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# Corporate Tax

**South Africa**
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# SOUTH AFRICA


## Law and Practice

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## Contents

# 1. Types of Business Entities Commonly Used, Their Residence and Their Basic Tax Treatment

## 1.1 Corporate Structures and Tax Treatment

Businesses usually adopt the form of a South African incorporated company. A South African tax resident company is taxed as a separate taxpayer, at a flat rate of 28%. 80% of capital gains are included in taxable income, giving an effective Capital Gains Tax (CGT) rate for companies of 22.4% (28% x 80%).

Alternative forms that businesses adopt are unincorporated businesses, where the business is carried on either in the name of an individual, or in a partnership between partners.

Individuals are taxed on a progressive basis up to a maximum tax rate of 45%. 40% of capital gains are included in an individual's taxable income, so the maximum effective CGT rate for individuals is 18% (40% x 45%).

Partnerships are not recognised as separate entities for income tax purposes and are fiscally transparent. Instead, the individual partners are taxed separately on their share of the partnership profits. The income and expenses of the partnership retain their nature and are taxed as such in the individual partner's hands.

## 1.2 Transparent Entities

**Partnerships**

Partnerships are commonly used as the main fund vehicle in the private equity sector.

Partnerships are not recognised as separate entities for income tax purposes and are fiscally transparent. Instead, the individual partners are taxed separately on their share of the partnership profits. The income and expenses of the partnership retain their nature and are taxed as such in the individual partner's hands.

**Trusts**

Where the income and/or capital gains of a trust do not vest in a beneficiary of the trust during the tax year in question, such income is taxed in the trust at a flat rate of 45%, while 80% of capital gains are included in the trust's taxable income (resulting in an effective tax rate of 36% on capital gains).

Trusts are commonly used as a collective vehicle for staff share schemes and Black Economic Empowerment schemes.

## 1.3 Determining Residence

A person other than a natural person (which therefore includes companies, partnerships and trusts) is a South African (SA) tax resident if it is incorporated, established or formed in SA, or if it has its place of effective management in SA.

## 1.4 Tax Rates

**Company**

Resident companies are taxed at a flat rate of 28% on income, with capital gains being taxed at an effective rate of 22.4% (28% x 80% inclusion).

**Individual**

Resident individuals are taxed on a progressive basis up to a maximum rate of 45%, with capital gains being taxed at an effective maximum rate of 18% (40% inclusion multiplied by the applicable income tax rate).

**Trust**

Where the income and/or capital gains of a trust do not vest in a beneficiary of the trust during the tax year in question, such income is taxed in the trust at a flat rate of 45%, while 80% of capital gains are included in the trust's taxable income (resulting in an effective tax rate of 36% on capital gains).

**Partnership**

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# 2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

## 2.1 Calculation for Taxable Profits

Taxable profit is referred to as "taxable income". Simply put, this is calculated as follows:

- gross income (included at earlier of receipt or accrual);
- minus exempt income (specific exemptions specified in the Income Tax Act);
- minus deductible expenditure (general deduction of expenditure when incurred and specific deductions specified in the Income Tax Act);
- plus relevant percentage inclusion of net capital gains (capital gains minus capital losses).

## 2.2 Special Incentives for Technology Investments

Section 11(gB) of the Income Tax Act provides a deduction for expenditure incurred in the following, provided such expenditure is used in the production of income:

- obtaining the grant, restoration or extension of term of any patent under the Patents Act;

- the registration or extension of the period of any design under the Designs Act; or
- the registration or renewal of any trade mark under the Trade Marks Act.

Section 11(gC) provides an allowance for expenditure incurred to acquire any:

- invention or patent under the Patents Act (5% per annum);
- design under the Designs Act (10% per annum);
- copyright under the Copyright Act (5% per annum);
- other property of a similar nature (excluding trade marks) (5% per annum); or
- knowledge essential to use the above (% allowance per above).

Section 11D provides the following incentives for "research and development" (as defined in the Income Tax Act) costs:

- a deduction equal to 150% of expenditure incurred directly for "research and development"; and
- an accelerated depreciation deduction (50%:30%:20%) for capital expenditure incurred on machinery or plant used for "research and development".

## 2.3 Other Special Incentives

The following other special incentives apply (please note that the following list is not exhaustive):

- Section 12B – capital allowances for certain assets used in farming or renewable energy;
- Section 12C – capital allowances for certain assets used in manufacture, hotels, aircraft and ships;
- Section 12E – an accelerated depreciation deduction (50%:30%:20%) for "small business corporations";
- Section 12H – additional allowances for "learnership agreements" offered by employers;
- Section 12I – additional allowances to support greenfield investments (ie, new industrial projects that utilise only new and unused manufacturing assets), as well as brownfield investments (ie, expansions or upgrades of existing industrial projects). The incentive offers support for both capital investment and training; and
- Section 12J – tax benefits for venture capital companies and their investors (these provisions are currently being amended).

## 2.4 Basic Rules on Loss Relief

Assessed losses (income losses) may be offset against capital gains; however, capital losses may only be set off against capital gains (not against income).

Capital losses may be carried forward. Assessed losses may be carried forward to future years of assessment, provided that the entity continues to trade (the assessed loss is forfeited if the taxpayer does not trade for a full year of assessment).

Assessed losses and capital losses are particular to the entity/person – ie, they cannot be transferred from one entity/person to another.

## 2.5 Imposed Limits on Deduction of Interest

Interest incurred should meet the general deduction criteria in order to be deductible (importantly, it must be incurred in the production of income, and in the carrying on of a trade).

Section 23M limits the deductibility of interest in accordance with a specified formula where the loan is provided by a person not subject to SA tax (eg, a non-SA resident or exempt person), who or which directly or indirectly holds at least 50% of the "equity shares" or voting rights in that company.

