

THE ROLE OF TAXATION IN ATTRACTING FOREIGN DIRECT INVESTMENTS TO SOUTH AFRICA: A BRICS COMPARISON

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ABSTRACT

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Foreign direct investment in South Africa is expected to increase economic growth thereby alleviating poverty. With technology offering a global trade arena it has become increasingly important for countries to compete for the attention of international investors. Through studies conducted to identify the matters international investors take into consideration in deciding where to invest, tax policies were identified as an area considered by foreign investors.

Although research has been performed on the tax policies applied by countries and the effect thereof on foreign direct investment, limited attention has been afforded to the tax policies of South Africa. With its recent inclusion in BRICS, South Africa will be competing with these expected future economic giants. Determining whether South Africa's tax policies are competitive with these countries would provide useful insight for the marketing of the country.

The study discusses and compares the foreign direct investment determinants identified as having an impact on investors' decisions in investing outside local borders before focusing on taxation in particular. Based on the literature reviewed and the comparison performed, the study concludes that South Africa's tax policies are competitive with those offered by BRICS countries.

Keywords:

Taxation

BRICS

Foreign direct investment

FDI

International investors

FDI determinants

OPSOMMING

DIE ROL VAN BELASTING IN DIE AANTREK VAN BUITELANDSE DIREKTE BELEGGINGS NA SUID AFRIKA: 'N BRICS VERGELYKING

deur

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Die verwagting is dat buitelandse direkte belegging in Suid-Afrika na ekonomiese groei sal lei en sodoende armoede verlig. Met tegnologie wat 'n globale handel arena aanbied, word dit al hoe belangriker vir lande om te kompeteer vir die aandag van internasionale beleggers. Deur middel van studies wat gedoen is om die aangeleenthede wat internasionale beleggers in ag neem en die besluit waar om te belê, te identifiseer, is die belastingbeleid geïdentifiseer as 'n gebied wat oorweeg word deur buitelandse beleggers.

Hoewel navorsing uitgevoer is op die belastingbeleid wat toegepas word deur die lande en die uitwerking daarvan op buitelandse direkte belegging, is daar beperkte aandag verleen aan die belastingbeleid van Suid-Afrika. Met Suid-Afrika se onlangse opname in BRICS sal die land meeding met hierdie verwagte toekomstige ekonomiese reuse. Om vas te stel of Suid-Afrika se belastingbeleid mededingend is met hierdie lande, sal nuttige insig verskaf word vir die bemarking van die land.

Die studie bespreek en vergelyk die buitelandse direkte belegging determinante wat verwag word om 'n uitwerking te hê op beleggers se besluite om te belê buite

hul plaaslike grense voor daar gefokus word op belasting in die besonder. Op grond van die literatuur en die vergelyking uitgevoer, het die studie tot die gevolgtrekking gekom dat Suid-Afrika se belastingbeleid mededingend is met dié wat deur BRICS lande beskikbaar gemaak word.

Sleutelwoorde:

Belasting

BRICS

Buitelandse direkte beleggings

Internasionale beleggers

Buitelandse direkte beleggings determinante

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CHAPTER 1

1 INTRODUCTION AND PROBLEM STATEMENT

1.1 BACKGROUND

More than 15 years after the Apartheid era, South Africa (SA) is still trying to recover from the mistakes made by the previous government. Poverty in SA remains a constant struggle and combined with the effects of HIV/AIDS, the country is in need of improved growth and economic results to relieve these and other difficulties facing it. This would, however, require funds, which it would seem SA does not have readily available at the moment. The country's net savings in 2009 was merely R39 449 million, a 19.5% decrease from 2008 (South African Reserve Bank, 2010:129), which seems to be insufficient funds to adequately address the problems of the country and increased funding is therefore required.

Funding from sources outside the borders of the country is expected to assist SA in effecting economic improvement. In a study performed by Mahmoud (2009:17), foreign direct investment (FDI) has been identified as a means for developing countries, such as SA, to acquire additional funding, achieve growth and thereby alleviate poverty. In addition to an increase in growth and revenue for the country, FDI is expected to lead to the transfer of knowledge and technology, providing further commercial and other benefits to the host country (Cleeve, 2008:137). Frequently corporations investing in a foreign country also create new jobs in such a country to deliver the products or services to a new market (Ajayi, 2006:15). Due to the expected positive contribution of FDI inflow on a country's economic position, it is understandable that competition for FDI exists.

As a means of tracking the competition between countries in this regard, the United Nations Conference on Trade and Development's (UNCTAD) has established a measure of where FDI is focused in their Inward Foreign Direct Investment Performance Index (IFDI Performance Index). SA was ranked 128th out of 141 countries in the latest IFDI Performance Index (UNCTAD, 2010), indicating the country's current inability to effectively compete with other countries in attracting FDI inflow.

Determining how SA can improve its attractiveness to foreign investors is expected to be beneficial. Various studies have been performed in the hope of establishing the determinants of FDI, identifying tax as one of the areas considered by foreign investors (Wahid, Sawkut & Seetanaah, 2009:8; Pajunen, 2008:652). Although tax in isolation would not improve FDI inflow it is an area where improvement can most easily be effected. Increased study relating to the enhancement that may be made to SA's tax policy with regard to foreign investors could result in increased FDI inflow.

In studying possible improvements that may be made to SA's policies in attracting FDI, a comparison with its perceived competitors may prove valuable. Late in December 2010, SA was formally invited to join BRIC (Brazil, Russia, India and China) (Ayodele, 2011:1), an acronym for a group of developing countries identified by Goldman Sachs in 2001 as having the potential to become a large force in the world market in the near future (Goldman, Purushothaman, & Wilson, 2003:1). A more detailed consideration of BRIC and what the inclusion of SA in this group might mean for the country follows.

1.2 BRIC AND SOUTH AFRICA

In the last 50 years the world has experienced significant changes to its economy and many expect that the next 50 years is to deliver further unexpected changes (Goldman *et al.*, 2003:3). With the focus turning to the developing world, Jim O'Neill, an economist with Goldman Sachs, identified Brazil, Russia, India and China in 2001 as four developing countries with the potential to exceed the current largest economic powers by 2040 (Ayodele, 2011:1; Seria, 2010:1; Goldman *et al.*, 2003:1). He coined the acronym BRIC after using Gross Domestic Product (GDP) growth rates amongst other factors to identify these countries and since then the concept has largely been accepted by the world. Although O'Neill did not expect the formation of a formal forum based on the research he performed (Du Plessis, 2011), the original four countries found benefit in increased ties, both for political and trade reasons, and established a forum with periodical meetings held by the heads of state (Seria, 2010:1).

As noted in a presentation attended that was held by Stanley Subramoney, Deputy CEO of PriceWaterhouseCoopers on 26 May 2011, he stated that he believes that the BRICS

countries represent a shift of the economic gravity. To support this argument he identified that these countries have large economic centres with the largest bank being found in China and the largest energy company in Russia. Furthermore he noted that in 2011 China is the second largest economy in the world with estimations that it will be the largest by 2015. India is expected to overtake Japan by 2013 to become the third largest economy. These are not mere developing countries but developing superpowers. With expectations like these, it is no wonder that the countries have aligned themselves together thereby increasing their reach and possibilities. SA's desire to join this group of countries is understandable. (Subramoney, 2011).

After a period of lobbying by President Jacob Zuma, SA was formally invited by Chinese President Hu Jintao in December of 2010 to join the BRIC countries resulting in a change in the acronym from BRIC to BRICS (Brazil, Russia, India, China and South Africa) (Seria, 2010:1). Association with these countries is expected to benefit SA politically and economically and could significantly increase SA's FDI inflow should the world recognise its inclusion as an indication of its potential. The world's focus is currently on these countries and SA's inclusion in this exclusive club is therefore a rather impressive marketable quality. SA, however, still needs to prove the validity of its inclusion within BRICS.

Where the other BRICS countries were identified based on research and the estimations of economists, SA was included by means of political actions and arguments are made regarding the reasonableness of its inclusion in BRICS. Some argue that SA is too small and that its potential for growth is insufficient and far below the estimates made for the other BRICS countries (Du Plessis, 2011). Others argue that SA, as a representative of Africa, has the ability to achieve the appropriate levels of growth should the correct policies be put in place (Rao, Sridharan & Vijayakumar, 2010: 2).

Regardless of the reason for SA's inclusion in BRICS, a comparison with these emerging super-powers is most likely to prove valuable. Such an investigation would provide evidence of SA's competitiveness with these countries as well as to identify possible areas for improvement, allowing for more competitive policies, which in turn could lead to increased FDI inflow. The problem of the best possible policies, specifically regarding

taxation, to be applied by SA with the intention of attracting FDI, should therefore be considered.

1.3 PROBLEM STATEMENT

A large volume of study has been afforded to assessing the relationship between tax policies and FDI inflow, with inconsistent results. Some studies indicated that tax policies have a negative relationship with FDI (Grubert & Mutti in Pajunen, 2008:655) whereas others mention the possibility that taxation may even have a positive relationship with FDI (Swenson in Pajunen, 2008:655). Further studies indicate taxation has no significant impact on FDI (Wheeler & Mody in Pajunen, 2008:655).

It is therefore clear that although broad based theories have been developed, a country specific analysis is required to better determine the effect that a tax policy has on the FDI inflow to a country. Furthermore, if the assessment made by Goldman and Sachs regarding the future of these BRICS countries is correct and SA can be accepted in the same light as the other countries, it is expected that there would be increased interest from foreign investors in the country. SA would need to compete with specifically these countries to attract FDI. With the very recent inclusion of SA in the BRICS countries, the competitiveness of the country's tax policies compared to the other BRICS countries has not been explored sufficiently and this presents the purpose of this paper.

1.4 PURPOSE STATEMENT

Although there are many contributors to attracting FDI, tax appears to be an area where adjustment can be made with more ease than most other FDI factors. It is, however, unclear what tax methods have been applied successfully in this respect. This study intends to address this knowledge gap by considering the tax methods employed by the BRICS countries through comparison and intends to identify possible tax policies that could be considered to improve the attractiveness of SA to foreign investors.

This study intends to add to the knowledge available regarding the role of tax in attracting FDI to SA through a review of literature, thereby allowing for more informed decisions in

developing tax policies. A specific comparison between the tax policies of BRICS countries would also allow for an indication as to where improvements to the current tax policy may be made to offer more competitive tax policies allowing SA to contend with these possible future world economic leaders. In performing this review, certain assumptions, delimitations and definitions apply.

Therefore, the purpose of this review is to determine the competitiveness of SA tax policies in comparison to those employed by other BRICS countries. It aims to offer a supported argument as to possible adjustments to the tax policies currently applied that should improve FDI, at least in theoretical terms. Specific research objectives intend to be satisfied by this study.

1.5 RESEARCH OBJECTIVES

In this study the focus will be on the following research objectives:

- To investigate the tax policies of the BRICS countries as being a factor for attracting FDI.
- To compare the competitiveness of SA's tax policies in the light of the tax policies employed by other BRICS countries.
- To suggest possible changes that could be made to improve SA's tax policies for to attracting FDI.

1.6 DELIMITATIONS

The focus of the study is limited as follows:

- A comparison of tax policies and other FDI determinants are to be performed only for the countries included in the BRICS group, being Brazil, Russia, India, China and South Africa.
- The taxation of corporations only is considered with no inclusion of tax on individuals.
- A consideration of other FDI determinants is to be limited to market size, labour costs, corruption, ease of conducting business, political stability and exchange rates.

- In considering the tax policies applied by SA in comparison with those of other BRICS countries, focus is to be placed only on income tax.
- This study is to consider pull factors of FDI only, being those within the control of the host country.

1.7 ASSUMPTIONS

The following assumptions are applicable to this study:

- FDI is influenced by the tax policies of a country.
- Theories as presented in the studies discussed are applicable to the countries included in the comparison.
- It is accepted throughout this paper that FDI is mainly the flow of money from corporations or governments of source countries and as the contribution from private investors is expected to be minimal, they are excluded from this study.
- India's tax rates are affected by a surcharge for companies with income in excess of Rs10m, approximately USD 194,000, (PKF International Limited, 2011c: 9). For purposes of this paper it is assumed that all companies have income in excess of Rs10m.
- In performing the tax comparison, the ranking of the countries on the IFDI Performance Index 2010 will be accepted as being an indication of where investors are currently focusing their funds.

