SCHOOL OF ACCOUNTANCY

University of Witwatersrand, Johannesburg

A research report to be submitted to the Faculty of Commerce, Law and Management in the partial fulfilment of the requirements for the degree of Master of Commerce (Specilaising in Taxation)

A critical analysis of the foreign business establishment exemption and its role in the prevention of base erosion and profit shifting

Abstract

Section 9D of the Income Tax Act 58 of 1962 sets out the controlled foreign companies rules. This section contains anti-avoidance provisions that seek to prevent South African tax residents shifting their taxable income to foreign countries by way of a controlled foreign company. In terms of section 9D the net income of controlled foreign companies is taxed in the hands of the South African residents in proportion or their shareholding, unless the amount is subject to one of the specific exemptions. One such exemption is the foreign business establishment exemption. This exemption has been criticised as the definition of foreign business establishment is not adequate. The criticism arises from the fact that many controlled foreign companies meet the definition of a foreign business establishment by default even though they do not constitute a bona fide foreign business establishment. This paper critically evaluates this exemption considering the OECD BEPS Pillar Two Rules, the Income Tax Act 58 of 1962 and the Mauritian and UAE substance standards and whether the rules of this exemption should be more specific and stringent.

The substance standards were found to be more stringent in comparison to the FBE definition and therefore enhanced the FBE definition. The scope of the Pillar Two blueprint meant that many South African companies would more likely than not be scoped out of its realms and therefore would not assist in enhancing the FBE definition.

Key words: Controlled foreign company, Resident, Foreign business establishment, Exemption, OECD, Base erosion and profit shifting, Anti-avoidance, Tax avoidance, Substance standards, Multinational Enterprises

Declaration

I declare that this research report is my own work. It is submitted in the partial fulfilment for the Masters in Commerce (specialising in Taxation) degree at the University of Witwatersrand in Johannesburg. It has not been submitted before for any other degree or examination at any other university.

Acknowledgments

I would like to Praise God without whom this would not have been possible. My parents, husband and daughter for their support and sacrifices made in order to get me to this point and my supervisor Reinhard, who continued to encourage me throughout the process.

List of acronyms and abbreviations

CFC	Controlled foreign company
FBE	Foreign business establishment
MNE	Multinational enterprise
ITA	Income Tax Act 58 of 1962
BEPS	Base erosion and profit shifting
OECD	Organisation for Economic Co-operation and Development
SARS	South African Revenue Service

Table of Contents

Abstract *2*

Declaration *3*

List of acronyms and abbreviations *5*

Chapter 1: *8*

Introduction: **8**

The research problem **13**

The sub-problems **14**

Research methodology **14**

Chapter 2: Review of the controlled foreign company provisions as set out in the Income Tax Act 58 of 1962 .... *15*

Chapter 3: A critical analysis of the foreign business establishment exemption and its role in preventing base erosion and profit shifting. *32*

CFC Rules **32**

Foreign business establishment in the context of Section 9D of the ITA **33**

Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd: **43**

Commentary on the draft strengthening the CFC rules report **47**

Chapter 4: Examination of the new substance standards imposed by UAE and Mauritius. *50*

Introduction of substance standards **50**

Mauritius: **55**

United Arab Emirates: **61**

Chapter 5: The impact of the substance standards imposed by the UAE and Mauritius on the foreign business establishment definition and exemption as set out in section 9D of the Income Tax Act. *64*

Mauritius: **66**

United Arab Emirates: **73**

Chapter 6: An examination of the impact of the new OECD Blueprints on the foreign business establishment exemption. ***79***

Chapter 7: Conclusion ***94***

Reference list ***96***

Chapter 1:

Introduction:

The international tax rules were developed in a past era, rendering them largely outdated in the current economic landscape. International tax has become a topical issue across the globe, as many markets and economies have become more integrated and globalisation of companies has become more prevalent. If these rules aren't updated, opportunities will be created for taxpayers to shift profits to lower tax jurisdictions and erode the tax base of their resident country. This places significant importance on modernising international tax rules to ensure that they reflect the current economic environment and that the profits earned by companies reflect their economic activity in the countries they are resident in.[1]

In February 2013, the Organisation for Economic Co-operation and Development (OECD) released a report entitled *Addressing Base Erosion and Profit Shifting.* Subsequently, a 15-Point Action Plan was adopted by all OECD and G20 countries in September 2013 to address Base Erosion and Profit Shifting (BEPS). This 15-Point Action Plan is based on three pillars, being:

> "*introducing coherence in the domestic rules that affect cross-border activities, reinforcing substance requirements in the existing international standards, and improving transparency as well as certainty".*[2]

Action 3 of the 15-Point Action Plan consists of "Designing effective controlled foreign company rules". Controlled foreign companies (CFCs) create the opportunity for BEPS.

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[1] OECD, 2015. *Designing Effective Controlled Foreign Company Rules, Action 3-2015 Final Report, p3* [Online]. Available: https://www.oecd-ilibrary.org/docserver/9789264241152-en.pdf?expires=1676447590&id=id&accname=guest&checksum=D42E7C697A3960839FEAF60220469B61 [2023, February, 15].

[2] OECD, 2015. *Designing Effective Controlled Foreign Company Rules, Action 3-2015 Final Report, p3* [Online]. Available: https://www.oecd-ilibrary.org/docserver/9789264241152-en.pdf?expires=1676447590&id=id&accname=guest&checksum=D42E7C697A3960839FEAF60220469B61 [2023, February, 15].

This is because resident taxpayers can obtain a controlling interest in a foreign company, the profits of which will be taxed in the foreign company's resident jurisdiction. The residents who have a controlling interest in the entity will not be subject to taxes on these profits. This allows for profit shifting and the long-term deferral of taxation in the absence of rules to address this risk.[3]

From a South African perspective, section 9D of the Income Tax Act 58 of 1962 (ITA) governs the rules of controlled foreign companies (CFCs). In terms of section 9D(1) of the ITA, CFCs are foreign companies in which South African tax residents have a majority shareholding, either alone or collectively. The net income derived by these companies, despite being the income of the foreign company, will be taxed in the hands of the South African tax residents in proportion to their participation rights in accordance with section 9D(2) of the ITA. In terms of National Treasury's Detailed Explanation to section 9D of the Income Tax Act, [4] the rationale behind the CFC rules of section 9D of the ITA is to prevent the deferral of tax through South African owned foreign entities. International law allows South Africa to tax non-residents on their South African source income. It does not, however, allow South Africa to tax foreign entities on their foreign source income even if South African residents hold a majority shareholding, thereby owning the entity.[5]

There are two instances in which the net income of a CFC is deemed to be nil and, therefore, no inclusion of section 9D will be taken into account in the taxable income of the resident that holds participation rights in the CFC. This essentially means that the CFC rules would not be applicable if the requirements for one of these exclusions have

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[3] OECD, 2015. *Designing Effective Controlled Foreign Company Rules, Action 3-2015 Final Report ,p9* [Online]. Available: https://www.oecd-ilibrary.org/docserver/9789264241152-en.pdf?expires=1676447590&id=id&accname=guest&checksum=D42E7C697A3960839FEAF60220469B61 [2023, February, 15].

[4] National Treasury, 2002. *National Treasury's Detailed Explanation to Section 9D of the Income Tax Act, p.1* [Online]. Available: https://www.treasury.gov.za/divisions/tfsie/tax/legislation/Detailed%20Explanation%20to%20Section%209D%20of%20the%20Income%20Tax%20Act.pdf [2023, February 15].

[5] National Treasury 2002. *National Treasury's Detailed Explanation of Section 9D of the Income Tax Act, p. 1* [Online]. Available: https://www.treasury.gov.za/divisions/tfsie/tax/legislation/Detailed%20Explanation%20to%20Section%209D%20of%20the%20Income%20Tax%20Act.pdf [2023, February 09].

been met. In terms of the section 9D(2A) second proviso (i)(aa) of the ITA, the net income of the CFC is deemed to be nil where

> *"the aggregate amount of taxes on income payable to all spheres of government of any country other than the Republic by the controlled foreign company in respect of the foreign tax year of that controlled foreign company is at least 67.5% of the amount of normal tax that would have been payable in respect of any taxable income of the controlled foreign company had that controlled foreign company been a resident for that foreign tax year."*

The second exemption is the foreign business establishment exemption, as set out in the second proviso (i)(bb) to section 9D(2A). This exemption states that the net income of the CFC in respect of the foreign tax year shall be deemed to be nil where the receipts and accruals of the company are attributable to a foreign business establishment (FBE) as defined in section 9D(1). The definition of a foreign business establishment is set out in section 9D(1) of the ITA as:

> "*a company with a fixed place of business located in a country other than the Republic that is used or will continue to be used for the carrying on of the business of the CFC for a period of not less than one year."*

This definition follows the options for substance analysis as set out in the *BEPS Action 3: Strengthening the CFC Rules* issued by the OECD. In this report the OECD states that an option in designing a substance analysis test for jurisdictions, is to consider whether the CFC has the necessary business premises and establishment in the CFC jurisdiction and the necessary number of employees with the required skill to conduct the activities of the business.[6]

[6] OECD, 2015. *Designing Effective Controlled Foreign Company Rules, Action 3-2015 Final Report ,p48* [Online]. Available: https://www.oecd-ilibrary.org/docserver/9789264241152-en.pdf?expires=1676447590&id=id&accname=guest&checksum=D42E7C697A3960839FEAF60220469B61 [2023, February, 15].

The substance analysis options set out in the BEPS Action 3 Report, and, by extension, the concept of a foreign business establishment, has been criticised for being too narrow.[7]

According to Olivier and Honiball, the FBE exemption is one of the most complicated provisions in the ITA. The exemption aims to strike a balance between exempting income from legitimate offshore entities and that of entities set for non-substantive undertakings[8]. From this it is evident that the FBE exemption may be taken advantage of and can erode the tax base of South Africa. This could result in large multinational entities shifting profits of non-substantive undertakings offshore to pay less tax causing the South African tax base to suffer.

The definition of the FBE lacks scope and specificity. Its application is also dependent on the nature of the business to define the facilities, equipment and people needed. This creates subjectivity. The subjectivity opens the definition up to interpretation[9]. This could result in many taxpayers taking advantage of the FBE exemption as specificity does not exist. It could also result in differences of opinions when applying these provisions between SARS and taxpayers resulting in disputes. This paper aims to discuss this exemption and the challenges created by it for South African tax residents and SARS as well as its role in base erosion and profit shifting (BEPS).

Mauritius and Dubai have introduced substance standards with the purpose of ensuring that the profit earned by a foreign company is proportionate in size and nature to the activities that the entity undertakes in the foreign country in which the company is resident.[10]

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[7] OECD 2015.
Comments received on Public Discussion draft BEPS Action 3: Strengthening CFC rules p234, para 9 [Online]. Available:]https://www.oecd.org/tax/aggressive/public-comments-beps-action-3-strengthening-cfc-rules-part1.pdf [2023, February 13].
[8] Olivier, L. & Honiball, M. 2011. *International Tax: A South African Perspective 5th Edition, p. 581.* Cape Town: Siber Ink.
[9] Tickle, D. 2022. Controlled Foreign Companies and the Future of the Foreign Business Establishment Exemption. *Tax Talk* 2022 (96): 40-43.
[10] Deloitte 2019. *New economic substance rules introduced by "tax havens" brought into force from 1 January 2019* [Online]. Available:

The Dubai and Mauritius substance standards may have the ability to work in harmony with the FBE exemption of SA. Both Mauritius and Dubai are jurisdictions that have been identified by the European Union Code of Conduct Group as jurisdictions with no or nominal tax[11] i.e., low tax jurisdictions and these standards may ensure that legitimate foreign companies are set up in Dubai and Mauritius, and that the profits of these entities match the activities of these entities in the country they are resident in. This may prevent residents from setting up FBEs simply to take advantage of the exemption as the substance requirements add an additional layer of conditions to be met in setting up the foreign company in Dubai and Mauritius.

Consideration should also be given to whether the substance requirements that have been implemented by Mauritius and Dubai enhance the section 9D provisions of the ITA to ensure that only bona fide FBEs are taking advantage of the section 9D FBE exemption.

The OECD released a framework to address the new challenges faced with regards to digitalisation from an international tax perspective. The OECD recognises that in this new economic environment, digitisation has become more popular which means that the tax rules need to keep up with these changes to ensure that they remain relevant. This framework is known as the *OECD/G20 Inclusive Framework on BEPS: The Reports on the Blueprints of Pillar One and Pillar Two*.[12]

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https://www2.deloitte.com/content/dam/Deloitte/xe/Documents/tax/me_new-economic-substance-rules-introduced.pdf [2023, February 20].

[11] Deloitte 2019. *New economic substance rules introduced by "tax havens" brought into force from 1 January 2019* [Online]. Available: https://www2.deloitte.com/content/dam/Deloitte/xe/Documents/tax/me_new-economic-substance-rules-introduced.pdf [2023, February 20].

[12] OECD 2020. *Tax Challenges Arising from Digitalisation- Report on Pillar One Blueprint, p. 7* [Online]. Available: https://read.oecd-ilibrary.org/taxation/tax-challenges-arising-from-digitalisation-report-on-pillar-one-blueprint_beba0634-en#page9 [2023, February 15].

The Two Pillars are a consensus-based solution. Pillar One focuses on "nexus and profit allocation and Pillar Two focuses on a global minimum tax intended to address remaining BEPS issues".[13]

The OECD BEPS Pillar Two Blueprint will impose a 15% minimum tax rate on all multi-national entities (MNE) with a consolidated group revenue of at least EUR 750 million from 2023.[14]

This may act as an enhancement to the current CFC rules and FBE exemption by imposing a minimum tax on all in scope entities in every country that they operate in. This forces FBEs that are set up to be liable for a minimum tax of 15% rendering the setting up of a FBE simply to take advantage of the FBE exemption less appealing as a minimum tax is still to be imposed on the FBE in all countries that the entity operates in.

This research also aims to consider whether the OECD Blueprints and the substance standards of Mauritius and Dubai aid in enhancing the FBE exemption or if they are merely superficial in nature and add no value in enhancing the local standards.

The research problem

This research will critically evaluate the controlled foreign company rules as a deterrent for base erosion and profit shifting by tax residents of South Africa, with particular focus on the foreign business establishment exemption.

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[13] OECD 2020. *Tax Challenges Arising from Digitalisation- Report on Pillar One Blueprint, p. 7* [Online]. Available: https://read.oecd-ilibrary.org/taxation/tax-challenges-arising-from-digitalisation-report-on-pillar-one-blueprint_beba0634-en#page9 [2023, February 15].

[14] OECD 2021. *OECD releases Pillar Two model rules for domestic implementation of 15% global minimum tax*. 2021 [Online]. Available: https://www.oecd.org/newsroom/oecd-releases-pillar-two-model-rules-for-domestic-implementation-of-15-percent-global-minimum-tax.htm [2023, February 1].

The sub-problems

To answer the primary research problem, the following sub-problems need to be addressed:

i. The first sub-problem involves determining what the CFC rules are in South Africa and how these entities are to be taxed from a South African perspective as well as any exemptions to these rules.

ii. The second sub-problem is to critically evaluate the foreign business establishment exemption and its role in preventing base erosion and profit shifting.

iii. The third sub-problem is to examine the new substance standards imposed by Dubai and Mauritius to determine if these standards aid in the prevention of the exploitation of the foreign business establishment exemption and whether they enhance local standards of the foreign business establishment exemption.

iv. The fourth sub-problem is to examine the impact of the OECD Blueprints on the foreign business establishment exemption and whether these blueprints may reduce the exploitation of the foreign business establishment exemption or not.

Research methodology

This study is qualitative in nature and is carried out by way of a literature review. The main sources that will be analysed will be South African tax legislation, case law, journal articles of tax experts in published journals, OECD guidelines and international law and substance standards, where applicable.

Chapter 2: Review of the controlled foreign company provisions as set out in the Income Tax Act 58 of 1962

In the sphere of international tax, a distinction is made between two types of investments, namely, direct investment and portfolio investment. Direct investment refers to investments in which an investor has a large enough stake in a company to influence the operations of the company, while portfolio investment refers to investments whereby an investor does not have such influence.[15] It is the direct investment, without anti-avoidance provisions, that poses a risk to the South African tax base. This is because earning foreign income in the name of a separate taxpayer may prove to reap many tax benefits such as the deferral of taxes on that income. It is in this context that the controlled foreign company rules are pertinent.[16]

Section 9D of the ITA sets out the provisions for controlled foreign companies. This section was introduced in the ITA in 2001 as part of South Africa's shift to a "residence minus" tax system. This move to a "resident-minus" tax system stemmed from an effort to reduce South African tax rates by widening the South African tax base. This system was introduced by the Minister of Finance in the Revenue Laws Amendment Act 59 of 2000.[17] The South African tax base was not as wide as it could have been because, under the "source plus" tax system only South African source income was taxed with a limited number of foreign source items being taxed as well. Under the "resident-minus" tax system, taxes are imposed on worldwide income with a limited category of foreign income not being taxed under this system.[18] The current system therefore widens the South

[15] Olivier, L. & Honiball, M. 2011. International tax: A South African perspective, 5th ed., *p.559*. Cape Town: Siber Ink CC.
[16] Olivier, L. & Honiball, M. 2011. International tax: A South African perspective, 5th ed*., p.559*. Cape Town: Siber Ink CC.
[17] National Treasury 2002. *National Treasury's Detailed Explanation of Section 9D of the Income Tax Act, p. iii* [Online]. Available: https://www.treasury.gov.za/divisions/tfsie/tax/legislation/Detailed%20Explanation%20to%20Section%209D%20of%20the%20Income%20Tax%20Act.pdf [2023, February 06].
[18] National Treasury 2002. *National Treasury's Detailed Explanation of Section 9D of the Income Tax Act, p. iii* [Online]. Available: https://www.treasury.gov.za/divisions/tfsie/tax/legislation/Detailed%20Explanation%20to%20Section%209D%20of%20the%20Income%20Tax%20Act.pdf [2023, February 06].

African tax base as more types and streams of income would be subject to South African tax and not only South African source income.

The reason for the CFC rules is for them to act as anti-avoidance provisions which prevent taxpayers with interests in foreign companies from shifting profits into a CFC, thereby stripping the tax base of their resident country.[19] Oftentimes these foreign entities are set up in a low tax jurisdiction and therefore the CFC rules specifically target these types of foreign investments.[20]

The aim of the CFC rules is for them to act as a deterrent, rather than to raise income tax on CFCs. The objective of these rules is to ensure that the profits earned by foreign companies remain within the tax base of the country of residence of the ultimate person holding a majority interest in the company, thereby preventing taxpayers from shifting profits into these CFCs to avoid paying taxes in their resident jurisdiction.[21]

It is important to note that the purpose of the CFC rules is anti-avoidance in respect of taxpayers diverting funds to CFCs to avoid paying taxes in South Africa and not to harm the South African international competitiveness. A balance needs to be struck with regards to the provisions of this section.[22] The CFC legislation needs to remain globally competitive while also protecting the tax base of the country. By making the CFC rules too rigid, this may pose a risk that taxpayers would find it too cumbersome to apply and

[19] OECD 2015. *Designing Effective Controlled Foreign Company Rules, Action 3-2015 Final Report, p. 16* [Online]. Available: https://www.oecd-ilibrary.org/docserver/9789264241152-en.pdf?expires=1675681175&id=id&accname=guest&checksum=4C850D2BEACE677D001B2D9B6B5C0846 [2023, February 06].

