Multinational Tax Avoidance - an Application within South African legislation

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Multinational Tax Avoidance: An application within South African legislation

Structured Abstract

Purpose:

This paper seeks to determine whether the South African tax legislation would limit the effectiveness with which the tax avoidance schemes identified to avoid the tax liabilities of multinational enterprises were they to be applied in South Africa.

Approach:

The paper reviews multinational tax avoidance schemes, namely the disregarding of Controlled Foreign Companies ('checking-the-box'), royalty payments, intra-group loans, transfer pricing and management fees. These schemes are then applied to the South African tax legislation framework.

Findings:

The effectiveness of certain schemes are curtailed while other schemes, particularly transfer pricing methods, may be able to exploit the legislation to derive a tax benefit.

Value:

The paper identifies potential improvements to the legislation in order to eliminate tax loopholes and allow the tax authority to collect greater corporate tax.

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1. Introduction

Multinational tax avoidance refers to the ability of a firm to reduce its liabilities by implementing avoidance methods that legally shift profits to lower tax jurisdictions or avoid paying tax altogether (Organisation for Economic Co-operation and Development, 2015). In the recent past there have been academic papers written regarding the schemes used by multinational enterprises to avoid tax and recommended changes to curtail the effectiveness of such schemes. Multinational tax avoidance has been brought to the broader public's attention as a result of the extensive criticism of the tax practices of a number of high-profile multinationals. Multinational enterprises generate taxable incomes that are significant sources of revenue to their respective tax jurisdictions and, as such, tax authorities realise the importance of collecting their fair share of tax revenue. There is a challenge in ensuring that tax authorities are not hindering global competitiveness upon instituting legislation to eliminate loopholes that are currently being exploited. Some countries, particularly those with smaller economies, have attempted to attract foreign investment through low corporate tax rates, although these methods of incentivising the investments are not limited to this. For example, Microsoft negotiated with the Puerto Rico tax authorities to be taxed at a rate of two percent, which is lower than the nation's corporate tax rate (United States Senate Committee on Homeland Security and Governmental Affairs, 2012). These negotiations have spurred criticism from other tax authorities such as Her Majesty's Revenue and Customs in the United Kingdom. Furthermore, the avoidance methods implemented by multinationals have resulted in tax authorities questioning the level of corporate social responsibility displayed, suggesting that manipulating the legislation is unethical (SABC, 2014). The criticism made by tax authorities has impacted the reputation of multinationals, resulting in some of them choosing to pay tax, posing as good corporate citizens and to please customers (Macalister, 2013). Starbucks announced in 2013 that it would pay tax in the United Kingdom in spite of its persistent reported losses, and Amazon has recently decided to record a portion of its sales in the United Kingdom where it will be consequently taxed, having previously re-routed those sales to Luxembourg – a lower tax jurisdiction (Bowers, 2015).

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South Africa has a substantial budget deficit, and one way in which to improve this is to collect more tax. South Africa has identified corporate tax collection as an area for

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improvement. Judge Dennis Davis of the Davis Tax Committee has stated how increasing the collection of corporate taxes is imperative if South Africa wishes to facilitate economic growth and reduce its budget deficit (Lamprecht, 2015).

This paper seeks to determine whether the South African legislation limits the effectiveness with which multinational tax avoidance schemes minimise tax liabilities. First, the paper reviews avoidance methods and provides application explaining how the schemes are allegedly used by multinationals such as Google, Microsoft, Apple and Starbucks. Following from this, the relevant South African tax legislation is explained and applied to the avoidance methods to determine its ability to limit the effectiveness of the methods were they to be applied within a South African context. Finally, the paper concludes by discussing the limitations inherent in the research and providing some recommendation in furthering the research on this topic.

2. A review of multinational tax avoidance schemes

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In South Africa, a resident is taxed on a residence basis (Haupt, 2015). The residence basis states that residents of South Africa must be taxed on their worldwide income irrespective of the source of the said income. A juristic person, such as a company, is deemed to be a South African resident if it is incorporated, established, or formed in South Africa, or if its place of effective management is in South Africa (Haupt, 2015).

Non-residents are taxed on a source basis (Haupt, 2015). This means that non-residents are taxed only on income which is of a South African source. The interpretation of the source basis has differed since its introduction and thus court cases have established the way in which the source of income is to be determined. In CIR v Lever Brothers and Unilever Ltd (1946 AD), the court held that the originating cause of the income must first be established. Following from this, the location of the originating cause must be determined in order to identify the source of the income. However, even with these principles, source can still be difficult to determine. It is possible for more than one originating cause to exist and as such the dominant cause must be determined.

Section 9 of the Income Tax Act (No. 58 of 1962) provides specific rules for certain types of income such as the sale of goods and royalty income. However, where the

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Income Tax Act does not explicitly provide for a type of income of a business, the source is often where the business is carried on or where the capital is employed.

Following from these rules, a company must pay tax to SARS if its income is subject to the said rules (ignoring double tax agreements which this paper does not consider). As such, a multinational may be said to be avoiding tax if it is diverting profits in such a manner that is legal in accordance with the Income Tax Act but results in it paying tax to a jurisdiction that is different from the jurisdiction implied by the source rules. Multinationals will seek to do this in order to pay tax in a jurisdiction that levies a lower tax rate on corporate profits. Multinationals by their very nature perform transactions between different companies within the multinational corporation that are situated in different tax jurisdictions. However, the substance of these transactions must be questioned in order to determine whether the transactions have economic substance and not for the purpose of minimising tax liabilities of multinationals.

The following tax avoidance schemes are used by many multinational enterprises. However, this paper focuses on multinational enterprises incorporated in or whose parent companies are residents of the United States. Furthermore the companies mentioned hereafter have foreign operations that have a large presence in Europe. As such this paper discusses principles from the tax systems of the United States and of some European countries as well as tax guidelines provided by the Organisation for Economic Cooperation and Development (OECD). While the focus of this paper is not to identify loopholes in the tax systems in which the multinational enterprises operate, this paper does provide discussion regarding foreign tax laws where relevant and explanations of how the implemented schemes exploit such loopholes in order to obtain a better understanding when applying the said schemes to the South African tax legislation. In some instances quantitative data is provided in order to further depict the substantial impact that the schemes have on the multinationals' tax liabilities and accordingly the tax benefits that they derive.

