

UNIVERSITY OF CAPE TOWN

FACULTY OF COMMERCE

DEPARTMENT OF FINANCE AND TAX



**THE POSSIBILITY OF BASE EROSION AND PROFIT
SHIFTING THROUGH SPECIAL ECONOMIC ZONES: A
CRITIQUE OF THE SOUTH AFRICAN AND KENYAN SEZ
REGIMES BASED ON BEPS ACTION 5**

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DEDICATION

To my late brother Mr Matshelo Zuvee Chimbombi *(21/09/1988-08/01/2016)*

ACKNOWLEDGEMENTS

My sincere and earnest gratitude goes to my supervisor Prof Johann Hattingh who has held my hand through the murky waters of international tax from my first day at UCT. My gratitude is not enough Prof, your true reward is in Heaven.

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Miss Ame Rebecca Chimbombi

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ABSTRACT

The OECD/G20's Base Erosion and Profit Shifting (BEPS) Project has been described as the most significant international tax initiative post the 2008/2009 global economic crisis. BEPS speaks to companies engaging in aggressive tax planning strategies that exploit loopholes in tax systems to make profits 'disappear' or shift them to tax jurisdictions with little or no overall corporate tax.

The BEPS Project has fifteen Actions targeting various formations, computations and permutations that could potentially give rise to BEPS. BEPS Action 5 is entitled "Countering Harmful Tax Practices More Effectively Taking into Account Transparency and Substance" and is of central importance to this minor dissertation.

Special Economic Zones (SEZs) are a creature of international trade law that refers to spatially delimited areas within an economy afforded favourable administrative, regulatory and fiscal benefits when compared to the rest of the economy. The term SEZ is used as an 'umbrella' or 'label' encompassing various types of spatially delimited areas with favourable conditions. Examples of SEZs are Free Trade Zones (FTZs) and Export Processing Zones (EPZs).

Although this minor-dissertation focuses mainly on tax benefits associated with SEZs, SEZs usually encompasses a wider range of benefits to the companies they host. Such other benefits could include a one-stop shop for setting up and processing work permits.

This minor-dissertation examines whether South Africa and Kenya's SEZs create conducive environments for harmful tax practices in light of and as described in BEPS Action 5.

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ACRONYMS

BEPS	Base Erosion and Profit Shifting
CFC	Controlled Foreign Company
EAC	East African Community
EPZ	Export Processing Zone
EPZA	Export Processing Zone Authority
FDI	Foreign Direct Investment
FHTP	Forum on Harmful Tax Practices
FTZ	Free Trade Zone
GATS	General Agreement on Trade in Services
G20	Group of 20
IDZ	Industrial Development Zone
ILO	International Labour Organisation
IP	Intellectual Property
MNEs	Multinational Entities/ Multinational Enterprises
OECD	Organisation for Economic Cooperation and Development
PE	Permanent Establishment
POEM	Place of Effective Management
R&D	Research and Development
RSA	Republic of South Africa
SADC	Southern African Development Community
SEZ	Special Economic Zone
STZ	Special Tax Zones

TIEA	Tax Information Exchange Agreement
UNCTC	United Nations Centre on Transnational Corporations
VAT	Value Added Tax
WTO	World Trade Organisation

CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND TO STUDY

Described as the most significant international tax initiative post the 2008/2009 global financial crisis, the Organisation for Economic Cooperation and Development (OECD)/G20 birthed the Base Erosion and Profit Shifting (BEPS) Project.¹ For some the BEPS Project is seen as tinkering with the paradigms and concepts of the past century in the hopes that they might better confront this century's economic realities.²

Such realities form the rationale behind the BEPS initiative which is rooted on public and political perception that the existing international tax standards may not appropriately address the way that multinational entities (MNEs) are organised and conduct business, and may as a result, allow MNEs to avoid tax by shifting profits away from the jurisdictions in which value is created.³

Essentially it is believed that BEPS is exacerbated by the increasing sophistication of tax planners in identifying and exploiting the legal arbitrage opportunities and the boundaries of acceptable tax planning thus giving MNEs confidence in taking aggressive tax positions.⁴ Therefore, the central aim for the BEPS Project is to better align taxing rights with economic activity.

In light of this, BEPS has been defined as:

*'tax planning strategies that exploit loopholes in tax rules to make profits disappear for tax purposes or to shift profits to locations where there is little or no real activity... resulting in little or no overall corporate tax being paid.'*⁵

¹ MH Plowgian & J Seales 'And the Hits Just Keep Coming: The Potential Impact of the BEPS Project on Financial Products and Services' (2015) 12(4) *Journal of Taxation of Financial Products* 11.

² MJ Graetz 'Can a 20th century business income tax regime serve a 21st century economy?' (2015) 30 *Australian Tax Forum* 551.

³ Plowgian & Seales op cit (no1) 11.

⁴ K van Raad (ed) *Materials on International, TP & EU Tax Law 14th Edition* (2014/2015) The Hague, International Tax Centre Lieden 1778.

⁵ M Nouwen 'The Gathering Momentum of International and Supranational Action against Aggressive Tax Planning and Harmful Tax Competition: The State of Play of Recent Work of the OECD and European Union' (2013) 53(10) *European Taxation* 3.

Others simply define BEPS as “*tax-motivated income shifting within multinational firms.*”⁶

The date for conception of the OECD/G20 BEPS Project goes back to the OECD’s March 2012 report entitled “Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues”.⁷ The report formed part of a series of papers concerning what is perceived to be aggressive tax planning and what the OECD deemed as a rise in the level of sophistication in the structuring of cross-border transactions.⁸

Thereafter, gestation continued in June 2012 when it is noted that the world of international tax received an unprecedented degree of political salience and public attention with the issuance of the G20 communiqué declaring that the G20 reiterates the need to prevent base erosion and profit shifting and will follow the ongoing work of the OECD in this area.⁹ Subsequently, in February 2013 the OECD issued a report detailing major issues surrounding BEPS.

The most popular landmark in the evolution of OECD/G20’s BEPS Project as it is understood today appeared in July 2013 when the OECD/G20 published fifteen Action Plans designed to counter aggressive tax planning strategies that result in BEPS.¹⁰ The first draft reports under the Action Plans were released in September 2014 and subsequently supplemented in February 2015 with three further papers. The final reports were released on 5th October 2015.

The fifteen OECD/G20 BEPS Actions address each of the following:

Action 1: The digital economy

Action 2: Hybrid mismatch arrangements

Action 3: Controlled foreign companies (CFC) regimes

Action 4: Financial payments

Action 5: Countering Harmful tax practices

⁶ D Dharmapala ‘What Do We Know about Base Erosion and Profit Shifting? A Review of Empirical Literature’ (2014) 35(4) *Fiscal Studies* 421.

⁷ Nouwen op cit (no5) 3.

⁸ *Ibid.*

⁹ Dharmapala op cit (no 6) 422.

¹⁰ M Herrington ‘The OECD BEPS Project- A Status Update’ (May/June 2015) *International Tax Journal* 26.

Action 6: Treaty abuse

Action 7: Permanent establishment (PE) status

Action 8: Transfer pricing and intangibles

Action 9: Transfer pricing and risks/capital

Action 10: Transfer pricing and other high risk transactions

Action 11: Data and methodologies

Action 12: Disclosure of aggressive tax planning

Action 13: Transfer pricing documentation

Action 14: Dispute resolution mechanisms

Action 15: A multilateral instrument

Realistically, BEPS occurs in various ways and eleven of the fifteen Actions each seek to address different formations, computations and permutations that could potentially give rise to BEPS. Crucial to the current discussion is BEPS Action 5 which seeks to devise and put in place mechanisms to counter harmful tax practices in preferential tax regimes.

Attracting foreign investment, dealing with structural economic deficiencies and creating employment are all economic realities for national governments. It is not clear whether these economic imperatives, which often justify the creation of Special Economic Zone (SEZ) regimes, have been taken into consideration in the OECD/G20 BEPS Project.¹¹ This minor-dissertation will investigate whether the South African and Kenyan SEZ regimes could potentially facilitate BEPS in terms of Action 5. The paper makes no confirmed assertion that BEPS actually occurs in these SEZ regimes but merely examines and explores to see whether they could create an avenue for BEPS.

¹¹ SB Law 'Base Erosion and Profit Shifting - An Action For Developing Countries' (January 2014) *Bulletin for International Taxation* 41.

A typical description of a SEZ is as follows:

*'Special economic zones (SEZs) are spatially delimited areas within an economy that function with administrative, regulatory, and often fiscal regimes that are different (typically more liberal) than those of the domestic economy.'*¹²

The conceptualisation of a SEZ involves many characteristics: '(a) it is a geographically delimited area, usually physically secured; (b) it has a single management or administration; (c) it offers benefits for investors physically within the zone; and (d) it has a separate customs area (duty-free benefits) and streamlined procedures.'¹³ Further, the term SEZ encompasses different variations of related concepts such as free trade zones, free ports, foreign trade zones, export processing zones, free export zones, trade and economic cooperation zones, economic processing zones, and free zones.

Despite the different colours the term SEZ may wear, the gist of such undertaking lies in the differential rules applicable to it principally dealing with investment conditions, international trade and customs, taxation, and the regulatory environment. The zone is given a business environment that is intended to be more liberal from a policy perspective and more effective from an administrative perspective than that of the national territory.¹⁴

The free ports of the Hanseatic League in the fourteenth century, Livorno in the sixteenth century and Amsterdam in the seventeenth century are seen as the embryonic historical predecessors to what is understood as an SEZ today.¹⁵ However, the first large scale contemporary embodiment of an SEZ dates to just post 1973.¹⁶ Thereafter the next notable SEZ development lies with the Chinese government that has vastly pursued SEZs from 1979 to date as a means of attracting investment.

The rationale behind the creation of an SEZ lies in the need to attract foreign investment by way of economic incentive to countries otherwise unable to develop

¹² T Farole *Special Economic Zones in Africa: Comparing Performance and Learning from Global Experience* (Washington DC: The World Bank, 2011) 17.

¹³ DZ Zeng 'Global Experiences with SEZs- with a Focus on China and Africa' (February 2015) The World Bank Trade and Competitiveness Global Practice.

¹⁴ Farole op cit (no 12) 23.

¹⁵ TJ Sigler 'Panama's Special Economic Zones: Balancing Growth and Development' (2014) 33(1) *Bulletin of Latin American Research* 2.

¹⁶ *Ibid.*

domestic industries, or to specific sub-national regions in need of economic stimulus.¹⁷ It is trite that the promotion and establishment of SEZs is an attempt to deal with structural deficiencies, procedural complexities, bureaucratic hassles and barriers raised by monetary, trade, fiscal, taxation, tariff, and labour policies.¹⁸

It follows that the proliferation of SEZs is indicative of developing countries' attempts to attract foreign investment.

The two developing countries examined in this minor-dissertation are the Republic of South Africa (South Africa) and the Republic of Kenya (Kenya). Both countries have significant geographical importance in Africa and established SEZ regimes. South Africa is the gateway to Southern Africa and arguably the strongest economy in Southern Africa. The exact sentiments are expressed for Kenya in the East African block. Kenya has emerged as the powerhouse of East Africa and like South Africa, Kenya has recently embraced the development of SEZs.