[20] Davis Tax Committee. *Summary of DTC Report on OECD Action 3: Strengthening Controlled Foreign Company Rules Annexure 3* [Online]. Available: https://www.taxcom.org.za/docs/New_Folder3/5%20BEPS%20Final%20Report%20-%20Action%203.pdf [2023, February 28].

[21] OECD 2015. *Designing Effective Controlled Foreign Company Rules, Action 3-2015 Final Report, p. 13* [Online]. Available: https://www.oecd-ilibrary.org/docserver/9789264241152-en.pdf?expires=1675681175&id=id&accname=guest&checksum=4C850D2BEACE677D001B2D9B6B5C0846 [2023, February 06].

[22] National Treasury 2002. *National Treasury's Detailed Explanation of Section 9D of the Income Tax Act, p. iii* [Online]. Available: https://www.treasury.gov.za/divisions/tfsie/tax/legislation/Detailed%20Explanation%20to%20Section%209D%20of%20the%20Income%20Tax%20Act.pdf [2023, February 06].

comply with these rules. This may result in them giving up tax residency in South Africa for a country where the tax laws are easier to comply with and are more favourable.[23] This would hurt the South African tax base.

Section 9D therefore makes provision for exemptions to these rules, as many companies may meet the definition of a CFC but undertake legitimate business activities offshore or may already be highly taxed. Imposing section 9D in these instances may stifle international competitiveness.

Accordingly, section 9(2) states that the net income of the CFC is to be included in the taxable income of the resident that holds voting rights or participation rights in the CFC in proportion to their participation rights unless there is an exemption available that deems net income to be in nil in terms of section 9D(2A) second proviso (i).

A natural person is a resident of South Africa for tax purposes as defined in section 1 of the ITA as a person who is ordinarily a resident of South Africa or by way of the physical presence test. 'Ordinarily resident' is not defined in the ITA and therefore case law must be referred to for further guidance in this regard. Residents are taxed on worldwide income in terms of the gross income definition in section 1 of the ITA.

In terms of the gross income definition in section 1 of the ITA, South African residents are taxed on worldwide income. This is in accordance with South Africa's policy of applying a residency-based tax system. It is therefore imperative that the residency of taxpayers is established to determine what constitutes local income and foreign income.

In terms of section 1 of the ITA, a foreign company is defined as a company that is not a resident. Section 1 of the ITA defines a resident as a person:

[23] Olivier, L. & Honiball, M. 2011. International tax: A South African perspective, 5th ed., *p.559*. Cape Town: Siber Ink CC.

> *"… (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic."*

Section 9D(1) defines a CFC as any foreign company:

> *"where more than 50 percent of the total participation rights in that foreign company are directly or indirectly held, or more than 50 per cent of the voting rights in that foreign company are directly or indirectly exercisable, by one or more persons that are residents other than persons who are headquarter companies: Provided that-*
>
> *(a) No regard must be had to any voting rights in any foreign company-*
>   - *(i) Which is a listed company; or*
>   - *(ii) If the voting rights in that foreign company are exercisable indirectly through a listed company.*
>
> *(b) Any voting rights in a foreign company which can be exercised directly by any other controlled foreign company in which that resident (together with any connected person in relation to that resident) can directly or indirectly exercise more than 50 per cent of the voting rights are deemed for the purposes of this definition to be exercisable directly by that resident.….."*

It is important to note that the first requirement for a company to meet the definition of a CFC and be classified accordingly, is that the company needs to be a foreign company. This means that if a company is effectively managed in South Africa, that company would not be a CFC as it would meet the definition of a resident as set out in section 1 of the ITA.

Participation rights are defined in section 9(1) as:

> *(a) "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; or*

> (b) *In the case where no person has any right in that foreign company as contemplated in paragraph (a) or no such rights can be determined for any person, the right to exercise voting rights in that company; and…"*

Participation rights comprise shares that represent equity share capital as well as well other forms of share such as non-participating preference shares. The benefits enjoyed with regards to participation rights would be rights to profits and capital of the entity.[24]

Simply put, this definition includes all rights of shareholders, whether in the form of equity shares or non-participating preference shares, to the profits and capital of the foreign company. [25] If a person does not have any participation rights as mentioned above, then the participation rights would be equivalent to the voting rights exercisable by that person in the foreign company.

The abovementioned definition is very broad, as to prevent South African taxpayers from entering into convoluted share arrangements aimed at preventing section 9D from being applicable.[26]

It is also noted that for the purpose of the participation rights definition set out in terms of section 9D(1), where that are no participation rights held then participation rights are deemed to be equal to the voting rights. This makes voting rights an alternative test to participation rights.[27]

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[24] National Treasury 2002. *National Treasury's Detailed Explanation of Section 9D of the Income Tax Act, p. 3* [Online]. Available: https://www.treasury.gov.za/divisions/tfsie/tax/legislation/Detailed%20Explanation%20to%20Section%209D%20of%20the%20Income%20Tax%20Act.pdf [2023, February 15].
[25] National Treasury 2002. *National Treasury's Detailed Explanation of Section 9D of the Income Tax Act, p. 3* [Online]. Available: https://www.treasury.gov.za/divisions/tfsie/tax/legislation/Detailed%20Explanation%20to%20Section%209D%20of%20the%20Income%20Tax%20Act.pdf [2023, February 15].
[26] National Treasury 2002. *National Treasury's Detailed Explanation of Section 9D of the Income Tax Act, p. 3* [Online]. Available: https://www.treasury.gov.za/divisions/tfsie/tax/legislation/Detailed%20Explanation%20to%20Section%209D%20of%20the%20Income%20Tax%20Act.pdf [2023, February 15].
[27] Olivier, L. & Honiball, M. 2011. International tax: A South African perspective, 5th ed., *p.567*. Cape Town: Siber Ink CC.

Section 9D(1)(a) further states that no regard is given to voting rights in a foreign company that is a listed company or if the voting rights in that foreign company are exercisable indirectly through a listed company.

The reason for this is because in the definition of participation rights as set out in section 9D, states that voting rights should only be considered when a person does not have any participation rights or cannot determine the participation rights in that foreign company (an alternative test). In the context of a listed company, it is highly unlikely that the rights of shareholders would not be clearly defined.[28]

Section 9D(1)(b) states that any voting rights in a foreign company exercisable by another CFC in which a resident, together with connected persons, holds more than 50 percent of the voting rights are deemed to be exercisable by that resident.

The abovementioned provision was added to the definition of a CFC in 2017 under the Taxation Laws Amendment Bill, 2017. This addition came about after concern raised by the government that taxpayers were using interposed trusts to foundations to conceal the link between the South African resident and the foreign company which would have been a CFC in the absence of the trust or foundation.[29]

This addition essentially states that any foreign company in which its financial results are reflected in the consolidated financial statements, in terms of IFRS 10, of a South African resident, will be a CFC.[30]

The reason for this is because voting rights do not dilute with indirect shareholdings while participation rights do. In terms of IFRS 10, control is a basis for consolidation[31] which

[28] Olivier, L. & Honiball, M. 2011. International tax: A South African perspective, 5th ed., *p.567.* Cape Town: Siber Ink CC.
[29] Taxation Laws Amendment Bill, 2017
[30] Taxation Laws Amendment Bill, 2017
[31] Taxation Laws Amendment Bill, 2017

means if a South African resident taxpayer has more than 50 per cent of the voting rights in a foreign company (foreign company 1) and that foreign company has more than 50 per cent of the voting rights in another foreign company (foreign company 2), both foreign companies would be deemed to be CFCs per section 9D(1)(b). This is because the South African tax residents who control foreign company 1 through more than 50 per cent of the voting rights, they essentially control foreign company 2 as foreign company 1 has more than 50 per cent of the voting rights in it. Both companies would therefore be CFCs.

Per Section 9D(1)(c), a person is not deemed to be a resident, when determining whether residents hold more than 50 percent of the voting or participation rights, if:

(i) *"In the case of a listed or foreign company, the participation rights held by that person indirectly through a listed company are less than 5 percent of the participation rights of that listed company; or*

(ii) *In the case of a collective investment scheme or a foreign company, the participation rights held and the voting rights exercisable in that scheme is less than 5 percent of the scheme or arrangement (Section 9D (1)(c)(ii)(aa)(bb)*

Unless more than 50 per cent of the voting rights are exercisable or participation rights held, are held by persons who are connected persons to each other."

Section 9D(1)I(i) was added in The Second Revenue Laws Amendment Act in 2001 as an exception to the general rule for listed foreign companies and foreign trusts. The reason for this exception is a practical one as it aims to avoid tracking problems as in many jurisdictions disclosure of shareholders in larger entities are limited to shareholders with a shareholding of at least 5 per cent.[32]

The practical effect of section 9D(1)(c)(ii) is that if there is a collective investment scheme held offshore and a resident is able to exercise less than 5 per cent of the voting rights or

[32] National Treasury 2002. *National Treasury's Detailed Explanation of Section 9D of the Income Tax Act, p. 5* [Online]. Available: https://www.treasury.gov.za/divisions/tfsie/tax/legislation/Detailed%20Explanation%20to%20Section%209D%20of%20the%20Income%20Tax%20Act.pdf [2023, February 15].

has less than 5 per cent of the participation rights that resident would not be deemed a resident and therefore section 9D would not be applicable in respect of the offshore collective investment scheme of that resident. The reason for this exclusion is the same as the one in section 9D(1)(c)(i) which is to reduce the administrative burden of determining the identify of shareholders in larger-scale entities who hold less than 5 per cent of the shares.[33]

Section 9D(1)(c) is not applicable if more than 50 per cent of the voting or participation rights are held by connected persons. This caveat is aimed at preventing economically related parties from each owning less than 5 per cent in order avoid the more than 50 per cent threshold set out in section 9D(1) definition of a CFC.[34]

In terms of section 9D(2)(a)(i), the income for the year of assessment of any resident who directly or indirectly holds any participation rights in a CFC shall include, on the last day of the foreign tax year of the CFC, if the CFC has been a CFC for the entire foreign tax year, an amount equal to the net income of the CFC in proportion to the participation rights held by that resident.

Section 9D(2)(a)(ii) goes on further to state that where a foreign company became a CFC during any stage of the foreign tax year, the resident may elect to either:

> *"(aa) include in their taxable income their share of the net income in proportion to their participation rights apportioned for the number of days the company was a CFC to the number of days in the foreign tax year or;*

[33] Olivier, L. & Honiball, M. 2011. International tax: A South African perspective, 5th ed., *p.569*. Cape Town: Siber Ink CC.
[34] National Treasury 2002. *National Treasury's Detailed Explanation of Section 9D of the Income Tax Act, p. 5* [Online]. Available: https://www.treasury.gov.za/divisions/tfsie/tax/legislation/Detailed%20Explanation%20to%20Section%209D%20of%20the%20Income%20Tax%20Act.pdf [2023, February 15].

(bb) include in their taxable income their share of the total net income in proportion to their participation rights from the day the foreign company became a CFC to the end of the foreign tax year."

This apportionment ensures that only the net income of the CFC for the duration that the company has been a CFC during the foreign tax year, will be included in the taxable income of the residents who individually or collectively have more than 50 per cent of the voting or participation rights. The taxpayer would likely elect the lower of the two amounts as this would be the most tax beneficial.

Section 9D(2)(A) of the ITA states that, there shall be no inclusion of the net income of a CFC in the taxable income of a resident, where a resident together with other connected persons holds less than 10 percent of the participation rights and may not exercise at least 10 percent of the voting rights of that CFC. In terms of section 9D(2)(b)(B) the same holds true if the participation rights are held indirectly by a resident through a resident company.

The reason for this is to exclude minority shareholders who do not have a say in the affairs of the company from having to include the net income of the CFC in their taxable income. [35]

The net income of a CFC in respect of the foreign tax year is defined, in section 9D(2A) as the taxable income of the CFC determined in:

"accordance with the provisions of this Act as if the controlled foreign company had been a taxpayer, and as if that company had been a resident for the purposes of the definition of gross income, sections 7(8), (10)(1)(h), 25Band paragraphs 2(1)(a), 24, 70, 71,72 and 80 of the Eighth Schedule."

[35] National Treasury 2002. *National Treasury's Detailed Explanation of Section 9D of the Income Tax Act, p. 5* [Online]. Available: https://www.treasury.gov.za/divisions/tfsie/tax/legislation/Detailed%20Explanation%20to%20Section%209D%20of%20the%20Income%20Tax%20Act.pdf [2023, February 15].

This provision in essence means that all provisions of the ITA will be applicable to the CFC when determining its net income including the provisions set out specifically in section 9D(2A) as stated above. This provision is, however not without its provisos.

In terms of section 9D(2A)(a), any deductions, allowances or set-offs against income of the CFC will be limited to the amount of such income. This means that the deductions or allowances cannot create a negative net amount but can only net off to nil. This proviso exists because South African tax residents cannot use the assessed losses of foreign companies against their taxable income.

The amount by which the deductions or allowances exceed the amount of income can be carried forward to the succeeding foreign tax year and be deemed to be a balance of assessed loss to be set off against the income of the CFC in the succeeding foreign tax year for the purposes of section 20, in terms of section 9D(2A)(b). This provision aims to protect the South African tax base from erosion by ensuring that the assessed loss is ring-fenced and can only be used against the CFC's future taxable income and not that of the South African tax resident.[36]

Section 9D(2A)(c) of the ITA states that, there shall be no deduction allowed for:

(i) "Interest, royalties, rental, insurance premium or income of a similar nature which is paid or payable or deemed to be paid or payable by that company to any other controlled foreign company (including any amount adjusted in terms of Section 31 [of the ITA].

[36] Olivier, L. & Honiball, M. 2011. International tax: A South African perspective, 5th ed., *p.576.* Cape Town: Siber Ink CC.

(ii) Exchange differences determined in terms of section 24I [of the ITA in respect of any exchange item to which that company and any other controlled foreign company are parties

(iii) *Exchange differences in respect of any forward exchange contract or foreign currency option contract entered into to hedge the item referred or in subparagraph (ii); or*

(iv) Reduction or discharge by that company of a debt owed to that company by any other controlled foreign company for no consideration or for consideration less than the amount by which the face value of the debt that has been so reduced or discharged

where that controlled foreign company and that other controlled foreign company form part of the same group of companies, unless that interest, rental, royalty, insurance premium, other income, adjusted amount, exchange difference, reduction or discharge is taken into account to determine the net income of that other controlled foreign company".

Section 9D(9)(fA) states that when determining the net income of a CFC in terms of subsection (2A) there must not be taken into account any amount which-

Is attributable to-

(i) "Interest, royalties, rental, insurance premium or income of a similar nature which is paid or payable or deemed to be paid or payable by that company to any other controlled foreign company (including any amount adjusted in terms of section 31 [of the ITA]

(ii) Exchange differences determined in terms of section 24I [of the ITA] in respect of any exchange item to which that company and any other controlled foreign company are parties

(iii) *Exchange differences in respect of any forward exchange contract or foreign currency option contract entered into to hedge the item referred or in subparagraph (ii); or*

(iv) *Reduction or discharge by that company of a debt owed to that company by any other controlled foreign company for no consideration or for consideration less than the amount by which the face value of the debt that has been so reduced or discharged*

where that controlled foreign company and that other controlled foreign company form part of the same group of companies".

The purpose of section 9D(9)(fA) is to allow South African multinational entities to utilise finance or foreign treasury subsidiaries as a tax-free means to channel group loans, leases, and licenses. These types of structures allow a group to obtain financing within a single administrative structure thereby creating opportunities for reduced group rates.[37]

It is noted from the abovementioned provisions that section 9D(2A)(c) states that no deductions are allowed for the items listed above when the amounts relate to transactions between CFCs within the same group. Conversely section 9D(9)(fA) states that no amount of the items listed above shall be included when determining the net income of a CFC when the amounts relate to transactions between CFCs within the same group.

It is therefore noted that section 9D(2A)(c) should be read together with Section 9D(9)(fA) as these rules work in harmony to prevent an artificial mismatch of deductible payments and receipts not included between companies within the same group. [38]

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[37] National Treasury 2002. *National Treasury's Detailed Explanation of Section 9D of the Income Tax Act, p. 22* [Online]. Available: https://www.treasury.gov.za/divisions/tfsie/tax/legislation/Detailed%20Explanation%20to%20Section%209D%20of%20the%20Income%20Tax%20Act.pdf [2023, February 15].

[38] National Treasury 2002. *National Treasury's Detailed Explanation of Section 9D of the Income Tax Act, p. 22* [Online]. Available:

Where a foreign company becomes a CFC after 1 October 2001, the valuation date for the purposes of determining the taxable capital gain or loss in terms of the Eighth Schedule will be the day before the company becomes a CFC as set out in section 9D((2A)(e).

Where the resident of whom the net income of the CFC is to be included in their taxable income is a natural person, special trust or insurer in respect of its individual policyholder fund, the taxable capital gain of the CFC will be 40 per cent of the net capital gain for the purposes of paragraph 10 of the Eighth Schedule for the relevant foreign tax year.

There are exemptions to the CFC rules aimed at excluding entities that pose little risk of base erosion and profit shifting. These exemptions also assist in the prevention of stiffing global competitiveness. By introducing these exemptions, the CFC rules become more targeted and effective and reduce the overall administrative burden by ensuring that certain companies are not affected by the CFC rules.[39] In South Africa, this mainly takes the form of the 'highly taxed' exclusion and the 'foreign business establishment' exclusion.

The second proviso (i)(aa) to section 9D(2):

> *"that the net income of the controlled foreign company for the foreign tax year shall be deemed to be nil where the aggregate amount of taxes payable to all spheres of government of any country other than the Republic by the controlled foreign company in respect of the foreign tax year of that controlled foreign company is at least 67.5 per cent of the amount of normal tax that would have been payable in respect of taxable income of the controlled foreign company has the controlled*

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https://www.treasury.gov.za/divisions/tfsie/tax/legislation/Detailed%20Explanation%20to%20Section%209D%20of%20the%20Income%20Tax%20Act.pdf [2023, February 15].

[39] OECD 2015. *Designing Effective Controlled Foreign Company Rules, Action 3-2015 Final Report, p. 33* [Online]. Available: https://www.oecd-ilibrary.org/docserver/9789264241152-en.pdf?expires=1675681175&id=id&accname=guest&checksum=4C850D2BEACE677D001B2D9B6B5C0846 [2023, February 06].

foreign company had the controlled foreign company been a resident for that foreign tax year..”

This exemption is often referred to as the highly taxed exemption [40] and demonstrates that a CFC which is already highly taxed in countries other than the Republic would pose a low risk to base erosion and profit shifting as the CFC is already paying a high percentage of taxes.

The other exemption which deems net income of the CFC to be nil is stated in Section 9D(2) second proviso (i)(bb) of the ITA and reads as follows:

“all receipts and accruals of the controlled foreign company are –

(i) Attributable to any foreign business establishment of that controlled foreign company as contemplated in subsection (9|)(b); and

(ii) Not required to be taken into account in terms of subsection (9A)…”

The intention of this exemption is to strike a balance between exempting income derived from legitimate business activities and that of non-substantive business undertakings.[41] This exemption therefore recognises that some companies are set up offshore for legitimate business purposes and earn an active income in the country of residence. This exclusion creates relief for the resident taxpayers who hold participation or voting rights in these companies as the net income inclusion would be deemed to be nil.