2.1 Controlled Foreign Companies and Royalties

Multinational enterprises by definition have foreign entities within their group structures. These foreign entities earning profits are sometimes required to have their

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profits included in the taxable income of the parent company that controls it. However with the introduction of "check-the-box" regulations, multinational enterprises are able to disregard the taxable income of foreign entities, thus avoiding having to pay United States corporate tax on the foreign entities' profits. In order for a multinational enterprise to exercise this option, it would need to ensure that the foreign entity could be classified as an "eligible entity". An eligible entity is a business entity that is not treated as a corporation. Once a foreign entity is determined to be an eligible entity, it may be classified as a disregarded entity if it has a single owner and the said owner does not have limited liability. Many multinational enterprises have structured their operations in such a way so as to utilise the check-the-box regulation. The check-the-box provision defers the offshore profits from being taxed in the United States because the repatriation of profits is deemed to be a dividend and is thus taxed upon repatriation. However these multinational enterprises are under no obligation to repatriate profits and very often they choose not to. The check-the-box regulations were introduced so as to simplify the process of classifying an entity. However it has provided scope for multinational enterprises to substantially reduce their tax liabilities which they have duly taken advantage of (United States Senate Committee on Homeland Security and Governmental Affairs, 2012).

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Royalty payments are often used in conjunction with the check-the-box regulations in order to shift profits to the lowest tax jurisdiction (Gravelle, 2015). Many of the multinationals that have successfully implemented tax avoidance schemes are technology companies who license their intellectual property in return for royalty payments. An example of the check-the-box regulations used in conjunction with royalty payments is the "Double Irish Dutch Sandwich" allegedly implemented by Google (Fuest et al, 2013). Google received approval over its proposed scheme from the Internal Revenue Service in 2006 which ensured that it fell within the definition of tax avoidance and not tax evasion. The scheme is explained below.

Google's parent company in the United States licenses its intellectual property to a subsidiary in Ireland, Google Ireland Holdings. Google Ireland Holdings owns a company, also situated in Ireland, named Google Ireland Limited. Bermuda is recognised as Google Ireland Holdings' place of effective management (Fuest et al, 2013). According to United States tax law Google Ireland Limited and Google Ireland

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Holdings are treated as one Irish company (Fuest et al, 2013). As a result, United States tax laws regarding Controlled Foreign Companies that would require the inclusion of the Irish company's net income in the parent company's taxable income are circumvented through the check-the-box regulation. This is because Google's parent company is the sole owner of the Irish subsidiaries and does not have limited liability. Therefore it meets the requirements to disregard the foreign entities, and thus to legally exclude the net income of the foreign entities from its own taxable income. Furthermore, Irish tax laws deem Google Ireland Holdings to be a resident of Bermuda (Fuest et al, 2013). Consequently, the taxable income of Google Ireland Holdings is taxed in Bermuda at a rate of zero percent (Hennigan, 2013).

Google Ireland Limited sells advertising and earned 88 percent of Google's foreign sales in 2009 (Drucker, 2010). However Google Ireland Limited reported a taxable income at a substantially smaller amount, as indicated by its pre-tax income in 2008 which was less than one percent of its sales (Drucker, 2010). Google Ireland Limited achieves this through paying a royalty to Google Ireland Holdings for the use of the intellectual property. For example, in 2008 Google Ireland Limited paid Google Ireland Holdings a royalty of $5.4 billion (Drucker, 2010). By 2012 the royalty amounted to $8.6 billion indicating an increase of 59% from 2008 (Smith, 2013). The royalty paid by Google Ireland Limited is not paid directly to Google Ireland Holdings. Instead, a company is created in the Netherlands, and it is this company that Google Ireland Limited pays. Paying the Dutch company results in no withholdings taxes on the royalty payment given that the amount is a transfer between countries within the European Union (Drucker, 2010). Any taxable income of Google Ireland Limited that remains after the royalty payment to the Dutch company is taxed at 12.5 percent, which is substantially lower than the 35 percent tax rate levied on corporations by the Internal Revenue Service in the United States. The Dutch company then makes a royalty payment to Google Ireland Holdings.

Starbucks' European subsidiaries made royalty payments amounting to six percent of turnover to a company in the Netherlands which headquarters its European operations (royalty payments of 4.7 percent have been made more recently after Starbucks' United Kingdom subsidiary appeared in front of Her Majesty's Revenue and Customs – the United Kingdom's tax authorities) (Bergin, 2012). In 2011 Starbucks' United Kingdom

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subsidiary made a royalty payment of £26 million which significantly contributed towards a £33 million loss that year resulting in no tax charge (Bergin, 2013). In comparison, other multinationals such as McDonalds – the largest restaurant chain around the globe – made royalty payments between four and five percent of turnover (Bergin, 2012).

According to tax legislation in the United Kingdom, these royalty payments can be deducted if Starbucks is able to show that the royalty payment is an arm's length transaction. One way in which Starbucks can justify this is to show the importance of the intellectual property, for which the royalty is paid, to the profitability of the operations of the United Kingdom subsidiary. Starbucks has maintained that its royalty payments are at arm's length in spite of the continued losses that its United Kingdom subsidiary has reported (Bergin, 2012).

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2.2 Intra-group loans

Starbucks has highly-geared subsidiaries (Bergin, 2012). By maximising the amount of debt used to fund operations relative to equity in Starbucks' subsidiaries, known as thin capitalisation, higher interest expenses are incurred resulting in a greater tax deduction. Furthermore the intra-group loans are provided by non-residents resulting in the interest income accruing to a person outside the tax jurisdiction in which the interest expense is incurred. Starbucks allegedly uses this as an opportunity to re-route its profits out of high tax rate jurisdictions and into tax havens.

