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Assessment of administrative burden on South African Controlled foreign company rules relative to the imputation

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A research report submitted to the Faculty of Commerce, Law and Management, University of the Witwatersrand, Johannesburg, in partial fulfilment of the requirements for the degree of Master of Commerce (specialising in Taxation)

Johannesburg, 2022

ABSTRACT

South African multinational enterprises must comply with the controlled foreign company (CFC) rules in section 9D of the Income Tax Act 58 of 1962 (the Act). The provisions of section 9D of the Act are collectively referred to in this document as CFC rules. The CFC rules are anti-avoidance provisions that discourage South African multinational enterprises from shifting income to foreign companies under their control. This study examines the administrative burden placed on South African multinational enterprises (MNEs) to comply with section 9D of the Act and assesses this administrative burden for reasonableness when compared to the amounts eventually imputed. The study investigates whether South African CFC (SA CFC) rules, which are complex, carry a significant administrative burden on South African MNEs. SA CFC rules are confusing and often are misunderstood by the South African multinational enterprises.

This study compares SA CFC rules to the Organisation for Economic Co-operation and Development (OECD), Base erosion and profit shifting (BEPS) action 3's recommendations for effective CFC rules.

Key words: Administrative burden, Controlled Foreign Company rules, CFC, Net income, OECD, SARS, Section 9D, Income Tax Act.

DECLARATION

I declare that this report is my own unaided work. It is submitted for the degree of Master of Commerce at the University of the Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination in any other university.

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ACKNOWLEDGEMENTS

To my family, thank you for your support during my studies.

To Thabiso Monyake, thank you for always believing in me and your encouragement during my dissertation.

To Janine Cason and Thabiso Mohokare thank you for your advice and support during every stage of my dissertation.

I would also like to express my appreciation to my supervisor Roy Blumenthal for his guidance on this dissertation.

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DEFINITION OF KEY TERMS

Controlled foreign company - is defined as any foreign company[1]:

a) in which one or more South African tax residents (other than a headquarter company) directly or indirectly hold more than 50% of the total "participation rights", in relation to a company, as the right to participate in all or part of the benefits of the rights, other than voting rights, attaching to a share or interest of a similar nature.
b) where no person has any of the participation rights referred to in (a), or no such rights can be determined, more than 50% of the voting rights in that foreign company are directly or indirectly exercisable by one or more residents; or
c) where the financial results of that foreign company are reflected in the consolidated financial statements (prepared in terms of International Financial Reporting Standard (IFRS 10) of a resident company, of any company that is a resident other than a headquarter company.

Country of residence - The country of residence in relation to a foreign company is the country where that company has its place of effective management.[2]

Foreign company – includes any company, including a close corporation, an association, scheme, or a co-operative that is not resident in South Africa. The definition of a foreign company also includes protected cell companies.[3]

Participation rights – is the right to participate in all or part of the benefits of the rights (other than voting rights) attaching to a share, or any interest of a similar nature in that company. If the participation rights cannot be determined, then the voting rights in that company must be used to determine the participation rights.[4]

[1] SILKE on South African Income Tax 2021: 634
[2] Professional Tax Handbook, 2021
[3] Professional Tax Handbook, 2021
[4] Professional Tax Handbook, 2021

1.1 CHAPTER 1: INTRODUCTION

The purpose of this study is to investigate the theory that the CFC rules are over-complex. The study analyses the findings in respect of the CFC rules and makes an assessment on the amount of time South African multinational enterprises spend when preparing their annual tax returns, as compared to the relative amounts imputed in South African multinational enterprises' taxable income. The study investigates and compares the administrative burden versus the CFC income imputed.

South Africa enacted CFC legislation to prevent the tax avoidance by South African multinational enterprises that may result from their offshore investments. The intention of the legislation is to ensure that the undistributed income of a CFC is taxed in South Africa at the time it is earned and not deferred.[5]

Section 9D is an anti-avoidance provision and casts a wide net to prevent the avoidance of taxation by South African residents using CFCs to divert South African income offshore to foreign companies with no substance. The purpose of section 9D is to ensure that tax resident is taxed on the income from their foreign company, even if the tax resident did not receive the income foreign income, certain foreign income will be taxed.[6]

CFC rules are necessary, they assist and protect the tax base of the countries in instances where the taxpayers with controlling interests in foreign companies shift profits into their CFCs and strip the tax base of their countries.[7]

OECD states: "A significant number of countries have adopted controlled foreign company provisions to address issues related to the use of foreign companies. Whilst the design of this type of legislation varies considerably among countries, a common feature of these rules, which are now internationally recognised as a legitimate instrument to protect the domestic tax base, is that they result in a Contracting State

[5] Oguttu, A.W, Resolving the conflict between 'controlled foreign company' legislation and tax treaties, 2009:73
[6] SILKE: South African Income Tax,2015
[7] The Davis Tax Committee - Executive, BEPS 2017

taxing its residents on income attributable to their participation in certain foreign entities."[8]

In the Tax Proposals Budget 2011 document, the South African Revenue Service (SARS) proposed a CFC legislation refinement. National Treasury acknowledged that some of the section 9D provisions are over-complex and not accommodating to normal business practices while others create unintended loopholes. SARS proposed that adjustments will focus on CFC rules without compromising the purpose of the rules.

The South African CFC rules are some of the most sophisticated and complicated within the Group of Twenty (G20) countries. The rules are stringent, particularly in respect to the so-called diversionary rules which create practical anomalies, especially with respect to the limitation relating to the foreign dividend participation. This makes the rules difficult to enforce practically.[9]

The Taxation Laws Amendment Act, 2019[10] also contains amendments to the CFC rules with respect to the diversionary income, this time targeting indirect diversionary transactions.

To some extent, the CFC legislation amendments that have been occurring continuously have discourage foreign investments.[11]

The South African CFC legislation has through some analysis shown that the legislation is quite difficult to understand, to administer and to comply with.[12]

From an administrative perspective, the conclusion that can be drawn is that complying with the requirements of the CFC legislation is costly.[13]

The administrative and compliance burden is supported by policy considerations made by the OECD Base Erosion and Profit Shifting action 3 that CFC rules that are entirely mechanical, may not be as effective as rules that allow more flexibility.

[8] OECD 2017, Model Tax convention (Full version) C (1)-32
[9] The Davis Tax Committee, BEPS 2017
[10] Taxation Laws Amendment Act, 2019
[11] Olivier & Honiball 2011:560
[12] Oguttu, Curbing offshore tax avoidance: The case of South African companies and trusts, 2007: 185
[13] Oguttu, Curbing offshore tax avoidance: The case of South African companies and trusts, 2007: 188

South African, like other African countries depends on corporate taxes to pursue their economic and social objectives. An effective international tax system for African countries is essential. As a result, African countries should be associated with OECD BEPS project. This will assist in protecting their tax bases from profit shifting into other countries because OECD BEPS project has the potential to put an end to tax avoidance by multinational enterprises and helps to maximise corporate tax systems. BEPS undermine the integrity of countries' tax systems.[14]

Corporate taxes from multinational enterprises contribute significantly to the tax bases of African countries. Therefore, the South African tax base should be preserved from depletion because it contributes to the domestic revenue which ensures government funding of public goods and services.[15]

Research Methods

This study is qualitative in nature. The following sources are used: OECD (Model Tax Convention on Income and on Capital) and OECD related reports, journal articles, academic books, academic reports, case law and the South African Income Tax Act.

The researcher used the above sources to determine how CFC rules are viewed by South African multinational enterprises (MNEs) considering the imputation relative to the compliance burden.

Chapter Overview

The structure of this report is as follows:

Chapter 2 discusses the CFC rules in comparison to the OECD Action Plan on BEPS action 3, and further assesses whether the rules deter South African MNEs' global competitiveness. The research analyses the complexities of the South African CFC rules and compares these rules to the OECD Base Erosion and Profit Shifting action 3, named

[14] Oguttu, AW, Tax base erosion and profit shifting in Africa - part 1, 2015:521
[15] Oguttu, AW, Tax base erosion and profit shifting in Africa - part 1, 2015:528

designing effective CFC rules. In the simplification of South Africa's CFC rules, the effectiveness of the South African CFC rules should not diminish.

In chapter 3, the net income determination is discussed in detail and the method to determine the amount of CFC income attributed to South African controlling company based on their proportion of ownership is explained.

Chapter 4 assesses the imputation of CFC income included in the South African resident taxpayer's taxable income. Considering the administrative burden of complying with section 9D of the Act, the chapter assesses the contribution CFC income imputation makes in the South African *fiscus*.

Chapter 5 discusses the outcome of a qualitative case study performed on a South Africa organisation which is a multinational enterprise.

To ensure that the contents of this study are valid, the researcher incorporated the case study, based on a practical situation. As a result, the conclusion in this research study was reached, based on this case study.

The researcher is employed by a reputable organisation within the financial services industry. The case study was performed based on the process the organisation follows when preparing to file for the controlled foreign tax return.

Chapter 6 contains the conclusion reached by the researcher on the research study and presents researcher's view of the findings.

2. CHAPTER 2: Examination of CFC rules in relation to OECD BEPS action 3

2.1 Background

This chapter examines the complexity of the CFC rules in relation to Action 3 of the BEPS. The objective of action 3 is to develop recommendations that are effective for CFC rules when dealing with the need to address BEPS.

Multinational enterprises have been using global tax avoidance strategies to make their profits as large as possible. As a result, countries have legislated numerous anti-avoidance measures to prevent these tax avoidance strategies.[16]

CFC rules are unilateral measures used by the parent jurisdiction to protect their tax base within the framework of international tax regimes and jurisdictions where the CFC are located, tolerate these CFC rules, provided they are limited in scope.[17]

With respect to the tax avoidance strategies, it is worth noting that there no single tax avoidance measures available to reduce all BEPS schemes effectively. Any weakness in the international tax laws may give rise to BEPS as well as lack of administrative capacity to assess international tax concerns which are exploited by Multinational enterprises.[18]

Most African countries have limited resources to assist in managing the BEPS risks.[19]

2.2 Inclusive Framework on BEPS

The G20 made a call for broad and consistent implementation of the BEPS package. The OECD/G20 Inclusive Framework on BEPS was established in 2016 in response to this call. A hundred countries (South African included) and jurisdictions became members of

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[16] Oguttu, AW, Tax base erosion and profit shifting in Africa - part 1, 2015:521
[17] Treaties in the Aftermath of BEPS
[18] Oguttu, AW, Tax base erosion and profit shifting in Africa - part 1, 2015:533
[19] Oguttu, AW, Tax base erosion and profit shifting in Africa - part 1, 2015:539

the Inclusive Framework. The Inclusive Framework on BEPS prioritises monitoring BEPS implementation, providing support to tax administrations and taxpayers.[20]

In June 2012, G20 leaders requested an OECD/G20 project wherein the key issues that lead to BEPS would be identified. As a result, in February 2013 and July 2013 both the OECD council and the G20 leaders, respectively, endorsed a report called *Addressing BEPS*. The report became the basis for the 15-point BEPS Action plan. The BEPS comprehensive package of measures in the 15 Actions was released in October 2015.[21]

The first objective of the OECD/G20 project, is to reinforce the coherence of corporate income tax rules at the international level, the second objective is to realign taxation rules with the substance of the economic activities, and the third objective is to improve transparency.[22]

With respect to the inclusion in the BEPS package, countries can implement some measures through a country's domestic laws. Four of the BEPS action plans were considered as the combination of common approaches in this regard. These are Action 2 (Neutralise the effects of hybrid mismatch arrangements), Action 3 (Strengthening CFC rules), Action 4 (Limit base erosion through interest deduction) and Action 12 (Requirements for taxpayers to disclose their aggressive tax planning arrangements).[23] The Davis Tax committee consider the four BEPS action plans best practice for domestic law.[24]

BEPS Action 3, the action of designing effective CFC rules relates to recommendations in the form of building blocks of effective CFC rules. Action 3 acknowledges the policy objectives of the CFC rules and their differences, jurisdiction by jurisdiction. This action plan recognises the existing CFC rules and their challenges that arise from passive income, such as services, intellectual property and digital transactions.[25]

[20] OECD Inclusive Framework on BEPS,2017
[21] OECD Inclusive Framework on BEPS,2017
[22] OECD Inclusive Framework on BEPS,2017
[23] OECD Inclusive Framework on BEPS,2017
[24] The Davis Tax Committee, BEPS 2017
[25] OECD Inclusive Framework on BEPS,2017

South African is a member of the G20 Inclusive Framework on BEPS which was created by the OECD, therefore SARS is part of working parties in the Inclusive framework. By virtue of this membership, SARS is required to adopt BEPS action plans. The previous paragraph stated that the Inclusive Framework Action 3 forms part of the combination of common approaches that could be implemented in country's domestic law. The researcher investigates whether South Africa has implemented Action 3 in its domestic law, SARS and domestic tax legislation. By virtue of SARS being part of the Inclusive framework, it could mean that they have agreed to consider BEPS action 3 in their domestic tax legislation.