The income of the CFC will not fall within the ambit of section 9D should a CFC meet the definition of an FBE unless section 9D(9A) applies.

A foreign business establishment is defined in section 9D(1) as:

[40] *The Tax Faculty 2020. Comparable Tax Exemption (Section 9D(2A)*) ***[Online].*** *Available:*https://taxfaculty.ac.za/news/read/comparable-tax-exemption-section-9d-2a *[2023, February 28].*

[41] Olivier, L. & Honiball, M. 2011. International tax: A South African perspective, 5th ed., *p.581*. Cape Town: Siber Ink CC.

"a fixed place of business located in a country other than in the Republic that is used or will continue to be used for the carrying on of a business of that CFC for a period of not less than one year where:

(i) The business is conducted through offices, shops, factories, warehouses or other structures;

(ii) The fixed place of business is suitably staffed with on-site managerial and operational employees of that CFC who conduct the primary operations of the business;

(iii) A fixed place of business suitably equipped for conducting the primary operations of the business;

(iv) The fixed place of business has suitable facilities for conducting primary operations of that business; and

(v) The fixed place of business is located outside the Republic solely or mainly for the purpose other than the postponement or reduction of tax imposed by the government of the Republic.

This exemption excludes the net income derived from South Africa of foreign companies that are carrying on legitimate business activities and "illusory or non-substantive business undertakings…"[42]

Section 9D(1) of the ITA should be read together with section 9D(9) and section 9D(9A) of the ITA as these provisions recognize that CFC are used for legitimate purposes and active income should be exempt in order for the foreign company to remain competitive.[43]

Section 9D(9) of the ITA states that:

[42] Olivier, L. & Honiball, M. 2011. International tax: A South African perspective, 5th ed. *p.581*. Cape Town: Siber Ink CC.

[43] National Treasury 2002. *National Treasury's Detailed Explanation of Section 9D of the Income Tax Act, p. 8* [Online]. Available: https://www.treasury.gov.za/divisions/tfsie/tax/legislation/Detailed%20Explanation%20to%20Section%209D%20of%20the%20Income%20Tax%20Act.pdf [2023, February 15].

“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-

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

(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.”

Section 9D(9A) aims to ensure the FBE’s income is not subject to an exemption to the extent that this income does not meet certain criteria and would be considered to be diversionary and not at arm’s length. These amounts include:

- The sale of goods by the CFC (that is a FBE) to any connected person to that CFC who is a South African tax resident in terms of section 9D(9A)(a)(i).

- The sale of goods by that CFC (that is a FBE) to a person, who is not a connected person to that CFC, and is a South African tax resident whereby the goods (or any tangible intermediary inputs thereof) were initially purchased from one or more connected persons to that CFC who are tax residents of South Africa in terms of section 9D(9A)(a)(iA).

- The supply of services performed by that CFC (that is a FBE) to a connected person who is a South African tax resident unless the service is performed outside of South Africa in terms of section 9D(9A)(a)(ii).

- An amount in respect of a financial instrument unless this financial instrument is attributable to the principal trading activities of the FBE and those activities are of a bank, financial service provider or insurer and excludes a treasury operation or captive insurer in terms of section 9D(9A)(a)(iii).

- Rental income in respect of movable property unless the property is lease via an operating lease or the lease constitutes a financial instrument in terms of section 9D(9A)(a)(iv).

- Income for the use or right to intellectual property as defined in section 23I of the ITA, unless the CFC regularly creates, develops, or substantially upgrades the intellectual property and does not constitute tainted intellectual property as defined in section 23I, in terms of section 9D(9A)(a)(v).

- Income from insurance premiums unless those amounts are attributable to the principal trading activities of insurers and do not constitute activities of a captive insurer in terms of section 9D(9A)(a)(vi).

From the above it is noted that all active business income would still not be included in the net income of the FBE while income that may be earned from transactions with connected persons or income that is passive in nature continues to be included in the net of section 9D of the ITA.

A further analysis will be done on the FBE exemption in Chapter 3.

Chapter 3: A critical analysis of the foreign business establishment exemption and its role in preventing base erosion and profit shifting.

CFC Rules

During 1997, the Katz Commission performed an inquiry with regards to the South African tax system's ability to deal with the effects of globalisation. The Katz Commission recommended that the residence-based tax system be gradually adopted by South Africa. This led to the introduction of the CFC rules.[44] In 1997, CFC rules were added to the ITA in the form of section 9D. This was being used to act as an anti-avoidance provision for tax on investment income that was included in the tax net under section 9C, through a foreign company or trust. When South Africa shifted to a residence-based tax system this resulted in section 9C being repealed. Section 9D then became applicable to all income including capital gains and not only investment income. [45]

The Revenue Laws Amendment Act 59 of 2000 saw the introduction of the term *business establishment* to section 9D of the ITA and thereafter this term was replaced by the term *foreign business establishment* in the Revenue Laws Amendment Bill of 2006.

National Treasury opted to apply a mechanical 'employees and establishment' test as opposed to a 'facts and circumstance' based test which is used by the United States of America. The intention of the mechanical application was to remove the complexity of fact intensive tests. The approach by National Treasury is similar to that which was applied by the UK's exempt activities test which has been abolished as part of the UK's relaxation of CFC rules. [46]

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[44] Grimm, W. & Kraamwinkel, C. 2018. CFC's: have we gone too far? *Tax Talk* 2018(72):28-31.
[45] Olivier, L. & Honiball, M. 2011. International tax: A South African perspective, 5th ed. Cape Town: Siber Ink CC.
[46] Grimm, W. & Kraamwinkel, C. 2018. CFC's: have we gone too far? *Tax Talk* 2018(72):28-31.

Since the introduction of the CFC rules in 2001, the rules have remained principally unchanged. These rules however have become arguably more onerous and less flexible over time. This is particularly in regard to the definition of the FBE and its substance test.[47] Historically a section 9D(10)(a) and (b) existed in the ITA. This section allowed the Minister of Finance discretionary powers to deem the FBE threshold to have been met in certain circumstances where the risk to the South African tax base was very small or none at all.[48] This section has been abolished which resulted in the old mechanical substance rules being applicable. These rules may have been deemed appropriate in 2001, however, 22 years later in the modern business era, the world differs substantially making the mechanical approach outdated.[49]

From a practical point of view, the South African CFC rules are time-consuming for taxpayers to comply with and for SARS to review [50]. This is further supported by the fact that the Davis Tax Committee commented that the South African CFC rules are some of the most sophisticated and complicated within the G20. [51]

Foreign business establishment in the context of Section 9D of the ITA

A foreign business establishment is defined in section 9D(1) of the ITA. As noted above however that this definition follows a mechanical approach and not one of facts and circumstances. This could result in many taxpayers taking advantage of the mechanical nature of the definition by using it to set up non bona fide FBE with the intention of obtaining the FBE exemption. By using this exemption, taxpayers are able to set up FBEs in low tax jurisdictions, and shift profits into these FBEs without having the inclusion of the FBEs net income in its taxable income.

[47] Grimm, W. & Kraamwinkel, C. 2018. CFC's: have we gone too far?. *Tax Talk* 2018(72):28-31.
[48] Grimm, W. & Kraamwinkel, C. 2018. CFC's: have we gone too far?. *Tax Talk* 2018(72):28-31.
[49] Grimm, W. & Kraamwinkel, C. 2018. CFC's: have we gone too far?. *Tax Talk* 2018(72):28-31.
[50] Grimm, W. & Kraamwinkel, C. 2018. CFC's: have we gone too far?. *Tax Talk* 2018(72):28-31.
[51] Grimm, W. & Kraamwinkel, C. 2018. CFC's: have we gone too far?. *Tax Talk* 2018(72):28-31.

The South African FBE test is based on the mechanical substance analysis as set out in *Action 3: Designing effective controlled foreign company rules* Report.[52] These substance analyses have been criticised for being too narrow.[53] The fact the that substance analysis which the FBE definition is based off has been criticised as being too narrow may lead to a lack of scope and specificity.

The introduction of the definition of a FBE was added to the ITA in 2006 following the deletion of the definition of a business establishment. The reason for this change as stated by the Explanatory Memorandum on the Income Tax Bill 2006 *"[t]he current definition of business establishment is too rigid, making it difficult for South African companies that are conducting genuine non-tax business activities"*.[54] It was also found that the definition did not properly account for the country in which active business should take place. Confusion also existed with regards to the locations of active business for international transport.[55]

Paragraph (a)_of the definition of 'foreign business establishment' in section 9D(1) defines a FBE as:

> *"a fixed place of business located in a country other than in the Republic that is used or will continue to be used for the carrying on of a business of that CFC for a period of not less than one year where:*

[52] OECD 2015. *Designing effective controlled foreign company rules, p48, para 85* [Online]. Available: https://www.oecd-ilibrary.org/docserver/9789264241152-en.pdf?expires=1676283251&id=id&accname=guest&checksum=5F75A956488F8B01485E0EAEA818C429 [2023, March 13].

[53] OECD, 2015. *Comments received on Public Discussion draft BEPS Action 3: Strengthening CFC rules p234, para 9* [Online]. Available:]https://www.oecd.org/tax/aggressive/public-comments-beps-action-3-strengthening-cfc-rules-part1.pdf [2023, February 13].

[54] SARS, 2006. *Explanatory Memorandum on the Revenue Laws Amendment Bill, p53* [Online]. Available: https://www.sars.gov.za/lapd-lprep-em-2006-01-explanatory-memorandum-revenue-laws-amendment-bill-2006/ [2023, February 13].

[55] SARS, 2006. *Explanatory Memorandum on the Revenue Laws Amendment Bill, p53* [Online]. Available: https://www.sars.gov.za/lapd-lprep-em-2006-01-explanatory-memorandum-revenue-laws-amendment-bill-2006/ [2023, February 13].

(vi) *The business is conducted through offices, shops, factories, warehouses or other structures;*

(vii) *The fixed place of business is suitably staffed with on-site managerial and operational employees of that CFC who conduct the primary operations of the business;*

(viii) *A fixed place of business suitably equipped for conducting the primary operations of the business;*

(ix) *The fixed place of business has suitable facilities for conducting primary operations of that business; and*

(x) *The fixed place of business is located outside the Republic solely or mainly for the purpose other than the postponement or reduction of tax imposed by the government of the Republic.*

Provided that for the purposes of determining whether there is a fixed place of business as contemplated in this definition, a controlled foreign company must take into account 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 -

(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 a similar nature;

(bb) if that 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".

A FBE also includes:

> *"(b) any place outside the Republic where prospecting or exploration operations for natural resources are carried on, or any place outside the Republic 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;"*

It is noted that this definition does not include economic substance since the fixed nature of operations makes it almost impossible to fabricate them for tax planning purposes.[56]

> *"(c) a site outside the Republic for the construction or installation of building, 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;"*

It is noted that the requirements for construction can take place at any location outside of the Republic and not just a country outside of the Republic as stated in section 9D(1) paragraph (a).[57]

> *"(d) agricultural land in any country other than the Republic used for bona fide farming activities directly carried on by that controlled foreign company;*
>
> *(e) a vessel, vehicle, rolling stock or aircraft used for the purposes of transportation of 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 the Republic for such purposes and is operated directly by that controlled foreign company or by any other company that has the same*

[56] Olivier, L. & Honiball, M. 2011. International tax: A South African perspective, 5th ed. p. 584. Cape Town: Siber Ink CC.

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 engaged in international shipping as defined in that section;

(g) a ship engaged in international traffic used mainly outside the Republic"

The FBE exemption that deems net income to be nil is stated in Section 9D second proviso (i)(bb). This exemption states that net income is deemed to be nil where all receipts and accruals of a CFC that are attributable to any foreign business establishment and are not required to be taken into account in terms of subsection (9A).
The purpose of section 9D(9A) is to exclude certain amounts of income within the FBE from attracting a nil inclusion in the taxable income of the South African residents. This is because this income would be considered to be diversionary and not at arm's length.[58] The amounts included in section 9D(9A) have been discussed in further detail in Chapter 2.

Accordingly, the net income of the CFC will not fall within the ambit of section 9D should a CFC meet the definition of an FBE, unless section 9D(9A) applies. Section 9D does recognise that there are foreign companies that are set up for legitimate business reasons and earn active business income. This income is therefore exempt from the provisions of section 9D in terms of section 9D(9). This ensures that businesses are able to remain competitive in the international market.[59]

The purpose of the introduction of section 9D was to act as an anti-avoidance provision. Section 9D aims to protect the South African tax base by preventing South African tax

[58] Ismail, F. 2018. *The Foreign Business Establishment Exemption and Other Aspects of Section 9D of the Income Tax Act.* Johannesburg: University of the Witwatersrand.
[59] National treasury, 2002. *National Treasury's Detailed Explanation of Section 9D of the Income Tax Act, p. 8* [Online]. Available: https://www.treasury.gov.za/divisions/tfsie/tax/legislation/Detailed%20Explanation%20to%20Section%209D%20of%20the%20Income%20Tax%20Act.pdf [2023, February 09].

residents from shifting income offshore to low tax jurisdictions using foreign companies. The FBE exemption promotes international competitiveness as the FBE exemption only applies to income that does not pose a risk to the South African tax base.[60]

Under section 9D(2A) second proviso (ii) read together with section 9D(9A), all foreign income of the CFC that is a FBE is exempt from the provisions of section 9D unless that income qualifies as mobile foreign business income, diversionary foreign business income, mobile foreign passive income.[61]

Mobile Foreign Business Income is income that is generated by companies that are simply companies on paper i.e., shell companies, but have no actual or economic substance. The main economic activity of these companies may be to maintain a website or post office, however, they have no real non-tax business reason to exist.[62]

The income of such companies will be included in net income in terms of section 9D(2) as these companies are unlikely to meet the definition of an FBE in terms of section 9D(1) paragraph (a). These companies are not likely to have a fixed place of business that is conducted though a shop, office, warehouse, factory, or other structure as set out in the definition of a FBE in section 9D(1) paragraph (a). Due to this, the provisions of section 9D(2) and 9D(2A) of the ITA will apply, resulting in this income of the CFC being included in the resident's taxable income for the relevant year of assessment. This type of income

[60] National treasury, 2002. [Online].
National Treasury's Detailed Explanation of Section 9D of the Income Tax Act, p. 8
Available:
https://www.treasury.gov.za/divisions/tfsie/tax/legislation/Detailed%20Explanation%20to%20Section%209D%20of%20the%20Income%20Tax%20Act.pdf [2023, February 09].

[61] National treasury, 2002. [Online]. *National Treasury's Detailed Explanation of Section 9D of the Income Tax Act, p. 8*
Available:
https://www.treasury.gov.za/divisions/tfsie/tax/legislation/Detailed%20Explanation%20to%20Section%209D%20of%20the%20Income%20Tax%20Act.pdf [2023, February 09].

[62] National treasury, 2002. [Online]. *National Treasury's Detailed Explanation of Section 9D of the Income Tax Act, p. 8*
Available:
https://www.treasury.gov.za/divisions/tfsie/tax/legislation/Detailed%20Explanation%20to%20Section%209D%20of%20the%20Income%20Tax%20Act.pdf [2023, February 09].

poses a risk to the South African tax base due to it arising from a company that has no business substance or purpose, which creates a strong argument that the company was simply set up to shift profits offshore to a lower tax jurisdiction.

Diversionary income refers to income that is made by the CFC from sales and service dealings with connected South African tax residents.[63] This type of income is largely associated with the transfer pricing regime as set out in section 31 of the ITA, as well as transfer pricing tax avoidance. This type of income is to be included in the net income of the CFC regardless of whether it qualifies as a FBE in terms of sections 9D(9A)(a)(i) and (ii) of the ITA. These sections aim to prevent South African residents from entering into transactions that shift profits to a more beneficial tax jurisdiction when the profits should actually form a part of the South African tax base and therefore these types of transactions pose a risk to the South African tax base.[64]

Mobile foreign passive income refers to income derived from dividends, interest, and royalties. The risk with this type of income is that South African residents may shift the passive assets from which these incomes are derived to a CFC to avoid paying tax.[65] Section 9D(9A)(a)(iii) to (vii) of the ITA however makes provision for these types of income to be included in the net income of the CFC regardless of whether the CFC is a FBE as defined.

As stated above a FBE is defined in section 9D(1) paragraph (a)-(g). This definition essentially states that the business must have locational permanence, economic

[63] National treasury, 2002. [Online]. *National Treasury's Detailed Explanation of Section 9D of the Income Tax Act, p. 8*
Available:
https://www.treasury.gov.za/divisions/tfsie/tax/legislation/Detailed%20Explanation%20to%20Section%209D%20of%20the%20Income%20Tax%20Act.pdf [2023, February 09].

[64] Ismail, F. 2018. *The Foreign Business Establishment Exemption and Other Aspects of Section 9D of the Income Tax Act.* Johannesburg: University of the Witwatersrand.

[65] National treasury, 2002. *National Treasury's Detailed Explanation of Section 9D of the Income Tax Act, p. 8* [Online].
Available:
https://www.treasury.gov.za/divisions/tfsie/tax/legislation/Detailed%20Explanation%20to%20Section%209D%20of%20the%20Income%20Tax%20Act.pdf [2023, February 09].

substance, and a non-tax business reason for operating abroad instead of locally.[66] These three requirements therefore exclude businesses that are simply businesses on paper but have no economic substance and, consequently, the income earned by these types of businesses will be subject to the CFC rules in terms of section 9D of the ITA. These three requirements will be discussed in further detail below.

Locational permanence:

This concept involves the business having a fixed or permanent location from which the business operates. This ensures that the business is not simply a website, post box address or mailing address but does truly have a place from which it operates. Locational permanence can be demonstrated (using the section 9D definition of the FBE as guidance) by the use of an office, shop, factory, warehouse, farm or other structure for use of not less than one year. Direct ownership or a valid lease agreement can prove that the structure exists however it will not be sufficient to satisfy the "use" requirement.[67]

Economic substance and business purpose:

In addition to the locational permanence a foreign company must demonstrate, in order to be a FBE, business and economic substance. The way this is demonstrated is through business operations and purpose. To show that the business is operational it must show that it is suitably equipped with on-site staff members who are responsible for operations

[66] National treasury, 2002. *National Treasury's Detailed Explanation of Section 9D of the Income Tax Act, p. 9* [Online].
Available:
https://www.treasury.gov.za/divisions/tfsie/tax/legislation/Detailed%20Explanation%20to%20Section%209D%20of%20the%20Income%20Tax%20Act.pdf [2023, February 09].

[67] National treasury, 2002. *National Treasury's Detailed Explanation of Section 9D of the Income Tax Act, p. 9* [Online].
Available:
https://www.treasury.gov.za/divisions/tfsie/tax/legislation/Detailed%20Explanation%20to%20Section%209D%20of%20the%20Income%20Tax%20Act.pdf [2023, February 09].

and are at all skill levels within the company. Equipment and other facilities necessary to conduct the core operation of the business is also necessary to be presented.[68]

By demonstrating these tangible items above it proves that the business is not simply just a business on paper or a way to disguise passive income but actually exists and has the necessary skills and equipment to conduct business.

<u>Bona fide non-tax reason for existence abroad:</u>

It must be demonstrated that the business has some reason for being set up abroad other than to avoid paying taxes at a higher rate i.e., the business must have a purpose and reason to be set up in the foreign country other than the fact that it is a low tax jurisdiction [69]. The proportion of income earned by these foreign companies should also match the business activities conducted in these foreign countries.