1.8 DEFINITION OF KEY TERMS

The following key terms are used in this document with the definitions ascribed below:

BRICS: An acronym for Brazil, Russia, India, China and South Africa being the countries identified by Goldman Sachs' economists as those that are expected to excel in the world markets in the near future (Goldman *et al.*, 2003:1). Please see section 1.2.

Corruption: Wrongdoing on the part of an authority or powerful party through means that are illegitimate, immoral or incompatible with ethical standards. Corruption often results

from patronage and is associated with bribery (businessdictionary.com (a), Not dated.). Please see section 4.2.3.

Effective tax rate: The effective tax rate is defined as “the ratio of taxes paid to a given tax base...for corporate income taxes, it is the ratio of taxes to book profits...” (teachmefinance.com, not dated.). Please see section 4.3.1.

Foreign Direct Investment (FDI): The flow of capital from a multinational enterprise or “parent firm” (a source country) to an enterprise outside the parent firm’s home country (a host country) (Pajunen 2008:653). Please see section 4.2.

Gross Domestic Product (GDP): A measure of the “...value of a country's overall output of goods and services (typically during one fiscal year) at market prices, excluding net income from abroad” (businessdictionary.com (b), Not Dated.). Please see section 4.2.1.

Place of effective management: SARS considers this to be the place “where the day-to-day activities of the business take place”. This is not the same as where the control of the company is held or exercised but rather from where the executive directors manage the company (De Koker & Williams, 2011). Please see section 4.4.

Resident: A resident as defined in section 1 of the South African Income Tax Act (58/1962) (hereinafter referred to as the Income Tax Act) “means any... person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic but does not include any person who is deemed to be exclusively a resident of another country for purposes of the application of any agreement entered into between the governments of the Republic and that other country for the avoidance of double taxation.” Please see section 4.4.

Statutory Tax Rate: “The term Statutory Tax Rate implies the tax rate specified by law. It includes the amount of charges imposed by the government upon personal or corporate income, capital gains, gifts, estates, and sales etc that are within the government’s statutory power to regulate (definitions.uslegal.com, Not dated.).” Please see section 4.3.1.

Withholding tax: “a tax levied by a country of source on income paid, usually on dividends remitted to the home country of the firm operating in a foreign country” (financial-dictionary.thefreedictionary.com, Not dated.). Please see section 4.9.2.

Throughout the document certain abbreviations have been used for ease of reading:

Table 1: Abbreviations used in this document

Abbreviation	Meaning
BRIC	Brazil, Russia, India and China
BRICS	The group of countries consisting of Brazil, Russia, India, China and South Africa
CGT	Capital Gains Tax
Companies Act	Companies Act 71 of 2008
DTA	Double Tax Agreement
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IFDI Performance Index	Inward Foreign Direct Investment Performance Index
IFDI Potential Index	Inward Foreign Direct Investment Potential Index
MTC	Model Tax Conventions
OECD	Organisation for Economic Co-operation and Development
Rs	Rubies (Currency of India)
SA	South Africa
SARS	South African Revenue Service
SDA	Secondary Data Analysis
STC	Secondary Tax on Companies
Income Tax Act	Income Tax Act 58 of 1962
UN	United Nations
UNCTAD	United Nation Conference on Trade and Development
US	United States of America
VAT	Value Added Tax

1.9 RESEARCH DESIGN AND METHODS

In performing the comparison of the tax policies used by BRICS countries, the relevant legislation, interpretive notes and other literature available regarding this topic are to be considered. In performing such a comparison the study aims to present an argument as to both the appropriateness of the current policies applied by SA and the potential improvement thereof. The study is not to be involved in the generating of new empirical evidence and is qualitative in nature. This study does not seek to validate any statements but merely provide an informed opinion. For this reason it is to be a non-empirical study.

The tax policies as determined to be considered by foreign investors in the literature reviewed is to be used to evaluate SA's tax policies in relation to those of the other BRICS countries. In Chapter Three a larger number of tax policies applied by countries are considered for inclusion in the comparison performed and the following tax policies are identified for inclusion:

- Corporate tax rate;
- Tax holidays;
- Investment allowances/ accelerated depreciation schemes; and
- Double Tax Agreements

1.10 OVERVIEW OF THE CHAPTERS

The inflow of FDI is dependent on a variety of influences. It is necessary to understand the factors that may play a role in affecting the inflow of FDI before tax policies. One of the factors affecting investors' decisions is therefore focused on and in **Chapter Two**, FDI and its determinants are discussed with a short review of the determinants, other than tax policies.

In **Chapter Three**, the focus moves to tax policies as an FDI determinant that includes the review of tax policies, as identified by various studies, that are most frequently used as incentives in attracting potential investors. This is to be followed by a discussion of SA and its tax policies in **Chapter Four** and a short overview of the tax policies of the other BRICS countries in **Chapter Five**, to allow for adequate background knowledge on the tax methods of these countries.

With the basic knowledge of the tax policies of the various countries established a comparison is to be performed in **Chapter Six** between the tax policies used by the various countries and their related FDI ranking. Lastly, a conclusion as to the role of tax on FDI and possible improvements as identified to the tax policies applied by SA is presented in **Chapter Seven**.

CHAPTER 2

2 DETERMINANTS OF FOREIGN DIRECT INVESTMENT

2.1 INTRODUCTION

FDI is expected to benefit a country, both financially as well as through other means such as improved knowledge of locals (Cleeve, 2008:15). In recent years, with the improvement of technology and increased globalisation, competition for FDI has increased together with a significant growth in worldwide FDI flows (Wijeweera & Mounter, 2007:2). Although Africa as a continent attracted a higher share of FDI than Asia and Latin America at the start of the 1970's, by 2000 the continent had attracted far less than the other two (Cleeve, 2008:137). This ratio has not improved considerably when considering the results of the latest UNCTAD's IFDI Performance Index (UNCTAD, 2009) where it was noted that African countries are usually not ranked highly. To change such indicators countries, including SA, need to know how to adequately market themselves to be more attractive to investors.

Investigating what factors foreign investors consider in assessing a possible country for investment purposes is therefore imperative to allow SA to better market itself as a country and thereby attempt to improve economic conditions. In order to assess the ability of SA to attract FDI it would be useful to compare the opportunities offered by SA to those countries it competes against for FDI. If the studies performed that indicate BRICS to be the future economic leaders were accepted, a comparison with these countries would be the most beneficial for an assessment of the ability of SA to attract FDI.

There are indications from the latest UNCTAD's Inward Foreign Direct Investment Potential Index (IFDI Potential Index) (UNCTAD, 2009) that SA in fact does have the potential to compete with these countries. Per Table 2, SA was ranked 74th out of 141 countries in 2009, the third-ranked African country. The index considers 12 economic and policy variables that are expected to contribute to investors' decisions, excluding market size and taxation, to provide a ranking of the potential FDI attractiveness of a country.

Similarly the IFDI Performance Index (Table 2) ranks countries by assessing the FDI received in comparison to its economic size for 141 countries (UNCTAD, 2009). It is therefore reasonable to consider the ranking of SA, relative to the other BRICS countries, in assessing whether SA has the potential to compete with these countries.

Table 2: IFDI Potential and Performance Index

Country	IFDI Potential Index ranking 2009 (141 countries)	IFDI Performance Index ranking 2009 (141 countries)	IFDI Performance Index ranking 2010 (141 countries)
Brazil	70	87	69
Russia	20	57	60
India	84	63	97
China	32	76	86
South Africa	74	79	128

Source: UNCTAD IFDI World Report, 2009 and 2010

Considering the results of 2009 in the table above it is clear that SA has been ranked within the range of the other BRICS countries, both within the potential as well as in relation to performance indexes. SA is therefore perceived as having the potential to compete with these countries, at least to the extent of attracting FDI.

In considering the results of the IFDI Performance Index of 2010, significant movement can be seen for the BRICS countries (UNCTAD, 2010). From 2009 to 2010, Brazil was the only country that showed an improved IFDI Performance Index ranking, with SA showing a significant decline. The improved results of Brazil may be attributed to the fact that it was identified as one of the first countries from the emerging markets to recover from the latest economic downturn (PricewaterhouseCoopers LLP, 2011e). Based on the results of 2010 it is clear that SA needs to improve its latest rankings.

Improving these perceptions and rankings would allow SA to compete within this new forum. For this reason the paper will compare various indicators of SA with those of the other BRICS countries, paying particular attention to the tax policies of these countries with the intention of identifying further means of attracting FDI to SA. Before a comparison can be made, however, clarity as to the meaning of FDI has to be established.

2.2 MEANING OF FOREIGN DIRECT INVESTMENT

FDI is roughly defined as the flow of capital from a multinational enterprise or “parent firm” (a source country) to an enterprise outside the parent firm’s home country (a host country) (Pajunen 2008:653). It is accepted throughout this paper that FDI is mainly the flow of money from corporations or governments of source countries and as the contribution from private investors is expected to be minimal, they are excluded from this study.

Investors from a foreign country would require sufficient incentive to invest outside their local borders. Different types of foreign investments have been identified by researchers based on the intention of investors as described in Table 3.

Table 3: Types of investment

Type of investment	Description
Natural-resource-seeking investment	These types of investors are intent on accessing the natural resources of a country. Mines would therefore attract these types of investors to a country.
Market-seeking investment	Corporations that are interested in increasing their brand and market size invest in foreign countries where there is a possibility of increased sales thereby increasing their profits.
Efficiency-seeking investments	This includes investors that intend to exploit the beneficial attributes of a specific country such as labour costs and infrastructure.

Source: Ajayi, 2006:17

From the above table one can see that the use of tax policies as an incentive is more likely to attract efficiency-seeking investments. The natural resources and market size of a country are limited but the adjustment of policies applied by a country appears to have less limitations. In fact if one considers the popularity of tax havens, beneficial policies offered by a country may still act as sufficient incentive to entice foreign investors even in the absence of the other two investment types. Tax havens, such as for example Mauritius, tend to be smaller countries with limited or no natural resources and market size, yet as a result of the beneficial tax policies they offer, still attracts a fair amount of FDI. Because of the limitations of natural resource and market seeking investors, this study focuses on the actions that can be taken to attract efficiency seeking investors with a short discussion of

the factors that are likely to be considered by investors interested in one of the other form of investment.

Furthermore, FDI is exposed to both push and pull elements. Elements outside to a host country are considered to be push factors. Examples of push factors are the worldwide economic climate and the growth experienced by countries that frequently invest outside their borders, usually developed countries. Pull factors are internal to a country and include matters such as the natural resources or local policies offered to attract investment. While the first element, the push element, is outside of SA's control, methods can be employed to strengthen the pull factor and the further assessment will therefore focus only on determinants of FDI that are pull factors. (Ajayi, 2006:18).

2.3 FOREIGN DIRECT INVESTMENT DETERMINANTS

A variety of studies have been performed which identify areas potential investors consider in making the decision to invest in a foreign country. These include (Wahid *et al.*, 2009:8; Pajunen, 2008:652):

- Market size;
- Labour costs;
- Corruption;
- Ease of conducting business;
- Political stability;
- Exchange rates; and
- Tax policies.

The results of the above studies were confirmed to be applicable to SA in a study performed that focused specifically on the determinants of foreign direct investment as experienced by SA (Rusike, 2008: 82). It should be noted that the list included above is not exhaustive. As can be expected none of these factors, in isolation, would prove effective in attracting foreign investors.