1.1.1 Synopsis of South Africa's SEZ Regime

South Africa recently enacted the Special Economic Zone Act of 2014 (SEZ Act of 2014) stemming from the 2012 SEZ Policy.¹⁹ The policy describes the SEZ Programme as:

*'one of the most critical instruments that can be used to advance government's strategic objectives of industrialisation, regional development and job creation. Moreover, the programme can assist in improving the attractiveness of South Africa as a destination for foreign direct investment.'*²⁰ (Emphasis mine)

The history of SEZs in South Africa started with the economic challenges that faced the democratically elected government of 1994 which sought to integrate South Africa back into the world economy by attracting investors, facilitating trade and increasing its Foreign Direct Investment (FDI). In such pursuit, the Industrial Development (IDZ) Programme was launched in 2000.

¹⁷ *Ibid.*

¹⁸ A Aggarwal 'Special Economic Zones: Revisiting the Policy Debate' (November 2006) 41 (43/44) *Economic and Political Weekly* 4533.

¹⁹ Accessed 23 December 2015 at www.gov.za/sites/www.gov.za/files/34968_qen45.pdf

²⁰ *Ibid.*

The IDZ programme was specifically targeted to accelerate economic growth and employment generation through the promotion of export oriented manufacturing and services industries. From its conception in 2000 to 2010 only four (4) IDZs have been designated and issued with operating permits by the Department of Trade and Industry. These are the East London IDZ Company, the Richard's Bay IDZ Company, O R Tambo IDZ, and the Coega Development Corporation.²¹ The other two IDZs namely Saldanha Bay and Dube Trade port remained largely non-operational.²²

Some of the key weaknesses identified in the South African IDZ programme include the policy limitation that only focused on one form of SEZ without exploring other forms.²³ Secondly, the South African IDZ programme offered no fiscal incentives and this reduced its attractiveness to foreign investors.²⁴

The revamped SEZ system, as an example, provides for a reduced rate of 15% corporate income tax as opposed to the standard rate of 28%. One author opines that South Africa lacked a targeted investment promotion that resulted in poor performance in attracting foreign direct investment.²⁵ Poor stakeholder coordination and ad hoc funding arrangements are also cited as additional reasons for the failure of the South African IDZ programme.²⁶

The 2012 SEZ programme is the successor to the IDZ programme that had had limited success and was subject to extensive challenges. Unlike a general SEZ an IDZ is an industrial estate linked to an airport or sea port that attracts FDI through export oriented manufacturing industries. Therefore, an IDZ is a type of SEZ.

The enactment of the South African SEZ Act No. 16 of 2014 correctly follows the SEZ policy programme as an embodiment of law through statute. Its preamble reiterates its purpose:

that measures must be implemented to enhance domestic and regional demand, increase foreign direct investment ... while at the same time strengthening the South

²¹ *Ibid.*

²² TIPS Working Paper, The geographical designation of Special Economic Zones (November 2014) at p. 3

²³ *Ibid*; see also South African SEZ Policy of 2012 accessed 10 April 2016 at

www.gov.za/sites/www.gov.za/files/34968_qen45.pdf

²⁴ *Ibid.*

²⁵ *Ibid.*

²⁶ *Ibid.*

African industrial base and promoting a labour-absorbing industrialisation path. (Emphasis mine)

Further, the SEZ Act defines an SEZ as an economic development tool to promote national economic growth and export through the use of support measures in order to attract targeted foreign and domestic investments and technology. On the backdrop of the SEZ Act is the SEZ tax legislation set out in section 12R and 12S of Income Tax Act, No. 58 of 1962. The provision provides for all the tax related benefits that emanate once an SEZ has been established.

1.1.2 Synopsis of Kenya's SEZ Regime

Kenya's Special Economic Zones Act No.16 of 2015 (SEZ Act of 2015) was given presidential assent by the President of the Republic, Uhuru Kenyatta on the 11th September 2015 and came into operation on the 15th December 2015.²⁷ This Act is therefore in its infancy providing an opportunity to critique and analyse whether its application would or would not lead to unwanted consequences such as BEPS.

In the field of tax, the new Kenyan SEZ Act provides for exemption from all duties and taxes payable under all domestic tax legislations including the East African Community Customs Management Act.²⁸ Although the Kenyan SEZ Act provides for exemptions from all duties and taxes payable under domestic tax legislation, the Kenyan Finance Act No.14 of 2015 (Finance Act of 2015) limits the tax benefits given by the Kenyan SEZ Act.²⁹

Similar to South Africa, Kenya has had Export Processing Zones (EPZ) managed by the Export Processing Zones Authority under the Export Processing Zone Act [Cap 517]. Like the IDZ envisioned in South Africa, EPZs are industrial estates offering special investment and operational incentives, mainly for export-oriented manufacturing. The new Kenyan SEZ Act opens up the spectrum to include business service parks (e.g. regional headquarters), free port zones, free trade zones, industrial

²⁷ EY Global Tax Alert, Kenya enacts Special Economic Zone Act, 2015 accessed 20 December 2015 at www.ey.com/.../Kenya_enacts_Special_Economic_Zones_Act_2015

²⁸ *Ibid.*

²⁹ Kenya Finance Act No. 14 of 2015 accessed 22 January 2016 at www.kenyalaw.org/kl/fileadmin/.../Acts/FinanceActNo14of2015.pdf

parks, information communication technology parks, science and technology parks, agricultural zones, livestock zones and tourist and recreation zones.³⁰

Developing countries rely heavily on corporate income tax revenue. As a result, it may be difficult to convince such countries to generally lower corporate tax rates in order to attract investors, facilitate trade and increase its Foreign Direct Investment (FDI). In a bid to by-pass this inherent challenge developing countries with high corporate tax rates may use SEZs to effectively provide a low (or even nil) corporate tax rate. Herein lies a potential problem that this minor-dissertation will seek to answer. Is it possible that in the creation of SEZs for legitimate aims such as to attract investors, countries such as South Africa and Kenya create enabling environments that may facilitate BEPS?

This minor-dissertation doesn't deal with measuring the extent of BEPS that may occur in South Africa or Kenya's SEZ regimes but rather with the identification of the possibility or avenues that could lead to BEPS.

1.2 STATEMENT OF THE RESEARCH PROBLEM

The main question that will be analysed is whether South Africa and Kenya's SEZ regimes may enable taxpayer behaviour that could lead to BEPS as described in Action 5. This is done by firstly examining the nature of SEZs together with the definition of BEPS to ensure that the position of SEZs in the matrix of BEPS Action 5 is the central component to this minor-dissertation.

From all forms of possible BEPS mechanisms, the OECD and economists generally agree that avoidance of corporate income tax is the worst kind of tax avoidance economically.³¹ This minor-dissertation will therefore primarily examine corporate income tax and whether the South African and Kenyan corporate income tax regimes may through the use of SEZs create an avenue for BEPS as described in BEPS Action 5. Simply, do these SEZ regimes create preferential environments that are potentially or actually a harmful tax practice for BEPS purposes?

³⁰ *Ibid.*

³¹ MJ Graetz 'Can a 20th century business income tax regime serve a 21st century economy?' (2015) 30 *Australian Tax Forum* 554.

1.3 SIGNIFICANCE OF STUDY

The magnitude and pace at which the OECD/G20 BEPS Project has evolved are indicative of the urgency and importance of addressing BEPS globally. As already noted, the project has been defined as the most significant international tax initiative post the 2008/2009 global economic crisis. This study explores a potential avenue of BEPS in a developing country context that has not been the subject of academic enquiry. Although the study only focuses on two African countries, it may be of use to other African countries pursuing SEZ policies and enacting SEZ legislation that could potentially or inadvertently enable BEPS.

If the study reveals that SEZs could potentially enable BEPS as conceived in BEPS Action 5, the next step, which falls outside the ambit of this study, would be to identify mechanisms to address BEPS through SEZs as has been done by the OECD/G20 in regard to CFCs and hybrid mismatch arrangements. This may be of particular interest and importance for developing countries.

1.4 RESEARCH QUESTIONS AND OBJECTIVES

The main research question is: do the South African and Kenyan SEZ regimes create an enabling environment for BEPS to occur as defined in BEPS Action 5? The corporate income tax of both countries will be considered in answering this question.

Secondary issues that arise from the main research question include an analysis of how BEPS is deemed to occur in BEPS Action 5 and whether such occurrence may be seen as potentially evident in the South African and Kenyan SEZ regimes.

The objective of the study lies in identifying a potential deficit in the OECD/G20 BEPS project, namely that in articulating BEPS Action 5 no consideration was given to the economic imperatives for developing countries that use SEZs to stimulate investment. The deficit stems from the possibility that SEZs could give rise to BEPS enabling environments and therefore create an unwanted avenue of tax avoidance.

1.5 RESEARCH METHOD

Desk-top research was employed to address the research problem and questions. Both primary and secondary sources of literature were consulted. Primary sources include statutes such as the South African SEZ Act of 2014, the Kenyan SEZ Act of 2015, the South African Income Tax Act, No. 58 of 1962, and the Kenyan Finance Act of 2015.

Additionally, policy recommendations from the OECD/G20 Actions on BEPS together with important policy documents regarding the establishment of SEZs in both South Africa and Kenya were consulted. These were read together with Ministry of Trade and Industry reports from the respective countries on the development and progress of SEZs.

Moreover secondary sources including books, journal articles and working papers published by scholars and relevant organisations researching on BEPS and Special Economic Zones were also utilised.

1.6 CHAPTER OUTLINE

The first chapter lays out the background to the minor-dissertation and gives a general introductory overview of key components such as BEPS and SEZs. It also goes further to outline the key research questions and the significance of the study.

The second chapter considers SEZs generally in the context of BEPS Action 5. It must be emphasised that this dissertation makes no attempt to calculate the revenue lost as a result of BEPS but merely seeks to critique BEPS Action 5 and its applicability to SEZs.

The third chapter looks closely at the South African SEZ regime by considering section 12R and 12S of the Income Tax Act, No. 58 of 1962 and the South African SEZ Act of 2014. The aim is to properly understand the requirements to enjoy the income tax benefits attached to a company setting up in an SEZ in South Africa. Once this is understood one is able to make a proper assessment of whether an enabling environment for BEPS Action 5 exists.

Subsequently, the fourth chapter examines Kenya's position relating to tax incentives envisioned in SEZs. The Chapter examines both the Kenyan SEZ Act of 2015 and the

Finance Act all of which have an impact on the requirements and tax benefits associated with a company setting up in an SEZ in Kenya. Similarly, the aim is to create a clear understanding of whether Kenya's SEZ regime can create a platform for BEPS Action 5 concerns to arise.

Lastly, the conclusion in the fifth chapter will advise whether SEZs in South Africa and Kenya can cause BEPS Action 5 concerns.