An issue that was brought to light is that it appears that the definition of a FBE as set out in section 9D(1) paragraph (a) does not define or further explain what the primary operations of a business should be, neither does it limit the scope thereof. The emphasis is mainly on the location of the business and not on what the term ‘primary operations’ should be defined as. This term is not defined in the ITA.[70]

While the locational permanence protects the South African tax base by ensuring that taxpayers will not be able to open ‘shell’ or ‘paper’ companies abroad simply to shift profits

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[68] National treasury, 2002. *National Treasury’s Detailed Explanation of Section 9D of the Income Tax Act, p. 9* [Online].
Available:
https://www.treasury.gov.za/divisions/tfsie/tax/legislation/Detailed%20Explanation%20to%20Section%209D%20of%20the%20Income%20Tax%20Act.pdf [2023, February 09].
[69] National treasury, 2002. *National Treasury’s Detailed Explanation of Section 9D of the Income Tax Act, p. 10* [Online].
Available:
https://www.treasury.gov.za/divisions/tfsie/tax/legislation/Detailed%20Explanation%20to%20Section%209D%20of%20the%20Income%20Tax%20Act.pdf [2023, February 09].
[70] Ismail, F. 2018. *The Foreign Business Establishment Exemption and Other Aspects of Section 9D of the Income Tax Act.* Johannesburg: University of the Witwatersrand.

to these companies and avoid paying taxes, the term ‘primary operations’ has no specific definition in the ITA or the Tax Administration Act[71] leaving a gap in the legislation. The fact that the ‘primary operations’ of the business is not defined, creates a potential opportunity for taxpayers to set up companies with a structure from which it operates with a few staff members, but have no economic activities taking place in the country it is resident of thereby abusing the FBE exemption.

The lack of definition of the phrase ‘primary operations’ also doesn’t address how, for example a business where the primary operations would be to actively manage service providers and agents, as with a business that manages outsourced services to other businesses should be accounted for in terms of section 9D of the ITA.[72].

Ambiguity is created due to the lack of further explaining what primary operations should consist of, thereby creating a situation where the taxpayers and receiver would find it time consuming to comply with and review respectively.[73]

This may lead to a company being treated as a CFC and not meeting the FBE definition, therefore, making the FBE exemption not available while the company may well be a FBE operating for bona fide business reasons in a foreign country and not simply to avoid tax. Conversely, the same holds true and a company may be set up for non bona fide tax purposes, however, may meet the definition of a FBE and is able to take advantage of the FBE exemption. Neither scenario is not good for the South African tax base and make applying the CFC rules cumbersome on the taxpayer to apply and SARS to review. This also creates difficulty for taxpayers to comply with the legislation as the analysis is to a certain extent subjective which could lead to SARS and the taxpayers coming to different conclusions resulting in disputes. These disputes are not well received by resident shareholders and all shareholders alike of these CFCs.

[71] Ismail, F. 2018. *The Foreign Business Establishment Exemption and Other Aspects of Section 9D of the Income Tax Act.* Johannesburg: University of the Witwatersrand.
[72] Ismail, F. 2018. *The Foreign Business Establishment Exemption and Other Aspects of Section 9D of the Income Tax Act.* Johannesburg: University of the Witwatersrand.
[73] Grimm, W. & Kraamwinkel, C. 2018. CFC’s: have we gone too far?. *Tax Talk* 2018(72):28-31.

Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd:

This concept is demonstrated in Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd.[74] The original case was heard in the Western Cape Tax Court under ABCDE SA Proprietary Limited v Commissioner for the South African Revenue Service (24596) [2021] ZATC 19; 84 SATC 251.

The Coronation Group describes itself as '*an active investment manager following a long-term valuation-driven investment philosophy'.*[75] Coronation Global Fund Managers (Ireland) Limited (CGFM) is tax resident of the Isle of Man and therefore met the definition of a CFC. This is because its holding company Coronation Investment Management SA (Pty) Ltd (CIMSA), is a South African tax resident, holding 100% of CGFM.

For this reason, section 9D of the ITA became applicable and, consequently, CGFM's net income was to be inclusive in the taxable income of CIMSA, unless an exemption applied in terms of the CFC rules set out in the ITA in section 9D.

The issue arose with regards to CGFM being a FBE as defined in section 9D(1) paragraph (a) and consequently, whether the net income of CGFM would be exempt from being included in the taxable income of CIMSA. This was dependent on what the primary functions of CGFM were as conducted in Ireland. If the primary operations took place in Ireland then CGFM would be a FBE and qualify for the FBE exemption. It is important to note that CGFM opted to apply an outsource business model which created contention when determining what the primary operations were from a tax perspective. It had therefore became questionable whether the primary business of CGFM was that of

[74] *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd* (1269/2021) [2023] ZASCA 10 (07 February 2023)
[75] Coronation Fund Managers, *About us Overview* [Online]. Available: https://www.coronation.com/en-za/personal/about-us/ [2023, March 14].

investment which didn't take place in Ireland or that of license maintenance and management of service providers which did take place in Ireland.[76]

SARS argued in the appeal that the definition has not been met as economic substance was not demonstrated. CIMSA argued in the appeal that the definition had been met. The main issue was what the 'primary operations' of CGFM were.

Upon its incorporation in Ireland in 1997, CGFM provided its clients with opportunities for investment in South African and Irish domiciled collective investment funds. It obtained a license from the Central Bank of Ireland in 2007 as a management company.[77]

According to CIMSA, the primary operations of CGFM are not the actual performance of investment management but rather the management of outsourcing the investment management functions in accordance with its license from the Central Bank of Ireland.[78]

CIMSA argued in *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd)*[79] that the primary operations of CGFM were:

- To ensure compliance with all regulatory requirements of any regulators under their license;
- To ensure compliance by funds with all regulatory and constitutional document requirements;
- To appoint and continuously supervise and monitor service providers including investment service providers;

[76] *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd* (1269/2021) [2023] ZASCA 10 (07 February 2023)
[77] *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd* (1269/2021) [2023] ZASCA 10 para 12
[78] *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd* (1269/2021) [2023] ZASCA 10 para 15
[79] *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd* (1269/2021) [2023] ZASCA 10 para 15

- Communication with and reporting to investors including management of complaints, disputes and investment reporting;
- The overall risk management of CGFM and other funds it was responsible for;
- The compliance with all legal corporate requirements of the Republic of Ireland;
- The financial control and reporting for CGFM and other funds it was responsible for; and
- Investment change management which involved informing investment managers when changes occurred to investment objectives, policies and restrictions of any of the portfolios and constitutional documents.

CIMSA also argued that it is common practice for investment functions to be outsourced by fund managers in Ireland, Europe and South Africa and that it is recognised as a legitimate practice by the fund managers by the Central Bank of Ireland.[80]

SARS found that all the requirements of the FBE were met based on the definition set out in section 9D(1) paragraph (a) of the ITA exempt for economic substance. SARS accepted and did not dispute that the CGFM offices were situated Dublin with a staff complement of four whom were all Irish residents. The staff members consisted of a managing director, a compliance officer and two accounting officers. It was not argued either that CGFM had been operating for over a year (section 9D(1) paragraph (a)(i)) and had a fixed place of business as set out in section 9D(1) paragraph (a)(ii) which was suitably staffed with suitable equipment and facilities (section 9D(1) paragraph (a)((iii)(iv)). SARS was also satisfied that the business of CGFM was not set up in Ireland for a reason other than the postponement or reduction in South African tax (section 9D(1) paragraph (a)(v)). [81]

[80] *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd* (1269/2021) [2023] ZASCA 10 para 16
[81] *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd* (1269/2021) [2023] ZASCA 10 para 16

The issue that SARS disputed was that CGFM did not have economic substance as the primary operations referred to in section 9D(1) paragraph (a)(ii)(iii)(iv) were not based in Ireland and as such did not meet the definition of the FBE. [82]

The court made the following judgment:

> *"If the key operations of the business have been outsourced (here, investment management), then the fixed place of business in Ireland lacks the staff and facilities to conduct those operations. If these operations are central to the business of CGFM, because they go to the very nature of what this business does, then CGFM does not conduct its primary operations in Ireland. Without the investment management operations, can it be said to conduct its primary operations in Ireland? The answer must be, 'no'*."[83]

The court also held that the fundamental operations of the business must be performed within the jurisdiction where the exemption is sought. While functions can be outsourced an entity may not outsource its primary business. The primary operations must be performed in the same foreign jurisdiction to remain internationally competitive.[84]

The judgement essentially concluded that the primary operations of CGFM's business was fund management including investment management. This was not conducted in Ireland and as such the FBE definition was not met and the FBE exemption was not available in terms of section 9D(1) paragraph (a). [85]

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[82] *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd* (1269/2021) [2023] ZASCA 10 para 16
[83] *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd* (1269/2021) [2023] ZASCA 10 para 52
[84] *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd*
(1269/2021) [2023] ZASCA 10 para 52
[85] *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd* (1269/2021) [2023] ZASCA 10 para 52

From the above we can note that the lack of definition for the phrase 'primary operations' created uncertainty with SARS and CIMSA applying this differently. We can also note that there is a major issue with regards to outsourcing and where a line should be drawn in terms of when primary operations are being outsourced and not non-core functions. This again comes back to the lack of guidance and definition to the phrase 'primary operations'.

It must be further noted that, this case was the appeal by SARS, which resulted in SARS winning the case and CIMSA having to include the net income of CGFM in its taxable income. The original case was heard in the tax court.

The tax court held that the reason for creating CGFM was to create opportunities for investors that were not available in South Africa. The tax court was therefore satisfied that CGFM has economic substance.[86] The court also held that without the management function performed by CGFM none of the other functions could lawfully take place. This is because the license obtained from the Central Bank of Ireland gave CGFM the ability to conduct the business of making investments and therefore all other functions of CGFM were dependent on the license.[87] It was based on the above that the tax court was satisfied that the management function performed by CGFM was the primary operation of the business and therefore was a FBE as defined and would qualify for an exemption in terms of section 9D. SARS then appealed the ruling in the Supreme Court of Appeal of South Africa.

The fact that this case was appealed, and a different ruling was made reiterates the fact that more scope and definition needs to be given to the phrase primary operations to remove the subjective nature of applying this section of the legislation.

Commentary on the draft strengthening the CFC rules report

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[86] *ABCDE SA Proprietary Limited v Commissioner for the South African Revenue Service (24596) [2021] ZATC 19; 84 SATC 251 para 40.*
[87] *ABCDE SA Proprietary Limited v Commissioner for the South African Revenue Service (24596) [2021] ZATC 19; 84 SATC 251 para 33.*

On 3 April 2015, a draft report on strengthening the CFC rules was released by the OECD to which they invited comment. Some of the concepts described in the report are the legislative approaches used to define income and included an establishment test. This test is what the definition of a FBE as set out section 9D(1) paragraph (a) of the ITA in South Africa is based on.

On 5 May 2015, the first part of comments the OECD was received [88]. There were many comments that highlighted concerns that the establishment test was too broadly defined and `leaves very little room for flexibility in accommodating commercial outsourcing arrangements. The comment made by Deloitte on this matter was that, although the employees and establishment analysis is less fact intensive the approach is narrow and does not consider outsourcing arrangements which is typical in certain industries and sometimes even forms part of core functions.[89]

The comments made cements the fact that outsourcing has become a prevalent part of business and that without a proper definition for the term 'primary operations' too much is left open to interpretation. These terms should be given a business like or commercially sensible meaning to prevent this ambiguity and interpretation. It is also relevant to the FBE definition as this definition is based on the substance analysis test as set out by the OECD guidance in question.[90]

In the final report released by the OECD on 5 October 2015 on strengthening the CFC rules, the above comment by Deloitte was not specifically addressed. However, a

[88] OECD, 2015. *Comments received on Public Discussion draft BEPS Action 3: Strengthening CFC rules* [Online]. Available:]https://www.oecd.org/tax/aggressive/public-comments-beps-action-3-strengthening-cfc-rules-part1.pdf [2023, February 13].
[89] OECD, 2015. *Comments received on Public Discussion draft BEPS Action 3: Strengthening CFC rules p234, para 9* [Online]. Available:]https://www.oecd.org/tax/aggressive/public-comments-beps-action-3-strengthening-cfc-rules-part1.pdf [2023, February 13].
[90] OECD 2015. *Designing effective controlled foreign company rules, p48, para 85* [Online]. Available: https://www.oecd-ilibrary.org/docserver/9789264241152-en.pdf?expires=1676283251&id=id&accname=guest&checksum=5F75A956488F8B01485E0EAEA818C429 [2023, March 13].

“substance analysis” was noted in the report for determining when the income falls with the net of the CFC rules.

It was noted in this report that the general theme and fundamental question all substance analyses ask is whether the CFC has the ability to earn income on its own?[91] It was further noted that substance analysis can be designed to address profit shifting concerns and be applied mechanically.[92]

The OECD provided options for types of substance analyses that jurisdictions could apply. South Africa chose to apply the third option. This option considers whether the CFC had the necessary business premises and establishment in the CFC jurisdiction to be able to earn an income and if the employees of the CFC were sufficient in number and skills to undertake the CFC’s core business functions. If this test is to be applied as a threshold test, all income without the necessary people and premises would be attributable to the CFC or it would exclude all income of a CFC that did have the necessary people and premises. If applied as a proportionate test, this would treat income earned as CFC income, when the CFC did not have the necessary people and premises.[93]

The inclusion of the substance analysis works in harmony with the definition of a FBE as defined in section 9D(1) paragraph (a) of the ITA which essentially places emphasis on whether the company has the necessary physical assets i.e., equipment, fixed place of operations and employees in order for it to perform its business activities. The definition,

[91] OECD, 2015. *Designing effective controlled foreign company rules, p47, para 81* [Online]. Available: https://www.oecd-ilibrary.org/docserver/9789264241152-en.pdf?expires=1676283251&id=id&accname=guest&checksum=5F75A956488F8B01485E0EAEA818C429 [2023, February 13].
[92] OECD, 2015. *Designing effective controlled foreign company rules, p47, para 84* [Online]. Available: https://www.oecd-ilibrary.org/docserver/9789264241152-en.pdf?expires=1676283251&id=id&accname=guest&checksum=5F75A956488F8B01485E0EAEA818C429 [2023, February 13].
[93] OECD, 2015. *Designing effective controlled foreign company rules, p48, para 85* [Online]. Available: https://www.oecd-ilibrary.org/docserver/9789264241152-en.pdf?expires=1676283251&id=id&accname=guest&checksum=5F75A956488F8B01485E0EAEA818C429 [2023, February 13].

however, appears to be more of a threshold test where an all-or-none approach is followed. The CFC either meets the definition of a FBE or not, which again leaves very little flexibility for all types of businesses to apply this definition.

It is noted that according to Kraamwinkel *et al* (2018), *over time they [the CFC rules] have become less flexible and more arduous to comply with. This is particularly so in relation to meeting the so-called "foreign business establishment" substance test.*[94] This further reiterates how the mechanical approach to the FBE definition has become cumbersome and frustrating to apply for taxpayers from a practical sense and for SARS to review these applications.

To close the matter, it would appear the FBE definition has created a similar problem, while it may no longer be as rigid as it was, it does not limit or define the scope of operations a business needs to undertake making it cumbersome for both the taxpayers and SARS to apply and to review respectively. This has also created a gap in the legislation which creates an opportunity for taxpayers to take advantage of the FBE exemption by setting up non bona fide FBEs.

Chapter 4: Examination of the new substance standards imposed by UAE and Mauritius.

Introduction of substance standards

This chapter will examine the substance standards that were imposed by UAE and Mauritius and their impact, if any, on enhancing the FBE requirements from a South African perspective. Particular focus will be given to whether these standards may assist

[94] Kraamwinkel, C, Grimm, W. 2018. *Is it time to change South Africa's CFC rules?* [Online]. Available: https://www.withoutprejudice.co.za/free/article/6281/view# [2023, February 14].

in preventing the South African tax base from being eroded by the exploitation of the FBE exemption.

The purpose of substance standards is to ensure that the profit earned by a foreign entity is proportionate in size and nature to the activities that the entity undertakes in that foreign jurisdiction. These standards essentially ensure that economic substance is demonstrated in the jurisdictions that the entity is tax resident of. This is in line with the OECD Action Plan on BEPS. It is important to note that not all 'relevant activities' are required to demonstrate economic substance and each jurisdiction will have a list of 'relevant activities' that would need to show economic substance. [95]

In 2015, the OECD presented the Base Erosion and Profit Shifting (BEPS) Framework which highlighted concerns of international tax avoidance by shifting profits from high tax jurisdictions to low tax jurisdictions. In line with this framework, the OECD regularly "identifies tax regimes that may unfairly impact the tax base of jurisdictions". These are known as harmful tax practices. [96]

During December 2017, the European Union (EU) Code of Conduct Group on Business Taxation performed an assessment of the tax policies of jurisdictions with no or nominal tax against the economic substance criterion. This criterion stated that a jurisdiction should not facilitate an offshore structure or arrangement if the economic substance in that jurisdiction did not match the profits being earned by that structure or arrangement.[97]

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[95] Anderson, K. 2019. Global implications for offshore financial centres and companies in the wake of EU requirements for economic substance. *Trusts & Trustees* 7(1):742-746.

[96] BBCIncorp 2023. *Mauritius Economic Substance Regulations: Important Updates (2023)* [Online]. Available: https://bbcincorp.com/offshore/articles/mauritius-economic-substance [2023, February 20]

[97] Deloitte 2019. *New economic substance rules introduced by "tax havens" brought into force from 1 January 2019* [Online]. Available: https://www2.deloitte.com/content/dam/Deloitte/xe/Documents/tax/me_new-economic-substance-rules-introduced.pdf [2023, February 20].

The above suggests that entities were being set up in these jurisdictions while the profits earned by these entities did not reflect the actual economic activities that took place in these jurisdictions.

The Code of Conduct Group on Business Taxation placed these non-cooperative jurisdictions on a grey list until they met the criteria. The criteria were based on transparency, fair taxation and anti-Base Erosion and Profit Shifting (BEPS). The requirement that entities demonstrate 'real economic activity' and meet substantial economic presence tests stemmed from the anti-BEPS criteria.[98]

During December 2017, a 'tax haven' blacklist was also created by the EU to encourage tax transparency and fair tax competition and discourage tax evasion, tax fraud and tax avoidance. Jurisdictions were blacklisted if they were identified as non-cooperative in terms of transparency, exchange of information standards, fair tax competition and harmful tax practices or regimes. Being blacklisted meant that jurisdictions would face reputational damage, EU sanctions and limited access to EU funding.[99]

To avoid being blacklisted, jurisdictions developed and implemented Substance Regulations in accordance with the guidelines of the EU and OECD. The objective of the Substance Regulations is to ensure that any harmful tax practices would be eradicated and that the taxation aligns itself to the economic substance within that jurisdiction.[100] This may aid in the prevention of taxpayers shifting profits offshore to low tax jurisdictions.

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98 Anderson, K. 2019. Global implications for offshore financial centres and companies in the wake of EU requirements for economic substance. *Trusts & Trustees* 7(1):742-746.

