PROFESSIONAL
TAXTALK
South Africa's Leading Tax Journal
Issue 91 November/December 2021

2021 ITR AWARDS WINNERS

Michiel Els

Michael Hewson

Billy Joubert

R25 • incl VAT

sait

The Remote tax practice: make it happen with CaseWare CloudTax

CloudTax helps tax practitioners solve many of today's challenges and lays the foundation for the tax practice of the future.

In the age of lockdowns and working from home, both practitioners and their clients find themselves having to run their businesses remotely. Many tax practices experienced revenue losses when the initial lockdowns were introduced. Others have been victim of cyber-attacks and ransomware. At the same time, SARS also increased auto-assessments to grow collection revenues, which has introduced additional challenges for practitioners to ensure assessments contain appropriate information.

One thing has become clear: there is a burning need for tax practitioners to effectively manage data and client information, to find better ways of assisting their clients from any location, whilst continuing to ensure that their clients' tax affairs remain in order.

Covid-19 has certainly reemphasized the urgency for tax practices to future proof their firms. There's no doubt that smart tax practices have already seen the writing on the wall and are looking to transition to cloud-based solutions. Research shows that this is where future-fit accountants still have considerable room to grow, with less than 20% of accountants using tax-preparation software, whilst the rest are still managing their practices using manual processes.

But moving to tax-preparation software is only the beginning. Whilst preparing the tax return is the final deliverable, it must be recognised that it is the result of a process that starts much earlier.

In fact, most taxpayers spend between 75% to 90% of their time gathering information and documents. As anyone who has done it knows, it's daunting to collaborate with clients via the phone or e-mail, and response times can often be very long. Another major issue is the use of spreadsheets to calculate and check numbers - an approach that introduces errors and that is time-consuming. It also means that the information is all over the place, wherever people are working on it—instead of in one central location where everybody can access it.

In addition, when information is dispersed, version control becomes a continuing and difficult issue to manage. And, of course, there is the time-consuming and inefficient process of submitting each tax return manually.

A better way

Tax practitioners who transition to cloud-based solutions can quickly overcome previous challenges and take advantage of significant benefits. For one thing, moving to a cloud-based solution means that the firm is always assured of using the latest technology—without the upfront capital costs of acquiring a licence every time a product is upgraded or needing to roll out upgrades to every user.

Some of the main benefits of moving to the cloud are:

- **Better cost model.** Costs are predictable and easy to manage, and practitioners do not need to invest in server and security infrastructure. This introduces considerable savings.
- **Better security.** Data is stored safely and securely on multiple remote servers, without needing any resources or costs from the practitioner to maintain. The firm's data, and that of its clients, is much more secure—no small thing given the Protection of Personal Information Act (PoPIA) and its stringent penalties.
- **Accessibility**. Tax practices and their teams can work from anywhere at any time, and all they need is a browser and access to the internet. This means that firms can save costs on VPN connections and do not need to coordinate software update installations with their IT teams.
- **Centralised Storage.** Clients don't have to struggle with managing multiple copies of the same information in different places. In addition, the cloud offers unlimited storage space and comes with useful features like automatic backup, so practitioners don't have to worry about losing or redoing any work.
- **Enhanced productivity.** Greater security is complemented by greater availability. Centrally located data is accessible to all who need it, from wherever they are. Tax professionals can service their clients from wherever they happen to be, and do not need to be in their offices to do so. Another big advantage is that any number of tax professionals can work on the same documents simultaneously.

Why tax practices need CloudTax

Adopting CloudTax is a great starting point for the move to the cloud because it has been specifically designed with the needs of the tax practitioner in mind. CloudTax enables tax professionals to access all the benefits of the cloud while minimising the risks. Some of the main benefits are:

- **Easy collaboration with clients.** Practitioners can make use of built-in queries and customisable questionnaires and send those to clients directly from within the app. Clients then respond easily by logging into their personal portal, answering the questions and uploading any necessary documents—even via smartphone. The system notifies the tax professional when new information is provided.
- **Deadline Management.** CloudTax keeps track of important deadlines and users can easily monitor provisional and annual return progress and status for all their entities.
- **SARS Integration.** CloudTax integrates directly with SARS eFilling, which means practitioners can process all taxpayer details, correspondence and tax return submissions automatically in bulk.
- **SARS Compliance.** Tax return forms and calculation frameworks are frequently kept up to date to ensure that they are compliant with all relevant tax legislation, greatly simplifying the tax return process.
- **Seamless Data Integration.** Trial balance information can easily and automatically be imported from CaseWare Working Papers, Xero, QuickBooks and Excel to pre-populate tax returns.
- **Optimisation.** Checklists, questionnaires and schedules are built-in that intelligently expand or collapse according to the complexity of the return.
- **Prepare, calculate, and submit tax returns directly to SARS eFiling**. CloudTax supports Provisional (IRP6), Individual (ITR12), Corporate (ITR14) and Trust (ITR12T) tax returns with built-in calculations aligned to SARS.

With CloudTax, tax practitioners are now more empowered than ever with a holistic cloud-based tax return solution, that can be used seamlessly for all provisional and annual returns for Corporates, Individuals and Trusts. The tax practice of the future will be cloud-based. With CloudTax, tax practitioners can take a very meaningful step towards setting up their firms for future success.

Prepare, Calculate & Submit Tax Returns

P
Provisional Tax (IRP6)

I
Individual Tax (ITR12)

C
Corporate Tax (ITR14)

T
Trust Tax (ITR12T)

Key Features

Deadline Management

Client collaboration

SARS Integration

SARS Compliance

Seamless Data Integration

Optimisation

Tax Management

Multiple-Taxpayer Support

4h30mins CPD
in this issue

CONTENTS

NOVEMBER/DECEMBER 2021 * ISSUE 91

ALL EYES ON AFRICA'S TRANSFER PRICING TRENDS

REGULARS

Q

Tell us what you think. Questions and suggestions can be sent to publications@thesait.org.za

FINDUS

Postal address
PO Box 712
Menlyn Retail Park
0063

Editorial head office
Summit Place Business Park
Building 3, Ground Floor
221 Garsfontein Road, Menlyn
Pretoria
South Africa
0081

Advertising sales
Muzikayise Mike Maseko
mmaseko@thesait.org.za

THETEAM

Editor at Large
Hellen Phushela
publications@thesait.org.za

Supporting Editor
Sadiyya Mosam

Editorial Advisors
Keith Engel
Muzikayise Mike Maseko

Design and Layout
Nastassja Hewitt
designer@thesait.org.za

Cover Illustration
Concept Tshegofatso Phiri
Illustration and design Nastassja Hewitt

Proudly Brought
to you by

sait South African Institute of Taxation

GUEST CONTRIBUTORS

Cabrini McCarrick
cmccarrick@reganvanrooy.com / +351 938 781 805

Job title and company
Regan van Rooy – Transfer Pricing Partner
Area of tax specialisation
Transfer pricing
Highest academic qualification
Tax Law

Caoilfhionn van der Walt
cvanderwalt@reganvanrooy.com / +230 5984 9172

Job title and company
Partner – Regan van Rooy
Area of tax specialisation
International tax and structuring
Highest academic qualification
Two Master's degrees (pure maths and theology), HDip in international tax

Daniel Erasmus
daniel@taxriskmanagement.com / +561 568 7115 / +27 11 698 0329

Job title and company
Chairman – TRM Daniel Erasmus Tax Court Practitioners
Area of tax specialisation
Transfer pricing and international tax law (adjunct)
Highest academic qualification
Baccalareus Procurationes, Bachelor of Arts (Law)

Daniel Ngumy
dng@africalegalnetwork.com / +254 703 032 000 / +254 20 364 0000

Job title and company
Partner at Anjarwalla & Khanna and heads the tax department
Area of tax specialisation
Regional and international tax law as well tax disputes and tax transactional matters
Highest academic qualification
Master of Laws LLM (Corporate & Commercial Law)

Deborah Tickle
deborah@tickleontax.co.za / +27 82 492 0375

Job title and company
Adjunct Associate Professor; University of Cape Town
Area of tax specialisation
Local and International Income Tax (including CGT): Corporate/ Individuals/ Trusts
Highest academic qualification
CA (SA) Honours (Taxation)

Job title and company
Consultant – Webber Wentzel
Area of specialisation
Transfer pricing
Highest academic qualification
Master of Tax Law

Job title and company
Tax Director Global Projects Unilever
Area of tax specialisation
International tax
Highest academic qualification
CA (SA), HDip International Tax Law, MCom Taxation

Job title and company
Director – Graphene Economics
Area of tax specialisation
Transfer pricing
Highest academic qualification
MCom Financial Economics, HDip Tax Law

Job title and company
EY- Country Managing Partner
Area of tax specialisation
Transactions tax, Compliance and Reporting, Indirect taxes
Highest academic qualification
Master Tax Practitioner

Job title and company
PwC Tanzania – Partner/Director
Area of tax specialisation
All rounder tax consultant
Highest academic qualification
Fellow of Association of Chartered Certified Accountants (FCCA), BSC Managerial and Administrative Studies

Job title and company
Associated Director – Deloitte
Area of tax specialisation
Transfer pricing
Highest academic qualification
CA (SA), MCom (International Tax)

Job title and company
Partner and Head Consumer and Industrial Markets/Transfer Pricing Tax, Regulatory and People Services, KPMG in Nigeria
Area of tax specialisation
Tax and transfer pricing
Highest academic qualification
BSc, MSc

Job title and company
Senior Manager International Tax at African Tax Administration Forum (ATAF)
Area of tax specialisation
International Tax
Highest academic qualification
Master's Degree in Development Finance

Job title and company
Director – Graphene Economics
Area of tax specialisation
Transfer pricing compliance in Africa, transfer pricing planning and transfer pricing controversy
Highest academic qualification
Master's Degree in Economics

SETTING A TRANSFER PRICING POLICY FOR AFRICA – IS IT POSSIBLE?

30 minutes CPD

▸ **KAREN MILLER**, Consultant at Webber Wentzel

Over the decades that I have been practising as a transfer pricing advisor, the transfer pricing landscape in Africa has changed markedly. Below, I look at some of the trends across the continent and the challenges they present to transfer pricing advisors and multinationals operating in Africa.

The legislative landscape

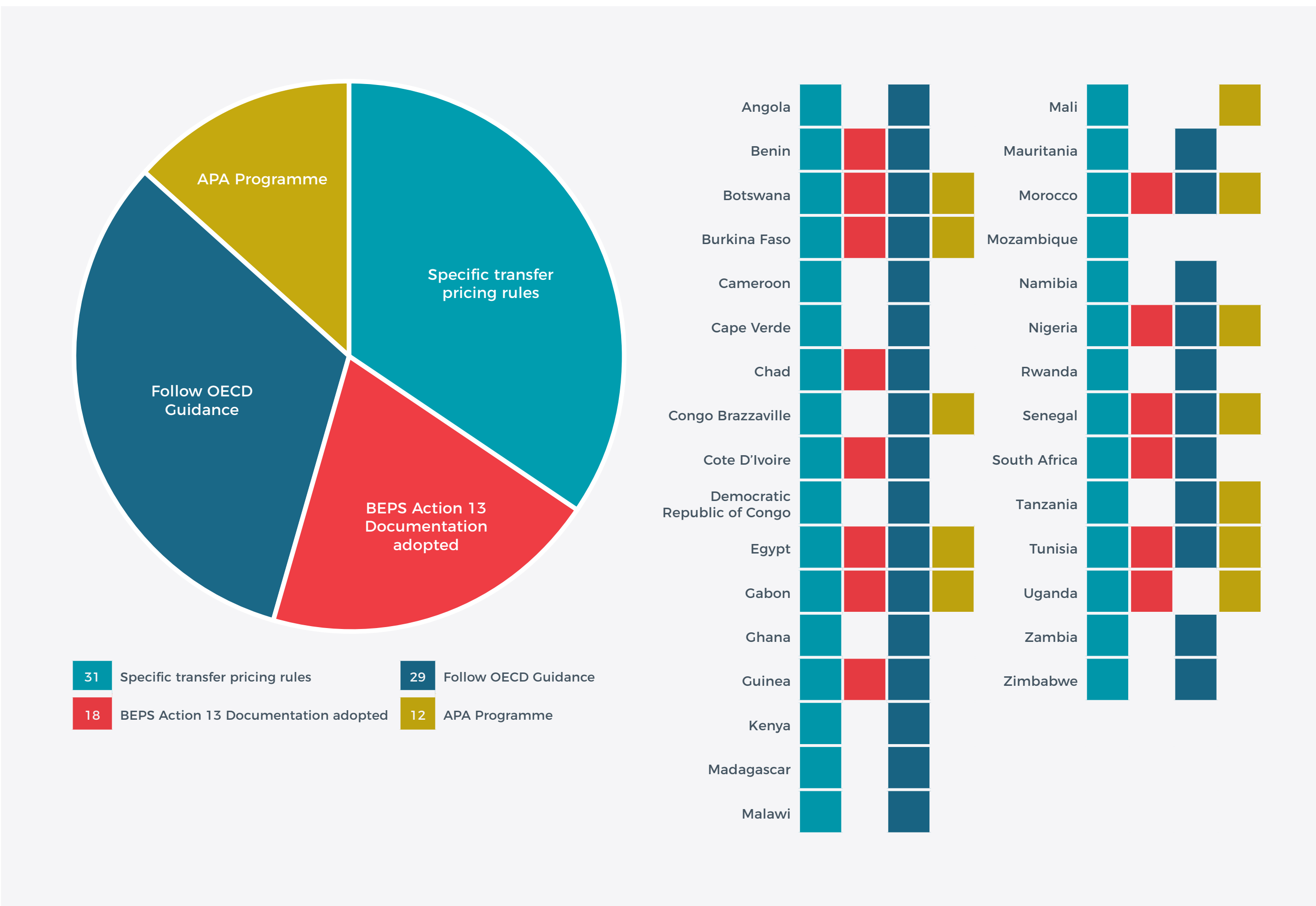
The legislative environment has definitely changed. Many African countries relied on broad anti-avoidance provisions for many years to enforce transfer pricing compliance. This has changed, with more and more African jurisdictions bringing in specific transfer pricing legislation.

Today, many African countries have introduced specific transfer pricing rules. Interestingly, many countries tend to copy developed countries' legislation. It makes sense – why reinvent something that works elsewhere? In addition, the African Tax Administration Forum (ATAF), which serves a similar purpose to the Organisation for Economic Co-operation and Development (OECD), Centre for Tax Policy and Administration (CTPA), for Africa, has also provided guidance on effective transfer pricing legislation. The Technical Assistance wing of ATAF issued guidance on drafting transfer pricing legislation. (Refer to *ATAF Suggested Approach to Drafting Transfer Pricing Legislation* (undated)). It is aimed at alignment with the OECD and UN Model Tax Convention as well as ATAF's own Model Tax Convention and seeks to provide a practical and simplistic solution to specific transfer pricing rules for countries to consider.

Irrespective of whether countries adopt this guidance or leverage from other countries' rules. Many African countries now have brought in specific transfer pricing rules which align with the arm's length principle (ALP) espoused in Article 9 of the OECD Model Tax Convention. Below is a summary of the African countries which have introduced specific transfer pricing rules (source *OECD and EY Global Transfer Pricing Guide*).

With the finalisation of the Base Erosion and Profit Shifting (BEPS) Action 13 report, many countries have also brought in mandatory documentation requirements in terms of which taxpayers must support that the pricing is at arm's length through the use of comparable evidence. Many African countries are members of the Inclusive Framework on BEPS and have introduced documentation in accordance with BEPS Action 13.

In Africa, this may pose one of the greatest challenges due to the lack of publicly available comparable data. While multinationals continue to prepare transfer pricing analyses using global databases, such as those provided by Bureau Van Dyk and Thompson Reuters, these databases contain very little African data. In 2014, the OECD issued a discussion paper on *Transfer Pricing Comparability Data and Developing Countries*.



"The challenge from the African tax authority is typically that the African subsidiary can undertake the activities itself and consequently the charge levied is excessive"

The paper proposed four approaches to addressing the lack of comparable data in developing countries:

1. Expanding the access to data sources for comparables
2. A more effective use of the data sources currently available, including making adjustments to comparable data from foreign sources
3. Using proxies for arm's length outcomes, the use of the profit's split method and safe harbours (the so-called sixth method approach)
4. The use of advanced pricing agreements and mutual agreement procedure.

None of the above posed a viable approach for the use of comparable data in transfer pricing analyses. The UN Manual on Transfer Pricing recognised the lack of data as a problem for African countries but also recognised that, in alignment with the OECD Guidelines on Transfer Pricing for Multinational Enterprises and Tax Administrations (TPG), non-domestic comparables should not be automatically rejected. In South Africa, SARS has long accepted the use of foreign comparable data. I also understand that ATAF is working with many of the African tax authorities to find a solution to this problem, which will create greater certainty in the acceptability of comparable data sets used.

The commonality in approach and guidance followed

As with the change in legislation environment, there has also been an increased amount of specific guidance on the implementation of various countries' transfer pricing rules. Most African countries have adopted the guidance from the OECD (OECD TPG). They were first published in complete form in 1995 (the 1979 guidelines were only aimed at tax administrations) and updated in 2010 and 2017.

The start of the introduction of guidance followed the unsuccessful outcome for the Kenyan Revenue Authority in the Unilever case in 2003 *(Unilever Kenya Ltd v Commissioner of Income Tax 753 of 2003).* Although Kenya had transfer pricing rules that followed the ALP espoused in Article 9 of the OECD Model Tax Convention (Section 18(3) of its Income Tax Act), Kenya lacked specific guidance on how this should be enforced. Section 18(3) stated:

> *"18(3) where a non-resident person carries on business with a related resident person and the course of that business is so arranged that it produces to the resident person either no profit or less than ordinary profits which might be expected to accrue from that business if there had been no such relationship, then the gains or profits of that resident person shall be deemed to be the amount that might have been expected to accrue if the course of that business had been conducted by independent persons dealing at arm's length."*

In this case, Unilever Kenya used a transfer pricing method to support its position that is typically found in the OECD TPG- the cost-plus method. The Kenya Revenue Authority did not accept the method, preferring to adopt a Comparable Uncontrolled Price (CUP) method to adjust the prices of the transaction. Interestingly, the CUP method is also endorsed by the OECD TPG.