As any single identified FDI determinant on its own cannot attract FDI, a short analysis and overview of certain elements involved follows (Table 4) in a tabular format with a point-by-point detailed assessment:

Table 4: Other Foreign Direct Investment determinant comparisons

BRICS	Market Size, GDP in '000,000 US\$	Labour Cost		Corruption ranking (178 countries)	Ease of doing business ranking (183 countries)	Political stability percentage	Exchange Rate against 1 US\$
		A	B				
Brazil	1,594,490	19%	8.3%	69	127	54%	2
Russia	1,231,893	16%	8.2%	154	123	22%	30
India	1,377,265	10%	N/A	87	134	13%	46
China	4,985,461	N/A	4.3%	78	2	30%	7
South Africa	285,366	13%	23.8%	54	34	43%	7

For the sources used to create the table above, refer to the following discussions.

2.3.1 Market size

One of the popular reasons investors consider foreign countries for investment is to increase their brand awareness and economic reach. Market size is considered by some to be one of the main determinants of FDI inflow as an increased market size is associated with increased sales. An increased market size is therefore expected to attract increased levels of FDI. (Pentecost & Rasciute, 2008:3).

As a measure of a country's market size, GDP is most frequently used (Wahid *et al.*, 2009:5). GDP measures the "...value of a country's overall output of goods and services (typically during one fiscal year) at market prices, excluding net income from abroad" (businessdictionary.com (b), Not dated.). It is an indication of the economic health and standard of living within a country and was used as a comparable indicator of market size. Specifically the GDP in United States of America dollar terms per the World Bank was used (2009b) to determine SA's ability to compete in this regard.

As can be seen from table 4, SA is by far the smallest of the five countries, which, most likely, will have a significant negative impact on the country's ability to generate FDI inflow. On the other hand it could indicate the further potential of the country, as there is room for growth within the GDP.

2.3.2 Labour Cost

One of the highest costs in the production of goods tends to be labour. It therefore stands to reason that if a corporation has the opportunity to produce goods in a country at cheaper labour rates it would serve as motivation to invest in such a country (Pentecost & Rasciute, 2008:3). This has been confirmed through empirical studies performed. Increased flexibility in the labour market results in improved FDI inflows (Javorcik & Spatareanu in Pajunen, 2008:654) and for this reason considered an applicable determinant to compare.

For this study, the compensation for employees as a percentage of expenses is evaluated as a measure of labour cost, consideration A (World Bank, 2009a). The comparison performed indicates that, not considering China whose information was not found; SA is the BRICS country with the second lowest labour cost, a definite advantage for the country. Coupled with unemployment rates, consideration B, of 23.8% in 2009, a percentage far higher than those reported for the other BRICS countries, SA has the low cost and high capacity for labour intensive investments. It is therefore expected to be an attractive option for foreign investors looking to decrease production costs (World Bank, 2009c).

2.3.3 Corruption

Corruption is defined as “wrongdoing on the part of an authority or powerful party through means that are illegitimate, immoral or incompatible with ethical standards. Corruption often results from patronage and is associated with bribery”. (businessdictionary.com (a), Not dated.).

Corruption, amongst others, is an indication of the risk associated with a country. A study performed by Wei (1997:24), found clear evidence that where there is an increase in corruption, a negative impact on FDI is experienced. The expected effect of corruption is also anticipated to be far more severe than many other indicators and it was further determined in the same study that corruption has a far larger effect on FDI than increases in tax rates do. The impact of corruption on a company's ability to attract FDI was determined to be significant by this study (Wei 1997: 24). If this is accepted, the corruption perception related to a country is an important determinant to consider.

SA residents have the perception that corruption is quite prominent based on frequent mention of such instances in the media. This is, however, not congruent with the results of the Transparency International's Corruption Perception index (2010), a measure of the global perception of corruption in a country, which ranked SA as 54th out of 178 countries reviewed (1st being the least corrupt). This demonstrates that there is not an excessively high perception of corruption occurring in SA. Of the BRICS countries SA also achieved the best rating, a matter that should add considerable weight to SA's appeal to foreign investors.

2.3.4 Ease of conducting business

Regulations relating to the management of businesses, where too strenuous on a company, can restrict the ability of multinational corporations to invest in foreign countries. Complex laws usually require additional costs, as expert advice is required in adhering to the provisions of these laws. Understandably, where it is easier to manage a business in a specific country it is an incentive for investors to invest in such a country.

As a measure of the ease of doing business with various countries the ranking of the World Bank in their "Doing Business 2011" report is considered. According to this report SA was rated 34th out of 183 economies (2011). The report assesses the regulations relating to the various areas of the life of a business in order to determine the ranking of the countries considered. Amongst others the ease with which companies can be started, property acquired and contracts enforced are considered in the study. SA performed exceptionally well in comparison with the rest of the BRICS countries, ranking second just

behind China with a significant gap to the third ranked BRICS country, being Russia who was placed 123rd in the report. It can be deduced that SA regulations regarding the operation of business within the country offer competitive business practices.

2.3.5 Political stability

Pajunen (2008:654) defined political instability as “the likelihood of violent threats to, or changes in, government”. Where war or another form of public violence exists and stability within the government is threatened, investors stand the chance of losing money as a result of businesses being closed. Political stability is therefore another of the methods of measuring the risk associated with a given country. Where a country is politically stable, FDI is expected to increase.

The World Bank (2010a) performed a study on 213 countries in which they assessed the political stability of countries allowing the countries to be rated from 0 to 100, 0 being perceived as excessively politically unstable. SA is ranked second highest of the BRICS countries, once again indicating that SA can realistically compete with these economies despite the instability experienced before 1994.

SA had its first democratic election in 1994 and has since introduced a reformed political regime. Taking into account the ranking of political stability achieved in such a short period after the conclusion of the Apartheid era, the realisation of the position in the 2010 study is made all the more remarkable and is indicative of potential further improvement in this area.

2.3.6 Exchange rates

The exchange rate affects the buying power of a foreign investor. Should the exchange rate be to the benefit of the investor, in other words the currency of the investor’s country is stronger in relation to the currency of the potential host country, investment is more likely. The instability of exchange rates is also an indicator considered in assessing the riskiness of a country (Ajayi, 2006:37).

As a measurement of exchange rate, the annual average of the local currency in relation to the US dollar is considered for 2010 (World Bank, 2010b). SA's currency is considered comparable with that of China. India and Russia shows a definite advantage in the exchange rates reported for 2010. This could decrease investment interest in SA, particularly from investors sourced in the US.

2.4 CONCLUSION

From the above comparison it may be argued that SA has the ability to compete with the BRICS countries. Further, it may be expected that SA would be fairly successful in attracting FDI. This theory is supported by the Institute for Management Development (2010:19) that considers SA as a competitor in the world by ranking the country as 44th out of the 58 countries in its 2010 World Competitive Yearbook.

The marketable qualities indicated above are, however, not reflected in the IFDI Performance Index of 2009, where SA ranked second weakest of the BRICS countries. One possibility for the lack of realisation of its potential may be the tax policies applied by SA in comparison to those of other BRICS countries. This therefore indicates that further study in this area would be warranted and justified.

CHAPTER 3

3 TAX AS A FOREIGN DIRECT INVESTMENT DETERMINANT

3.1 INTRODUCTION

A large volume of research attention has been afforded to the relationship between tax and FDI. This may be as a result of taxation being an institutional factor and therefore, arguably, an identified determinant that can be manipulated with more ease than most others. Logically, where all other factors are equal, a company would want to avoid paying unnecessary taxes and this is the basis with which most studies investigating the relationship between FDI and tax have been performed. Tax rates, together with other tax incentives are frequently used as advantageous methods in creating competitive tax policies (Klemm & Van Parys, 2009:22).

3.2 TAX AS AN INVESTMENT INCENTIVE

Arguments may be made both for and against the use of tax as a method of increasing a country's competitiveness. Although tax policies are adaptable it should be kept in mind that making changes in fiscal policies are not without risks. Increased tax incentives offered could result in a loss of revenue should they not attract sufficiently increased levels of investment to offset the income lost in offering the incentive. The correct balance between the benefit for the investor and the investee therefore has to be achieved and maintained for the use of tax policies to be successful in increasing the revenue of the country.

Offering tax incentives within the tax policies of a country also tend to lead to more complex tax laws, which could be counterproductive in attracting interest from investors (Kransdorff, 2010:77). Another drawback of tax policies as a form of attracting FDI is that only profitable companies can benefit, as tax is not levied on companies that suffer losses. Regardless of its benefits or disadvantages, tax as a means of attracting FDI has

remained a major focus of researchers for a number of years with various studies aimed at identifying the impact of tax policies on FDI flows.

3.3 THE RELATIONSHIP BETWEEN TAX AND FOREIGN DIRECT INVESTMENT

A variety of studies have been performed with the intention of addressing the relationship between tax and FDI. Conclusions reached by the studies performed have, however, been inconsistent. Some of the earliest studies performed date back to 1955 where Barlow and Wender (*in* Morisset & Pirnia, 1999: 6) found taxation not to be a significant determinant of investment decisions based on surveys performed. This was further confirmed by evidence gathered using time-series analysis for a period from 1966-1970 (Morisset & Pirnia, 1999: 8).

However, in 1996 Hines (1996: 43), based on evidence available at the time, determined that taxation could significantly affect the actions of multinational corporations and thereby resulting in increased FDI inflows. Hines' findings were supported in a later study conducted by Wei (1997:24). Kransdorff (2010:71) argued that although there were studies that indicated that tax policies do not have a significant impact on FDI, studies with these results tend to be out dated. In comparison, he argued that more recent studies indicate that tax policies do in fact play a role in attracting FDI in certain circumstances, at least in developing countries, which was largely the focus of the study he performed.

After identifying that most of the research focus has been on developed countries, Dethier and Madiès (2010:20) performed a study to determine if FDI inflows are sensitive to tax policies for developing countries specifically. Based on empirical research performed they concluded developing countries' FDI inflows tend to be responsive to tax policies, albeit to varying degrees. In the same study it was found that tax holidays were a particularly useful form of attracting FDI in developing countries such as SA.

In 2010 a study was performed to specifically compare SA's tax policies with those of its perceived FDI rivals (Kransdorff, 2010:74). The FDI rivals were identified using UNCTAD's IFDI Potential Index based on the presumption that countries with a similar attractiveness, as indicated by this index, would be SA's greatest rivals in the bid for FDI. The study

indicated that SA does not offer a large variety of tax inducements. It pointed out that this could be a possible element in the country's inability to attract the interest of foreign investors and thereby perform on a sufficient scale in the world market. Of the BRICS countries, only Brazil was included in the comparison performed by Kransdorff (2010:74). Investigation into the competitiveness of SA's tax policies in relation to all BRICS countries has therefore not been performed based on the literature reviewed. The study did, however, include the types of tax policies that appear to be used most frequently.

3.4 TAX POLICIES

In assessing the tax policies of SA's perceived rivals, Kransdorff (2010:76) identified most of the following forms of tax policies used:

- Corporate tax rate;
- Tax holidays;
- Investment allowances/ accelerated depreciation schemes;
- Research and Development allowances;
- Deduction for qualified expenses;
- Double tax agreements; and
- VAT or other forms of duty charges

The tax policies as indicated above will be further addressed below. These methods will then be considered for inclusion in the comparison to be performed between the BRICS countries as the focus of this paper.

3.4.1 Corporate tax rate

Corporate tax rates are the rates applied to the income of companies only and not individuals. Corporate tax rates allow for ease as well as comparability of analysis across both a range of countries and time periods. The use of lower tax rates as an incentive is also fairly simple from an administrative view (Bolnick, 2004: 82). It has therefore been one of the areas of research and focus of study to analyse the effects of changes in corporate income tax rates with regard to attracting FDI.

The majority of studies conducted indicate that an inverse relationship exists between corporate income tax rates and FDI inflow. Wijeweera and Mounter (2007:140) assessed the effect that a change in tax rate had on Australia's FDI inflow over a six-year period and found that decreased tax rates lead to increased levels of FDI. The same result was noted in a 2007 study performed on the United States (Clark, Dollery & Wijeweera, 2007: 116) and confirmed to be applicable to African countries (Stapper, 2010:61). Changes in corporate income tax rates were found to affect the FDI inflow more markedly in developed countries than in developing countries (Goodspeed, Martinez-Vazquez & Zhang, 2009:25). It was further noted that developed countries have used decreasing corporate tax rates as the latest form of tax incentive (Wijeweera & Mounter, 2007:2). Having confirmed the relationship between FDI and tax, further studies were performed in the hope of quantifying the relationship.

