhauled after SARS announced its intention in 2010 and 2011 to align the transfer pricing legislation with the OECD transfer pricing guidelines. The new transfer pricing rules came into effect on 1 October 2011. The new section 31 of the Income Tax Act aims to include both direct and indirect transactions in the

transfer pricing net, effectively broadening the scope and application of the legislation. In this study, the revised section 31 of the Income Tax Act is discussed, since it is the transfer pricing rules currently applicable.

Although South Africa is not a member of the OECD, the country is one of the key partners of the OECD with a responsibility to participate. SARS has accepted the OECD guidelines as an important document and has indicated an intent to have its transfer pricing rules in line with OECD guidelines. The OECD provides transfer pricing guidelines, as well as a model convention with respect to taxes on income and capital.

In an attempt to evaluate whether transfer pricing rules are in line with the guidelines issued by the OECD an understanding of the working of the transfer pricing rules in question was first obtained. Section 31(2)(b) of the Income Tax Act details that transfer pricing may be triggered if any term or condition of a transaction, operation, scheme, agreement or understanding differs from arm's length terms and conditions and will result in a tax benefit being derived by any person who is a party to said transaction. Section 31(2) of the Income Tax Act states that the taxable income of each person that derives a tax benefit and is party to the affected transaction must be calculated as if the transaction had been entered into on arm's length terms. There is also an exception from applying the transfer pricing rules currently provided for in the Income Tax Act. Section 31(6) of the Income Tax Act sets out the circumstances under which the transfer pricing rules do not apply. These requirements are that the financial assistance must be given to a CFC by a resident, the CFC must have a foreign business establishment as defined in section 9D(1) of the Income Tax Act and the CFC must be in a high tax jurisdiction. If the requirements as stipulated by section 31(6) of the Income Tax Act are met, a South African company providing financial assistance to a non-resident shareholder, specifically a CFC, does not have to apply transfer pricing rules. However, the same or similar relief is not provided to a non-resident CFC providing financial assistance to a South African taxpayer.

This absence of a similar exemption from applying transfer pricing rules for foreigners providing loans to residents was identified as possibly resulting in non-conformation to the OECD transfer pricing guidelines. Foreign taxpayers providing assistance to

residents remain obligated to apply the transfer pricing rules. In addition, the South African taxpayer receiving the financial assistance may be required to apply transfer pricing rules if the terms and conditions of the loan (such as interest on the loans received not charged at a market related rate) are not market related. This study then considered whether the different treatment resulted in a burden that is higher for the non-resident than for the resident, as well as whether the relief provided for South African taxpayers is justified.

With regard to whether the relief for South African taxpayers is justified, it was found that a high-taxed CFC (which is the type of company for which the exception will be available when funds are provided by a South African taxpayer) will save only marginally on worldwide tax by understating interest. The opportunity for tax avoidance by understating interest and obtaining a tax saving is therefore considered to be marginal. Since the exception is only available for controlled foreign companies, the income earned by the CFC may, subject to the provisions of section 9D of the Income Tax Act, be taxed in the hands of the resident who has participation interest in the CFC.

After obtaining an understanding of the transfer pricing rules, the OECD guidelines were considered. Specifically, article 24 of the model convention, which is a non-discrimination article which states that "Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected." This article details that taxpayers of different countries should not be discriminated against based on their residency.

In paragraph 5 of the commentary on article 24(1) it is noted that this article sets out the principle that taxation discrimination on the basis of nationality is forbidden. The commentary in paragraph 5 continues to state that, "subject to reciprocity, the nationals of a contracting state may not be less favourably treated in the other contracting state than nationals of the latter state in the same circumstances". It is

submitted that the mere absence of an exemption for a non-resident may suggest that there is a difference in treatment based on residence in this case.

With reference to "other or more burdensome", the possible burdensome effects of having to apply and comply with transfer pricing rules were then considered. The following factors were identified as being possibly "burdensome": The additional burden as a result of an increased tax liability, the additional burden due to the costs involved in applying the transfer pricing rules, the additional burden resulting from a lack of guidance provided by SARS regarding the application of transfer pricing rules, and the administrative burden placed on taxpayers having to apply the transfer pricing rules.