G20 leaders mentioned that they support timely, consistent, and widespread implementation of the BEPS package. In addition, the G20 leaders called upon all relevant and interested parties to commit to the BEPS package, if not committed yet, and to join the Inclusive Framework on an equal footing.

Although G20 Finance Ministers made a call to the OECD to build a framework by early 2016 with the involvement of interested non-G20 countries and jurisdictions on an equal footing, the G20 leaders reiterated this request in their November 2015 communique, "To reach a globally fair and modern international tax system, we endorse the package of measures developed under the ambitious G20/OECD BEPS project. To monitor the implementation of the BEPS project globally, we call on the OECD to develop an inclusive framework by early 2016 with the involvement of interested non-G20 countries and jurisdictions which commit to implement the BEPS project, including the developing economies, on an equal footing".[26]

2.3 Davis Tax Committee

In his 2013 Budget Speech, the South African Minister of Finance announced a need to set up a tax review committee. In response, the Davis Tax Committee (DTC) was formed on 17 July 2013 and was expected to take into account international developments. The DTC was tasked with addressing BEPS concerns in the context of corporate income tax,

[26] OECD Inclusive Framework on BEPS, 2017

as identified by the OECD and G20. With respect to this task, the DTC decided to create a special sub-committee, called the BEPS Sub-committee. The BEPS Sub-committee performed an investigation on BEPS and produced a BEPS final report that set out the DTC's position as of 30 May 2016.[27]

The purpose of the DTC BEPS report is to provide South Africa with recommendations required to incorporate the minimum standards of OECD, best practice guidelines and international standards on BEPS into South Africa's international tax framework. The DTC has cautioned that the recommendations must consider the perspective of the South African international tax policy. The circumstances surrounding South African economy must be considered in the international tax policy. Different dimensions considered in the OECD BEPS project could affect countries in different ways, depending on whether the country is source based or residence based. A source-based country attracts foreign direct investment, and residence-based country relates focuses on which investments flow to other countries. South Africa's economy conforms with both categories. South Africa is an emerging market country and has a significant group of home-grown multinationals. Therefore, analysing a range of international tax policy considerations for South Africa could be challenging. This analysis is required for the purpose of providing recommendations to address BEPS in South Africa.[28]

The DTC recommended that South Africa adopts the position of protecting its own interests, and, in the process, South Africa should not lead or set the trend, but rather follow. With respect to CFC legislation in South Africa, the DTC recommended that it should not be changed significantly until it is clear what other countries intend to do. The DTC's counter-argument is that South Africa's CFC legislation is very sophisticated and robust, relative to other G20 countries and that the DTC does not see a need to strengthen South Africa's CFC legislation. The DTC concluded that South African's CFC legislation serves its purpose as an anti-avoidance measure and a deterrent for profit shifting, is aligned with recommendations set out in the BEPS action 3 report, and not any further.[29]

[27] The Davis Tax Committee, BEPS 2017
[28] The Davis Tax Committee, BEPS 2017
[29] The Davis Tax Committee, BEPS 2017

2.4 BEPS Action 3: 2015 Final report

South Africa forms part of the G20 countries. In terms of Action 3 of the BEPS final report, 30 of the countries participating in the OECD/G20 BEPS project have already enacted CFC rules and many other countries have expressed interest in implementing the CFC rules.

Action 3 of BEPS came up with ways that design effective CFC rules upon realising that the existing CFC rules have not kept pace with the changes in the business environment internationally. It was upon this matter that the OECD BEPS Action Plan decided to respond to these challenges faced by the existing CFC rules by developing the recommendations pertaining to the design of CFC rules.[30]

According to the Action 3 of BEPS final report, the OECD agreed to continue working together with the G20 to ensure that the implementation of the BEPS recommendations are consistent and well-co-ordinated. The final report provides the recommendations in the form of six building blocks. The report has highlighted that the jurisdictions that choose to implement these recommendations can have effective rules that prevent taxpayers from shifting profits into their CFCs. Established CFCs are attached with risks. There is a risk that a South African tax resident can strip the South African tax base by shifting income into the CFC. CFC rules therefore exist to respond to these risks.[31]

The six building blocks for the design of effective CFC rules are: definition of CFC, CFC exemptions and threshold requirements, definition of income, computation of income, attribution of income, prevention, and elimination of double taxation.

According to Action 3 of the BEPS final report, the purpose of these building blocks is to allow countries with existing CFC rules, such as South Africa, to modify their CFC rules to align more closely with the BEPS recommendations.

[30] OECD BEPS Action 3, Final Report 2015:9

[31] OECD BEPS Action 3, Final Report 2015:3 and 9

Below is a discussion on the BEPS six building blocks discussed separately and comparing to the South African existing CFC rules.

2.4.1 Rules for defining a CFC

With respect to the recommendations of the first building block, and according to Action 3 of BEPS, a foreign company must first meet the definition of a CFC and the parent company must have sufficient influence or control over the foreign company that is a CFC. Some transparent entities and permanent establishments are required to apply CFC rules provided there are BEPS concerns surrounding these entities. Either a legal, or an economic control test must be considered for the CFC rules. A foreign company is considered a controlled foreign company if more than 50% control is held by a South African tax resident directly or indirectly. The 50% control in the foreign company can be established through the aggregated interest of related parties or unrelated parties in the same country of residence.[32]

With respect to South African CFC rules, in section 9D of the Act, a foreign company is a controlled foreign company where more than 50% of the total participation rights in the foreign company are held by a South African tax resident.[33]

In accordance with section 9D of the Act, South African CFC rules require attribution of CFC income only from foreign companies, which excludes partnerships and trusts.

In addition, a foreign company is a controlled foreign company where the financial results of a foreign company are reflected in the consolidated annual financial statements prepared in terms of IFRS 10.[34]

De facto control refers to the analysis of which entity makes the decisions pertaining to the affairs of the foreign company or who could direct or influence the day-to-day activities of the foreign company.[35]

[32] OECD BEPS Action 3, Final Report 2015:21
[33] SILKE Tax Yearbook, 2021:862
[34] SILKE Tax Yearbook, 2021:862
[35] OECD BEPS Action 3, Final Report 2015:11

Permanent establishments can still be caught in the CFC rules where a foreign company has a Permanent establishment in another country.[36]

In a multinational group, the payer and the payee can be treated as the one entity for CFC purposes. In other words, the deductible transactions in one entity that become income in another entity must not be considered, therefore must be ignored. This applies to the income that would otherwise be attributable as CFC income.[37]

In South African CFC rules and in terms of section 9D(2A)(*c*) of the Act, deductions are not allowed for certain passive transactions that occur between the CFCs in the same group. There is a correspondence between section 9D(2A)(*c*) of the Act and section 9D(9)(*f*A) of the Act. Section 9D(9)(*f*A) of the Act governs the income received by a CFC from another CFC in the same group, this income is excluded from the net income.

Conclusion

It has been established that the definition of CFC in terms of the South African CFC rules aligns to the BEPS Action 3's first building block through the more than 50% control concept.

South African CFC rules refer to foreign business establishment whereas Action 3 of BEPS refer to a Permanent establishment.

De facto control is equivalent to IFRS 10 in the context of South African CFC rules.

2.4.2 CFC exemptions and threshold requirements

The second building block and in accordance with Action 3 of the BEPS final report, is the recommendation in determining the tax rate to apply to the foreign companies. As a result, taxation will not be applicable on the foreign companies that have an effective tax rate that is sufficiently similar to the tax rate applicable to the parent jurisdiction. It was noted that using the foreign company's statutory tax rate may reduce administrative

[36] OECD BEPS Action 3, Final Report 2015:11
[37] OECD BEPS Action 3, Final Report 2015:22

complexity and compliance costs, and the report therefore recommends the use of an effective tax rate. The report argues that the tax rate exemption does not necessarily prevent base erosion and profit shifting since the parent company can establish controlled foreign companies in countries with higher effective foreign tax rates. When determining the effective tax rate, the ratio of the actual tax paid in the foreign company is relative to the total taxable income of the parent company.[38]

Under the South African CFC rules, a high tax exemption is applied with the high tax exemption rate currently being at 67.5%. Any controlled foreign company of a South African resident company, with an effective tax rate of 18.9% or higher will not result in an imputation, the so-called high tax exemption will apply.

Most South African taxpayers welcome the so-called high tax exemption. The calculation, however, proves to be overly complex because in accordance with section 9D(2) of the Act, the CFC must be treated as if it had been a South African taxpayer and apply South African tax legislation to the CFC. Taxpayers have requested a relief in that the high tax exemption should apply if a CFC's foreign statutory tax rate is 18.9%. without performing a notional tax computation applying South African legislation. The requests have been rejected continually on the basis that there may be a significant deviation between a simple statutory approach and the effective rate due to a variety of unique foreign statutory provisions. The DTC notes that if the tax rules of the South African tax resident were the same as the tax rules of the country in which the CFC is a tax resident, the CFC income subject to a 18.9% foreign effective tax would not be imputed in the South African tax resident's taxable income.[39]

Action 3 of the BEPS final report further explains the types of CFC exemptions and threshold requirements as follows:

- *De minimis* threshold.

  This is a threshold where the income of certain foreign companies would not be included in the taxable income of the parent company. It was noted that some

[38] OECD BEPS Action 3, Final Report 2015:33
[39] The Davis Tax Committee, BEPS 2017

countries provide an entity-based exemption where an entity's attributable income is less than either a percentage of the CFC's income or fixed amount of the CFC.[40]

In South Africa, and in accordance with section 9D(9A)(*a*)(iii) of the Act, this threshold applies where the income from the financial instrument does not exceed 5% of the total of all receipts and accruals of the CFC with the exclusion of passive income. Therefore, imputation of the income of the CFC will not be required.

- Anti-avoidance requirement.

  This applies in situations where there are transactions and structures that have the intention of avoiding CFC rules, an anti-avoidance threshold requirement would apply. Anti-avoidance has not been ruled out as an element that cannot play a role in CFC rules that tackle base erosion and profit shifting.[41]

2.4.3 Definition of CFC income

The third building block, and in accordance with Action 3 of the BEPS final report, defines the income of the CFC that is required to determine the foreign company's income that is attributable to the parent company. The recommendation is that all the income that poses a risk of base erosion and profit shifting must be attributed to the parent company with a controlling shareholding in the foreign company. The report allows countries to define their CFC income. The report acknowledges that countries' existing CFC rules include a variety of factors when they determine the CFC income. For example, some countries consider whether income is geographically mobile, some countries consider whether the CFCs earned the income through some sort of assistance from their parent company or other CFC in the same group of companies, some countries consider source of the income and some countries consider the level of activity in the CFC.[42]

The explanation that the report highlights is that income that has been earned with the intention of avoiding or reducing tax must be included in the CFC rules. Types of income[43]:

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[40] OECD BEPS Action 3, Final Report 2015:33
[41] OECD BEPS Action 3, Final Report 2015:36
[42] OECD BEPS Action 3, Final Report 2015:43
[43] OECD BEPS Action 3, Final Report 2015:44-45

- Dividends – By nature dividends are passive income. Dividends are generally known for erosion of profits into the controlled foreign companies except if the dividends are paid out of active income.
- Interest – Interest earned from related parties poses a risk of base erosion and profit shifting because interest income can be easy to shift through the related parties.
- Royalties and Intellectual property income – The income from Intellectual property is highly mobile. As a result, this income is easy to shift to the controlled foreign companies as it can easily be exploited and distributed in many forms.