CHAPTER TWO

COMMON FEATURES OF SEZs IN THE CONTEXT OF BEPS ACTION

5

2.1 INTRODUCTION

BEPS Action 5 is expressly based on the OECD's 1998 Report on *Harmful Tax Competition: An Emerging Global Issue* (1998 Report) which provides the groundwork for it.³² A salient issue which cuts across both the erstwhile 1998 Report and the current BEPS Action 5 is whether tax incentives in preferential regimes cause 'harmful' tax practices. This Chapter undertakes an examination of whether the common features or characteristics of an SEZ can make it a preferential regime that enables 'harmful' tax practice as articulated in BEPS Action 5.

An SEZ is not a uniform concept with universal features and therefore an examination of its compliance with BEPS Action 5 must always be tested against actual features of a specific SEZ regime in a country. The description of an SEZ is at most an umbrella or label under which domestic incentives including domestic tax incentives with certain common features may be grouped.

The examination of whether these common features may create room for harmful tax competition in a general sense will carefully pave the way for an analysis where a more direct examination is made to the South African SEZ regime and Kenyan SEZ regime in Chapters three and four respectively.

BEPS Action 5 is spearheaded by the Forum on Harmful Tax Practices (the FHTP) and has been published with the intention:

*“to counter harmful tax practices with respect to geographically mobile activities such as financial and other service activities, including the provision of intangibles... that unfairly erode the tax bases of other countries, potentially distorting the location of capital and services”.*³³

³² HM Liebman, W Heyvaert, & V Oyen 'Countering Harmful Tax Practices: BEPS Action 5 and EU Initiatives-Past Progress, Current Status and Prospects' (February/March 2016) *European Taxation* 102; JM Weiner & HJ Ault 'The OECD's Report on Harmful Tax Competition' (September 1998) 51(3) *National Tax Journal* 601.

³³ OECD (2015), *Countering Harmful tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5-2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting, OECD Publishing, Paris 11.

The reason for the careful selection of geographically mobile activities is the realisation that in the era of globalisation and technological progressions such activities have become easier to shift from one tax jurisdiction to the next.

Laukkanen has proposed that since an SEZ usually does not cover the entire jurisdiction then it cannot be considered to be a preferential regime for purposes of BEPS Action 5.³⁴ He opines that the phrase 'harmful preferential regime' is used in Action 5 as a synonym for tax haven and therefore Action 5 could not have envisioned undertakings such as SEZs.³⁵

On the contrary, it is submitted that the drafters of BEPS Action 5 could potentially have chosen to use 'preferential regime' or 'harmful preferential regime' as the case may be, to extend the parameters of their undertaking beyond tax havens. Consequently, caution should be exercised to avoid a narrow interpretative position in applying BEPS Action 5. Harmful tax practices could very well exist in 'legitimate undertakings' such as SEZ. Additionally, there is no evidence in BEPS Action 5 indicating that its application should be limited only to low tax jurisdictions.

In fact, Laukkanen ultimately concedes that SEZs such as the former Turkish FTZs that were free from VAT and corporate and individual tax led to tax evasion and competitive disadvantages.³⁶ He further notes that a critical issue with BEPS and Special Tax Zones (STZs), which are subsets to SEZs, is when companies within the SEZs hold intangible assets.

Laukkanen acknowledges that although STZs are ideally not harmful because they are approved by the government, '*any tax incentive in an area not experiencing financial difficulty or constraint is deemed to be distortive, making it more a tax haven than an STZ.*'³⁷ It is submitted that the statement applies *mutatis mutandis* to SEZs.

³⁴ A Laukkanen 'The Development Aspects of Special Tax Zones' (March 2016) *Bulletin for International Taxation* 152.

³⁵ *Ibid.*

³⁶ *Ibid.*

³⁷ *Ibid.*

Similarly, other commentators opine that caution should be exercised when dealing with state-sponsored tax incentives as they have the potential to distort the global economy if they amount to harmful tax competition.³⁸

In effect, Laukkanen recognises that SEZs may contain low tax jurisdiction characteristics as one aspect of the larger jurisdiction but not the whole jurisdiction itself.

Therefore, a narrow interpretation that harmful tax competition is confined to practices of countries traditionally viewed as tax havens is not in line with the overall goal of the BEPS Project. All forms of practices that may amount to harmful tax competition including SEZ regimes are to be examined in the context of BEPS Action 5.

2.2 WHAT IS A HARMFUL PREFERENTIAL TAX REGIME?

According to the 1998 OECD Report the analysis for a harmful preferential tax regime involves a three tier examination assessing:

- i. whether a regime is within the scope of work done by the FHTP and whether it is preferential;
- ii. consideration of four key factors and eight other factors to determine whether the preferential regime is potentially harmful;
- iii. consideration of economic factors to distil whether the regime is actually harmful.

Under BEPS Action 5, the examination is similar to the 1998 OECD Report involving a three-tier examination as highlighted above. However, the revamped BEPS Action 5 expands on the second tier to include a fifth key factor being the substantial activity requirement. Although the substantial activity requirement was there in the erstwhile 1998 OECD Report it has been elevated to a key factor in BEPS Action 5.³⁹ The current test can therefore be succinctly outlined as a three-tier analysis examining:

- i. whether a regime is within the scope of work done by the FHTP and whether it is preferential;

³⁸ M Herrington & C Lowell 'A Call to Rewrite the Fundamentals of International Taxation: The OECD BEPS Action Plan' (November/December 2013) *International Transfer Pricing Journal* 370.

³⁹ BEPS Action 5 op cit (no33) 23

- ii. consideration of five key factors and eight other factors to determine whether the regime is potentially harmful; and
- iii. consideration of the economic factors to detect whether a regime is actually harmful.

The BEPS Action 5 examination is undertaken below for common features of SEZs and for South Africa and Kenya in Chapters 3 and 4 respectively. It is submitted that if the analysis reveals that common features of typical SEZs could be seen as preferential regimes that are potentially or actually harmful this doesn't automatically dictate the same for the South African and Kenyan SEZ regimes. The reality could be that the specific tax jurisdictions under examination have measures in their SEZ legislative or regulatory frameworks to ensure that the characteristics that facilitate harmful tax practices are prevented.

2.3 Step 1: May common features of SEZs constitute preferential regimes?

BEPS Action 5 prescribes that a regime is considered preferential if it offers some form of tax preference in comparison with the general principles of taxation in the relevant country.⁴⁰ There is no express requirement on the form of preference that renders a regime preferential; it may take a range of forms including tax reductions, tax breaks or holidays and/or flexible terms for the payment or repayment of taxes. More importantly, it must be emphasised that even the smallest degree of tax preference may render a regime preferential.⁴¹ Once it is determined that a regime provides some favourable deviation from the generally applicable tax laws in a country then the regime is preferential.

For the following reasons an ordinary meaning of this requirement suggests that a typical SEZ falls within the definition of a preferential regime as defined by BEPS Action 5. Common features of an SEZ refer to spatially delimited areas within an economy that function with administrative, regulatory, and often fiscal regimes that are different (typically more liberal) than those of the domestic economy.⁴² These characteristics lead one to the conclusion that often times a SEZ is a typical example

⁴⁰ BEPS Action 5 op cit (no33) 19

⁴¹ *Ibid*

⁴² Farole op cit (no14) 17.

of a preferential regime. In general terms therefore, an SEZ can only be 'preferential' if it enjoys any form of a tax advantage over the rest of the domestic economy. In the end it is submitted that common tax features of SEZs often reflect this.

It is worth highlighting that an SEZ creates a wider preferential base than the one envisioned by BEPS Action 5 because its liberal and favourable climate extends beyond the parameters of tax alone. SEZs offer incentives in other areas such as labour and one-stop shops for company registration and incorporation as opposed to the usual and possibly lengthier process that a company would usually encounter in a bid to set up in a jurisdiction.

The next question is whether common tax features associated with SEZs are covered by work classified as being within the scope of the FHTP. The FHTP targets income from geographically mobile activities such as financial services and the provision of intangibles. SEZs are usually the result of a process that starts with a policy proposal that then ripens into a bill of Parliament and ultimately matures into statutory law through an Act of Parliament. A typical and appropriate example is the South African SEZ Policy of 2012⁴³ that opened the gates to the South African SEZ Act of 2014.⁴⁴ The formation of an SEZ and its characteristics is therefore at the discretion of the lawmakers of each sovereign state.

In light of this, it is submitted that an SEZ regime can include income from geographically mobile activities (i.e. work covered by the FHTP) because there is no constraint on domestic political processes that create SEZ regimes. The Botswana SEZ Policy of February 2011 as an example aims to turn Botswana into a financial services hub. Similarly, both the South African and Kenyan SEZ Acts propose the formation of business parks and service centres. This is exactly the type of geographically mobile services that are envisioned by the FHTP.

⁴³ South African SEZ Policy 2012 accessed 15 April 2016 at www.gov.za/sites/www.gov.za/files/34968_gen45.pdf; see also https://www.thedti.gov.za/financial_assistance/financial_incentive.jsp?id=59&subthemeid

⁴⁴ South African SEZ Act accessed 15 April 2016 https://www.thedti.gov.za/industrial_development/docs/SEZ_Act.pdf

2.4 Step 2: May common tax features of SEZs constitute potentially harmful preferential regimes?

Since the first examination to the three-tier analysis has been answered in the affirmative above, the preliminary conclusion is that SEZs may amount to preferential regimes falling within the ambit work done by the FHTP. The next requirement asks whether the preferential regime is potentially harmful. In answering, BEPS Action 5 requires that five key factors and eight other factors be considered in the context of the preferential regime.

The first factor (known as the gateway criterion) asks whether the regime imposes no or low effective tax rates on income from geographically mobile financial and other service activities.⁴⁵ The issue is whether, with reference to common features of SEZs, no or low effective tax rates on income from geographically mobile financial and other service activities are usually imposed? It is submitted that the gateway criterion may be met if the SEZ policy and legislation is drafted to encompass no or low effective tax rates. Since SEZs speak to administrative or regulatory regimes that are different and typically more liberal than those generally applicable in the domestic economy, there is no inherent expectation that such liberality should be in relation to tax.

In reality, not all SEZ regimes will encompass no or low effective tax rates. An example of such SEZ framework is the former South African IDZ regime which provided no fiscal incentives or preferences.⁴⁶ Other preferences applied like strategic locations for companies to do business such locations being targeted to service the global and African market.⁴⁷

Therefore, not all SEZ regimes will meet the gateway criterion but as noted above often times a tax preference is given as a common feature of SEZs. Assuming the gateway criterion is met, the next is to examine the other key factors.

The second key factor is that the regime is ring-fenced from the domestic economy and the third is a lack of transparency.⁴⁸ The term ring-fence is synonymous to isolate or set aside if considered in its ordinary grammatical sense. In BEPS Action 5 it is

⁴⁵ BEPS Action 5 op cit (no33) 20.

⁴⁶ TIPS Working Paper The geographical designation of Special Economic Zones (November 2014) 3.

⁴⁷ H Jauch 'Export Processing Zones and the Quest for Sustainable Development: A Southern African Perspective' (April 2002) 14(1) *Environment and Urbanisation* 109 – 110.