Section 23N limits the deductibility of interest where the loan proceeds are used to acquire:

- equity shares in an "operating company" (being a company that derives income from a business carried on continuously by that company, and in the course of furtherance of which goods or services are provided or rendered by the company for consideration) in terms of section 24O (a minimum of 70% of the equity shares in an operating company must be held by the acquirer in order to qualify for the deduction);
- assets in terms of a section 45 intra-group transaction (corporate rollover relief section to transfer assets between group companies on a tax-neutral basis); or
- assets in terms of a section 47 liquidation/deregistration transaction (corporate rollover relief section to distribute assets between group companies on a tax-neutral basis).

The interest deduction limitation (under both section 23M and section 23N) is currently equal to about 42% of the "adjusted taxable income" (which is essentially the taxable income calculation applied to accounting earnings before interest, tax, depreciation and amortisation), minus other interest incurred (not subject to the limitation) plus interest received/accrued.

Section 31 limits the deductibility of interest in respect of related party cross-border debt in terms of the local thin capitalisation and transfer pricing rules.

## 2.6 Basic Rules on Consolidated Tax Grouping

Group tax is not applicable in SA; each entity in a group is a separate taxpayer. Tax losses may not be transferred between entities, and there are anti-avoidance rules to prohibit transferring assets into a company for the sole or main reason of utilising that entity's tax loss. The acquisition of a company with an assessed loss which exceeds ZAR50 million constitutes a "reportable arrangement".

### 2.7 Capital Gains Taxation

SA resident companies are taxed on capital gains (essentially proceeds minus the base cost in the relevant asset/s) at an effective rate of 22.4%.

There is an exemption from CGT on gains derived from the sale of foreign shareholdings, under paragraph 64B of the Eighth Schedule to the Income Tax Act, if the seller:

- has held at least 10% of the equity shares and voting rights in the company being sold for at least 18 months immediately prior to the sale;
- sells the shares to a non-SA tax resident entity that is not a controlled foreign company (CFC) and is also not a "connected person" in relation to the seller; and
- received proceeds for the shares being sold that are equal to or exceed their market value.

### 2.8 Other Taxes Payable by an Incorporated Business

Securities Transfer Tax is levied upon a transfer of shares, at a rate of 0.25% of the market value of the shares or the consideration paid, whichever is higher.

Value-added tax (VAT) at a rate of 15% may be payable by the seller upon the disposal of certain assets (however, such amount may generally be claimed as an input VAT deduction by the purchaser if the purchaser is itself a registered VAT vendor). The disposal of a going concern can be zero-rated for VAT purposes, and transfers of shares are exempt for VAT purposes.

Transfer duty (rates on a sliding scale) may be payable upon the disposal of property.

Interest, dividend and royalty withholding taxes on payments to non-residents are also applicable in SA, but can be reduced by tax treaties where applicable.

### 2.9 Incorporated Businesses and Notable Taxes

In addition to those taxes already mentioned, employers are responsible for Pay-As-You-Earn (PAYE), which is a withholding of employees' tax, and customs and excise duty may be applicable on imports.

## 3. Division of Tax Base Between Corporations and Non-corporate Businesses

### 3.1 Closely Held Local Businesses

Most closely held local businesses operate in corporate form – ie, as South African incorporated companies.

### 3.2 Individual Rates and Corporate Rates

Companies are subject to income tax at 28%. Post-tax profits distributed to shareholders are subject to dividends tax at a rate of 20% (if they are distributed to an individual and/or person that does not qualify for an exemption or reduced rate). This results in an effective tax rate of 42.4%, ultimately in the hands of an individual shareholder. This rate is comparable to the individual rates, which are on a sliding scale up to 45%.

Furthermore, any company or trust that meets the definition of "personal service provider" and is in receipt of "remuneration" as defined in paragraph 1 of the Fourth Schedule to the Income Tax Act is subject to the deduction or withholding of employees' tax.

### 3.3 Accumulating Earnings for Investment Purposes

No rules prevent closely held corporations from accumulating earnings for investment purposes.

### 3.4 Sales of Shares by Individuals in Closely Held Corporations

Dividends are subject to dividends tax at a rate of 20% (to be withheld by the company, although the tax is imposed on the shareholder other than in the case of dividends in specie, where the company itself is liable for the tax).

If shares are held by an individual on revenue account, the tax profit on the sale of shares is subject to income tax on a progressive basis, up to a maximum tax rate of 45%.

If shares are held by an individual on capital account, the capital gain on the sale of shares is subject to CGT at a maximum effective tax rate of 18%.

### 3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Individuals are taxed on the same basis as set out in **3.4 Sales of Shares by Individuals in Closely Held Corporations**.

# 4. Key Features of Taxation of Inbound Investments

## 4.1 Withholding Taxes

The following withholding taxes apply in the absence of tax treaties:

- dividends withholding tax: 20%;
- interest withholding tax: 15%; and
- royalties withholding tax: 15%.

Relief is provided under applicable double tax agreements (DTAs). Subject to certain requirements being met, specific exemptions are available, such as dividends paid by one SA corporate to another SA corporate.

## 4.2 Primary Tax Treaty Countries

SA has a large tax treaty network, including a large number of treaties with African countries.

## 4.3 Use of Treaty Country Entities by Non-treaty Country Residents

In practice, it is not common for the South African Revenue Service (SARS) to challenge the application of tax treaty relief, with investigations generally being limited to a compliance review of relevant beneficial ownership declarations. South Africa became a signatory to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting ("Multilateral Instrument" or MLI) on 7 June 2017, which will introduce the so-called "Principal Purpose Test" (PPT) into its treaties. It is estimated that this will become effective during the course of the next 12 months. The PTT may result in the denial of treaty benefits where it is reasonable to conclude that one of the principal purposes of an arrangement or transaction was to obtain tax treaty benefits.