Starbucks' parent company in the United States has made intra-group loans to its subsidiary in the United Kingdom. According to Reuters, a review of Starbucks' United Kingdom subsidiary's financial statements reports that the subsidiary is entirely funded by debt (Bergin, 2012). Starbucks' group bonds have a coupon rate of LIBOR plus 1.3 percent (Bergin, 2012). LIBOR refers to the London Inter-Bank Offered Rate and is a benchmark across international markets. Starbucks' parent company lends to the United Kingdom subsidiary at an interest rate of LIBOR plus four percent (Bergin, 2012). The interest expense incurred by the United Kingdom subsidiary in 2011 was £2 million, all of which was deductible for tax purposes (Bergin, 2012). In comparison, McDonalds' United Kingdom subsidiary pays its group companies at an interest rate of

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LIBOR and KFC levies a rate of LIBOR plus two percentage points on its subsidiaries (Bergin, 2012). Relative to these comparable multinational enterprises, Starbucks charges a significantly higher interest rate and this has contributed to the UK subsidiary's ability to report losses to Her Majesty's Revenue and Customs, resulting in it incurring no tax liability for the majority of its operating history in the United Kingdom (Bergin, 2012).

2.3 Transfer pricing

Transfer pricing is a common tax avoidance method used by multinational firms in shifting profits. The OECD's guidelines on transfer pricing state that an asset must be transferred at an arm's length as if the parties that were transacting were not connected. Parties who are not connected would normally transact at a market price or market rate for that asset (Organisation for Economic Co-operation and Development, 2010). A company within a multinational enterprise that resides within a high-tax jurisdiction can purchase an asset at an inflated price from a related company that resides within a low-tax jurisdiction. The structure of this transaction allows the company within the low-tax jurisdiction to recognise high margins and the company within the high-tax jurisdiction to claim a greater tax deduction on the purchase of the asset. Consequently, the multinational enterprise can shift its profits to a low-tax jurisdiction and its deductible expenditure to a high-tax jurisdiction.

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Transfer pricing has proved to be a more difficult method of tax avoidance to evaluate. This can be attributed to the fact that many multinational enterprises are buying and selling millions of assets throughout a financial period. Furthermore there are assets such as intellectual property that may have very distinct characteristics that are very specific to the multinational enterprise resulting in greater difficulty in determining a market value (Fuest et al, 2013).

Starbucks has been accused of engaging in transfer pricing along with its royalty payments and intra-group loans (Bergin, 2012). Starbucks has a subsidiary in Switzerland called Starbucks Trading Coffee Company. The beans from the Swiss subsidiary are sent to another subsidiary in Netherlands to be roasted. The beans are purchased from the Swiss subsidiary at a mark-up of 20 percent on cost to the Swiss

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subsidiary (Hawkes, 2013). For the last three years, the corporate tax rate in Switzerland has been approximately 18 percent (KPMG, 2015) which, relative to many countries across the world and many of the countries which Starbucks operates in, would be considered a tax haven.

While there are allegations of Starbucks engaging in transfer pricing through the purchasing and selling of coffee beans, a tangible asset, between companies within a multinational enterprise, other multinational enterprises such as Apple allegedly engage in transfer pricing of intellectual property (Sahadi, 2013). The specific form of transfer pricing is a 'Cost Sharing Arrangement' (otherwise known as a Cost Contribution Arrangement) in which companies within a multinational enterprise agree to share in the cost of developing an intangible asset that is used by each of the companies in its operations (IRS, 2008). The costs are apportioned amongst the companies according to the benefits that each company reasonably anticipates to derive from the intangible asset (Organisation for Economic Co-operation and Development, 2010). For intangible assets that existed at the inception of a company wishing to participate in the use of the intangible asset, a 'buy-in' is required according to the same aforementioned proportion. The buy-in payment will be included in the taxable income of the parent company. The difficulty lies in determining an arm's length price for the buy-in payment given that the intangible is not completely developed at the time at which the transaction is concluded and thus it allows for greater manipulation by multinational enterprises (Fuest et al, 2013).

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In transfer pricing schemes the subsidiaries often earn a disproportionate amount of income from the intangible asset versus the percentage of the value that the subsidiary contributes. For example, Apple entered into a cost-sharing agreement with its subsidiaries in Ireland regarding its intellectual property, in the form of research and development, amongst other rights. Apple Sales International, an Irish subsidiary of Apple, earned pre-tax profits of $74 billion over the period 2009-2012 and made cost-sharing payments of $4.9 billion towards the research and development costs. This equates to a ratio of approximately 15:1. In that same time period Apple's parent company in the United States made pre-tax profits of $38.7 billion and corresponding cost-sharing payments amounting to $4 billion towards the research and development costs. Apple's parent company achieved a ratio of approximately 10:1 (Sahadi, 2013).

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Apple's Irish subsidiary is thus enjoying greater benefits from the intellectual property indicating that its payments may not be representative of the fair value. In addition, Apple's parent company has a greater incentive to receive smaller payments so that it has less taxable income.

The application of transfer pricing to Apple's tax avoidance strategy focuses on the price at which the Apple subsidiary acquires and contributes to the rights to the intellectual property. Microsoft also engages in a cost-sharing agreement but its alleged tax avoidance strategy involves another transfer pricing mechanism called Contract Manufacturing. Contract Manufacturing, as defined by the OECD, refers to a manufacturer, often located in a low-cost jurisdiction, which has obtained a licence to use intangible property developed by the parent company (Organisation for Economic Co-operation and Development, 2015). From this, the manufacturer produces tangible property, which is then sold to the parent company for sale to final consumers. Contract manufacturing allows the subsidiary to produce the tangible property at a low cost and sell it to the parent for a substantially higher amount. The parent company selling the tangible property to consumers in a high-tax jurisdiction will often add a smaller margin on its purchase price so as to minimise its tax liability.

Microsoft licences its intellectual property developed by the parent company in the United States to its subsidiary in Puerto Rico, Microsoft Operations Puerto Rico. The subsidiary produces digital and physical copies of the Microsoft products before selling them to Microsoft subsidiaries in the United States who in turn make the final sale to the consumer. The implementation of contract manufacturing has allowed Microsoft to transfer 47 percent of its gross revenue from sales within the United States to Puerto Rico (United States Senate Committee on Homeland Security and Governmental Affairs, 2012).

2.4 Management fees

The payment of management fees is a method of avoiding tax that is easier to understand yet equally difficult to scrutinise. Parent companies (or another company within the multinational enterprise for that matter) can charge other companies within the group management fees in order to reduce the taxable income of the subsidiaries.