With respect to income from related parties and in their existing CFC rules, some countries include income from sales to a related party and income from a sale of goods that were initially purchased from a related party.[44]

With respect to substance analysis, this is an analysis that focuses on whether the CFC is engaged in substantial activities. The existing CFC rules in some countries apply more mechanical rules. The report noted that despite these mechanical rules adding complexities to the CFC rules, these rules may be the solution to identify the income that has been shifted to the controlled foreign companies. The report acknowledges these rules can assist to identify and quantify shifted income accurately.[45]

According to Action 3 of the BEPS final report, one of the policy considerations is to reduce the compliance and administrative burdens without creating loopholes for tax avoidance. Qualitative measures are the most reliable measures in the substance analyses because they may be more accurate than a pure mechanical approach. The report highlighted that the inclusion of qualitative measures could result in administrative and compliance burdens because they require detailed analysis of the CFC facts and circumstances.[46]

[44] OECD BEPS Action 3, Final Report 2015:46
[45] OECD BEPS Action 3, Final Report 2015:47
[46] OECD BEPS Action 3, Final Report 2015:51

Entity approach

Under this, the entity approach, there will not be an attributable income to a CFC where a CFC does not earn certain income that engages in certain activities, regardless that some of its income will be of an attributable nature. This approach may reduce administrative burdens because CFC rules may be applicable or not as tax administrators can determine that certain income is attributable to a CFC or that the CFC engaged in a certain level of activity. As an example, say CFC1 primarily engages in activities that generate active income. CFC1 may decide to shield a large amount of passive income from the CFC rules. To some extent, the entity approach may not reduce administration burdens significantly because a CFC may be required to determine streams of income that are attributable or not. This determination is done on the individual streams of income.[47]

Transactional approach

Under the transactional approach, to determine whether the income attributable to the CFC should be imputed, each stream of income is assessed. Each stream of income must be assessed to determine whether it falls within the definition of CFC income. Although the transactional approach is generally more accurate when dealing with income attributable to the CFC, this approach may increase administrative and compliance burdens.[48]

With respect to the definition on income, the BEPS report notes that jurisdictions need to decide which approach, entity approach or transactional approach, should be used.[49]

In terms of South African CFC rules, before the amendment of section 9D in 2000, the transactional approach was applied. Under the transactional approach, the income that was attributed to the South African tax resident was certain tainted income. Section 9D was amended, with respect to the determination of income that is attributed to the South

[47] OECD BEPS Action 3, Final Report 2015:51
[48] OECD BEPS Action 3, Final Report 2015:51
[49] Schmidt - Taxation of CFC in context of OECD/G20 project on BEPS

African tax resident, the method used is the entity approach. The entity approach considers all the profits of the CFC into the attribution.[50]

2.4.4 Computation of income

The fourth building block of Action 3 of the BEPS final report detailed the recommendations on computing income. Once the third building block has determined the CFC income attributable to the controlling shareholders, the next step is to determine how much income to attribute. The first recommendation by the report is that the parent company may use their CFC rules in accordance with their country to compute the CFC income.[51]

Action 3 of the BEPS final report considered the following four options with regards to the country CFC rules that can be used to calculate taxable income:

1. The parent company should apply the law of its country's CFC rules. This option can reduce the tax administration costs and it is recommended by the BEPS Action Plan.
2. The CFC's country rules may be used. It was noted that this option may result in some inconsistences with Action 3 of the BEPS final report because less income may be attributed. The option may increase tax administration costs.
3. A choice of either country's computational rules.
4. Parent company may use IFRS. Although this option could result in international consistency because the parent company and its CFCs would be using the same rules, this option may increase the administration burden and compliance costs since some of the countries do not use IFRS currently to calculate taxable income.[52]

Secondly, the report recommended that countries put in place specific rules to limit the CFC losses used to offset the profits. It was recommended that CFC losses should not

[50] Olivier & Honiball 2011:613
[51] OECD BEPS Action 3, Final Report 2015:57
[52] OECD BEPS Action 3, Final Report 2015:57

be used to offset the profits of another CFC that is in a different country. Instead, these losses must only offset the profits of the same CFC that has losses or other CFCs in the same country. CFC losses may be carried forward for use against profits.[53]

Under the South African CFC rules, limitation of losses (provisos (a) and (b) to the definition of 'net income' in s9D(2A)) of the Act, states: "The deductions or allowances which may be allowed, or any amounts which may be set off against the income of a CFC, are limited to the amount of income of the CFC. A loss cannot therefore be attributed to a SA resident in terms of section 9D of the Act. Any excess of the unused loss is carried forward to the following year of assessment and is deemed to be a balance of assessed loss, which may be set off against the income of the company in that following year."

2.4.5 Attribution of income

The fifth building block of Action 3 of the BEPS final report recommended the attribution of income, once the fourth block has determined the amount to attribute. This step details how to attribute the income to the shareholders appropriately. This is done through the five steps below:

1. It is the responsibility of countries to determine to whom the income is to be attributed. Most existing CFC rules attribute the CFC income to the *tax residents who have the minimum control (e.g., 10%) and the tax residents who have* control over the controlled foreign company. The minimum control threshold is necessary to save the tax residents below the minimum control administrative burden and compliance costs. Tax residents with sufficient control over the CFC may easily obtain the financial information from the CFC because of their influence over the CFC.
   In terms of section 72A of the Act, where a tax resident who, together with their connected person, holds at least 10% of the participation rights in any CFC, these tax

[53] OECD BEPS Action 3, Final Report 2015:57

residents are required to submit an income tax return, called IT10B, to the Commissioner.

2. Income to be attributed should be determined based on the proportion of ownership of each shareholder. The shareholding proportion can be determined on the last day of the year to ensure accuracy. This will also accommodate the taxpayers that had ownership for a period less than a year.
3. Existing CFC rules require taxpayers to include the attributed CFC income in the financial year end of the CFC.
4. According to the existing CFC rules, attributable CFC income may be treated as deemed dividend or as income earned by the parent company. Action 3 of the BEPS final report approve both approaches. As a result, the countries may decide which approach to follow, taking into account their domestic law.
5. CFC existing rules require the parent company to apply its country tax rate on the attributable CFC income to be included in their taxable income.[54]

In terms of South African CFC rules, the portion of the net income to be included in the income of the South African tax residents is based on their proportional share of the participation rights in the CFC.

2.4.6 Prevention and elimination of double taxation.

The sixth building block of Action 3 of the BEPS final report recommended rules to prevent or eliminate double taxation. Most companies are determined to expand, and some consider expanding globally. Investing into other countries come with taxation implications and at times, this can result in double taxation. Countries have different taxation laws.

Double taxation can discourage companies from entering international markets and it may pose an obstacle to international competitiveness, growth and economic development.

[54] OECD BEPS Action 3, Final Report 2015:62

This building block's purpose is to make sure the CFC rules do not create double taxation. Countries are required to test the effectiveness of their existing double taxation relief provisions to ensure that there is a relief on all the double taxes that may arise. It was recommended that CFC rules should include provisions that assist multinational enterprises from being taxed more than once on the same income. Three situations where taxation may arise are: (i) Attributed CFC income taxed in the CFC country, in accordance with the country tax laws, (ii) CFC rules of different countries applying to the same income, and (iii) where the CFC distributes dividends out of income that has already been attributed to the CFC's shareholders or shareholder disposes of the shares in CFC. To avoid double taxation on the latter situation, exempting these dividends is recommended and not taxing subsequent gains realised by a taxpayer in respect of the disposed shares of a CFC. This would apply where the shares of a CFC are disposed of, and the shareholder has previously been taxed on the undistributed income of the CFC.[55]

With respect to the first two situations, BEPS Action 3 recommended that taxpayers should be given tax credit for the foreign taxes paid. Withholding taxes and all other taxes borne by the CFC should be included in the tax paid. These taxes should be on income that has not qualified for other tax relief. The taxes paid must in fact be the actual tax paid, this is to ensure that the tax credits are not given on the foreign taxes that are subject to a refund.

[55] OECD BEPS Action 3, Final Report 2015:68

2.5 Public comments on BEPS Action 3

2.5.1 Background

In July 2013, OECD BEPS commenced the work on the 15 Actions plan. The Public Discussion draft on the draft BEPS action 3 was later made available to the public.

The Committee on Fiscal Affairs invited interested parties to send written comments on the Public Discussion draft. The parties were notified that their comments regarding this draft would be made public.[56]

Some of these rules initiated by the OECD are aimed at protecting the country's tax base and have proven to be cumbersome, based on the public commentary that was received by the OECD in relation to BEPS Action 3. Below are some of the public comments examined by the author to support the above notion:

2.5.2 Public comments from: Banking and Finance Company Working Group on BEPS

The working group of global banks and finance companies, in their response to the BEPS Action 3 draft added the following:

With respect to the CFC income definition, some of the observations and options raise concerns for regulated global financial institutions. The group accepted the draft's statements that where a CFC earned income during an active business, this does not warrant BEPS concerns. As a result, this income should not form part of CFC income attributed to shareholder controlling the CFC. The draft acknowledges that where a CFC is taxed by its home jurisdiction, the CFC rules should not apply.[57]

The working group acknowledged the statement in the draft that where the CFC's home country tax regime is used as a base when calculating the CFC's effective rate, this may cause some inconsistency. The working group believed that these inconsistences could

[56] OECD Public Discussion Draft on BEPS Action 3, 2015:2
[57] OECD, Public Comments received on BEPS Action 3 Public Discussion draft Part 1, 2015, Page 54

be significant and could drive entities operating businesses in relatively high-tax jurisdictions into the CFC regime. The use of a 'whitelist' is recommended. [58]

The use of a 'blacklist' or a 'whitelist' simplifies the application of the CFC rules for the tax administrators as they simply indicate which countries to exclude from the CFC rules application. This will also make it easier for the taxpayers because they will know in advance which of their CFCs will be subject to CFC rules and which CFCs will not.[59]

The working group concluded that a substance analysis formed on the regulated status of both the parent company and the local business entity should be the base in determining whether CFC rules should be applicable to banking entities.[60]

2.5.3 Public comments from: Deloitte and Touche Tohmatsu Limited (Deloitte)

Deloitte made their comments from the perspective of the United Kingdom. Deloitte commented that when the recommendations and principles in the Discussion Draft are fully developed, it should allow countries to design new CFC rules or assess their existing rules. Deloitte throws its weight behind the design in flexing to allow the CFC rules of a country to reflect its domestic tax legislation. Deloitte's view is that the effectiveness of CFC rules is in protecting diversion of profit from the parent country although are not the appropriate way to counter profit from subsidiaries.[61]

With respect to intellectual property income, the abusive arrangements are a recurring theme in every part. In this regard, the draft considers the excess profit approach to be followed when dealing with intellectual property income. Deloitte considers the excess profit approach to be too mechanical in nature due to a number of subjective assumptions that do not relate to profit shifting. Deloitte commented that in practice, this approach would not be a viable solution, and this could result in the compliance burden significantly increasing for a little benefit.[62]

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[58] OECD, Public Comments received on BEPS Action 3 Public Discussion draft Part 1, 2015, Page 57
[59] OECD, Public Comments received on BEPS Action 3 Public Discussion draft Part 1, 2015, Page 57
[60] OECD, Public Comments received on BEPS Action 3 Public Discussion draft Part 1, 2015, Page 57
[61] OECD, Public Comments received on BEPS Action 3 Public Discussion draft Part 1, 2015, Page 229
[62] OECD, Public Comments received on BEPS Action 3 Public Discussion draft Part 1, 2015, Page 230

Deloitte commented that many countries adopt the parent jurisdiction's tax rules to compute CFC income required for imputation in the parent. Deloitte suggested that a narrow version be adopted even though it is likely to create a significant compliance burden. This is because a narrow version is a better target for BEPS activities rather than broad version which may capture income which does not pose BEPS concerns.[63]

Based on Deloitte's experience, a significant administrative burden is created when calculating a low tax threshold based on a percentage of tax that the parent jurisdiction would have paid. Deloitte commented that a whitelist is important with qualifications for some types of income. Deloitte acknowledged that they were not aware of any CFC rules that attribute categories of income accurately while at the same time, reducing administrative and compliance burdens. An excess profits approach can lead to uncertainty as it lacks focus. A transactional approach better targets BEPS activity even though it requires greater analysis on an income-by-income stream basis.[64]

2.5.4 Public comments from: Ernst & Young Global Limited (EY)

EY commented that the draft does not include recommendations relating the type of income that should be included in the CFC income and instead includes the only options on the type of this income. EY welcomed the statement that the recommendations will be included in the final report on BEPS Action 3.[65]

The recommendation in the final report was that regarding the income to be included in the CFC income, flexibility is necessary in this regard. Flexibility will ensure that jurisdictions can create CFC rules that are compatible with their domestic policy framework.[66]

The July 2013 Action plan on BEPS had the following as an objective: to help protect the tax bases of the third world countries. Although the draft made a mention of this objective, it did not develop it in any detail. EY called on the OECD to be clearer on the

[63] OECD, Public Comments received on BEPS Action 3 Public Discussion draft Part 1, 2015, Page 230
[64] OECD, Public Comments received on BEPS Action 3 Public Discussion draft Part 1, 2015, Page 233
[65] OECD, Public Comments received on BEPS Action 3 Public Discussion draft Part 1, 2015, Page 253
[66] OECD, Public Comments received on BEPS Action 3 Public Discussion draft Part 1, 2015, Page 2553

recommendations about the objectives behind the CFC rules. EY is of the view that the purpose of CFC rules should be anti-abuse rules. To achieve this purpose, the CFC rules should be narrowly targeted. EY commented that the draft takes an approach that is broader and counts on the OECD to revisit this issue and develop a CFC design approach that better aligns with the anti-abuse rule.[67]