99 Fox, C. 2019. *Changing The Rules of The Game: Economic Substance & Harmful Preferential Regimes* [Online]. Available: https://www.thesait.org.za/news/469250/Changing-The-Rules-of-The-Game-Economic-Substance--Harmful-Preferential-Regimes.htm [2023, February, 22].

100 Brown, H. 2020. *The economic substance test* [Online]. Available: https://www.taxadvisermagazine.com/article/economic-substance-test [2023, March 09].

Several non-cooperative jurisdictions were placed on a 'grey list, which meant that these entities were given a year to comply with substance requirements to avoid being placed on the blacklist. Mauritius and the UAE were on the grey list, among other jurisdictions.[101]

In 2019, in response to the OECD BEPS framework and the EU Code of Conduct Group, the Mauritian Government introduced substance standards which aimed to address the harmful tax practices brought to light by the OECD's BEPS framework and to avoid being blacklisted by the EU. These substance standards became effective from 1 January 2019.[102]

The UAE was placed on the EU's grey list after being removed from the blacklist on 23 January 2018, together with eight other countries.[103] This list was subject to close monitoring. The shift from the blacklist followed commitment by the UAE to the EU that it would remedy the EU's concerns as well as implement the minimum standards as set out by the OECD BEPS Framework.[104]

The substance standards implemented by many countries would be mostly similar as they were modelled based on the guidance issued by the EU and the OECD.[105] These

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[101] Deloitte 2019. *New economic substance rules introduced by "tax havens" brought into force from 1 January 2019* [Online]. Available: https://www2.deloitte.com/content/dam/Deloitte/xe/Documents/tax/me_new-economic-substance-rules-introduced.pdf [2023, February 20].
[102] KPMG 2019. *Economic Substance Requirements- Mauritius* [Online]. Available: https://assets.kpmg/content/dam/kpmg/mu/pdf/2019/mu-Economic-Substance-Requirements-Mauritius.pdf [2022, February 20].
[103] Deloitte 2018. *UAE has been removed from the EU's 'tax haven' blacklist* [Online]. Available: https://www2.deloitte.com/xe/en/pages/tax/articles/vat-gcc-uae-removed-from-eu-tax-haven-blacklist.html [2023, February 20]
[104] Deloitte 2019. *New economic substance rules introduced by "tax havens" brought into force from 1 January 2019* [Online]. Available: https://www2.deloitte.com/content/dam/Deloitte/xe/Documents/tax/me_new-economic-substance-rules-introduced.pdf [2023, February 20].
[105] Deloitte 2019. *New economic substance rules introduced by "tax havens" brought into force from 1 January 2019* [Online]. Available: https://www2.deloitte.com/content/dam/Deloitte/xe/Documents/tax/me_new-economic-substance-rules-introduced.pdf [2023, February 20].

substance standards are principally made up of three rules (with the exact rulings varying depending on the jurisdictions).[106]

The three rules are:

1. **The 'Directed and Managed' test:**

   This test essentially means that the entity will need to be managed and directed in the jurisdiction that relevant economic activities take place in. This includes where board meetings are conducted, minutes are kept and whether enough directors are physically present at these meetings and if they have the required skill and expertise to run the business.[107]

2. **The 'Core Income Generating Activities' (CIGA) test:**

   The entity must need to demonstrate that the relevant CIGA are being undertaken in the jurisdiction with regards to the level of income derived from that activity. The CIGA may be outsourced to a service provider within the jurisdiction with the entity overseeing this process. It is important to note that the CIGA would vary depending on the relevant activity.[108]

3. **The 'Adequate' test:**

   The entity must have an adequate number of qualified employees in the jurisdiction, incur adequate expenditure in the jurisdiction in proportion to the level of activity and

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[106] Deloitte 2019. *New economic substance rules introduced by "tax havens" brought into force from 1 January 2019* [Online]. Available: https://www2.deloitte.com/content/dam/Deloitte/xe/Documents/tax/me_new-economic-substance-rules-introduced.pdf [2023, February 20].

[107] Deloitte 2019. *New economic substance rules introduced by "tax havens" brought into force from 1 January 2019* [Online]. Available: https://www2.deloitte.com/content/dam/Deloitte/xe/Documents/tax/me_new-economic-substance-rules-introduced.pdf [2023, February 20].

[108] Deloitte 2019. *New economic substance rules introduced by "tax havens" brought into force from 1 January 2019* [Online]. Available: https://www2.deloitte.com/content/dam/Deloitte/xe/Documents/tax/me_new-economic-substance-rules-introduced.pdf [2023, February 20].

have an adequate physical presence in the jurisdiction. The term ‘adequate’ is not prescriptive and would be a matter of assessing facts and circumstances of what ‘adequate’ should constitute.[109]

The substance standards implemented by Mauritius and the UAE will be discussed in further detail below.

Mauritius:

As part of its 2018 and 2019 tax reform in line with complying with the substance requirements, the previous deemed foreign tax regime was abolished by the Government of Mauritius and replaced it with the partial exemption regime. Under the deemed foreign tax regime, the rate of tax of a global business companies (GBCs) was set at a maximum of 3 per cent. This is calculated as 20 per cent of the 15 per cent flat tax rate, thereby equating to an 80 per cent exemption. According to the Mauritian Income Tax Act 1995, Second Schedule Part II, under the new partial tax regime, the 80 per cent exemption will only be applicable to certain income streams such as:

- foreign source dividend earned by a company. This is provided that the dividend has not been allowed as a deduction in the source country (Item 6 of Sub-Part B);
- interest earned by a company other than a bank, non-bank deposit taking institution, money exchanger, foreign exchange dealer, leasing company, insurance company and a company that provides credit sales facilities, factoring, or hire purchase facilities (Item 7 of Sub-Part B);
- income that relates to a permanent establishment (Item 40 of Sub-Part C);

[109] Deloitte 2019. *New economic substance rules introduced by “tax havens” brought into force from 1 January 2019* [Online]. Available: https://www2.deloitte.com/content/dam/Deloitte/xe/Documents/tax/me_new-economic-substance-rules-introduced.pdf [2023, February 20].

- income from a company dealing in reinsurance and reinsurance brokering activities (Item 44 of Sub-Part C);
- income from a company that deals in leasing and provision of international fibre capacity (Item 45 of Sub-Part C);
- Sale, arrangement, financing and asset management of an aircraft and its spare parts as well as the aviation advisory services that relate to it (Item 46 of Sub-Part C);
- income obtained by a collective investment scheme (CIS), closed-ended fund, CIS manager, CIS administrator, investment adviser or asset manager, provided the company satisfies the conditions relating to the substance of its activities as prescribed (Item 41 of Sub-Part C); *and*
- income obtained by a company engaged in the leasing of aircraft and ship leasing, if the company satisfies certain conditions relating to the substance of its activities (Item 42 of Sub-Part C).

The tax residency criteria and definition of companies in Mauritius has been amended to state that if the company is not managed and controlled in Mauritius then the company will not be a tax resident of Mauritius regardless of whether the company was incorporated in Mauritius. This provision is effective from 1 July 2019.[110]

A GBC is a company incorporated in Mauritius for the purpose of doing business primarily outside of Mauritius[111]. A GBC in relation to the Mauritian substance standards regulations refers to the following entities below:

- *"Collective Investment Scheme (CIS)*
- *Closed-end Fund*
- *CIS Manager*

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[110] KPMG 2019. *Economic Substance Requirements- Mauritius* [Online]. Available: https://assets.kpmg/content/dam/kpmg/mu/pdf/2019/mu-Economic-Substance-Requirements-Mauritius.pdf [2022, February 20].

[111] Financial Services Commission Mauritius 2013. *Fact Sheet Global Business* [Online]. Available: https://www.fscmauritius.org/media/1352/fact-sheet-on-global-business-fsc-final-22-march-2013.pdf [2023, May 08]

- *CIS Administrator*
- *Investment Adviser*
- *Ship and Aircraft Leasing company*
- *Company engaged in reinsurance activities*
- *Company engaged in leasing and international fiber capacity; and*
- *Company engaged in the sale, financial arrangement, asset monitoring of aircraft and its related parts, and aviation advisory services in connection thereto".*[112]

For a GBC to qualify for the exemptions under the partial exemption regime and to maintain its global business license, two tests need to be satisfied, namely:

Test 1: Substance requirements

The GBC:

- Must ensure that core income-generating activities (CIGAs) are conducted in Mauritius (refer below to test 2);
- Must ensure that it employs, either on a direct or indirect basis, a sufficient quantity of qualified workforce members;
- must incur a minimum amount of expenditure which is in proportion to its level of activities.[113]

Test 2: Core Income Generating Activities:

A GBC is required to ensure that their core income generating activities (CIGA) are being carried out in or from Mauritius. The list of core income generating activities for GBCs has been summarised below:

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[112] BBCIncorp 2023. *Mauritius Economic Substance Regulations: Important Updates (2023)* [Online]. Available: https://bbcincorp.com/offshore/articles/mauritius-economic-substance [2023, February 20].

[113] BBCIncorp 2023. *Mauritius Economic Substance Regulations: Important Updates (2023)* [Online]. Available: https://bbcincorp.com/offshore/articles/mauritius-economic-substance [2023, February 20].

- **Collective Investment Scheme (CIS):** Investment of funds for securities, or other financial assets, real property or non-financial assets; diversification of risks; redemption on the request of the holder.

- **Closed-end Fund**: Investment of funds collected from investors, for securities, or in other financial or non-financial assets, or real property.

- **CIS Manager**: Management of a Collective Investment Scheme, making decisions on the holding and selling of investments; monitoring risks and reserves; taking responsibility on currency or interest fluctuations, and preparing relevant reports for authorities and investors.

- **CIS Administrator**: Service provider regarding the operations and affairs of a Collective Investment Scheme including accounting, valuating, or reporting services.

- **Investment Adviser**: Advising, guiding, or recommending persons, either personally or through printed materials or other means, with regards to entering securities transactions; managing or holding himself out to manage securities work; advising on corporate finance advisory matters concerning securities transactions.

- **Ship and Aircraft Leasing company**: Agreeing on funding terms, identifying and acquiring assets to be leased, setting the terms and duration of any leasing, monitoring and revision of any agreements, and management of any risks.

- **Company engaged in reinsurance activities**: Prediction and calculation of risk, reinsuring against risks, administrating clients' cells, providing related services, preparing regulatory reports, and providing clients technical advice in respect of reinsurance of liabilities.

- **Company engaged in leasing and international fiber capacity**: Agreeing on funding terms, identifying and acquiring the capacity to be leased or otherwise provided, settlement of out the terms and duration of leasing or right to use contracts, revising any agreements, and monitoring any risks.

- **Company engaged in the sale, financial arrangement, asset monitoring of aircraft and its related parts, and aviation advisory services in connection thereto**: Negotiation of terms of purchase and sale of aircraft and its spare parts, arranging for sale and leasing, agreeing on funding conditions and providing advisory services regarding aviation. [114]

The Financial Services Authority (FSC) will consider many factors in determining if the GBCs are managed and controlled from Mauritius. Some of these factors include whether the entity maintains its main bank account in Mauritius; whether meetings are inclusive of at least two directors from Mauritius; if all accounting records are kept at its registered offices in Mauritius at all times; if the entity prepares statutory financial statements, and if such financial statements are audited in Mauritius; if the entity has at least two directors, resident in Mauritius, of sufficient caliber to exercise independence of mind and judgement.[115]

Subject to the GBC's constitution, the board meetings can take place virtually in which all directors who are participating constitute a quorum. This allows directors to join these meetings from any location. The main requirement being that at least two directors are from Mauritius and that these meetings are initiated, held, and chaired from Mauritius.[116]

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[114] BBCIncorp 2023. *Mauritius Economic Substance Regulations: Important Updates (2023)* [Online]. Available: https://bbcincorp.com/offshore/articles/mauritius-economic-substance [2023, February 20].

[115] Fowdur B., Xavier, S. 2022. *In brief* : *economic substance requirements In Mauritius* [Online]. Available: https://www.lexology.com/library/detail.aspx?g=3032cb31-9de5-4aa3-8c32-9c2be23c211e [2023, February 20].

[116] Fowdur B., Xavier, S. 2022. *In brief* : *economic substance requirements In Mauritius* [Online]. Available: https://www.lexology.com/library/detail.aspx?g=3032cb31-9de5-4aa3-8c32-9c2be23c211e [2023, February 20].

The FSC considers the nature and level of the CIGA, including the use of technology, by the GBC as well as the persons employed directly or indirectly by the GBC and if they have the relevant qualifications and skills to perform the CIGA.[117]
The FSC Circular sets out guidelines with regards to the intent of the term ‘a reasonable number of suitably qualified persons’ and ‘a minimum expenditure which is proportionate to its level of activities’. Assessments are conducted on a case-by-case basis dependent on the kind of business activities being conducted and specific facts and circumstances of the GBC.[118]

The Mauritian Revenue Authority (MRA) will also perform an assessment on a case-by-case basis as to what should be classified as CIGA of the GBCs before the issuance of a tax residency certificate. Consideration is given to activities that are ‘essential activities carried out to generate income of the company.[119]

In terms of the substance requirements outsourcing of relevant activities is allowed in terms of the Income Tax (Amendment No. 2) Regulations 2019 of Mauritius, stipulated that the activities are conducted in Mauritius and that there is sufficient monitoring by the GBC of these activities. These activities are not allowed to be captured as a demonstration of economic substance by multiple companies multiple times when evidencing their substance in Mauritius.[120] This means that these activities that have been outsourced can only be used to demonstrate economic substance for the GBC employing the outsourcing company and not be used by the outsourcing company itself to demonstrate economic substance.

[117] Fowdur B., Xavier, S. 2022. *In brief* : *economic substance requirements In Mauritius* [Online]. Available: https://www.lexology.com/library/detail.aspx?g=3032cb31-9de5-4aa3-8c32-9c2be23c211e [2023, February 20].
[118] Fowdur B., Xavier, S. 2022. *In brief* : *economic substance requirements In Mauritius* [Online]. Available: https://www.lexology.com/library/detail.aspx?g=3032cb31-9de5-4aa3-8c32-9c2be23c211e [2023, February 20].
[119] Fowdur B., Xavier, S. 2022. *In brief* : *economic substance requirements In Mauritius* [Online]. Available: https://www.lexology.com/library/detail.aspx?g=3032cb31-9de5-4aa3-8c32-9c2be23c211e [2023, February 20].
[120] Fowdur B., Xavier, S. 2022. *In brief* : *economic substance requirements In Mauritius* [Online]. Available: https://www.lexology.com/library/detail.aspx?g=3032cb31-9de5-4aa3-8c32-9c2be23c211e [2023, February 20].

United Arab Emirates:

In response to its removal from the EU's blacklist, the UAE introduced Economic Substance Regulations in 2019. These Regulations came into effect on 1 January 2019. The main purpose of these regulations is to ensure that UAE onshore companies, free zone companies and other companies that carry out Relevant Activities exhibit and sustain sufficient economic substance in the UAE in relation to the activities being undertaken[121] as well as to report profits that are in proportion to the economic activities that take place within the UAE.

The substance regulations imposed by the UAE applies to any legal person (incorporated in or outside of the UAE) or an unincorporated partnership registered in the UAE (A Licensee) that carries out a 'Relevant Activity'. It is important to note that 'a Licensee' also includes entities registered in any of the UAE's free zones (including the financial free zones i.e., Abu Dhabi Global Market and Dubai International Financial Centre) and therefore would apply to any company set up in the UAE. [122]

Although considered 'Licensees' under the previous Economic Substance Regulations, natural persons, sole proprietors, trusts and foundations do not form part of the scope of these Regulations.[123]

The Relevant Activities include:

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[121] United Arab Emirates Ministry of Finance 2019. *Economic Substance Regulations* [Online]. Available: https://mof.gov.ae/economic-substance-regulations/ [2023, May 10].

[122] Rwashdeh, M., Abu-Shattal, Z. & Rehman K. 2020
The New UAE Economic Substance Regulations [Online].
Available: https://www.natlawreview.com/article/new-uae-economic-substance-regulations [[2023, February 20].

[123] Rwashdeh, M., Abu-Shattal, Z. & Rehman K. 2020
The New UAE Economic Substance Regulations [Online].
Available: https://www.natlawreview.com/article/new-uae-economic-substance-regulations [2023, February 20].

1. Banking Business
2. Insurance Business
3. Investment Fund Management Business
4. Lease Finance Business
5. Headquarters Business
6. Shipping Business
7. Holding Company Business
8. Intellectual Property Business
9. Distribution and Service Centre Business[124]

Guidance on whether an entity undertakes one or more Relevant Activity is provided in Schedule 1 of the Ministerial Decision 100 of 2020 as well as further information on each Relevant Activity.[125] This Schedule is a guide issued by the Ministry of Finance to assist with further explanations and information on each of the relevant activities.

To satisfy the above test, the Licensee must conduct all CIGAs in the UAE.[126]
Guidance on Core Income Generating Activities is provided in Article 3 of the Resolution and Schedule 1 of the Decision. "The Core Income Generating Activities are the activities that are of central importance to a Licensee for generating income from the Relevant Activity.[127]

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[124] United Arab Emirates Ministry of Finance 2019. *Economic Substance Regulations* [Online]. Available: https://mof.gov.ae/economic-substance-regulations/ [2023, May 10].
[125] Ministerial Decision No. 100 for the year 2020 on the Issuance of Directives for the Implementation of the Provisions of the Cabinet Decision No 57 of 2020 Concerning Economic Substance Requirements Article 3.
[126] Rwashdeh, M., Abu-Shattal, Z. & Rehman K. 2020
The New UAE Economic Substance Regulations [Online].
Available: https://www.natlawreview.com/article/new-uae-economic-substance-regulations [2023, February 20].
[127] Rwashdeh, M., Abu-Shattal, Z. & Rehman K. 2020
The New UAE Economic Substance Regulations [Online].
Available: https://www.natlawreview.com/article/new-uae-economic-substance-regulations [2023, February 20].

The Licensee's Relevant Activity must also be directed and managed in the UAE by ensuring that:

- The board of directors meet in the UAE a sufficient number of times. The quorum is also required to be physically present in the UAE;
- Minutes of the board of directors' meetings are kept, these minutes are in writing and note all strategic decisions. These minutes must also be signed by all directors who attended the meeting;
- All board of directors' minutes of meetings and records are kept in the UAE and;
- The directors possess the required knowledge and skills to perform their duties on the board.[128]

A sufficient number of qualified full-time employees are also required to be physically present in the UAE as well as premises in the UAE and annual operating expenditures. Outsourcing of CIGAs is allowed. However, these CIGAs must be outsourced to an entity within the UAE and full control over these activities must remain with the entity.[129]

The employees that are carrying out the CIGA must in principle be residents of the UAE and if they are not, they would be required to be physically present in the UAE while carrying out these activities under the direction of the Licensee and the Licensee must bear all costs related to that non-resident employee.[130]

Similar to that of the Mauritian Economic Substance requirements discussed above, the guidance issued in these Regulations may give some clarity on the term 'primary operations' which is not defined in the ITA FBE definition. It is noted that even though

[128] Ministerial Decision No. 100 for the year 2020 on the Issuance of Directives for the Implementation of the Provisions of the Cabinet Decision No 57 of 2020 Concerning Economic Substance Requirements Article 4.
[129] Ministerial Decision No. 100 for the year 2020 on the Issuance of Directives for the Implementation of the Provisions of the Cabinet Decision No 57 of 2020 Concerning Economic Substance Requirements Article 4.
[130] Ait Ben Idir, A. 2020. *UAE Economic Substance Regulations now in force: Are you prepared?* [Online]. Available: https://www.nortonrosefulbright.com/en/people/121924 [2023, February 22].

these substance requirements are not South African, the CFC and related FBE in question is the same entity in questions from both a South African and international perspective. The fact that the UAE and Mauritius are implementing these standards creates an additional layer of conditions and requirements to be met in setting up these FBEs which can deter taxpayers from setting up non-bona fide FBEs.