The result of this case was that the court held that, in the absence of specific guidance issued by the legislature to support the manner in which the statute should be interpreted, reliance can be placed on international guidance such as the OECD TPG.

Judge Visram stated that (referring to the use of the OECD TPG), "it would be fool-hardy for any court to disregard internationally accepted principles of business". The case was perhaps one of the most important transfer pricing cases in Africa. It set the precedent for countries to ensure they provide specific transfer pricing guidance or at least condone the use of the OECD TPG.

Many of the countries listed above advocate the use of the OECD TPG for guidance in applying their respective legislation. Some of these have provided specific guidance based on the OECD TPG.

Transfer pricing audit activity

Transfer pricing audit activity across Africa is on the rise. Historically, South Africa led the way in terms of audit activity, but in recent years many other African jurisdictions are not just playing catch up but are exceeding South Africa in terms of activity.

Uganda, for instance, reported a successful transfer pricing audit that yielded €13 million in 2021 (Tax Transparency in Africa – OECD 2021). The case centred on an adjustment to remuneration paid for management services.

The area of management services and the requirement for an African subsidiary entity to demonstrate that it receives commercial value for the services charge levied is a common area of audit activity. The challenge from the African tax

authority is typically that the African subsidiary can undertake the activities itself and consequently the charge levied is excessive. Multinationals almost always centre certain management functions in either the parent company or a centralised/regional service company. These companies are required to cover the costs they incur, together with a profit margin on services they render across the group. Failure to do so would put them in breach of the transfer pricing rules in their jurisdiction. This inevitably creates conflict and gives rise to double taxation.

One of the most significant developments is the collaboration between Africa and foreign tax authorities through the Tax Inspectors Without Borders initiative (TIWB). A joint initiative between the OECD and UN; it deploys qualified experts from developed countries to developing countries in need of additional capacity. In 2021, the TIWB Governing Board stated that more than $1 billion in additional tax revenues has been achieved through the initiative. The ATAF reported in April 2021 that 21 African countries either benefit from or aid under the TIWB initiative. While most of this support comes from tax authorities in the developed world, the South-South Co-operation has seen collaboration between African countries. In 2016, the Kenyan Revenue Authority provided technical assistance with transfer pricing audits to the Botswana Unified Revenue Service. In 2018, SARS provided two officials to assist with a transfer pricing programme for the Zambia Revenue Authority. The first Francophone collaboration occurred in 2019 between Morocco and Cameroon. These collaborations have reportedly raised over $592 million in additional tax revenues and $1.8 billion in tax assessments (Source: TIWB newsletter April 2021).

Certainty of the tax costs – resolving double taxation through the use of a Mutual Agreement Procedure and Advance Pricing Agreements

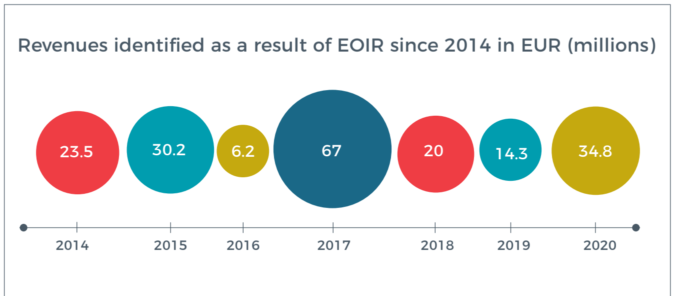
One of the biggest challenges in ensuring certainty of a transfer pricing outcome is the lack of ability or availability of remedies from double taxation. Both the Mutual Agreement Procedure (MAP) (Article 9(2) and Article 25 of the OECD Model Tax Convention) and the Advanced Pricing Agreement (APA) (domestic rules coupled with Article 9(2) and Article 25 of the Model Tax Convention) require the country to have a broad network of Double Taxation Treaties (DTTs) available. Across Africa, this is not the case.

Rwanda, for instance, has only 12 DTTs (Tax Transparency in Africa – OECD 2021). This makes resolving instances of double taxation as a result of a transfer pricing adjustment in that country problematic. Furthermore, the lack of resources and experience makes multinationals hesitant to use the MAP option. None of the African DTTs includes mandatory arbitration which would ensure a resolution within a reasonable timeframe. This creates as much uncertainty around using an MAP as taking your chances in court.

What is interesting is the number of African countries that have introduced APAs. Whether unilateral, bilateral or multilateral, APAs enable a multinational to get certainty on the transfer pricing methodology adopted. As most APAs have a tenure of three to five years, this ensures a multinational can focus on its business as opposed to managing its transfer pricing risk. Interestingly, South Africa is lagging many of its African neighbours in introducing an APA programme but at least now this has entered SARS' strategic plan. SARS issued a discussion paper on APAs outlining its thoughts on the programme. Sadly, the discussion paper concluded that SARS was not ready to implement an APA programme just yet!

Collaboration across Africa

The *2021 Tax Transparency in Africa* report referred to in this article indicates the continued drive of African countries to share information to improve tax collection. This will undoubtedly lead to increased transfer pricing audit activity and greater collaboration between the countries. The report provides feedback on revenues generated from the exchange of information programme since 2014 in EUR (millions).



Tax Transparency in Africa 2021 - OECD and African Tax Administration Forum

This collaboration will likely lead to an increase in joint audits into transfer pricing practices. The question is, will it also lead to greater collaboration to resolve the incidence of double taxation?

Conclusion

For tax managers of multinationals with operations in Africa, transfer pricing undoubtedly remains a headache. Lack of certainty, lack of capacity and difficulty in resolving double taxation continue to create problems. However, the landscape is changing, as increased legislative guidance and the increased availability of APAs are bringing greater certainty. This trend is set to continue

COVID-19 – TRANSFER PRICING IMPACT, TRENDS AND UNIQUE ADJUSTMENTS REQUIRED

▶ **CABRINI MCCARRICK,** Transfer Pricing Partner at Regan van Rooy

The COVID-19 pandemic has had a negative impact on global business. This article delves deeper into the adjustments made in the tranfer pricing industry.

The unprecedented and far-reaching impact of the COVID-19 pandemic certainly did not bypass transfer pricing. For many multinational groups, robust transfer pricing documentation has become another key issue to consider in their business and tax management strategies, while still dealing with the operational impacts of COVID-19. This article addresses the key transfer pricing impacts of COVID-19, and what businesses should be considering to effectively manage potential transfer pricing challenges from 2020 through the recovery years.

Loss-making entities, cashflow and financing arrangements

As a result of the economic slowdown, business disruptions and resulting financial impact, many multinationals required additional funding from group members in addition to third-party financing arrangements. This support may have been in the form of working capital advances, intercompany loans or discounting of prices. In other cases, intercompany payments were delayed, alleviating local cashflow requirements. While inter-group financing support is of course permitted under the arm's length principle (ALP), groups need to ensure that any steps taken remain aligned to wider external financing arrangements and do not erode the ALP as the fundamental basis of Transfer Pricing.

Many multinationals made significant losses or saw significant volatility in their financial performance following the COVID-19 pandemic. These fluctuations will need to be carefully explained and evidenced in the transfer pricing documentation to ensure it can be demonstrated (in so far as possible) that such losses were not because of transfer pricing but rather due to specific identifiable impacts of COVID-19. Comparability analysis has become a key challenge for groups due to the reliance on historical data and the delay in information typically available for third-party benchmarks. The nature and form of adjustments that would need to be performed is extremely fact-specific and a critical part of the analysis now required in transfer pricing documentation.

Supply chain and operational changes

Due to the immediate impact of COVID-19 on global businesses, the functional profile of entities within the group supply chain may have undergone operational or risk-based changes. For example, a manufacturer may have had to cease activities and convert to a procurement entity or there may have been a temporary transfer of functions to another jurisdiction to deal with specific COVID-19 in-country rules. Any change in functional or risk profile should trigger a review of the transfer pricing policies applied.

A common question has arisen with respect to low-risk entities which typically earn stable returns for routine functions. Typically, under this transfer pricing model, the parent bears most of the risks, helping substantiate that a routine return is an appropriate compensation for a low-risk entity within the group. As a result of COVID-19, the low-risk entity may have incurred substantial losses, begging the question as to whether the transfer pricing model should be reassessed to determine whether if higher returns are warranted due to higher non-routine risks being borne. At the same time, this could be an opportunity to check if a low-risk entity should share in a portion of the losses of a multinational group by reducing its typical routine return. The historic transfer pricing model cannot simply be ignored or modified to suit the current situation; rather many groups are taking the opportunity to reassess their existing transfer pricing models to re-evaluate whether they remain fit-for-purpose and endeavour how best to continue applying the ALP in complex economic and operational circumstances.

As such, one of the key transfer pricing trends emerging as a result of COVID-19 is that transfer pricing models may have been or may need to be adjusted to reflect any change to the intercompany transactions, value creating activities or functional and risk profile of relevant entities within the group.

Contractual arrangements and transfer pricing documentation

As always in transfer pricing, it is key to ensure that a group ensures that its intercompany contractual agreements align with the underlying substance of the arrangements. Any changing fact pattern that occurred because of the COVID-19 pandemic should be carefully captured in the relevant legal agreements.

Furthermore, it is critical for groups to carefully document all economic, business and transfer pricing model impacts in their annual transfer pricing documentation to ensure as robust support as possible for their transfer pricing position. Unfortunately, it seems transfer pricing documentation may be getting heavier and more complicated despite our global focus on digitising and simplifying the transfer pricing process!

The OECD guidance on transfer pricing implications of COVID-19

In December 2020, the Organisation for Economic Co-Operation and Development (OECD) issued guidance (*OECD Guidance*) on the transfer pricing implications of the COVID-19 pandemic. The OECD Guidance remains grounded in the APL as the appropriate basis for supporting transfer prices in the COVID-19 environment. The OECD Guidance focuses on four key areas:

1. Comparability analysis
2. Losses and allocation on COVID-19 specific costs
3. Government and assistance programmes
4. Advanced pricing agreements (APAs)

Comparability analysis

The OECD Guidance recognises the difficulties arising in performing robust comparability analyses in the COVID-19 environment. The OECD Guidance lists several approaches that may be useful in addressing the comparability challenges faced, such as lack of comparable data and reliance on historical data. The approaches suggested include endeavouring to quantify the COVID-19 impact and essentially strip out of the tested party results a statistical analysis, such as regression analysis, and the use of budgeted information to create a 'but for' analysis to isolate the COVID-19 impact. Other approaches

"Existing APAs may become difficult to implement as a direct result of the economic impact of the COVID-19 pandemic. APAs currently under negotiation will likely be subject to certain changes and potential delays"

- focus more on the third-party comparable data, such as using historical data from a previous recessionary period, and the inclusion of loss-making entities in the comparable set. The OECD Guidance also notes that the use of more than one transfer pricing method may provide meaningful collaborative support. All guidance is issued with caution to be used with judgment and best efforts to obtain a reasonable estimate of an arm's length outcome based on the particular facts and circumstances at hand.

Losses and allocation of COVID-19 specific costs

The OECD Guidance focuses largely on the key question of which entity(s) in a multinational group is responsible for bearing exceptional or specific costs and how losses should be shared. In seeking to address the question, the Guidance highlights that it would first be necessary to accurately delineate the controlled transaction to understand which party has the responsibility for performing activities relating to the costs and which party assumes risks related to these activities. The OECD Guidance highlights the importance of accurate risk allocation between the parties and how profits and losses would be shared between independent parties in comparable circumstances. Essentially, the allocation of costs/losses needs to represent the true allocation of risk between the entities. The Guidance also notes that renegotiation of intercompany agreements in light of the COVID-19 pandemic may well be considered arm's length behaviour. However, third-party evidence is a prerequisite to substantiating any contractual amendments.

Government and assistance programmes

This section of the OECD Guidance looks at whether government assistance would need to be factored into an arm's length analysis and whether such an economic benefit should be retained or passed on to group members. The short answer is – it depends. Whether government assistance may be considered an 'economically relevant characteristic' that would need to be priced into a controlled transaction depends on the nature of the assistance itself. Furthermore, government assistance may need to be considered as part of the comparability analysis and any such adjustments will likely prove complex.

APAs

While APAs are not yet common in Africa, APAs are becoming a more important tool globally to manage potentially contentious disputes and complex transfer pricing models. Existing APAs may become difficult to implement as a direct result of the economic impact of the COVID-19 pandemic. APAs currently under negotiation will likely be subject to certain changes and potential delays. The OECD Guidance is clear that tax authorities and taxpayers alike need to continue to work together to find meaningful solutions.

What is next?

Tax authorities, just like everyone else, are under extreme pressure to raise revenues. We have seen a dramatic increase in transfer pricing audits and disputes in recent years, which is only increasing further as a result of the COVID-19 pandemic. There are pockets to be filled, transfer pricing documentation and supporting analyses have become more complicated and, as the pressure mounts, the best bet is to be as prepared as possible. COVID-19 shocked and tested us all both personally and professionally. Many of us learnt that we are more resilient than we thought; some of us learnt to be productive in our pyjamas and, from a transfer pricing perspective, we are perhaps still learning that as the cornerstone of international tax, transfer pricing will not just go away and requires ongoing investment to manage compliance and risk effectively.

THIN CAP, EBITDA and the regional state of play for other interest limitations

30 minutes CPD

STEVEN BRESLIN, Associate Director: Transfer Pricing at Deloitte Africa Tax & Legal

This article describes the trends relating to interest deductibility and how legislation is currently evolving within the African landscape.

> *"It recommended both general and specific interest limitation rules to mitigate against the excessive use of debt funding. One of the main areas of the BEPS Action plan 4 was the use of 'EBITDA' as a measure in limiting interest deductibility."*

This article describes the trends relating to interest deductibility and how legislation is currently evolving within the African landscape.

The evolution started with the Base Erosion and Profit Shifting (BEPS) Action 4 on 'Limiting Base Erosion Involving Interest Deductions and Other Financial Payments', which recommends a three-tiered approach for limiting interest deductibility:

1. Application of a 'fixed ratio' for setting a limitation threshold, using the maximum net interest to Earnings before Interest, Tax, Depreciation and Amortisation (EBITDA) ratio
2. Optional group concessions
3. Specific target rules and concessions

This article also references the African Tax Administration Forum's (ATAF's) publication, *Suggested Approach to Drafting Interest Deductibility Legislation, (Excluding the Banking and Insurance Sector)*, wherein the ATAF provides recommendations for addressing the profit shifting risk and refers to the BEPS Action 4 report as a basis for their recommendations.

Thin capitalisation in Africa

Before the introduction of BEPS Action 4, the most common approach taken by African tax authorities for addressing the profit shifting risk was through a fixed ratio thin capitalisation rule. This approach linked interest deductibility to the level of equity in an entity by using the debt-to-equity test. However, this method did not necessarily have the intended impact because the debt-to-equity test allowed significant flexibility in terms of the interest rates that an entity was charged on debt, which had the effect of multinational groups claiming excessive interest deductions by charging relatively high interest rates on debt. The equity test also allowed entities with higher levels of equity capital to deduct more interest expenses that made it relatively simple for multinational entities (MNEs) to impact the outcome of the test by increasing the level of equity in a particular entity. This was not necessarily problematic – since the effect of injecting more equity was that the entity was no longer thinly capitalised. However, it was considered anomalous for an entity to be claiming interest deductions which were disproportionate when compared with the extent of its economic activity.

In other instances, certain African countries have chosen to rely on a general deduction rule of limiting interest deductibility on the basis that the interest is exclusively incurred in the production of taxable income. This approach has had a relatively small impact for mitigating the profit shifting risk in that MNEs continued to implement tax planning opportunities of profit shifting by way of excessive interest payments and thereby eroding the tax base of a country.

The underlying problems were identified through several studies undertaken by the Organisation for Economic Co-ordination and Development (OECD). Their most significant finding was that MNEs used leveraged debt in subsidiaries located in high tax countries. Other key findings showed that there was a strong correlation between thin capitalisation and MNEs, i.e. foreign-owned groups used more debt than comparable domestically owned businesses. This impacted both developed as well as developing countries and, where thin capitalisation rules applied for limiting intercompany debt, this increased third-party debt.

In responding to these challenges and as part of an international drive to eliminate harmful tax practices globally, the OECD issued a number of BEPS Action Plan initiatives with one of them being BEPS Action 4. It recommended both general and specific interest limitation rules to mitigate against the excessive use of debt funding. One of the main areas of the BEPS Action 4 was the use of EBITDA as a measure in limiting interest deductibility. The document noted that the most compelling reason for using EBITDA was that interest deductions are directly linked to the extent of the entity's economic activities. In order words, it is considered the most effective way of matching net interest expenses to activities that generate taxable income and drive value creation.

From an African perspective, ATAF members are of the view that the use of both third-party and related-party interest is one of the most common profit shifting techniques used in Africa and poses a significant risk to the African tax base. As a result, ATAF is involved in driving the BEPS Actions throughout the continent and accordingly has issued a publication providing suggested approaches for tax authorities for addressing the excessive use of debt funding by MNEs.

ATAF's publication, in line with BEPS Action 4 as a basis, highlights the following issues:

- The recommended use of the fixed ratio rule using EBITDA as a measure for limiting interest deductibility.
- The fixed ratio rule should be based on a corridor falling between 10% and 30% of the taxable profit or taxable EBITDA.
- An exemption for entities that pose the lowest risk from the scope of the general interest limitation rule by applying the 'De Minimis' rule threshold based on a value on net interest expenses.
- Options for carrying forward periods of previously disallowed interest with a limitation period, e.g. five years.
- Recommendations where the recipient of the interest obtains a taxable benefit in its country of residence.
- Recommendations for group companies resident within the same country but subject to different tax regimes, e.g. free trade zones.
- Recommendations in the scenario where the recipient of the interest is resident in a jurisdiction that is considered to be a beneficial tax regime.
- Regarding the banking and insurance sectors, EBITDA would not be a suitable measure for economic activity across a group in these sectors.