## 4.4 Transfer Pricing Issues

Inbound investors may experience transfer pricing challenges as a result of legislative difficulties and uncertainties. One of the biggest challenges faced by inbound investors is the deductibility of interest on inbound financial assistance. Inbound debt funding from connected persons currently falls within the ambit of transfer pricing rules, as set out in the Income Tax Act. Historically, South Africa followed a simple formulaic approach in determining an acceptable level of debt. This was contained in Practice Note 2 (PN 2), which dated back to 1996, but has now been officially withdrawn.

The intention was to replace the PN with a new Interpretation Note (IN), of which a draft was released. However, this has not been finalised, although SARS is of the view that this guidance should be followed. This creates increased uncertainty as to what would constitute arm's-length levels of debt and interest rates, as the guidance has not kept pace with international case law or the OECD developments on excessive interest deductions (BEPS Action 4). Coupled with the lack of consistency between transfer pricing legislation and other parts of South Africa's income tax legislation, which place specific restrictions on the deductibility of interest payments to non-residents, this presents challenges to inbound investors seeking to expand into South Africa.

SARS has advised that it will be finalising the guidance once the OECD paper on Financial Transactions is final. This suggests that some of the guidance contained therein may be adopted.

Another key area creating uncertainty is the recent proposal by SARS to expand the connected person definition for transfer pricing. SARS proposed adopting an "either/or" approach to using the existing connected person definition as well as the associated enterprises term used by the OECD in Article 9 of the Model Tax Convention. Associated enterprises is, however, not a defined term and, in light of significant comments from the public, SARS has postponed implementing this until due consideration is given to defining the term.

## 4.5 Related-Party Limited Risk Distribution Arrangements

SARS audits transactions between a local entity and a related non-resident entity relating to the supply of goods, whether the supply is to South African customers or to non-South African-based customers. SARS will look closely at remuneration paid to a local related party distributor to ensure it is at arm's length and, similarly, where the distributor is outside South Africa and is selling goods produced by a related party in South Africa, SARS will scrutinise the margin made by the offshore distributor and adjust the income of the local producer if the distributor's margin is considered excessive.

SARS has indicated that it will not be adopting the OECD's guidance on low value-added services introduced into the 2017 transfer pricing guidelines. SARS still considers service transactions to be high risk base eroding transactions, which should be adequately supported.

## 4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

SA transfer pricing rules follow arm's-length principles. SARS has adopted the transfer pricing documentation proposals espoused by the OECD following the finalisation of BEPS Action 13. However, as indicated above, SARS does not automatically adopt all the guidance provided by the OECD in its latest transfer pricing guidance.

# 5. Key Features of Taxation of Non-local Corporations

## 5.1 Compensating Adjustments When Transfer Pricing Claims are Settled

No compensating adjustments have been made by SARS in respect of the settlement of transfer pricing claims. South African domestic legislation does not provide for this. SARS has entered into a number of Mutual Agreement Procedures (MAPs) on transfer pricing matters, and it is understood that some of these have been completed.

## 5.2 Taxing Differences

If the local branch of a non-local corporation creates a "permanent establishment" in SA, it is required to register for SA tax as an "external company" and is taxed on the same basis and at the same tax rates as a resident company. The key difference between branches and subsidiaries is that when a local subsidiary distributes its profits to its foreign parent, the distribution would be subject to dividends tax, whereas the branch remittance of profits is not subject to any withholding tax.

## 5.3 Capital Gains of Non-residents

Non-SA residents are not subject to CGT on the sale of shares in SA companies, unless:

- those shares are "land rich" – ie, 80% or more of the market value of such shares is attributable directly or indirectly to immovable property situated in SA, held other than as trading stock. This may be subject to DTA relief; or
- the shares are attributable to a "permanent establishment" of the non-resident in South Africa.

SA can impose CGT on indirect share sales (where a foreign company sells shares in another foreign company that holds shares in a SA company) but only where the conditions referred to above are met.

## 5.4 Change of Control Provisions

There are no change of control provisions that could trigger tax or duty charges.

## 5.5 Formulas Used to Determine Income of Foreign-owned Local Affiliates

Formulas are not used to determine the income of foreign-owned local affiliates selling goods or providing services.

## 5.6 Deductions for Payments by Local Affiliates

Payments by local affiliates for management and administrative expenses incurred by a non-local affiliate should meet the requirements set out in the general deduction formula in section 11(a) and section 23(g) of the Income Tax Act in order to be tax deductible – ie, expenditure must be incurred in the production of income and in the carrying on of a trade in order to qualify for deduction. Further to this, the expenditure would be subject to the local transfer pricing rules, which in summary limit the deduction based on arm's-length principles.

## 5.7 Constraints on Related-Party Borrowing

The rate of interest charged on related party borrowing by local affiliates of a foreign lender is subject to transfer pricing provisions (such rate should be an arm's-length rate in order to be tax deductible).

The quantum of borrowing is subject to the thin capitalisation rules (such amount of the borrowing should be an arm's-length amount in order for the related interest to be tax deductible).

See **2.5 Imposed Limits on Deduction of Interest** on the section 23M limitation on interest deductibility.

# 6. Key Features of Taxation of Foreign Income of Local Corporations

## 6.1 Foreign Income of Local Corporations

SA residents are (subject to certain exemptions) taxed on their worldwide income (subject to the provisions of any relevant DTA), while non-residents are only taxed on South African-sourced income (subject to the provisions of any relevant DTA).

Foreign dividends derived by an SA resident are exempt if certain requirements are met (one of which is that the SA person holds at least 10% of the equity shares and voting rights of the foreign company).

## 6.2 Non-deductible Local Expenses

Any expenditure incurred that relates to exempt income (whether this is foreign or local) will not be deductible for tax purposes as it is "not incurred in the production of income" or "carrying on of a trade". "Income" is defined as gross income minus exempt income.

## 6.3 Taxation on Dividends from Foreign Subsidiaries

Foreign dividends are taxable in the hands of South African tax residents at a rate of 20% (subject to certain exemptions relating to both equity and non-equity shares), with effect from 1 March 2012 for individuals and trusts, and from 1 April 2012 for companies.