Studies have been performed to establish the degree to which changes in tax rates impacts on FDI. It was determined that a 1% increase in corporate tax rates leads to a 1% decrease in FDI inflow for the United States particularly (Wijeweera & Mounter, 2007:140). After reviewing studies performed over a period of 15 years, Hines established that on average FDI increased with 2% for every 1% decrease in the corporate tax rate (Hines in Kransdorff, 2010:71). Based on these studies, investors clearly consider corporate tax rates in assessing where to do business. A more detailed assessment of what is included in the term "corporate tax rate" therefore needs to be performed.

In assessing the relationship between corporate tax rate and the FDI inflow to the country, either the statutory or effective corporate tax rate can be used. According to definitions.uslegal.com (Not dated) the term Statutory Tax Rate implies the tax rate specified by law. It includes the amount of charges imposed by the government upon personal or corporate income, capital gains, gifts, estates, and sales, and so forth that are within the government's statutory power to regulate." The effective tax rate is defined as "the ratio of taxes paid to a given tax base...for corporate income taxes, it is the ratio of taxes to book profits..." (teachmefinance.com, not dated.).

In a paper by Wijeweera and Mounter (2007:5), it was argued that the statutory corporate tax rates are used for decision-making purposes. However, they stated that the effective

tax rate was preferable for the purposes of estimating the actual tax liability of a company. A study performed that assessed the relationship between both the statutory and effective tax rates, indicated that the results based on statutory rates are more robust (Clark *et al.*, 2007: 116). It therefore appears that statutory tax rates would be a better indicator in performing an assessment.

The main negative impact related to decreasing the corporate tax rate to attract new investments, is that the benefit of reduced tax rates is enjoyed by all parties even in the absence of additional investment. It therefore results in the decrease of tax revenues should it not be combined with the implementation of other measures to increase the tax base that generate revenues (Bolnick, 2004: 82). Other tax policies may therefore prove to be more effective.

3.4.2 Tax holidays

Tax holidays allow for the exemption of enterprises from tax for a specified period of time on the achievement of certain conditions (Jorratt, Lemgruber & Villela, 2010:7). Tax holidays were identified as the form of tax incentive that matters the most in attracting FDI to Sub-Saharan African countries in a study that used empirical evidence for a period from 1990-2000 (Cleeve, 2008:150). This is a tax policy frequently used by both developing and developed countries in tax competitive strategies (Klemm & Van Parys, 2009:22) but it is an incentive that poses various problems.

Tax holidays tend to be criticised by specialists in tax as a significant loss in revenue can be experienced from such policies. It is further argued that in cases where significant potential is obtained by the investor from the use of these policies, the nature of the project being undertaken is such that it would have occurred even in the absence of such tax incentives. The use of tax holidays is also associated with tax avoidance depending on the method of administration and thus vigilant monitoring is required. There is also the possibility of companies removing themselves from a country once the period allowed by the tax holiday has expired (Bolnick, 2004: 83).

Regardless of the potentially negative impact of tax holidays, it is still a frequent form of tax policy used as evidenced by the study performed by Kransdorff (2010:75). For this reason tax holidays are considered in the comparison of the tax policies employed by the BRICS countries together with more general policies such as allowances.

3.4.3 Investment allowances/ accelerated depreciation schemes

Investment allowances or accelerated depreciation schemes are tax policies where a deduction is allowed, usually over a set period of time, for the use of capital goods, not usually deductible as an expense against the income of a company. Investment allowances therefore ensure the deduction of the cost of capital goods over the period in which they are used to produce income (Jorratt *et al.*, 2010:7).

The effectiveness of using investment allowances to attract FDI is questionable as indicated by an empirical study performed (Klemm & Van Parys, 2009:22). However, for this study an evaluation of investment allowances as a tax policy is still considered to be valuable and is considered further in comparing the BRICS countries. Countries also offer incentives in the form of allowances to attract investors to particular areas where a country could obtain benefit. One such incentive is the use of research allowances.

3.4.4 Research and Development allowances

Throughout the world progress in the field of technology and science is evident. One frequently hears about advances made in this regard. It therefore comes as no surprise that countries are attempting to entice investors to the field of research and development.

One method of attracting investors to expend on research and development is through the offering of tax incentives for research that meets set requirements. Investors are offered deductions on expenses in excess of the actual cost incurred as well as accelerated claims. Because of the specific nature of such policies, this aspect is excluded from the comparison performed within this study.

3.4.5 Deductions for qualified expenses

In order to determine the taxable income of a company, certain expenses are deducted from the net income. These expenses are deducted in terms of a general deduction or the specific deduction of expenses that qualify in terms of the respective country's tax laws. These deductions are therefore employed to decrease the base against which the relevant tax rate is applied.

It is expected that countries have prescriptions within their tax laws governing the nature and limitations of such deductions. As the range of such deductions can vary significantly, it requires in-depth study in truly considering the benefits of such incentives offered as a tax policy within a country in comparison to that of others. This form of tax policy is therefore excluded from the study performed in this paper.

3.4.6 Double tax agreements

Although the use of double tax agreements (DTA) was not identified as a tax policy used to attract FDI in the study performed by Kransdorff (2010:76), it is a tool used to attract the investment from particular countries. DTAs are defined as "...an international treaty concluded between two states to determine the incidence of tax in, and the application of tax laws by, each state with the object of avoiding double taxation" (Honiball & Olivier, 2008:573). The creation of DTAs may be considered complex, as the regulations of two or more countries have to be considered.

To ensure the standardisation of DTAs, model tax conventions (MTC) have been created by some international forums. The most popular of such organisations are the United Nations (UN) and the Organisation for Economic Cooperation and Development (OECD). These organisations have some of the most influential countries in the world as members and policy setting occurs by means of voting. It has been noted that most double tax agreements are based on the model created by the OECD (Honiball & Olivier, 2008:7). Although the focus of DTAs is the avoidance of double taxation, other benefits such as information sharing are also facilitated.

Where DTAs are in place, foreign investors have additional comfort that taxation by both the investor's home country and the country that the investment is situated in will not be possible. DTAs ensure that no discrimination between a foreign and local investor can be made. Foreign investors therefore enjoy protection from additional taxes imposed purely due to the status of the investor as a non-resident of a country. It stands to reason that investors are more likely to invest in a country with which their home country has a treaty and a study was performed in by Paolini, Pistone, Pulina and Zagler (2011:3) to assess such a relationship.

A study performed in 2011 has indicated that there is dissension regarding the ability of DTAs to attract FDI (Paolini *et al*, 2011:3). As DTAs also inspire trade between parties to the agreement the number of DTAs available in a country may indicate the appeal of a country for investors, as agreements will only be entered into where there are mutual perceived benefits. Thus, where a single DTA may not provide a significant incentive for investors, a number of DTAs may do so. For this reason the number of DTAs held by each country will be considered in comparing the BRICS countries. Income tax is not the only form of tax and most countries also use VAT or other similar duty charges.

3.4.7 VAT or other forms of duty charges

Value-Added Tax (VAT) is an indirect tax that is imposed on goods and services that are consumed within the country. In SA VAT is governed by a separate act being the Value-Added Tax Act 89 of 1991. VAT is not a SA specific concept and an excess of 50 countries worldwide applies a similar system. It is considered as an indirect tax as SARS taxes the transactions and not an entity directly (Stiglingh, 2009:850). A company that is required to pay VAT (output VAT) is also entitled to claim VAT refund (input VAT) on the materials and expenses incurred in order to produce the goods or services and is therefore only exposed to the net effect of VAT.

Similarly, customs and other duties are taxes that are levied on the goods or services imported into the country. Customs duties tend to be applied as a disincentive for importing goods as this usually results in the flow of funds out of the country and in

removing the prospect for production within the country's borders and it also decreases job and learning opportunities.

These charges tend to form part of the cost of the goods or services produced and are usually incorporated in the selling prices. In other words the final consumer usually carries these costs. For this reason, these taxes will be excluded from further investigation in this particular study.

3.5 CONCLUSION

Based on studies performed, taxation does play a role in attracting the interest of foreign investors. This study is aimed at comparing the tax policies of the BRICS countries in particular to identify the measures taken by the expected emerging superpowers and thereby allow for improved policy setting for SA specifically.

In performing such a comparison, the focus is on the following tax policies as identified in this chapter:

- Corporate tax rate;
- Tax holidays;
- Investment allowances/ accelerated depreciation schemes; and
- Double Tax Agreements

Before an evaluation and comparison is done on these specific measures employed, a general overview of the tax policies employed by South Africa and the other BRICS countries is performed. Such an overview enables a general perspective before a more specific approach is followed.

CHAPTER 4

4 SOUTH AFRICAN TAX SYSTEM

4.1 INTRODUCTION

SA is a country with much to offer the world and is considered by some to be the gateway to Africa as noted in a presentation by Stanley Subramoney, Deputy CEO of PricewaterhouseCoopers on 26 May 2011. Yet to date it has failed to attract sufficient international interest and investment to the extent of improving growth and alleviating poverty in the country. As it is accepted that FDI is an important factor in allowing for growth in developing countries, it would benefit to understand how SA could market itself to draw the attention of international investors. This section aims to place SA and its tax system into context. All references to a section is within this chapter are referring to the Income Tax Act No. 58 of 1962 (“Income Tax act”).

4.2 AFRICA AND SOUTH AFRICA AS INVESTMENT OPPORTUNITIES

Currently Africa is a largely untapped market. The population in Africa is expected to reach levels of over 2 billion by 2050 (Elliott, 2010:23), a significant market by any standards. The population of Africa is fairly young with more than 70% being people under the age of 40 (Elliott, 2010:23), creating a market ripe for the latest technological advances. There is also a large opportunity for the investment in natural resources in Africa. Yet with matters such as epidemics and political unrest constantly disrupting the continent, investors are generally hesitant to expose themselves to Africa (Marafa, 2009: 19). There also seemsWith a lack of such foreign investment, poverty remains a constant struggle for Africa. As Subramoney (2011) said in at an event presented on 26 May 2011, “Africa is rich but Africans are poor”. SA has been included in BRICS recently and, as some believe, represents Africa amongst the proposed future superpowers.

SA is currently viewed as the “major economic hub of Southern Africa”. About 20% of the economic activity of the continent is focused in SA (Elliott, 2010:33). With the opportunities

offered by Africa and the long standing political friendship between SA and China (Marafa, 2007: 3), it is understandable that BRIC decided to include SA in the forum even without the official identification of the country as a potential economic giant in terms of the original study performed. Time will tell if SA has the ability to compete with these expected economic giants and it is reasonable to believe that the country is likely to do everything in its power to disprove doubts posed by those opposed to SA's inclusion in BRICS. In this study the focus is on comparing SA's tax policies to evaluate its competitiveness with these countries and to identify changes that could increase the effectiveness of the policies applied.

The following is a short overview of the tax policies of SA. The taxation of foreign investors and the tax policies used as described above are the focus of the overview.

4.3 INCOME TAX IN SOUTH AFRICA

South Africa's tax regime has undergone significant changes since the end of the Apartheid era under the guidance of Trevor Manuel from 1996 to 2008 (WhosWhoSA.co.za, 2009). He implemented various changes within the period he fulfilled the role of SA's Minister of Finance.

Some of those changes include the introduction of Capital Gains tax (CGT). SA started to impose the concept of CGT in 2001 (Manuel, 2002:5). CGT is a tax imposed on the profit derived from the sale of capital goods and is governed by Schedule Eight. In terms of paragraph 10(c) of the Schedule Eight of the Income Tax Act, 50% of the net capital gain of a company is included in the taxable income of the company. If considering the corporate tax rate of 28% this results in a tax of 14% levied on the gain derived from the sale of a capital asset.