Lastly, with reference to the South African context, the country's approach is also in line with international concerns regarding the South African tax base that could potentially be at risk of allowing interest deductions in excess of what is incurred overall by a group.

> *"The banking and insurance industries are also considered important sources of debt funding and, accordingly, are considered as 'net lenders' by a significant margin"*

- However, this is mitigated to a large extent through the following existing measures in place in South Africa:
  - **Exchange control:** The interest rate payable on loan financing obtained from a non-resident is capped and subject to pre-approval by the South African Reserve Bank (SARB). The SARB places a cap on the interest rate payable on these loans.
  - **Transfer pricing:** Section 31, read together with SARS' Draft Interpretation Note on Thin Capitalisation, requires taxpayers to not only price the interest rate at arm's length but also to determine whether it is thinly capitalised on an arm's length basis.
  - **Income tax legislation:** Sections 8F, 8FA, 23N and 23M of the South African Income Tax Act of 1962 restrict or postpone interest deductions in certain circumstances.
  - **Withholding Tax (WHT) on interest:** With effect on 1 March 2016, a WHT was imposed on South African sourced interest paid to non-resident persons, subject to Double Taxation Treaty (DTA) relief.

All the above measures should prevent excessive interest deductions, provided taxpayers comply with the rules and measures in place.

EBITDA as a measurement indicator for interest expense deductibility

'Accounting EBITDA' is defined as the sum of Net Profit before Tax, Net Interest Expense, Depreciation and Amortisation, while "Taxable EBITDA" is defined as the sum of Taxable Profits, Net Interest Expense, Depreciation and Amortisation.

The benefits of using EBITDA as a measure for limiting interest expenses deductibility include the following:

- Interest deductions claimable by a company are directly linked to the extent of its economic activities. In order words, it is considered the most effective way of matching net interest expenses to activities that generate taxable income and drive value creation.
- EBITDA is a relatively straightforward measure for groups to apply and for tax authorities to audit.
- EBITDA is a good indicator of an entity's ability to meet its interest-bearing obligations.
- It offers a certain level of protection against eroding a country's tax base.
- Several African countries have already implemented the fixed ratio rule of 30% of EBITDA, namely Benin, Botswana, Burundi, Cote d'Ivoire, Kenya, Nigeria, Togo, Uganda and Zambia.

Yet, EBITDA also has its limitations in that:

- It ignores leverage requirements of different industry sectors and even within an industry sector some groups are more highly geared for reasons other than tax.
- An entity may be in a loss-making position during a start-up phase.
- An entity's expenses and earnings may occur in different periods, which in turn creates volatility in earnings and the ability of an entity to deduct interest charges on a year-on-year basis.
- EBITDA is not an appropriate measure for the banking and insurance industries as interest income is the main contributor to their revenue base and EBITDA would not be a suitable measure for economic activity across a group in these sectors. The banking and insurance industries are also considered important sources of debt funding and, accordingly, are considered 'net lenders' by a significant margin.

Regional state of play for other interest deducibility

In addition to ongoing initiatives on the African continent, there have also been other regional developments that need mentioning:

- The reclassification of loans with no repayment dates may be considered as being equity from a tax perspective, giving tax authorities the opportunity to deny interest deductions for these types of loans. An example of this scenario in section 95(4) of the Zambian Income Tax Act deals with the reclassification of a loan as equity due to the terms of the loan not being consistent with a normal loan. This section allows the tax authority to recharacterise a purported loan as equity and disallow the related interest expenses should the tax authority believe it does not qualify as a loan. Therefore, it is imperative for a taxpayer to demonstrate that the loan is indeed such.
- Provision of interest-free loans to entities in African countries which have deeming interest provisions in their legislation – the implications of this is that tax legislation imposes withholding tax on imputed arm's length interest. Nevertheless, because no interest was charged, no deduction is available in respect of the imputed interest

Conclusion

There is an evolving trend for African countries to follow global trends by protecting their tax base against profit shifting measures taken by group companies. As this article shows, African countries are using measures to avoid excessive interest deductions. However, this focus on anti-avoidance nevertheless must be balanced by supporting the necessity for direct investment into the African continent.

15 minutes CPD

IMPACT OF DIGITISATION ON transfer pricing analyses

▶ **MICHAEL HEWSON,** Director at Graphene Economics

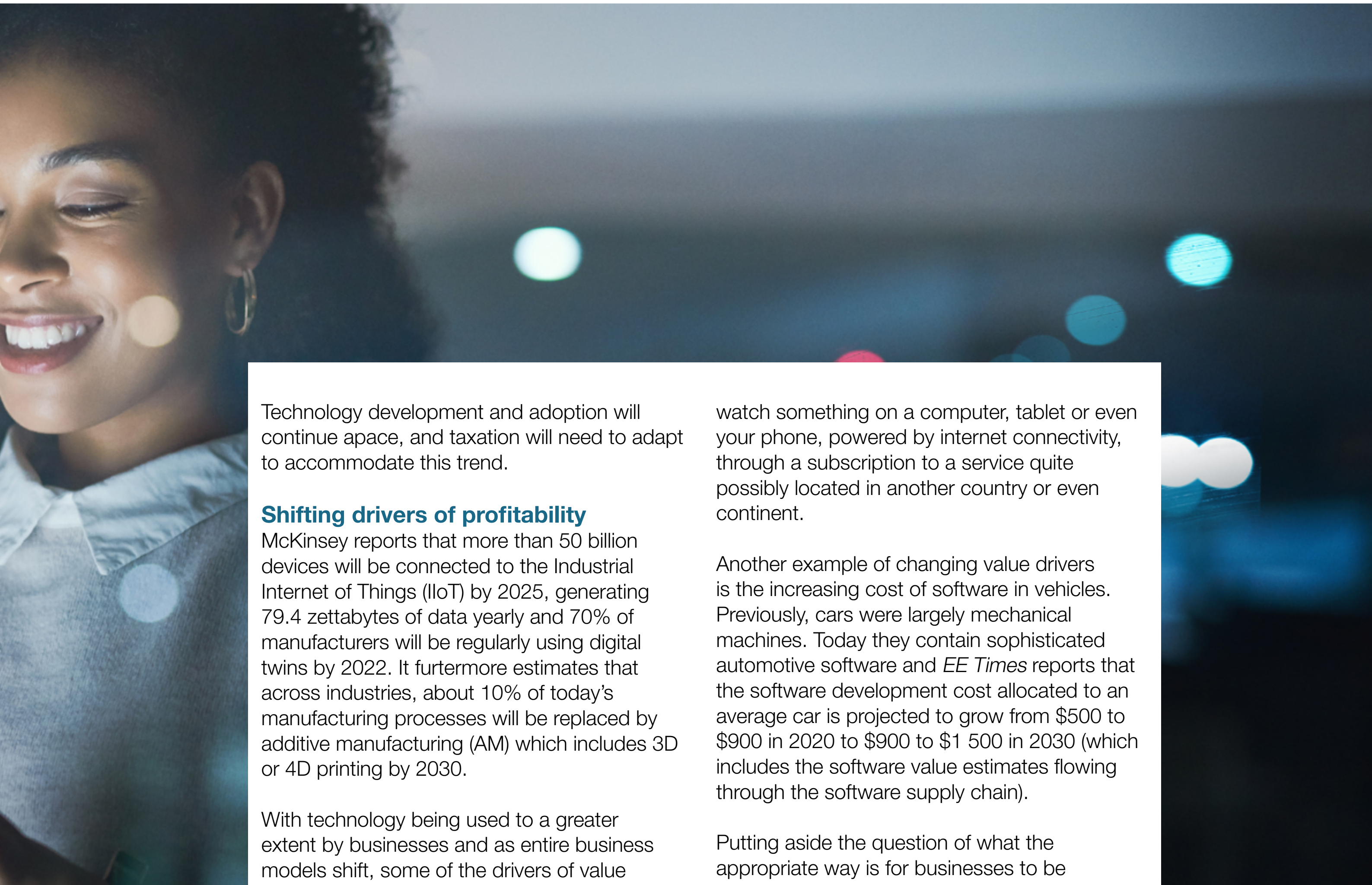
How has the increase in digitisation influenced the delineation of transactions and the substance required in different entities? Is the guidance in the OECD Transfer Pricing Guidelines still adequate for businesses that have become more digital?

"McKinsey reports that more than 50 billion devices will be connected to the Industrial Internet of Things (IIoT) by 2025, generating 79.4 zettabytes of data yearly and 70% of manufacturers will be regularly using digital twins by 2022"

Beyond its devastating health effects, COVID-19 has upset economies, upended supply chains and had a far-reaching impact on businesses that will be felt for years to come. But on the positive side, it has also accelerated digital transformation at a rate that few could have predicted. While this acceleration offers many benefits, whether in terms of communication technologies or entire new product and service categories, it has also disrupted business models and value chains and will, therefore, affect taxation.

As McKinsey notes in its report, *Twenty-five years of digitisation: Ten insights into how to play it right*, sectors with a high level of digitisation also display the largest productivity growth. The report notes:

> *"Industries that are ahead in digitisation tend to be services or sectors that deliver products that are less physical and more immaterial than physical. Other sectors that display more rapid digitisation include those with direct consumer links, faster capital turnover and are more global than local. Among the sectors that are most advanced in digitisation are media and finance; among the laggards are pharmaceuticals and large swaths of manufacturing."*



Technology development and adoption will continue apace, and taxation will need to adapt to accommodate this trend.

Shifting drivers of profitability

McKinsey reports that more than 50 billion devices will be connected to the Industrial Internet of Things (IIoT) by 2025, generating 79.4 zettabytes of data yearly and 70% of manufacturers will be regularly using digital twins by 2022. It furtermore estimates that across industries, about 10% of today’s manufacturing processes will be replaced by additive manufacturing (AM) which includes 3D or 4D printing by 2030.

With technology being used to a greater extent by businesses and as entire business models shift, some of the drivers of value and profitability are also changing. An obvious example is how, just a few years back, it was common to visit a DVD store to rent a film to watch whereas there is now widespread adoption of streaming services and technologies.

Previously, being in the home entertainment business might have meant renting physical stores and stocking them with physical DVDs, which would have had to been sourced from a supplier. Those products would have been licenced, manufactured and shipped – all part of a supply chain that has been largely disrupted in the past few years.

Now, consumers have access to movies and series through completely different channels. While previously the first step in accessing home entertainment was to purchase a TV and set up an aerial to receive a signal from national broadcasters, the advent of cable TV saw a shift as consumers embraced paid-TV options and then digital streaming. Today, you might watch something on a computer, tablet or even your phone, powered by internet connectivity, through a subscription to a service quite possibly located in another country or even continent.

Another example of changing value drivers is the increasing cost of software in vehicles. Previously, cars were largely mechanical machines. Today they contain sophisticated automotive software and *EE Times* reports that the software development cost allocated to an average car is projected to grow from $500 to $900 in 2020 to $900 to $1 500 in 2030 (which includes the software value estimates flowing through the software supply chain).

Putting aside the question of what the appropriate way is for businesses to be taxed for their revenue derived from digital transactions (i.e. the discussions on the Organisation for Economic Co-operation and Development (OECD) Pillar I and unilateral digital services taxes), it is important to understand within businesses what contributes to value creation. In many cases, it is clear that the relative importance of a physical presence is less than it used to be, and the value of technology or intellectual property has increased.

What the OECD Transfer Pricing Guidelines[1] say

The OECD Base Erosion and Profit shifting (BEPS) project had 15 Action Items, which were developed specifically to focus on the things that lead to BEPS. A big focus of Action 8 was intellectual property. There was much work put into considering what regulations and guidance should be provided for transfer pricing purposes regarding the cross-border use of intellectual property (including digital intellectual property).

1 OECD’s Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations

But while the latest version of the OECD Transfer Pricing Guidelines published in 2017 contains some additional considerations regarding intellectual property, for the most part, the main transfer pricing principles that are applicable to transactions involving products and services are also applicable to transactions with digital aspects.

In particular, the arm's length principle (ALP) (namely that the price applied between related parties should be consistent with the price that would have been in place between independent third parties) remains as well as the fact that determination of the ALP requires careful consideration of the functions performed, risks assumed and assets used by the parties. It is still important to consider the circumstances in which the transaction took place as well as other factors, such as the broader strategy of the business.

In this regard, the six-step framework set out in Chapter 6 of the OECD Guidelines provides a useful structure for a transfer pricing analysis of digital transactions.

Important transfer pricing questions multinational corporations need to ask

While the approach to a transfer pricing analysis remains the same, what has changed is the relative contribution of parties to each of these elements listed above and the value of those contributions. For example, while it is still necessary to consider the functions, assets and risks within multinational enterprises (MNEs), the following must also be considered:

- Are all those functions being performed in the same way by the same people (i.e. stock counting may have been done in person in the past but is now done virtually through the use of blockchain)?

"The growth in the level of digitisation will continue to increase, and this will give rise to other transfer pricing considerations too"

To the extent that digitisation of a function has resulted in it being transferred to another entity in another country, it will be necessary to consider if that transfer should have been for a fee and what the potential tax implications would be.

- Are the assets the same (is the entity still using as many offices and as much showroom floor in the various countries or is there an online shop driving lots of sales or is social media being used to channel e-commerce)?
- How have the key risks changed? For example, as businesses have become more reliant on technology, they will need to factor things like Protection of Personal Information Act (POPI Act) and cybersecurity into their risk assessments. It is also relevant to consider who is responsible for maintaining the digital intellectual property and what will be the legal and economic implications for the owner and users of the system if it crashes.

It is necessary to obtain a clear understanding of the impact that digitisation has had on the value chain of a particular business. For example, a bespoke system may have been developed to operate as a customer relationship management (CRM) process and rolled out for use by all affiliates within an MNE. Depending on the level of intelligence that the system produces and the value of the data, the CRM system may be more or less valuable.

Conversely, an algorithm may have been developed to identify significant efficiencies in the supply chain or the data that the MNE obtains and may therefore be considerably more valuable. Therefore, it is important to understand the nature of the digital intellectual property, the value it provides to the organisation as well as the roles and responsibilities of the parties in developing, enhancing, maintaining, protecting and exploiting it.

The growth in the level of digitisation will continue to increase, and this will give rise to other transfer pricing considerations too. For example, whether countries will adopt multilateral, bilateral or unilateral measures with regard to digital services tax.

However, as a starting point, MNEs should be interrogating how digitisation will affect their businesses and apply their minds to the effects of digitisation of not just their value chains but also how this will affect their transfer pricing strategies in the future. Every MNE will be affected by digital transformation in some way, and businesses cannot afford to be caught off guard when it comes to digitisation – they need to embrace a forward-thinking approach.

TRANSFER PRICING ADJUSTMENTS AS BUSINESS MODELS CHANGE AND ENTITIES RESTRUCTURE IN A POST-COVID WORLD

30 minutes CPD

▶ **THULANI SHONGWE,** Senior Manager International Tax at African Tax Administration Forum

African countries have been trying to enhance their tax yield from corporates by introducing new measures, such as robust legislation and administrative measures to stop aggressive transfer pricing schemes by multinational enterprises, measures to strengthen fiscal mining regimes and new policies on tax incentives. However, the digitalisation of the global economy has created new challenges as many African countries are unable to tax highly digitalised businesses based on the current international tax rules.

The rapid digitalisation of African economies often enables multinational enterprises (MNEs) to carry out business in African countries with no or very limited physical presence in those countries. This trend has increased due to the use of digitalised processes necessitated by the COVID-19 pandemic, which has seen some MNEs with a physical presence in a country close their premises and move to online trading. Such digitalisation makes it difficult for countries to establish taxing rights over the profits the MNE makes from those business activities to the detriment of national tax collection.

The Inclusive Framework (IF) statement of 8 October 2021 sets out the high-level political agreement by 136 of the 140 IF members on a two-pillar solution to address the tax challenges arising from the digitalisation of the economy. Pillar I rules will lead to the allocation of 25% of the deemed residual profits (Amount A) of the in-scope MNEs to the market jurisdictions. This will be allocated to market jurisdictions where the MNE creates a nexus based on a special-purpose rule where the nexus is determined based on the revenue sourced from a market jurisdiction. Amount A will be allocated to the market jurisdictions even in circumstances where no physical presence is established by the in-scope MNE.

> *"The introduction of new business models in the post-COVID era, such as increased digitally provided services, may make it more difficult to accurately delineate the transaction and establish all the relevant facts"*

The African Tax Administration Forum (ATAF) has expressed disappointment on the quantum of Amount A allocated to the market jurisdictions, as ATAF has called for Amount A to be at least 35% of the deemed residual profits. However, the IF agreement will result in some of the profits of the largest and most profitable digital companies being taxed in African countries where they have users of services provided by those digital companies, such as social media platforms and search engines. This will be the case even where the users do not pay for such services and where those businesses do not create sufficient physical presence status in those countries to meet the current tax nexus rules.

It is important to note that the new Amount A rules do not replace the arm's length principle (ALP) as MNEs will continue to determine their global profit allocation to jurisdictions based on the ALP. However, for in-scope MNEs, there will be a second step of then reallocating some of that profit to market jurisdictions under the Amount A rules. There will be a possible interaction of the new Amount A rules with the ALP through the marketing and distribution profits safe harbour.

The IF Statement provides that where the residual profits of an in-scope MNE are already taxed in a market jurisdiction through the ALP, the marketing and distribution profits safe harbour, which is still under development, will cap the residual profits allocated under Amount A to the market jurisdiction.

As MNEs and tax administrations will continue to apply the ALP to determine the taxable profits of all MNEs, this article provides further insights into the probable challenges of the application of the ALP in the post-COVID world.