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These management fees are commonly reported to be remuneration for marketing, strategy, technical and advisory services (ActionAid, 2012).

Accra Brewery, a subsidiary of SABMiller, which is the second largest brewery in the world, is situated in Ghana and pays another subsidiary of SABMiller, Bevman Services AG based in Zug, Switzerland, a management fee equal to 4.6 percent of its turnover. In 2010 this amounted to £0.93 million (ActionAid, 2012). The Ghanaian tax authorities levy an eight percent withholdings tax on these management fees which somewhat reduces the ability to avoid tax although with very limited effect.

Most tax authorities are concerned over the reasonability of the size of the payments with regard to the services performed by management and as such the arm's length principle is applied.

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3. Summary of Avoidance Schemes

In summary, the following schemes have been implemented by high-profile multinational enterprises to avoid tax:

Controlled Foreign Companies check-the-box provision, allowing the parent company to disregard its foreign subsidiaries. The parent company was allowed to make an election insofar as the foreign subsidiaries were eligible entities. For the purposes of applying the South African legislation to this avoidance method, resident parent company A seeks to exclude the taxable incomes of foreign Companies B and C respectively.

Royalties were used in conjunction with the check-the-box provision in order to shift profits. A foreign subsidiary would make a royalty payment to another subsidiary to ensure the profits were transferred to a lower tax jurisdiction. Contrary to the assumptions for the Controlled Foreign Companies scheme, for the purposes of applying section 23I of the South African Income Tax Act, Company C is deemed to be a resident, which pays a royalty to foreign Company B. Parent Company A is also assumed to be a foreign resident.

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The use of intra-group loans to maximise debt thus incurring a high interest expense in order to claim a greater interest deduction. The payment of interest to a foreign company within the group allowed the multinational to re-route its profits to a lower tax jurisdiction. The following application assumes foreign parent Company F provides resident Company E with intra-group loans.

Cost-Sharing Arrangements, which allows companies in a higher tax jurisdiction to contribute more to the use of intellectual property, relative to the estimated benefits to be derived, in order to claim a greater tax deduction. Resident parent Company G and foreign Company H are assumed to be parties to the Cost-Sharing Arrangement when applying the relevant South African legislation.

The implementation of Contract Manufacturing, which shifted profits to a lower tax jurisdiction by ensuring that a greater percentage of the total mark-up on the manufactured product was recorded in the said jurisdiction. In the following application, resident parent Company K and foreign Company L are assumed to be parties to this scheme.

Management fees, which allowed a company to make a payment to a lower tax jurisdiction to company within a lower tax jurisdiction, for providing value-added services. The company paying the management fees shall be referred to as resident Company M.

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4. Methodology

Following from the literature review, this paper seeks to determine whether the South African tax legislation would limit the effectiveness with which the schemes identified would operate to avoid the tax liabilities of multinational enterprises were they to be applied in South Africa. The schemes that will be applied to the South African tax legislation are the disregarding of Controlled Foreign Companies (‘checking-the-box’), royalty payments, intra-group loans, transfer pricing and management fees.

In most scenarios where the schemes are applied to the tax framework of South Africa, it is assumed that the parent company of the relevant multinational enterprise is a tax

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resident of South Africa. Given that these multinationals have been alleged to strategically locate their subsidiaries in order to derive tax benefits, in some instances a subsidiary within the group is assumed to be a South African resident. This paper first explains the relevant South African tax legislation before applying it to a scheme. In some instances the South African tax legislation does not incorporate sections that specifically govern the relevant transactions and schemes. However the legislation will often refer to foreign tax codes, for example the guidance provided by the OECD, which the Commissioner for SARS will consider as the basis for determining the substance of a transaction or scheme with respect to tax avoidance. Therefore the guidelines of the referenced tax codes will be applied to the schemes as this is representative of what the Commissioner would consider. There are also facts and circumstances that the Commissioner may consider upon making an inquiry into the tax practices of multinational enterprises. While these facts and circumstances are not incorporated within the legislation, they are still relevant to the decision-making of the Commissioner and thus are also necessary to consider for the purposes of the following section. Double tax agreements are not considered by this paper.

5. Application to the South African Legislation

5.1 Controlled Foreign companies

According to section 1 of the Income Tax Act, a company is a resident if it is incorporated or effectively managed within the Republic. If neither requirement is fulfilled then a company constitutes a non-resident company.

The South African Revenue Services (SARS) has implemented section 9D in the Income Tax Act which governs the treatment of Controlled Foreign Companies. The section was introduced because it was felt that more multinational enterprises would artificially transfer profits offshore to tax havens where South African tax would not likely impede on international competitiveness (Engel, 2002). The legislation states that a Controlled Foreign Company is any foreign company in which one or more residents holds directly or indirectly more than 50 percent of the participation rights or has the ability to exercise more than 50 percent of the voting rights (Haupt, 2015). Furthermore if a resident company together with connected persons (resident and non-resident)

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controls a foreign company in accordance with the aforementioned requirements, and in turn that foreign company has the ability to exercise more than 50 percent of the voting rights in another foreign company, then the latter foreign company is also deemed to be a Controlled Foreign Company. The net income of these Controlled Foreign Companies is included in the taxable income of the parent company to the extent of the parent company's effective interest in each Controlled Foreign Company. Certain exemptions exist that preclude the parent company from having to include the net income of the Controlled Foreign Company in its taxable income. If the parent company together with connected persons holds less than ten percent of the participation rights in the Controlled Foreign Company then the net income inclusion amounts to nil (Haupt, 2015). In addition, if the foreign tax levied on the Controlled Foreign Company is equal to or greater than 75 percent of the South African tax calculated on the Controlled Foreign Company's taxable income, then the net income inclusion also amounts to nil. Lastly, if the Controlled Foreign Company is a foreign business establishment of the resident parent company, the net income shall not be included in the taxable income of the parent. The deductions against the income of a Controlled Foreign Company are limited to the said income. Therefore the inclusion of a Controlled Foreign Company's net income cannot reduce the taxable income of the parent company. If the deductions exceed the net income, the excess deductions are carried forward to the next year of assessment (Haupt, 2015).