Chapter 5: The impact of the substance standards imposed by the UAE and Mauritius on the foreign business establishment definition and exemption as set out in section 9D of the Income Tax Act.

In line with the OECD Action Plan on BEPS, substance standards were introduced to ensure that the profit earned by foreign entities is in proportion to the size and nature of the activities that the entity undertakes within the jurisdiction that it is a tax resident in. These standards aim to ensure that economic substance is demonstrated in the country of which the entity is a tax resident. [131] The chapter aims to discuss whether the substance standards introduced by Mauritius and the UAE would assist in enhancing the local FBE provisions from a South African perspective.

Mauritius was one of the jurisdictions that were placed on the grey list. This meant that Mauritius had committed to comply with the substance requirements within one year [132]. The UAE was initially placed on the blacklist but was removed on the 23rd of January 2018 subject to close monitoring. This shift also followed a commitment by the UAE to remedy the EU's concern and implement the minimum standards set out by the OECD BEPS Framework.[133]

[131] Anderson, K. 2019. Global implications for offshore financial centres and companies in the wake of EU requirements for economic substance. *Trusts & Trustees* 7(1):742-746.
[132] Deloitte 2019. *New economic substance rules introduced by "tax havens" brought into force from 1 January 2019* [Online]. Available: https://www2.deloitte.com/content/dam/Deloitte/xe/Documents/tax/me_new-economic-substance-rules-introduced.pdf [2023, February 20].
[133] Deloitte 2019. *New economic substance rules introduced by "tax havens" brought into force from 1 January 2019* [Online]. Available:

From a South African perspective, the Substance Regulations have the potential to enhance the application of FBE definition and exemption as set out in terms of section 9D of the ITA. The main objective of these requirements is to ensure that the taxation matches the economic substance. In other words, the taxation should follow the jurisdiction in which economic substance is present. This means that if a company is merely set up in a jurisdiction to obtain tax residency in that jurisdiction, but all business operations are taking place in another jurisdiction, the taxation should follow the latter.

It was noted and discussed in Chapter 3 that certain elements of the FBE definition are lacking in clarity and therefore have opened itself up to subjectivity and interpretation. The subjective nature of the definition has the potential to lead to many different parties interpreting the definition to suit their agenda leading to lengthy and costly disputes. The unintended interpretation of the FBE definition and exemption alike has the potential to go unnoticed and could lead to it being unfairly taken advantage of, eroding the South African tax base.

By creating this additional layer of Regulations to be met from an international perspective, it makes it more cumbersome from a South African perspective to set up these companies offshore should it not be for bona fide business purposes. These requirements may also provide more clarity on what type of business operations should take place and what type of activities should be undertaken to demonstrate economic substance. This in turn may enhance the FBE definition as the objective of the definition and exemption is to exempt income from entities carrying on a legitimate business.[134] This means that from both a South African and international tax perspective companies would need to demonstrate a valid economic presence to be able to qualify as a company in the foreign jurisdiction as well as a FBE in terms of section 9D of the ITA.

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https://www2.deloitte.com/content/dam/Deloitte/xe/Documents/tax/me_new-economic-substance-rules-introduced.pdf [2023, February 20].

[134] Olivier, L. & Honiball, M. (2011). *International Tax: A South African Perspective 2011 p.581.* Cape Town: Siber Ink CC

The new UAE and Mauritius substance standards may have the ability to work in harmony with the FBE exemption of South Africa. Both Mauritius and UAE countries are considered low tax jurisdictions and these standards may ensure that legitimate foreign companies are set up in UAE and Mauritius, and that the profits of these entities match the activities in the country they are resident in. This may prevent residents from setting up FBEs simply to take advantage of the exemption as the substance requirements adds an additional layer of conditions to be met in setting up the foreign company in UAE and Mauritius.

Mauritius:

Consideration needs to be given to the substance requirements that have been implemented by Mauritius and whether the above substance requirements implemented by Mauritius enhance the section 9D provisions of the Income Tax Act to ensure that only bona fide FBE are taking advantage of the section 9D FBE exemption or if these requirements are simply additional administrative requirements that need to be met but add no value in the prevention of the FBE exemption being exploited.

The Mauritian substance requirements contain two tests to be satisfied for a GBC to qualify for the 3 per cent tax rate. The tests that should be satisfied are:

Test 1: Substance requirements

The GBC:

- Must ensure that core income-generating activities (CIGAs) are conducted in Mauritius (refer below to test 2);
- Must ensure that it employs, either on a direct or indirect basis, a sufficient quantity of qualified workforce members;

- must incur a minimum amount of expenditure which is in proportion to its level of activities.[135]

Test 2: Core Income Generating Activities:

A GBC is required to ensure that their core income generating activities (CIGA) are being carried out in or from Mauritius.

If these requirements are not met, then the global business company will not qualify for the partial exemption and would therefore not be taxed at a significantly lower rate of 3 per cent compared to the normal 15 per cent tax rate. From a South African perspective, even if a company does not qualify as a GBC, it would still be beneficial to set up a company in Mauritius to take advantage of the lower tax rate. It is noted, however that if the intention for setting up the company is purely to take advantage of a low tax rate, the taxpayer would not gain the full advantage of the 3 per cent tax rate if the company does not meet the GBC requirements. It would therefore appear from this that the substance requirements may aid in determining whether a true FBE exists per section 9D, however, a further assessment of each of these requirements would need to be performed.

As discussed in Chapter 4, in order to determine whether a GBC is managed and controlled from Mauritius, the Financial Services Authority (FSC) consider many factors. Some of which include where the entity maintains its principal bank account; whether meetings include at least two directors from Mauritius; where the accounting records are always kept; where financial statements are audited; whether the entity has at least two directors, resident in Mauritius, of sufficient caliber to exercise independence of mind and judgement.[136]

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[135] BBCIncorp 2023. *Mauritius Economic Substance Regulations: Important Updates (2023)* [Online]. Available: https://bbcincorp.com/offshore/articles/mauritius-economic-substance [2023, February 20].

[136] Fowdur B., Xavier, S. 2022. *In brief* : *economic substance requirements In Mauritius* [Online]. Available: https://www.lexology.com/library/detail.aspx?g=3032cb31-9de5-4aa3-8c32-9c2be23c211e [2023, February 20].

The table below will discuss the similarities between the requirements of the FBE definition and the substance standards to demonstrate whether the substance standards add value to the FBE definition.

Requirement	FBE definition[137]	Substance requirement
Locational permanence	- The business is conducted through one or more offices, shops, factories, warehouses or other structures.	- The GBC must have a physical address in Mauritius;[138] - The CIGAs of the GBC must always be conducted from Mauritius; [139]
Employee and staff requirements	- 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;	- GBCs must always ensure that their CIGAs are being conducted by employing, either directly or indirectly, a reasonable number of suitably qualified persons to carry out the CIGA; [140] - Have a certain number of employees who are residents of Mauritius;[141]

137 Income Tax Act 58 of 1962, Section 9D paragraph (a)
138 Financial Services Commission Mauritius 2016. *Circular Letter CL1-231216* [Online]. Available: https://www.fscmauritius.org/media/3730/fsc-issues-circular-letter-on-employment-and-substance-requirements-for-new-licensees.pdf [2023, May 08].
139 Fowdur B., Xavier, S. 2022. *In brief* : *economic substance requirements In Mauritius* [Online]. Available: https://www.lexology.com/library/detail.aspx?g=3032cb31-9de5-4aa3-8c32-9c2be23c211e [2023, February 20].
140 Fowdur B., Xavier, S. 2022. *In brief* : *economic substance requirements In Mauritius* [Online]. Available: https://www.lexology.com/library/detail.aspx?g=3032cb31-9de5-4aa3-8c32-9c2be23c211e [2023, February 20].
141 Financial Services Commission Mauritius 2016. *Circular Letter CL1-231216* [Online]. Available: https://www.fscmauritius.org/media/3730/fsc-issues-circular-letter-on-employment-and-substance-requirements-for-new-licensees.pdf [2023, May 08].

		- The quorum of directors must include at least two directors resident in Mauritius; [142] - Has at least two directors resident of Mauritius of sufficient caliber to exercise independence of mind and judgement. [143]
Suitability of equipment and facilities	- That the fixed place of business is suitably equipped for conducting the primary operations of that business; - That the fixed place of business has suitable facilities or conducting the primary operations of that business; -	- None. However, this is implied as the as the CIGAs are to be conducted in Mauritius at all times and this can only be performed with the relevant equipment and facilities.
Main reason for incorporation	- That the fixed place of business is located outside the Republic solely or mainly for a purpose other than the postponement or reduction of any tax imposed by any sphere of government in the Republic.	- None.

[142] Fowdur B., Xavier, S. 2022. *In brief* : *economic substance requirements In Mauritius* [Online]. Available: https://www.lexology.com/library/detail.aspx?g=3032cb31-9de5-4aa3-8c32-9c2be23c211e [2023, February 20].
[143] Fowdur B., Xavier, S. 2022. *In brief* : *economic substance requirements In Mauritius* [Online]. Available: https://www.lexology.com/library/detail.aspx?g=3032cb31-9de5-4aa3-8c32-9c2be23c211e [2023, February 20].

Additional requirements.		-Maintains its principal bank account in Mauritius, at all times; - Accounting records must be kept at its registered office in Mauritius at all times; [144] - Annual financial statements must be prepared and audited in Mauritius; [145] - Annual expenditure of the GBC must be incurred in Mauritius.[146] - A minimum level of expenditure is incurred which in proportion to the GBC's level of activity; [147]

From the above it is noted that the substance standards have additional requirements that do not have a counterpart in terms of the FBE definition. Due to this, the substance standards have the ability to enhance the FBE definition. From a Mauritian perspective, an extra layer of conditions is created by these additional requirements. These additional conditions ensure that from both a South African and Mauritian perspective a company set up in Mauritius must demonstrate locational permanence and a business purpose in Mauritius and that the company is a bona fide FBE and not one just on paper.

[144] Fowdur B., Xavier, S. 2022. *In brief* : *economic substance requirements In Mauritius* [Online]. Available: https://www.lexology.com/library/detail.aspx?g=3032cb31-9de5-4aa3-8c32-9c2be23c211e [2023, February 20].
[145] Fowdur B., Xavier, S. 2022. *In brief* : *economic substance requirements In Mauritius* [Online]. Available: https://www.lexology.com/library/detail.aspx?g=3032cb31-9de5-4aa3-8c32-9c2be23c211e [2023, February 20].
[146] Financial Services Commission Mauritius 2016. *Circular Letter CL1-231216* [Online]. Available: https://www.fscmauritius.org/media/3730/fsc-issues-circular-letter-on-employment-and-substance-requirements-for-new-licensees.pdf [2023, May 08].
[147] Fowdur B., Xavier, S. 2022. *In brief* : *economic substance requirements In Mauritius* [Online]. Available: https://www.lexology.com/library/detail.aspx?g=3032cb31-9de5-4aa3-8c32-9c2be23c211e [2023, February 20].

The substance standards require, in addition to having a minimum number of suitably skilled employees, that a minimum number of directors must be residents of Mauritius. It is also necessary for resident directors to be part of the quorum for board meeting purposes. While both the substance requirements and the FBE definition require operations to be undertaken from a physical location, the substance standards require the operations to always take place from the physical location making it a more stringent requirement. Other administrative requirements are also necessary in terms of the substance standards such as the preparation and audit of the financial statements to be done in Mauritius. These substance standard requirements therefore would enhance the FBE definition as it is more stringent in nature.

In terms of the substance standards, a minimum level of expenditure is also required to be incurred in relation to the GBC's activity level as well as that the GBC must have its annual expenditure incurred in Mauritius. This requirement or anything similar does not form part of the FBE definition. This requirement particularly stringent and would act as an enhancement to the FBE definition ensuring that a company set up in Mauritius is for bona fide economic purposes and not simply a shell company.

The only part of the FBE definition that is not matched with an equivalent substance standard is the part that requires the company to be set up in a foreign jurisdiction not for the purpose of the postponement or reduction in South African taxes. This part, however is partially addressed by the fact that a GBC can only enjoy the benefits of the reduced 3 per cent tax rate if it maintains its global business license. To maintain this license, the GBC is required to satisfy all substance requirements. As discussed above if a company is not taxed as a GBC a tax rate of 15% would apply which is still lower than the 27% payable in South Africa.

The FSC also refers to its guidelines set out in the FSC Circular to assess what is meant by the terms 'reasonable number of suitably qualified persons and 'a minimum expenditure which is proportionate to its level of activities'.[148]

In addition, the Mauritian Revenue Authority (MRA) performs an assessment on a case-by-case basis as to what should be classified as CIGA of the GBCs before the issuance of a tax residency certificate. Consideration is given to activities that are 'essential activities carried out to generate income of the company.[149]

Test 2 as mentioned above, will aide in ensuring that legitimate FBEs are set up per the ITA as the CIGA of the CFC must take place in Mauritius and will be assessed by the MRA in order to qualify for the partial exemption. This would deter South African tax residents from setting up a shell corporation in Mauritius as the partial exemption would not be applicable under Mauritian tax law if no CIGA are taking place by the company in Mauritius therefore enhancing the fact that a bona fide FBE would need to be set up.

These requirements also assist with the fact that the term 'primary operations' is not clearly defined in the FBE definition. By having an assessment of what the CIGA are from a Mauritian perspective this may give the South African application of the FBE more foundation as these activities should be similar to that of the 'primary operations' of the entity. If the MRA finds that an activity is CIGA it is highly likely this activity would fall part of the 'primary operations' of the entity as mentioned in the FBE definition. This may remove the subjective nature of applying the FBE definition slightly thereby removing the opportunity for its exploitation.

Although there is no requirement that the GBC would need to have "physical premises in Mauritius, they must however have a physical address in Mauritius, a minimum number

[148] Fowdur B., Xavier, S. 2022. *In brief* : *economic substance requirements In Mauritius* [Online]. Available: https://www.lexology.com/library/detail.aspx?g=3032cb31-9de5-4aa3-8c32-9c2be23c211e [2023, February 20].
[149] Fowdur B., Xavier, S. 2022. *In brief* : *economic substance requirements In Mauritius* [Online]. Available: https://www.lexology.com/library/detail.aspx?g=3032cb31-9de5-4aa3-8c32-9c2be23c211e [2023, February 20].

of employees in Mauritius and an annual expenditure in Mauritius" in order to qualify for tax holidays.[150] These requirements enhance the local substance of the FBE exemption as CFC's will be required to employ resident Mauritian employees, obtain a physical address, and incur expenditure in Mauritius all of which would require the company to be a bona fide company operating in the Mauritian jurisdiction and not that of an entity simply resident in Mauritius but operating from South Africa. The expenditure incurred should also be in proportion to the income earned from the CIGA therefore further enhancing that CIGA's would need to be performed in Mauritius.

Outsourcing of relevant activities is allowed in terms of the Income Tax (Amendment No. 2) Regulations 2019 of Mauritius however these activities must be conducted in Mauritius and be subject to adequate monitoring by the GBC. The activities are not allowed to be double captured which means that these activities cannot be used to demonstrate economic substance by multiple companies more than once.[151] Activities that are outsourced can only be used to demonstrate economic substance for the GBC employing the outsourcing company and not the actual outsourcing company itself.

This can ensure that only legitimate FBE are being set up as it unlikely for service providers to take on CIGAs because they cannot use it to demonstrate their own economic substance. Monitoring is also required by the GBC of these activities which is another deterrent for outsourcing companies.

United Arab Emirates:

In an effort to be removed from the EU's blacklist the UAE introduced Substance Economic Regulations in 2019. The finer details of which are discussed in Chapter 4. The

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[150] Financial Services Commission Mauritius 2016. *Circular Letter CL1-231216* [Online]. Available: https://www.fscmauritius.org/media/3730/fsc-issues-circular-letter-on-employment-and-substance-requirements-for-new-licensees.pdf [2023, May 08].
[151] Fowdur B., Xavier, S. 2022. *In brief* : *economic substance requirements In Mauritius* [Online]. Available: https://www.lexology.com/library/detail.aspx?g=3032cb31-9de5-4aa3-8c32-9c2be23c211e [2023, February 20].

substance requirements required all licensees who carry out relevant activities to satisfy the Economic Substance Test.[152]

The Economic Substance Test meant that the licensee must conduct all CIGAs in the UAE.[153] This requirement will assist in ensuring that legitimate FBEs are set up as the Licensee must ensure that all their activities essential to their business take place in the UAE forcing the CFC to conduct most of its business in the UAE and not in any other country. This will prevent taxpayers from setting up a FBE in the UAE simply to shift profits into it.

The table below demonstrates the similarities between the Economic Substance requirements of the UAE and the FBE definition as set out in section 9D of the ITA:

Requirement	**FBE definition[154]**	**Substance requirement**
Locational permanence	- The business is conducted through one or more offices, shops, factories, warehouses or other structures.	- The Licensee must conduct the Core Income Generating Activities in the UAE; [155]. - With regards to the Relevant Activity, there are physical assets within the UAE;
Employee and staff requirements	- That fixed place of business is suitably staffed with on-site managerial and	- The directors possess the necessary skills and

[152] Rwashdeh, M., Abu-Shattal, Z. & Rehman K. 2020
The New UAE Economic Substance Regulations [Online].
Available: https://www.natlawreview.com/article/new-uae-economic-substance-regulations [2023, February 20].
[153] Rwashdeh, M., Abu-Shattal, Z. & Rehman K. 2020
The New UAE Economic Substance Regulations [Online].
Available: https://www.natlawreview.com/article/new-uae-economic-substance-regulations [2023, February 20].
[154] Income Tax Act 58 of 1962, Section 9D paragraph (a)
[155] Ministerial Decision No. 100 for the year 2020 on the Issuance of Directives for the Implementation of the Provisions of the Cabinet Decision No 57 of 2020 Concerning Economic Substance Requirements Article 4.

	operational employees of that controlled foreign company who conduct the primary operations of that business;	knowledge to serve on the board; [156] - An adequate number of full-time employees are physically present in the UAE; [157]
Suitability of equipment and facilities	- That fixed place of business is suitably equipped for conducting the primary operations of that business; - That fixed place of business has suitable facilities or conducting the primary operations of that business; -	- None, however this is implied as all CIGAs must be conducted from the UAE and therefore suitable facilities and equipment would be required in order for this to be possible.
Main reason for incorporation	- That fixed place of business is located outside the Republic solely or mainly for a purpose other than the postponement or reduction of any tax imposed by any sphere of government in the Republic.	- None

[156] Ministerial Decision No. 100 for the year 2020 on the Issuance of Directives for the Implementation of the Provisions of the Cabinet Decision No 57 of 2020 Concerning Economic Substance Requirements Article 4.
[157] Ministerial Decision No. 100 for the year 2020 on the Issuance of Directives for the Implementation of the Provisions of the Cabinet Decision No 57 of 2020 Concerning Economic Substance Requirements Article 4.