Another of these changes was to tax in SA based on a residence basis. The residence basis ensures that a resident of SA is taxed on its worldwide income as opposed to non-residents that are only taxed when the source of income is within SA (section (1) Definition of "Gross Income", Income Tax Act). This change in policy was also affected in 2001 once it was recognised that SA residents are investing overseas after the lessening of

Exchange Controls since the conclusion of the Apartheid era (Manuel, 2002:5). It is therefore important to understand which companies are considered to be residents of SA as this could have a significant impact on the inclusion of sourced income in the tax base against which the corporate tax charge is applied.

4.3.1 Residence in South Africa

A resident as defined in section one on the Income Tax Act

“means any... person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic but does not include any person who is deemed to be exclusively a resident of another country for purposes of the application of any agreement entered into between the governments of the Republic and that other country for the avoidance of double taxation (section 1, Definition of “Resident”, Income Tax Act).”

Although the terms *“incorporated, established or formed”* are not defined in the Income Tax Act it is accepted that where a company is incorporated as prescribed by the Companies Act 71 of 2008 (“Companies Act”), it is a resident (De Koker & Williams, 2011). It is more difficult to determine the residency status of a company where it was not incorporated under the Companies Act as the term *“place effective management”* can be interpreted in various ways.

Again the term is not defined in the Income Tax Act and the South African Revenue Service (“SARS”) considers it to *“mean where the day-to-day activities of the business takes place”*. This is not the same as where the control of the company is held or exercised but rather from where the executive directors manage the company (De Koker & Williams, 2011). Due to the difficulty in applying the term additional guidance was issued by SARS in Interpretation Note 6 (South African Revenue Services (b), Not dated). Even though the term is likely to be used by a variety of countries, there is no single meaning or interpretation applied internationally which may lead to a company being considered as a resident in more than one country.

To combat the inclusion of one company as a resident of multiple countries, DTAs are frequently used. The definition of a resident specifically excludes instances where the residency of a company has been determined by means of a DTA and the guidance and interpretations offered for determining residency would therefore be limited by such an agreement (section 1, definition of “resident”, Income Tax Act). The SA tax law also has specific considerations for the taxation of non-residents.

4.4 TAXATION OF NON-RESIDENTS

Non-resident companies pay tax at the same rate as resident companies, except in the case of royalties, interest and the fees received by non-resident sports persons or entertainers where a non-resident is taxed at a lower rate. The deductions and allowances as discussed are available regardless of the resident status of a company. A non-resident is, however, only taxed on income from a SA source or deemed SA source (De Koker & Williams, 2011).

4.4.1 South African source income

The Income Tax Act does not define the term “source within the Republic” although generally speaking it seems to be fairly easy to determine the source of income. Difficult cases might, however, arise and due to the nature of the statement the source needs to be assessed individually per case and no generalised standard can be set. It has therefore been left largely to the courts to determine what is meant by the term “source within the Republic” in instances where it is not clear. The guidance regarding when income is deemed to be from a source in SA tends to be clearer (De Koker & Williams, 2011 5.3).

The income deemed to be from a SA source is mostly detailed in section 9. The section covers income types such as royalty income in section 9(1)(b), remuneration for the provision of services in section 9(1)(e), interest income in section 9(6) and income from annuities in section 9(1)(g), amongst others. Immovable property, or an interest in immovable property situated in SA is determined to be from an SA source per section 9(2) and other assets are deemed to be from SA if it is used in the operation of a permanent

establishment within the country per section 9(2). To make the collection of income tax from residents easier, SA imposes withholding tax on some income streams.

4.4.2 Withholding tax

Withholding tax is “a tax levied by a country of source on income paid, usually on dividends remitted to the home country of the firm operating in a foreign country” (Financial-dictionary.thefreedictionary.com, Not dated.). The principle of withholding tax allows for the tax that is due on the income generated, to be withheld at the source of the income before payment is made to the recipient. This tax is then paid over to the tax authorities on behalf of the recipient. Tax authorities therefore do not have to struggle to receive tax from a foreign country as the liability is settled before the payment is made to the recipient. In SA withholding tax is levied on various forms of income received by foreign investors.

One such income stream is royalties deemed to be from SA. Royalties are deemed to be from a source within SA if the intangible asset that generates the income is used within SA, regardless of where the asset was produced or registered according to section 9(1)(b). Such royalties are, however, not taxed at the standard tax rate but bear tax at a rate of 12% of the income received per section 35(1). The tax is required to be paid over by the person liable for the payment within 14 days after the end of the month that the liability arose as required by 35(2). As this tax is a final tax the company is exempt from normal tax in terms of section 10(1)(l).

Another stream of income that is subject to withholding tax by SA, are the fees received by foreign sportspersons and entertainers for services delivered within SA which is governed by section 47B(1). The rate of tax to be levied is 15% and is regarded as the final tax to be paid according to section 47B(2). Again the person liable for payment to the foreign recipient is required to withhold the amount in terms of section 47D(1).

From 1 January 2013 section 37J(1) determines that interest income paid to a non-resident is also subject to withholding tax of 10%. Various entities and types of debt are, however, exempt from this withholding tax as detailed in section 37K. Again the person

responsible for making the payment of interest is required to withhold the tax in terms of section 37L(1). This new requirement seems to be a way for SA to obtain foreign lending but still protect its tax base (De Koker & Williams, 2011:14.4).

Other than the income streams, capital gains from the disposal by a non-resident of immovable property situated in SA is also subject to withholding tax. A person, resident or non-resident, who makes payment to a non-resident company for the acquisition of immovable property in SA is required to withhold an amount of 7.5% of the amount payable in terms of section 35A(1). Other than in the other cases section 37A(3) determines that where tax was withheld, this is not a final tax payment but rather an advance on the tax due on the capital gain. This section, however, is not applicable if the amount of the payment made to the non-resident recipient does not exceed R2million as allowed by section 35A(14)(a).

Together with these provisions, the DTAs of SA are the main areas of recourse for taxation in SA that a non-resident may consider. The use of DTAs in SA is considered under the review of the tax policies identified as being included in the comparison.

4.5 TAX POLICIES

From the above review of the taxation system in SA in general and the provisions applicable to non-residents, attention is now moved to the tax policies that are compared to those of the other BRICS countries. Both the implementation of taxation on the residence basis and CGT results in an increase in the taxable income against which the applicable tax rate is applied. These additional measures appear to have been introduced to combat the effects of the decrease in the corporate tax rates as the changes were implemented shortly before a significant decrease in the corporate tax rate.

4.5.1 Corporate tax rates

The tax rate is applied against the taxable income in determining the tax liability of a company as per section 5(2). The SA effective and statutory tax rates have shown a significant decrease in the past 15 years. In 1999, the statutory corporate tax rates were

reduced to 30% from 35% (Manuel, 2002:5) a rather significant drop considering that only a further 2% drop has been experienced since. As discussed earlier in this chapter, the introduction of CGT was made in order to expand the tax base of the country and thereby countering the effect of the significant decrease in corporate tax rates to some extent. As only 50% of the net capital gain of a company is included in taxable income, tax is effectively levied at 14% on profits from capital assets, which still allows for an effective decrease in the corporate tax rate. Based on the knowledge obtained from studies conducted on the relationship between FDI and corporate tax rates, a decrease in corporate tax rates is considered to be one of the most effective means of tax policy, it is deduced that SA has the intention of affecting investment in the country with this form of incentive.

The corporate tax rate of SA is currently 28% according to the tax tables per the Income Tax Act. Small businesses are, however, afforded some relief. To qualify as a small business a company must be a close corporation or private company with all shareholders being natural persons. Furthermore, the company must have a gross income of less than R14million per annum and less than 20% of the gross income of such a company must be from investment income or fees for personal services (PKF International Limited. 2011e: 9). Small businesses are taxed at the following rates:

Table 5: Taxation of small businesses in South Africa

Taxable Income	Rates of tax
R0 – 57,000	Nil
R57, 001 – R300, 000	10% of the amount over R57, 000
R300, 001 +	R24, 300 + 28% of the amount over R300, 000

Source: PKF International Limited. 2011e: 9

SA corporations are, however, not exposed to only the statutory tax rate. In SA, the effective tax rate is mainly affected by the statutory tax rate and the Secondary Tax on Companies (STC).

STC is a tax that is levied on a company based on the profits distributed by a company to its shareholders in the form of dividends. When a company pays dividends, the difference between the dividends declared and the dividends received by the company from its

investments are taxed per section 64B. Before 1996 the STC tax rate was 25% which, combined with the statutory tax rate, resulted in a 48% tax on companies. Since then the STC rate has decreased to 10% (section 64B(2)) and the corporate tax rate to 28% (Appendix I to the Income Tax Act), resulting in an effective tax rate of 34.55% in 2010. A further decrease in the corporate tax rate is expected on the replacement of STC.

SA is in the process of replacing the practice of STC with a policy of dividends tax after an announcement made by the Minister of Finance in 2007. The policy is, however, not yet effective and the date on which the new policy is to become effective has not yet been announced (De Koker & Williams, 2011). The effect of this change on the effective tax rate should already be taken into consideration as the change is imminent.

The most significant change from STC to dividends tax is that the party taxed under the dividends tax policy would be the shareholder, where currently STC is a tax that is levied on the company. In other words, once the withholding tax policy is in place, STC no longer contributes to the effective tax rate of a company resulting in a decrease in the country's effective tax rate to its statutory tax rate of 28%. If the general theory regarding the relationship between the tax rate and FDI inflows is applicable to SA, this could increase SA's attractiveness for foreign investors. Under the dividends tax policy, exemption is to be enjoyed based on the nature of the party receiving the dividend. In particular, companies that are considered to be SA residents are to be exempt from dividends tax. (Section 64F(a)).

It is clear that SA is in the process of decreasing its effective tax rate, both through the reduction of the corporate tax rate and the expected abolishment of STC. Although studies indicate that a reduction in corporate tax rates would affect FDI, other tax policies are also used to entice prospective investors.

4.5.2 Tax holidays

A study performed, which compared SA with a number of other countries most closely ranked to it on UNCTAD's IFDI Potential Index in 2009, determined that SA does not offer tax holidays as an incentive within the ambit of its tax law. This study confirmed that tax

holidays are a popular form of tax policy used in attracting FDI as seven out of the nine countries considered in the study were found to use tax holidays as an incentive (Kransdorff, 2010:75). The use of tax holidays may, however, be administratively troublesome and the benefits derived there from are still debateable (Bolnick, 2004: 83). SA therefore seems to have acted in a more cautious fashion by avoiding this form of tax incentive for the practice of offering allowances.

4.5.3 Investment allowances/ accelerated depreciation schemes

There are a number of investment allowances and accelerated depreciation schemes available within the ambit of the SA tax law. The general allowance, as governed by section 11(e), enables taxpayers to deduct the cost of an asset, used for purposes of generating taxable income, over a period against such income generated. Practice Notes No. 15, 19 and 39 prescribes the period of deduction.

There is also provision in the Income Tax Act for allowances on capital goods depending on the nature of the company and the purpose of the asset. Section 12E prescribes shortened periods of write-off against income generated for small businesses. Section 12C has accelerated depreciation for assets that are used in the manufacture of goods or the provision of hotel services. Allowances are also offered based on the nature of the asset. For example, the entire section 13 governs the allowances with regard to immovable property.

Should a company's deductions and allowances exceed the taxable income and losses are generated, the losses may be carried over in terms of section 20 and utilised against taxable income in subsequent years. Exemptions from income tax are also available on the income received from investments such as securities.

With the current STC taxes that are applicable, taxes are exempt in the hands of the recipient in terms of section 10(1)(k). Investors are therefore exempt from paying tax on the receipt of profits that are distributed. As discussed previously, this will change once dividends tax become effective as then the recipient of the dividend will be liable for the tax received and not the company making the profit distribution.

4.5.4 Double tax agreements

SA taxes residents on their worldwide income and non-residents on their SA source income. To prevent the depletion of the country's tax base by companies, measures such as transfer pricing and thin capitalisation have been included in the Income Tax Act in section 31. This section ensures that group companies enter into transactions at arm's length thereby ensuring that excessive profits aren't moved to a company within the group that either falls outside of the SA tax net or that have losses available which can be used against the income. On the other hand companies that operate in multiple countries are also exposed to the risk of double taxation.

