South Africa's 2017 budget includes overall commitment to BEPS project

The South African Minister of Finance (MOF) presented the 2017 budget to parliament on 22 February 2017, proposing a number of changes to the tax rules for companies and individuals and reiterating South Africa's overall commitment to the OECD BEPS project. The budget now must be approved by parliament. Once approved, the tax proposals in the budget will enter into effect on various dates: some on the date the budget was presented, some from 1 March 2017 (or from years of assessment commencing on or after 1 March 2017) and some when further legislation is promulgated (certain proposals are still subject to further investigation and public consultation before being finalized).

The 2017 budget includes a provision that would increase the top individual marginal income tax rate to 45% (from 41%), effective from 1 March 2017. No changes are proposed to the corporate income tax rate. The tax proposals that would affect nonresident companies and multinational groups doing business in South Africa include the following:

Withholding tax rate increases

The rate of withholding tax on taxable dividends paid by South African companies to nonresidents would be increased from 15% to 20%, effective from 22 February 2017, and would result in an increased combined effective statutory tax rate on such dividends of 42.4% (up from 38.8%). The maximum rate on inbound foreign dividends also would be increased from 15% to 20%, effective from years of assessment commencing on or after 1 March 2017.

The rate of withholding tax imposed on the sale of immovable property in South Africa by nonresidents, which represents an advance payment of the capital gains tax, would be increased to 10% (from 7.5%) for companies and to 7.5% (from 5%) for individuals, in line with the increased capital gains tax rates that became effective on 1 March 2016. The increased rates would apply to disposals occurring on or after 22 February 2017.

Expansion of dividend stripping rules

The dividend stripping rules would be extended to apply to dividend stripping schemes where the loan funding is provided by a third party.

South Africa's tax rules target dividend stripping avoidance schemes where, just before the disposal of shares in a company, the controlling shareholder causes the company to declare a dividend that reduces the value of the shares for capital gains tax purposes. Consequently, under current law, if a company declares a dividend that is not subject to income or withholding tax and that is funded through a loan or guarantee from the acquirer of the shares (or a person related to the acquirer), the dividend will, in certain circumstances, be added to the share sale proceeds for purposes of calculating the capital gains tax due. A 2017 budget provision would apply the rules to situations where third-party loans are used to fund such dividend payments.

Deductions for intellectual property (IP) royalties paid to certain nonresidents

Current rules prohibit tax deductions for royalties incurred by South African taxpayers for the use of, or the right to use, "tainted IP" (*i.e.* locally developed IP assigned to a foreign entity located in a low-tax jurisdiction and licensed back to the South African taxpayer in exchange for royalty payments). The MOF has acknowledged that this anti-avoidance provision may dissuade South African-based groups from further local development of offshore IP for purely commercial reasons. Accordingly, the budget includes a proposal for the government to consider a relaxation of these rules under certain conditions still to be determined.

Other income tax measures

The following are some of the other income tax-related proposals included in the 2017 budget:

- A special tax dispensation would be introduced for foreign investors that invest in funds in South Africa for onward investment into the rest of Africa and the world, in particular, to encourage the establishment of financial hubs in the country.
- The qualifying criteria for "domestic treasury management companies," which are not required to recognize foreign exchange gains or losses for tax purposes, would be relaxed.

- Legislation would be proposed that would curb the use of offshore trusts and controlled foreign companies that reduce a taxpayer's liability for tax in South Africa.
- Legislation would be proposed that would prevent the avoidance of withholding tax and capital gains consequences on dividend distributions from "contributed tax capital" to foreign parent companies.
- Limited tax relief (available with respect to certain lending arrangements under current law) would be extended to include listed foreign government bonds.
- Foreign "donor funding organizations" would be exempt from withholding tax, in addition to income tax.

Value added tax (VAT) measures

The standard rate of VAT would remain at 14%.