A foreign dividend is defined as any amount paid by a foreign company (essentially a non-resident company) that is treated as a dividend or similar payment by the foreign company for the purposes of the laws relating to tax on income in the foreign country, or where the foreign country does not impose any tax on income for company law purposes.

A foreign dividend received by, or accrued to, any person will be exempt from income tax (among other things) where:

- the shareholder (together with all other companies forming part of the same group of companies) holds at least 10% of the total equity shares and voting rights in the foreign company (known as the "participation exemption");
- the foreign dividend has been included in the resident recipient's income in terms of the CFC rules;
- the shareholder is a foreign company and the foreign dividend is declared or paid by another foreign company that is resident in the same country as the shareholder company;
- the foreign dividend is received by or accrues to a person in respect of a listed share and does not consist of a distribution of an asset in specie; or
- the foreign dividend is received by or accrues to a resident company in respect of a listed share and consists of the distribution of an asset in specie.

### 6.4 Use of Intangibles

Royalties or fees paid by a foreign subsidiary to a South African resident are subject to the transfer pricing provisions, which may deem an arm's-length fee to be earned by the SA company providing the use of the intangible property concerned, which would be subject to SA tax in the SA company.

If the intangible asset is disposed of by the SA company to the non-local subsidiary, then CGT may be applicable for the SA company.

### 6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules

Section 9D of the Income Tax Act contains CFC rules, which seek to tax the "net income" of CFCs in the hands of the local company.

Non-local branches form part of the SA company and therefore the taxable income of such branches is automatically included in the taxable income of the SA company (subject to DTA relief).

### 6.6 Rules Related to the Substance of Non-local Affiliates

From a South African CFC perspective, the primary exemption from having to impute the income of a CFC into the taxable income of the South African shareholder is the so-called foreign business establishment (FBE) exemption, which requires the CFC to have sufficient employees, facilities and equipment in its particular jurisdiction in order to conduct its primary operations. If a CFC meets the FBE threshold, broadly speaking all active income attributed to that FBE will be disregarded for CFC purposes. Further analysis is required to determine whether other income such as income derived from financial instruments can also be protected by this exemption. The FBE test is fact-specific and subject to complex exclusions and exemptions, which should be considered on a case-by-case basis.

### 6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

Gains on the sale of shares in non-local affiliates are subject to income tax (if on revenue account) or CGT (if on capital account). The capital gain or loss may, however, be disregarded under paragraph 64B of the Eighth Schedule of the Income Tax Act if certain requirements are met (see **2.7 Capital Gains Taxation** for detail).

## 7. Anti-avoidance

### 7.1 Overarching Anti-avoidance Provisions

The general anti-avoidance rules (GAAR) are detailed in sections 80A to 80L of the Income Tax Act, and are applied where a transaction or step in a transaction is entered into for the sole or main purpose of obtaining a tax benefit.

## 8. Other

### 8.1 Regular Routine Audit Cycle

There is no routine audit cycle; audits are at the discretion of the revenue authority.

## 9. BEPS

### 9.1 Recommended Changes

Following South Africa's re-entry into the global economy after its first democratic elections in 1994, increased efforts to curtail BEPS have formed part of South Africa's tax policy debate. As a result, at the time the OECD delivered its BEPS Project final reports in 2015, South Africa already had a fairly comprehensive BEPS package built into its domestic tax system, despite not formally being a member state of the OECD. This included items such as CFC rules, transfer pricing and thin capitalisation rules, rules to deal with hybrid instruments, reportable arrangements rules, and a Voluntary Disclosure Programme. In addition, South Africa has sophisticated GAAR, which may also be applied in the BEPS context. South Africa also has Exchange Control legislation that seeks to regulate and control the cross-border flow of funds, which in itself curtails BEPS to a degree.

In light of the above, the OECD's BEPS recommendations have not generally resulted in the widespread introduction of new BEPS concepts into South Africa's tax system, but instead have influenced the refinement of existing concepts. Some of the more noteworthy refinements are discussed briefly below.

In line with Action 15, South Africa became a signatory to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting ("Multilateral Instrument" or MLI) on 7 June 2017, which aims to implement a series of tax treaty measures to update international tax rules and lessen the opportunity for tax avoidance by multinational enterprises. It contains both minimum (ie, compulsory) and optional provisions. South Africa has reserved its position on a number of optional aspects, including mandatory binding arbitration procedures. However, the impact of the minimum standards introduced by the MLI in the context of anti-treaty shopping measures are likely to have a significant practical impact on traditional international group structuring involving South Africa. South Africa has elected to introduce the so-called "Principal Purpose Test" (PPT) into its treaties, and it is estimated that this will become effective during the course of the next 12 months. The PPT may result in the denial of treaty benefits where it is reasonable to conclude that one of the principal purposes of an arrangement or transaction was to obtain tax treaty benefits. South Africa has elected for almost all of its tax treaties to be Covered Tax Agreements for the purposes of the MLI.

BEPS recommendations that have been implemented include the three-tier transfer pricing documentation requirements proposed in Action 13, which have largely been implemented in line with the BEPS proposals. For instance, South Africa has implemented the requirement for completion of a Country-by-Country Report by South African-based multinationals in line with the thresholds proposed by the OECD (ZAR10 billion consolidated turnover). South Africa has also introduced the compulsory submission of a Master File and Local File where the South African resident entity has an aggregate of transactions exceeding ZAR100 million in value.

South Africa also became a signatory of the Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports and of the Multilateral Competent Authority Agreement on the automatic exchange of financial account information and intended first information exchange date status.

SARS has also indicated that it needs to consider the existing interest deductibility rules in light of the BEPS recommendations in Action 14 and the current draft paper on Financial Transactions. It is anticipated that changes will be proposed once the Financial Transactions paper is finalised by the OECD.