Double taxation may arise because of the different approaches followed within other countries in taxing income. Although section 6quat offers a general reduction in tax in the case of double taxation, SA has also entered into various DTAs with countries considered to create beneficial relationships for SA residents. With an increase in globalisation leading to an increased need for DTAs, models have been established by forums to allow for the best practices of such agreements (Honiball & Oliver, 2008:7)

One such a model is the model developed by the OECD. Although SA is not a member of the OECD, it has been awarded the status as an "observer" and therefore uses this model in setting DTAs (Honiball & Oliver, 2008:9). A double tax agreement becomes part of the SA tax law once it has been approved by Parliament and published in the Gazette (section 108 of the Income Tax Act). Currently SA has DTAs in place with over 50 different countries, which includes the other BRICS countries (SARS (a), Double Tax Agreements listing, Not dated.), indicating that SA has reasonably strong trade ties with a large number of countries.

4.6 CONCLUSION

From the overview above, SA has various positive tax policies and based on the decreasing tax rates, it seems as if SA is in the process of improving the competitiveness of its tax policies. An improved indication of the possible success of the policies used

would, however, be obtained from a comparison with the other BRICS countries. Before a comparison is made it is, however, necessary to understand the basics of the tax policies employed in these countries.

CHAPTER 5

5 THE TAX POLICIES OF OTHER BRICS COUNTRIES

5.1 INTRODUCTION

Before an analysis of the various tax policies used by countries to attract FDI is possible an overview of the basics of the tax policies used by the countries is needed to provide background information. As the review is required for background information only, the tax policies are not discussed in detail and only highlight the key matters considered necessary for purposes of this paper. Therefore, although mention of the existence of further or other allowances may occur, additional detail thereof is not discussed. This section aims to provide the background of the BRICS countries' tax policies, other than South Africa, starting with Brazil.

5.2 BRAZIL

5.2.1 Corporate tax rate

In Brazil companies are taxed based on the accrual basis on a single tax rate of 25%, which consists of 15% fixed tax rate and 10% on profits before tax that exceed US \$240 thousand per annum. Although the tax is levied annually, advance payments need to be made monthly, based on the estimates of the tax that will be payable. Additionally to the normal companies tax rate, Social Contribution on Net Profit tax at a rate of 9% is payable, bringing the total tax rate relating to companies to 34%. The corporate tax rate is applied against the taxable income in establishing the tax liability, which includes capital gains. (PKF International Limited, 2011a: 9).

Capital Gains are generally treated as ordinary taxable income but tax may be charged on a cash basis for permanent assets that are sold over an extended period of time. Capital losses may only be utilised to decrease capital gains and such losses are treated in a manner similar to that of other income tax losses. (PricewaterhouseCoopers LLP, 2011a).

Taxable income is the difference between the gross income generated by a company and the “expenses needed to obtain, maintain and preserve such income” which is in essence the same as the general allowance found in the SA tax law (section 11(a) of the Income Tax Act). Other than this general allowance regarding expenses incurred, certain specific allowances are also available to apply against the gross income of the company to determine the taxable income. (PKF International Limited, 2011a: 12).

5.2.2 Tax holidays

As discussed in Chapter Three, tax holidays have been found to be a method used to attract FDI by developing countries. Based on the review of literature on the tax policies of Brazil, however, there is no indication that this country makes use of tax holidays. Other allowances are, however, offered to benefit investors.

5.2.3 Investment allowances/ accelerated depreciation schemes

One such allowance is a “depreciation” allowance that may be utilised against the fixed assets acquired or held by a company. The tax policy of Brazil allows for the write-off of fixed assets on a straight line basis over specified rates depending on the nature of the asset held (Deloitte Touche Tohmatsu, 2010a:10). A taxpayer therefore receives an allowance for the investment made in fixed assets. Other allowances are also available as incentives to attract investment to the country.

Incentives are available in the form of a reduction in the income tax, and thereby the tax liability, or the exemption from withholding tax. Such incentives are offered for the export of technological information services, the undertaking of specific new projects within the borders of the country and allowances for the acquisition of assets by exporting companies. (PKF International Limited, 2011a: 13).

Other matters affecting the determination of taxable income include the taxation of dividends. Dividends declared by Brazil companies, whether to locals or foreigners, are exempt from tax, so profits may be distributed to shareholders without additional charges being levied (PKF International Limited, 2011a: 12). Tax losses may also be carried

forward and utilised against future tax profits to the extent of 30% of those profits. Tax losses may only be used by the company it resulted in and may not be set-off against the taxable income of a group of companies (Deloitte Touche Tohmatsu, 2010a: 10). Other measures are in place relating to profits from or transactions with companies outside the borders of Brazil.

5.2.4 Double tax agreements

Brazil taxes on the residency basis, meaning foreign source income is taxed for resident companies. Relief in the form of tax credits are, however, available to alleviate a double tax burden. Measures are in place to ensure that companies do not move their profits to another country to avoid tax. (PricewaterhouseCoopers LLP, 2011a).

There is a limit on the charges from foreign related parties that are allowable as deductions against gross income and transfer pricing is applied to limit the moving of profits between borders (PricewaterhouseCoopers LLP, 2011a). Furthermore, transfer policy guidelines and thin capitalisation measures are followed to discourage the moving of profits between related parties for the purpose of utilising tax losses (Deloitte Touche Tohmatsu, 2010a: 12).

Non-residents are taxed on sources of income considered to be from Brazil. Withholding taxes are usually applicable at a rate of 15%, except in the instance of capital profits. To avoid the taxing of profits in more than one country Brazil has entered into various DTA's. Brazil is a member of the OECD and therefore enforces its guidelines in the setting of DTAs (PKF International Limited, 2011a:14). Currently Brazil holds DTAs with about 29 countries. DTAs are held with Russia, China, India and SA, all of the BRICS countries (Deloitte Touche Tohmatsu, 2010a:11).

5.3 RUSSIA

5.3.1 Corporate tax rate

Russia differentiates between local and foreign companies in the manner in which they are taxed. Local companies are taxed on their worldwide income whereas foreign companies are taxed only based on income sourced from within Russia. Local companies are those that have been incorporated under the Russian tax law and foreign companies those that generate profits from a permanent establishment in the country. The rate paid is, however, consistent regardless of whether the company is local or foreign. (PricewaterhouseCoopers LLP, 2011b).

Currently tax is levied at a standard rate of 20% for both types of companies as mentioned above. Income received by a foreign company that does not relate to a permanent establishment in the country is also taxed at a rate of 20% with dividends being taxed at a lower rate of 15%. Tax is levied annually but monthly advance payments of tax have to be made by local companies and quarterly payments by foreign entities. Depending on the decision of the local authorities, small business may be taxed at lower rates. (PKF International Limited, 2011b: 9).

Small businesses enjoy decreased tax rates either in the form of “common tax” which is levied at a rate of 15% instead of the usual 20%, or alternatively through a simplified means of tax. The simplified method gives the small business the option of paying either 15% on the income generated less the expenses incurred, or a rate of 6% of gross income. (PKF International Limited, 2011b: 10).

In determining the tax levied, the rates as mentioned are applied against the taxable income to determine the tax to be paid over. One therefore needs to look at how taxable income is determined. As a general rule all expenses incurred in the operation of a business are deductible against the gross income in determining the taxable income (Deloitte Touche Tohmatsu, 2011:16). It should be noted that any profit generated by the sale of capital assets is taxed as normal business profit (PKF International Limited, 2011b: 9). Additionally certain allowances are available.

5.3.2 Tax holidays

Similarly to Brazil, the literature reviewed did not indicate the use of tax holidays within the tax policies of Russia as an allowance to decrease the tax liability relating to the country. Other allowances are, however, available to reduce the taxable income.

5.3.3 Investment allowances/ accelerated depreciation schemes

As an allowance relating to capital assets, depreciation is calculated on a monthly basis. Companies can either apply the straight-line or accelerated depreciation method and deciding which to use is left to the discretion of the company. The depreciation allowance is based on rates prescribed which is dependent on the nature of the assets held (Deloitte Touche Tohmatsu, 2011:21). Other allowances include, for example, the allowance of the costs that a company incurred to “maintain certain social facilities” and the exemption of assets transferred between group companies, being companies where an interest of at least 50% is held (PKF International Limited, 2011b: 9). These allowances combined with the general deduction of expenses incurred in operating the business, may result in tax losses.

Tax losses may be carried forward to be used in the future for a maximum period of ten years. Profits of a group cannot be combined and taxed together and each company is therefore taxed in its own right. The tax authorities also have the right to control the prices against which transactions between related parties are taxed thereby avoiding the possibility of moving profits to use tax losses. (Deloitte Touche Tohmatsu, 2011:24).

Furthermore, the distribution of profits is taxed through a withholding tax. Local companies pay tax on dividends at 9% where foreign companies are taxed at 15%. From 2011 dividends declared between group companies are subjected to a 0% withholding tax provided the holding existed for at least one year before such a distribution (PKF International Limited, 2011b: 11). Although the tax will be withheld and paid over by the company, the tax is in effect levied on the recipient. Other considerations are applicable to the taxation of foreigners and foreign profits.

5.3.4 Double tax agreements

As mentioned, local companies are taxed on their worldwide income whereas foreign companies are taxed only based on income sourced from within Russia. The profits received by foreign companies relating to dividends, royalties and interest are subject to withholding tax to ensure payment of the taxes. (PricewaterhouseCoopers LLP, 2011b).

Additionally, to avoid the transfer of profits between borders certain measures have been instituted. Russia may control the prices of transactions and thin capitalisation rules are applied where the interest that is deductible by a Russian company is limited depending on the shareholding and the debt to equity ratio. (Deloitte Touche Tohmatsu, 2011:23).

Tax credits are available for the foreign taxes paid on income received from foreign sources that are expected to be taxed by both another country and Russia but these tax credits are limited to the tax paid on that income within Russia (PKF International Limited, 2011b: 11). Furthermore DTA's with about 76 countries are in place to prevent the double taxing of profits with these countries (PKF International Limited, 2011b:12). DTAs are held with each of the BRICS countries. The large number of DTAs held could be an indication of the strength of the international ties held by Russia.

5.4 INDIA

5.4.1 Corporate tax rate

India taxes companies based on the resident basis, meaning that domestic companies are taxed on their worldwide income and foreign companies on their Indian sourced income only. The tax rates applied to local and foreign companies are also different. Local companies are taxed at a rate of 33.22% and foreign companies at 42.23%. (PKF International Limited, 2011c: 9).

These tax rates comprise of five different components being prescribed tax rates, a surcharge tax rate for companies with income in excess of Rs10m, Education Cess tax and Secondary and Higher Education Cess. All of these taxes together create the company's tax rate. The tax rates applicable may therefore vary depending on the income generated by the company. (PKF International Limited, 2011c: 9).

For companies that do not have income in excess of Rs10m the tax rates would be 30.9% for local companies and 41.2% for foreign companies. For purposes of this paper it is assumed that all companies have income in excess of Rs10m. Further variances in the tax rate may be experienced by foreign companies as for certain types of income foreigners are taxed differently. (Deloitte Touche Tohmatsu. 2010b: 15).

The following table indicates the rates applicable to the types of income generated by a foreign company. These rates are to be applied to the gross income generated.

Table 6: Tax rates applicable to foreigners in India for specific income streams

Income stream	Tax rate
Royalty and Fees for Technical Services, agreement entered into before 1 June 2005	21.12%
Royalty and Fees for Technical Services, agreement entered into after 1 June 2005	10.56%
Interest Income	21.12%
Income from units of Mutual Funds purchased in foreign currency	21.12%
Income from Global Depository Receipts	10.56%
Income from offshore funds (overseas company)	10.56%
Income of Foreign Institutional Investors in listed securities – Short term capital gains in respect of transactions chargeable to Securities Transaction Tax	15.84%
Income of Foreign Institutional Investors in listed securities – Short term capital gains in cases other than the one mentioned above	31.67%
Income of Foreign Institutional Investors in listed securities – Long term capital gains (other than those subjected to Securities Transaction Tax)	10.56%
Income of Foreign Institutional Investors in listed securities – Other income	21.12%

Source: PKF International Limited, 2011c: 10

Different rates are also applicable for the taxation of profits on the sale of capital assets. These profits are calculated by deducting the cost of the asset and the transfer duties paid on the sale from the selling price. Assets that are held for a long term, being more than three years, may adjust these expenses for inflation in certain instances, which is known as indexation. Long-term assets are also taxed at a different rate. (Deloitte Touche Tohmatsu. 2010b: 18).