Specific transfer pricing issues in the post-COVID world in Africa

The pricing of a controlled transaction requires that such a transaction be accurately delineated to determine the functions performed, assets used and risks controlled and assumed by the parties to the transaction. This is a fact-intensive process and typically entails establishing the functions performed, assets used and risk assumed and controlled in each jurisdiction. The introduction of new business models in the post-COVID era, such as increased digitally provided services, may make it more difficult to accurately delineate the transaction and establish all the relevant facts. This, in addition to the difficulties in using historical data to determine transfer prices for both taxpayers and tax administration, will likely increase tax uncertainty and the risk of market jurisdictions not being allocated appropriate taxing rights.

It is these risks to the tax base of market jurisdictions and to tax certainty that inspired the ATAF Pillar I proposal, calling for a more

comprehensive scope that included many more MNEs than the IF Pillar I rules through a lower global revenue threshold and a portion of the total profits of the MNE being reallocated to a market jurisdiction instead of only allocating a percentage of the residual profits.

As these aspects of the Pillar I proposal were not accepted by the IF, tax administrations will now need to deepen their understanding of the new business models of MNEs to enhance their capacity to accurately delineate the controlled transactions and carefully analyse any business restructurings entered by MNEs. With regard to such business restructurings, African countries should consider enacting enhanced transfer pricing documentation rules to ensure taxpayers fully disclose to the tax administration all the facts where a taxpayer has entered or is affected by a business restructuring. This information will be critical for effective transfer pricing risk assessment to ensure such business restructurings are subject to audit where there is a high transfer pricing risk.

The other critical issue relates to comparability analysis. First and foremost, African countries and many other developing countries do not have local comparables making it often challenging to reliably determine the arm's length price of transactions. The COVID-19 pandemic has exacerbated this situation as the pandemic has created and continues to create unique circumstances that may make it challenging to use historical data for pricing-controlled transactions. Determining whether comparability adjustments may be required, which is already very challenging, will become even more so in the post-COVID world, where accurately delineating the transaction will often be even more difficult than in the pre-COVID era. Comprehensive information to accurately establish the impact of the pandemic on the controlled transaction will be needed to ensure the comparables used are reliable.

Taxpayers will need to fully disclose all information to the tax administrations to enable a detailed analysis to be undertaken of the impact of the pandemic on the controlled transaction. Other related issues that may arise are whether prior year comparables may be

"The pandemic continues to create economic challenges for some MNEs in various respects, including the decreased demand for their products and services as well as disruption of supply chains"

used and whether comparability adjustments will increase the reliability of the comparables. The question of whether loss-making companies may be used as comparables given that the pandemic may have created those losses under arm's length conditions will also need to be considered. Evaluation of whether these loss-making companies may be used will depend on the specific facts and circumstances of the tested transaction and whether the conditions are in accordance with the ALP.

The pandemic continues to create economic challenges for some MNEs in various respects, including the decreased demand for their products and services as well as disruption of supply chains. These challenges have resulted in operating losses for some MNEs, and this situation may continue during the recovery period. The allocation of losses between associated entities can give rise to disputes between taxpayers and tax administrations and hence is an issue that requires consideration given the probable increase in the frequency and magnitude of losses in the current economic environment.

Important issues in respect of loss allocation include how these exceptional operating losses may be allocated between associated entities having regard to how independent parties would have agreed to share the losses and the complex analysis of whether the parties to the transaction would have invoked the force majeure clauses in the contracts to limit the extent of the losses. These are complex issues that require not only accurate delineation of the controlled transactions but also an assessment of the commercial rationality of the loss allocation and the selection of the appropriate comparables to price the delineated transactions. A practical issue that may affect many developing countries is the pricing of so-called limited risk distributors, as such entities are often prevalent in these countries. It will be critical to establish the facts and circumstances of the transaction before, during and after the pandemic to establish the risks assumed by the distributor and if it would have incurred losses based on that assumption of risk. In addition, consideration will need to be given as to whether the parties would have agreed to renegotiate the contractual terms during the pandemic if they had been dealing at arm's length.

ATAF will continue to provide technical guidance to African countries on how to address these challenging transfer pricing issues in the post-COVID world. This will include policy considerations, especially on the need for revisions to transfer pricing documentation rules to ensure tax administrations obtain all the documentation and information needed to accurately delineate controlled transactions.

Additionally, ATAF will continue to advocate for the simplification of transfer pricing rules to make it easier for both taxpayers and tax administrations to determine the pricing of controlled transactions that are likely to be even more complex to price in the digital era posing tax revenue risks to governments and increasing tax uncertainties for business. The current IF workstream under the so-called Amount B is one of these simplification measures that, if well designed, may benefit taxpayers and tax administrations in determining the pricing of baseline marketing and distribution activities where there are no reliable comparables.

30 minutes CPD

HAS THE **MULTI-LATERAL INSTRUMENT** FINALLY BROUGHT **TREATY SHOPPING TO AN END?**

DEBORAH TICKLE, Adjunct Associate Professor at the University of Cape Town

"The principles behind the MLI were agreed to by over 100 countries in November 2016 and it became effective for covered tax agreements – those for which the MLI is operative – in January 2019"

This article analyses the multi-lateral instrument on treaty shopping. It takes a closer look at issues that influenced treaty abuse and preventing the granting of treaty benefits in inappropriate circumstances.

Before engaging in a discussion to attempt to answer the question: 'Has the multi-lateral instrument (MLI) finally brought treaty shopping to an end?' one first needs to understand the context of the question and the references made therein.

Firstly, some brief history. The first model Double Taxation Treaty (DDT) was developed in 1928 by the League of Nations with a view to addressing the fact that, as trade became more global, countries competed for the taxes on that trade. Thus, the objective of DTTs was to allocate taxing rights among the relevant countries with a view to facilitating trade by preventing double taxation. The League of Nations treaty essentially developed into the Organisation for Economic Co-operation and Development (OECD) Model Tax Treaty and formed the basis of the UN and other model tax treaties and, although these have seen many adaptations over the years, the principles and structures have largely remained the same.[1]

However, as the bilateral tax treaty network developed – there are now 'between 3 000 and 4 000 treaties in force worldwide'[2] – so did the practice of treaty abuse and 'treaty shopping' arrangements. Treaty shopping 'typically involves the attempt by a person to indirectly access the benefits of a tax treaty between two jurisdictions without being a resident of one of those jurisdictions'. [3] (Treaty shopping is not generally considered to be "illegal" provided the domestic laws of the relevant countries are adhered to.)

Thus, in 2012, at the instance of the G20, the OECD commenced its work to combat the erosion of countries' tax bases through profit shifting practices (commonly known as Base Erosion and Profit Shifting [BEPS]. This work resulted in the issue, in October 2015, of 'Final' Reports on 15 Actions. The work is, nevertheless, ongoing.

The Report on Action 6 deals with 'Preventing the Granting of Treaty Benefits in Inappropriate Circumstances'. Its contents are viewed as a "minimum standard", i.e. countries adopting the BEPS Actions must apply the provisions.

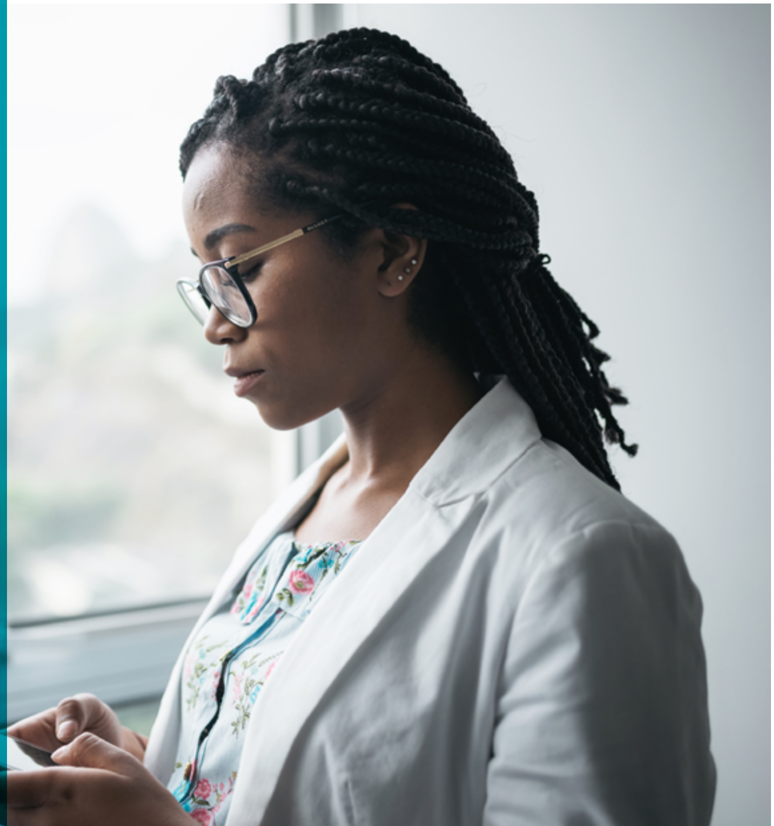
The Report on Action 15 set out the proposal for an MLI which is designed to accelerate the ability of countries to effect the treaty changes proposed in the remaining Actions, including those of Action 6. The principles behind the MLI were agreed to by over 100 countries in November 2016 and it became effective for covered tax agreements (CTA) – those for which the MLI is operative – in January 2019. Since October 2021, the MLI has had the effect of amending over 1680 bilateral tax agreements for 62 countries. In total, 96 jurisdictions have

1 Michael Kobestsky. *International Taxation of Permanent Establishments Principle and Policy 2011.* Cambridge University Press, p106-151.

2 https://read.oecd-ilibrary.org/taxation/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-action-6-2015-final-report_9789264241695-en#page1 Introduction. Accessed 19 October 2021.

3 https://read.oecd-ilibrary.org/taxation/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-action-6-2015-final-report_9789264241695-en#page1. Accessed 19 October 2021.

signed up but are all in various stages of the process which must be followed.[4] Once all countries that have signed up have ratified and deposited (with the OECD) their version of the MLI (i.e. effectively set out a list of the DTTs they wish to be amended and the relevant clauses of the MLI that they are adopting), the current potential is for over 2 800 DTTs to be amended.[5]



So, since the mechanism for effecting change to DTTs is clearly progressing and all the CTAs add some form of the anti-avoidance clauses set out in Action 6 (as a minimum standard), the question still must be answered: "Has this process brought treaty shopping to an end?"

Although the mechanism for amending DTTs is clearly in place, it must be remembered that not all DTTs are included. For taxpayers dealing with those that are not affected by CTAs, there may already be anti-treaty shopping provisions (e.g. DTTs with the US, which generally contain detailed Limitation of Benefits [LOB] clauses, which tend to deal with conduit companies and require determination of the beneficial owner) or the treaties may not deal with treaty shopping. On this basis, treaty shopping is not at an end but may have been severely curtailed where CTAs are in place.

For those DTTs where there are CTAs, one needs to look at the detail of Action 6 to establish the effect of its implementation on treaty shopping. The MLI provides, in line with Action 6, for countries to include in their selected DTTs (via the MLI), firstly in the preamble, an express statement on the purpose of the DTT, being to facilitate trade and not non-taxation or reduced taxation through tax evasion (including through treaty shopping) (Article 6) and then one of three methods may be adopted for addressing abuse of the treaty, including treaty shopping (Article 7):

1. *"a principal purpose test (PPT) (this is explained in paragraph 9 of Article 29 of the 2017 OECD Model Tax Convention) together with either a simplified or a detailed version of the limitation on benefits (LOB) rule (paragraphs 1 to 7 of the 2017 OECD Model); or*
2. *the PPT alone; or*
3. *a detailed version of the LOB rule together with a mechanism (such as a treaty rule that might take the form of a PPT rule restricted to conduit arrangements or domestic anti-abuse rules or judicial doctrines that would achieve a similar result) that would deal with conduit arrangements not already dealt with in tax treaties.[6]"*

4 https://www.oecd.org/tax/treaties/beps-mli-signatories-and-parties.pdf Accessed. 19 October 2021.

5 https://www.oecd.org/tax/treaties/multilateral-instrument-BEPS-tax-treaty-information-brochure.pdf. Accessed 19 October 2021.

6 Ibid.

The PPT is viewed as being much broader and far reaching than the LOB provision.

The matrix[7] on the OECD website allows one to establish whether a CTA exists (i.e. whether the two countries have selected that DTT to be amended by the MLI, whether the CTA is in force, and which clauses match, i.e., that the amendment applies). Not all countries have selected the preamble or the simplified LOB and some have chosen to bilaterally agree on an extended LOB in line with the minimum standard, however in the majority of instances the PPT applies as set out in Article 7(1) of the MLI:

> *"Notwithstanding any provisions of a Covered Tax Agreement, a benefit under the Covered Tax Agreement shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the Covered Tax Agreement.[8]"*

7 https://www.oecd.org/tax/treaties/mli-matching-database.htm. Accessed 19 October 2021.

This clause has, however, led to much debate about whether the mere fact that the benefit of a certain Article in a DTT is claimed would lead to the conclusion that its use must have been one of the principal purposes for the arrangement or transaction, thereby removing the benefit.

The debate largely revolves around the fact that the article refers to 'one of' the principal purposes, implying that the existence of other, genuine, commercial purposes is not relevant.[9] On that basis, one could argue that where CTAs exist. Treaty shopping must have come to an end as the revenue authority of the country losing tax is likely to apply the PPT clause wherever it catches the slightest whiff of something that could look like treaty shopping because the defense of commerciality has been rendered irrelevant.

The tax authority does not need to find conclusive proof of the taxpayer's intent (which the taxpayer also cannot simply assert was not to obtain the benefit), it must merely, after an evaluation of the facts and circumstances, be reasonable for it to conclude that one of the principal purposes was to obtain the benefit. Globally, such reasonableness tests are not uncommon and even South Africa's general anti-avoidance legislation (GAAR) is based on a similar principle, i.e. the subjective intention that the sole or main purpose for obtaining the tax benefit is objectified.[10]

"The message from this is that taxpayers need to decide on what works for them commercially. The DTTs will then ensure that they do not pay double or excessive tax. The old adage "The tax tail should not wag the commercial dog" comes to mind"

9 PS LA 2020/2 issued by the Australian Tax Office. https://www.ato.gov.au/law/view/document?DocID=PSR/PS20202/NAT/ATO/00001&PiT=99991231235958. Accessed 19 October 2021.

10 The Reasonableness Test of the Principal Purpose Test Rule in OECD BEPS Action 6 (Tax Treaty Abuse) versus the EU Principle of Legal Certainty and the EU Abuse of Law Case Law by Dennis Weber* (August 2017).

However, Action 6 makes it clear that a purpose will not be a principal purpose if it is reasonable to conclude that the DTT benefit was not a principal consideration or cause and it 'would not have justified entering into the transaction or arrangement... That has resulted in the benefit. In particular, where it is inextricably linked to a core commercial activity.'[11]

The Australian Tax Office nicely explains this by stating that the PPT should not be applied "where the arrangement may be fairly described as an ordinary commercial dealing". 'That is, one that is not contrived, has economic substance, forms part of a presence in the jurisdiction that is involved in carrying on the core business activities of the entity or group that adds economic value.'[12]

The message from this is that taxpayers need to decide on what works for them commercially. The DTTs will then ensure that they do not pay double or excessive tax. The old adage "The tax tail should not wag the commercial dog" comes to mind. The PPT in the CTAs is providing tax authorities with a lot more "teeth" to ensure that taxpayers remember this.

11 https://read.oecd-ilibrary.org/taxation/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-action-6-2015-final-report_9789264241695-en#page60. Accessed 19 October 2021.

12 PS LA 2020/2 issued by the Australian Tax Office. https://www.ato.gov.au/law/view/document?DocID=PSR/PS20202/NAT/ATO/00001&PiT=99991231235958. Accessed 19 October 2021.

15 minutes CPD

TRANSFER PRICING ASPECTS OF BUSINESS RESTRUCTURINGS

VALDIS LEIKUS, Director at Graphene Economics

The COVID-19 pandemic has disrupted African economies and businesses operating in Africa. Many multinational companies have had to rethink their strategies and adjust their supply chains. Some industries were severely impacted with participants having to sell parts of their businesses or restructure operations to minimise losses. Other industries thrived during the pandemic with participants recording their highest profits yet.

Many African economies have shown some signs of recovery. For example, according to Baker McKenzie's analysis of Refinitiv data, Africa's mergers and acquisitions activity soared in the first six months of 2021, with deals recorded worth more than $57.7 billion, up from $8.5 billion year-on-year.

Where business restructurings take place within a multinational enterprise (MNE), it is necessary to evaluate the impact from a transfer pricing perspective.

What is a business restructuring for transfer pricing purposes?

A business restructuring does not necessarily relate to the sale or acquisition of operations. The Organisation for Economic Co-operation and Development (OECD) defines business restructuring as the cross-border reorganisation of the commercial or financial relations between associated enterprises, including the termination or substantial renegotiation of existing arrangements.

For instance, a transfer of a business unit (e.g. shared service centre operations) from a South African company to a related party in Kenya or the conversion of the manufacturing operations from a full risk model to a limited risk model would constitute a business restructuring for transfer pricing purposes.

Some countries have specific business restructuring regulations and definitions embedded in their local legislation. Within Africa though, most of the countries do not have a specific definition or regulations on transfer pricing aspects of business restructuring embedded in their legislation. Some countries, such as Zambia, have released a practice note containing a section about business restructurings. These guidelines are largely aligned with the OECD's interpretation and guidance.

Important transfer pricing considerations

To understand the transfer pricing consequences of a business restructuring arrangement, the OECD indicates that the first step is to delineate the transactions comprising the business restructuring. This requires undertaking a functional analysis to identify economically significant activities and responsibilities undertaken, assets used and risks assumed before and after the restructuring by the parties involved. Understanding the risks assumed by the parties is another critical element in the context of business restructurings because the transfer of risks from one entity to another is likely to impact the level of compensation.

Another important consideration is the business reasons for and the expected benefits from the restructuring. In most instances, business restructurings are commercially driven. They are initiated for a variety of reasons, including the provision of more centralised control and management of manufacturing, research and distribution functions; savings from economies of scale; efficiency and lower costs and integrations of newly acquired operations. The business restructuring needs to be considered from the perspective of the group as well as from the perspective of the individual entities to evaluate to what extent the parties are likely to benefit.