## 9.2 Government Attitudes

The BEPS debate is very much on the South African government's policy agenda. South Africa is a developing nation with a long-term national development plan aimed at eliminating poverty and reducing inequality by 2030. Within this context, the South African government appointed the Davis Tax Committee on 17 July 2013 to inquire into the role of South Africa's tax system in the promotion of inclusive economic growth, employment creation, development and fiscal sustainability. The DTC was expected to take recent domestic and international developments into account, particularly the long-term objectives of the national development plan. On the international front, the Davis Tax Committee was required to address concerns about BEPS, especially in the context of corporate income tax, as identified by the OECD.

According to the Executive Summary of the Davis Tax Committee Second Interim Report, "South Africa will have to develop a balanced approach as it responds to BEPS challenges. South Africa's BEPS approach should encourage the competitiveness of home grown multinationals that are expanding abroad but this has to be weighed against profit shifting opportunities that are likely to increase with such an expansion. Since the country needs foreign direct investment and the associated access to technology and capital, South Africa has to effectively protect its source tax base against the associated base erosion concerns. In addition, since South Africa has ambitions to position itself as a gateway for investment into Africa, it has to consider how this ambition fits in the context of the OECD/G20 BEPS Action Plan."

The South African tax regime can be described as sophisticated and comparable to the tax regimes of many developed nations, and particularly when compared with the tax regimes of other developing nations in the African region. South Africa has been an early and enthusiastic adopter of selected OECD BEPS measures, despite not being an OECD member state and the OECD's caution around unilateral implementation. A practical example of such a case is the recent broadening of the country's CFC tax rules to include foreign entities as CFCs if the financial results of that foreign company are reflected in the consolidated financial statements, as contemplated in IFRS 10, of any company that is a South African tax resident. This happened despite the fact that the Davis Tax Committee "recommended that the current South African definitions for control be retained, subject to any significant moves from other global players towards widening the definition based on the principle of consolidation, using IFRS 10 as the guideline."

In light of the above and judging by the level of implemented BEPS tax measures, the South African government can be regarded as a strong supporter of the OECD's BEPS action campaign.

## 9.3 Profile of International Tax

The South African economy is projected to be in a budget deficit for at least the medium term, with low growth forecasts putting increased pressure on revenue collection generally. Within this context, as part of SARS' specialised tax units, international tax and transfer pricing have taken a more prominent role over the last five years, judged by the number of major international tax and transfer pricing audits and disputes involving mainly South African outbound multinationals.

Although South Africa is not a member state of the OECD, it has been regarded as an early adopter of OECD BEPS measures to complement its already comprehensive BEPS-related and general tax avoidance provisions, which have existed for many years in South African domestic tax legislation. From a tax policy perspective, international tax continually features in South Africa's annual tax legislation amendment cycle, and measures relating to it thus continue to develop and evolve.

Examples of South Africa actively taking part in the international tax arena include the signing of the MLI on 7 June 2017, as already mentioned. South Africa has also renegotiated certain tax treaties with countries where South Africa perceived a high risk of BEPS – eg, the treaty between South Africa and Mauritius was renegotiated to allow for higher withholding taxes in certain instances, and to amend the tie-breaker provisions determining the tax residency of companies wishing to rely on this tax treaty.

South Africa can generally be regarded as being at the forefront of BEPS-related tax legislation, and this trend is expected to continue.

## 9.4 Competitive Tax Policy Objective

The South African tax regime is characterised by a comprehensive BEPS package embedded into the domestic tax legislation, with only limited competitive tax policy objectives. The primary example of such a competitive tax policy from an international tax perspective is the South African headquarter company regime.

South Africa's headquarter company regime is intended to enable the country to become a gateway for foreign investment, aimed at Africa but not limited thereto. Essentially, a headquarter company is a South African tax resident company that meets certain asset and income tests – ie, it should primarily own investments outside of South Africa and earn passive income from such investments, but no direct "substantive activity" threshold is established to qualify for the regime. Consequently, certain anti-avoidance rules, such as CFC rules and transfer pricing, have been relaxed with regard to headquarter companies, and withholding tax on payments by the headquarter company is abolished in particular cases. Notably, the headquarter company regime does not provide any corporate tax rate incentive nor any preferential IP regime. An analysis of the key characteristics of the headquarter company regime shows that it is actually a holding company regime that enables multinational groups to use South Africa as a conduit for passive income flows.

The Davis Tax Committee appointed by the South African Minister of Finance in 2013 to inquire into the role of South Africa's tax system in the promotion of inclusive economic growth, employment creation, development and fiscal sustainability was also mandated to address concerns about BEPS, especially in the context of corporate income tax, as identified by the OECD. In the DTC's report "SUMMARY OF DTC REPORT ON ACTION 5: COUNTER HARMFUL TAX PRACTICES MORE EFFECTIVELY, TAKING INTO ACCOUNT TRANSPARENCY AND SUBSTANCE", the headquarter company regime was specifically considered. The Davis Tax Committee makes the following recommendations for South Africa:

"It is important that South Africa balances its international obligations not to engage in harmful tax practices with the need to preserve the competitiveness of the economy. More so, as the National Development Plan provides that South Africa should aspire to be a gateway for investment in Africa. There is potential for substantial job creation and tax revenue to the Government in the form of VAT and employees' tax from which South Africa would benefit, as long as it ensures that it complies with the OECD's substance requirements. The bottom line is that BEPS is both a risk and an opportunity for South Africa.

From a tax perspective, consideration should be given to instituting a reduced corporate income tax rate for headquarter companies which meet minimum substance requirements. This would make South Africa more attractive as a destination for regional headquarters. While this may result in the perception that there will be a notional cost related to corporate income tax foregone, the direct and indirect spin-offs of an increased number of such companies (that would otherwise go elsewhere) which would result in increased tax revenues, as well as from increased employment taxes, consumption taxes and profit taxes of suppliers should outweigh such perceived forgone taxes.