An increased tax liability could be the result of a South African taxpayer that obtained funds from a non-resident at terms that are not market related and as a result of applying transfer pricing rules are not allowed an interest deduction against any additional revenue generated by the additional funds available. This could possibly result in the South African company (and from the group's perspective, the MNE) being liable for more income tax.

Assessing whether or not transactions are entered into at arm's length terms could also lead to an additional burden in the costs involved in applying transfer pricing rules. Instead of the safe harbours provided in the outdated Practice Note 2, the Draft Interpretation Note requires taxpayers to assess whether financial assistance is excessive and interest rates are considered at arm's length with reference to both the lender and the borrower's position. This leads to a significant responsibility for the taxpayer, since considering whether the financial assistance occurred on market related terms will for all intents and purposes require the same evaluation procedures as that of a bank considering providing financial assistance. Companies that are not financial service providers will naturally not be equipped to do this type of vetting and will have to incur costs to follow this process. The costs to obtain comparable information may also be extremely high, especially in cases where only one or two loans are assessed.

A lack of guidance from SARS regarding the application of transfer pricing rules adds to the burden of applying said rules. After the amendments to section 31 of the Income Tax Act in 2012 the expectations were that SARS will release an updated Practice Note on the application of the new rules but such clarification has still not been issued. This results in uncertainty with regard to applying the rules.

The documentation burden related to transfer pricing and the number of additional requirements to remain compliant is increasing. This documentation required by SARS according to a Draft Public Notice prescribes documents that are different from the documentation recommended by the OECD in BEPS Action Plan 13. Additional documentary requirements will increase the efforts and work needed by the taxpayer to comply, which will increase costs to the taxpayer.

It is submitted that there is a possibility that an additional burden, either financial or administratively, could have a detrimental effect on the tax compliance of tax payers, since complex tax laws and high tax rates have been identified in previous research to be factors that decrease tax compliance. In chapter four, which will be discussed later, it was also noted that uncertainty regarding the application of tax legislation is a factor that negatively impacts on potential foreign investors' investment decisions.

Based on the earlier discussion of the additional burden as a result of applying the transfer pricing rules, both with regard to costs and administration, it appears as if not allowing for relief from applying transfer pricing rules may be considered more burdensome. That would suggest that a different treatment for foreigners providing financial assistance to residents than for residents providing financial assistance to foreigners is potentially not in line with the OECD Model Convention .

5.3. CURRENT LEGISLATION CONDUCIVE TO FOREIGN INVESTMENT

Chapter three investigated the possibility that the current South African tax legislation, specifically with regard to the exception available from applying transfer pricing rules, might not be conducive to international investment. The OECD guidelines aim, among other things, to promote international investment. If the OECD guidelines are

formulated to serve as an encouragement to international investment, it stands to reason that tax legislation that is not in line with the OECD guidelines runs the risk of acting as a deterrent to international investment. As a starting point, factors that encourage foreign investment were identified.

FDI is a type of international investment that is mainly entered into by multinational enterprises and is an indispensable source of private external funding, especially for developing countries (such as South Africa). When discussing investment, it was found that there should be distinguished between developed and developing countries since the factors which affect investment in developed countries are different to the factors affecting investment in developing countries.

The first finding that was considered relevant to answer the question posed in chapter three is that there are factors that are considered more important by investors when making their investing decisions. South Africa is currently listed by the World Population Review's Developing Countries 2019 list as a developing country, which means the circumstances under which investment will take place are different than for a developed country. This was found to be specifically true when considering non-tax factors such as market stability, labour skills and availability, infrastructure, political stability and tax administration procedures. Developing countries, such as South Africa, with small markets, are experiencing increased pressure on their investment policies as a result of the fact that potential investors are increasingly searching for investment locations that offer optimal conditions and potential to deliver new and high-quality products quickly. A number of international studies on factors that encourage foreign investment have indicated that general economics and framework conditions are much more likely than tax incentives to influence the amount and quality of investment into a country. The international studies referred to above all list the following as the most important factors that influence foreign investment: market size and real income levels, skill levels in the host country, the availability of infrastructure and other resources, trade policies, and political and economic stability of the host country. It was found that special tax incentives did not specifically stimulate direct foreign investment.