With respect to the CFC rules, EY mentioned that countries have made different choices based on their decisions regarding competitiveness and to encourage global investments. As a result, EY does not believe that a single set of CFC design recommendations is a realistic or appropriate goal. EY urged the OECD to address situations where multiple anti-abuse rules could apply, situations where CFC income is held by a chain of entities.[68]

2.5.5 Public comments from Grant Thornton International

Grant Thornton concurs with the draft in that CFC rules should be designed in a way that they apply to stripping of the base of the parent jurisdiction. Grant Thornton's suggestion on the draft was that, to minimise the compliance burden on taxpayers and ensure that only real cases of serious tax avoidance are targeted by CFC rules, there must be a provision for exemptions applicable to an entity that is in a high tax country and has only a negligible profit. To prove that there is diversion of profits from the parent entity, it must be proven that the activities that generate the CFC's profits are in fact from a source located in the parent jurisdiction.[69]

With respect to threshold requirements, where there is a low tax threshold based on an effective tax rate, this could impose a significant compliance burden if the parent company's tax rules are applied to the profits of the CFC. Grant Thornton suggested that in situations where there is a low tax threshold, the simple approach would be to apply rules on a company-by-company basis, rather than using a country-by-country approach. This is because the purpose of some companies in a single jurisdiction is not to artificially

[67] OECD, Public Comments received on BEPS Action 3 Public Discussion draft Part 1, 2015, Page 253
[68] OECD, Public Comments received on BEPS Action 3 Public Discussion draft Part 1, 2015, Page 254
[69] OECD, Public Comments received on BEPS Action 3 Public Discussion draft Part 1, 2015, Page 274

divert profits. To mitigate the potential compliance burden, countries must impose alternative tests in their CFC regime, such as a blacklist or whitelist.[70]

The taxpayers would have to deal with some amount of compliance work for confirmation that CFC is earning income which has a genuine risk of being included in the CFC rules. Nonetheless, the taxpayers should not be faced with a significant amount of work to confirm that no CFC is income imputation, mostly if it is clear, based on the activities of the CFC that they would not be CFC income imputation. Grant Thornton commented that applying the tax laws of the parent jurisdiction on the CFC can be an effective method for computing CFC income. Grant Thornton cautioned that giving the taxpayers a choice on the rules to apply when computing the CFC income could create uncertainty while potentially planning opportunities.[71]

2.5.6 Public comments from KPMG International Limited (KPMG)

KPMG commented that where the BEPS concerns arise, the CFC rules should apply to that income. The income that arises from genuine activities of a CFC should be excluded, therefore an appropriate substance-based exemption should apply to this income. CFC rules create a significant annual compliance burden for the taxpayer, and as a result, CFC rules should contain blacklists or whitelists as practical entity-based exemptions. This will assist the CFCs which do not pose BEPS concerns as they can be relatively excluded. It must be noted that if CFC rules are overly strict, it can lead to competitiveness concerns.[72]

KPMG agrees that a low tax threshold can assist by eliminating the CFC where income arises from genuine activities and do not pose BEPS concerns. The threshold should apply on a company-by-company basis. A draft proposes an effective tax rate comparison test and considers it a method to focus on base erosion. A CFC in a high-tax jurisdiction could potentially fail the low tax threshold where the CFC income calculation is based on the effective tax rate due to timing differences. Effective tax rate calculation would impose

[70] OECD, Public Comments received on BEPS Action 3 Public Discussion draft Part 1, 2015, Page 276
[71] OECD, Public Comments received on BEPS Action 3 Public Discussion draft Part 1, 2015, Page 281
[72] OECD, Public Comments received on BEPS Action 3 Public Discussion draft Part 2, 2015, Page 365

a very significant annual compliance burden if required to be applied on every CFC's profit in the group using the parent jurisdiction's tax rules.[73]

With respect to accurate attribution of income, substance analysis should reflect the reality of how the business structure internationally operates. A one-size-fits-all approach does not work well in practice when one considers different businesses. A viable independent entity approach would be better as it deals on a case-by-case basis. In practice, the calculation of the normal return would not be straightforward when using the excess profits approach. Therefore, an excess profits approach is not considered workable as a standalone approach. A categorical approach is considered the most likely approach to attribute income that gives rise to BEPS concerns accurately. A transactional approach does create a compliance burden for taxpayers and therefore it should be used on many numbers of reduced CFCs which are more likely to present BEPS concerns. From BEPS perspective, a transactional approach is a better approach when dealing with the determination of individual income streams.[74]

With respect to rules for computing income, KPMG commented that the draft provides little discussion relating to allocation of attribution of expenses. This could result in double taxation if different jurisdictions allocate expenses differently.[75]

2.5.7 Public comments from: PricewaterhouseCooper (PwC)

PwC commented that their concerns from the BEPS policy perspective is relating to the identification of the appropriate income to be apportioned to the parent jurisdiction. CFC rules should not tax CFC activities where there are genuine economic activities. With respect to which entities can be considered CFCs, PwC is of the view that parent jurisdiction rules should determine which entities could be considered CFCs because it is the parent entity's jurisdiction's rules that govern the determination of CFC income. It must

[73] OECD, Public Comments received on BEPS Action 3 Public Discussion draft Part 2, 2015, Page 369
[74] OECD, Public Comments received on BEPS Action 3 Public Discussion draft Part 2, 2015, Page 378
[75] OECD, Public Comments received on BEPS Action 3 Public Discussion draft Part 2, 2015, Page 379

be noted that when taxpayers are faced with a lot of work when dealing with the domestic tax systems because of the differences in the systems.[76]

PwC commented that based on their experience a *de minimis* exemption simplifies compliance with CFC rules greatly. With respect to a low tax threshold exemption and based on PwC's experience, taxpayers do not rely on lower levels of tax exemptions. This applies to entities located in higher tax jurisdictions as well. The main reason for this is that there is complexity involved in the computation of taxable profits of every CFC using the parent jurisdiction tax rules. Although there will be timing differences in this approach, it must be noted that not all the differences between parent and CFC's tax base would give rise to BEPS concerns. PwC commented that although following the lower level of taxation exemption can be recommended, a whitelist approach is a more practical form of entity exemption.[77]

PwC suggested that it should be straightforward for the taxpayers to self-assess their control in a CFC, however, to prove that parties are acting together, the onus should be on the tax authorities. PwC acknowledge the development of the digital economy and believes that the most practical solution to ensuring that CFC rules are focused on BEPS activity, a form-based approach that targets the types of mobile income streams should be adopted. This form-based approach will ensure that CFC rules do not become overly burdensome to taxpayers and tax authorities. An excess profit approach is arbitrary, this approach requires the proof that assets are used in the active conduct of trade. This places the burden on the taxpayer as the taxpayer is required to prove that.[78]

Although a transactional approach comes with the benefits from being proportionate, this approach may result in more administrative effort for taxpayers. PwC recommends a combination of approaches to balance the BEPS challenges without creating an undue burden on taxpayers. An entity approach with threshold exclusions is appropriate for lower risk entities. A transactional approach with more detailed financial analysis and

[76] OECD, Public Comments received on BEPS Action 3 Public Discussion draft Part 2, 2015, Page 449
[77] OECD, Public Comments received on BEPS Action 3 Public Discussion draft Part 2, 2015, Page 453
[78] OECD, Public Comments received on BEPS Action 3 Public Discussion draft Part 2, 2015, Page 454

complexity of CFC rules is appropriate for higher risk entities. PwC commented that the practical challenge in the existing CFC rules is obtaining information from the CFCs.[79]

2.5.8 Public comments from various entities

The Association of British Insurers in the United Kingdom commented that the OECD BEPS Action 3's recommendations should include a *de minimis* threshold for profit and in addition, a whitelist. The two would ensure that the BEPS activity are tackled at the same time and reduce the compliance burden for the taxpayers.[80]

AstraZeneca UK Limited in the United Kingdom, commented that from a practical perspective, applying effective tax rates requires the profits of a CFC to be calculated under the parent jurisdictions tax rules and believes this would create a significant compliance burden. As a result, a whitelist for CFCs located in jurisdictions which meet specified high-tax criteria is suggested.[81]

CBI commented that a *de minimis* threshold and a whitelist would significantly reduce the compliance burden for taxpayers. A whitelist of countries should be inclusive of jurisdictions with similar rules and rates.[82]

The European Business Initiative on Taxation commented that, in their experience, a whitelist reduces compliance burdens rather than a low tax threshold exemption. This is because a low tax threshold exemption requires detailed tax computations that bring issues such as foreign tax credits' relief.[83]

The Insurance Company Working Group on BEPS commented that since the use of a low tax threshold of 75% of the parent country's rate would mean that CFC rules would apply to subsidiaries in every jurisdiction in which the parent operates, the threshold would not act as a meaningful limitation. The main challenge with the effective tax rate approach is the requirement of profit for every CFC in the group to be determined under

[79] OECD, Public Comments received on BEPS Action 3 Public Discussion draft Part 2, 2015, Page 461
[80] OECD, Public Comments received on BEPS Action 3 Public Discussion draft Part 1, 2015, Page 15
[81] OECD, Public Comments received on BEPS Action 3 Public Discussion draft Part 1, 2015, Page 49
[82] OECD, Public Comments received on BEPS Action 3 Public Discussion draft Part 2, 2015, Page 182
[83] OECD, Public Comments received on BEPS Action 3 Public Discussion draft Part 1, 2015, Page 248

the parent jurisdiction's tax rules. Therefore, the OECD BEPS Action 3's recommendations should consider a whitelist of countries that act as an override to a low tax threshold.[84]

The International Underwriting Association of London in the United Kingdom commented that they do not support a threshold test based on the effective tax rate if it is computed by adopting accounting standards for the group as this would require accounting adjustment for tax purposes. This would create a compliance burden. As this test would be required to be performed year on year, it would create administrative work for the taxpayer. Therefore, a simpler method would be preferred, such as a whitelist.[85]

Keidanren commented that the threshold should be meaningfully low when adopting a low tax threshold based on the tax rates of individual countries if the focus is on CFCs in the jurisdictions where the BEPS concerns are extremely high. Keidanren agrees with the public discussion draft that a low tax threshold be introduced but made a point that such threshold must be clear and simple. Therefore, to reduce the burden of examining the effective tax rates, a whitelist approach should be introduced as this approach allows the exclusion of CFCs located in the countries that pose little BEPS risk.[86]

Repsol, S.A in Paris commented that there are problems that come with threshold requirements such as firstly, the distortion of the effective average taxation due to timing differences and temporary tax incentives granted by developing countries and secondly, cumbersome calculations when adopting parent jurisdiction tax rules. Therefore, they suggested that the problems can be overcome by introducing a whitelist that will exclude CFCs located in listed jurisdictions which are sufficiently similar in terms of tax base to the parent jurisdiction.[87]

Taxand, in the United Kingdom commented that in their experience, using an effective tax rate resulted in a problem as this method calculates actual tax paid by a CFC that is a member of a tax grouping. In some instances, one member pays tax on behalf of all

[84] OECD, Public Comments received on BEPS Action 3 Public Discussion draft Part 2, 2015, Page 182 and 189
[85] OECD, Public Comments received on BEPS Action 3 Public Discussion draft Part 2, 2015, Page 346
[86] OECD, Public Comments received on BEPS Action 3 Public Discussion draft Part 2, 2015, Page 366
[87] OECD, Public Comments received on BEPS Action 3 Public Discussion draft Part 2, 2015, Page 466

entities in the same jurisdiction. Therefore, based on their practical experience, a *de minimis* or whitelist would be helpful exemptions.[88]

2.5.9 Conclusion

The comments from the organisations that submitted their comments clearly share the same view that to some extent, the CFC rules place administrative and compliance burdens on taxpayers. The organisations highlighted the challenges that come with applying a low tax threshold considering that the method requires the CFC income computation be based on the parent jurisdiction's tax rules. Based on their comments, the researcher concludes that a low tax threshold carries a significant administrative burden because of the challenges the taxpayers experience when obtaining the information from the taxpayers. Therefore, the introduction of a whitelist is recommended.

[88] OECD, Public Comments received on BEPS Action 3 Public Discussion draft Part 2, 2015, Page 502

3. CHAPTER 3: Determination of net income

This chapter provides a detailed analysis of the net income determination, being the method of determining the net income of the CFC to be imputed into the taxable income of the South African multinational enterprises.

When residents hold more than 50% of the participation or voting rights in a CFC, the net income, as defined, of the CFC is deemed to constitute income in the hands of certain South African tax residents. The portion of the net income to be included in the income of the resident will be based on their proportional share of the participation rights in that company.

