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Base Erosion and Profit Shifting: A Blueprint for Africa's Response

IBFD
Centre for Studies in African Taxation

Base Erosion and Profit Shifting: A Blueprint for Africa's Response

Why this book?
Increased globalization and technological enhancement have led to the integration of the global economy, allowing multinational enterprises to operate more efficiently. In most cases, this involves complex structures and may present challenges from a tax perspective due to gaps and mismatches in countries' tax systems. A significant challenge is the risk of tax base erosion and profit shifting (BEPS).

The last few years have witnessed many coordinated initiatives in the international tax arena to identify and address the causes of BEPS. Various organizations have been at the forefront in this regard, including the OECD, UN, IMF and the World Bank Group (collectively constituting the Platform for Collaboration on Tax) and the African Tax Administration Forum (ATAF).

Base Erosion and Profit Shifting: A Blueprint for Africa's Response discusses the relevance to Africa of the various measures proposed under the OECD project to tackle BEPS. It approaches the different topics from policy and practical perspectives that will be useful for all readers. It enriches both of these perspectives by setting out African countries' experiences and challenges and discussing case law from the region. The book discusses the opportunities for Africa by proposing options to aid in implementing the BEPS measures. This book is the first comprehensive publication on international taxation in Africa.

This book is essential reading for policymakers, public and private tax practitioners, students and other stakeholders interested in African taxation matters. The author presents the information in an easy-to-understand manner that ensures that no reader is left behind. This work creates a platform that will stimulate further discussions within the region regarding the essential topics covered and broader tax issues for Africa.

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Foreword

It is my pleasure to write the foreword for this book *Base Erosion and Profit Shifting: A Blueprint for Africa's Response*.

This book is the first publication of the IBFD Centre for Studies in African Taxation (CSAT). It marks the launch of a book series that will offer in-depth treatment of various aspects of tax law in Africa.

CSAT is an independent think tank, devoted to the study and development of taxation in Africa. It executes its mission via conferences (such as the notable annual Africa Tax Symposium), training sessions for tax administration officials and research activities.

When we launched CSAT in 2015, the international tax world was eagerly awaiting publication of the recommendations of the OECD/G20 Base Erosion and Profit Shifting Project (BEPS measures). The BEPS measures would set out the future policy direction of international taxation, possibly for decades to come.

Given the global significance of the BEPS measures, a crucial question – for African tax professionals – concerned the applicability of the new proposals within the African context. While this question was likely not foremost in the minds of the drafters of the Action Plans (as evidenced by the paucity of input from Africa), it was nevertheless a burning issue for Africa. Faced with a raft of policy proposals, certain questions arose: What is relevant? What is at risk? How should Africa react?

The author addresses these questions, and more. The book opens with a timely (and thorough) reminder of the importance of tax revenues (specifically corporate tax revenues) in Africa's development. Next, it highlights the problems that ensue when such revenues fail to materialize. It then zeroes in on its main theme – base erosion and profit shifting, identifying this as one of the main reasons for poor domestic resource mobilization in Africa. The author then highlights the relevant BEPS measures, and proceeds to analyse them in the African context, enriching the text with examples from Africa's domestic laws and tax treaties.

In commissioning this book, we had one main aim – to analyse the BEPS measures from an African perspective. Our plan was to present our analysis in a rich bed of contextual material, drawn from the law and practice of the entire continent. We have achieved this objective.

This book is written for those with an interest in tax policy in Africa. For the tax administration official, it is a helpful guide to the solid principles undergirding current and emerging tax law. For the tax practitioner, it is a comprehensive text on international tax law in Africa. For the legal draftsman, it provides inspiration for innovative and effective rule-making.

We are honoured to have had Professor Annet Wanyana Oguttu as author of this book, and, consequently, as the first-ever CSAT Research Fellow. Annet is a highly regarded tax scholar and champion for Africa. Over the past decades, she has played a crucial role in the development of African tax policy, at national, regional and international levels. I cite as examples her work as a Commissioner on the South African Law Reform Commission and as the BEPS Chair of South Africa's Davis Tax Committee, her engagement with the African Tax Administration Forum (ATAF) and her role as technical adviser to various UN bodies concerned with taxation. I would like to thank her for her dedication to this project.

I would like also to thank everybody who made this book possible – the in-house CSAT research team, led by Emily Muyaa (CSAT Manager, and also Managing Editor of this book); our linguistic editor, Kim Hutchings; the IBFD Publisher, Jane Kerr; and the IBFD Production department.