⁴⁸ BEPS Action 5 op cit (no33) 20.

understood to mean where a regime implicitly or explicitly excludes resident taxpayers from taking advantage of its benefits or where an entity that benefits from the regime is prohibited from operating in the domestic market.⁴⁹ In a more relevant context it is not noted that the term ring-fence has been used to refer to SEZs.⁵⁰

SEZs speak to spatially delimited areas which are afforded benefits by governments and used as investment tools. It is a reasonable expectation that such investment tools will be set aside or isolated from the domestic economy. For the above reasons it is submitted that common features of SEZs may therefore be seen to meet the requirement of the second key factor.

However, the third factor concerning a lack of transparency requires a more subjective assessment relating to a specific SEZ. BEPS Action 5 considers a regime to lack transparency where details of the regime or its application are not apparent or where there is inadequate regulatory supervision or financial disclosure. Although it would be incorrect to suggest that typical SEZs are transparent or lack transparency it is noted that they are used as tools to attract investors and increase FDI. Consequently it is more likely that the details and operations of a regime used to market a country's attractiveness to investors will be known.

An issue of transparency in the SEZ context may not only arise in the marketing of the SEZ to investors, it may perhaps arise in other related operations of SEZs such as the granting of licenses to investors if it is made dependent on administrative discretion. It is submitted that determination of whether administrative discretion can be unduly exercised is best made in context examining specific SEZ legislation.

The fourth key factor is a lack of effective exchange of information with respect to the regime. This factor must be analysed with reference to the tax treaty network of a specific country.

2.4.1 Substantial Activity Requirement

In BEPS Action 5 the substantial activity requirement has been refined and strengthened to realign taxation of profits with the substantial activities that generate

⁴⁹ BEPS Action 5 op cit (no33) 69

⁵⁰ R Fisman & E Werker *Innovations in Governance* (2011) 84 accessed 13 August 2016 at <http://www.nber.org/chapters/c12045>.

them.⁵¹ As already highlighted above, this requirement is not a new creature and was included in the 1998 OECD Report. In BEPS Action 5 it has been elevated to a fifth key factor.

In its approach, BEPS Action 5 deals extensively with Intellectual Property (IP) regimes and lays out requirements and approaches to analyse the substantial activity requirement. FHTP had considered three approaches: value creation, transfer pricing and nexus. Ultimately the nexus approach was agreed on and endorsed by the G20. Essentially the nexus approach seeks to ensure that there is a direct link between the expenditure of the company and the tax benefits to which it is entitled.

In IP-regimes therefore, expenditure incurred for tax purposes must be linked with the location where the IP asset generating the income is owned. In essence, expenditure considered to be relevant are the expenses of the actual research and development activity in respect of the owned IP which was undertaken by the taxpayer.⁵²

In the context of non-IP regimes BEPS Action 5 doesn't provide an express account of how the assessment should be made. It appears to present two possible ways of examining substantial activity. Initially a reading of the requirement aligns it with the way substantial activity is tested in IP-regimes, that is, using the nexus approach that focuses on expenditure.⁵³

Thereafter another approach that focuses on income is proposed. According to this second approach qualifying taxpayers are those taxpayers that undertook the core income generating activities required to produce the type of business income covered by the preferential tax regime.⁵⁴

Undoubtedly, this examination is best suited in a more contextual setting where a specific SEZ is being examined. This will be done in the subsequent chapters on the South African and Kenyan SEZ regime. However, in light of the current discussion on common features of SEZ it is submitted that SEZ regimes could have characteristics of both IP-regimes and non-IP regimes.

⁵¹ *ibid*

⁵² BEPS Action 5 op cit (no33) 35 para. 55

⁵³ BEPS Action 5 op cit (no33) 37 para.71

⁵⁴ *ibid*

On the one end an SEZ may house an innovation hub which generates income from IP assets; it may also be a non-IP regime that relates to, for example, diamond polishing or textiles which may be classified as non-IP regimes. In whichever context, the purpose of the substantial activity requirement is to ensure that any benefit given to a taxpayer in a preferential regime is directly linked to core-income generating activities.

One author provides that for other non-IP preferential regimes, a similar principle to that underpinning the nexus approach will only apply where tax benefits are granted to the extent that the taxpayer undertook the core income-generating activities required to produce the type of income covered by the regime.⁵⁵

The analysis above suggests that policy makers should ensure through legislation or regulation that the favourable tax environment offered in SEZ zones is directly linked to core income-generating activities so as to meet the substantial activity requirement.

It is important to note that the eight other factors are also to be considered when conducting an overall examination of whether a regime is potentially harmful. Similar to the key factors the eight other factors were also in the 1998 OECD Report. The current BEPS Action 5 has maintained them as factors worthy of consideration with a particular emphasis on the last factor which requires an examination of whether a regime encourages operations and arrangements that are purely tax-driven and involve no substantial activities.⁵⁶

The other factors question whether the regime has the existence of secrecy provisions, an artificial definition of a tax base, failure to adhere to international transfer pricing principles, negotiable tax rate or tax base, foreign source income exempt from residence country taxation, and access to a wide network of tax treaties.⁵⁷

In this study, when assessing whether characteristics of SEZs in general could be potentially harmful regimes, only the five key factors (i.e. the four key factors and the substantial activity requirement) have been examined. This approach is both practical for the parameters of this discussion and considered sufficient for determining whether

⁵⁵ Ramm op cit (no54).

⁵⁶ BEPS Action 5 op cit (no33) 23

⁵⁷ BEPS Action 5 op cit (no33) 20

a regime is potentially harmful.⁵⁸ The same examination will be carried on for the South African SEZ regime and Kenyan SEZ regime in Chapters 3 and 4 respectively.

2.5 Step 3: May common features of SEZs constitute actually harmful preferential regimes?

Since it has been ascertained that SEZs in general could be potentially harmful regimes, BEPS Action 5 prescribes the next assessment to be whether they are actually harmful preferential regimes. The core issue addressed in this minor-dissertation is the question whether SEZs (with South Africa and Kenya as case studies) can be deemed to constitute actually harmful preferential regimes to be subjected to BEPS scrutiny.

To determine whether a potentially harmful regime is actually harmful BEPS Action 5 provides that the 'economic effects test' must be performed. It is guided by the following questions:

- i) Does the tax regime shift activity from one country to the country providing the preferential tax regime, rather than generate significant new activity?
- ii) Is the presence and level of activities in the host country commensurate with the amount of investment of income?
- iii) Is the preferential regime the primary motivation for the location of an activity?

BEPS Action 5 states that the questions are to be considered in an assessment of whether a regime is actually harmful. It however falls short of stating whether the assessment is cumulative or whether a regime answering one of the questions in the affirmative will be rendered harmful. Further, an effective economic effects test needs statistical data and economic indicators to show the level and shift of investment in the country offering the preference.

Additionally it is noted that some aspects of the assessment are seen in general anti-avoidance rules (GAARs) in common law jurisdictions that have not attempted to codify GAARs. The assessment 'allows the court to look at a series of transactions to

⁵⁸ BEPS Action 5 op cit (no33) 23.

determine whether the transactions have any economic purpose other than the avoidance of tax.⁵⁹

2.6 Conclusion

From the above analysis various preliminary conclusions arise. The first is that a narrow interpretation of a preferential regime is not sustainable. It was contended that BEPS Action 5 should be read in a wider context appreciating that legitimate undertakings such as SEZs could potentially create harmful tax competition and lead to harmful tax practices.

Another conclusion is that SEZs are not a uniform concept that refer to a fixed or definite creature. The term SEZ is merely a label or umbrella term used to refer to different domestic incentives (tax or otherwise) that are granted in respect of a spatially delimited area of a jurisdiction presenting a more favourable climate than prevailing in the rest of the jurisdiction. This rationale is supported by the different incentive-permutations and types of zones that tend to qualify as SEZs. The chapter therefore examined common features of SEZs to determine whether they could be considered harmful tax regimes in the context of BEPS Action 5.

The chapter notes that common tax features of SEZs render them preferential tax regimes in the context of BEPS Action 5 because by their very nature they give a tax preference over the rest of the jurisdiction. When determining whether they are potentially harmful preferential regimes the discussion finds that they could be potentially harmful if the regime is tailored in a way that it meets the key factors.

On them being actually harmful, BEPS Action 5 falls short of explaining the test to be applied with precision. The test is said to be guided by three questions but doesn't reveal whether they are to be satisfied cumulatively, alternately or otherwise. It was pointed out that the test of actual harmfulness requires an economic test that requires statistical data for every specific business set-up in a SEZ. For example, one has to evaluate whether the presence and level of activities in the host country are commensurate with the amount of investment of income. This aspect of the test may

⁵⁹ R Prebble & J Prebble 'Does the use of General Anti-Avoidance Rules to combat tax avoidance breach principles of the rule of law? A comparative study' (2010-2011) 55 *St. Louis U. L.J.* 27.

be challenging to apply and therefore constitute a weakness in the BEPS Action 5 proposal.

CHAPTER THREE

THE SOUTH AFRICAN SEZ REGIME IN THE CONTEXT OF BEPS ACTION 5

3.1 History of the South African SEZ Regime

Jauch opines that historically South African SEZs were initially conceived in the 1980s through decentralised industrial areas in apartheid homelands.⁶⁰ The decentralised industrial areas had various fiscal incentives, prohibition of trade unions, and compromises on working conditions.⁶¹

This minor-dissertation differs with the position adopted by Jauch to the extent that these apartheid homelands couldn't have meant to be SEZs but investment programmes designed to create jobs that would prevent urban migration of the blacks to the 'white' areas. The compromised working conditions and non-unionised employees speak to more deeply rooted political issues outside the idea of pure industrial incentives for industrial enclaves.

It was only after the end of apartheid that the newly appointed government attempted to integrate back into the global economy by attracting investors, facilitating trade, and increasing FDI.⁶² The first type of SEZ in South Africa was the Industrial Development Zone (IDZ) pursuant to the IDZ Policy. For one to fully understand the current SEZ regime, it is important to understand why the erstwhile IDZ regime failed or fell into disuse.

It has been submitted that the IDZ regime didn't work successfully because the South African model provided no exemptions on labour and other social and environmental legislation.⁶³ This appears to depart from the common features of the concept of an SEZ which strive at providing 'favourable' conditions as compared to the rest of the jurisdiction.

⁶⁰ H Jauch 'Export Processing Zones and the Quest for Sustainable Development: A Southern African Perspective' (April 2002) 14(1) *Environment and Urbanisation* 109-110.

⁶¹ *Ibid.*

⁶² South African SEZ Policy 2012 op cit (no43) 13.

⁶³ *Ibid.*

Another limitation created by the South African IDZ Programme was the geographical aspect pinned on the creation of an IDZ. An IDZ could only be designated adjacent to a sea port or international airport excluding all other areas in the country that did not meet this narrow criterion.

The current SEZ regime attempts to not only correct these wrongs but enhance its application to make it more attractive so as to attain its goal of regional development, industrialisation and job creation. It is seen as one of the most critical instruments that can be used to advance government's strategic objectives of industrialisation, regional development and job creation.⁶⁴

This minor-dissertation critiques the South African SEZ Act, section 12R and 12S of the South African Income Tax Act, No. 58 of 1962 against BEPS Action 5 to determine whether the South African SEZ regime as evidenced by these pieces of legislation creates an avenue for 'harmful' tax practices.