When evaluating the costs and benefits of the restructuring to the various related parties, it is necessary to consider whether there are other options realistically available to the parties which may have been even more beneficial to that entity. This is important in evaluating what decision an entity would have undertaken if it was operating as a separate legal entity on an arm's length basis.

All of the steps above enable the parties to identify whether there should be compensation for the identified transactions. The OECD clarifies that, when applying the arm's length principle (ALP) to business restructurings, the question is whether there is a transfer of something of value or the termination or substantial renegotiation of existing arrangements and that transfer, termination or substantial renegotiation would be compensated between independent parties in comparable circumstances.

A transfer of something of value might include tangible assets (e.g. equipment), intangible assets (e.g. patents, trademarks, designs, copyrights, know-how, customer lists) or transfer of activity (e.g. functioning, economically integrated business unit). The compensation for the transfer of these assets is usually determined by way of performing a valuation study.

"Over the last few years, several African countries updated their transfer pricing documentation requirements, where taxpayers are required to disclose their business restructurings and transfers of intangibles in their annual transfer pricing compliance reports"

- Another important consideration, which became relevant during the COVID-19 pandemic, is the loss-making operations of the MNE. In this regard, the OECD states that if the loss-making activity is transferred to a related party, there might be a situation where a transferee should be compensated by the transferor for taking over a loss-making activity because the financial costs and social risks of closing down the activity would be such that the transferor finds it more advantageous to pay a transferee, which will attempt to reconvert the activity and will be responsible for any redundancy plan that may be needed.

Risks associated with business restructuring transactions

It is evident that business restructurings are complex exercises and require collaboration between commercial divisions of the business and finance (tax) division. There are several risks associated if business restructuring is not implemented correctly.

Assume an MNE changes its pricing methodology by converting its operations in South Africa from a fully-fledged distributor to a limited risk distributor. Prior to the business restructuring, the company was making an average of 15% return on sales.

The post-restructuring return on sales would reduce to 2%. Tax authorities perform a tax audit and determine that the change in pricing methodology is not consistent with the actual conduct of the parties, i.e. the local distributor continues to perform economically significant activities post-restructuring. In this scenario, tax authorities are likely to recharacterise the transaction and adjust the return on sales of the distributor to the pre-restructuring level. Depending on the size of the operation, this recharacterisation might result in significant additional income taxes to be paid by the local distributor, notwithstanding the penalties and late payment interest.

Another example might be where an MNE has set up operations in another jurisdiction but failed to move its employees performing these activities to that jurisdiction. In this case, the MNE is exposed to the risk that any profits will be allocated to the country where the operational team is based.

Non-arm's length compensation for the transfer of something of value could also create risks for MNEs, especially where no detailed analysis was performed at the time of the restructuring.

These risks should not be taken as hypothetical ones. Over the last few years, several African countries updated their transfer pricing documentation requirements, where taxpayers are required to disclose their business restructurings and transfers of intangibles in their annual transfer pricing compliance reports.

Due to the complex and unique nature of these arrangements, it is common globally for MNEs to approach tax authorities in advance and enter into advance pricing agreements where the pricing methodology is agreed upon and cannot be challenged for an agreed period (subject to certain terms and conditions). Unfortunately, an MNE operating in Africa can hardly use this avenue because most of the countries in Africa have not adopted the necessary regulations.

Other considerations

In addition to transfer pricing considerations of business restructurings, there are often various local factors and tax considerations that are important in the business restructuring process and should be considered carefully. For example, local legislation in certain African countries do not allow for the transfer of licenses or intellectual property. Exchange control regulations might also restrict business restructuring arrangements. Tax consequences of the movement of personnel, in-country VAT regulations and withholding taxes are other examples that MNEs should consider prior to entering into a business restructuring transaction. MNEs should adopt a holistic approach by considering all these aspects.

Outlook for business restructurings

It is clear that business restructuring is a complex process. Given the immense pressure for tax authorities to collect additional tax revenues, it is likely to become a contentious item of controversy in the future. Since transfer pricing is still perceived as a means of shifting profits out of the Africa region, MNEs should consider transfer pricing and other local tax and regulatory consequences before embarking on business restructuring.

TRANSFER PRICING LITIGATION IN AFRICA: AN UPDATE

15 minutes CPD

DANIEL ERASMUS, Independent Tax Counsel

This article looks closely at the low-hanging fruit that is transfer pricing for many revenue authorities to emphasise the importance of keeping contemporaneous transfer pricing documentation, whether required by law or not.

Transfer pricing is 'low-hanging fruit' for many revenue authorities because the nature of the beast is notoriously controversial with the result that cases end up becoming litigious and/or settled, where the taxpayer invariably writes the revenue authority a sizeable cheque. However, what taxpayers often overlook is the power of the audit stage. This is the commencement of a revenue authority's communication with the taxpayer. In many instances, a letter requesting 'relevant material' might just be a fishing expedition. Alternatively, a notification for audit is simply a routine exercise. Other times, there are grounds for a revenue authority to investigate the taxpayer.

Regardless of the reason, it is imperative that the audit proceedings be approached in the correct manner, with proper oversight and the right interactions. It is for this reason that a seasoned tax advisor, who is skilled in both transfer pricing, tax administration and tax litigation, should assist the taxpayer with this crucial stage. Once the landscape of the taxpayer's transfer pricing is understood, the advisor can determine the appropriate strategy. This will inform the way in which the audit should be run, with the objective being to avoid litigation. In the event legal action is unavoidable, the advisor will have laid a suitable foundation whereupon the merits and concomitant dispute can unfold. Exhausting this step thoroughly will also ensure that due process is followed and, in the event the revenue authority bypasses fair procedures, the taxpayer will have grounds to challenge the revenue authority.

There are a myriad of moving parts and permutations to any audit but transfer pricing is especially complex. Taxpayers are urged to appreciate this and employ the best composite team from the outset so that their rights are protected and the proper remedies invoked.

Different African revenue authorities have applied interesting approaches to transfer pricing adjustments. Whether it be that the transfer prices charged amounts to a tax avoidance arrangement or characterising the taxpayer as a 'fully fledged risk manufacturer' after a creative reading of the supply management agreements, African revenue authorities always seem to produce innovate ideas to substantiate their transfer pricing adjustments. A contentious issue amongst different African revenue authorities is whether the methodology imposed by the revenue authorities can override the taxpayer's transfer pricing methodology to determine arm's length pricing. In this regard, the taxpayer bears the onus to persuade the courts that the transfer pricing methodology applied is the most appropriate having regard to its specific circumstances.

Some African revenue authorities have also argued that the Double Taxation Agreement (DTA) concluded between two countries is applicable as enabling transfer pricing law. In this regard, the specific article applied is akin to Article 9 of the Organisation for Economic Co-operation and Development (OECD) Model DTA. However, transfer pricing provisions are creatures of domestic law and, to implement transfer pricing rules, each country is required to formulate its own detailed domestic legislation (*United Nations Practical Manual on Transfer Pricing for Developing Countries,* prepared by Members of the UN Tax Committee's Subcommittee on Practical Transfer Pricing Issues at 27).

In other matters, the issue of the difference between 'fully-fledged risk bearing manufacturers' as opposed to 'contract manufacturers' is the focus of revenue authorities in making transfer pricing adjustments. Many African businesses in the manufacturing and agricultural sectors usually classify themselves as 'contract manufacturers' where most of the risk and reward is allocated to their out of country associated trading party. In this regard, some African revenue authorities attempt to manipulate the facts to suit their adjusted tax assessments. The affected taxpayer in the supply chain is allocated more economically valuable functions and are assigned to bear more significant risks. This results in substantial upward transfer pricing adjustments in that country.

Various transfer pricing trials are currently ongoing with respect to 'contract manufacturer' issues, with no final judgments handed down yet. What has emerged though is that the preparation of a key factual witness sketching the background to the transactions and parties' relationship is essential. Also, transfer pricing studies relied upon should align with those facts. Lastly, having an experienced independent transfer pricing expert testify to assist the tax court in understanding the underlying complex transfer pricing principles is essential.

Assisting all the witnesses in properly preparing for testimony in court is also essential. transfer pricing is complex. The facts are usually complex. The transfer pricing studies are often dated and completed outside the court jurisdiction without a contemporaneous assessment of the in-country facts affecting the taxpayer. Thus, making sure the transfer pricing studies are contemporaneous and aligned with the in-country facts is further also essential. Simply relying upon the say-so of reputable international firms of advisors is not enough. Oftentimes the advisors involved in preparing the exchange of documents with a revenue authority in a transfer pricing audit are not skilled in the legal principles of correct procedures intertwined with the technicalities of the transfer pricing law and regulations. This can cause unnecessary problems later when the case goes to tax court.

In a recent case where judgment is currently pending, the African revenue authority made transfer pricing adjustments on the basis that the taxpayer did not provide sufficient evidence to support that it received the actual management services contracted for and supported by written agreements. The taxpayer provided testimonies from various witnesses with first-hand accounts of the actual management services received, corroborated with extensive documentation. In the final arguments presented to the tax court, the revenue authority simply argued that all the evidence did not meet the standard of proving 'the extent to which the services were rendered and received'. The revenue authority wanted to see timesheets of all involved in providing the services to prove 'the extent to which the services were rendered and received'. It disregarded the balance of probability test for the taxpayer to discharge its onus to prove that the actual expenditure in procuring the services was incurred through the oral and documentary evidence produced by the taxpayer. The principles of the law of evidence informed the transfer pricing adjustments that were made.

"A contentious issue amongst different African revenue authorities is whether the methodology imposed by the revenue authorities can override the taxpayer's transfer pricing methodology to determine arm's length pricing"

In another transfer pricing case, the tax court discredited all the oral evidence produced by various witnesses for the taxpayer. This included the expert evidence on the basis that the court made a finding that the transfer pricing expert was a 'hired gun'. The judge was suspicious of the evidence from the inception of the case, distrusting any submissions made by the taxpayer's witnesses in explaining why historically no royalty charges were made by the taxpayer for the use of its intellectual property in new territories. The main defence of the taxpayer was that the value of the intellectual property in the new territories was fully ascribed to the marketing expenditure and contributions of its associates in those new territories. Without them, the intellectual property had no value in those new territories. It was not intellectual property akin to an international brand such as Coca Cola. The problem the taxpayer faced was that the tax period under review was prior to the implementation of the transfer pricing provisions in the Income Tax Act. The revenue authority simply relied on the general anti-avoidance provisions to justify its adjusted assessment to impute an income stream of royalty income, where non previously existed. The matter has been taken on appeal, challenging the powers of the revenue authority to create a royalty income stream in the absence of specific transfer pricing provisions in the Income Tax Act. The Income Tax Act has since been amended.

The difficulty with this argument is that the revenue authority will have to show that the transaction between two cross-border companies have been affected for the purposes of avoiding tax and not to realise profits. The taxpayer argues that the revenue authority is not empowered to impute or create income that was not there in the first place and tax it to address the purported tax avoidance.

The importance of keeping contemporaneous transfer pricing documentation, whether required by law or not, cannot be over emphasised. In a recent case, the revenue authority regarded the interest rate on a shareholder loan as excessive despite it being supported by a detailed comparability analysis and a justified country adjustment. Instead, the revenue authority determined an arm's length, interest rate without providing any support for is country adjustment. In handing down judgment, the judge held the opinion that the revenue authority failed to justify its assertion that it relied on to fix an arm's length, while the taxpayer adduced ample evidence to justify its interest rate and found for the taxpayer. Although the judge did not confirm whether the interest rate was actually arm's length, he could not decide otherwise seeing that the revenue authority did not provide any proof in this regard.

Although African revenue authorities and multinationals are usually keen to settle matters, there are developments that taxpayers are keener to go to court and obtain more certainty on the applicable principles. Preparing for a potential court case in the whole build-up of transfer pricing documentation from inception thus becomes very important.

PANDORA PAPERS – EXPOSING ILLICIT FLOWS

15 minutes CPD

▶ **KARL MULLER,** Tax Director at Global Projects at Unilever

The Pandora Papers are the latest in a series of headlines driven by a growing concern that tax revenues and cash are flowing out of Africa. These outflows represent potential lost revenues as well as economic viability. This article explores the validity of these concerns and the potential range of sources causing this leakage, including the dangers caused by transfer mispricing.

Introduction

On Sunday, 3 October 2021, the proverbial Pandora's box was opened with the revelations by the International Consortium of Investigative Journalists. This is not their first foray into this arena and it follows on the Offshore Leaks Investigation (2013), the China Leaks Investigation (2016), the well-known Panama Papers (2016), the Bahamas Leaks (2016) and the Paradise Papers (2017-2018).

What makes this leak notable is that, while other leaks focus on known tax havens such as Panama and the Bahamas, the Pandora Papers expose 206 US-based trusts, including nearly 30 trusts holding assets linked to people or companies accused of fraud, bribery or human rights abuses. They expose an American trust industry that promises levels of protection and secrecy that rival or surpass those offered in the offshore tax havens. *(Suspect foreign money flows into booming American tax havens on promise of eternal secrecy – Will Fitzgibbon, Debbie Cenziper and Salwan Georges* – 4 October 2021*)*

Revelations in the Pandora Papers

The Pandora Papers leak just shy of 12 million documents, and exposes 14 offshore firms that assist the rich and powerful to hide their assets and dealings. While the focus by many governments and social justice networks is on the fact that the illicit flows are driven by multinationals, the Pandora Papers expose a much broader picture in naming more than 330 politicians and high-level public officials in more than 90 countries as well as 35 country leaders. In addition, they name more than 130 billionaires as well as bankers, political donors, arms dealers, international criminals, pop stars, spy chiefs and sporting giants. *(About the Pandora Papers – Fergus Shiel 3 October 2021)*

Is the information public?

All of this information is public and the revelations in the leaks mentioned in the introduction have resulted in a searchable database that is accessible to not only journalists but also the general public. The data contained in this database is sourced mainly from the Panama Papers, the Paradise Papers and now the Pandora Papers. This database can be accessed via the following link: https://offshoreleaks.icij.org/pages/database

What do they reveal about Africa?

Unfortunately, there are a lot of politicians or family members of politicians named, and the countries affected are Chad, Angola, Zimbabwe, Nigeria, Equatorial Guinea and Gabon.

For example, the papers mention a Zimbabwean businessman linked to corruption and tax evasion as well as a Mauritanian businessman and a former government official are among the notable clients of the offshore firms.

The Premium Times of Nigeria in an article by Yusuf Akinpelu dated 11 October 2021 highlights 21 Nigerians listed in the Pandora Papers. While 17 of these are local businessmen with interest in various companies, ranging from services, energy, fashion, packaging, oil and gas, telecoms and financial services; there are also two former military governors, a former minister, and a former presidential adviser. The combined assets of the 21 mentioned above and disclosed in the Pandora Papers exceed $200 million.

Are these exposures proof of wrongdoing and complicity in illicit flows?

The immediate reaction of people may be to say, if a group of investigative journalists can expose this, how come tax authorities do not seem to have the same level of success and

"All of this information is public and the revelations in the leaks mentioned in the introduction have resulted in a searchable database that is accessible to not only journalists but also the general public"

why do they not just access the database and take action against the people and companies mentioned.

It must be stressed that the mere fact that people use offshore structures or have activities and interests managed out of tax havens does not imply that they have broken any laws or acted improperly. There may be legitimate reasons for using these and, if the source of the money was disclosed to tax authorities and the correct taxes were paid, it is incorrect to assume they are participants in illicit flows.

Responses from some people named in the list of notable clients have indicated that their country of tax residence is fully aware of all their assets and all income has been declared. Based on this being a truthful response, there cannot be a presumption that they are guilty of any improper conduct and that the monies held in trust are not part of any illicit flows.

What is clear, however, is that there are some individuals and companies that probably have a lot to answer for and for this reason exposures such as the Pandora Papers are of great value.

Do revenue authorities act on these leaks?

Governments and revenue authorities definitely do take action, but many will not disclose what they have recovered. Sean McGoey in an article titled *Panama Papers revenue recovery reaches $1.36 billion as investigations continue* (April 2021) lists Australia, Germany, the United Kingdom, Spain and France as the five countries that have recovered more than $100 million in revenues. Countries such as Japan, Canada, Finland, Norway Belgium and Denmark are also pursuing recoveries, but the amounts cannot be substantiated.

The link to multinationals and transfer pricing

While the Pandora Papers do not name any multinational enterprises as notable clients in the list, there are businesspeople with links to large companies that provide at least a rebuttable presumption that they have benefitted from these entities and have used the wealth so gained to set up trusts to hide assets.

Where transfer pricing is used to shift profits and such pricing is mispriced or not at an arm's length, it can be classified as an illicit flow. Companies listed in the database should be considered for investigation. What is abundantly clear, however, is that illicit flows are not due only to multinational enterprises, something which governments, tax authorities and civil society groups should take notice of.

While the battle should continue to ensure arm's length and fair pricing, the focus should be broadened to ensure the net covers political leaders, corrupt officials, celebrities and smaller companies, all of whom are playing a significant role in shifting wealth and who are likely part of the illicit flows issue as well. The narrative should change from only naming or blaming multinational enterprises to one that addresses all the participants.

In the Luanda Leaks, Sydney P Freedberg, Scilla Alecci, Will Fitzgibbon, Douglas Dalby and Delphine Reuter in an article dated 19 January 2020 exposed two decades of unscrupulous deals that made the daughter of former President José Eduardo dos Santos Africa's wealthiest woman and left oil- and diamond-rich Angola one of the poorest countries on earth. Illicit flows are clearly mentioned in this article and western firms or multinationals are implicated. The Pandora Papers list Isabel dos Santos, former President José Eduardo dos Santos' daughter, as a notable client of Alpha Consulting Limited. (https://www.icij.org/investigations/pandora-papers/secrecy-brokers)

Conclusion

The Pandora Papers will most certainly not be the last leak we will witness. The Organisation for Economic Co-operation and Development (OECD), International Monetary Fund (IMF), G20, the Inclusive Framework and Investigative Journalism will all contribute to making it more difficult for illicit flows to take place.