A significant component of the success of a Double Irish Dutch Sandwich scheme is that Company A is able to 'check-the-box' resulting in Companies B and C, being treated as an Irish resident from a United States tax law perspective. Due to the absence of an elective provision from the South African legislation to disregard foreign subsidiaries, Company A would need to look to other provisions for exclusion. Company A holds 100 percent of the participation rights in its Companies B and C. Therefore it cannot apply the exclusion for holding together with its connected persons less than ten percent of the participation rights in the Companies B and C. Ireland's corporate tax rate is 12.5 percent. This is significantly less than the 21 percent (calculated as 75 percent of 28 percent) effective tax rate required for the exclusion to apply. As such Company A cannot apply the 75 percent rule either.

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The foreign business establishment exclusion was implemented in order to facilitate international competitiveness. However this exclusion can only apply if it does not threaten the South African tax base (Engel, 2002). Accordingly the three factors that a business establishment must possess are permanence, economic substance and a reason for operating in a foreign country other than for tax purposes. With reference to the last said factor, Companies B and C must have a bona fide non-tax business reason for operating in Ireland and not in South Africa (Engel, 2002). This paper has undertaken to outline Google's tax advantage from having subsidiaries in Ireland. In order to convince SARS that its Irish subsidiaries are foreign business establishments, Company A must provide a reason that bears significance to its operations in Ireland. Such schemes typically revolve around the use of intellectual property – an intangible asset. An advantageous quality of an intangible asset is that it is easily transferrable across international borders. Because Company A operates via the internet, it can reach its customers around the world. Therefore Company A could reach its global customer base from its country of residence without necessarily requiring subsidiaries in foreign countries to expand its international competitiveness. In assessing the precision with which Company A has tactically implemented its Double Irish Dutch Sandwich and with specific reference to the tax residences of the subsidiaries within the scheme, Company A may have difficulty in explaining why it chose the specific residences it did and why it transacts in the sequence in which it does without the reason bearing sole significance to its avoidance of tax. If SARS were to hold this view and deem its reasoning for operating abroad inadequate, the foreign business establishment exclusion would not apply.

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Therefore Company A would not meet any of the requirements to exclude the net income of its Irish subsidiaries. The net income would be included in the taxable income of the parent company and subject to a corporate tax rate of 28 percent under section 9D. The absence of a check-the-box provision in the South African Income Tax legislation and the provisions of section 9D prevents multinational enterprises from earning offshore profits through its subsidiaries without it being taxed in the country in which the parent company is resident. The South African legislation ensures that profits are taxed as they accrue and prevents such tax avoidance.

5.2 Royalties

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Section 9D(9) of the South African Income Tax Act states that a Controlled Foreign Company must exclude any amount in the form of royalties from its net income if those royalties are received from another Controlled Foreign Company and both said Controlled Foreign Companies form part of the same multinational enterprise. Following from this, the Controlled Foreign Company paying the royalties is disallowed from deducting the royalty payments when determining its net income. A Double Irish Dutch Sandwich typically involves the payment of a royalty between two Controlled Foreign Companies, in this case Companies B and C. However the application of section 9D treats the transaction as though it did not occur. As such, section 9D not only ensures that the multinational enterprise's Controlled Foreign Companies are taxed but also ensures that the profits are attributed to the Controlled Foreign Companies in which they were earned.

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For the purposes of applying the following section of the South African legislation, it is assumed the intellectual property of the multinational enterprise was created in South Africa, and the multinational enterprise has subsequently transferred the said intellectual property out of South Africa. As stated in section 3, for the purposes of considering section 23I, it is assumed that Company C is a resident company (if Company C is not a resident, section 23I would not apply but then the operations of Company C would have to be located outside of South Africa). The multinational enterprise would need to consider whether section 23I of the Income Tax Act would prevent it from reducing its tax liability. Section 23I of the Income Tax Act prohibits the deduction of royalties paid to a non-resident (and tax exempt entities) for the use of what is referred to in the Act as 'tainted intellectual property (Haupt, 2015)'. There are numerous provisions, only one of which is required to be met, which may result in the intellectual property to be deemed 'tainted'. Essentially the provisions require that the intellectual property is or was the property of either a taxable person or the end user and that the intellectual property is used within the republic. A taxable person, as defined under section 23I, refers to a person that is a resident with certain exclusions that are not relevant for the purposes of this paper. In addition the section defines an end user as a taxable person or a person with a permanent establishment that uses the said intellectual property to derive income. If the intellectual property is not tainted then section 23I will not apply. Furthermore if the person to which the royalty is paid will

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be taxed in South Africa on the receipt of the royalty payment, this section will not apply. In the event that section 23I does not apply, the royalty payment shall be deductible in its entirety.

Company C is the end user given that it uses the intellectual property to derive income not by means of granting use to another person. However the intellectual property is not the property of Company C. It is the property of Company B. Company B is not a taxable person of South Africa as defined, given that it is not a resident. Therefore at no stage was the intellectual property the property of a person who is a resident of South Africa, which suggests that the intellectual property is not tainted. Given that the intellectual property is not tainted, section 23I will not apply.

While Company C is not prevented from deducting its royalty payment in full, it must look to section 49 to determine whether it is obliged to withhold a royalties withholding tax of 15 percent upon the payment of a royalty to a non-resident – the Dutch subsidiary – hereafter referred to as Company D. The only exemption to section 49B that is available to companies (other than headquarter companies) is if the non-resident company carried on business at any time during the 12-month period preceding the date on which the royalty was paid, if the business was carried on through a permanent establishment of the non-resident in South Africa. Company C is not a permanent establishment of Company D given that they are separate legal entities (Organisation for Economic Co-operation and Development, 2003). As such the exemption does not apply. Company C would be obliged to withhold 15 percent royalties withholdings tax which is effectively levied on the Company D. Google would be able to avoid tax by paying at less than the corporate tax rate of 28 percent but the withholdings tax ensures that SARS receives a portion of tax on the transaction.