CSAT is delighted to present this book – our latest contribution to African tax policy. We trust you will find it of great value.

Belema R. Obuoforibo CTA ATT (Fellow)
Chair, IBFD Centre for Studies in African Taxation

April 2021

Preface

The inspiration for this book was hatched at the IBFD 2nd Africa Tax Symposium in Entebbe, Uganda, in 2016, when Ms Belema Obuoforibo and I pondered the dearth of books on international tax in Africa and in particular on base erosion and profit shifting (BEPS) from an African perspective. This book acknowledges that, while BEPS practices occur in all countries – and are damaging everywhere – the social and economic impact on developing countries such as those in Africa is more severe, given their smaller markets, heavier reliance on corporate income tax and weaker tax enforcement capabilities. Even though BEPS is a global concern, the nature of BEPS concerns is not uniform for all countries. Certain BEPS schemes that work to undermine the European or American tax base often do not coincide with the African paradigm.

This book analyses the experiences and challenges of addressing BEPS in Africa. It goes beyond the concerns identified by the OECD BEPS Project, and analyses other factors that contribute to BEPS in Africa (such as tax incentives) and other interrelated matters, like illicit financial flows, that are of particular concern to Africa. Consequently, beyond the OECD recommendations to address BEPS, this book explores other practical measures and tailored approaches which may be more suitable for capacity-constrained African countries in addressing their particular BEPS concerns, without undermining the integrity of the international tax system. The book enjoins African countries to make use of the current international focus to address BEPS and develop their international tax laws while the international political will and support of the international community still stands.

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Introduction

Increased globalization and technological enhancement have led to the integration of economies, allowing multinational enterprises (MNEs) to operate more efficiently and adapt their supply chains to new ways of doing business. This development presents opportunities and challenges for stakeholders. One of the key opportunities is the ease of operation and access to the global economy. However, MNEs often operate through complex structures, presenting challenges both from a technical and an administrative perspective.

In recent times, there have been many discussions in the international tax arena to find solutions to enable countries to protect their tax bases. Examples of cross-border transactions that often receive much focus in this regard include management and technical service payments, royalty payments and interest payments from a general international tax and transfer pricing perspective. Other issues include treaty shopping and structures involving hybrid entities and instruments, etc. In that regard, most countries have implemented domestic legislation that denies treaty benefits, disallows or limits deductions, etc. Consequently, tax disputes may result, which can take a long time to resolve. Other challenges involve the pricing of cross-border related-party transactions, notably intra-group services, intangibles and financial transactions. There remains a backlog of tax cases in most countries, and there is a need to resolve such disputes effectively.

It is no wonder, then, that the last few years have seen momentous developments in taxation both at the national and international levels, especially those initiated by the OECD/G20 Base Erosion and Profit Shifting Project, which commenced in 2013. The BEPS Project aimed to address the concerns of countries globally regarding the erosion of their tax bases. Base erosion results mainly from gaps and mismatches in countries' tax rules, which enable the use of planning strategies that shift profits to low or no-tax jurisdictions with little or no economic activity. These gaps and mismatches arise from the interaction of countries' domestic rules in the context of cross-border transactions and dealings involving MNEs.

In 2015, the OECD presented the BEPS Project outcome as a series of final reports, presenting recommendations based on a 15-point Action Plan (the BEPS Package) covering areas that were critical in addressing the concerns raised by countries regarding base erosion and profit shifting. The project initially took off as an initiative driven mainly by developed countries (OECD member countries). It was later opened for participation by other, including developing, countries through the Inclusive Framework initiative. The Inclusive Framework was established in 2016 in recognition of the vital role that developing countries could play in ensuring a practical international tax framework through the implementation of the BEPS Package. As of February 2021, the Inclusive Framework had approximately 139 members.

The final reports contained critical findings regarding the way forward towards reshaping the international tax framework to tackle base erosion and profit shifting. The final reports set out recommendations for implementation of BEPS measures in at least four formats: (i) as minimum standards, i.e. those measures where no action by some countries would result in negative spillovers for other countries; (ii) best practice and common approaches for domestic law; (iii) reinforcement of international standards; and (iv) analytical reports on how certain BEPS concerns should be addressed. More specifically, members of the Inclusive Framework have committed to implementing the measures presented as minimum standards. Peer reviews, undertaken over multiple phases, are the primary tool used to monitor the measures' implementation status. The OECD publishes the findings from the peer reviews from time to time. The uptake regarding implementation of the BEPS measures varies across countries.