Another component that needs to be strengthened is law enforcement and real action by governments to combat illicit flows. The Pandora Papers will add to the momentum to end corporate secrecy and push hesitant decision makers into taking decisive action. There should be pressure to ensure that worldwide, countries require that there are public registers of company owners. Lastly, it is now time for national governments to get their affairs in order as it is unacceptable that there are more than 300 politicians who allegedly have evaded scrutiny. *(Transparency International* – 8 October 2021*)*

KENYAN CROSS-BORDER TRENDS:

Mixing the positives and the negatives?

15 minutes CPD

▶ **DANIEL NGUMY,** Partner and Head of the tax department at Anjarwalla & Khanna

This article looks at the Kenyan cross-border trends. Despite the continent having a diverse range of jurisdiction, Kenya presently does not have specific penalties for transfer pricing tax matters.

The African continent holds a diverse range of jurisdictions at varying stages of economic development. With significant foreign investment and rapid growth over the recent years, many African countries are taking steps to shore up their tax systems and ensure their ability to tax a share of profits attributable to their jurisdictions is not eroded. At the same time, African states need to balance the need for a robust tax system with creating an enabling environment that seeks to create favourable conditions for business activity and investment.

This geopolitical push and pull have moved transfer pricing to the top of the agenda. Many countries in Africa have recently adopted or updated transfer pricing rules in line with the Organisation for Economic Co-operation and Development's (OECD) guidelines. This has resulted in multinational enterprises (MNEs) with significant cross-border business facing deepening scrutiny from tax authorities on their cross-border arrangements. At the same time, there is a push for greater accountability from investors and other stakeholders concerning the various MNEs' approach to tax and where they pay it, particularly with growing global calls for MNEs to pay the "fair" amount of tax in the countries in which they generate their income.

In this article, we highlight some of the most important transfer pricing reforms affecting cross-border transactions in this dynamic region.

Background

The Kenya Revenue Authority (KRA) introduced transfer pricing regulations in 2006, shortly after they had lost their first transfer pricing case (*Unilever Kenya Limited v. Commissioner of Income Tax*) at the High Court. In that case, the High Court upheld the taxpayer's use of a cost-plus method under the OECD Transfer Pricing Guidelines to support the pricing of export sales to a related cross-border entity. In determining the case in favour of the taxpayer, the High Court determined that the OECD Transfer Pricing Guidelines were applicable in Kenya where the regulations either did not exist or where the regulations did not adequately prescribe how an appropriate transfer pricing methodology should be applied.

The regulations establish the various transfer pricing methods that a taxpayer in Kenya can apply to determine an arm's length price and indicate the type of transactions that would require transfer pricing documentation to be kept.

The regulations are promulgated pursuant to the provisions of Section 18(3) of the Kenya Income Tax Act, which broadly sets out the requirement for a Kenyan entity trading with a related non-Kenyan entity to ensure that all transactions as between them be entered into at an arm's length price. However, given the fact that the Kenyan regulations are not all encompassing, it is the case in Kenya that reliance on the OECD Transfer Pricing Guidelines is increasingly accepted by the KRA in Kenya.

Kenya, unlike some of its East African neighbours, only requires that the transfer pricing documentation be produced by a taxpayer as evidencing how a transfer pricing method was used to arrive at the arm's length price upon request by the KRA. Tanzania, for instance, requires that taxpayers who have a turnover beyond a certain threshold and who have related party cross-border transactions file their transfer pricing documentation simultaneously with the filing of the annual corporate tax returns.

Kenya presently does not have specific penalties for transfer pricing tax matters. Instead, the interest and penalties that are applicable in respect of corporate tax matters also apply to transfer pricing cases. Any taxes arising from such a transfer pricing adjustment is subject to additional penalties of 5% on the late payment of tax and a 1% interest charge.

Recent developments affecting cross-border transactions

To highlight a few changes, in 2021, the Finance Act expanded the definition of the term 'control' in relation to a body corporate. This term defines who constitutes a related party for tax purposes, including for transfer pricing purposes. Traditionally, an entity was considered to be in the control of another through the holding of shares or voting power of 25% or more by one entity in the other.

The new expanded definition now includes instances where a person:

1. Holds more than 20% of the voting rights of a company;
2. Advances a debt or gives a debt guarantee of at least 70% of indebtedness of a company;
3. Has the power to appoint more than 50% of the board of directors of a company or at least one director or executive member of the governing board of that company;
4. Owns or has the exclusive right to the intellectual property rights that a company is dependent on for the manufacture or processing of goods for its business;
5. Supplies or purchases at least 90% of the purchases or supplies of a company or has influence on the supply of goods, prices or markets of a company; or
6. Has any other relationship, dealing or practice with another person which the commissioner may deem to constitute control.

This expanded definition of the term 'control' has a far reaching impact on business dealings between resident and non-resident persons. Kenyan entities that undertake business based on franchise models and exclusive supplier/dealer licences, such as the motor business sectors, may be deemed to be controlled by the non-resident principals/franchisors for tax purposes. In this regard, the resident and non-resident parties will be required to put in place a transfer pricing policy to govern their business dealings. Businesses whose purchases from one supplier or supplies to one purchaser constitute at least 90% of the purchases or supplies will also need to ensure that their dealings comply with the transfer pricing rules under the Income Tax Act.

Also, the Finance Act 2021 introduced a requirement for ultimate parent entities for multinationals based in Kenya to submit returns on an annual basis of their group's financial activities in Kenya and all other jurisdictions where any of the group entities have a taxable presence. The return is required to contain information, including information relating to the amount of revenue, profit or loss before income tax, income

"The return is required to contain information, including information relating to the amount of revenue, profit or loss before income tax, income tax paid, income tax accrued, stated capital, accumulated earnings, number of employees and tangible assets other than cash or cash equivalents"

tax paid, income tax accrued, stated capital, accumulated earnings, number of employees and tangible assets other than cash or cash equivalents. This requirement will now apply to companies which has a turnover that exceeds the prescribed threshold which will be set out in the regulations that are expected to be published in relation to the implementation of this new requirement.

The amendment is based on the OECD's Base Erosion and Profit Shifting (BEPS) Project Action Point 13 (Transfer Pricing and Country-by-Country Reporting) which requires all large MNEs to prepare Country-by-Country (CbC) reports with aggregate data on the global allocation of income, profit, taxes paid and economic activity among tax jurisdictions in which it operates. The CbC report to be shared with KRA is aimed at increasing international tax transparency and improving access to information regarding the global allocation of the income, the taxes paid and certain indicators of the location of economic activity among tax jurisdictions in which the relevant MNE operates through the automatic exchange of annual CbC reports.

The CbC reports are expected to assist the KRA in assessing high-level transfer pricing risks and other BEPS-related risks as well as for economic and statistical analysis. The rules and procedures for competent authorities of jurisdictions implementing BEPS Action Point 13 are set out in the Multilateral Competent Authority Agreement on the Exchange of CbC Reports (CbC MCAA). A bilateral relationship between jurisdictions under the CbC MCAA becomes effective only if the respective jurisdictions have filed the required notifications and have listed each other as participating countries. Kenya is expected to imminently give notice on the implementation of the CbC MCAA and sign it once it puts in place the relevant domestic laws on implementation of the CbC reporting.

Kenya is increasingly becoming a preferred investment destination for MNEs looking to set up in Africa and there is a need for a delicate balance between ensuring that there are no tax leakages and creating a favourable environment for business activity and investment. The recent developments affecting cross-border transactions are examples of mixing the positives and negatives with the expansion of the term 'control', requiring a wider pool of taxpayers to comply with the transfer pricing regulations as the CbC reporting for MNEs increases international tax transparency and improves access to information regarding the global allocation of the income.

MAURITIUS CROSS-BORDER TRENDS:

Adjusting to a Post-BEPS world

15 minutes CPD

▶ **CAOILFHIONN VAN DER WALT,** Partner at Regan van Rooy

Mark Twain famously said that God first created Mauritius and then modelled paradise after the Indian Ocean Island. Who knows whether that is true or not (though those of us in Mauritius would warrant so), but, in recent years, Mauritius has certainly been battling to remain a paradise from the tax perspective.

Since 2018, Mauritius has been scrutinised by various oversight bodies, notably the Organisation for Economic Co-operation and Development (OECD) and the EU, as part of the global response to the OECD Base Erosion and Profit Shifting (BEPS) initiative. To stay on the right side of these bodies, Mauritius bit the bullet and brought in huge and sweeping changes, including new substance and controlled foreign company rules as well as abolishing the GBC2 and deemed credit regimes.

On 1 July 2021, therefore, Mauritius started a bright new dawn as a cleaned-up jurisdiction with a 15% tax rate applying across the board – how simple is that! A flat 15% rate for corporate tax, personal income tax, VAT and withholding taxes, with of course some exceptions, and very good scope for having an effective tax rate significantly below 15%.

So, Mauritius had tidied its house, and all was looking smooth, a smooth sea of 15% waves you could say.

But almost immediately, there were further changes to the global landscape. Mauritius had done what it was told, only for the Pillars (if not the goalposts) to be shifted overnight.

After lots of discussion and with some kick-starts from Mr Biden, in mid-2021, the G7 met and signed an agreement on global tax reform, based on the very same OECD BEPS that we have all been talking about for donkey's years but making some pretty serious commitments and agreeing to real deadlines. Then shortly after the G7 meeting, on 1 July 2021, the OECD announced that 130 out of 139 countries in the Inclusive Framework had agreed to this bold new framework for international tax reform, including every single G20 country AND they say it will be implemented in 2023. Wow, so things are finally happening!

For those who need reminding, this framework was based on two so-called pillars, seeking to ▶

make global tax 'fair', whatever that means in the new digital age. The intention of Pillar I is to ensure profits and taxing rights are distributed equitably across relevant countries, in particular concerning large multinationals, while Pillar II focuses on the introduction of a global minimum corporate tax rate, which was concluded to be at least 15%. Further, Pillar II would allow high tax countries to charge a 'top-up' tax, via either the Undertaxed Payments Rule (UTPR) or the Subject to Tax Rule (STTR) which means the home country can tax more if the subsidiaries avails lower tax rates overseas, which in theory would deter against any effective tax rate lower than 15%.

So big changes then and immediately after Mauritius's new dawn! Has Mauritius gone to all these lengths to tidy up its tax regime over the last three years only to be wiped out by the 2021 Inclusive Framework? Is it game-over for Mauritius?

In our view, a resounding no.

Mauritius still meets the main criteria for being a hub for African businesses, both in terms of investment outbound from Africa and investment inbound across Africa. As anyone who has done business in Africa knows, structuring via the right jurisdiction is not primarily about tax (NB OECD, EU and all civil servants!) but rather about protecting your assets, minimising your currency risk and minimising exchange control complications, with tax being, at most, an important nice-to-have. Mauritius, with its strong banking infrastructure, currency flexibility and lack of exchange controls, ticks all of these boxes. How many other countries in Africa allow you to transact in your currency of choice, do not have nationalisation or capitalisation requirements and do not tie you up with exchange control red tape every time you try to make a payment? Practically none is the answer and certainly none that will also give you access to hard-currency funding, listing and acquisition markets, while also having non-punitive tax for your employees and your companies.

So yes, we think Mauritius still makes sense to structure for Africa, even with a 15% tax rate. But let us spend a moment looking at the main options available in Mauritius which result in a very attractive effective tax rate (although likely only of interest if the main parent is not in a country implementing Pillar II).

"Finally, Mauritius has a very generous double taxation relief system – foreign tax credits are not subject to a limitation and can be pooled, i.e. set off against other taxable foreign income in the same year"

Firstly, there is the Partial Exemption Regime, which exempts 80% of certain income streams from tax, resulting in a 3% rate on:

- Foreign-source dividends
- Interest income
- Profits of a permanent establishment
- Income from collective investment schemes and reinsurance
- Income from ship and aircraft leasing
- Income from international fibre capacity

Secondly, Mauritius has many generous tax holidays. For larger groups wanting to hold, support or fund their African operations from a Mauritian holding company, the global headquarter administration or global treasury regimes are attractive. Other key tax holidays, which apply for five or eight years (in addition to the beneficial rates for export activities and freeport manufacturing) include:

- Global legal advisory activities
- Overseas family office
- Innovation-driven or high-tech activities related to intellectual property development in mauritius
- E-commerce platform activities
- Peer-to-peer lending
- Tertiary education campus
- Manufacture of nutraceutical, pharmaceutical or medical products

Finally, Mauritius has a very generous double taxation relief system – foreign tax credits are not subject to a limitation and can be pooled, i.e., set off against other taxable foreign income in the same year. Also, where foreign dividends are earned, the Mauritian recipient can claim credit not only in respect of the withholding tax levied but also on the corporate tax levied on the profits out of which the dividends were paid! This is particularly relevant for Mauritian companies holding African subsidiaries, which are almost always subject to high taxes and thus can often lead to 0% tax payable in Mauritius.

So, if you do not need to worry about the top-up tax, there are also strong tax benefits to Mauritius!

Having successfully navigated a challenging period, Mauritius is now globally recognised as a fully compliant jurisdiction, having recently exited the Financial Action Task Force (FATF) blacklist. With no exchange controls and a flat 15% tax across all regimes, it is always worth considering as a structuring location whether investing into or out of Africa. And yes, this applies even in this post-BEPS, bi-pillared environment, although if your parent company is subject to Pillar II, you may not want to claim any of Mauritius's generous tax reliefs.

Africa is a great place for investment, but it is also a place you can lose your proverbial shirt as well as the skin off your back. The risks in Africa and thus the criteria for structuring for Africa are not about minimising your tax, it is all about minimising the risks endemic to Africa in terms of currency, country risk, political risk and exchange control risks. And while that remains the case Mauritius will remain a good option.

NIGERIAN CROSS-BORDER TRENDS:

Tightening the screws

15 minutes CPD

▸ **TAYO OGUNGBENRO,** Partner and head consumer and industrial markets/transfer pricing tax, regulatory and people services at KPMG in Nigeria

In retrospect, Nigeria is a oil rich country that was previously doing exceptionally well in the cross-border trade. This article explores how the country is now tightening the screws after its markets plunged and the global pandemic hit.

The discovery of oil in commercial quantity with the attendant increase in the price of crude oil in the international market led to the retraction of Nigeria's agrarian economy by the mid-70s. Fiscal revenue from oil has since accounted for more than 70% of foreign exchange (forex) earnings. Hence, the performance of the economy became tied to the fortune of the oil and gas industry. For instance, when the price of Bonny light (Nigeria's crude) plunged from about $115 per barrel in June 2014 to $31 per barrel by January 2016, the forex reserves also dropped drastically. Consequently, the naira lost more than half of its value against international convertible currencies within the same period. The country experienced the worst full year economic recession in 2016 since 1987.

Based on the above, the Federal Government (FG) through its fiscal and monetary managers adopted measures to curtail the crisis. One of the first measures was the Central Bank of Nigeria's (CBN's) restriction of access to forex reserve for the importation of 41 items through the official window.

Despite all efforts, the country still failed to meet the forex demand for importation of eligible items, including raw materials crucial to the operation of manufacturing companies. The situation was exacerbated with the decline in the amount of foreign direct investment – another major source of forex earnings in Nigeria – as a result of the increase in the level of insecurity especially in the northern part of Nigeria. The inability of the government to tackle the insecurity situation was a source of serious concern for potential investors in the country.

Unfortunately, in 2020, when it appeared that the country was about to overcome the economic crisis, the COVID-19 pandemic set in. The enforcement of a lockdown occasioned the loss of livelihood for many small- and medium-scale businesses which depended on daily commercial activities and physical movement to earn a living. Consequently, Nigeria's GDP declined in Q2 and Q3 of 2020, plunging the economy into a second recession within five years.

The FG responded by introducing palliative measures, such as the ₦2.3 trillion stimulus plan called the Nigeria Economic Sustainability Plan (NESP). This led to additional government expenditure in the face of dwindling revenue. Relatedly, the FG also spent 98% of its revenue to service debt in the first half of 2021.

We have provided this extensive background as a prelude to the basis for tightening screws by the FG in respect of cross-border transactions. In the remaining part of this article, we will review some of the measures taken by the FG and offer recommendations to investors to take advantage of the opportunities available in the country.

Tightening the screws on cross-border transactions

1. Import substitution

The FG implemented the import substitution policy to reduce the county's dependence on foreign markets. Thus, while it did not reverse the policy in respect of the ban on some imported items, the government granted incentives to investors that can demonstrate that it has incorporated the policy in its programme. For instance, manufacturers of dairy products that have started breeding animals for milk production locally were granted temporary access to forex reserves through the official window to import semi-processed milk.

2. Procurement arrangement

Typically, most multinationals use related parties set up in tax friendly jurisdictions as procurement companies for the importation of tangible items into Nigeria. According to the FG, some of these procurement companies charge non-competitive mark-ups for their services.

"Despite all these efforts, by August 2021, Nigeria was still one of the most highly indebted countries in the world"

Consequently, in 2020, the CBN amended the policy to increase the level of transparency in the billing process. Importers that use procurement-related parties are now required to produce copies of the actual terms of the arrangement with the Original Equipment Manufacturers (OEM) as a precondition for accessing forex through the official window. Transfer Pricing Regulations were also amended accordingly.

3. Aggressive review of forex use and tax audit exercise from non-traditional quarters

In 2015, both the legislative and executive arms of the government started reviewing the records, especially those relating to the allocation of the CBN's forex in a bid to establish any form of sanctionable infractions. One of the leading telecommunication companies in Nigeria was the first casualty. Between 2015 and 2019, the multinational battled with the Office of the Attorney General of the Federation and CBN over an alleged underpayment of taxes in respect of imports into Nigeria and unapproved repatriation of forex, respectively. The combined value of the alleged infraction was about $10.10 billion. It should be noted that the average forex reserves of the country during the same period were $43 billion, implying that one company allegedly fleeced the country of 25% of total forex reserves.