5.3 Thin Capitalisation

The interest on the intra-group loans Company E receives from foreign parent Company F may be subject to section 23M. Section 23M limits the deduction of interest that can be claimed by a resident debtor calculated using a formula laid out in the section. Furthermore the interest income received by the creditor, who must have a controlling relationship with the debtor, must not be subject to South African tax in order for this

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section to apply. This section often applies to creditors who are not residents of South Africa for tax purposes (Haupt, 2015).

In applying section 23M to the intra-group loans, one of the key points is that Company F, the creditor, must not be subject to South African tax. Two forms of taxes which are levied on interest are interest withholdings tax and income tax. Section 50A to section 50H of the Income Tax Act states that interest withholdings tax is levied at 15 percent on interest from a South African source for the benefit of a non-resident person. Therefore Company F would be liable for 15 percent of the interest income it receives. In the event that Company F is subject to interest withholdings tax, it is not subject to any further South African tax on the interest and as such it is necessary to look at section 50 before considering section 23M.

Section 50D lists the exemptions from interest withholdings tax that can be applied. One exemption that is particularly relevant to Company E states that if the interest is paid to a foreign person as a result of debt which is connected to a permanent establishment of the non-resident person in South Africa, the withholdings tax shall not apply (Haupt, 2015). The Income Tax Act refers to Article 5 of the Model Tax Convention on Income and on Capital of the OECD in order to determine the definition of a permanent establishment. In accordance with the definition in Article 5, the fact that Company E in South Africa is controlled by another company in a different contracting state – the United States – does not itself result in Company E being considered to be a permanent establishment (Organisation for Economic Co-operation and Development, 2003). Therefore the interest withholdings tax would apply and Company F would be taxed at a rate of 15 percent on the interest accruing to it. Accordingly section 23M would not apply which would allow for the Company E to deduct its interest expense in its entirety. However it is important to note that SARS has an alternative limitation in section 23M should section 50 not apply, ensuring that SARS receives its fair share of tax revenue. Although the parent company is taxed on its interest income, it is only taxed at a rate of 15 percent which is substantially less than the South African corporate tax rate of 28 percent. In spite of the ability of the South African subsidiary to deduct its interest expense in full, section 50 limits the multinational's ability to minimise its tax liability with section 23M as a potentially alternative limiting section.

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While section 23M of the Income Tax Act is a matter of law, the provisions of section 31 are a matter of facts and circumstances. Section 31 governs thin capitalization and affects the ability of the resident borrower to deduct interest expense in accordance with section 24J or section 11(a) of the Act. SARS considers that a company with a debt to equity ratio in excess of 3:1 poses a greater risk of thin capitalization (Haupt, 2015). However this detail is guidance to companies; it is a matter of judgement and not law and will likely result in an inquiry from SARS. In addition, it is considered by SARS that an interest rate of two percentage points in excess of JIBAR, the Johannesburg Interbank Agreed Rate, is of high risk. If the debt is denominated in a foreign currency, two percentage points in excess of the foreign country's base rate is considered risky (Haupt, 2015).

A SARS inquiry will review the terms of the transaction. More specifically, SARS will review whether the terms of the transaction are at an arm's length. In the event that SARS deems a loan to be in excess of what a company would be able to borrow having considered the aforementioned factors, it disallows the deduction of the interest expense on the portion of the loan that is deemed to be excessive. If the interest rate is deemed to be excessive, the excess portion of the interest expense is disallowed. In addition, SARS is able to enforce a secondary adjustment. The excessive loan portion is deemed to be a dividend in specie paid by the borrower to the lender. In accordance with section 64 of the Income Tax Act, a dividends withholding tax of 15 percent is levied on the dividend and the borrower, who pays the deemed dividend, is also liable to SARS for the withholdings tax.

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This paper assumes that if Company E, which is entirely funded by debt and reports consistent losses (thus mimicking Starbuck's subsidiary), and subsidiaries of comparable multinational enterprises are residents of South Africa (in line with the assumption made above for the purposes of applying section 23M and section 50), Company F will lend according to JIBAR (in place of LIBOR), being South Africa's base rate, plus any percentage points. Therefore the application of this assumption implies that Company F will lend to its Company E at JIBAR plus four percentage points. Given that this interest rate is in excess of what SARS deems to be indicative of higher risk of thin capitalization it would result in a SARS inquiry. SARS is able to take

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into account comparable information by looking at comparable taxpayers. It was mentioned that the subsidiaries of McDonalds and KFC borrow at lower interest rates than Starbucks – by at least two percentage points (Bergin, 2012). The interest rate levied may also appear excessive from the perspective of SARS if it considers that the multinational's bonds would attach a coupon rate of only JIBAR plus 1.3 percent. Collectively these indicators could result in SARS disallowing interest deductions in excess of JIBAR plus two percentage points. Considering the fact that Company E is entirely funded by debt, the disallowance of a portion of the interest deduction could significantly reduce the efficacy of the tax avoidance scheme.

When comparing Company E's high-gearing to its equity, SARS could also deem a portion of its loans borrowed from its parent company to be excessive. Given that Company E has consistently reported losses and consequently paid no income tax, it implies that the subsidiary's equity is either negative or very small. In light of this it would appear that the debt to equity ratio is likely to exceed 3:1 re-enforcing the probability of a SARS inquiry in addition to its excessive interest rates. Therefore Company E would not only have its interest deduction limited to the allowable portion on the loan but would also be liable to SARS for dividends withholdings tax on the excessive portion at a rate of 15 percent. As such section 31 limits the ability of multinational enterprises to manipulate the size of its loans and interest charges thereon in order to minimise its tax liability in South Africa.

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5.4 Transfer Pricing

Section 31 can also be applied to transfer pricing, but to a lesser extent. It states that if a resident and a non-resident are connected persons and are not transacting at arm's length, then the Commissioner for SARS is able to adjust the price of the goods or services transferred. The problem with section 31 is that there is no guidance provided to assist persons in determining an arm's length price. Furthermore the section also neglects to discuss how the terms and conditions of an arrangement or transaction are interpreted which may support a price quoted for goods or services or, on the contrary, provide evidence of tax avoidance. For example, the Commissioner may seek to determine whether there are bona-fide reasons for quoting a higher or lower price that would otherwise appear to avoid tax purposely. As a result, the Commissioner may be

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inclined to look at section 80 together with section 31 in assessing transfer pricing practices of multinational enterprises.