It is, however, important that any revised headquarter regime be bundled with a package of measures to address all of the impediments and externalities associated with the choice of South Africa as a location for regional headquarters, including with respect to exchange control (although there is relief for headquarter companies, better alignment with the tax regime is required), labour law policy, availability of power and immigration.

To ensure the headquarter regime is in line with Action 5, reforms to the provisions should be considered, that incorporate minimum levels of substance as required by the OECD, so that it does not slip into the area of a harmful tax practice. It is therefore important that South Africa considers revising its criteria for headquarter companies in line with the OECD."

Although there may be some aspects of the headquarter company regime that may be open to an academic challenge on the basis of insufficient substance requirements, the OECD's Final Report to Action 5 described the South Africa's headquarter company regime as potentially constituting a harmful tax practice, but did not regard the regime as being actually harmful. Overall, the regime has not been very successful. There are other factors that, in practice, outweigh the tax criteria when choosing South Africa as a regional headquarter location, most notably exchange controls, labour law policy, the availability of guaranteed power sources, and immigration requirements relating to work permits as well as general foreign investor concerns around political stability.

Considering that the South African tax policy stance is generally in favour of comprehensive BEPS provisions, and balancing this against the country's need for job creation and growth, it is foreseeable that the headquarter company regime may evolve from its current "holding company characteristic" into more of a regional headquarter company regime. This will likely comprise increased substantial activity requirements to benefit from the regime, coupled with measures to address the non-tax impediments – ie, work permit facilitation.

### 9.5 Features of the Competitive Tax System

See **9.4 Competitive Tax Policy Objective**.

### 9.6 Proposals for Dealing with Hybrid Instruments

A hybrid financial instrument is described in the 2014 OECD Report on Hybrid Mismatches as "any financing arrangement that is subject to a different tax characterisation under the law of two or more jurisdictions such that a payment under that instrument gives rise to a mismatch in tax outcomes." As an example, a company in Country B issues a financial instrument to a company in Country A. Country B regards payments under the instrument as deductible interest expense, whilst the tax law of Country A regards the receipts as exempt dividends.

The OECD essentially determines the extent of a mismatch by comparing the tax treatment of the payment under the laws of each jurisdiction where the mismatch arises – ie, focusing on a deductibility mismatch or other clear tax leakage – and seeks to achieve greater tax neutrality. This principle of comparing the laws of each jurisdiction also finds its way into the OECD's recommendations as a pillar insofar as it relates to domestic tax changes aimed at addressing hybrid mismatches. It therefore presupposes knowledge of and co-operation between jurisdictions in addressing hybrid mismatches on a domestic front.

South Africa has anticipated several of the recommendations in the OECD 2015 Reports on Hybrid Mismatch Arrangements, and there have for a while been various specific and complex provisions in the South African tax regime aimed at the objectives of the OECD as formulated in BEPS Action 2. South Africa has not, however, consistently followed the principle of focusing on a deductibility mismatch or other clear tax leakage. Instead, South African hybrid instrument rules may alter the tax treatment of an instrument where no obvious leakage arises, such as in circumstances where a deduction is matched by a taxable receipt, or a non-deductible payment is exempt – the rules look purely at substance over form, without considering whether mismatch actually exists.

The South African hybrid instrument rules are mainly focused on protecting the South African tax base and are rather in favour of the South African fiscus as opposed to facilitating consistent tax treatment in the context of cross-border transactions. An example of this is section 8FA of the Income Tax Act, which deals with hybrid interest. Section 8FA focuses on the nature of the yield and targets amounts that are not determined with reference to a rate of interest or the time value of money, or that are determined with reference to profits or gains and reclassifies such interest amounts as non-deductible dividends (which may be exempt). This may be the case where a South African company takes on a profit participating loan from abroad, with the result being a denial of otherwise deductible interest due to this interest being reclassified as non-deductible dividends. By contrast, if the South African company was the holder of a similar instrument issued by a foreign company, there would not be reclassification of taxable interest income to exempt dividends – even if the payment was not deductible for purposes of the domestic tax rules of the foreign company.

An example where South Africa did follow the mismatch measures as contemplated in the OECD requirements is section 23M of the Income Tax Act, which seeks to limit interest deductions paid by a South African debtor to a creditor that is in a controlling relationship to the debtor, if that interest is not subject to tax in the hands of the creditor.

The South African hybrid instrument rules are characterised by anti-avoidance sections aimed at particular transactions. These provisions are often complex and difficult to apply.

Since South Africa has for many years had legislation aimed at targeting tax avoidance possibilities in the context of both equity and debt instruments, it is considered unlikely that the OECD's BEPS proposals around hybrid instruments will significantly alter South Africa's approach to hybrid instruments in the medium term.

### 9.7 Territorial Tax Regime

South Africa does not have a territorial tax regime. It taxes its residents on a worldwide income basis, with non-residents potentially being taxable on income from a South African source. Limiting BEPS due to interest deductions is therefore a high priority for South Africa due to the potential risk of loss to the fiscus.

South Africa has historically been (partly) shielded from interest deduction base erosion by South Africa's comprehensive Exchange Control provisions. Cross-border loans entered into by South African Exchange Control residents require formal Exchange Control approval, which will not be given if (among other things) the interest flows from South Africa will exceed certain specified thresholds.

South Africa also has various tax provisions aimed at curbing the avoidance of tax using interest and similar instruments, including an interest withholding tax of 15%, transfer pricing and thin capitalisation provisions (with no "safe harbour" debt-to-equity ratio), and various re-characterisation rules and provisions that limit the deductibility of interest. The plethora of legislation dealing with the incurral and deductibility of interest creates considerable uncertainty for investors into South Africa.

In light of the above, the OECD's interest deduction proposals are not expected to have a significant impact on investing into or from South Africa, as these proposals have been preceded by complex and comprehensive interest deduction limitation rules, which continue to evolve.