4. Closure of land border

Nigeria shares land borders with the Republic of Benin in the west, Chad and Cameroon in the east, and Niger in the north. There are significant economic activities along the borders.

In March 2020, Nigeria decided to close its borders to prevent the smuggling of banned items and encourage the consumption of locally produced substitutes. The border closure was expected to be a temporary measure that would reduce pressure on the use of forex reserves. However, the borders were still closed about 18 months thereafter.

5. Taxation of the players in the digital economy

In a bid to shore up fiscal revenue, Nigeria abstained from signing the OECD's Two Pillar Solution to address the tax challenges arising from the digitalisation of the economy. Rather, it incorporated the concept of Significant Economic Presence (SEP) into its local tax laws.

- The Companies Income Tax (SEP) Order 2020 requires companies that derive gross turnover or income of over ₦25 million (about $61 000 as of October 2021) through digital or related services outlined in the Order to file and remit Companies Income Tax (CIT) returns in Nigeria.

It is expected that the revenue that will be generated from this hitherto non-taxed sector will augment the lean fiscal revnue.

Despite all these efforts, by August 2021, Nigeria was still one of the most highly indebted countries in the world. Based on the proposed 2022 budget, the FG expects to spend ₦3.61 trillion on debt servicing, which comprises about 36% of the total expected revenue of ₦10.13 trillion for the year.

Notwithstanding the above measures to tighten cross-border transactions, the FG has established policies to accommodate investors and encourage the inflow of foreign direct investment into the country.

1. Exemption from incorporation

The Federal Executive Council has exercised its power to grant exemption to certain foreign companies from the statutory requirement to incorporate a local company in Nigeria. The categories of eligible foreign companies include:

- Those invited by or with the approval of the FG to execute special projects
- Those who are in Nigeria for the execution of specific loan projects on behalf of donor countries or international organisations
- Foreign government-owned companies engaged solely in export promotion activities
- Engineering consultants and technical experts engaged in specialist projects under contracts with any of the governments of the federation or their agencies or under contracts with any person where such contracts have been approved by the FG

The exemption will dispense the need for companies that provide the above listed to incorporate local subsidiaries but may continue to operate in Nigeria as non-resident companies with the benefits of local companies.

2. Pioneer status

Interested companies are required to apply to the Nigerian Investment Promotion Council (NIPC), after which the NIPC will issue the pioneer status certificate. Some of the benefits of pioneer status include:

- Profits derived by the pioneer company from pioneer products are exempted from CIT.
- Qualifying capital expenditure incurred during the tax relief period is treated as having been incurred on the first day following the tax relief period.
- Dividends paid out of pioneer profits are not taxable.
- Losses incurred during the tax relief period are deemed to be incurred on the first day following the tax relief period and can be set off against the assessable profits of the company in subsequent tax years.

3. Location within a Free Trade Zone (FTZ)

Approved entities operating within the FTZ are exempt from Federal, State and Local Government taxes, levies and rates. Approved entities can import 'any capital goods, consumer goods, raw materials, components or articles intended to be used for the purposes of and in connection with an approved activity' free of customs duty charges.

Concluding thoughts

It is evident that Nigeria must closely regulate cross-border transactions to avert impending inflation and economic regression. Unfortunately, the FG's policies also entail a negative impact for companies heavily involved in the importation of the restricted items.

We have observed that investors that have adjusted their value chain for deeper backward integration into Nigeria's economy are receiving enormous support from the government. Similar support is available to any other investor that plans to follow suit.

TANZANIA CROSS-BORDER TRENDS:

New winds?

15 minutes CPD

RISHIT SHAH, Partner/Director at PwC Tanzania

Tanzania has developed a reputation for being a high tax risk location. With the change in political leadership, it appears there is hope for more business-friendly policies. This hope is further supported by Tanzania's unique growth picture.

Many in Tanzania and outside would be pondering what a difference a year makes! In the last 12 months as a country, we have witnessed a yoyo ride in terms of the pandemic, have held an election and in March this year sadly lost our fifth president. Perhaps the most dramatic development has been to have a female president for the first time in the country's history, namely Mama Samia Suluhu Hassan who is currently the only female president in Africa with executive powers (Sahle-Work Zewde of Ethiopia's position as president is only a ceremonial one).

Tanzania's growth in 2020 of 4.8% (2019: 7.0%) though impacted by the global pandemic nevertheless was much more robust than the negative average rates for sub-Saharan Africa. All sectors showed growth apart from the hospitality sector (which was expected due to the pandemic). In addition, the currency has been stable for the last two years and inflation has remained under 5% over the same period.

However, positive macroeconomic results should not camouflage our historic challenges. Tanzania's challenges in recent years concerning investment and doing business are well known. To recap, I have summarised them below:

- Policy – There have been legislative and policy changes with little if any consultation (sometimes resulting in dysfunctional regulations) and often with a very short period for the affected stakeholders to implement the changes.
- Distrust of and consequent hostility to foreign investment and the private sector generally – As evidenced in legislative changes (e.g. the 2017 extractive sector changes), administrative changes (e.g. difficulty in getting work permits renewed even for C-suite of multinationals), liberal use of economic sabotage rules (and consequent arrests) and a move of certain activities from the private to the public sector.

- Aggressive revenue targets and the consequent impact on the approach taken by the Tanzania Revenue Authority (TRA) officials – for example, it was common to see agency notices issued which led to the freezing of bank accounts, withdrawal of funds and a general default to the most extreme/negative interpretation (as a defensive measure) of the legislation. A task force had also been created and a lot of powers were given to this unit, including the power to arrest without necessarily going through the tax dispute resolution process.
- Tax dispute resolution – Generally, there was a sense that there was not a balanced playing field, with concerns that tax assessments were sometimes rushed with the aim to accelerate the payment of the minimum one third tax payment deposit to validate an objection and against a background of appellate level decisions more often than not going the way of the TRA in more recent years.

However, following the election in October 2020, there was a noticeable positive change in attitude and language, and a reaching out to investors (evidenced not least by the late former President making a direct reporting line to him from the Minister for Investment) – recognition that action needed to be taken to turn the tide on depressed inbound foreign direct investment in recent years. These initiatives have gathered even more pace in the last six months or so under the new president and garner a much more positive investor mindset regarding Tanzania.

Overall, a change in tone or approach on several fronts has helped confidence to slowly return. Some areas that have been positively affected are:

- The U-turn on the approach to the pandemic has meant the World Bank approved assistance in May 2021 through three projects with combined financing of $875 million from the International Development Association. In addition, the International Monetary Fund (IMF) last month approved $567 million as emergency lending for Tanzania's economic recovery against the pandemic.
- Relaxation in the issuance of work permits by recognition of 'opening our borders to professional talent'. Steps are in place to extend the work permit maximum period to eight years from the current five years and it now takes around seven working days for work permits to be issued. The latter has been possible by automating the process, rationalising supporting documents and applications being done online.
- The TRA has moderated their approach – and looked to better understand taxpayer concerns; for example, the new Commissioner General recently hosted a stakeholder discussion with large taxpayers to seek to understand their grievances. To support the image of the TRA, mediation was introduced on 1 July in the Tax Revenue Appeals Act as well as the reintroduction of the power given to the TRA to waive interest and penalties. A plethora of agency notices on bank accounts that had been in place were lifted with the focus of moving to dialogue between the taxpayer and the TRA.
- Measures have been taken to increase liquidity by the government. The key development has been the commencement of payment of the backlog of VAT and other tax refunds. For some taxpayers, such refunds go back more than three years. The government has also increased the frequency of payments to subcontractors.

- There has been a conscious effort on regional outreach with Mama Samia travelling to many neighbouring countries. These trips have had a positive effect on trade in particular with the East African Community (EAC). Tanzania has also recently completed the ratification of the Africa Continental Free Trade Area (AfCFTA) Agreement. The AfCFTA Agreement provides an opportunity to face the current trade and economic development challenges in Africa in a manner that will greatly assist to grow the continent's trade volumes and consequently respective countries' economies.
- Many initiatives on rebranding and encouraging investment into large-scale assembly manufacturing and production facilities have taken place in the last six months. The last budget in June also saw many measures taken to protect local industries. Dialogue has taken place with the key stakeholders in the extractive sector and negotiations are about to commence with various LNG companies.
- A very aggressive outreach has been made to investors in so far as Zanzibar is concerned by launching a new tax and residency programme for expatriates to live and invest in the island. Under this new programme, foreigners who buy property will qualify as investors and will enjoy a few tax and other benefits.

In conclusion, I would like to recite the famous quote from Tom Lehrer: "Life is like a piano. What you get out of it depends on how you play it". Similarly for Tanzania, while the composition of the "improved and trusted business environment" song has started with optimism, playing the right notes like meaningful consultation and collaboration on policy changes, promoting trust, accelerating the implementation of the Blueprint for regulatory reforms to improve the business environment ('the Blueprint'), timely completion of the negotiations in relation to the Host Government Agreement for the processing of gas and carrying out a review of the legislation for the extractive sector will create a musical 'win-win' business environment. God bless Africa; God bless Tanzania!

"All sectors showed growth apart from the hospitality sector (which was expected due to the pandemic). In addition, the currency has been stable for the last two years and inflation has remained under 5% over the same period"

ZAMBIAN CROSS-BORDER TRENDS:

Rollercoaster tax policy

15 minutes CPD

▶ **PATRICK MAWIRE,** Country Managing Partner at EY

Zambia is known for its wild swings in tax policy, especially concerning mining. Can Zambia's new leadership find the right balance?

Over the past decade, Zambia has witnessed significant changes to its tax policy, many of which have had a significant impact on investor sentiment, particularly in the mining sector. Fiscal authorities have grappled with the pressure to show significant economic improvements on the back of the mining industry. The mining industry has been Zambia's largest export income earner and the government has been anxious to translate this into dramatically improved economic conditions for the general population. A significant breakdown of trust between the government and the mining industry has also led to what could only be termed knee jerk reactions to the tax policy, with a desire to increase the tax take at the expense of longer-term growth objectives.

A history of conflict

Some of the controversial tax policy measures across the years have included the following:

- In 2008, Zambia introduced a 15% profit variable tax and a 25% revenue-based mineral windfall tax. The corporate tax rate applicable to mining was also increased to 30% from 25%. Mineral Royalty Tax (MRT) was also increased to 3% from 0.6%. These measures were introduced at the top of the late 2000s commodity price boom that soon evaporated in the global recession that followed. In reversing these measures, in 2009, the then Minister of Finance Mr Situmbeko Musokotwane (who incidentally is the newly appointed Minister of Finance under the recently elected government) acknowledged that in a ministerial statement that the measure had led to effective tax rates of between 64% and 96% for high-cost mines and between 57% and 64% for low-cost mines.
- Despite the reversal of the 2008 measures in 2009, MRT has gradually increased to the current maximum of 10% for copper prices above $9 000 per tonne effective 1 January 2019. Furthermore, MRT was subsequently made non-deductible, resulting in a significant adverse impact on effective tax rates for mining companies.
- The introduction of documentation requirements for VAT export zero rating purposes (VAT Rule 18) which led to the accumulation of significant amounts of refunds for both mining and non-mining entities that are still unpaid (current estimate over $1 billion). VAT Rule 18 requires an exporter to produce proof of export up to the final destination of goods, which is impractical in many cases.

"The uncertain fiscal environment has led to declining copper output, even with historically high copper prices. Discoveries of gold and an increase in cobalt production have not been able to offset the loss of revenue arising from failing copper output"

- The imposition of a 5% duty on imported copper concentrates led to a significant loss of refining capacity as copper refineries could not import ore rich concentrate that was critical to the operation of most refineries in Zambia given the low grade of copper available locally.
- Piecemeal adoption of the Base Erosion and Profit Shifting (BEPS) agenda, including the introduction of Country-by-Country Reporting without signing the multilateral instrument (MLI).

The key driver for many of the tax changes has been a breakdown of trust between the government and the mining industry. In the face of what the government has considered aggressive tax avoidance by the industry, the government has responded with sweeping tax changes rather than targeted enforcement. Each measure has fractured already frail relations between the government and the industry. This was exacerbated when the government placed Konkola Copper Mines under involuntary liquidation.

The uncertain fiscal environment has led to declining copper output, even with historically high copper prices. Discoveries of gold and an increase in cobalt production have not been able to offset the loss of revenue arising from failing copper output. Many new projects have been left moribund with mining houses waiting for direction from the government on a new fiscal regime, particularly the reform of the MRT regime. The President of the Chamber of Mines, Dr Godfrey Beene, recently estimated that a favourable fiscal regime could unlock up to $2 billion in expansion projects.

The New Dawn Government

The New Dawn Government, as they have coined themselves, were ushered into office following the national presidential elections on 22 August 2021. The new President Mr Hakainde Hichilema has made the reform of the mining fiscal regime a priority of his administration. This is in the face of a significant national debt burden and fiscal deficit. The revenue projected in the 2021 national budget could only fund about 52% of the projected spending, most of which was targeted at debt servicing and public sector emoluments. The two budget items accounted for about 90% of the spending for the year. The COVID-19 pandemic added significant pressure to the fiscus with growth in 2020 contracting by 1.2%.

The new Finance Minister has announced a plan to achieve an annual growth rate of 10% by 2030. The government has also indicated that it plans to provide an environment that will boost copper production to about 3 million tonnes per annum from the current production of under 1 million.

While the Minister of Finance has not yet provided a detailed tax policy in advance of his budget speech, he has outlined the broad fiscal objectives of the new government. These include plans to broaden the tax base and reduce the individual tax burden. Emphasis will be on improving the collection of consumption taxes and property taxes. The new administration has also identified the reform of tax administration as a key objective. The reform process will include further enhancing the technological capabilities of the Zambia Revenue Authority (ZRA).

The minister has also indicated that he has embarked on a process of consultation with key stakeholders on a new mining tax regime. While the proposed measures are due to be announced in the upcoming budget speech, there will likely be significant reform to the MRT regime.

The appointment of a new Commissioner General of the ZRA with a background in technology and tax modernisation is an indication that the government intends to further enhance the digital and technological capabilities of the ZRA. While the ZRA has been able to build one of the most robust and capable tax online systems globally, the full realisation of those capabilities remains a challenge. The lack of technological advancement within the ecosystem in which the ZRA operates has hindered the authority's efforts to efficiently leverage the use of digital capabilities available to them. The challenges include the lack of a digital personal identity system and limited penetration of fourth generation point of sale and payment systems. These challenges will require a broader government agenda beyond the ZRA and the Ministry of Finance. The new president has indicated that these challenges will be given priority and he has signalled his intent by establishing a new Ministry of Technology that will be responsible for driving this agenda.

The way forward

The nation eagerly awaited for the new minister to present his 2022 National Budget on 29 October 2021. The presentation was delayed for a month to allow the new government to infuse some of its agenda items into the budgeting process. However, the minister has indicated that it would be too soon to expect the 2022 budget to be fully reflective of the new government's policy agenda. The minister expects that the 2023 National Budget will be more reflective of the government's agenda. However, it is expected that the 2021 budget will deal with some of the more urgent matters and set the tone for the mining industry and other stakeholders. The Zambian business sector is anxious to gauge if indeed there is a move towards stability in the Zambian tax system or whether more turbulence should be expected ahead.

CASE LAW WRAP-UP

JASHWIN BAIJOO, jashwin@taxconsulting.co.za
JOSHUA TORPEY, joshua@taxconsulting.co.za
THOMAS LOBBAN, thomas@taxconsulting.co.za

PUBLIC PROTECTOR SOUTH AFRICA V THE COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICE (84074/19) (435/2020)

Issue

In this matter, the Constitutional Court canvassed two issues. The first was the condonation of the late filing regarding an application for leave to appeal, and the second was an application for leave to appeal, as sought by the Public Protector ('the applicant') against the Gauteng High Court's judgment of 23 March 2020 ('the High Court judgment') in favour of the Commissioner of the South African Revenue Service and others ('the respondents').

Facts

The High Court judgment passed on 23 March 2020 can be summarised as below:

1. A SARS official is permitted and required to withhold taxpayer information, to which information the subpoena powers of the applicant do not extend.
2. Not only was the applicant's counter-application dismissed with costs, but the applicant was also ordered to pay the costs of the application, including that of two counsels, together with a 'de bonis propriis' or penalty cost order, being 15% of the applicant's taxed costs.

In seeking to appeal this judgment, the applicant failed to timeously submit its application for leave to appeal within the stipulated 15-day period, as per Rule 49(1) of the Uniform Rules of Court. This failure has resulted in the current application for condonation in terms of Rule 49(1)(b) of the Uniform Rules of Court for which the applicant must provide evidence of the prospects of success on the merits of the appeal, provide reasonable grounds for the late filing of the application, provide reasonable grounds for the extended delay in the late filing, and provide evidence to the Court that the respondents would suffer no prejudice by the granting of condonation.

As both the application for condonation and application for leave to appeal hinge on the same requirement, being the prospects of success, for the purposes of this judgment, that was the only requirement addressed in line with section 17(1) of the Superior Courts Act.

The applicant's reason for delay, and the length thereof, was that it had erred in judgment, and, instead of approaching the Full Bench of the High Court or Supreme Court of Appeal, it directly approached the Constitutional Court to appeal the High Court judgment which court refused to deal with the application. In the current matter, it is found that this rationale is both reasonable and acceptable.

The applicant's case

In the court *a quo*, the applicant argued the powers as per section 7(4) of the Public Protection Act (PPA), superseding those of the Tax Administration Act (TAA), which argument is maintained in the present matter, even though the same forms part of the court a *quo's* judgment.

The applicant argued that the judgment passing on its subpoena powers was in error, as it centered on sections 11(3) and 11(4) of the PPA, which the applicant deemed irrelevant. Further, the Public Protector's powers emanate directly from the Constitution and not the PPA, as previously held.

Counsel for the applicant also argued that merits of the matter must be considered and that they were not conclusively considered by the Constitutional Court and therefore not *res judicata.*

The respondents' case

The respondents' counsel argued that the applicant had no prospects of success, which alone was enough to refuse the application for condonation.