As the CFC regime is aimed at avoidance structures, the net profit that is to be included into the taxable income of a South African tax resident excludes amounts that do not pose an avoidance threat.[89]

The previous chapter discussed how important it is to obtain the financial information from a foreign company that is a CFC. This chapter provides the details of determining the net income of a CFC after it has been established that a foreign company is a CFC.

Although section 9D seeks to include foreign income of the CFCs owned by South African residents, only limited forms of net income of CFCs create an inclusion in the South African taxable income. The limited forms of foreign income from the CFCs mainly include income that poses a potential threat to the South African tax base.[90]

It has been noted that although a CFC may exist, this may not warrant the imputation of the net income of the CFC in taxable income of the South African tax resident. With regards to the imputation of net income of the CFC and in terms of section 9D(2A) of the Act, there are exemptions available to a South African tax resident *inter alia,* a *de minimis* exemption. Under a *de minimis* exemption, a South African tax resident that holds less than 10% of participation rights of the CFC and cannot exercise more than 10% of the voting rights in the CFC, is not required to determine net income that must be used for

[89] SILKE: South African Income Tax, 2021: 860

[90] National Treasury's Detailed Explanation to Section9D of the Income Tax Act

the purpose of imputation. When determining the 10% of participation rights or voting rights in the CFC, a South African tax resident must be considered together with their connected persons. That being the case, a South African tax resident who, together with connected persons, holds more than 10% participation rights or voting rights is not eligible for a *de minimis* exemption. Consequently, this South African tax resident will be required to impute net income of the CFC in their taxable income even though this South African tax resident holds less than 10% of participation rights or voting rights in the CFC. The timing to determine the 10% of participation rights or voting rights in the CFC is of vital importance. A South African tax resident is required to determine the 10% participation rights or voting rights on the last day of the foreign tax year. In cases where CFC does not exist at the end foreign tax year, the date of 10% determination will be on the last day that the foreign company ceased to be a CFC.

The determination of net income of the CFC for the purpose of imputation is a crucial step. This is a step that brings to light the net income of the CFC that should be attributed to the South African tax resident in terms of section 9D(2) of the Act. When a South African tax resident determines the amount of the net income that must be used for the purpose of imputation into their taxable income, it is worth noting that only the portion of the CFC's net income is imputed. This portion of the net income that a South African tax resident must impute is referred to as the proportional amount. The South African tax resident must impute their proportionate share of the profits of their CFCs in their taxable income.

The net income of a CFC in respect of a foreign tax year shall be determined in the functional currency of that CFC and shall, for purposes of determining the amount to be included in the income of any resident during the year of assessment, be translated to the currency of South Africa by applying the average exchange rate for that foreign tax year.[91]

As Olivier and Honiball (2011, 572) note, the net income of the CFC is calculated at the end of the foreign tax year of the country in which the CFC is a resident. The calculated amount is included in the South African resident taxpayer's taxable income at the end of

[91] Section 9D(2A) (6) of the Income Tax Act

the South African year of assessment. Sometimes a CFC becomes a CFC during the year and at the end of the foreign tax year is still a CFC, the net income of the CFC is included in the income of the South African tax resident (section 9D(2)(*a*)) of the Act. In this instance, the South African resident taxpayer will not include the CFC net income for the full foreign tax year. There is however, a choice to include either, the income that accrued to or was received by the CFC during the actual days of the foreign tax year when the company was a CFC (section 9D(2)(*a*)(ii)(aa)) of the Act, or an amount in proportion to the number of days the company was a CFC (section 9D(2)(*a*)(ii)(bb)) of the Act.[92]

The determination of net income is explained clearly and expressed in the Act. In terms of section 9D(2A) of the Act the net income of a CFC in respect of a CFC's foreign tax year is an amount equal to the taxable income of the CFC determined in accordance with the South African Income Tax Act. In this regard, the CFC would be treated as if it had been a South African taxpayer and as if that CFC had been a South African tax resident. Earlier in the chapter, the discussion on a *de minimis* exemption was covered. This is an exemption that a South African tax resident obtains towards the imputation of the net income in general. There are situations where the imputation of the net income is required, and it must be noted that even though the imputation is required, there are some exclusions to this, the net income.

Section 9D (9) of the Act governs the exclusions from net income. The seven exclusions, however, only apply to an amount which:

- is attributable to any foreign business establishment, this exclusion is subjected to further exclusions and sub-exclusions (referred to as the diversionary rules) in section 9D(9A), to be discussed separately below.
- is attributable to certain long-term insurance policyholders.
- is subject to withholding tax of interest and royalties.
- The amounts do not pose an avoidance threat as the South African government would have earned the tax already through withholding tax.

[92] Olivier & Honiball 2011:572

- is included in the taxable income of the CFC.

  (the amounts would have been taxed already through a CFC that is taxed in South Africa, therefore there is no avoidance threat posed)
- is attributable to foreign dividends declared by any other CFC out of amounts imputed / imputable less tax credits / exemptions.

  (In the event a CFC 1 receives dividends from another CFC 2, however the profit which these dividends are declared from are included in the net income of CFC 2 for the purpose of calculating the proportional amount of CFC 2. Essentially, including these dividends in the net income of CFC 1 will constitute double taxation. As a result, these dividends are to be excluded in the net income of CFC 1[93]).
- is attributable to any interest, royalties, rental, insurance premium, or income of similar nature which is paid or payable by other CFC.

  In the event of income as a result of passive income between the CFC and another CFC in the same group.
- is attributable to the disposal of any asset.

  In the case of a particular CFC that does not qualify for FBE exemptions, but the CFC's asset forms part of the business of other CFC which qualifies for FBE exemptions, e.g., in the shipping industry, it is common that a ship operator does not own the Vessel. The vessel would be owned by other CFC[94].

The deductions that are disallowed in the calculation of net income are governed in Section 9D(2A)(b) of the Act. The following deductions are disallowed:

- any interest, rental, insurance premium, or income of a similar nature which is paid or payable to another CFC in the same group.
- exchange difference as a result of exchange items where parties involved are CFCs from the group CFC.
- the difference between amount owed to the CFC by another group CFC.

Furthermore, there are exemptions to the imputation of net income into the taxable income of the South African tax resident. In terms of Section 9D(2A) in para (i) of the Act,

[93] Cor Kraamwinkel 2021 WITS Lecture

[94] Cor Kraamwinkel 2021 WITS Lecture

there are two exemptions where net income of a CFC shall be deemed to be nil, as a result no imputation is required. The first exemption is where the aggregate amount of taxes on income payable to all spheres of government of any country other than South Africa by the CFC in respect of the foreign tax year of that CFC is at least 67.5% of the amount of normal tax that would have been payable in respect of any taxable income of the CFC had the CFC been a resident for that foreign tax year. This exemption can also be referred to as the high-tax exemption. The second exemption is where all the receipts and accruals of that CFC are attributable to any foreign business establishment of that CFC. This exemption can also be referred to as foreign business establishment exemption. The two exemptions are discussed separately in detail below.

3.1 High-Tax exemption

According to De Koker and Williams (2021:670) "There is an additional requirement, which is set out in para (ii) Section 9D(2A) of the Act. It states that the aggregate amount of tax payable referred to in para (i) of Section 9D(2A) of the Act must be determined, firstly after considering an applicable double tax agreement and any credit, rebate or other right of recovery of tax from a sphere of government of a country other than South Africa. Secondly after disregarding a loss for a year other than a year referred to in para (i) or from a company other than a company contemplated in para (i) of this further proviso". The effective consequence of this further proviso is that a resident shareholder of a CFC will not be required to include in his income his proportionate share of its net income when it has paid tax to another country and the tax so paid is at least 67.5% of the normal tax that would have been paid in South Africa on its taxable income had it been a resident".[95]

Silke on South African Income Tax (2021:867) states that where there is little South African tax at stake, high-tax exemption removes the burden of having to apply the CFC rules in cases[96].

[95] SILKE on South African Income Tax 2021: 670

[96] SILKE: South African Income Tax, 2021: 867

With respect to the high-tax exemption and in cases where South African tax on the net income of the CFC would have been very little or nil, the high-tax exemption applies. Based on this reason, the high-tax exemption can be viewed as a method to ease the compliance burden for the South African tax residents as net income of the CFC will be excluded in the taxable income of South African tax residents. Exclusion of this net income of the CFC in the taxable income will result in South African tax residents eliminating the need for the South African tax residents to claim section 6*quat*-rebate.[97] In terms of section 6*quat,* South African tax residents can claim foreign tax rebate from the tax imposed on the foreign income, provided their foreign source income was taxed in the foreign country. In this regard, there is a limit on the rebate, the rebate to be claimed is limited to the tax on foreign source income based on the South African tax rate.[98]

De Koker and Williams (2021:643) cite the Explanatory Memorandum on the Taxation Laws Amendment Bill (2009:60) and state that the purpose of the high-tax exemption is to 'disregard tainted CFC income if little South African tax is at stake once section 6*quat*-rebate' is considered.

In making the decision of whether the high-tax exemption is applicable or not, the CFC's financial information is critical. With regards to the 67.5% of the normal tax that would have been payable in respect of any taxable income of the CFC, the South African tax resident must determine the taxable income of the CFC in accordance with the South African Income Tax Act, subject to a number of tax allowances, tax deductions and exemptions. Thereafter, the South African normal tax can be determined from this taxable income. This normal tax will then be compared to the aggregate amount of taxes payable by the CFC to all spheres of government of any country other than South Africa. If this normal tax is at least 67.5% of the aggregate amount of taxes on income payable to all foreign governments, the South African tax resident will impute nil of the CFC's net income because the income tax rate will be considered high.

To achieve this, the South African tax resident is obliged to obtain relevant financial information from the CFC. Obtaining financial information from the CFC comes with

[97] PwC- 2019 Proposed amendments to the CFC rules

[98] Jooste R - The Imputation of Income of Controlled Foreign Entities, 2001:486

challenges which create an administrative burden for South African tax resident. The CFC may, for example, present financial statements in their official preferred language which can be a foreign language to a South African tax resident. South African tax resident will then be required to employ the systems that enable translation of the financial statements into South African official language, preferably in English.

The high-tax exemption is essentially about exempting controlled foreign companies that are in any event subject to a sufficiently high level of non-South African tax. Previously, the threshold (*i.e.,* acceptable level of foreign tax) was 75% of the equivalent South African tax that would hypothetically have been paid, whereas that threshold is now reduced to 67.5%[99].

The decrease to the threshold from 75% to the 67.5% came into effect for tax years ending on or after 1 January 2020.

3.2 Foreign business establishment (FBE) exemption

In order for a CFC to have FBE, there must be a business that has some permanence, economic substance, and a non-tax business reason for operation outside South Africa.[100] For the South African tax residents who have controlling interests in the CFCs, to qualify for CFC rules exemption, as of 01 January 2001, a permanent establishment is no longer required but a business establishment is required.[101]

In terms of section 9D(9)(b) of the Act, subject to subsection (9A), in determining the net income of a controlled foreign company, in terms of subsection (2A), there must not be taken into account any amount which:

"Is attributable to any foreign business establishment of that controlled foreign company (whether or not as a result of the disposal or deemed disposal of any assets forming part

[99] SAIT - Corporate Tax Rates, BEPS and SA's CFC changes: https://www.thesait.org.za/news
[100] National Treasury's Detailed Explanation to Section9D of the Income Tax Act
[101] Olivier L - The permanent Establishment Requirements in an International and Domestic Taxation Context, 2002:881

of that foreign business establishment) and, in determining that amount and whether that amount is attributable to a foreign business establishment-

i. that foreign business establishment must be treated as if that foreign business establishment were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the controlled foreign company of which the foreign business establishment is a foreign business establishment, and
ii. that determination must be made as if the amount arose in the context of a transaction, operation, scheme, agreement or understanding that was entered into on the terms and conditions that would have existed had the parties to that transaction, operation, scheme, agreement or understanding been independent persons dealing at arm's length".

Based on the above, it is important to discuss the meaning of foreign business establishment.

The foreign business establishment definition consists of the requirements of a FBE that a controlled foreign company must comply with in order to be a foreign business establishment.