### 9.8 CFC Proposals

South Africa does not have a territorial tax system and taxes its residents on a worldwide basis. South Africa already has comprehensive and complex CFC rules that apply to CFCs owned by South African residents.

The South African CFC system contains most if not all the building blocks of a CFC system as recommended by the OECD BEPS Action 3.

### 9.9 Anti-avoidance Rules

In its summary report on BEPS Action 6, the Davis Tax Committee commented as follows:

"To ensure protection against treaty abuse, including treaty shopping, the OECD recommends that at a minimum countries should include in their tax treaties an express statement that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements; and countries should implement this common intention through either:

- using the combined LOB and PPT approach described above; or
- the inclusion of the PPT rule; or
- the inclusion of the LOB rule supplemented by a mechanism (such as a restricted PPT rule applicable to conduit financing 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."

As previously mentioned, in 2017 the South African government signed the MLI, which aims to implement a series of tax treaty measures to update international tax rules and lessen the opportunity for tax avoidance by multinational enterprises, and contains both minimum (ie, compulsory) and optional provisions. Although South Africa has reserved its position on a number of optional aspects, for example by not electing the LOB clause, the impact of the minimum standards introduced by the MLI, such as the so-called PPT, may have significant practical impact on traditional international group structuring involving South Africa. The PPT may result in the denial of treaty benefits where it is reasonable to conclude that one of the principal purposes of an arrangement or transaction was to obtain tax treaty benefits.

The factual determination required under the PPT test is similar to that required to make an "avoidance transaction" determination under South Africa's GAAR rules – in particular, whether the primary purpose of a transaction (or series of transactions of which the transaction was a part) was to achieve a tax benefit, broadly defined.

Since the two serve a similar purpose, it may be argued that the GAAR can be applied to prevent the abuse of treaties to protect South Africa's tax base (although the GAAR test may arguably involve a higher burden of proof relating to sole or main purpose). Thus, the introduction of the PPT test insofar as it relates to inbound investors into South Africa is arguably not fundamentally different from what was already the case based on South African domestic law. For outbound investors, however, where erosion of the South African tax base was not at stake, but rather the use of intermediary holding companies to reduce high foreign withholding taxes incurred in repatriating funds back to South Africa, the PPT brings into play a concept that was historically less prominent. As the PPT is a minimum standard applicable to all treaties covered by the MLI, the avoidance aspect must now be considered not only in relation to the South African tax base (which arguably was already the case before the PPT was introduced), but also in relation to the targeted investment jurisdiction.

For these outbound investors, justifying the location of an intermediary holding company so as to pass the PPT test will require value judgement on aspects of commercial and tax importance, which may differ greatly in the eye of the beholder. This judgement may only be evaluated ex post facto by the tax authorities years later, which creates imprecision and uncertainty and does not bode well for international trade. In the context of investments in jurisdictions characterised by high withholding taxes levied on a gross basis, adding to the uncertainty around the tax outcome may prove sufficiently risky to deter potential investors altogether. It will be some time before the application of the PPT test in practice will become clear, and until that time investors are cautioned to properly consider and document their rationale for establishing any intermediary holding company structures where tax treaty benefits result from those structures.

## 9.10 Transfer Pricing Changes

The transfer pricing changes have largely followed the recommendations of the BEPS action plan, and have focused on the documentation requirements. The only divergence from the recommendations of the OECD relates to the documentation retention requirements contained in section 29 of the Tax Administration Act. These place far more onerous requirements on South African-based multinational enterprises in the nature of source documentation required to be retained to support the transfer pricing policies than are proposed by the OECD.

There is limited audit activity into intellectual property as most audit activity is focused around supply chain at this stage. This level of audit activity is very evidence-based, with taxpayers having to provide substantive evidence of how the supply chain is managed. In addition, the tax administration is taking a very restrictive approach to comparable support in that it is disregarding vast amounts of comparable information and making erroneous adjustments based on the incorrect interpretation of an arm's length range.

## 9.11 Transparency and Country-by-country Reporting

SARS has endorsed and implemented the country-by-country reporting recommendations in the form proposed by the OECD. There are, however, some practical impediments that are affecting the ability of many multinational enterprises to file in an efficient manner. These are being resolved over time but the Tax Administration has shown a lack of practical sensibility by introducing penalties for late filing whilst these impediments still exist.

Multinational enterprises that have filed country-by-country reports and Master Files have also expressed concern at the lack of guidance provided by the tax administration on how this information will be shared with other tax administrations.

## 9.12 Taxation of Digital Economy Businesses

South Africa does not have taxing rules in place that deal specifically with the direct taxation of profits generated by digital economy businesses. It has also not yet adopted any of the proposed solutions to address BEPS in the digital economy as identified pursuant to the BEPS Project. The Davis Tax Committee has, however, made the recommendations listed below, which have not yet been implemented:

- The proposals by the OECD to change the definition of a permanent establishment in double tax treaties will help to address this matter. In adopting any e-commerce legislation, it is crucial to understand the technology and ensure that South Africa does not implement taxing provisions that are attached to a particular type of technology because by the time the provision is promulgated the technology in question may be obsolete and redundant. To enable South Africa to impose tax on non-resident suppliers of goods and services via e-commerce to South African customers, new source rules that deal with the taxation of the digital economy need to be enacted.
- The current scope of the source rules under section 9 of the Income Tax Act needs to be expanded to include rules that cover proceeds derived from the supply of digital goods and services derived from a source in South Africa. The new rules should be based on the payor principle (like a royalty). The rules could, for instance, provide that digital goods or services are sourced where the recipient who pays for the digital goods or services is based, which would be where the South African tax resident – physically present in South Africa – is at time of supply. The rules should also aim to clarify the characterisation of the typical income flows from digital transactions. Enacting such rules would create the basis on which South Africa can apply the OECD recommendations on the taxation of the digital economy.