The constitutionality of section 69(1) of the TAA was not previously raised by the applicant and so, as correctly argued by counsel for the respondents, cannot at this stage be raised in this forum. Furthermore, this in itself was the main reason for the Constitutional Court refusing to hear the matter.

The point of 'institutional bias', another point which was not previously raised, finds no support in the objective facts of the matter and, as such, the applicant cannot succeed here either. Counsel for the respondents, in short, centered its argument on the applicant's flawed understanding of the applicable legislation and incorrect interpretation thereof.

Outcome

The Court was not satisfied of the applicant having passed the test as per section 17(1) of the Superior Courts Act, nor that a different court would conclude differently.

The rationale for this was that the constitutionality of section 69(1) of the TAA, as previously not articulated, cannot be noted as a grounds of granting leave to appeal. The basis of 'institutional bias' was also never fully fleshed out and not satisfactorily argued by the applicant's counsel. As stated by the learned Judge Mabuse, "the contention of institutional bias is simply confused".

Furthermore, the applicant, again with a flawed interpretation of the law, had come across as seeking to appeal an argument, rather than a judgment. The applicant offered no argument for 'just cause', a point which it conceded to, and the applicant's course of action, even if the procedural flaws are ignored, followed undue process.

From the above, the applicant failed in satisfying not just the requirement pertaining to its prospects of success, but holistically, in satisfaction of all noted requirements.

Takeaway

It is of integral value that the right to privacy, as enshrined in the Constitution, be upheld by all stakeholders, both public and private alike. These basic human rights must, in the hierarchy of laws, be ranked above permissive provisions.

SARS is obligated to ensure the protection of all confidential taxpayer information which is not covered by the Public Protector's subpoena powers and access to which will require additional permissions.

It must further be noted that although this right to privacy is absolute, there are instances in which even SARS may be obligated to divulge certain information, as per the Access to Information protocols implemented on an inter-revenue authority basis.

CSARS V VAN DER MERWE AND OTHERS
(7255/2019) [2021] ZAWCHC 197 (21 SEPTEMBER 2021)

Issue
The first issue in this matter was whether the respondents should be declared vexatious litigants in terms of section 2(1)(b) of the Vexatious Proceedings Act (VPA).

Facts
The applicant (SARS) approached the High Court for relief, following numerous applications brought against it by the respondents.

The Court considered, in detail, the historical nexus of the matter, which stemmed as far back as 2004, when SARS initially investigated and later charged one of the respondents with numerous fraud and tax-related offences. This led to various legal proceedings being instituted against the respondents which, as at the date of the judgment in this matter, have not yet been finalised.

SARS constantly attempted to recover the respondent's assessed tax liability. Eventually, on 30 August 2013, SARS obtained an ex parte preservation order in terms of section 163 of the Tax Administration Act (TAA), against the assets of the respondents and certain connected persons in relation thereto. Following an inquiry into the tax affairs of the aforementioned parties, SARS accordingly raised assessments against them.

Thereafter, instead of following the normal dispute resolution avenues, the respondents instituted a number of proceedings against SARS and various other parties, causing unnecessary complexity and delay to the dispute, which could have been resolved via the normal dispute resolution mechanisms.

In any event, on the numerous occasions that the applications were instituted by the respondents, a number of these applications were dismissed with punitive costs awarded against them and in favour of SARS.

The applicant's case
The applicant sought the striking out of certain paragraphs and an annexure of the respondents' answering affidavit on the basis that the material was irrelevant, vexatious, scandalous or inadmissible and was prejudicial to SARS.

There appears to be no indication in the judgment of SARS' argument in the Vexatious Litigant aspect.

The applicant opposed the striking out application on the basis that one of the respondents lacked *locus standi* in relation to the objections raised in respect of the other respondents, nor was their evidence inadmissible, irrelevant or in breach of the confidentiality provisions of the TAA.

The respondents' case
The respondents argued that the order in terms of section 2(b) of the VPA should not be granted, as much of the litigation that could be instituted by the respondents has already been instituted and that there is little purpose in declaring the respondents as vexatious litigants.

Outcome
The Court found in favour of the applicant, with costs awarded against the respondents.

Core reasoning
The Court granted SARS' striking out order on the basis that the numerous allegations raised by the respondents were scandalous, frivolous and vexatious, and found that there would be no prejudice to the respondents in this instance.

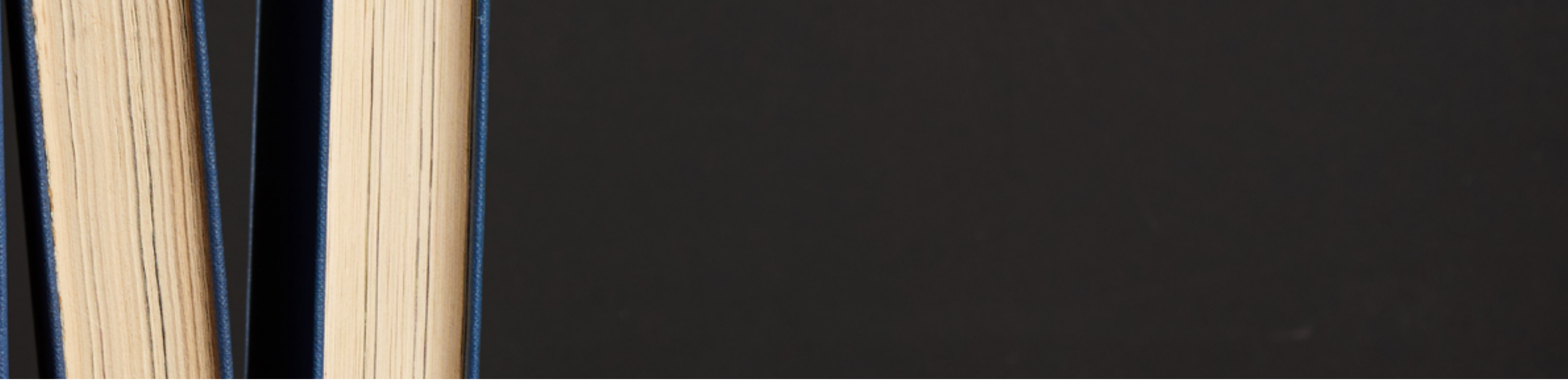
The court commented that a scandalous matter consists of "allegations which may or may not be relevant but which are so worded as to be abusive or defamatory", a vexatious matter consists of "allegations which may or may not be relevant but are so worded as to convey an intention to harass or annoy" and an irrelevant matter consists of "allegations which do not apply to the matter in hand and do not contribute one way or the other to a decision of such matter".

In relation to prejudice, it was said that this "does not mean that, if the offending allegations remain, the innocent party's chances of success will be reduced. It is substantially less than that. How much less depends on all the circumstances…". The respondents were found to have met the comments made in this judgment as far as scandalous, vexatious and irrelevant matters are concerned.

The Court found that neither was the material introduced by SARS inadmissible nor had it been put up in breach of the confidentiality provisions detailed in section 68 of the TAA (which protects a taxpayer's right to confidentiality of personal information), with regard to the tax affairs of the respondents, which were directly relevant to the issues raised in the main application.

There was, therefore, no basis to the striking out of the application. It was found that SARS would suffer prejudice if the respondents' allegations against it were not struck out due to the allegations having no basis.

Section 2(1)(b) provides a mechanism for a court to declare an individual to be a vexatious litigant, which, limits this person's



ability to institute any action or application against any other person, without leave of the court to do so.

Takeaway

Taxpayers should be cautious in instituting frivolous and vexatious matters against SARS in fear of being ordered to be a vexatious litigant. Taxpayers contemplating any litigation against SARS should always be mindful of section 2(1)(b) of the VPA. The consequences of being declared a vexatious litigant can be long-standing to a taxpayer's future litigatory endeavours and of a costs order being awarded against the taxpayer.

ABC TRADING V COMMISSIONER FOR SARS (SARSTC VAT 1908) (21 JUNE 2021)

Issue

The core issue before the Tax Court in this case was whether the appellant was entitled to be deregistered as a vendor for VAT purposes.

Facts

The vendor conducted the business of administering funeral policies on behalf of a long-term insurer ('the insurer'). It was both a registered VAT vendor and financial services provider. Its business involved negotiating policies on behalf of the insurer; collecting these premiums and paying them over to the insurer; submitting detailed monthly collection reports; and processing claims by beneficiaries. The appellant was paid an administration fee by the insurer for these services.

On 31 October 2016, the appellant applied to SARS to be deregistered as a VAT vendor. The application was denied by SARS on the basis that the appellant was acting as an administrator for the insurer and charges an administrative fee that is subject to VAT.

Following unsuccessful appeal proceedings with the Tax Board, the vendor lodged a further appeal with the Tax Court for hearing.

The appellant's case

Counsel for the appellant argued that the fees which the appellant is paid by the insurer for performing its administration services formed part of the premium.

The insurer was VAT exempt in terms of section 12 of the VAT Act as a supplier of a deemed financial service as defined in section 2(1)(i) of that Act. Its business qualified as a deemed financial service since the proviso to section 2(1) of the VAT Act, which provides that the service of providing advice directly in connection with VAT-exempt financial services for a separate fee would not be deemed a financial service, does not itself directly refer to section 2(1)(i).

Accordingly, the appellant submitted that the fees earned by it would fall outside the exclusions in that proviso and are exempt in terms of section 12 of the VAT Act.

The respondent's case

The respondent argued that the determining factor was actually whether the appellant's business constituted the 'provision of a long-term insurance policy' in terms of section 2(1)(i). In the absence of this, the proviso was irrelevant. While the appellant may have advanced the services of the insurer, it did so as an independent contractor.

Outcome

The Court found in favour of the respondent, SARS.

Core reasoning

The appellant's argument was fundamentally flawed, given that the issue to be considered was not whether the intention of the legislature was for the proviso to section 2(1) to have the fees earned by those conducting similar services to the appellant be exempt for VAT purposes. Rather, as correctly argued by SARS, the determining factor was whether the appellant's business constituted the 'provision of a long-term insurance policy' as defined. As this was not the business of the appellant, the proviso was irrelevant to the matter.

The agreement between the appellant and the insurer confirmed that the appellant was an independent contractor, carrying out a separate trade to the insurer. In terms of the agreement, inter alia, the appellant had no authority to determine premiums under a policy, nor settle a claim. (It could pay claims but not reject them.)

In short, it was abundantly clear that the appellant was performing entirely administrative services on behalf of the insurer and for consideration in the form of a fee. It did not itself provide a long-term insurance policy.

Takeaway

Taxpayers should ensure that they understand their tax obligations when entering into an agreement for the rendering of services. In each case, the VAT consequences of the specific services rendered must be taken into account when determining the amount and nature of the consideration to be paid.

BINDING RULINGS

JOSHUA TORPEY, joshua@taxconsulting.co.za

BINDING CLASS RULING: BCR
Capital Gains Tax consequences of in specie *distribution by a company to its shareholders*

Issue

This ruling determines the capital gains tax consequences of an *in specie* distribution by a company to its shareholders.

Facts

The applicant is a listed company incorporated in and a resident of South Africa. The applicant and its subsidiaries are holding companies with portfolios of interests in various companies. Their objective is to hold the investments on capital account.

The applicant and its subsidiaries have commenced a corporate restructuring. The proposed transaction is the last step in the restructuring. Before the restructuring commenced, the applicant and its subsidiary structure was as follows:

- The applicant held all the ordinary shares in Company A, a resident company that is a wholly owned subsidiary of the applicant.
- Company A held all the ordinary shares in Company B, a resident company that is a wholly owned subsidiary of Company A.
- Company B held all the shares in Company C, a non-resident company and the majority of its shares are held by Company A. Company C has a primary listing of its ordinary shares on both the JSE and on a foreign exchange. Company C is a controlled foreign company in relation to Company B.

It is proposed that the shares in Company C be distributed to the shareholders of the applicant. The eventual distribution of the shares of Company C entails various transaction steps, some of which have already been implemented. The proposed transaction relevant for this ruling is the final transaction step.

Transaction steps one to three have been implemented as follows:

a) **Step one:** Share consolidation – The issued ordinary shares in Company C were consolidated to eliminate fractional shares.

Step two: Unbundling of Company C shares – Company B unbundled all its shares in Company C to Company A in accordance with paragraph (b) of the definition of 'unbundling transaction' in section 46(1).

b) **Step three:** Asset-for-Share Purchase – Company C acquired investment assets from Company B in exchange for the issue of its own shares to Company B.

Transaction step four will be implemented as follows:

c) **Step four:** Equity Repurchase –

i) Company A will repurchase a certain number of its own ordinary shares from the applicant at a certain consideration amount. The repurchase consideration will be settled by Company A transferring a certain number of shares in Company C to the applicant and will reduce the contributed tax capital of Company A's ordinary shares. The base cost of shares that the applicant holds in Company A will also be reduced.

ii) The applicant will acquire an aggregate base cost in Company C shares equal to the value of those shares. The values at which this transaction step will be done will be determined by the applicant.

The final transaction step which is the proposed transaction will be implemented as follows:

e) **Step five:** Distribution of Company C shares – The applicant will distribute *in specie* all the shares it holds in Company C to its shareholders. The distribution will reduce the applicant's contributed tax capital.

Ruling

This ruling is subject to the following additional conditions and assumptions:

a) The directors of the applicant will pass a resolution, directing that the distribution of Company C shares will constitute a return of capital and not a dividend.

b) The shareholders of the applicant will hold their shares on capital account.

The ruling issued by SARS is as follows:

a) The distribution *in specie* by the applicant of Company C shares to its shareholders will fall within the ambit of paragraph 75. Consequently, the shareholders will be treated as having acquired Company C shares for expenditure equal to their market value on the date of distribution as contemplated in paragraph 74, which expenditure will be treated as expenditure actually incurred by each shareholder for purposes of paragraph 20(1)(a).

b) The shareholders must, in terms of paragraph 76B(2), reduce the expenditure in respect of their shares held in the applicant by the amount of the market value of Company C shares determined on the date that Company C shares are received or accrued to the shareholders.

c) Where the market values of Company C shares as contemplated in paragraph 76B(2) exceed the expenditure in respect of a shareholder's shares in the applicant, the excess amount must, in terms of paragraph 76B(3), be treated as a capital gain in determining the shareholder's aggregate capital gain or aggregate capital loss for the year of assessment in which Company C shares are received by or accrue to the shareholder.

Cova advisory™

your sustainable service provider

PROFESSIONAL ADVISORY SERVICES

Cova Advisory is a 51% black owned company with a specific focus on government programmes including grants and tax incentives. Cova has positioned itself as an independent advisor on matters ranging from Customs and Excise, Carbon and Energy strategy, green related funds, Carbon Tax and carbon policies, and renewable energy. Cova has also set up a strong local network within the private and government sectors. To offer a comprehensive service our team is made up of engineers, accountants and lawyers.

Cova Advisory is one of only 7 active inspection bodies accredited by the South African National Accreditation System (SANAS) to measure and verify energy savings (Certification Number EEMV0007). Our team comprises certified Measurement and Verification (M&V) professionals to do this inspection work.

What we do

Cova Advisory has unrivalled expertise in 4 key areas:

- Providing advice on the tax incentives and government grants which the South African Government has on offer for new projects.
- Providing advice on the green landscape and government measures to encourage firms to become more energy efficient.
- Customs and Excise advisory work.
- DFI finance raising

Incentive advisory services

Cova offers a comprehensive service to companies on the grants and incentives offered by government to various sectors of the economy. This includes the assessment of projects to determine the best support scheme(s) available and assistance with the preparation of applications, liaison with government agencies and the vital follow-up on successful applications to ensure all criteria for sustained support are

Business advisors on Customs matters

Cova plays an integral role in facilitating inward and outward investment by providing Customs and Excise advisory services to companies operating in various sectors. Our aim is to assist companies with navigating their way through the process of entering new markets as well as mitigating Customs and Excise risks and ensuring compliance.

Our Customs and Excise services include:

- Registrations with the International Trade Administrations Commission of South Africa (ITAC).
- Customs dispute resolution
- Customs valuation opinions
- Customs registrations
- Stage consignment rulings
- SARS preferred trader programme
- IDZ / SEZ advisory
- Tariff opinion
- Trade Agreement advisory (including Rules of Origin and Authorised Economic Operator)
- Rebate compliance
- Trade agreements (e.g. AfCFTA) – impact and planning for the future
- Customs & Excise training

Energy and carbon advisory services

Cova is ideally placed to help companies to understand the challenges related to going green, and to reap the rewards of adopting a green strategy.

Accreditation

Cova Advisory is one of only 7 active inspection bodies authorised by the South African National Accreditation System (SANAS) to measure and verify energy savings. Our team comprises certified professionals to do this inspection work in energy Measurement and Verification (M&V). Our energy advisory services include:

- Measurement and Verification services for the Section 12I and Section 12L Tax Allowance Incentives.
- Energy audits.
- Drafting of energy management plans.
- Carbon related services including carbon emissions reporting and carbon policy assistance.
- Carbon Tax advisory, including Carbon Tax calculations and Carbon Tax registration with government.
- Carbon offset advisory.

DFI finance advisory services

Cova Advisory can assist companies with raising finance from the various Development Finance Institutions (DFIs) in South Africa through a process of:

- **Opportunity assessments:**
- **Creating a funding strategy:**
- **Project preparation:**

COVA advisory™

your sustainable service provider

Incentives | Customs | Energy | Finance

@cova_advisory Cova Advisory B-BBEE Level 2

Building 1 | Magwa Crescent
Maxwell Office Park | Waterfall City | Midrand
011 568 3340
info@cova-advisory.co.za
www.cova-advisory.co.za

Directors | Duane Newman | Tumelo Chipfupa


SUBSCRIBE TO
TAXTALK
TAXTALK
ROAD TO RECOVERY
DIGITAL
SUBSCRITION
1 year / 6 issues
R150
SUBSCRIPTION METHODS:
Email info@thesait.org.za
Call +27 (12) 941 0400
Visit https://www.thesait.org.za/page/taxtalk_journal