De Koker and Williams (2021:644) cite Section 9D(1) of the Act and define a foreign business establishment in relation to a controlled foreign company as,

a) "a fixed place of business located in a country other than the South Africa that is used or will continue to be used for the carrying on of the business of that controlled foreign company for a period of not less than one year.
b) any place outside South Africa where prospecting or exploration operations for natural resources are carried on, or any place outside South Africa where mining or production operations of natural resources are carried on, where that controlled foreign company carries on those prospecting, exploration, mining or production operations.
c) a site outside South Africa for the construction or installation of buildings, bridges, roads, pipelines, heavy machinery, or other projects of a comparable magnitude

which lasts for a period of not less than six months, where that controlled foreign company carries on those construction or installation activities.

d) agricultural land in any country other than South Africa used for *bona fide* farming activities directly carried on by that controlled foreign company.
e) a vessel, vehicle, rolling stock or aircraft used for purposes of transportation or fishing, or prospecting or exploration for natural resources, or mining or production of natural resources, where that vessel, vehicle, rolling stock or aircraft is used solely outside South Africa for such purposes and is operated directly by that controlled foreign company or any other company that has the same country of residence as that controlled foreign company and that forms part of the same group of companies as that controlled foreign company.
f) a South African ship as defined in section 12Q of the Act engaged in international shipping as defined in that section; or
g) a ship engaged in international traffic used mainly outside South Africa".

The application of the above foreign business establishment requirements is discussed below:

With regards to the FBE requirement part (b), Place of offshore prospecting, exploration or mining and production of natural resources: on reflection of this FBE requirement, it would not make business sense for a company to be exploring minerals in country A, for example, with the intention to avoid tax in the South African government. If the required minerals cannot be found in South Africa but in country A, clearly the establishment of CFC in country A was for *bona fide* business.[102]

With respect to FBE requirement's part (c), Offshore construction or installing sites not less than 6 months old and part (d) Agricultural land outside South Africa used for *bona fide* farming. On reflection of these FBE requirements, it is as scarce as hen's teeth that a South African tax resident can have a CFC established outside South Africa to avoid tax in the South African government.

[102] Cor Kraamwinkel 2021 WITS Lecture

With respect to FBE requirement's part (e), vessel, vehicle, rolling stock or aircraft used or purposes of transportation/fishing and prospecting. If a South African tax resident owns some rolling stock or aircraft in a foreign country, having a CFC established in that country constitutes *bona fide* business.[103]

3.3 Fixed place of business

With respect to the fixed place of business requirements as set out in section 9D(9)(b) of the Act, De Koker and Williams (2021:644) state that fixed place of business is where:

i. "that business is conducted through one or more offices, shops, factories warehouses or other structures.
ii. that fixed place of business is suitably staffed with on-site managerial and operational employees of that controlled foreign company who conduct the primary operations of that business.
iii. that fixed place of business is suitably equipped for conducting the primary operations of that business.
iv. that fixed place of business has suitable facilities for conducting the primary operations of that business; and
v. that fixed place of business is located outside South Africa solely or mainly for a purpose other than the postponement or reduction of any tax imposed by any sphere of government in South Africa".

Provided that for the purposes of determining whether there is a fixed place of business as contemplated in the definition above, a controlled foreign company may consider the utilisation of structures as contemplated in subparagraph (i), employees as contemplated in subparagraph (ii), equipment as contemplated in subparagraph (iii), and facilities as contemplated in subparagraph (iv), of any other company:

[103] Cor Kraamwinkel 2021 WITS Lecture

(aa) if that other company is subject to tax in the country in which the fixed place of business of the controlled foreign company is located by virtue of residence, place of effective management or other criteria of similar nature.

(bb) if that other company forms part of the same group of companies as the controlled foreign company; and

(cc) to the extent that the structures, employees, equipment, and facilities are located in the same country as the fixed place of business of the controlled foreign company'.

With respect to sub-paragraph (aa), where CFC1's fixed place of business is in the same country as the CFC2 and where CFC1 utilises the structures of CFC2. CFC2 must be subjected to tax in that country by virtue of residence and not subject to tax for other reasons.

With respect to FBE requirement part (a), fixed place of business, this requirement is read together with part (i) to (v) as set out above. Basically, it means that once the primary operations of the business are established, suitably staffed with managerial and operational employees must be in place, and suitably equipped. For example, in the case of an Accounting and Auditing firm, the following elements are crucial for the operation of the firm - Accountants and Auditors together with their superiors. These staff employees must spend most of the relevant time on site to carry out the activities.

The office must be suitably equipped with suitable normal facilities such as office furniture, office equipment, water, power, computers, internet and telephone connections for the employees to perform their functions on site. With regards to the office space, the CFC does not have to own the office space, and as a result, if a CFC is leasing the office, that office is still adequate as a fixed place of business.

As a further step, parts (aa) to (cc) are read together with the five requirements for the fixed place of business as described per point (i) to (v). In fact, the sharing of substance is far more common in the multinational enterprises, therefore it is acceptable.

To discuss the fixed place of business, the following court case was considered.

There was a dispute on the foreign business establishment concept. This was heard in the court case between the Appellant and the Commissioner of South African Revenue Services (Respondent) where judgement was handed down by Judge Hack A.J. in this case. The issue between the parties was "primary operation". The parties differed as to what is the primary operation of the Appellant's CFC.

The Respondent argued that the Appellant was supposed to include the net income of its controlled foreign company incorporated and registered in the Republic of Ireland. The Appellant did not include the net income in the taxable income on the basis that the net income is subject to FBE exemption. This exemption was granted in terms of section 9D(9)(b) of the Act. Both Respondent and Appellant disputed whether the CFC had complied with the requirements of FBE exemption and, to be specific, the fifth requirement regarding the motive or purpose for which the CFC was set up. In respect of the fifth requirement, the Respondent was of the view that the Appellant's CFC was set up solely or mainly for the purpose of postponing or reducing the tax imposed by the South African government.[104]

The Respondent was of the view that the Appellant's CFC is an investment management company, meaning its purpose is to manage an investment, that is, to do all the things necessary to endeavour to grow the investment, and that requires a limited number of activities. On the other hand, the Appellant argued that the CFC is a Fund management company. Fund management is more complex and requires obtaining and securing the correct licences, ensuring compliance with laws whether statutory, regulatory, and professional, making decisions when and by what amount to distribute profits to investors[105].

It was important to determine whether the Appellant's CFC complied with all five FBE requirements or not in order to make the correct decision about the treatment of the CFC's net income. The judgment was granted in favour of the Appellant as follows: The

[104] Appellant v Commissioner for SARS
[105] Appellant v Commissioner for SARS

Respondent was directed to issue the Appellant with a reduced assessment for the year of assessment in question.

As indicated in the FBE exemption section 3.2 above, the FBE exemption is subjected to further exclusions and sub-exclusions, or diversionary rules. Notwithstanding the requirements of the FBE exemption, the FBE exemption requirements as in part (a) on fixed place of business, the net income for the CFC with fixed place of business can still be required for imputation, provided certain provisos apply. To follow these further exclusions and sub-exclusions, the diversionary rules are discussed below.

3.4 Diversionary rules

Although meeting the FBE requirements provide South African tax residents an exemption from having to impute the CFC's net income into their taxable income, this could allow South African amounts to be diverted to the CFC. To avoid the misuse of the FBE exemption, the South African government has put in place diversionary rules. Section 9D(9A) of the Act governs these anti-diversionary rules.

An FBE can create a potential avoidance opportunity. South African tax residents that may try to create the transactions that artificially divert South African amounts into their controlled foreign companies will be required to impute these CFC's net income into their taxable income in terms of section 9D(9A) of the Act diversionary rules. The diversionary rules are a measure put in place to protect the South African *fiscus* against the transactions that artificially divert South African profits into the controlled foreign companies.[106]

CFCs, with receipts and accruals that fall within the ambit of the categories that have the potentially diversionary income, do not qualify for the FBE exemption. These CFCs must determine the net income in terms of section 9D(2A) of the Act, to impute in the South African taxable income. With respect to CFCs that seek to rely on the FBE exemption,

[106] SILKE: South African Income Tax,2021

the diversionary rules are relevant. The three sets of diversionary rules relate to goods and services, namely CFC inbound sales, CFC outbound sales, CFC inbound services[107].

In the 2021 Budget speech, clarification on diversionary rules on controlled foreign companies was provided. The following was highlighted: the South African Government reinstated the diversionary rules in 2016 after they were abolished in 2011. To be specific, these were diversionary rules governing the outbound sale of goods. In reinstating these diversionary rules for the outbound sale of goods, the Government wanted to ensure the rules' effectiveness in preventing base erosion and profit shifting. In 2016, the diversionary rules for CFC outbound sale of goods provided for an exemption if similar goods were purchased by the CFC, from unconnected persons to that CFC, mainly within in the country of residence of that CFC. The South African Government noted that certain South African tax residents were circumventing these rules by merely entering into a contract of purchase and sale that implies that the purchase of goods took place in the country of residence of the CFC, when sometimes this is not the case. To curb this abuse, Government proposed that these diversionary rules be amended[108].

In 2019, National Treasury amended the diversionary rules to include the phrase 'directly or indirectly'. For example, if CFC1 sells goods to CFC2 which in turn, sells the goods to a connected person who is a SA tax resident, the new diversionary rules ensure that the profits of both CFC1 and CFC2 are taken into account. Whereas, in contrary, the previous rules would only have targeted the profits of CFC2. The amended diversionary rules furthermore ensure that profits of the CFC1 are also caught in cases where the CFC1 sells goods to an unrelated third party (whether SA-resident or not) which in turn, sells the goods to a connected person in relation to CFC1 who is SA tax resident. As a result, these profits will be subjected to the imputation. These are referred to as multi-layered structures. To strengthen the diversionary rules on these multi-layered structures, it was proposed that the previous diversionary rules be extended to include the diversionary income where the CFC earns income from selling goods to any connected SA tax resident

[107] Pwc- 2019 Proposed amendments to the CFC rules
[108] National Treasury Budget Review 2021, p149

person, on-selling goods that were purchased from any SA-resident connected person and rendering services to any SA-resident connected person[109].

In respect of the previous diversionary rules and using the above example, only the profits of CFC2 would be caught.

Section 9D(9)(b) of the Act, prior to contemplating the various other FBE exclusions and provisos of FBE exemption, the requirements of an FBE as set out above in part (a) to (g) are essential to the process.

The same taxable income determined under the high-tax exemption above and which equals the net income of the CFC is referred to under FBE exemption.

3.5 Conclusion

With respect to high-tax exemption, a detailed calculation is required in order to determine the CFC's net income. The fact that the taxable income of a CFC must be determined in accordance with the South African Income Tax Act creates an administrative burden for the South African tax residents.

With respect to FBE, section 9D(9)(b) of the Act provides that any amount which is attributable to any FBE must not be included into net income of a CFC. However, it must be noted that the South Africa tax residents cannot simply exclude the amounts that are attributable to the FBE from the net income of the CFC. This is not a straightforward exclusion. There are, however, various exclusions and provisos when FBE exemption is applicable which render the FBE complex to administer.

[109] SAIT - Corporate Tax Rates, BEPS and SA's CFC changes: https://www.thesait.org.za/news

4. CHAPTER 4: Administrative burden placed on South African multinational enterprises in respect of section 9D compliance

The purpose of this chapter is to consider the administrative burden that is placed on South African multinational enterprises in applying the CFC rules in order to remain compliant with section 9D of the Act. This includes an assessment of whether the rules discourage South African multinational enterprises' global competitiveness. Although, in simplifying CFC rules, the effectiveness of the South African CFC rules should not diminish. If CFC rules are not flexible, South African multinational enterprises will be unable to compete in the global markets.

South Africa is the only country in the Southern African Development Community (SADC) and in Africa that has developed and introduced the CFC legislation.[110]

Judge Hack A.J stated that an overall determination of whether the counter-argument of the South African tax resident is the true motive of having set up the CFC, as opposed to being, not to postpone or reduce the tax liability of South African tax resident. Judge Hack A.J noted that when the South African financial industry started to normalise at the approaching demise of the previous regime, South Africans were presented with better opportunities to invest abroad. South African investors had an appetite to broaden their previous restrictive investment opportunities[111].