Current law requires foreign entities to register for, collect and remit VAT on supplies of electronic services to South African consumers. A budget proposal would broaden the scope of the definition of electronic services subject to VAT to include cloud computing and other services that are provided using online applications.

The definition of "resident" for VAT purposes would be amended to exclude certain foreign entities that currently are "effectively managed" from South Africa, in keeping with the spirit of the law being a destination-based tax.

Exchange control measures

Budget proposals relating to exchange control include:

- The government's review of South Africa's exchange controls against best practices in other developing economies;
- The initiation of a consultation process with interested parties on new inward listings, "loop structures" and trusts, intended to discourage tax inversions where companies relocate their legal residence to lower-tax jurisdictions;
- The lifting of Reserve Bank approval requirements and certain other restrictions for standard IP transactions; and
- The permitted listing of exchange-traded funds referencing foreign assets on South African exchanges by collective investment scheme management companies.

Commitment to BEPS

The MOF acknowledged in his budget speech the work being undertaken by South Africa with respect to its involvement in the OECD BEPS project. South Africa already has the legislation in place to address many of the BEPS areas of concern. The country's current positions on the OECD recommendations on the 15 BEPS actions are as follows:

- **Digital economy (action 1):** Foreign multinationals rendering electronic services to local customers are required to register as South African VAT vendors. The regulations are under further review.
- **Hybrid mismatches (action 2):** South Africa has detailed tax rules deeming dividends on certain shares to be income and deeming interest on hybrid debt instruments to be dividends where appropriate. Further refinements may be considered.
- **Controlled foreign company (CFC) rules (action 3):** South Africa has detailed CFC rules.
- **Interest deductions (action 4):** South Africa has implemented detailed legislation to prevent the erosion of the tax base through excessive interest deductions. The government will review the legislation in light of the OECD recommendations and continue its focus on curbing excessive debt financing.
- **Harmful tax practices (action 5):** South Africa took part in the Forum on Harmful Tax Practices and has completed a self-review of preferential regimes.
- **Treaty abuse (action 6):** New treaties will comply with the BEPS project's minimum standards, while the multilateral instrument will address existing treaties. South Africa has opted to apply the principal purpose test to deal with treaty shopping, where an entity may be denied the benefits of a tax treaty if it is reasonable to conclude that obtaining such benefits was one of the main purposes of entering into a transaction.
- **Permanent establishment (PE) status (action 7):** South Africa will follow the recommendations to prevent entities from artificially avoiding PE status by fragmenting a cohesive business into smaller operations. These preventative measures will be incorporated in future tax treaty negotiations.

- **Transfer pricing (actions 8-10):** The tax authorities are updating the transfer pricing practice note in line with the OECD transfer pricing guidelines and the BEPS project and, specifically, the agreed approach to ensure the appropriate pricing of intangibles.
- **Data analysis (measuring and monitoring) (action 11):** South Africa will continue to work with other countries to curb BEPS through improved statistics and evaluation.
- **Mandatory disclosure (action 12):** The South African reportable arrangement rules have been used as a benchmark in the BEPS action 12 recommendations.
- **Transfer pricing documentation (action 13):** The regulations on country-by-country reporting and mandatory transfer pricing documentation were gazetted in 2016 and are in effect.
- **Dispute resolution (action 14):** The South African model treaty will be updated to include the minimum standards. South Africa has not committed to mandatory binding mutual agreement procedure arbitration.
- **Multilateral instrument (action 15):** South Africa is among a multitude of countries that have reached consensus on the OECD multilateral instrument, with the aim of incorporating BEPS recommendations into the existing network of bilateral treaties.

Comments

While the overall aim of the proposed budget is to raise tax revenue by increasing tax rates and curbing certain perceived tax avoidance opportunities (including by addressing BEPS-related actions and recommendations), the government also has proposed certain relief measures that hopefully would aid South Africa in becoming a destination of choice for large multinational groups focused on expanding their international presence.

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