This book discusses the BEPS measures and their implementation from an African perspective. It undertakes a thorough analysis of the action points presented in the BEPS Package and considers the experiences, challenges and opportunities for African countries. The book also discusses other key aspects for African countries (and developing countries in general) that were not (sufficiently) tackled by the BEPS Project, such as tax incentives.

The book is divided into five parts. Part 1 is dedicated to the background context regarding domestic resource mobilization and BEPS. The remaining parts discuss the BEPS measures based on their recommended mode of implementation for members of the Inclusive Framework, as follows:

– Part 2 comprises the measures whose implementation (or aspects thereof) constitutes a minimum standard. These are: Action 5 (countering harmful tax practices); Action 6 (preventing treaty abuse); Action 13 (re-examining transfer pricing documentation); and Action 14 (improving dispute resolution).

– Part 3 includes measures that are priority best practices that African countries could emulate. These are: Action 2 (neutralizing hybrid mismatch arrangements); Action 3 (strengthening controlled foreign company (CFC) rules); Action 4 (limiting base erosion through interest expenses); and Action 12 (mandatory disclosure of aggressive tax planning).

- Part 4 comprises measures that contain international standards: Action 7 (preventing the artificial avoidance of permanent establishment status) and Actions 8-10 (ensuring that transfer pricing outcomes are in line with value creation). The Action 2 aspect regarding mismatch arrangements involving dual resident entities is discussed in Part 3 under Action 2.

- Part 5 comprises measures presented as analytical reports regarding the way BEPS concerns should be addressed. It covers measures set out under Action 1 (addressing the tax challenges of the digital economy, and subsequent work on the subject), Action 11 (establishing methodologies to collect and analyse data on BEPS and the actions to address it), and Action 15 (developing a multilateral instrument). There has not been much work in Africa regarding Action 11. As such, this item is not dealt with in detail in this book (*but see* Chapter 2 (section 2.10.4.) for a summary of Action 11). Part 5 also contains Chapter 15, which provides concluding remarks.

It is essential to ask ourselves a critical question in order to successfully put in context the debate surrounding the BEPS Project from an African perspective: Why are taxes and protecting tax bases important? Chapter 1 answers this question by setting the scene regarding implementing the BEPS measures in Africa. It does so first by tracing the roots of taxation (from early times and post-independence) and the growth of the international economy. It discusses domestic resource mobilization, a concept that is of great importance in ensuring that countries can generate revenues for sustainable development, and considers some setbacks faced by African countries in mobilizing revenue resources. It then introduces the meaning of BEPS, considers the causes and the financial impact of BEPS and gives a synopsis of the OECD BEPS measures and the fundamental pillars on which the measures are based.

Various aspects aggravate the risk and impact of BEPS in Africa, and might vary from one country to another. However, what are some of the more widely encountered factors in this regard? Chapter 2 takes the reader through some pertinent issues and poses various questions regarding the BEPS Project and Africa's response. For example, it draws attention to crucial policy considerations that are relevant for African countries in deciding whether and how to implement the measures. It also considers measures that are a priority for African countries. Various international organizations and bodies have undertaken many initiatives to continue the dialogue on effective tax systems through coherent international (and domestic) tax rules during and after the BEPS debate. These initiatives are discussed in this chapter and throughout the book. They include those by the International Monetary Fund (IMF), the United Nations (UN) and the World Bank Group (WBG), individually or together as members of the Platform for Collaboration on Tax (PCT), the African Tax Administration Forum (ATAF), etc.

Over the years, there have been many discussions regarding how a country's tax system can be harmful to other countries' tax systems, especially where the former affords taxpayers secrecy that inhibits transparency and the exchange of information. Furthermore, preferential tax regimes can also harm other countries' tax systems, e.g. by encouraging harmful competition (the so-called race to the bottom). Another feature of most such tax systems in the past has been that countries imposed no substance requirements to ensure that tax practices were not harmful. Chapter 3 discusses the measure to counter harmful practices more effectively, taking into account transparency and substance (Action 5 of the BEPS Package). It begins by giving the context for some of the OECD's previous work in the area of harmful tax competition. It then discusses the critical considerations under Action 5. The chapter explores examples of African countries (e.g. Botswana, Liberia, Mauritius, Seychelles and South Africa) that have preferential regimes that are noteworthy in the context of Action 5. The chapter concludes by discussing special economic zone regimes and tax incentives more generally and their interaction with BEPS.