3.2 THE SOUTH AFRICAN SEZ ACT

The South African SEZ Act No. 16 of 2014 (the RSA SEZ Act)⁶⁵ was enacted to provide for the designation, promotion, development, operation and management of SEZs in South Africa. The RSA SEZ Act further provides for the establishment and appointment of members to the SEZ Advisory Board and the establishment of the SEZ Fund.

3.2.1 Definition of SEZ in the RSA SEZ Act

Two important definitions are stipulated under the RSA SEZ Act. Firstly the preamble provides that SEZs will:

"be designated areas to promote targeted economic activities, supported through special arrangements and support systems including incentives, business support services, streamlined approval processes and infrastructure";

Secondly, section 1 defines a SEZ as 'an area designated as a Special Economic Zone in terms of Section 23(6)'. Section 23(6) then provides that the Minister of Trade and Industry may after consultation with the SEZ Advisory Board and the Minister of Finance designate an area as an SEZ by notice in the Gazette.

⁶⁴ South African SEZ Policy 2012 op cit (no43) 8.

⁶⁵ Accessed 10th March 2016 at https://www.thedti.gov.za/industrial_development/docs/SEZ_Act.pdf

Therefore, in terms of the RSA SEZ Act a SEZ as an area designated by the Minister of Trade and Industry to promote targeted economic activities. This definition is closely related to the generic idea of a SEZ discussed in Chapters 1 and 2.⁶⁶

3.2.2 Objectives and Operations of SEZs under the RSA SEZ Act

Section 2 of the RSA SEZ Act outlines the objectives of the RSA SEZ Act. Section 2(e) states that the RSA SEZ Act provides for 'regulatory measures and incentives for SEZs in order to attract domestic and foreign direct investment' and section 2(f) explains that it aims to 'establish a single point of contact or a one-stop shop that delivers the required government services to businesses operating in the SEZs'. It is noted that these objectives mirror the common features of SEZs as discussed in the previous Chapters.

Section 4 provides for the purposes, policy and strategy of SEZs. One of the purposes as enunciated by section 4(2)(a) is facilitating the creation of an industrial complex, having strategic national economic advantage for targeted investments and industries in the manufacturing sector and tradable services. Other purposes include the creation of decent work and other economic and social benefits in the region where the SEZ is located.⁶⁷

Thereafter, section 24 spells out the designation of SEZs and the types of SEZs that may be envisioned by the Act. The four main types are a free port, a free trade zone, an industrial development zone and a sector development zone. The list is not exhaustive and consequently other types of SEZs could fall within the ambit of the RSA SEZ Act.

Sector development zones are defined as zones focused on the development of a specific sector or industry through the facilitation of general or specific industrial infrastructure, incentives, technical and business services primarily for the export market.

Besides the section highlighted above the bulk of the Act addresses the administrative aspects of the formation and operation of an SEZ including SEZ operators, SEZ Fund,

⁶⁶ Provided in Chapter 1 as *spatially delimited areas within an economy that function with administrative, regulatory, and often fiscal regimes that are different (typically more liberal) than those of the domestic economy.*

⁶⁷ Section 4(2)(h) SEZ Act.

SEZ Advisory Board and the issuance, suspension and denial of permits for operators in the zone. The Act commenced on 9 February 2016.⁶⁸

In light of the above it is evident that the objectives underpinning the formation of SEZs in South Africa are legitimate economic realities as noted in Chapter 1. Consequently it is fair for one to conclude that the regime is not purely tax-driven.

3.3 INCOME TAX ACT

The income tax consequences for qualifying SEZ are set out under Section 12R and 12S of the South African Income Tax Act, No. 58 of 1962 (South African ITA). Both sections will be analysed to understand the nature of income tax benefits for a company setting up in a South African SEZ.

3.3.1 SECTION 12R

The provision starts by defining a qualifying company stating a list of requirements that should be met. The first requirement is that the company should be incorporated by or under a law in force in the Republic of South Africa or in any part thereof.⁶⁹

It is submitted that this requirement may be a deliberate step to exclude foreign incorporated companies and/or foreign incorporated non-resident companies with a permanent establishment in South Africa from qualifying.

Further, this requirement automatically disqualifies companies incorporated in countries colloquially classified as 'tax havens' from enjoying income tax benefits under the South African SEZ regime. However, the requirement doesn't exclude a South African incorporated company that has a PE in a 'tax haven' to qualify.

The requirement in section 12R(a)(ii) is that a company that is by implication not incorporated in South Africa, should have its place of effective management (POEM) in South Africa. This requirement is given in the alternative to 12R(a)(i). Simply, a company needs to meet only one of the two requirements to satisfy section 12R(a).

POEM is not defined in the Income Tax Act and one is therefore tasked with understanding the drafters' intention for this requirement. The decision of the South

⁶⁸ SARS website accessed 20 June 2016 at <http://www.sars.gov.za/Legal/Secondary-Legislation/Pages/Proclamations.aspx>

⁶⁹ Section 12R (1) (a)(ii) Income Tax Act No. 58 of 1962.

African High Court in *The Oceanic Trust Co. Ltd N.O. v The Commissioner of South African Revenue Service*⁷⁰ (*Oceanic Trust Case*) provides authority on the understanding of POEM in the South African context. In this case, the High Court was tasked with determining whether the POEM of a trust created in Mauritius was tax resident in Mauritius or South Africa. The court had to decide whether POEM was a factual or legal examination for jurisdictional purposes. The court relied on the English decision of *Commissioner of Her Majesty Revenue and Customs v Smallwood & Another*⁷¹ (*Smallwood case*) which provides that the POEM will be the centre of top level management where key management and commercial decisions are in substance made. Ultimately, the court in the *Oceanic Trust case* found that the facts as had been established did not prove that the POEM of the trust was in Mauritius, but the court did not conclude on whether it was located in South Africa. Nonetheless, the *Oceanic Trust case* gave an important indication that a South African court is likely to follow the approach of foreign courts that are aligned to the OECD's view on the meaning of the POEM criterion.⁷²

The SARS Interpretation Note No. 6 (Issue 2)⁷³ (SARS Interpretation Note) also provides guidance on the understanding of POEM. In SARS' view the POEM of a company is the:

*“place where key management and commercial decisions that are necessary for the conduct of its business as a whole are in substance made.”*⁷⁴

The SARS Interpretation Note further advises that the POEM must be supported by facts. It relies on section 102 of the South African Tax Administration Act No. 28 of 2011 which provides that a company bears the onus of providing its POEM and must retain the necessary evidence to support the view taken.

This approach is consistent with both the *Oceanic Trust Case* and the *Smallwood Case*. It is crucial to highlight that this view was adopted from the OECD Commentary

⁷⁰ Western Cape High Court Case No. 22556/09 judgment delivered 13 June 2011.

⁷¹ 2010 EWCA Civ 778 cited at 26 of judgement in *Oceanic Trust Case*.

⁷² I Duplessis 'The residence of a Trust for South African Income Tax purposes' (2009) 21 *South African Mercantile Law Journal* 322.

⁷³ Dated 3 November 2015 accessed 28 June 2016 at <http://www.sars.gov.za/Pages/Find-a-Publ.aspx?sq=1&k=place%20of%20effective%20management> .

⁷⁴ *ibid.*

on Article 4(3).⁷⁵ It is also important to note that the SARS Interpretation Note requires a substantive analysis of the business activities of the company in its entirety. In situations where the decisions under examination are made at more than one location, the SARS Interpretation Note states that the POEM will be the place where such decisions are primarily and predominantly made.

Additionally, the Interpretation Note examines various facts and circumstances that could have a bearing on the POEM of a company and ultimately adopts a substance over form approach to POEM. It would therefore appear that in the South African context, guidance on the requirement of POEM for SEZs as embodied in section 12R(a)(ii) of the ITA rests on the SARS Interpretation Note No.6 and the *Oceanic Trust Case*. It is perhaps important to note that the requirement isn't that the POEM should be in the SEZ but just in South Africa.

Once a company is incorporated under the laws of South Africa or it is determined that it has its POEM in South Africa, the next requirement stipulated in section 12R(b) is that it should be carrying on its business in a SEZ designated by the Minister of Trade and Industry in terms of the SEZ Act.

The *Oceanic Trust Case* draws a distinction between the POEM and the concept of 'carrying on its business'. The court expressly provides that the question of a company carrying on its business is a purely factual assessment requiring a case by case assessment of where the business activities actually take place.⁷⁶

Therefore, the phrase 'carrying on its business' may have been deliberately inserted to ensure that the main business activities of the qualifying company (i.e. what it is in the business of doing) take place within the SEZ.

Holmes⁷⁷ provides that the concepts of 'permanent establishment' and 'carrying on business' are inextricably bound together. He acknowledges that the assessment involves examining a series of activities undertaken by the company such as the conclusion of contracts.

⁷⁵ S Shalhav 'The evolution of Article 4(3) and its impact on the place of effective management tie-breaker rule' (2004) 32(Issue 10) *Intertax* 460.

⁷⁶ Paragraph [48] of the judgment.

⁷⁷ K Holmes *International Tax Policy and Double Tax Treaties-An Introduction to Principles and Application* Second Revised Ed (2014) Chapter 9: Permanent Establishments.

This position can be supported by not only the requirement for carrying on business but the subsequent requirement in section 12R(c) that the business or services contemplated in paragraph (b) should be conducted from a fixed place of business situated within an SEZ. Like the carrying on business requirement, the fixed place of business requirement is also echoed in the assessment of permanent establishments. It is suggested that an interpretation similar to the one proposed by Holmes may be appropriate in this context too.

If such an approach is adopted the fixed place of business requirement will ensure that the business that is being carried on is linked to the establishment in the SEZ. This will preclude the instance where a qualifying company may want to allocate income earned from activities outside the SEZ to the SEZ.

The last requirement for a qualifying company provided under section 12R(d) is that 90 per cent or more of the company's income must be derived from carrying on business or providing a service within one or more of the SEZs. It is noticeable that the requirement of carrying on business has a significant role in the determination of a qualifying company for SEZ purposes. As such, it is proposed that the same interpretation recommended for 12R(b) and (c) should apply to 12R(d).

Simply, the question of carrying on business and the income derived in respect thereof within one or more SEZs should be determined on factual case-by-case assessment of the business activities of the company in question.

Section 12R(2) provides that the rate of tax on taxable income attributable to income derived by a qualifying company within a SEZ is 15%. This tax rate is more favourable when compared with 28% applicable to the rest of the country.

Section 12R(4) gives an account of all qualifying companies that are not entitled to the lower tax rate under section 12R(2). It states that the excluded business activities are those classified under Section C Manufacturing in the SIC Code. These include the distillation, rectifying and blending of spirits, manufacture of wines, tobacco products and weapons and ammunition.