5.4.1 General Anti-Avoidance

Section 80 of the Income Tax Act contains the general anti-avoidance legislation. SARS seeks to identify avoidance arrangements which lack commercial substance or are not at an arm's length and the sole or main purpose is to derive a tax benefit (Haupt, 2015). The onus falls on the taxpayer to prove that the sole or main purpose of the arrangement is not to avoid tax. In establishing the purpose of the arrangement, the substance of the arrangement is assessed and not the form (Haupt, 2015). This is essential in determining the intention of the parties. Furthermore the taxpayer must show that there is an element of normality embodied by the arrangement. To show normality, one must show that there is a bona-fide reason for the arrangement absent of any tax considerations (Haupt, 2015). Should the Commissioner for SARS determine that an impermissible tax avoidance arrangement has occurred, he is able to levy tax by re-characterising terms of the arrangement (for example, treating separate connected persons as one person). Section 80 is principle-based and thus requires application to each arrangement. It is not prescriptive and provides limited guidance to companies for the way in which they should price intangible and tangible assets for sale between connected persons.

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The Income Tax Act does not specifically refer to arrangements such as Cost Sharing Arrangements or Contract Manufacturing and given the lack of prescription within the aforementioned sections governing tax avoidance, multinational enterprises may have the ability to manipulate their transfer pricing practices to derive a tax benefit. While the Commissioner has the power to exercise his discretion, there are practical limitations in doing so. The central issue within these practical limitations is the determination of an arm's length price. The determination of an arm's length price is affected by numerous factors such as the nature of the asset, the industry and the terms of the arrangement. Although SARS is not a member of the OECD, it refers to the principles within the OECD's transfer pricing guidelines for the basis of its assessment (Organisation for Economic Co-operation and Development 2013). Together with these guidelines SARS will consider the substance of a transaction rather than its form in determining whether the primary intention of the transaction is to avoid tax.

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5.4.2 Cost Sharing Arrangements

The fact that South Africa has not instituted legislation that governs Cost Sharing Arrangements makes it a more desirable scheme for multinational enterprises to exploit in South Africa. SARS would apply the OECD's guidelines on Cost Sharing Arrangements in determining whether its cost contributions for the use of resident parent Company G's intangible property were at an arm's length price. The OECD's guidelines require that the multinational company makes substantial disclosure regarding its arrangement including the basis on which the cost contribution was determined. For example, a cost sharing arrangement requires that the cost contribution made by Company G is in proportion with the benefits it expects to derive from the use of the intellectual property. Foreign Company H would need to project its expected benefits. The OECD states techniques that participants may use such as the additional income or costs saved by each participant as a result of entering into the arrangement and subsequently using the intangible property. Participants could also use allocation keys such as sales units to determine the proportion of costs that must be contributed (Organisation for Economic Co-operation and Development, 2010).

Even with the use and disclosure of these techniques to forecast expected benefits the Commissioner may still struggle to find significant deviations from the arm's length principle. Company H could have made projections that were not made in good faith. The projections are subjective and Company H also has inside information that would allow it to argue that it used the best available information at the time to make such projections. The OECD's guidance also noted how problems may arise when the arrangement ends before the expected benefits are realised. This would allow Company H to claim deductions in the current year of assessment while deferring its taxable income to later year of assessments. These are factors that the Commissioner would need to consider in determining whether Company H is contributing an arm's length amount to the arrangement.

For example, the fact that Apple's parent company is deriving expected benefits at a ratio of 10:1 in proportion to its contributed costs versus the 15:1 ratio realised by Apple

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Sales International, provides insight into the reason why Apple was heavily criticised for practices which were alleged to be for the purpose of tax avoidance.

An excessive contribution by Company H would allow it to claim a greater deduction in South Africa where the corporate tax rate is 28 percent, and allow foreign Company G to under-contribute in the tax jurisdiction of Ireland. The subsidiary's small contribution allows the multinational enterprise to realise more of the profits arising from the arrangement in Ireland. The Commissioner may not have the resources to conclude that the arrangement is not in compliance with the anti-avoidance provisions. Multinational enterprises have substantial economic power and importance especially to third world countries such as South Africa and thus attempting to enforce the anti-avoidance provisions is likely to result in a lengthy legal process over and above the limited resources that the Commissioner has to prove that such avoidance has occurred (the onus is on the taxpayer to prove that they have not avoided tax, however the Commissioner must have a basis for holding a different view, hence the necessity for a justifiable opposing conclusion). Assuming the Commissioner was able to justify his belief that tax avoidance was present within the arrangement following the taxpayer's argument, he could disregard any part of the arrangement or any accommodating party amongst other remedies. However the OECD guidelines suggest that the Commissioner should only consider these remedies if the facts and circumstances differ significantly from the terms of the arrangement or a trend analysis shows that the proportion of costs contributed to the benefits realised have deviated. Where the Commissioner deems the cost contribution to be inappropriate, the OECD suggests an adjustment of contributions.

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5.4.3 Contract Manufacturing

The OECD provides relatively less specific guidelines for contract manufacturing resulting in the Commissioner for SARS having to exercise further judgement in determining whether transfer pricing practices are at an arm's length. Resident parent Company K would purchase its inventory from its foreign Company L at a high mark-up in order to obtain a greater section 11(a) deduction and shift a significant portion of its revenues to a foreign country. Chapter 2 of the transfer pricing guidelines discusses numerous methods that can be applied to transfer pricing arrangements in order to

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determine whether Company K is purchasing its inventory from the Company L at an arm's length price. Amongst these methods is the comparable uncontrolled price method (the 'CUP' method). This method compares the price charged on the inventory sold in a controlled transaction to the price in a comparable uncontrolled transaction. Any difference between the prices compared may suggest that the parties in the controlled transaction did not transact at an arm's length. Other methods include the Cost-Plus Method which first considers the costs incurred by the manufacturer, in this case Company L, and then determines an appropriate mark-up with reference to mark-ups on inventory in comparable uncontrolled transactions.