Base erosion and profit shifting through treaty shopping and generally obtaining treaty benefits in the circumstances not intended by policymakers are significant concerns for African countries, even though most of them have relatively small tax treaty networks. It is also an area that received broad international focus in developing countries more generally, even before the BEPS Project commenced, specifically in capacity-building efforts targeted towards African countries. From an African perspective, it is essential to consider certain aspects regarding the granting of treaty benefits; for example, what factors enable treaty shopping? To what extent, if any, do existing anti-avoidance measures such as the beneficial ownership concept effectively tackle treaty shopping? And what are the crucial tax treaty policy considerations when determining whether to enter into bilateral tax treaties? Chapter 4 discusses these key considerations and sets out the BEPS Project's recommendations to prevent treaty abuse (Action 6 of the BEPS Package). The chapter discusses the main rules developed under Action 6, mainly the principal purpose test and the limitation-on-benefits provision. The chapter concludes by examining aspects relevant for Africa to prevent treaty abuse that were not covered in the BEPS Project.

The pricing of cross-border transactions between related parties is another area in which most African countries have placed great focus. Key challenges from a transfer pricing perspective relate to the complexity of the subject, coupled with the inaccessibility of the information on which to benchmark the prices set for related-party transactions. As with any other area of tax, transparency is crucial for transfer pricing purposes. Although several African countries now have domestic legislation requiring some form of documentation for transfer pricing, it is an area that is still largely under development for most countries in the region. Chapter 5 discusses transfer pricing documentation requirements in the context of the BEPS Project's recommendations for a three-tiered documentation approach (Master File, Local File, and country-by-country (CbC) report). The chapter places greater focus on the CbC report, as the component that is to be implemented as a minimum standard by the Inclusive Framework members under Action 13 of the BEPS Package on re-examining transfer pricing documentation. The chapter discusses vital issues, including the crucial prerequisites for countries to exchange (and receive) CbC reports, and looks at the progress of implementing CbC reporting in Africa.

Certain related-party transactions have been a point of significant focus for African countries, including intra-group services, commodities and intangibles. The main concern is the non-alignment of transfer pricing outcomes with value creation. The question regarding risk allocation and control is vital for determining the outcome of related-party transactions. Transfer pricing issues generate disputes because of the complexity and uncertainty surrounding the application of the arm's length principle. Are there measures that could ease this challenge? Chapter 12 discusses all these issues and gives an in-depth analysis of the alignment of transfer pricing outcomes with value creation in the context of Actions 8-10 of the BEPS Package.

Interest and other financial payments are also a significant focus area for African tax administrations. Such expenses are unique in the sense that they present issues that go beyond transfer pricing considerations. Before the BEPS Project, most countries already had measures in place, such as thin capitalization rules, to limit interest expense deductibility. The BEPS

Project examined this aspect in order to arrive at a more uniform approach regarding the limitation of interest expense deductibility and other financial payments under Action 4 of the BEPS Package. Chapter 9 of this book discusses this and other relevant measures.

Operating structures involving hybrid entities, instruments or other arrangements present a challenge for many countries. The challenge arises because a mismatch in the way such aspects are dealt with under countries' domestic legislation can give rise to the unintended outcome of non-taxation, double deductions, etc., in one or more countries. Chapter 7 discusses these issues in the context of Action 2 of the BEPS Package. Operating through a permanent establishment (PE) also poses challenges, for example, in determining whether a PE exists due to practices such as artificial avoidance of PE status through activities such as splitting contracts to fall outside the time threshold for PE, commissionnaire arrangements, etc. Chapter 11 discusses these aspects.

Deferring tax in situations that might give rise to a perpetual exemption from taxation of the income of CFCs set up in offshore low or no-tax jurisdictions is of concern to many countries. The interaction of countries' domestic laws can result in outcomes that erode the tax bases of often high(er) tax jurisdictions. Chapter 8 deals with the measure under Action 3 of the BEPS Package on strengthening CFC rules. Only a few African countries have implemented CFC rules (or closely similar rules), notably Mauritius, South Africa and Tanzania (which is understandable, as the related companies in most African countries are not the parent companies of the MNE group). However, this chapter helps the reader to understand the operation of the rules for subsidiary companies in Africa, whose income might be covered under the parent company jurisdiction's CFC rules. This scenario might arise with such subsidiaries benefiting from specific incentives or meeting other criteria that qualify them as CFCs in the parent company's jurisdiction.