The second finding in chapter three is that while the most important factors that influence foreign investment are not tax related, there are some tax factors that do have some influence on foreign investment. These factors were found to be transparency, simplicity, stability and certainty in the application of tax legislations and tax administration, tax rates and tax incentives and were noted by potential investors as having more significance with regard to their investment decisions than tax incentives, which have a limited effect on foreign investment. The decision to invest is more likely to be influenced by the burden to comply with tax legislation, as well as the complexity, transparency and predictability of tax legislation. It is therefore submitted that if tax incentives that are difficult to comprehend, keep record of or to comply with are considered a discouragement to investment, tax legislation that is difficult to comply with (such as complicated transfer pricing rules) will also be discouraging to potential investors. This could indicate that the current transfer pricing legislation is not necessarily conducive to investment.

The third finding is that research suggested that investment is more affected by tax rates in countries with positive investment climates. This means that investing in South Africa may not be as attractive as investing in a developed country with a more attractive investment climate. According to research done previously, it is possible that changes to tax rates are not as effective an incentive for investment in developing countries as in developed countries. It is suggested that this is due to the fact that investors may not be interested in further improving an investment by paying higher taxes if the investment climate had been good to begin with.

Research findings seem to indicate that investors are less disapproving of higher tax rates in countries where the higher taxes paid are used to fund improvements of the investment climate, which in turn plays a part in the productivity of capital. It is therefore possible that a reduced tax liability in countries with a poor investment climate is not very effective. Reducing tax rates while the investment climate is still not a desirable one will not necessarily have any effect if foreign investors need fundamental investment conditions to be in place before they will invest.

In conclusion, the main factors affecting foreign investment were found to be factors such as market size, skills levels, infrastructure and resources available in the country

in which the investment is to be made, trade policies, and political and economic stability in the country receiving the investment. Only after considering those factors are tax related factors considered by investors when making investment decisions and even then survey analyses have indicated that the role of tax incentives is very limited when it comes to foreign investment decisions.

It is submitted that while the current legislation may not be conducive to foreign investment, it appears that amending the legislation will not automatically increase foreign investment. Other non-tax related factors have a bigger effect on encouraging foreign investment. For countries with a poor investment climate (such as South Africa with political and economic uncertainty), tax incentives or favourable tax legislation are not considered adequate compensation to entice investors to invest.

5.4. EFFECT OF DTA'S ON THE APPLICATIONS OF TRANSFER PRICING RULES

The third secondary objective is discussed in chapter four. The aim of chapter four was to evaluate the possibility that some relief from the burden of applying transfer pricing rules and the subsequent primary and secondary adjustments are provided by DTAs.

Chapter two discussed the additional burden placed on taxpayers that have to apply transfer pricing rules. In chapter four the focus was on the burdens of interest as a result of the primary adjustments and the deemed dividend as a result of the secondary adjustment. These adjustments will result from transactions where foreign loans are received by residents from non-residents in terms that are not considered to be at arm's length. The first potential burden from which DTAs could possibly provide relief was the interest as resulting from the primary adjustment.

With regard to relief from the deemed interest, Binding Private Ruling 192, issued by SARS on 28 May 2018 is considered applicable. According to the ruling, if a section 31 of the Income Tax Act adjustment is made to taxable income or tax payable, no withholding tax will be payable by the foreign company and the resident company will not be required to withhold an amount of withholding tax on the interest. This ruling

therefore provides relief from the potential withholding tax burden in the case of a section 31 of the Income Tax Act primary adjustment on taxable income and therefore it is not necessary for DTAs to provide any relief.

The second potential burden that was considered is the deemed dividend resulting from the secondary adjustment. The secondary adjustment requires that such an adjustment takes the form of either a deemed dividend *in specie* (distribution of an asset *in specie*) in the case of a company or a deemed donation in the case of persons other than companies. The deemed dividend will be subject to dividends tax, currently levied at 20 per cent (Grant Thornton, 2016). It was therefore necessary to consider whether there is possibly any relief from the burden of withholding tax on the deemed dividend provided by DTAs.

From the literature reviewed, it appears that it is not the intention that DTAs provide any such relief. The Davis Tax Committee (2014) was of the opinion that no DTA relief should be available since transfer pricing adjustments are made when value is transferred from South Africa to another country for insufficient compensation. Transactions such as these, which lead to a debilitation of the South African tax base is similar in nature to outward dividends paid to foreign related parties. As a result of the similarities in nature of these transactions, the deemed dividend resulting from a secondary adjustment should be subject to a tax that is comparable to dividends tax. Since the South African company and not the foreign company will be liable for this tax, no relief would be provided from a DTA.