One of the objectives in the OECD/G20, final report on the BEPS Action 3 recommendations is that CFC rules must be designed in a way that struck a balance between taxing income in the CFC and the competitiveness globally. The plan on the CFC rules is not to raise revenue on the CFC income, the rules are designed to protect the base of the country by discouraging profit shifting to foreign companies.[112]

FBE exemption is one of the most complicated provisions in section 9D of the Act.[113]

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[110] Olivier & Honiball 2011
[111] Appellant v Commissioner for SARS, 2021
[112] OECD BEPS Action 3, Final Report 2015
[113] Olivier & Honiball 2011:581

From 2001, South Africa adopted the residence principle of taxation, followed by tax base extension to include foreign source income. The aim of extending the tax base was to improve fairness and create a global presence for South African entities.[114]

4.1 Complexities in the South African CFC rules

The chapter further assesses whether CFC rules have a negative impact on South African multinational enterprises and their investments globally, resulting in challenges in global competition, thereby blocking valid commercial structures. If so, South African-owned businesses will be placed in an uncompetitive position. There must be a fine balancing act between ensuring that the scope of the CFC rules is sufficient to counter avoidance schemes, while at the same time, not impacting legitimate cross-border activity.[115]

The article by PwC from the PWC website commented that SA's international tax laws on CFCs have not entirely kept pace with the advent of globalisation and technology as the CFC rules in South Africa are rigidly mechanical and may not cater for the *bona fide* business operations of modern business and specialist industries.[116]

With respect to mechanical CFC rules, these rules may be simple, however they are susceptible to misrepresentation. Whereas subjective rules are theoretically accurate, they can be harder to enforce and create uncertainty in terms of compliance.[117]

The notion exists that South Africa's CFC legislation is not part of a well-thought-through policy but is rather a piecemeal effort to close loopholes. Government should ensure that the country's policies are competitive globally, although that global competitiveness often

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[114] Koch SF - Economic growth and the structure of taxes in South Africa
[115] SILKE: South African Income Tax, 2021: 860
[116] PwC International Tax Services, 2016 - https://www.pwc.co.za/en/search.html?searchfield=cfc+rules+are+rigid&tp=long&pwcGeo=ZA&pwcLang=en&pwcSiteSection=&pwcHideLevel=0#

[117] The Davis Tax Committee, BEPS 2017

can be in direct conflict with tax policies. If CFC rules are too rigid, taxpayers may be unable to compete globally.[118]

Judge Hack A.J stated that section 9D of the Act is a lengthy provision with multiple subsections and has been subject to numerous amendments. Hack A.J highlighted that it was necessary for South African Tax legislation to provide the various exemptions in section 9D of the Act in order to strike a balance between the objective of preventing the deferral or avoidance of tax and potential prejudice to South Africa tax residents.[119]

As countries make an effort to ensure that their residents' companies that hold controlling shares in foreign companies preserve the net income earned by these foreign companies, a fine balance must be struck. Although countries need to protect their tax base against erosion, sight should not be lost of the relative ease with which corporations can relocate in response to tax avoidance measures and rate changes.[120]

The intention of the foreign business establishment exemption is to promote international competitiveness. The exemption is applicable on the foreign income with little or no threat to the South African tax base. [121]

4.2 Administrative burden

The primary focus is on the administrative burden CFC rules impose on South African multinational enterprises to comply with section 9D of the Act. The assessment of the administrative burden is relative to the contribution of the CFC imputation in the taxable income of South African multinational enterprises, and as a result, into the South African *fiscus.* South African multinational enterprises noted that when applying South African CFC rules, they potentially impute little or no net income from the foreign profits in their CFCs. A comparison between the administrative burden and the amount of imputation is therefore necessary. It can be administratively complex to comply with the lengthy provisions in section 9D of the Act.

[118] Olivier & Honiball 2011:559
[119] Appellant v Commissioner for SARS
[120] Olivier & Honiball 2011:559
[121] National Treasury's Detailed Explanation to Section9D of the Income Tax Act

Section 9D of the Act is a lengthy section with numerous provisions and subsections that require a thorough read to follow and understand. In the CFC regime, there are also a large number of exemptions and exclusions.

A copy of the financial statetments of financial records, including foreign tax calaculations, of a CFC is required in order to determine the net income of the CFC. If this is not available, other methods must be employed.

Countries have come up with various methods that resident taxpayers can make use of to obtain information that will assist with determination of CFC net income. The methods can assist those residents that do not have sufficient control to obtain information regarding the income of the CFC. For example, amounts to be attributed can be based on the increase in market value of the taxpayer's interest in the CFC[122].

In terms of section 72A(3)(b)(i) of the Act, the taxpayer that fails to comply with the submission of a copy of financial statements of the CFC without reasonable grounds that their failure was beyond its control, or it is believed it was not subject to the requirement to obtain that copy of financial statements, the taxpayer must include receipts and accruals of the CFC as the proportional amount in terms of section 9D.

SARS requires necessary information to assess section 9D compliance by the South African tax resident. South African tax residents who have the requisite holding interest in a CFC have an obligation in terms of section 9D. All these residents must be aware of their holding interest because South African tax residents who hold a minority interest but together with connected persons, have the requisite holding interest, therefore have an obligation in terms of section 9D. Section 72A is the provision of the necessary information gathering. This places a significant administrative burden on taxpayers. [123]

It is worth noting that section 72A provides no sanction for the South African tax residents who fail to comply with it, however section 9D(10) of the Act provides that the South African tax residents who fail to comply with section 72A will not be eligible to claim foreign

[122] Olivier & Honiball 2011:572
[123] Jooste R - The Imputation of Income of Controlled Foreign Entities, 2001:500

business establishments exemptions, such as CFC dividend, CFC interest, CFC rents, and royalties.[124]

Although effective CFC rules are necessary, the CFC rules should not be excessively burdensome in terms of tax enforcement and tax compliance. A balance must be struck between the need for reduced complexity inherent in mechanical CFC rules and the effectiveness of subjective rules.[125]

According to the shared policy considerations of the BEPS Action 3, the need to balance effectiveness with reducing administrative and compliance burdens, was highlighted as well as the need to balance effectiveness with preventing or eliminating double taxation.

The high-tax exemption requires a detailed calculation to determine CFC's net income and that therefore, the FBE exemption is likely to be less time consuming and less onerous to apply. The author mentioned that FBE exemption is the simple exemption to apply.[126]

Olivier and Honiball (2011), in *International Tax,* states that, when designing CFC rules, in the process of assessing the tax rates, the compliance cost should be considered as well. Therefore, the compliance cost that flows from overcomplicated legislation should be weighed up against the direct and indirect revenue derived from taxing foreign entities[127].

According to Action 3 of the BEPS final report, the chapter on CFC exemptions and threshold requirements highlighted that its purpose is to ensure that the foreign companies that are unlikely to pose a risk of base erosion and profit shifting should be excluded in CFC rules. The report also noted that these requirements are ways of assisting in making CFC rules more targeted and effective, as well as reducing the administrative burden of complying with CFC rules.[128]

Generally, in calculating the net income of a CFC, companies must keep two sets of

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[124] Jooste R - The Imputation of Income of Controlled Foreign Entities, 2001:501
[125] OECD BEPS Action 3, Final Report 2015
[126] SILKE: South African Income Tax, 2021: 867
[127] Olivier & Honiball 2011:560
[128] OECD BEPS Action 3, Final Report 2015

books, one for the country in which the CFC is a resident, and one for South African tax purposes. This obligation places a compliance burden on companies, as a full audit of each company is required.

A form has to be completed and submitted to the South African Revenue Service (SARS) for each CFC, which is almost as burdensome as completing a tax return for each respective company. From an administrative point of view, it can be concluded that compliance with section 9D of the Act is a costly exercise.[129]

4.3 Conclusion

Action 3 of the BEPS final report recognises that countries that work together can address concerns about the competitiveness.[130]

As South Africa respond to BEPS challenges, a balanced approach must be developed. The balanced approach should encourage the competitiveness of South African multinational enterprises to expand globally while ensuring that the profit shifting opportunities that are likely to increase with the expansions are well managed. South Africa needs foreign direct investment and the associated access to technology capital. Therefore, South Africa's tax base must be protected against concerns relating to base erosion and profit shifting.[131]

[129] Oguttu, Curbing offshore tax avoidance: The case of South African companies and trusts, 2007: 123
[130] OECD BEPS Action 3, Final Report 2015
[131] The Davis Tax Committee, BEPS 2017

5. CHAPTER 5: Case Study

5.1 Introduction

The researcher is employed by a reputable organisation within the financial services industry. This chapter gives an overview of the process followed by this organisation in complying with the requirements of section 9D of the Act. The organisation is a multinational enterprise with subsidiaries in different countries, including South Africa. A large number of these subsidiaries are controlled foreign companies, as defined in section 9D of the Act.

The researcher collected data by way of a case study. The case study was performed, based on the process the organisation follows when preparing to file for the controlled foreign companies tax return, IT10B.

5.2 Background on the organisation

The case study is based on a reputable organisation that operates in the financial services industry. The organisation is a South African registered company and is listed on the Johannesburg Stock Exchange. The organisation is a group of companies which holds several investments in some South African companies and some international companies.

The group offers a comprehensive range of products in the South African market and in certain international markets. The shareholders of the group are amongst others, corporates, pension funds, insurance companies, unit trusts and private investors.

The group company, which is also the holding company for all the controlled foreign companies, oversees other responsibilities in all its subsidiaries. The controlled foreign companies have, amongst other departments, a finance department, and a tax department. The tax departments are responsible for the submission of the tax related

matters in accordance with the tax legislation in respective jurisdictions to ensure taxation compliance in their respective countries.

The ultimate holding company, which is based in South Africa, has a centralised tax department. The centralised tax department takes overall responsibility for the taxation related matters to ensure tax compliance management in the group. The department works in close liaison with SARS and the entire group. The department consists of various specialist teams, *inter alia*, an Advisory team and a Compliance team.

The advisory team is responsible for providing transactional support and tax-related advice to the overall group to assist in mitigating tax risks. The compliance team is responsible for collating the information required from the CFCs and to determine the amount of the CFC income that must be imputed in accordance with section 9D of the Act. The ultimate responsibility of filing the IT10B tax return rests with the compliance team.

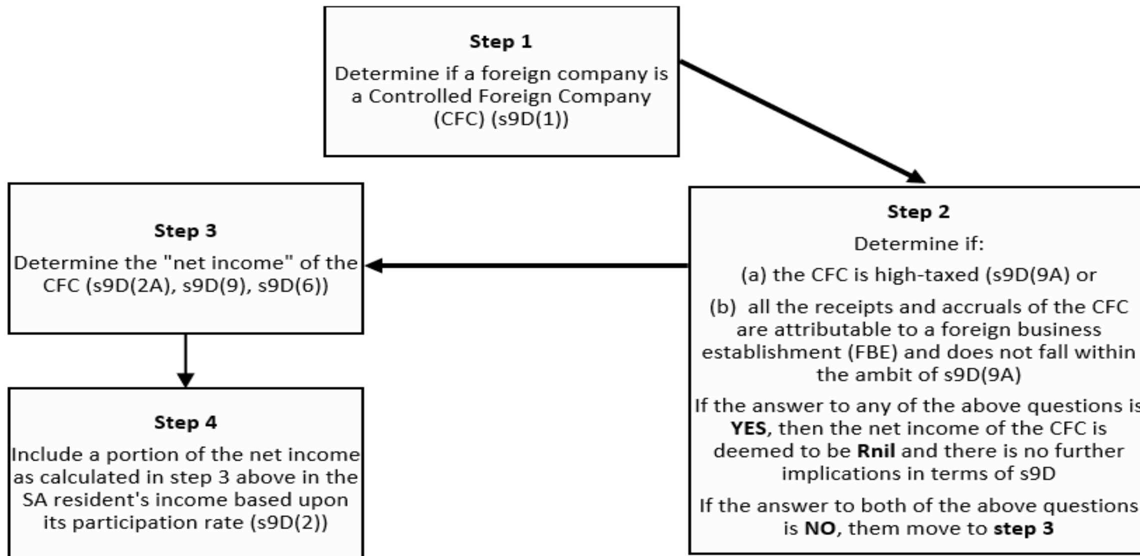
With regards to filing for the IT10B return, the centralised tax department has a formal process to follow to ensure that the IT10B return is prepared in time and that the amount imputed in terms of section 9D of the Act is accurate.

5.3 Processes of the organisation

The ultimate holding company, as a South African resident that holds the investments in the foreign companies, must consider the provisions of section 9D of the Act.

The centralised tax department takes the following section 9D overview in mind. Refer to the diagram below.[132]

[132] SILKE: South African Income Tax,2015



5.3.1 Step 1: Determination of a CFC

With respect to the foreign investments of the group, the advisory team initiates the communication with the CFCs and gathers relevant information that can assist with the knowledge of the foreign companies. The team analyses the investments to determine whether the holding company has the controlled foreign company or not.

In determining whether a foreign company is a CFC or not, the advisory team ensures that both the voting and participation rights are considered. Participation rights and voting rights are dealt with separately.

For example, if the sum of the participation rights or voting rights of South African resident 1, resident 2 and resident 3 is >50% in a foreign company, then the foreign company is a CFC. SA residents 1, 2 and 3 need not be connected persons for the CFC definition to apply.

In addition, regard must also be given to certain provisos in respect of voting rights and participations rights. South African residents need not be connected persons in relation to each other or the foreign company for the purpose of the CFC definition.