Additional requirements.		- The board meetings' minutes and all records are kept in the UAE; [158]. - The board of directors' meetings take place in the UAE, with adequate frequency and a quorum is physically present in the UAE. [159] - The board of directors' meetings are recorded in minutes in which strategic decisions are noted and these minutes are signed by the directors; [160] - There is adequate operating expenditure incurred in the UAE. [161]

[158] Ministerial Decision No. 100 for the year 2020 on the Issuance of Directives for the Implementation of the Provisions of the Cabinet Decision No 57 of 2020 Concerning Economic Substance Requirements Article 4.

[159] Ministerial Decision No. 100 for the year 2020 on the Issuance of Directives for the Implementation of the Provisions of the Cabinet Decision No 57 of 2020 Concerning Economic Substance Requirements Article 4.

[160] Ministerial Decision No. 100 for the year 2020 on the Issuance of Directives for the Implementation of the Provisions of the Cabinet Decision No 57 of 2020 Concerning Economic Substance Requirements Article 4.

[161] Ministerial Decision No. 100 for the year 2020 on the Issuance of Directives for the Implementation of the Provisions of the Cabinet Decision No 57 of 2020 Concerning Economic Substance Requirements Article 4.

It is noted that, like that of the Mauritian substance standards, the UAE substance regulations would enhance the FBE definition. The substance regulations add an extra layer of conditions to be met that are not required in terms of the FBE definition.

The substance regulations require employees to be physically present in the UAE, in addition to being suitably qualified to perform the CIGAs. It is also noted that, in addition to conducting operations from a physical location the substance regulations require the company to have physical assets to perform its relevant activity. This is more stringent in nature and would enhance the FBE definition. There are also administrative requirements that form part of the substance regulations but do not have a corresponding requirement in the FBE definition. These requirements include the requirement that the minutes of board meetings to be kept in the UAE and ensuring all board meetings take place in the UAE. These additional requirements play a role in ensuring that companies set up in the UAE are for bona fide business purposes.

The UAE substance regulations, much like that of Mauritian substance standards, also require operating expenditure to be incurred in the UAE. This requirement is particularly stringent and enhances the FBE definition by ensuring that companies are set up in the UAE are for operating purposes and are not simply companies on paper. This requirement is also not present in the FBE definition.

Premises are required in the UAE and evidence of annual operating expenditures must be demonstrated. An adequate number of full-time staff is also required to be physically present in the UAE.[162] While outsourcing of CIGAs is allowed these CIGAs must be outsourced to an entity within the UAE and full control over these activities must remain with the entity.[163]

[162] Oton, A. 2021. *The UAE Introduced Economic Substance Regulations – How Does This Affect You?* [Online]. Available: https://uae-eu.com/blog/the-uae-introduces-new-economic-substance-laws-how-are-you-affected.html [2023, February 20].
[163] Oton, A. 2021. *The UAE Introduced Economic Substance Regulations – How Does This Affect You?* [Online]. Available: https://uae-eu.com/blog/the-uae-introduces-new-economic-substance-laws-how-are-you-affected.html [2023, February 20].

The employees that are carrying out the CIGA must in principle be resident of the UAE and if they are not, they would be required to be physically present in the UAE while carrying out these activities under the direction of the Licensee and the Licensee must bear all costs related to that non-resident employee.[164]

The abovementioned requirements may assist in ensuring the legitimate FBE are set up as the Licensee cannot simply add persons on the payroll to meet this requirement as the employees need to be qualified, resident of the UAE and physically in the UAE. If UAE non-resident staff members are employed, they would need to demonstrate physical presence in the UAE under the Licensee's cost. This would prove a deterrent and onerous on a taxpayer who is only setting up a company in this jurisdiction to shift profits into and take advantage of the low tax rate. This would therefore mean that the FBE exemption is enhanced as it is unlikely to set up a FBE for non bona fide purposes due to this costly and burdensome condition.

There also needs to be adequate expenditure undertaken in the UAE in relation to the profits. This would also ensure that legitimate FBE are being set up as it would be challenging to have operating expenditure in the UAE relative to profits if operations are not in fact taking place in the UAE. The Licensee would also need to ensure that they have enough physical assets in the UAE. This will constitute some sort of capital investment for the FBE which may not be attractive to a profit shifting company.

The fact that there is guidance provided on what a Relevant Activity is and what Core Income Generating Activities also enhances the local FBE definition as set out in the ITA. This is because, although not within the local definition of an FBE, it provides scope and definition of what type of a business should be undertaken as well as what the core activities are.

[164] Ait Ben Idir, A. 2020. *UAE Economic Substance Regulations now in force: Are you prepared?* [Online]. Available: https://www.nortonrosefulbright.com/en/people/121924 [2023, February 22].

Similar to that of the Mauritian Economic Substance requirements discussed above, the guidance issued in these Regulations may give some clarity on the term ‘primary operations’ which is not defined in the ITA FBE definition. It is noted that even though these substance requirements are not South African, the CFC and related FBE in question is the same entity in questions from both a South African and international perspective. The fact that Dubai and Mauritius are implementing these standards creates an additional layer of conditions and requirements to be met in setting up these FBE which can deter taxpayers from setting up non-bona fide FBE.

As discussed above, in conclusion some requirements of both the Dubai and Mauritian substance standards would enhance the local standards while some appear to simply be administrative in nature. The guidance provided on certain terms such as ‘Relevant Activity’ and ‘Core Income Generating Activities’ in the Mauritian and UAE substance standards can assist with the application of the FBE definition as set out in section 9D of the ITA. The substance standards also add a layer of conditions to be met to set up companies in foreign jurisdictions. This may act as a deterrent for taxpayers who simply wish to set up these companies to shift profits into these foreign jurisdictions and take advantage of the low tax rates thereby making it harder to set up non-bona fide FBE.

Chapter 6: An examination of the impact of the new OECD Blueprints on the foreign business establishment exemption.

This chapter will examine the impact of the new OECD Blueprints on the FBE exemption. Focus will be given to whether these Blueprints reduce the problem of eroding the South African tax base and act as a value adding mechanism to the FBE exemption in terms of section 9D of the ITA or not.

With the integration of national economies and markets significantly increasing in recent times, the international tax rules have become outdated as they were designed many decades ago which has placed them under strain. Due to this many flaws in the tax system have arisen which has created an opportunity for base erosion and profit shifting (BEPS). BEPS, if left unremedied can prove to be detrimental to the tax bases of many jurisdictions and could lead to harmful tax practices. For confidence to be restored in the system and to ensure that profits are taxed where economic activities take place, policy makers are required to make changes.[165]

Globalisation being on the rise has meant that changes in tax laws cannot happen unilaterally and in silos by nations as it may cause bigger issues. Unilateral decisions may result in unrelieved double taxation and inconsistencies between tax systems. These inconsistencies may result in loopholes or gaps in tax systems, the consequences of which may be that income goes untaxed or taxed at very low rates.[166] Many companies span across many jurisdictions which means that cooperation is needed between states. It would therefore prove beneficial and practical to address these tax issues via an international institution that can set up international standards and guidelines. The OECD is a good example of such an international organisation as the OECD Model Tax Convention has a big influence on treaties worldwide.[167] The OECD is also made up of 38 member states.[168] The OECD's BEPS project is one of the most impressive on international tax reforms of the century in which both OECD and G20 members as well as developing counties are participating. The OECD is also able to publish recommendations and guidelines on international tax issues which are not legally binding even if followed by its member states.[169] It is for these reasons that the OECD is the best international organisation to take on the task of facilitating the unity between jurisdictions in redeveloping and redefining the international tax laws.

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[165] OECD 2020. *Tax Challenges Arising from Digitalisation- Report on Pillar Two Blueprint, p.3* [Online]. Available https://www.oecd-ilibrary.org/docserver/abb4c3d1-en.pdf?expires=1686768793&id=id&accname=guest&checksum=1AEE40BCAEFDC77DA4E25A68BD221A5F [2023, February 23].
[166] Rootsma, E. 2021. *Adapting Taxation of Business Profits to the Digital Economy, p.17.* Sweden: Uppsala Universitet.
[167] Rootsma, E. 2021. *Adapting Taxation of Business Profits to the Digital Economy, p.17.* Sweden: Uppsala Universitet.
[168] OECD 2023. *Our global reach* [Online]. Available: https://www.oecd.org/about/members-and-partners/ [2023, February 24].
[169] Rootsma, E. 2021. *Adapting Taxation of Business Profits to the Digital Economy, p.17.* Sweden: Uppsala Universitet.

In February 2013, the OECD released a report Addressing Base Erosion and Profit Shifting and shortly thereafter in September 2013 the OECD and G20 countries adopted a 15-Point Action Plan to address BEPS. This Action Plan consisted of 15 actions which included three key pillars namely:

> *"…introducing coherence in domestic rules that affect cross border activities, reinforcing substance requirements in existing international standards and improving transparency as well as certainty".* [170]

Measures in response to the 15 actions were developed into a BEPS package of measures and this represented the first substantial renovation of international tax rules in almost a century.[171] With globalisation of the world and businesses, global solutions and global dialogue needed to be established which would go beyond the OECD and G20 countries.[172]

Tax challenges arising from digitalisation was acknowledged as an outstanding BEPS issue that needed to be resolved[173]. Addressing the tax challenges that arose from this new digitalisation of economies became a top priority for the BEPS Project and Inclusive Framework since 2015 with the release of the BEPS Action 1 Report.[174] It was agreed that members of the Inclusive Framework would examine proposals in Two Pillars which

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[170] OECD 2020. *Tax Challenges Arising from Digitalisation- Report on Pillar Two Blueprint, p.3* [Online]. Available: https://www.oecd-ilibrary.org/docserver/abb4c3d1-en.pdf?expires=1686768793&id=id&accname=guest&checksum=1AEE40BCAEFDC77DA4E25A68BD221A5F [2023, February 23].

[171] OECD 2020. *Tax Challenges Arising from Digitalisation- Report on Pillar Two Blueprint, p.3* [Online]. Available: https://www.oecd-ilibrary.org/docserver/abb4c3d1-en.pdf?expires=1686768793&id=id&accname=guest&checksum=1AEE40BCAEFDC77DA4E25A68BD221A5F [2023, February 23].

[172] OECD 2020. *Tax Challenges Arising from Digitalisation- Report on Pillar Two Blueprint, p.3* [Online]. Available: https://www.oecd-ilibrary.org/docserver/abb4c3d1-en.pdf?expires=1686768793&id=id&accname=guest&checksum=1AEE40BCAEFDC77DA4E25A68BD221A5F [2023, February 23].

[173] Bammens, N. & Bettens, D. 2023. The Potential Impact of Pillar Two on Tax Incentives. *INTERTAX* 51(2):155-169.

[174] OECD 2020. *Tax Challenges Arising from Digitalisation- Report on Pillar Two Blueprint, p.3* [Online]. Available: https://www.oecd-ilibrary.org/docserver/abb4c3d1-en.pdf?expires=1686768793&id=id&accname=guest&checksum=1AEE40BCAEFDC77DA4E25A68BD221A5F [2023, February 23].

would form a base for a consensus-based solution to address the tax challenges from digitalisation. Pillar One focused on nexus and profit allocation and Pillar Two focused on a global minimum tax intended to address the remaining BEPS issues.[175]

The introduction of the Two Pillar consensus-based solution can ensure that there is fairness and equity in the tax systems and fortify the international tax framework which is vital in the ever changing business and economic environment.[176]

As of December 2022, over 138 countries[177] have joined the Two Pillar solution to remedy the international tax laws to ensure fairness when it comes to multinational enterprises (MNEs) paying their share of taxes in the jurisdictions they operate in.[178]

The Two Pillar approach may assist in acting as a value adding mechanism to the local FBE definition and exemption as its aim is to create a "*sustainable taxation framework reflective of today's digitalising economy with the potential to achieve fairer and more efficient allocation of taxing rights".*[179] The key element relative to the value add of FBE definition and exemption is the fact that a fairer allocation of taxing rights is to be achieved. This has the potential to ensure that together with the substance requirements, the

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[175] OECD 2020. *Tax Challenges Arising from Digitalisation- Report on Pillar Two Blueprint, p.3* [Online]. Available: https://www.oecd-ilibrary.org/docserver/abb4c3d1-en.pdf?expires=1686768793&id=id&accname=guest&checksum=1AEE40BCAEFDC77DA4E25A68BD221A5F [2023, February 23].

[176] OECD 2020. *Tax Challenges Arising from Digitalisation- Report on Pillar Two Blueprint, p.3* [Online]. Available: https://www.oecd-ilibrary.org/docserver/abb4c3d1-en.pdf?expires=1686768793&id=id&accname=guest&checksum=1AEE40BCAEFDC77DA4E25A68BD221A5F [2023, February 23].

[177] OECD 2022. *Members of the OECD/G20 Inclusive Framework on BEPS joining the October 2021 Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy as of 16 December 2022* [Online]. Available: https://www.oecd.org/tax/beps/oecd-g20-inclusive-framework-members-joining-statement-on-two-pillar-solution-to-address-tax-challenges-arising-from-digitalisation-october-2021.pdf [2023, May 10].

[178] OECD 2021. *Action 1 Tax Challenges Arising from Digitalisation* [Online]. Available: https://www.oecd.org/tax/beps/beps-actions/action1/ [2023, February 24].

[179] OECD 2020. *Tax Challenges Arising from Digitalisation- Report on Pillar Two Blueprint, p.11* [Online]. Available: https://www.oecd-ilibrary.org/docserver/abb4c3d1-en.pdf?expires=1686768793&id=id&accname=guest&checksum=1AEE40BCAEFDC77DA4E25A68BD221A5F[2023, February 23].

entities being set up in foreign jurisdictions, i.e., CFCs and potential FBEs, are taxed in the jurisdictions in which the economic activity takes place.

As discussed in previous chapters, the FBE definition is lacking in definition and scope which has the potential to lead to many taxpayers taking advantage of this to their own benefit. The Two Pillar framework may decrease the opportunity for the FBE exemption from being taken unfair advantage of.

Pillar One:

Pillar One focuses on nexus and profit allocation and aims to expand the taxing rights of market jurisdiction.[180] The purpose of Pillar One is the reallocation of taxing rights. This pillar aims to ensure a fairer distribution of taxing rights among jurisdictions with the largest MNEs, including digital companies. This would entail the reallocation of taxing rights over MNEs from their home jurisdictions to the jurisdictions where they carry on business activities and earn profits, irrespective of whether these MNEs have a physical presence in these jurisdictions.[181]

The scope of Pillar One is MNEs with a global turnover of above 20 billion euros and profitability above 10 per cent. This is calculated using an averaging mechanism with the turnover threshold reducing to 10 billion euros, depending on the successful implementation of Amount A.[182]

Amount A is designed to allocate parts of the profits of MNEs to countries where they sell their products and provide services. The key objective of amount A being to restore

[180] Bammens, N. & Bettens, D. 2023. The Potential Impact of Pillar Two on Tax Incentives. *INTERTAX* 51(2):155-169.
[181] OECD 2021. *Action 1 Tax Challenges Arising from Digitalisation* [Online]. Available: https://www.oecd.org/tax/beps/beps-actions/action1/ [2023, February 24].
[182] OECD 2021. *Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* [Online]. Available: https://www.oecd.org/tax/beps/brochure-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf [2023, March 08].

stability in the international tax framework by preventing uncoordinated unilateral tax measures.[183]

The purpose of Pillar One of the Two Pillar solution does not seem like it would assist in adding value to the FBE definition and exemption as it appears to only be applicable to the biggest and most profitable MNEs. This would mean that smaller entities attempting to circumvent the South African tax laws via the exploitation of the FBE exemption would not be covered under this pillar.

Pillar Two:

While Pillar One is still a work in progress, Pillar Two has been made a part of the Global Anti-Base Erosion (GloBE) Rules which were released in December 2021.[184] The GloBE rules are to serve as a coordinated system ensuring that MNE groups are subject to a minimum tax rate in each of the jurisdictions in which the operate.[185]

As noted in the beginning of this chapter OECD/G20 Action Plans came about as a response to the increase in globalisation within the business world as well as the ever-changing economy making international tax rules outdated. Due to this, opportunities became available for base erosion and profit shifting and the OECD created the 15-Point Action Plan to ensure that these opportunities were minimised and that profits are taxed in the jurisdiction in which the activities that generated those profits are performed and where value is created.[186]

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[183] OECD 2022. *Progress Report on Amount A of Pillar One Frequently asked questions* [Online]. Available: https://www.oecd.org/tax/beps/frequently-asked-questions-progress-report-on-amount-a-pillar-one-july-2022.pdf [2023, March 08].
[184] OECD 2023. *Tax Challenges Arising from the Digitalisation of the Economy – Administrative Guidance on the Global Anti- Base Erosion Model Rules (Pillar Two)* [Online]. Available: https://www.oecd.org/tax/beps/agreed-administrative-guidance-for-the-pillar-two-globe-rules.pdf [2023, March 03].
[185] OECD 2021. *OECD releases Pillar Two model rules for domestic implementation of 15% global minimum tax* [Online]. Available: https://www.oecd.org/tax/beps/oecd-releases-pillar-two-model-rules-for-domestic-implementation-of-15-percent-global-minimum-tax.htm [2023, May 03].
[186] OECD 2020. *Tax Challenges Arising from Digitalisation- Report on Pillar Two Blueprint, p.3* [Online]. Available: https://www.oecd-ilibrary.org/docserver/abb4c3d1-

The imperative question that needs to be asked is whether the Pillar Two Blueprints objective is in line with the OECD/G20 Action Plans objective. This is an important question in relation to the CFC rules of a jurisdiction, and for the purposes of this research, the FBE definition and exemption. This is because the purpose of the FBE exemption is to remove income generated from legitimate business from the section 9D net as this would likely mean that the profits are being generated in the jurisdiction in which activities are taking place and value is created and taxed accordingly in that jurisdiction which is in line with the OECD/G20 Action Plans to combat BEPS. This exemption also aims to remove income that poses a low risk of BEPS from the section 9D net.

Upon initial publication the OECD had appeared to have suggested a much broader objective of the GLOBE rules beyond countering BEPS mechanisms and further BEPS work.[187] In the 2019 Policy Note on Action 1, the need for Pillar Two was justified due to the fact that, in the absence of some sort of multilateral action, there is a risk that uncoordinated unilateral action will take place in an attempt to attract more tax base and protect the existing tax base which could be detrimental for all counties involved.[188] The 2019 Programme of Work also stated that to stop the race to the bottom global action is required. There is a risk that taxes would be shifted to fund public goods onto less mobile bases including labour and consumption which would ultimately undermine the tax sovereignty of nations and their legislators.[189] The 2019 Programme of Work states that Pillar Two aims to limit the impact of direct taxes on investment and business location decisions by providing jurisdictions with the right to tax back where they have not

en.pdf?expires=1686768793&id=id&accname=guest&checksum=1AEE40BCAEFDC77DA4E25A68BD221A5F [2023, February 23].

[187] Bammens, N. & Bettens, D. 2023. The Potential Impact of Pillar Two on Tax Incentives. *INTERTAX* 51(2):155-169.