The opinion of the Davis Tax Committee is confirmed by the proposed amendments in the Tax Laws Amendment Bill of 2018, which suggest that it was never the intention that double tax treaty relief should be available for deemed dividends as a result of secondary transfer pricing adjustments. If the deemed dividend as a result of the secondary adjustment meets the definition of a dividend as per section 1 of the Income Tax Act, this may mean that tax treaty relief is available for that amount. In the 2018 Draft Explanatory Memorandum on the 2018 Draft Tax Law Amendment Bill, the proposal was made that in an attempt to address that unintentional consequence, there should be specific mention of the fact that an amount deemed as a dividend *in specie* that resulted from a secondary transfer pricing adjustment as per section 31 of

the Income Tax Act is excluded from the dividend definition as provided for in section 1 of the Income Tax Act.

It therefore appears that for both the burden as a result on the primary adjustment and the secondary adjustment, other legislation either provides relief or prevents any DTA relief from being available to provide the necessary relief and therefore no specific DTAs were reviewed.

5.5. SUGGESTIONS FOR FURTHER STUDIES

In order to achieve the secondary objectives, the absence of an exemption from applying transfer pricing rules in cases where a foreigner provides financial assistance to a resident was evaluated. A suggestion for further research would be to consider whether an exemption for foreigners, if introduced, could possibly be abused or result in Base Erosion and Profit Shifting from a South African perspective. The interactions of such an exemption and the workings of section 9D of the Income Tax Act could also be investigated.

In chapter one it was noted that research has been performed regarding the possibility that section 23M of the Income Tax Act was in conflict with the OECD non-discriminatory article (Bredenkamp, 2015). Whether or not interest is deductible for tax purposes has been a controversial topic for years, especially after section 23M of the Income Tax Act came into effect on 1 January 2015. To put it briefly, section 23M of the Income Tax Act places a restriction on the amount of interest that can be deducted from taxable income by a taxpayer in cases where debts are directly or indirectly owed to a creditor that is in a "controlling relationship" with a debtor.

Section 23M(2) of the Income Tax Act stipulates that interest deductions will be limited in cases where the amount of interest incurred is not taxable in the hands of the person to whom the interest accrues. The amount of interest that will be allowed as a deduction from taxable income will be calculated and limited by the application of a formula. Where withholding tax is charged on the interest, the interest which accrues

to the non-resident is then subject to tax and section 23M of the Income Tax Act should not apply (Integritax, 2015).

A further addition to legislation with regard to interest and income tax (apart from section 23M of the Income Tax Act as mentioned above) was noted in the form of interest withholding tax provisions as per sections 50A to 50H of the Income Tax Act. These sections came into effect on 1 March 2015. In chapter 3 consideration was given to whether the current legislation was conducive to foreign investment. During the research for this chapter, especially with regard to conditions that will act as an incentive for investment and considering the controversy around interest and tax legislation a question arose as to whether sections 23M and 50 of the Income Tax Act will have any effect on the amount of foreign investment that will be injected into the South African market. This question is further complicated by the fact that the South African market is already facing difficulties as a result of political and economical instabilities and could potentially be an area for further research.

Also, although there are some exemptions for both section 23M and section 50 of the Income Tax Act, the sections are not mutually exclusive (Integritax, 2015). A suggestion for further research is evaluating the interaction of sections 50 and 23M of the Income Tax Act, specifically with regard to whether these sections should apply simultaneously and in all instances, as well as attempting to determine if the fact that the sections are not mutually exclusive was an unintentional exclusion by the legislators or if it was intended that both sections should apply in all situations. Further research could also be done into what the effect would be in situations where the interest deductions are not unreasonably high and whether relief from this limitation can be provided by a DTA in terms of which South Africa has no taxing right.

While it does not fall within the scope of this study, it was noted during the research for chapter four on DTAs that there have been a number, although limited, of Mutual Agreement Procedures concluded between SARS and other tax authorities. These Mutual Agreement Procedures are entered into to resolve transfer pricing disputes in the case of double taxation between two jurisdictions. As a suggestion for further research, consideration could be given to whether these Mutual Agreement Procedures may provide the relief that is not provided by DTAs.

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