Unfortunately even with these methods SARS still faces substantial practical limitations in applying these methods to Company K and Company L. While contract manufacturing is not a complex scheme, the enforcement by SARS is difficult to apply. The CUP method is limited by the fact that there might not be any comparable uncontrolled transactions given material differences in the nature of the product sold by the multinational enterprise. For example, Apple's products and Microsoft products differ and thus it would be impractical to compare Microsoft's controlled transactions with Apple's uncontrolled transactions. The Cost-Plus method's shortfalls involve different accounting treatments of costs incurred by comparable companies and whether there is a tangible relationship between the costs incurred and an arm's length price. The CUP method is said to be the most optimal method for contract manufacturing if it is determinable with the best alternative being the Cost-Plus method.

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Company K would choose the method that allows Company L to set a high price in order for a greater portion of revenue to be recognized in a low tax jurisdiction and providing for greater deductions in South Africa. Furthermore the multinational is under no obligation to determine an arm's length price using the methods proposed in the OECD guidelines. Provided that the multinational is able to justify why its own method would determine a more accurate arm's length price and that it maintains appropriate documentation, it is able to use another method. Given that it is not feasible for the guidelines to propose a method for every specific transaction and considering the fact that Companies K and L have inside information into its own operations, it is possible for the multinational to determine an arm's length price using a method which is convenient for itself. Company K would also need to put forward an argument to

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SARS, convincing them that there is no tax avoidance implicit in the determination of the price, because the onus falls on the taxpayer. However, in order for SARS to justifiably amend the practices of Company K, it would need to have a sufficient basis for doing so. Given the lack of prescription of the methods in determining an arm's length price and the argument put forward by Company K supporting its method, further analysis and resources would be required by SARS in order to gather sufficient evidence of mispricing as a basis for amendment (particularly if the case were to be heard in the South African Tax Court). Thus further consideration must be given to the extent of SARS' "manpower" in investigating the practices of the multinational enterprise.

5.5 Management Fees

Management fees levied for the provision of intra-group services also fall within the scope of transfer pricing guidelines. SARS would need to consider whether intra-group services have been provided to resident Company M and if so, whether the fees levied upon Company M are commensurate for the services provided. In determining whether services have been provided, the Commissioner of SARS would need to consider whether the services provided have economic value that would improve the commercial position of Company M. The question needs to be asked whether the subsidiary would be willing to pay for the said services from an independent third party. Section 80C states that for the transaction to lack commercial substance, a party must derive a significant tax benefit (Haupt, 2015). However it is not clear how the significance of the benefit is to be determined. The question remains whether the Commissioner should consider the significance of the tax benefit in a subjective manner i.e. from the perspective of the benefitting party, or objectively i.e. from the perspective of the man in the street (Haupt, 2015). The lack of clarity within the legislation results in the Commissioner having to exercise further judgement and as such the facts required to substantiate the Commissioner's argument become more onerous.

As of 1 January 2016 Section 10(1)(LB) will take effect which stated that service fees paid to a non-resident from a South African source are subject to a withholdings tax of 15 percent (Haupt, 2015). Therefore Company M will be subject to a withholdings tax but would likely not result in the multinational enterprise restructuring its practices.

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Provided that the service fees are subject to the withholdings tax, it is exempt from South African normal tax. However, a deduction may still be claimed.

6. Conclusion

This paper sought to determine whether the South African tax legislation would limit the effectiveness with which tax avoidance schemes implemented by multinational enterprises to minimise their tax liabilities. It discussed how multinational enterprises are structuring their operations in such a manner that shifts their profits to lower tax jurisdictions and minimise their tax liabilities. These avoidance schemes included disregarding of Controlled Foreign Companies (checking-the-box), royalty payments, intra-group loans, transfer pricing and management fees. Application was provided by showing how multinational enterprises such as Google and Microsoft are alleged to have implemented the said methods within its tax avoidance schemes. The paper proceeded to apply the avoidance methods to the South African tax legislation. To serve this purpose, the paper assumed that either the parent company or one of its subsidiaries was a South African tax resident depending on which company within the multinational enterprise was considered central to the operation of the avoidance scheme.

The paper found mixed results. In some circumstances the South African tax legislation, and more specifically the Income Tax Act, limited the effectiveness with which multinational schemes could avoid tax in South Africa. Controlled Foreign Companies' net incomes would be required to be included in the taxable incomes of their parent companies if the Commissioner deemed the foreign business exclusion to not apply through the use of judgement. South Africa's withholdings taxes on interest and royalties impaired the ability of multinationals to avoid tax along with the legislation regarding thin capitalisation. In other circumstances the results demonstrated either an inability of the legislation to curtail the effectiveness of avoidance schemes, or the requirement for substantial evidence and judgement in order to limit the schemes' effectiveness. The discussion on transfer pricing suggested that South Africa's legislation is unlikely to limit the effectiveness of those tax avoidance schemes given the practical limitations faced by the Commissioner for SARS.

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The paper is subject to quantitative limitations in determining the extent to which the South African legislation limits (where applicable) the ability of multinationals to minimise its tax liabilities. Access to quantitative data could allow for further research into this topic to evaluate the extent to which the South African legislation limits the effectiveness of the avoidance schemes. Some schemes used by multinationals lack prescriptive legislation, as is the case in respect of transfer pricing. Instead the legislation is principle-based requiring application to each specific scheme and judgement on the part of the Commissioner. Therefore the results were not absolutely conclusive.

This paper also provides a basis for which recommendations can be made to improve the South African legislation governing transactions and schemes which are reducing tax. Transfer pricing has proven to be a particularly difficult area to govern, and South Africa lacks comprehensive depth in, and interpretation notes for, transfer pricing. Thus it could be an important area of focus going forward. Furthermore, recommendations for the inclusion of new sections governing specific transactions could prove to be necessary as the tax legislation evolves to negate new and more complex methods of multinational tax avoidance. South Africa has no specific legislation governing Cost Sharing Arrangements which may provide an incentive for multinationals to exploit this potential loophole. The developing economy of South Africa requires substantial funding in order to facilitate economic growth and given the country's significant budget deficit, SARS' ability to collect tax in the future from multinationals will have a major impact on both economic growth and balancing the budget.

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