The following table details the rates applicable for companies generating income in excess of Rs10m:

Table 7: Tax rates applicable to profits on the sale of capital assets in India

Type of capital asset	Rate for foreign companies	Rate for local companies
Long term capital assets		
For listed securities or units or zero coupon bonds	10.56% without indexation or 21.12% with indexation whichever is lower	11.33% without indexation or 22.66% with indexation whichever is lower
For others	21.12%	22.66%
Short term capital assets		
For listed securities or units or zero coupon bonds	15.83%	17.00%
For others	42.23%	33.99%

Source: PKF International Limited, 2011c: 11

Any losses made on long-term capital assets may only be used to reduce long-term gains but there is no such restriction on losses made on the sale of short-term assets. These losses may only be applied against gains of the same type and may only be carried forward for a period of eight years. (Deloitte Touche Tohmatsu. 2010b: 17).

Additional to the corporate tax rates and capital gains tax rates above, a company is also responsible for paying taxes on the distribution of its profits to the shareholders. Generally a company is required to pay tax at a rate of 16.61% on the distribution of dividends with some relief offered to equity funds. Distributions made by money market or similar funds and mutual funds are, however, taxed at a higher rate (PKF International Limited, 2011c: 11). The dividends are then exempt in the hands of the recipient, from 1 April 2003 (PKF International Limited, 2011c: 10).

The determinations of the taxable income against which the corporate tax rates are applied are also fairly involved. In determining the taxable income of the company, expenses incurred to produce the income are deductible (PKF International Limited, 2011c: 12). Any expenses incurred to generate income that is exempt from tax are, however, specifically excluded (PKF International Limited, 2011c: 13). For non-residents that are involved in specified types of business, there is a deemed provision relating to the income as follows:

Table 8: Deemed business income for certain businesses operated by non-residents in India

Business type	Business income as a percentage of gross receipts
Services in connection with exploration of mineral oils	10%
Operation of aircraft	5%
Civil construction or erection of plant and machinery or testing/ commissioning in connection with turnkey power projects	10%
Operation of ships	7.5%

Source: PKF International Limited, 2011c: 12

Further allowances and other forms of tax incentives are also available to attract FDI, yet at the same time protect the tax base of the country.

5.4.2 Tax holidays

The main form of incentive used is that of tax holidays. Tax holidays are available for companies that export only or for companies located in specific areas known as free zones. These tax holidays are, however, only available until 2012. For qualifying companies, they are exempt from tax for a period of five years and are only required to pay tax at a decreased rate for a set period subsequent to the five years. Tax holidays are also afforded to industrial companies that are involved with specified undertakings in areas that are considered to be “backward”. (PKF International Limited, 2011c: 15).

Together with this form of incentive, other allowances are also available.

5.4.3 Investment allowances/ accelerated depreciation schemes

Certain allowances are available for the investment in capital assets. For example, research and development costs incurred on capital assets are deductible in full and in some instances even up to 200%. Expenses incurred with regard to mergers or demergers are deductible over a period of five years (PKF International Limited, 2011c: 13). Furthermore, allowances are available on capital assets in the form of depreciation. Depreciation is allowed at various rates, being dependent on the nature of the capital asset (Deloitte Touche Tohmatsu. 2010b: 16). Exemptions of certain types of income are

also available. For instance dividends received that have been subjected to the Dividend Distribution Tax, is exempt from tax in the hands of the recipient of such dividends (Deloitte Touche Tohmatsu. 2010b: 13).

Losses that result may be carried forward to subsequent years and used to reduce the income generated in such years. The period during which the loss may be carried forward, however, depends on the nature of the loss. Business losses may be carried forward for a period of eight years. Speculative losses may, however, only be carried forward for four years and these losses may only be applied against speculative profits. (Deloitte Touche Tohmatsu. 2010b: 16).

As a company is responsible for the

5.4.4 Double tax agreements

As mentioned, the taxation of resident and non-resident companies differs within India's tax policies. Residents are taxed on their worldwide income. Tax credits are available to residents that are also liable for tax in another country. Residents are required to report transactions with non-resident related parties and the country's tax authorities retain the right to adjust prices if it appears as if transactions do not occur at an arm's-length basis with related parties. (Deloitte Touche Tohmatsu. 2010b: 22).

Where residents are taxed on their worldwide income, non-residents are only taxed on their income from a source within India. 'Advance Rulings' may be applied for in determining the tax liability of non-residents in advance, thereby avoiding legal problems. Withholding tax is also applied to the income received by a non-resident. (PKF International Limited, 2011c: 15).

Additional to the tax credits available to residents, the country has entered into a number of DTAs to avoid the double taxation of income. The DTAs usually specify the rates applicable to dividends, interest, royalties and technical service fees together with other provisions. India has DTAs with about 82 countries at present, including all four of the other BRICS countries. (PricewaterhouseCoopers LLP, 2011c).

Based on the review of India's tax policies, the provisions of this country's tax laws seem to be fairly intricate. The variety of matters that have to be considered, at least in comparison with the tax policies of the other BRICS countries reviewed thus far, makes determining the tax liability for companies appear rather complex. A review of the tax policies of the last BRICS country, China, follows.

5.5 CHINA

5.5.1 Corporate tax rate

In 2007 China passed its Enterprise Income Tax Law that governs the taxing of local and foreign companies. From this point companies are charged at the same tax rate, being 25%, regardless of whether it is a local company, a foreign company or a "foreign invested" company. Companies that generate small profits may, however, be taxed at a reduced rate of 20%. The source that these companies may be taxed on, however, differs depending on the nature of the company. (PKF International Limited, 2011d: 9).

The Enterprise Income Tax Law increased the scope of countries that are considered to be a resident of China. A company is now a resident in China if it is either incorporated in the country or if China is the place of effective management of the company. Residents are taxed on their worldwide income. Non-residents that have a permanent establishment in China are taxed on the profits that are generated by such an establishment whereas non-residents with no permanent establishment in China are only be taxed on the income from a source within China. (PKF International Limited, 2011d: 9).

Taxable income is calculated on the accrual basis and is considered to be 'gross income in a tax year after deduction of non-taxable income, tax-exempt income, various deductions, and allowable losses brought forward from previous years. Gains on the sale of capital assets are taxed as normal income derived by a company. (PricewaterhouseCoopers LLP, 2011d).

China offers a variety of incentives, specifically with the aim of attracting foreign investment and investment to specific areas. Tax rates as low as 15% are offered depending on the location and operations of the companies. Further benefits, such as tax holidays, are available for companies involved in specific trade and areas. (PKF International Limited, 2011d: 12).

5.5.2 Tax holidays

Although tax holidays that were available according to the previous law have been largely replaced with other forms of incentives, such as reduced tax rates, China still has tax holidays as one of their tax policies. For example, companies involved with new or high technology are only taxed at 15% and if these companies are situated in specified areas they enjoy a tax holiday for a period of two years and for a period of three years thereafter will be subject to only half of the applicable tax rate. (PKF International Limited, 2011d: 12).

Similarly, companies involved with the development of infrastructure or the protection of the environment enjoy a three-year tax holiday and pay tax at half the rate for three years thereafter. Companies that produce software enjoy a two-year tax holiday with a 50% reduced tax rate for three years thereafter and companies that deliver technology-advanced services in certain cities pay tax of only 15% between 1 January 2009 and 31 December 2013. (PKF International Limited, 2011d: 12).

From the above the drive for technological advancement in China is apparent. Other than the use of tax holidays, further allowances are also available.

5.5.3 Investment allowances/ accelerated depreciation schemes

A depreciation allowance is available against the cost incurred on capital assets. This depreciation allowance is calculated by means of the straight-line method over the useful life of the asset and the minimum depreciation period is dependent on the nature and business use of the assets. (Deloitte Touche Tohmatsu, 2010c: 12).

Certain exemptions are also provided for within the ambit of the tax law of China. For example, dividends received by one tax resident from another tax resident is exempt from tax by the receiving party, unless the dividend is publicly traded and held for a short period of time, being less than 12 months. (PricewaterhouseCoopers LLP, 2011d).

Resulting tax losses in the case where the deductions and allowances exceed the taxable income of the company may be carried forward for a period of five years. Such tax losses may however not be carried backwards. (PKF International Limited, 2011d: 11)

5.5.4 Double tax agreements

To ensure that profits are not moved across borders certain restrictions are in place. Management fees paid to related parties overseas are usually not deductible. Specific authority is required to deduct such fees in the determination of taxable income (PKF International Limited, 2011d: 10). Related parties are also required to transact on an arm's length basis and China reserves the right to change the value of transactions as deemed necessary in the event that it did not take place at arm's length (Deloitte Touche Tohmatsu, 2010c: 16).

To control the payment of taxes on income leaving the country, withholding tax is applied. Withholding tax is charged at a rate of 10% for the payment of dividends, interest, royalties and rent (Deloitte Touche Tohmatsu, 2010c: 13). Provision has also been made to avoid double taxation on an income source.

As mentioned, residents are taxed on worldwide income and non-residents only on income from a Chinese source. In the event of income being taxed twice, relief is available in the form of tax credits. These credits are, however, limited to the amount of Chinese tax payable on the income. The credits may be carried forward for a period of five years (Deloitte Touche Tohmatsu, 2010c: 13). China, in comparison to the other BRICS countries, also has the most DTAs in place. The country has 99 DTAs that aim to avoid double taxation, including DTAs with each of the other BRICS countries (PKF International Limited, 2011d: 13).

5.6 CONCLUSION

The review of the tax policies of Brazil, Russia, India and China in this chapter aimed to provide a basic background of the tax laws applicable in the various countries. Similarities in the tax policies are already apparent, for example, the fact that all these countries, including SA, tax residents on their worldwide income and non-residents on their income from a source within the country. The use of tax policies to attract interest to specific areas or activities in some countries was also noted. Together with the review performed on the tax system of SA in chapter four, a comparison may be made between the tax policies of the BRICS countries.

CHAPTER 6

6 COMPARISON OF TAX POLICIES OF BRICS COUNTRIES

6.1 INTRODUCTION

As background regarding the tax policies of the various BRICS countries has been obtained, a comparison may be made of the policies used by these countries in attracting FDI. The countries each use various tax policies to attract the interest of foreign investors. This paper, however, focuses only on a few types of tax policies that have been identified as being of interest to investors in considering investment in a country outside their borders, being the following:

- Corporate tax rate;
- Tax holidays;
- Investment allowances/ accelerated depreciation schemes; and
- Double Tax Agreements

In performing this comparison, the ranking of the countries on the IFDI Performance Index 2010 is considered. This ranking is accepted as being an indication of where investors are currently focusing their funds. The following table represents the comparative information gathered on the BRICS countries tax policies from a variety of sources reviewed:

Table 9: Tax comparison of BRICS

Country	Corporate tax rate	Tax holidays (longest period)	Investment allowances/ accelerated depreciation schemes	Number of double tax agreements held	IFDI Performance Index ranking 2010 (141 countries)
Brazil	34%	None	Various	30	69
Russia	20%	None	Various	77	60
India	42.23%	5 years	Various	82	97
China	25%	3+ years	Various	99	86
South Africa	28%	None	Various	74	128

Source: Compiled from sources reviewed in chapter four and five

The following is an analysis of the table by tax policy type.

6.2 CORPORATE TAX RATE

According to the review of the literature it appears that there is a general expectation that the FDI inflow to a country has an inverse relationship with the corporate tax rate of a company. It is, however, noted that changes in corporate income tax rates in developing countries does not affect FDI as markedly as in developed countries (Goodspeed *et al.*, 2009:25). As all the BRICS countries are developing countries the change in corporate tax rate may therefore not have as much of an effect on FDI inflow. This approach, however, seems to have worked if one looks at the results obtained by Russia.