Additionally, the Taxation Laws Amendment Act, 2015 amended section 12R by inserting a further disqualification from the lower tax rate applying. The amendment stipulates that section 12R(2) will not apply to a qualifying company if i) more than

twenty per cent of tax deductible expenditure or ii) more than twenty per cent of the income of the company is in respect of transactions with connected persons who are either a SA tax resident or a non-resident but the transactions in question are attributable to a permanent establishment of that connected person in South Africa. According to the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2015⁷⁸ the reason for this amendment is to avert the risk of profit being artificially shifted from fully taxable connected persons to the qualifying SEZ company. Essentially this is to prevent existing businesses in South Africa (fully taxable connected persons) from branching out to a SEZ, thus precluding them from shifting existing business into a SEZ entity.

Ultimately, Section 12R(5) places a cap on the application of section 12R. The provision ceases to apply in respect of any year of assessment on or after January 2024 or ten years after commencement of carrying on business in an SEZ. It must be highlighted that this provision has still not come into force despite only remaining with 8 years before it ceases to apply.

3.3.2 SECTION 12S

This provision expressly relates to deductions in respect of buildings in SEZs. Section 12S(2) entitles a qualifying company an allowance equal to ten per cent of the cost to the qualifying company of a new or unused building, and new and unused improvements to any building owned by the qualifying company. The building (and improvements) must be wholly or mainly used to produce the income of the company within the SEZ in the course of trade.

Buildings that constitute residential accommodation are expressly excluded. Section 12S(2) further provides that the allowance is applicable if the building or improvement is used by the qualifying company for producing its income during the year of assessment. Section 12S(3) explains that the allowance extends further to include instances falling under section 12N where the qualifying company completes an improvement. Essentially, the deductions anticipated under section 12S tie back to reducing the taxable income of the qualifying company.

⁷⁸ Accessed 26th August 2016 at <http://www.sars.gov.za/AllDocs/LegalDoclib/ExplMemo/LAPD-LPrep-EM-2015-01%20-%20Explanatory%20Memorandum%20on%20the%20TLA%20Bill%2029%20of%202015.pdf>

Section 12S(4) provides for the computation of what the cost to the qualifying company is taking into account requirements such as ensuring that the transaction is conducted at arm's length. Subsequently the provision gives guidance on instances where the allowance is not permitted. Similar to section 12R(5) section 12S(10) states that the provision ceases to apply in January 2024.

The section 12S deductions form part of the matrix of income tax benefits specifically designed to make investment in the South African SEZ attractive.

3.4 THE SOUTH AFRICAN REGIME VIS-À-VIS BEPS ACTION 5

Under this heading the BEPS Action 5 three-tier analysis of a SEZ described in Chapter 2 will be applied to the South African SEZ regime. The first step is to determine whether the South African SEZ regime qualifies as a preferential regime. If this first investigation is answered in the affirmative the subsequent and more important issue will be whether such regime qualifies as a potentially harmful and/or actually harmful preferential regime for BEPS Action 5 purposes.

Below the five key factors noted under BEPS Action 5 are considered. Thereafter the examination goes to the economic effects test to determine actual harm.

3.5 Step 1: Is the South African SEZ regime a preferential regime within the FHTP's scope?

The conclusion under the related heading in Chapter 2 was that generic aspects of SEZs indicate that they are typical preferential tax regimes because they often time give a tax preference. The South African IDZ regime being the predecessor to the SEZ regime had no exemptions on labour and other social and environmental legislation. It also didn't provide more favourable tax treatment and companies that set up in the IDZ were expected to pay taxes like all other companies in South Africa. It did however provide the companies with strategic locations, innovative business solutions and access to new markets.

The current South African SEZ regime has been conceptualised differently. SEZs are established under the SEZ Act that provides for support 'through special arrangements and support systems including incentives, business support services, streamlined

approval processes and infrastructure'.⁷⁹ Section 12R of the South African Income Tax Act is one such special arrangement and incentive. As is noted in the discussion above qualifying companies that have set up in SEZs are subjected to a reduced corporate tax of 15% instead of the standard 28% rate.

Additionally, in terms of section 12S the qualifying SEZ companies receive an accelerated tax allowance for qualifying buildings of 10% instead of the standard 5% in respect of commercial buildings. For the above reasons SEZs in the South African context are preferential tax regimes. The unclear and more controversial analysis is whether they can be seen as falling within the scope of the work of the FHTP which is to focus on geographically mobile activities such as financial services and the provision of intangibles.

Although no express mention of financial services and the provision of intangibles is made in both the RSA SEZ Act and the South African ITA, two interesting points are worth noting. The RSA SEZ Act makes reference to the provision of tradable services and the establishment of a sector development zone which includes technical and business services.

Since tradable services and technical and business services are not defined, general rules of statutory interpretation are applicable. The case of *Natal Joint Municipal Pension Fund v Endumeni Municipality*⁸⁰ provides that words in a statute are to be given their ordinary meaning in the context that they used. This places emphasis on not only the ordinary meaning but the context in which the words arise. The court expressly stated that context is to be understood in the first instance especially in the case of general words and not at some later stage where ambiguity might be thought to arise.

Therefore, since the term tradable service appears in the context of the SEZ Act it is to be given its ordinary meaning in such context. SEZs are creatures of international trade and investment law and thus its contextual meaning emanates therein. In a trade law context, the phrase 'tradable services' refer to services that fall within the General Agreement of Trade in Services (GATS) under the World Trade Organisation (WTO).

⁷⁹ Section 4 RSA SEZ Act.

⁸⁰ [2012] ZASCA 13 para [17] of judgement.

The ordinary meaning under GATS is services that are not given in the exercise of government authority.⁸¹ Financial Services form part of services that can be traded under the auspices of the GATS. South Africa has listed financial services in its schedule of commitments to GATS.⁸²

It is therefore reasonable to conclude that South Africa's SEZ regime falls within the scope of work covered by the FHTP. To this end the preliminary conclusion is that the South African SEZ regime meets the first tier of the analysis.

3.6 Step 2: Is the South African SEZ regime potentially harmful?

The examination moves to the realm of whether the South African SEZ regime is potentially harmful. As already noted, BEPS Action 5 requires that the five key factors should be considered for determining whether a regime is potentially harmful. The gateway criterion requires that the regime imposes no or low effective tax rates on income from geographically mobile financial and other service activities.

Section 12R (2) states that 'the rate of tax on taxable income attributable to income derived by a qualifying company within a special economic zone must be 15%'. The rate varies from the standard rate of 28% imposed on the rest of the jurisdiction falling outside the SEZ. Consequently, it can be reasonably concluded that the South African SEZ regime meets the gateway criterion.

The second key factor is that the regime is ring-fenced from the domestic economy. Could it be suggested that the South African SEZ regime is ring-fenced from the rest of the domestic economy?

The South African SEZ policy introduces the South African SEZ regime as a government incentive to promote and facilitate employment creation and trade and investment. It is reasonably expected that the South African government will take positive steps to ensure that the South African SEZ regime succeeds. In such bid, it introduces benefits in the RSA SEZ Act and in the South African ITA as detailed above.

⁸¹ Article I 3(b) of General Agreement on Trade in Services accessed 18 July 2016 at https://www.wto.org/english/docs_e/legal_e/legal_e.htm#services

⁸² South African schedule of commitments to GATS accessed 18th July 2016 at https://docs.wto.org/dol2fe/Pages/FE_Search/FE_S_S009-DP.aspx?language=E&CatalogueIdList=10361,29477,20075,10347&CurrentCatalogueIdIndex=2&FullTextHash=

The section 12R and 12S benefits are examples of risk mitigating benefits creating some degree of 'ring-fencing' to qualifying companies setting up in the SEZ.

Moreover, the Taxation Laws Amendment Act, 2015 introduces a disqualification under section 12R(2) that essentially thwarts South African resident companies from shifting business into the SEZ, it is effectively creating a 'ring-fence' around the SEZs. Additionally, this disqualification reflects the definition of ring fencing envisioned under BEPS Action 5.⁸³

To this end it is submitted that the South African SEZ regime is ring-fenced from the domestic economy and meets the second key factor. As far as section 12R and 12S go, such ring-fence will be removed in ten years after setting up in the SEZ or in 2024, whichever comes first.

The third key factor asks whether the regime lacks transparency in its manner of application or inadequate regulatory supervision or financial disclosure. The income tax benefits to the South SEZ regime give a detailed and extensive account of what is perceived as a qualifying company that is entitled to tax benefits. It employs terms such as POEM and 'carrying on business', which are well known in international tax law, to ensure that only entitled companies benefit.

Furthermore despite the tax benefits given to them, SEZ companies are not absolved from the general tax compliance obligations applicable to other South African resident companies. Further the SEZ Act sets up an SEZ Advisory Board and provides detail of how permits for operators in the zones are issued, suspended, and denied. It is submitted that the South African SEZ regime is transparent in its application and operations and therefore does not meet the third key factor.

The fourth key factor speaks to no effective exchange of information with respect to the regime. South Africa has an elaborate tax treaty network with various countries in Africa and the rest of the world.⁸⁴ South Africa has also signed Tax Information Exchange Agreements with countries such as Barbados and Liberia.⁸⁵ It will therefore

⁸³ BEPS Action 5 op cit (no33) 69 para. 158.

⁸⁴ SARS website accessed 1 September 2016 at <http://www.sars.gov.za/AllDocs/LegalDoclib/Agreements/LAPD-IntA-DTA-2013-01%20-%20Status%20Overview%20of%20All%20DTAs%20and%20Protocols.pdf>

⁸⁵ SARS website accessed 1 September 2016 at <http://www.sars.gov.za/Pages/Find-a-Publ.aspx?k=TIEA>

be unreasonable to allege that there is no effective exchange of information relating to the South African SEZ regime.

3.6.1 Substantial Activity Requirement

As noted under Chapter 2, the substantial activity requirement for non-IP regimes appears to have two possible approaches. The first approach that mimics the nexus approach for IP-regimes focuses on expenditure. In the South African SEZ regime, this manner of ensuring 'substance' is not reflected. Therefore as far as this first approach goes, the South African SEZ regime doesn't meet the substantial activity requirement.

However, in the context of the second possible approach which provides that for substantial activity there should be a direct link between the income qualifying for the tax benefit and the core activities necessary to earn the income, the South African SEZ regime is better placed. It has the 'carrying on business' requirement that is aimed to ensure substantial activity occurs within a SEZ. This requirement echoes the second possible approach for the substantial activity requirement under BEPS Action 5.

However, the carrying on business requirement would in terms of BEPS Action 5 not satisfy the substantial activity test if IP related activity is carried on in a SEZ because of the absence of an expenditure based requirement to enjoy SEZ tax benefits.

Consequently, it is noted that the South African regime has a mixed account for the test for potential harm. On the one hand the regime meets the first two key factors and only in part fulfils the substantial activity requirement. For the above reasons it is concluded that the South African SEZ regime could qualify as a potentially harmful regime under BEPS Action 5.

Despite being potentially harmful it is generally observed that the South African SEZ regime does not appear to meet many of the other eight factors such as being used as being promoted as a tax minimisation vehicle. It does not have secrecy provisions and does not appear to encourage operations and arrangements that are purely tax driven and involve no substantial economic activities. However, SEZ entities are tax residents and therefore appear to have access to South Africa's wide network of tax treaties. There are no specific provisions in the South African SEZ tax legislation that would prevent them from being used for, say, tax treaty shopping purposes.