- The recommended new source rules for non-resident suppliers of goods and services via e-commerce to South African customers should cover the situation where physical goods and services are delivered or rendered in South Africa for which payment is made electronically to a non-resident (consider, for example, where payment is made to a non-resident but the service is rendered in South Africa, or where goods are delivered in South Africa but payment is made to a non-resident). However, any such services should be deemed to not be from a South Africa source where they do not meet the South Africa source rule.
- Currently, non-residents are required to submit tax returns for trade carried on through a South African permanent establishment. The lack of data in respect of inbound flows, as well as the lack of discernment between inbound and outbound flows, has resulted in little evidence indicating tax abuse as a result of the digital economy in South Africa. SARS does not keep a separate register for inbound foreign companies. There is a need to isolate and focus on foreign multinationals and get them to submit tax returns.
- Rules should be enacted that require non-resident companies with South African-sourced income (excluding certain passive income) to submit income tax returns even if they do not have a permanent establishment in South Africa.
- To alleviate the compliance burden on non-residents having to submit comprehensive tax returns, notwithstanding that they may not be liable to tax in South Africa, an alternative measure would be to introduce a self-assessment system for income tax purposes. A further possibility would be for a non-resident to be able to apply for a ruling to the effect that it is not liable to tax in South Africa on its specific facts and circumstances, and to be relieved of the obligation to submit tax returns for so long as there is no change in the circumstance (including the law).
- South Africa's existing source rules need to be aligned to accounting mechanisms and should not rely too heavily on tax law to attempt to reconcile and determine tax liability.

With regard to indirect taxes, on 1 June 2014 South Africa implemented rules to compel foreign merchants to register as South African VAT vendors and to account for VAT, inter alia, where the foreign merchant provides electronic services to South African consumers or receives payment for such electronic services from a South African bank and the revenue exceeds ZAR50,000 a year.

As part of its review of the South African tax system and relying on international best practice, the Davis Tax Committee made certain recommendations to the Minister of Finance in relation to VAT and e-commerce transactions, including:

- that supplies qualifying as electronically supplied services should be categorised and elaborated upon in a guide or interpretation note;
- that a distinction should be made between supplies made between businesses, so-called business-to-business (B2B) and business-to-consumer supplies (B2C), with only the latter being subject to the e-commerce rules;
- that the invoice basis of accounting for VAT should be the default position; and
- that the VAT registration threshold for foreign electronic suppliers (as defined) should be made the same as the compulsory VAT registration threshold – ie, a taxable turnover of ZAR1 million in any 12-month period. In considering the VAT e-commerce regulations in a broad manner, the Davis Tax Committee recommended that more flexible legislation is required to ensure South African VAT legislation regulating e-commerce stays relevant.

Contrary to the Davis Tax Committee recommendations, the Minister of Finance announced in the Budget Speech 2018 that the VAT base for the supply of electronic services by foreign businesses to South African consumers would be broadened, inter alia, to include those supplies of electronic services that were previously excluded. The announcement was accompanied by regulations in this regard. Practically, the regulations target all foreign businesses that supply electronic services to South African businesses for inclusion in the South African VAT net. Intermediaries facilitating the supply of electronic services and responsible for issuing invoices and collecting payments are also affected and will be deemed to be the supplier for VAT purposes, and will therefore be required to register as a VAT vendor in South Africa where the value of the taxable supplies made by them exceeds the VAT registration threshold of ZAR1 million in any consecutive period of 12 months. The intermediaries will need to account for VAT on the supplies made by the foreign supplier on behalf of the foreign supplier, and will need to issue the requisite prescribed tax invoice relating to those supplies and account for VAT in respect thereof.

In this regard, it appears that National Treasury and SARS have adopted a rigid approach to regulate a fluid issue. In particular, the failure to distinguish between B2B and B2C supplies is a step away from the international harmonisation of taxing e-commerce transactions, and may potentially create enforcement problems for SARS on cross-border transactions in future. As noted in many reports relating to the taxation of cross-border supplies of electronic services, it makes no sense to impose VAT on B2B transactions where the relevant jurisdiction has a reverse charge mechanism, as any VAT imposed on B2B transactions where the recipient would not be entitled to a full input deduction would be caught by the reverse charge mechanism.

It is also concerning that the approach adopted by National Treasury and SARS stands in stark contrast with the recommendations made by the Davis Tax Committee that the treatment of electronic services should be aligned with international treatment and especially harmonised with OECD principles, and that the principle of neutrality should be adhered to.

### 9.13 Digital Taxation

South Africa does not have tax rules in place that deal specifically with the direct taxation of profits generated by digital economy businesses. Please see **9.12 Taxation of Digital Economy Businesses**.

### 9.14 Taxation of Offshore IP

South Africa has not introduced any specific new direct tax rules dealing with the taxation of offshore intellectual property that is deployed within South Africa. Income associated with such intellectual property is taxed according to long-established principles – ie, where such income is attributable to a permanent establishment in South Africa it will be subject to normal tax; alternatively, a royalty withholding tax of 15% may apply (subject to tax treaty relief, if applicable).

### 9.15 Other General Comments

There are no other general comments.

**Webber Wentzel** is a full-service law firm with more than 150 years' experience and an integrated and multi-skilled team of more than 40 tax experts (comprising both lawyers and accountants), who work closely with other practice areas to bring clients bespoke solutions to complex problems. The team is best known for its expertise in the areas of corporate tax (including M&A, initial public offerings and private equity-related work), employees' tax, indirect tax, international tax (including Africa tax and transfer pricing) and exchange control, as well as tax dispute resolution. It has worked on some of the most high-profile transactions, including two of the largest private equity deals concluded in South Africa. The international and Africa-based tax teams are well known for their depth of expertise, and make use of an extensive best friends network across the African continent and alliances to advise on investments in Africa.

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