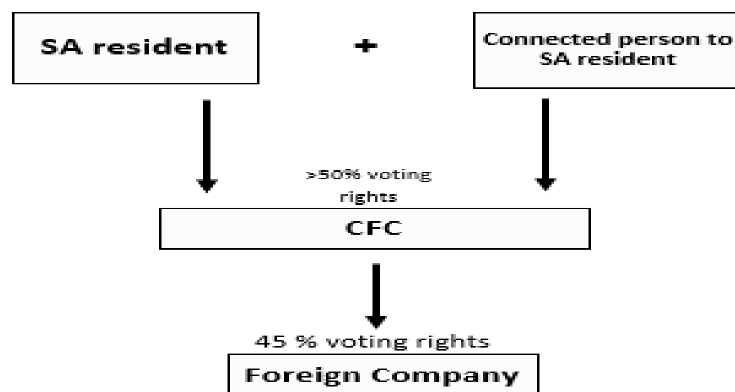
The below provide further examples of a CFC.

Proviso a(i) to S9D(1)

Where the South African resident holds a percentage of the voting rights in a foreign listed company, those foreign voting rights, regardless of the percentage, will be ignored when determining whether the foreign listed company is a CFC. Therefore, only participation rights will be considered to determine whether a listed foreign company is a CFC.

Proviso (ii) to s9D (1)

Where a South African resident and a connected person percentage holds more than 50% in another CFC and this CFC holds a percentage of the voting rights in the foreign company, the voting rights are deemed to be exercisable directly by the South African resident. When determining whether the foreign company is a CFC, since the South African resident can exercise >50% of the voting rights in the CFC directly, it is deemed that the South African resident can exercise its 45% voting rights in foreign company. Refer to the illustration below:



The advisory team ensures that all CFCs are identified, the group structure is updated accordingly. The list of the confirmed CFCs is compiled and reviewed by the senior manager.

5.3.2 Information gathering

When the Advisory team has the list of confirmed CFCs ready, it hands over the list to the compliance team to begin with the process of filing for IT10B return. The compliance team ensures that the group structure is updated with the new CFCs, where necessary. The compliance team is introduced to all the relevant business units within the CFCs. The business units include the taxation unit, finance unit and the secretarial office.

The compliance team designed a CFC questionnaire to assist them in gathering all required non-financial information from each CFC. This is a document that details all the relevant questions the team aims to obtain answers for from the CFCs. The questionnaire is designed in accordance with the section 9D provisions. The questionnaire gathers data on the structure, shareholding, Board of Directors, Director's meetings held during the year, financial year end, in-country tax status and other relevant business and financial information. The responses to the questionnaire are utilised to update the group structure, identify further CFCs omitted in the previous step, identify CFCs principal activities, determine whether the Foreign Business Establishments (FBE) exemption is likely to apply, highlight whether any divisionary income had been earned by the CFC during the financial year and identify the in-country tax position of the foreign companies.

Each CFC is required to complete one questionnaire. Each year, the compliance team ensures that the questionnaires are circulated to all CFCs after year end of the CFC. The responsibility of completing the questionnaire lies with the Chief Financial Officers (CFOs) of all CFCs companies in the group.

The advisory team holds monthly catch-up meetings with the CFOs and tax managers of all foreign entities in the group. Therefore, when reviewing the responses to the questionnaires, knowledge gained during these regular catch-up meetings is used to validate the accuracy and completeness of the information contained in the questionnaires.

The centralised tax department has acquired a CFC data collector tool from an independent consulting firm to assist in this regard. The CFC data collector tool is populated using the information in the CFC questionnaire obtained from the CFCs.

The compliance team put together a formal letter to request information. Information requested includes trial balances, signed annual financial statements (AFS), foreign tax computations, any other relevant schedules and supporting calculations.

This letter is sent to the CFOs and the tax managers of the CFCs.

The compliance team begins the determination of CFC net income using the financial information obtained from the CFCs. With respect to the determination of the net income of the CFCs, the team applies South African taxation rules in terms of the Income Tax Act. As a result, the South African tax computation is ultimately populated using the CFC financial information. The SA tax computation must be determined for each CFC separately. Due to the large number of the CFCs within group, the compliance team designed a standard tax pack template. The standard tax pack template is designed to maintain consistency when determining the net income of each CFC. The tax pack ensures an efficient and standardised process as well.

5.3.3 Step 2: CFC net income exemption

High-taxed CFC exemption

In terms of the proviso (i)(aa) to the definition of “net income” in section 9D of the Act, if the amount of income taxes payable by the CFC to all spheres of foreign governments in the foreign tax year is at least 67.5% of the amount of normal tax that would have been payable by the CFC had it been a resident during the applicable foreign tax year, then the net income of the CFC is deemed to be R nil.

When putting to test whether the CFC meets the requirements of high tax exemption, the compliance team use the tax pack. The tax pack, together with the calculations, support the determination of high tax exemption and ensures that the calculation is correct.

Foreign business establishments

Although some CFCs do not meet the requirements of high tax exemption, as discussed above, the compliance team does not automatically include the CFC net income in the group taxable income. As a result, these CFCs are considered for the FBE exemption. With respect to FBE exemption, the compliance team makes use of information gathered in the questionnaire, as well as the CFC data collector tool.

With regards to FBE exemption and with the assistance of the tool, the formulae built into the tool automatically determine that FBE exclusion is applicable where all receipts and accruals of a CFC are attributable to any FBE of that CFC and the CFC did not earn any passive or diversionary income (e.g. royalties, interest, insurance premiums, etc.) which would otherwise be included in the CFC's net income, therefore the net income of that CFC is deemed to be R nil in terms of the proviso (i)(bb) to the definition of "Net income" in section 9D(2A).

FBE exclusion applicable

Section 9D(9A) of the Act has several special provisions that deal with the determination of the net income of the CFC where there are amounts attributable to FBE of a CFC.

In terms of s9D(9A)(a) of the Act, the FBE exclusion does not apply to certain transactions between the CFC and its connected persons. However, the FBE exclusion does apply in the following circumstances:

- In terms of goods supplied (directly or indirectly) by the CFC to a connected SA resident, and in accordance with s9D(9A) (a)(i), provided:
    - The goods are purchased from the unconnected person in the CFC country of residence.
    - CFC adds significant value to the goods.

  - Significant quantity of goods to unconnected persons.
  - Goods that are same or similar are purchased mainly within the CFC country of residence.
- In terms of sale of goods purchased (directly or indirectly) by the CFC from a connected SA resident, and in accordance with s9D(9A)(a)(iA), provided:
  - Goods purchased from the connected SA resident amount to an insignificant value in relation to total goods.
  - CFC adds significant value to the goods.
  - Goods are sold to unconnected persons situated within the CFC country of residence.
  - Goods that are same or similar are purchased mainly within the CFC country of residence.
- In terms of services performed (directly or indirectly) by the CFC to a connected resident, and in accordance with s9D(9A)(a)(ii), provided:
  - Services are performed outside of South Africa.
  - Services performed in marketing or sale of goods to connected SA resident are delivered to non-connected persons within the CFC country of residence.
  - Services performed for a connected SA resident and performed within the CFC country of residence.
  - Services performed to a connected SA resident to the extent that deduction was denied in South Africa.

- Passive income of a CFC in accordance with section 9D(9A)(a)(iii) – (vii).

  Passive income (also referred to as mobile income) will automatically be taxable in terms of s 9D unless specific exemptions are applicable. The FBE exemption applies to passive income, provided it resulted from the following four categories of passive income:
  - Financial instrument income, section 9D(9A)(a)(iii)

  The income from the financial instrument or the amounts attributable to any exchange difference arises from the trading activities of a bank, a financial services provider, or an insurer. As a result, the CFC must conduct more of its principal

trading activities in the country in which its FBE is located than in any other country. The CFC must accept deposits regularly or make loans to clients who are not connected persons. In addition, the amounts derived from the principal trading activities of the CFC with unconnected persons are <50% of the total amounts attributable to the activities of the FBE.

If a connected person who is a resident of the CFC is allowed a deduction of the financial instrument income (including the s24I exchange difference) in the calculation of its taxable income, such financial instrument income will not qualify for the FBE exclusion.

- Rentals of movable property (s9D(9A)(a)(iv)

The FBE exclusion does not apply to the net income of the CFC resulting from the rental of any movable property unless the movable property is leased in terms of an operating lease or the lease constitutes a financial instrument.

- Intellectual property (royalties and capital gains) s9D(9A)(a)(v)

Royalties and capital gains from the sale of intellectual property derived by a CFC are taxable and usually do not qualify for the FBE exclusion. However, if the CFC regularly and directly creates, develops, or substantially upgrades any intellectual property and this intellectual property gives rise to the royalties received or the capital gain so derived, such income will qualify for the FBE exclusion. If the IP constitutes tainted intellectual property (s 23I) had the CFC been a resident, then the FBE exemption will not be available.

- Insurance premiums (s9D(9A)(a)(vii)

Insurance premiums received by a CFC do not qualify for the FBE exclusion unless the CFC's principal trading activity is that of an insurer.

5.3.4 Step 3: Determine CFC net income

Notwithstanding the above discussion that both the voting and participation rights are considered when determining whether a foreign company is a CFC or not, it is noted that when determining the portion of the net income of the CFC that must be included in the income of the South African tax resident, only participation rights are considered.

The net income of a CFC is the taxable income that the CFC has earned during its foreign tax year, calculated in terms of section 9D(2A). The calculation is done at the end of the CFCs foreign tax year.

Translation of foreign currency (s9D(6))

The net income of a CFC must be determined in the functional currency of that CFC. The amount included in the income of any resident will be translated into ZAR at the average exchange rate for the foreign tax year.

- **Income already included in the taxable income of a CFC (s9D(9)(e))**
  Section 9D of the Act will not apply if that income was already subject to tax in SA in the hands of the CFC as a taxpayer in SA.

5.3.5 Step 4: Inclusion of CFC net income in the taxable income

Once the correct portion of the net income amount is determined and converted into South African currency, it is included in the SA resident's income based upon its participation rate (s9D(2).

5.4 Reviews

The financial information, foreign tax computation, questionnaire, SA Tax Pack and completed templates are then submitted for external review as follows.

External auditors are involved in the CFC Tax return process. A formal meeting with the external auditors is set up to arrange the audit timelines, audit scope and CFC processes. The final group structure, with clearly identified CFCs, is shared with the external auditors identify the CFCs that will be included in the audit sample. The reviewed files for CFCs which have been selected by the auditors are then submitted to the external auditors for review. After the external audit review has been completed and any recommended changes by them have been made, the tax computation of the group is updated to include the CFC net income amounts to be imputed in terms of section 9D of the Act.

5.5 Conclusion

The above case study was performed on a multinational enterprise, an organisation that has standardised procedures to ensure an efficient process in order to remain section 9D of the Act compliant. Despite the effort of the organisation, it is evident that to comply with section 9D of the Act is administratively burdensome. A large number of the organisation's CFCs are foreign business establishments, however, as discussed in the final conclusion below, meeting the requirements of foreign business establishments does not necessarily bring relief with respect to the administrative burden for the South African tax residents.

6. CHAPTER 6: Final Conclusion

This chapter summarises the findings of the research study. The aim of this study was to critically examine the notion that CFC rules are not easy to understand. The researcher limited the study to the South African CFC rules perspective.

The motive in setting up the CFC is important. The South African government must be satisfied that a South African tax resident had no motive to gain any tax advantage by setting up a CFC. The South African tax resident must also be able to prove that there was no desire to avoid paying tax in South Africa by the creation of the CFC.

It is evident in this study that there are methods suggested to simplify the complexity of section 9D of the Act. With respect to the high tax exemption method, the South African tax resident must obtain financial information, as mentioned in the above section "information gathering" in chapter 5. The challenges associated with obtaining the financial information from the CFCs, as discussed in chapter 3, are referred. This financial information is necessary to ensure that the CFC net income calculation is determined in accordance with the South African Income Tax Act. This method is administratively burdensome for the South African tax residents.

Section 9D(9) of the Act governs the amounts to be excluded when determining the net income of the CFC. However, the South African tax residents do not know with certainty whether they have to account for the amounts falling within the scope of the section.[133]

Based on the discussion above on FBE exemption, it is evident that if the FBE exemption is relied on as the first choice of methods, it may prove to have some adverse effects in the determination of CFC net income. This is because of the exclusions and provisos contained with respect to the FBE exemption in accordance with section 9D(9A) of the Act. Where the FBE exemption is applicable, because there will be potential imputation, the FBE exemption method becomes unfavourable to apply as the first choice. Therefore, the high-tax exemption can be used as the first choice of method. This is because if South African tax residents meet the requirements of high-tax exemption, the net income

[133] Olivier & Honiball 2011:580

attributable to CFC will be deemed to be R nil and no imputation is required at all. If South African tax residents do not meet the requirements of the high tax exemption, the FBE exemption will be the next method to follow.

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