Additionally the Davies Tax Committee interim report on BEPS Action 5 notes that care should be taken to ensure that South Africa's provisions relating to SEZs comply with the substance requirements.⁸⁶ The interim report was however made in response to the September 2014 BEPS deliverables and not the final October 2015 Final Report relied on for this minor-dissertation.

3.7 Step 3: Is the South African SEZ regime actually harmful?

The test of whether a potentially harmful preferential regime is actually harmful involves an exploration of the economic effects of the regime. As highlighted in Chapter 2, three key questions are given as a guide to answering whether a regime is actually harmful using the economic effects test. As an example, one of the questions is whether the presence and level of activities in the host country are commensurate with the amount of investment or income. To effectively answer this question the economic analysis requires data to have been collected over a period of time after the regime came into operation to be able to compare it with a prior existing set of facts. Simply, one would have to know the level of activities and the amount of investment or income for a period before the commencement of the SEZ Act and a subsequent period thereafter.

Another question is whether the regime shifts activity from one country to the country providing the preference. Since the design of the South African SEZ regime doesn't expressly require that the activity in the SEZ should be 'new', it may be taken that the South African SEZ tax regime allows for activities from other countries (perhaps high-tax jurisdictions) to move and set up in a South African SEZ. It is only South African resident companies and local PE's that are precluded through the Taxation Laws Amendment Act 2015 from 'shifting' existing income-generating activities into SEZs. Therefore a BEPS Action 5 red-flag may arise in this context.

It is also unclear whether the economic effects question is cumulative or whether there is a gateway criterion that requires that just one of the questions should be answered in the affirmative for a regime to be perceived as actually harmful. It is obviously premature to assess with any precision whether the South African regime is actually

⁸⁶ Accessed 30 August 2016 at <http://www.taxcom.org.za/library.html>.

harmful when it commenced in February 2016. Despite this, the concern noted above is important.

3.8 Conclusion

The South African SEZ regime shares similarities with the common features of SEZs explored in Chapter 2. Its objectives are also aligned to the general objectives of SEZs as understood in Chapters 1 and 2. In this regard, it strives to attract FDI and establish a single point of contact or a one-stop shop that delivers the required government services to businesses operating in the SEZ. It is also envisioned to be an employment generating tool.

The South African Income Tax Act grants tax benefits for all qualifying companies setting up in a South African SEZ. Section 12R and 12S of the South African ITA provides tax benefits and allowances to qualifying companies. The provisions are preceded by firm rules on what is perceived as a qualifying company. Section 12R uses concepts like POEM and carrying on business as checks and balances to ensure that the true beneficiary receives the tax benefits.

Further, the Taxation Laws Amendment Act, 2015 introduces an anti-shifting provision that prevents South African resident companies and PEs from shifting their business into the SEZ. However no similar undertaking is made with respect to non-resident companies.

Despite the various safeguards in the tax rules, the South African SEZ regime may be considered a potentially harmful preferential regime in the context of BEPS Action 5. Real economic data is required to establish whether the South African SEZ regime is actually harmful. Due to its recent introduction the economic effects test cannot be performed because it requires reliable actual economic and investment data which does not exist.

However a preliminary observation is made that although the regime prohibits shifting with South African resident companies and local PEs it appears to allow non-resident companies to set up without a similar anti-shifting measure. If, for example, a foreign owned MNE siphons off ownership of IP to a qualifying company in a South African SEZ. The said MNE s IP may be subject to existing long term licence contracts with subsidiaries across Africa. If all the licence fees are then booked to the South African

SEZ company nothing would disqualify it from receiving the 15% tax rate and use South Africa's tax treaty network to claim tax treaty benefits in respect of that income. Unfortunately BEPS Action 5 doesn't give a guide on the test of actual harmfulness so although the South African SEZ regime appears to meet one of the questions in accessing actual harm as given in the hypothetical example, actual data is not yet available and the conclusion can only be that the regime is potentially harmful.

CHAPTER FOUR

THE KENYAN SEZ REGIME IN THE CONTEXT OF BEPS PLAN 5

4.1 History of the Kenyan SEZ Regime

Similar to the South African SEZ Regime which seeks to replace the erstwhile IDZ Programme; Kenya's SEZ regime has its history rooted in export processing zones (EPZs) as 'engines of outward-oriented economic growth'.⁸⁷ Kenya adopted the EPZ Programme following the enactment of the Export Processing Zones Act (Cap 517) (No.12 of 1990) in 1990 as part of its efforts to promote investment and spur economic and export trade.⁸⁸

However, unlike the South African IDZ Programme the Kenyan EPZ initiative provides for several procedural and tax incentives. The tax benefits within the EPZ include a ten year tax holiday and a subsequent 25% corporate tax rate with the possibility of it being lowered to 15% (as opposed to the 30% rate applicable in the rest of the country), ten year tax holiday from withholding taxes on dividends and other remittances for non-resident parties, exemption from Value Added Tax (VAT) and customs import duty on inputs; and 100% investment deductions on investment in new buildings and machinery.⁸⁹

An EPZ is defined in terms of the Kenyan EPZ Act as:

*"a designated part of Kenya where any goods introduced are generally regarded, insofar as import duties and taxes are concerned, as being outside the customs territory but are duly restricted by controlled access and wherein the benefits provided under this Act apply"*⁹⁰

Although Martin concedes that the Kenyan EPZ Program created some employment in Kenya he argues that the biggest winners in the Kenyan EPZ Programme were not the Kenyans or the Kenyan government but the foreign owned companies that set up

⁸⁷ T Kusango & Z Tzannatos Export Processing Zones: A Review in need of Update (January 1998) *SP Discussion Paper No. 9802* 1.

⁸⁸ FM Mwega & RW Ngugi *Foreign Direct Investment in Sub-Saharan Africa: Origin, Targets, Impact and Potential (Chapter 7 on Foreign Direct Investment in Kenya)* (2013) 119.

⁸⁹ D Martin *Industrialisation and Development in Kenya: The Case of Export Processing Zones* MA (International Development Studies) (Halifax, Nova Scotia) (May 2011) 86.

⁹⁰ Section 2 Kenyan EPZ Act accessed 10 June 2016 at <http://www.kenyalaw.org/lex//actview.xhtml?actid=CAP.%20517>.

in the EPZs and enjoyed the procedural and tax incentives.⁹¹ He further explains that this is because the said companies could enjoy the tax benefits and repatriate their profits without penalty. It is on this backdrop that the current Kenyan SEZ regime was created.

4.2 THE KENYAN SEZ ACT

The Kenyan Special Economic Zones Act No.16 of 2015 (Kenyan SEZ Act) was adopted by the Kenyan Parliament on 12 February 2015 and came into operation on 15 December 2015. Its preamble states its purpose as:

“an act for the establishment of SEZs, the promotion and facilitation of global and local investors; the development and management of enabling environment for such investments and for connected purposes.”

This description of the purpose of the Kenyan SEZ regime shows that, like in South Africa, it is conceived as a mechanism to stimulate investment. The Act further provides for the establishment of the Kenyan SEZ Authority and Kenyan SEZ Fund.

4.2.1 Definition of SEZ under the Kenyan SEZ Act

Section 2 of the Kenyan SEZ Act provides an elaborate list of definitions for different types of SEZs established under the Act. As a starting point it defines a SEZ as ‘a zone declared as such under section 4’. Section 4 in turn provides that an SEZ shall be:

“a designated geographical area where business enabling policies, integrated land uses and sector-appropriate on-site and off-site infrastructure and utilities shall be provided, or which has the potential to be developed, whether on a public, private or public-private partnership basis, where any good introduced and specific services provided are regarded, in so far as import duties and taxes are concerned as being outside the customs territory and wherein the benefits provided under this Act apply.”

The section further sets out the types of SEZs contemplated under the Kenyan SEZ Act.⁹² It provides that SEZs may include nine types of activities but the list is not exhaustive. It is observed that the list differs from the one given under the First Schedule of the Kenyan SEZ Act. The latter gives only eight types of SEZs with the omission of livestock zones that have only been included in section 4. Since both

⁹¹ Martin op cit (n79) 87.

⁹² Section 4(6) Kenyan SEZ Act.

provisions expressly provide that the list is not exhaustive, the difference in the types of SEZs listed in the Kenyan SEZ Act is therefore inconsequential.

The nine types of SEZs for which a definition is provided are agricultural zones, business service parks, free port zone, free trade zone, industrial park, information communication technology park, livestock zone, science and technology park and tourist and recreation centre.

4.3 Tax Benefits under the Kenyan SEZ Regime

4.3.1 Kenyan SEZ Act

Section 35(1) of the Kenyan SEZ Act provides for the benefits accruing to SEZ enterprises, developers and operators. It expressly provides that all licensed SEZ enterprises, developers or operators shall be granted exemption from all taxes and duties payable under the Excise Duty Act, Income Tax Act, East African Community Customs Management Act and Value Added Tax Act in respect of all SEZ transactions. The section gives further exemptions in respect of other licences, fees, duties or payment in other Kenyan statutes such as the County Governments Finance Act, the Alcohol Drinks Control Act and the Foreign Investment and Protection Act.

Although both the Kenyan and South African SEZ regimes require that a company be incorporated in their respective countries, the South African SEZ regime is silent on whether a hundred per cent foreign participation is permitted. Meanwhile section 29 of the Kenyan SEZ Act authorises the SEZ Authority to grant licences where a business enterprise is incorporated in Kenya whether or not it is 100 per cent foreign owned.

4.3.2 Kenyan Finance Act No. 14 of 2015

The Kenyan Finance Act No. 14 of 2015 (Kenyan Finance Act) provides some limitations to the open book that is presented by the Kenyan SEZ Act. Section 18(h) of the Kenyan Finance Act places the corporate tax rate at 10% for the first 10 years in a SEZ and 15% for the subsequent 10 years. The preamble to the Kenyan Finance Act expressly states it is to amend the laws relating to various taxes and duties, thus also covering the Kenya SEZ Act.

Further section 18(n) places a withholding tax rate of 10% on all payments other than dividends made to non-residents. Dividends paid to non-residents are expressly excluded from the 10% withholding tax. This places the dividends back in the

exemption contained in the Kenyan SEZ Act. This may be considered to be another tax benefit to companies that set up in a Kenyan SEZ.

4.4 The Kenyan SEZ Regime vis-à-vis BEPS Action 5

This requires the three-tier analysis observed in Chapters 2 and 3.

4.5 Step 1: Is the Kenyan SEZ regime a preferential regime within the FHTP's scope?

One of the objectives of the Kenyan SEZ regime as provided by section 3 of the Kenyan SEZ Act is the creation of incentives for economic and business activities in areas designated as SEZs. One such incentive is the exemption from taxes, licences, fees and duties in Section 35 of the Kenyan SEZ Act. Further, section 18(h) of the Kenyan Finance Act offers a reduced corporate tax rate of 10% and 15%.