For 2010 Russia performed the best on the IFDI Performance Index being ranked 60th. From the above table it is clear that the Russian Federation has the lowest corporate tax rate at a mere 20%. It therefore seems as if the general theory regarding the inverse relationship between corporate tax rates and FDI is applicable in the case of Russia.

If one looks at the results of the other countries, however, this expected inverse relationship does not seem to be applicable. Brazil for example is the country with the second highest corporate tax rate but is ranked second on receiving FDI income of BRICS. Similarly China with the second lowest corporate tax rate is ranked third on receiving FDI. SA's corporate tax rate, at 28%, is about the average of the tax rates but is ranked far lower on the IFDI Performance Index of 2010 than any of the other countries.

It is only in terms of India that one may argue the applicability of the inverse relationship as, with the exclusion of SA, the significantly higher tax rate did impact the FDI received. It should be noted that the tax rate used in the comparison performed for India is the rate applicable to foreign companies. Should a foreign investor decide to operate within India, the formation of a local company would enable taxation at the lower rate of 33.22%. If this rate is considered, the argument made would still hold as even though the rate is significantly lower than the rate applicable to foreign companies, it is relatively high which is congruent with the low ranking received in the IFDI Performance Index of 2010.

Based on the comparison performed on BRICS it is unclear if decreasing tax rates would have a positive effect on the FDI inflow to SA. Decreasing the tax rate would be a benefit offered to all investors, both current and potential, which could have a significant decrease in the tax revenues produced by the country. As observed by Bolnick (2004:82), a decrease in corporate tax rates is only effective in increasing the tax revenues if the increase in the tax base of the country is greater than the decrease in the tax rate.

In other words, if a decrease in the tax rate does not result in a significant increase in the FDI inflow, SA would suffer net losses using this form of incentive within its tax policies. As the comparison of the corporate tax rates of BRICS did not really support the theory that a decrease in corporate tax rates would result in increasing FDI inflow, it does not seem prudent for SA to attempt this form of tax policy to a greater extent. Furthermore the corporate tax rate of SA as it is currently seems to be competitive with those of BRICS as the rate is just slightly below the average of the BRICS countries.

6.3 TAX HOLIDAYS

The only two countries that applied tax holidays are India and China. India offers tax holidays for export and industrial companies located in specific areas for a period of five years with reduced tax rates for a further set period thereafter (PKF International Limited, 2011c: 14). It therefore appears as if India is attempting to draw investors to specific areas. Attention should, however, be drawn to the fact that these holidays are only available until 2012 (PKF International Limited, 2011c: 14). Based on the sources reviewed there is no indication that these tax holidays are to be replaced with others and it therefore seems as if India is in the process of phasing out this type of tax policy.

Similarly one of the tax holidays offered by China is for investors that operate within certain areas but this country's focus is more on the industry that investors operate in. Tax holidays are offered to investors in industries such as the development of infrastructure and software production. It is therefore apparent that the country has identified specific needs in the country and used tax holidays to draw investors to these areas.

Based on a comparison of BRICS, the use of tax holidays does not seem to be very effective in generating FDI. Both India and China fall in the lower rankings on the IFDI Performance index for 2010 and as it seems that India is moving away from this type of incentive as a tax policy, it can be argued that they have not received sufficient benefit from the application of tax holidays. The criticism that specialists afford to tax holidays therefore appears to be valid.

Bolnick (2004: 83) argues that tax holidays lead to significant revenue losses and that due to the nature of projects for which tax holidays are received, this form of incentive is irrelevant to the decision-making process. He also points out that the administration of tax holidays tends to be difficult and there is not much incentive for investors to stay within the country after the tax holiday period has lapsed. It is therefore doubtful that using tax holidays would prove to be beneficial for SA and the lack of having such tax policies is not expected to negatively impact the competitiveness of SA's tax policies in relation to the other BRICS countries.

6.4 INVESTMENT ALLOWANCES/ ACCELERATED DEPRECIATION SCHEMES

From the above table it is clear that all the countries offer investors some form of allowance for the investment in capital assets. Every country has a type of depreciation allowance where the period of useful life is dependent on the nature of the capital asset. Other than Russia that offers investors a choice, the BRICS countries allow for depreciation over a straight-line period with differing useful lives.

As all the countries offer investment allowances or accelerated depreciation schemes and the FDI inflow received differs significantly, it does not seem as if this is an area that investors are particularly focused on in considering investment within the BRICS countries. This form of incentive would most likely only be considered important for investors that are considering significant investment in capital assets. Based on the apparent lack of investor interest in this form of incentive, it is not recommended as a potential incentive for attracting FDI to SA and further adjustments to the allowances offered by SA are not expected to increase the competitiveness of its tax policies within BRICS.

6.5 DOUBLE TAX AGREEMENTS

It may be argued that the number of DTAs a country holds serves as an indication of the strength of trade ties that a country has as this type of agreement is usually entered into with countries where frequent trade is undertaken. It is therefore expected that the greater the number of DTAs a country has, the greater the FDI inflow would be as more trade with foreign investors is taking place.

This, however, does not seem to be the case if looking at the BRICS comparison. China, the country with the most DTAs is not ranked very high on the IFDI Performance Index of 2010 whereas Brazil, with the least number of DTAs ranks 17 places higher. With this apparent incongruent result, the DTAs held by a country do not appear to have a significant impact on the FDI performance of a country. A drive to enter into more DTAs is therefore not expected to have a significant positive impact on the FDI inflow to SA. To further support this, the number of DTAs held by SA is very close to those of Russia and India and therefore it appears as if SA is competitive with these countries in this regard.

6.6 CONCLUSION

In comparing the tax policies of the BRICS countries with regard to corporate tax rate, tax holidays, depreciation allowances and DTAs, no specific potential improvement to SA's tax policies was identified. In instances such as considering the corporate tax rate of Russia, it may be argued that there is a possibility that decreased tax rates could increase FDI but combined with the results on the other countries and the potential revenue losses, this does not appear to be a prudent option.

Furthermore with the lack of identifiable relationships between the tax policies used and the FDI inflow, it may be argued that tax policies do not have a significant impact on the decision of foreign investors to invest outside their borders. This result is contradictory to studies performed on the relationship between tax and FDI and this may be because of the fact that the comparison was focused on specific countries. Regardless of the reason for the discrepancy, based on the comparison performed it is argued that in attracting foreign investment to SA, tax does not play a significant role.

The comparison, however, revealed that SA's tax policies are competitive with those offered by the other BRICS countries. No instance was identified where SA was not on a par with the other countries and thus no specific improvements to be made by SA were identified to increase its competitiveness within BRICS.

CHAPTER 7

7 OVERALL CONCLUSION

SA is a country that struggles with poverty and HIV/AIDS and improved growth and economic results are required to relieve these and other difficulties facing the country. FDI has been identified as a means for SA to acquire some of the funding needed to alleviate poverty. Additionally, FDI has been shown to facilitate the transfer of knowledge and technology as well as providing employment that is expected to further improve the country's current problems. With the likely positive contribution of FDI it seems logical that the competition for FDI would increase and that SA should consider the options available to make the country a more attractive investment opportunity for foreigners.

There are various determinants of FDI, including taxation, and this study considers the position of SA in relation to some of its competitors. With SA only recently joining BRICS, the countries expected to experience significant growth in the next 50 years, determining the competitiveness of attracting FDI with these countries was deemed the most beneficial for the country.

As none of the FDI indicators can be considered in isolation, indicators other than tax were considered and it was found that in most areas of interest to foreign investors, SA was able to compete within BRICS. The one area where SA was, however, found not to be very competitive is the country's market size. As one of the main reasons investors move their business abroad is to access new markets, market size is considered by some to be one of the main determinants of FDI inflow (Pentecost & Rasciute, 2008:3). SA's market size is significantly smaller than that of the other BRICS countries and this would mean that investors looking to increase their market share would not be attracted to invest in SA. With the results obtained by considering the other FDI determinants, attention was moved to taxation as a means of attracting FDI that is the focus of this paper.

7.1 ACHIEVEMENT OF THE OBJECTIVES

7.1.1 Tax policies of BRICS as a factor for attracting Foreign Direct Investment

From literature reviewed four areas of importance within the tax policies of BRICS were identified for comparison. These areas being:

- Corporate tax rate;
- Tax holidays;
- Investment allowances/ accelerated depreciation schemes; and
- Double Tax Agreements

Studies performed on the relationship of corporate tax rates indicated an inverse relationship with FDI (Wijeweera & Mounter, 2007:140; Clark *et al.*, 2007: 116; Stapper, 2010:61). A decreased corporate tax rate is therefore expected to result in increased FDI. Tax holidays and investment allowances were identified as frequently being used by developing countries to attract FDI and DTAs as an indication of trade ties with other countries were expected to result in increased FDI (Klemm & Van Parys, 2009:22).

The comparison performed, however, indicated some surprising results. Firstly it was found that within BRICS, decreased tax rates did not necessarily result in increased FDI. The use of tax holidays within BRICS was also not prominent and India, being one of two countries that are making use of tax holidays currently, appears to be in the process of abolishing the use of such incentives. Indeed the use of this form of incentive is in fact decreasing. As all countries offer some form of investment allowance yet the FDI rankings differed significantly and no relationship between FDI and this form of incentive could be identified. Similarly no relationship between FDI and the DTAs held by a country was noted. Based on these results there does not seem to be a significant relationship between the tax policies and FDI inflow within BRICS.

7.1.2 Competitiveness of South Africa's tax policies in relation to BRICS

From the comparison performed it is clear that the policies offered by SA, are similar to those offered by the other BRICS countries. The only instance where the contrary may be

argued is regarding the use of tax holidays. Only China and India, however, currently offer such tax incentives and it appears as if India is in the process of abolishing the use of tax holidays.

It therefore appears as if this type of tax policy has not been successful for India and therefore the lack of its use by SA does not infringe upon the competitiveness of the policies applied by SA. Based on the comparison performed it therefore appears that, should tax policies be an area of consideration for international investors, SA's tax policies would be competitive with those offered by the other BRICS countries.

7.1.3 Possible improvements to South Africa's tax policies

As the tax policies offered by SA appear to be competitive with those offered by other BRICS countries, no possible improvements to the tax policies of SA have been clearly identified through this study. The only change that might benefit SA is a decrease in the tax rate as, based on the results of Brazil alone and this may increase FDI.

However, if the results of all the BRICS countries are considered, there is no evidence to suggest that a decrease in the corporate tax rate would result in a significant increase in the FDI inflow. Should the decrease in corporate tax rates not attract significantly more FDI to the country, SA would suffer net losses using this form of incentive within its tax policies. It therefore does not seem prudent for SA to attempt this form of tax policy and therefore this study did not identify any improvements that can be made to SA's tax policies.

7.2 FUTURE RESEARCH

Because of the limitations of this study, future possible studies may achieve different results. Some of the possibilities for further study in this area are therefore possible.

This study only focused on the tax policies of the BRICS countries in relation to FDI inflow and therefore a comparison with other countries may indicate different results. Comparisons with, for example countries that are most successful in attracting FDI as per

the IFDI Performance Index could prove useful. Similarly a comparison with countries within Africa exclusively may further benefit SA.

In addition, the study only compared four identified tax policies. With the number of tax influences that are present a more detailed review and comparison of all tax policies and incentives offered by the BRICS countries may provide a better indication as to the competitiveness of SA's tax policies. A more detailed review of the tax policies of the BRICS countries may also identify areas where SA can improve.

A comparison was only performed based on the latest IFDI Index results and the related tax policies. A time series analysis may show tax policies that were applied successfully by some of the other BRICS countries. A further study of the changes in the IFDI Performance Index, specifically with a focus on the change experienced by Brazil, the only one that showed improvement, and SA, the country that showed the most significant decline, could also provide additional insight.

The insight obtained from this study, within the limitations thereof, was that tax policies do not significantly impact the FDI inflow. Furthermore, as SA's tax policies are competitive with those offered by the other BRICS countries, no possible improvements to SA's tax policies were identified.

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