Promoting transparency continues to be a significant factor in discussions in the international tax arena. Countries have implemented various mechanisms requiring taxpayers and advisors to disclose aggressive tax planning arrangements in advance. What constitutes aggressive tax planning arrangements is determined under the domestic law systems. Chapter 10 discusses the proposals for the design of mandatory disclosure rules and examines South Africa's domestic rules vis-à-vis the recommendations in Action 12 of the BEPS Package. The chapter discusses South Africa's position as the only country in Africa with (comprehensive) mandatory disclosure rules.

Implementation and practical application of the various BEPS measures may result in uncertainty, especially where different countries implement the measures in their domestic law in varied ways. Consequently, disputes will arise/heighten in such cases. Chapter 6 deals with dispute resolution in detail. It discusses the mutual agreement procedure (MAP) for cross-border dispute resolution and the recommendations for making MAPs more effective (a minimum standard for Inclusive Framework members under Action 14 of the BEPS Package). The chapter also considers the United Nations' guidance on MAPs, which helps developing countries understand the process.

Implementing the treaty-related BEPS measures would require bilateral tax treaties to be adjusted through renegotiation of existing treaties. Of course, it might be that the recommendations will be taken up by contracting states during the negotiation process for new treaties. However, given the numerous tax treaties currently in force between countries and the complexity and length of time it would take for such an exercise, the OECD adopted a multilateral approach to implementing the treaty-related BEPS measures (encompassed mainly in Actions 2, 6, 7 and 14). Accordingly, the OECD developed the multilateral instrument (MLI). Chapter 13 discusses the MLI, including its operation, the status of signing, policy options and considerations for Africa and other developing countries when considering whether to sign the MLI.

Digitalization of the economy and the tax challenges arising from it has remained a cornerstone of the Inclusive Framework's deliberations. When the OECD first tackled digitalization in the context of Action 1 of the BEPS Package, the focus was more on digital companies, so to speak. There has since been a proliferation of unilateral measures by countries to address the tax challenges of the digitalization of the economy. These measures have included digital service taxes and nexus rules based on various indicators, such as significant economic presence, etc. The main concern was that the recommendations under Action 1 of the BEPS Package did not (sufficiently) consider new business models, which might not necessarily be (adequately) taxed under the existing international tax system. These concerns led the Inclusive Framework to continue discussions in this area. The Inclusive Framework's latest developments in this regard include a proposal for taxation based on two pillars that could form the basis for a consensus solution. In a nutshell, Pillar One presents a proposal for profit allocation and nexus rules applicable to business profits and expands market jurisdictions' taxing rights. Pillar Two proposes developing a set of coordinated rules to prevent the shifting of profits by MNEs to jurisdictions where they are subject to very low or no tax (the global anti-base erosion proposal).

At the time of writing the chapter, the most recent work of the Inclusive Framework on the subject had been the delivery of the Pillar One and Pillar Two Blueprints in October 2020, and the expectation was that further deliberations would continue on pending items with the hope of reaching consensus by mid-2021. The proposals are a significant development, as they involve a substantial shift from "normal" taxing principles. Readers need to monitor developments in this area. In 2020, ATAF published guidance on a suggested approach for drafting legislation on a digital services tax. Some African countries have implemented unilateral measures to address the tax challenges of the digitalization of the economy. These include Kenya (digital services tax) and Nigeria (nexus rule based on significant economic presence). Chapter 14 of this book discusses all these aspects of the tax challenges of the digitalization of the economy.

Chapter 15 rounds up the discussion on the various topics covered in the book by presenting some concluding remarks and insights.

This book is unique because it is the first comprehensive publication on international taxation in Africa, generally focusing on base erosion and profit shifting. It approaches the different topics from policy and practical perspectives useful for all readers. It enriches both these perspectives by setting out the experiences, lessons and challenges that African countries face by discussing case law from the region. The book presents opportunities for Africa by proposing options that would be helpful when implementing the BEPS measures.

The editor hopes that this work will stimulate further discussions on these essential topics on a regional basis between policymakers, public and private tax practitioners, students and other stakeholders interested in Africa's taxation matters.

Emily Muyaa
Managing Editor
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Editor's note: Unless otherwise specified, this book is based on information available and last reviewed as of August 2020.

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