In light of these features the Kenyan SEZ regime is considered a preferential regime when compared with the rest of the Kenyan jurisdiction. The Kenyan SEZ regime is more generous from a tax perspective when compared with the South African SEZ regime. Whereas South Africa grants income tax rate reductions and accelerated allowances, the Kenyan SEZ Act completely exempts all licenced enterprises from all taxes and duties payable under the several tax statutes. Although the Kenyan Finance Act subsequently reinstated some of the income and withholding taxes, these are still more preferential as compared with the standard applicable elsewhere in Kenya.

The FHTP scope targets geographically mobile activities such as financial services and the provision of intangibles. From the nine types of SEZs expressly defined in the Kenyan SEZ Act, four relate to the provision of services and intangibles. One example is the business service park which facilitates the provision of services including regional headquarters, call centres, management consulting and advisory services. On such basis it can be concluded that the activities envisioned under the Kenyan SEZ Act fall within the FHTP scope.

4.6 Step 2: Is the Kenyan SEZ regime potentially harmful?

This requires that the five key factors should be examined. The gateway criterion is met when the regime imposes no or low effective tax rates on income from geographically mobile financial and other services activities. The Kenyan Finance Act imposes low effective income tax rates on companies in Kenyan SEZs. Under the

Kenyan SEZ Act complete exemption is provided for a number of other taxes, including Value Added Tax. Due to these reductions and exemptions the Kenyan SEZ regime meets the gateway criterion.

The second key factor is whether the regime is ring-fenced from the domestic economy. The Kenyan SEZ regime is considered by statute to be a 'special territory' outside Kenya.⁹³ Although geographically within the border of Kenya, section 6(b) of the Kenyan SEZ Act provides that goods that are brought out of a SEZ are deemed to be imports into Kenya. SEZs enjoy protections and benefits enshrined in the Kenyan SEZ Act. In light of this it is submitted that Kenyan SEZs are optimally located to reduce risk and thus ring-fenced from the domestic economy.

The third factor asks whether the Kenyan regime lacks transparency in its application or there is inadequate regulatory supervision or fiscal disclosure. Like the South African SEZ regime the Kenyan SEZ regime is outlined in the relevant statutes from which its application is apparent. The Kenyan SEZ Act not only establishes an SEZ Authority⁹⁴ but also expressly states the rights and obligations of SEZ entities.⁹⁵ It would therefore be unreasonable to conclude that the Kenyan SEZ regime *prima facie* lacks transparency.

On the fourth key factor of exchange of information with respect to the regime, Kenya has made strides to sign tax treaties with various countries.⁹⁶ Although its network is not as elaborate as the South African tax treaty network, it would still be quixotic to allege that there is no effective exchange of information possible for the Kenyan SEZ regime.

4.6.1 Substantial Activity Requirement

It is noted that none of the two possible tests for substantial activity are reflected in the Kenyan SEZ regime. The Kenyan SEZ regime appears to give a carte blanche to companies setting up in a Kenyan SEZ. Section 29 of the Kenyan SEZ Acts provides that the Authority shall grant a license to operate within a SEZ if the application meets the objectives of the Kenyan SEZ Act and four further requirements. The business

⁹³ Section 4(4) Kenyan SEZ Act.

⁹⁴ Part III of Kenyan SEZ Act

⁹⁵ Part VI of the Kenyan SEZ Act

⁹⁶ Kenyan Revenue Authority website accessed 2 September 2016 at <http://www.revenue.go.ke/ito/ltodta.html>

enterprise should be incorporated in Kenya (whether or not 100% foreign owned), propose a business activity eligible to be in a SEZ, such business activity should not have negative impact on the environment and conduct such business in accordance with the law.

These requirements would not ensure a direct link between the business activities in a Kenyan SEZ and profits booked, which qualifies for the tax reliefs or exemptions. There is no requirement that the beneficially taxed profits of an enterprise should be directly connected to the carrying on of actual business within the SEZ or even have its POEM in Kenya.

As noted in the hypothetical scenario given in the South African context, a 100% foreign-owned company operating in a high-tax jurisdiction could siphon away profitable activities such as intellectual property ownership to a wholly-owned subsidiary situated in a Kenyan SEZ. There is no provision in the Kenyan legislation that would disqualify profits arising from such passive ownership from enjoying the tax reliefs and exemptions. Presumably the company would need to set up a physical office in a SEZ, but there is no requirements that business should be carried on at such an office such as the research and development that creates the income generating intellectual property, or that the profits claimed as covered by the SEZ regime should be attributable to such business. It would appear that the liberal Kenyan SEZ tax regime would enable corporate structures that could be considered to give rise to BEPS concerns. The regime may also be considered harmful from a BEPS Action 5 perspective.

In light of the above one may find that the BEPS Action 5 substantial activity requirement for non-IP-regimes is entirely absent in the Kenyan tax rules relating to SEZs.⁹⁷ Additionally, for non-IP business, no requirements are set to enjoy the Kenya SEZ tax regime that would ensure substantial activities are performed within the SEZ. Similar to the position in South Africa, it appears also that foreign wholly owned companies incorporated in Kenya to do business in a SEZ, would qualify as tax residents to make use of Kenya's tax treaties in an unrestricted way that could enable tax treaty shopping.

⁹⁷ BEPS Action 5 op cit (no33) 37 para. 71.

4.7 Step 3: Is the Kenyan SEZ regime actually harmful?

The concerns raised with conducting the economic effects test under the South African SEZ regime apply *mutatis mutandis* to the Kenyan SEZ regime. The Kenyan SEZ Act commenced on the 15th December 2015. In effect it has been in operation for less than one year. The test used to measure whether a regime is actually harmful requires a more detailed economic analysis. It cannot be understated that this mini-dissertation is at a deficit because the time period that the regimes have been in place is too small to measure their actual harm.

Another similarity that can be made between the South African and Kenyan SEZ regime is that both do not state whether the activity should be 'new activity' and thus one may speculate that the Kenyan SEZ regime allows for activities from other countries (perhaps high-tax jurisdictions) to move and set up.

4.8 Conclusion

In line with the generic idea of an SEZ, the Kenyan SEZ regime shares similarities with the common features of SEZs discussed in Chapter 2. It was conceived as an investment tool backed by legislation creating and managing an environment to support such investment.

This chapter further revealed that the Kenyan SEZ regime is more liberal than the South African SEZ regime. It has a more radical stance to granting tax benefits to a company setting up in a Kenyan SEZ. Additionally a less stringent approach applies to issuing licenses to operate in an SEZ. Effectively, it is not only easier to set up in a Kenyan SEZ but more beneficial from a tax perspective.

Despite this, the Kenyan regime, like the South African regime is only considered to be potentially harmful in terms of BEPS Action 5. Although the chapter did not set out to answer all the questions that show whether or not the regime is actually harmful it highlights that BEPS Action 5 red flags exist in the Kenyan SEZ regime. One such red flag is failure of the Kenya SEZ tax regime to meet the substantial activity requirement. The elevated importance of the substantial activity requirement under BEPS Action 5 is indicative of the need for preferential regimes to ensure that they imbed this requirement in their tax legislation. .

CHAPTER FIVE

CONCLUSION AND RECOMMENDATIONS

The purpose of this minor dissertation was to analyse SEZs in the context of BEPS Action 5. In particular the analysis focused on the South African SEZ regime and the Kenyan SEZ regime. The discussion began by appreciating that the OECD/G20 BEPS Project is an initiative that stems from public and political perception that existing international tax standards do not properly address the way MNEs conduct business and may allow them to avoid tax and shift profits away from jurisdictions in which value is created. More specifically BEPS Action 5 deals with mechanisms to counter harmful tax practices in preferential tax regimes.

Although it has been the convention to study BEPS Action 5 in the context of countries or jurisdictions as a whole, this minor-dissertation has found that the same principles applied in the country-specific context may be applied *mutatis mutandis* to territories within a country such as SEZs. This is because preferential tax regimes that may create harmful tax practices may not always be low-tax jurisdictions or 'tax havens' as has been traditionally the case, but they may very well lie within legitimate undertakings like SEZs.

This minor dissertation has also found that the formation of SEZs in general, and specifically in the cases of South Africa and Kenya was not purely tax motivated and therefore was not premised on the creation of an avenue for BEPS but rather based on economic realities that national governments wish to address through SEZs. Both the South African and Kenyan legislation on SEZs expressly provides that they are created to facilitate trade, attract FDI, and create employment.

Despite this, the current examination has found that both SEZ regimes are considered to be potentially harmful in context of BEPS Action 5. However, this is not an indication that both regimes have identical legislation. Both regimes were tested against the five key factors and it was found that they each meet at least three of the factors. Both regimes meet the gateway criterion and the ring-fencing factor. Additionally both regimes fail the substantial activity requirement albeit to different degrees

When tasked with examining whether both the South African and Kenyan SEZ regimes are actually harmful, no definite conclusion could be reached. Apart from the lack of real economic data about the specific effects of the South African and Kenyan SEZ regimes on behaviour of investors, another reason is based on how the economic effects test is prescribed in BEPS Action 5. This test is not detailed enough on how to conduct the test. Although it outlines questions to be considered, it doesn't explain whether the test is cumulative or alternate. Consequently this minor-dissertation has only been able to address one of the actual harmful questions for both the South African and Kenyan SEZ in the affirmative. The conclusion is that both SEZ regimes are only potentially harmful.

BEPS Action 5 has highlighted the importance of the substantial activity requirement. It is a requirement that ensures that there is a direct link between business activity, income generation and tax benefits. BEPS Action 5 provides that substantial activity should be considered along with the factors examined for determining potential harm and has in effect been elevated to the fifth key factor to be examined under BEPS Action 5. BEPS Action 5 short of explaining whether meeting the substantial activity requirement absolves a preferential tax regime from being considered harmful.

This minor dissertation has illustrated that the South African SEZ regime has better safeguards than the Kenyan SEZ regime such as the requirement for 'carrying on business' built into its legislation to address the substantial activity requirement. The Kenyan SEZ regime on the other hand, doesn't have such measures in place but only requires that the qualifying company should have its place of incorporation as Kenya.

In the end it has become apparent that although BEPS Action 5 concerns may have not been initially considered in the context of SEZs, it is an area fraught with BEPS concerns. The minor-dissertation also indicates that it will be premature to suggest that SEZs in South Africa and Kenya create an actual avenue for BEPS. Both SEZ regimes are in their infancy and more time and clarity about the actual take up and effect on behaviour of foreign investors will be required to observe the consequences of their existence in the context of BEPS Action 5. This is especially so given the requirement for actual economic harm.

As a recommendation, fiscal policy makers should consider BEPS Action 5 implications for their SEZ legislation. An example is the South African Taxation Laws

Amendment Act 2015 that excludes South African resident companies and local PEs through the 20% anti-profit shifting provision from the SEZ tax regime but doesn't envision the same for non-residents. It would also benefit the Kenyan SEZ regime to consider the inclusion of safeguards that assist in meeting the substantial activity requirement. Given that both South Africa and Kenya are perceived as gateway economies, this study indicated a related BEPS concern outside the ambit of BEPS Action 5, namely whether SEZ entities should have unrestricted access to South Africa and Kenya's tax treaties, since they may enable treaty shopping by foreign investors.

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