BIZCOMMUNITY

Exploring alternative sources of state income

By Christian Wiesener

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Times are tough for the South African economy and this is further negatively affecting state finances with a significant deficit of several billion rands every month. Therefore, all eyes go to the Minister of Finance, Tito Mboweni, who will present the 2020 Budget on 26 February.

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Analysts have been warning that there is very little room to cut expenditure further, unless this relates to reducing wasteful expenditure items. In addition, particularly items such as bail-outs for state-owned entities, infrastructure maintenance, social grants and the looming National Health Insurance (NHI) are putting more pressure on the already fragile budget.

Prospects to increase state income on the other hand also look dire. The vast majority of gross income, about 80%, comes from personal income tax, VAT and corporate tax, with personal income tax generating most income. However, there is not a lot of room for tax increases as South Africa already hovers at the top when comparing tax rates internationally and in Africa. In addition, tax increases would be extremely unpopular. An increase in corporate taxes would also further stall much needed foreign investment into the country.

Interestingly, keeping corporate tax rates low and therefore incentivising global trade is one of the reasons behind the Organisation for Economic Cooperation and Development (OECD)'s Base Erosion and Profit Shifting (BEPS) 2.0 initiative. This is expected to have a significant, mostly positive, impact on developing countries including South Africa.

The OECD BEPS Initiative

A few years back, in 2015, the OECD, tasked by the G20, published *Reports on 15 BEPS Actions* designed to combat undesired tax avoidance and related matters at a global level, and the in,itiative brought about, arguably, the most significant changes to the international tax system since the early 20th century.

Following this, a growing number of countries, 137 to date, (the Inclusive Framework), including South Africa and several other African nations, implemented or committed to implement four BEPS minimum standards. These minimums standards relate to recommendations on addressing harmful tax practices (BEPS Action 5), treaty abuse (BEPS Action 6), country-by-country reporting (BEPS Action 13), and dispute resolution (BEPS Action 14). Many countries also implemented fully or partly some of the other BEPS actions, working towards combatting double non-taxation, but also double taxation.

However, very soon after BEPS Actions reports were released a new concern arose, because several countries took unilateral steps to ensure that they would not lose out on tax revenues due to BEPS related legislative changes around the world. For example, the US Tax Reform in 2017 included some specific rules to ensure broad taxation of US companies' foreign operations, the UK created several tax related incentives for taxpayers including a very low corporate tax rate and a diverted profits tax, and more recently, France and some Scandinavian countries have introduced digital sales taxes or are considering these. The increase in proposed and actual unilateral tax measures by countries to try and retain tax revenue from multinational groups bears the threat that it will jeopardise the desired effect of the BEPS initiative and negatively impact international trade.

OECD BEPS Pillar I and Pillar II proposals

Again, the G20 called the OECD to help finding a solution that would satisfy all and ensure a level playing field, this time ensuring that tax challenges arising from the digitalization of the economy would be addressed, resulting in corporate taxes being paid in a fair and equal manner across the world.

Then, in early 2019, considering various proposals from different jurisdictions the Inclusive Framework issued a policy note agreeing on further work to be done regarding a Two-Pillar approach. Subsequently, two discussion drafts were published and comments received late last year.

Having confirmed its commitment to find a consensus solution, still within 2020, the Inclusive Framework is now working further towards developing the two pillars.

The widely debated Pillar I proposals address the reallocation of taxing rights between jurisdictions, including a potential reconsideration of permanent establishment principles, the arm’s length principle, the future of multilateral cooperation on tax matters, the avoidance of unilateral tax measures and the taxation of highly digitalised multinational enterprises as well as multinational groups selling directly to consumers.

One of the intentions stated by the OECD is to specifically achieve that developing countries receive a fairer share of taxing rights. While there were initially several proposals and different views in respect of Pillar I at a meeting of the Inclusive Framework on 29 and 30 January 2020, it was agreed that the architecture of a unified approach, which is trying to find a consensus, is now being worked on and the deadline set for this is end 2020. It should be noted that South Africa participated in the Inclusive Framework meeting and the decision to follow the unified approach seeking a consensus based solution was confirmed during a meeting with National Treasury and stakeholders the week before.

Pillar II, which is also referred to as the GloBE (Anti Global Base Erosion) proposal focuses on the development of a set of rules with the aim to provide taxing rights to jurisdictions in circumstances where other jurisdictions have not accordingly exercised their primary taxing rights (taxing back) or in cases where the payment of tax is otherwise subject to low levels of taxation.

Potential benefits for South Africa

Although the proposed Pillar I and Pillar II approach has been widely discussed and met by many with criticism, the Inclusive Framework seems adamant to complete the work required by the end of the year. In all fairness it must be conceded that it is important that a globally accepted approach is implemented across the board. Failing this, international trade is likely to be impeded and this may result in a further decrease of much needed investment and economic activity in South Africa and Africa.

A success of the Pillar I and Pillar II initiative would in all likelihood be to South Africa's benefit. This is because one of the aims is that countries, in which consumers of services or goods provided by multinationals are situated, are to receive a larger share of the overall taxable profits of the relevant multinational. In addition, conceptually, the proposed new rules will be more beneficial to countries with significant in-bound multinational activity and South Africa is such a country, because the proposed rules are designed to increase the profit share attributable to the jurisdiction where the group provides services/goods to the customers.

The result of this would be increased tax collections. Furthermore, a simplification of existing tax collection and tax dispute resolution mechanisms, which is also contained in the Pillar I and Pillar II proposals, would furthermore help increase timeous tax collections and at the same time boost South Africa as investment destination, because improved tax administration means more certainty and consistency for taxpayers.

While it is reportedly difficult in the current environment for the state to reduce expenditure (other than perhaps wasteful, fruitless and similar expenditure), there is also not much room to increase tax collections significantly. Thus, the minister of finance will have a difficult task explaining plausibly how South Africa will be able to contain the budget deficit and move towards a positive outlook.

However, one of the sources of state income that, although not immediately, promises to increase South African tax revenues in the future is tax to be collected from multinational companies that generate income from consumers in South Africa, based on the Pillar I and Pillar II proposals. While historically often only minimum profits were subject to the South African tax net the new, proposed, rules will result in an additional portion of the profits made by a qualifying multinational group from its sales to South African consumers to be taxable here.

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