[188] Bammens, N. & Bettens, D. 2023. The Potential Impact of Pillar Two on Tax Incentives. *INTERTAX* 51(2):155-169

[189] OECD 2019. *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from Digitalisation of the Economy* [Online]. Available: https://www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.pdf [2023, March 08]

exercised their primary taxing rights or where they are subject to very low levels of taxation.[190]

The above statements suggest that the aim of Pillar Two is not limited to base erosion but also to curbing tax competition.[191] The suggestion was such that the focus was not only on preventing the shifting of profits to low tax jurisdictions where no economic activity took place but also on the fact that tax competition is harmful and should be addressed in spite of the fact that the tax benefits may be granted for actual economic activities taking place.[192]

This objective changed in the beginning of 2020 when the Pillar Two Blueprint was released whereby the rules were not fully aligned with such a broad objective. It is however noted that in the October 2021 *Two Pillar Solution to Address Tax Challenges Arising from the Digitalisation of the Economy* document released by the OECD still refers to Pillar Two putting a floor on tax competition with the introduction of the 15 per cent global minimum tax rate. It also states that although Pillar Two does not eliminate tax competition it sets a multilaterally agreed limitation to it.[193] It therefore appears that the purpose of Pillar Two is still in line with the broader objective and not just to curb BEPS.

Pillar Two introduces a global minimum corporate tax rate of 15 per cent for all MNEs. This Pillar specifically scopes in entities with an annual group consolidated revenue of more than €750 million or equivalent however even entities who do not meet the threshold

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[190] OECD 2019. *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from Digitalisation of the Economy* [Online]. Available: https://www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.pdf [2023, March 08]

[191] Bammens, N. & Bettens, D. 2023. The Potential Impact of Pillar Two on Tax Incentives. *INTERTAX* 51(2):155-169.

[192] Bammens, N. & Bettens, D. 2023. The Potential Impact of Pillar Two on Tax Incentives. *INTERTAX* 51(2):155-169.

[193] OECD 2021. *Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* [Online]. Available: https://www.oecd.org/tax/beps/brochure-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf [2023, March 08].

may apply this Pillar. This Pillar aims to put the brakes on the competition over corporate income tax and allow jurisdictions to protect their country's tax bases.[194]

The introduction of this minimum tax payable means that MNE groups will be required to assess the effective tax rate paid in each jurisdiction in which they operate against the 15 per cent. If this effective tax rate is lower than 15 per cent the top up tax will need to be paid if the MNE group falls within the scope of Pillar Two.

The GloBE rules are applied on a jurisdictional basis.[195] This means that the effective tax rate for a jurisdiction is calculated as the sum of covered taxes of each entity within the jurisdiction divided by the aggregate GloBE income or loss of each entity.[196] It is therefore possible that no top up tax would be applicable even though an entity may have a tax rate lower than 15 per cent on a stand-alone basis because this the effective tax rate is being averaged along with the tax rates of the other entities within the jurisdiction.[197]

It is noted that the 15 per cent minimum tax rate would be applicable regardless of the jurisdiction's local tax rate or tax base. This is in response to the challenge faced with regards to the digitalisation of the economy which enables large MNEs to take advantage of existing rules such as the FBE exemption to avoid paying tax. Even though entities who do not meet the threshold may still apply Pillar Two these rules are targeted to MNEs

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[194] OECD 2021. *Action 1 Tax Challenges Arising from Digitalisation* [Online]. Available: https://www.oecd.org/tax/beps/beps-actions/action1/ [2023, February 24].

[195] OECD 2021. *Tax Challenges Arising from Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two)*, *p.7* [Online]. Available: https://www.oecd-ilibrary.org/docserver/782bac33-en.pdf?expires=1678106836&id=id&accname=guest&checksum=B664B0D6A840032C23B9FCF32969DEE9 [2023, March 06].

[196] Bammens, N. & Bettens, D. 2023. The Potential Impact of Pillar Two on Tax Incentives. *INTERTAX* 51(2):155-169.

[197] Bammens, N. & Bettens, D. 2023. The Potential Impact of Pillar Two on Tax Incentives. *INTERTAX* 51(2):155-169.

as these companies have the resources to take advantage of the digitalisation of the economy.[198]

There are two defined inter-locking mechanisms that have been put in place to apply this top up tax of 15 per cent. These are the Income Inclusion Rule (IIR) and the Undertaxed Payments Rule (UTPR).[199]

The IIR works as a top-up tax whereby the parent entity will be taxed on the income of the subsidiary that is based in a foreign jurisdiction with a tax rate lower than 15 per cent.[200] The amount of tax to be paid would essentially be the difference between the rate on the foreign jurisdiction and the 15 per cent minimum set out in Pillar Two.

The UTPR plays a supporting role in relation to the IIR in which deductions are denied or a similar adjustment made in the event that the parent companies' subsidiaries of low tax jurisdictions are not subject to the IIR.[201]

A Subject to Tax Rule forms part of the Pillar Two design as well. This is a treaty-based rule and is a covered tax and would be applied first before the IIR and UTPR. This rule overrides treaty benefits for certain related party transactions such as interest and royalties that are not subject to a minimum of 9 per cent tax rate in the recipient jurisdiction.[202] This essentially allows source jurisdictions to apply limited source taxation

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[198] OECD 2021. *Addressing the tax challenges arising from the digitalisation of the economy, p.14* [Online]. Available: https://www.oecd.org/tax/beps/brochure-addressing-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2021.pdf [2023, February 24].

[199] OECD 2021. *Tax Challenges Arising from Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two)* [Online]. Available: https://www.oecd-ilibrary.org/docserver/782bac33en.pdf?expires=1677752058&id=id&accname=guest&checksum=C689311CABE256EB6B8C711EA9A7AA85 [2023, March 02].

[200] KPMG 2022. *Pillar Two: Global minimum taxation* [Online]. Available: https://assets.kpmg.com/content/dam/kpmg/xx/pdf/2021/11/beps-pillar-two-web.pdf [2023, March, 06].

[201] KPMG 2022. *Pillar Two: Global minimum taxation* [Online]. Available: https://assets.kpmg.com/content/dam/kpmg/xx/pdf/2021/11/beps-pillar-two-web.pdf [2023, March, 06].

[202] KPMG 2022. *Pillar Two: Global minimum taxation* [Online]. Available: https://assets.kpmg.com/content/dam/kpmg/xx/pdf/2021/11/beps-pillar-two-web.pdf [2023, March, 06].

on certain related party transactions that were not otherwise subject to the minimum tax of 9 per cent.[203]

The STTR specifically targets risks to the source jurisdiction that result from BEPS structures relating to intragroup payments that take advantage of low or nominal tax rates in the jurisdiction of the payee. The STTR is based on the reasoning that a source jurisdiction that has ceded its taxing right due to a tax treaty should be able to apply a top up tax to the agreed minimum rate where intragroup payments are not taxed or taxed below the minimum tax rate in the other contracting jurisdiction due to the treaty. The STTR is specifically targeting cross border structures that use certain provisions of a tax treaty to shift profits between group entities from source jurisdictions to jurisdictions where the payments are subject to low or nominal tax rates.[204]

The STTR could therefore assist in the curtailment of the exploitation of the FBE exemption as certain intragroup deductions that are provided by way of a treaty will be denied which is a deterrent for taxpayers to set up FBE not for bona fide purposes. It must also be noted that this aims to protect the tax base of the recipient and not that of the taxpayer that set up the foreign company which again may act as a deterrent for setting up an FBE other than for bona fide purposes.

The IIR and UTPR could potentially assist with the reduction in the exploitation of the FBE exemption as the imposition of the minimum tax, in the parent jurisdiction, on foreign income i.e., that of a CFC, will deter MNEs from setting up FBEs simply to take advantage of the exemption and for the purposes of shifting profit to a lower tax jurisdiction. The UTPR acts as further insurance to the IIR as this will allow a further tax on any low taxed income that was not covered by the IIR which again acts as a deterrent from setting up an FBE simply to shift profits to the low tax jurisdiction.

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[203] Bammens, N. & Bettens, D. 2023. The Potential Impact of Pillar Two on Tax Incentives. *INTERTAX* 51(2):155-169.

[204] OECD 2020. *Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint, p.150* [Online]. Available:https://www.oecdilibrary.org/docserver/abb4c3d1en.pdf?expires=1678092296&id=id&accname=guest&checksum=47CEC3BD5C41C6EB1A1E62EF455FDDF3 [2023, March 06].

A substance-based income exclusion exists within Pillar Two which allows for income to be excluded, for the purposes of determining the top up tax if it arises from adequate substance within a jurisdiction.[205]

The substance-based exclusion amount is the sum of the payroll carve out and the tangible asset carve out except for constitute entities that are investment entities.[206] The payroll carve out is the extent to which income is derived from employees and the tangible asset carve out is the extent to which income is earned from capital assets.[207]

The payroll carve out is calculated as 5 per cent of eligible payroll costs of eligible employees that perform activities for the MNE group. Eligible payroll costs that are capitalized and added to the carrying value of eligible tangible assets are excluded as well as costs attributable to international shipping income.[208]

The tangible carve out equates to 5 per cent of the carrying value of eligible tangible assets.[209] Eligible tangible assets include:

(a) property, plant, and equipment located in that jurisdiction;

[205] Tickle, D. 2022. Controlled Foreign Corporations and the Future of the Foreign Business Establishment Exemption. *Tax Talk* 2022 (96): 40-43.

[206] OECD 2021. *Tax Challenges Arising from Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two)*, *p.30* [Online]. Available: https://www.oecdilibrary.org/docserver/782bac33en.pdf?expires=1677752058&id=id&accname=guest&checksum=C689311CABE256EB6B8C711EA9A7AA85 [2023, March 02].

[207] Tickle, D. 2022. Controlled Foreign Corporations and the Future of the Foreign Business Establishment Exemption. *Tax Talk* 2022 (96): 40-43.

[208] OECD 2021. *Tax Challenges Arising from Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two)*, *p.30* [Online]. Available: https://www.oecd-ilibrary.org/docserver/782bac33en.pdf?expires=1677752058&id=id&accname=guest&checksum=C689311CABE256EB6B8C711EA9A7AA85 [2023, March 02].

[209] OECD 2021. *Tax Challenges Arising from Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two)*, *p.30* [Online]. Available: https://www.oecd-ilibrary.org/docserver/782bac33en.pdf?expires=1677752058&id=id&accname=guest&checksum=C689311CABE256EB6B8C711EA9A7AA85 [2023, March 02].

(b) natural resources located in that jurisdiction;

(c) a lessee's right of use of tangible assets located in that jurisdiction; and

(d) a licence or similar arrangement from the government for the use of immovable property or exploitation of natural resources that entails significant investment in tangible assets. [210]

Land and building held for sale, lease or investment as well as tangible assets used in international shipping income are specifically excluded. The computation carrying value of the tangible assets is based on the average of carrying value, net of accumulated depreciation, amortisation, or depletion and including any amount attributable to capitalisation of payroll expense) at the beginning and ending of the reporting fiscal year as recorded for the purposes of preparing the Consolidated Financial Statements of the Ultimate Parent Entity.[211]

Based on the above-mentioned tangible assets carve out and payroll carve out, the OECD is expecting income to be generated by people and tangible assets with a 5 per cent return on income from employees and tangible assets. Anything over and above this amount would be considered excessive and a top up tax would be required to be paid.[212] It is noted that the 5% threshold will only be applicable from the 2033 fiscal year as the transitional rules provide relief for MNE by decreasing the percentage over a 10 fiscal year period from 10 per cent to 5 per cent.[213]

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210 OECD 2021. *Tax Challenges Arising from Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two)*, *p.30* [Online]. Available: https://www.oecd-ilibrary.org/docserver/782bac33en.pdf?expires=1677752058&id=id&accname=guest&checksum=C689311CABE256EB6B8C711EA9A7AA85 [2023, March 02].

211 OECD 2021. *Tax Challenges Arising from Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two)*, *p.30* [Online]. Available: https://www.oecd-ilibrary.org/docserver/782bac33-en.pdf?expires=1677752058&id=id&accname=guest&checksum=C689311CABE256EB6B8C711EA9A7AA85 [2023, March 02].

212 Tickle, D. 2022. Controlled Foreign Corporations and the Future of the Foreign Business Establishment Exemption. *Tax Talk* 2022 (96): 40-43.

213 OECD 2021. *Tax Challenges Arising from Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two)*, *p.50* [Online]. Available: https://www.oecd-

The introduction of the 15 per cent minimum global tax and the substance-based exclusion raises a question with regards to how this would interact with the CFC rules of local jurisdictions. Many shareholders of CFCs would be required by their local legislation to include the net income of that CFC in their taxable income. This inclusion has exemptions from a South African perceptive in the form of the highly taxed exemption and the FBE exemption, as discussed in previous chapter. These exclusions are aimed at retaining international competitiveness for CFCs who carry on substantial and legitimate business activities offshore.[214]

The FBE exemption negates certain types of income if they meet the criteria for the diversionary rules as these incomes are highly likely to relate to passive income of the South African resident and would therefore form part of the net income of the CFC,[215] even if that CFC is a FBE as defined in section 9D of the ITA .

Consideration needs to be given to CFCs that meet the definition of the FBE as defined in section 9D of the ITA (and therefore qualify for the FBE exemption) and whether these entities may still be liable for the 15 per cent top up tax. This scenario is possible as the substance-based income exclusion and the FBE test are different and are not intended to be similar. Pillar Two is also not in place to replace local CFC rules or to render them redundant.[216]

It is also highly unlikely for smaller entities who do not meet the threshold to be inclined to apply these rules. It is therefore noted that this application rule excludes any smaller entities and for these entities the existing rules in this case the FBE exemption will have to be sufficient and therefore for smaller entities the Pillar Two Blueprint would not curtail the FBE exemption exploitation problem. It is also noted that the EUR750 million

ilibrary.org/docserver/782bac33en.pdf?expires=1677752058&id=id&accname=guest&checksum=C689311CABE256EB6B8C711EA9A7AA85 [2023, March 02].

[214] Tickle, D. 2022. Controlled Foreign Corporations and the Future of the Foreign Business Establishment Exemption. *Tax Talk* 2022 (96): 40-43.

[215] Tickle, D. 2022. Controlled Foreign Corporations and the Future of the Foreign Business Establishment Exemption. *Tax Talk* 2022 (96): 40-43.

[216] Tickle, D. 2022. Controlled Foreign Corporations and the Future of the Foreign Business Establishment Exemption. *Tax Talk* 2022 (96): 40-43.

consolidated revenue threshold approximates ZAR14.5 billion in today's terms. Most South African MNE groups would not meet this threshold and is therefore not likely to be affected by the Pillar Two requirements.[217]

In addition, it is also noted that there is a de minimis exclusion. This means that even if a South African MNE group met the EUR750 million threshold, the top-up tax could be deemed to be zero if for the current and previous two tax years the GloBE revenues of the constituent entities in a specific jurisdiction is less than EUR10 million and the average GloBE income or loss in such a jurisdiction is less than EUR1 million. This exclusion makes it highly likely that the Pillar Two requirements would not be applicable to South African MNE groups.[218]

The exclusions mentioned above limits the scope of Pillar Two in a vast manner making it less effective in combating BEPS as it would only be applicable to certain entities. Many South African entities would not meet these thresholds to be scoped into Pillar Two. It also appears that the underlying purpose of the Pillar Two Blueprint remains to challenge and curb tax competition even if it relates to legitimate business activities. This is not in line with curbing BEPS while retaining international competitiveness. Since the purpose of the FBE exemption is to retain international competitiveness and curb BEPS the Pillar Two Blueprint differs significantly from it and therefore is not likely to add any value to the FBE definition and exemptions.

Due to these factors mentioned above It would therefore be more effective to strengthen the local CFC rules to prevent BEPS from occurring than to use the Pillar Two minimum

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[217] Tickle, D. 2022. Controlled Foreign Corporations and the Future of the Foreign Business Establishment Exemption. *Tax Talk* 2022 (96): 40-43.

[218] OECD 2021. *Tax Challenges Arising from Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two)*, *p.32* [Online]. Available: https://www.oecd-ilibrary.org/docserver/782bac33en.pdf?expires=1677752058&id=id&accname=guest&checksum=C689311CABE256EB6B8C711EA9A7AA85 [2023, March 02].

tax do so.[219] In effect the Pillar Two Blueprint would not aid in adding value to the FBE definition and exemption.

Chapter 7: Conclusion

In conclusion this research report has critically evaluated the CFC rules as set out in Section 9D of the ITA. Particular focus was given to the FBE definition and exemption and its role in preventing BEPS. Consideration was also given to whether the economic substance standards that have been implemented by the UAE and Mauritius assisted in ensuring that bona fide FBE were set up or not. It was also considered whether the OECD Pillar One and Pillar Two Blueprints assisted with this matter or added no value to the FBE definition and exemption. In performing this analysis, the OECD BEPS Action Plan reports were used as well as the relevant tax legislation, case law, and the economic substance requirements were used.

The introduction of section 9D to the ITA was to act as an anti-avoidance measure and to protect the tax base of South Africa. The aim of this section is to ensure that South African tax residents do not set up companies in low tax jurisdictions for the sole purpose of shifting profits to these companies to pay less tax. This section does however, recognise that many companies are set up in foreign jurisdictions by South African residents for legitimate business reasons. These types of companies are excluded from the section 9D net. This is known as the FBE exemption.

It was found that the FBE definition went through many changes over the years before it was settled on its current definition. This definition is based off the substance analyses guidelines as set out by the OECD in the Action 3: Strengthening the CFC Rules Report. This analysis includes an employees and establishment test.

[219] Bammens, N. & Bettens, D. 2023. The Potential Impact of Pillar Two on Tax Incentives. *INTERTAX* 51(2):155-169.

The substance analyses were criticised for being too narrowly defined and for not considering the impact of outsourcing. By extension this criticism holds true for the FBE exemption as it is based off the OECD guidelines. it was also found that the mechanical nature of the FBE definition rendered it outdated in the current business environment.

Emanating from the analyses and findings above, a situation whereby the FBE provision is onerous on both the taxpayer and SARS to comply with and review respectively. This opens up an opportunity for taxpayers to take advantage of the FBE exemption as its basis is a substance test which is not clearly defined, particularly when it comes to what constitutes the ‘primary activities’ of a business. This lack of clarity within the FBE definition and exemption makes it subjective which has the potential to create opportunities for taxpayers to use the FBE exemption to their advantage and simply set up a non-bona fide FBE in a low tax jurisdiction to shift profits into and still be exempt from section 9D of the ITA.

The economic substance standards were introduced under the guidance of the EU and OECD to ensure that income and profits are taxed in the jurisdiction that core business activities take place and where value is created. A further analysis was done into the substance standards issued by the UAE and Mauritius and whether it would assist in ensuring that bona fide FBE are set up from a South African perspective. This is because these standards add an additional layer of requirements to be met for the foreign company to be set up in the low tax jurisdiction in this case the UAE and Mauritius. These additional requirements create more effort for taxpayers especially those setting up non-bona fide FBE’s and may deter them from doing so. The substance standards were also found to be more stringent in its requirements in comparison to the FBE definition and therefore acts as an enhancement to the FBE definition.

The OECD introduced the Pillar One and Pillar Two Blueprints to address the tax challenges that were on the rise in the new digitalised economy. Currently the Pillar One Blueprint is still in progress. Pillar Two, however, has been added to the GLoBE rules.

It was found that Pillar Two only included MNE with a consolidated revenue of at least €750 million. This threshold is significantly high and would not likely apply to a South African company even those with a global presence. There were also many other exclusions that scoped out entities, even those who met the €750 million threshold.
For these reasons it was found that the Pillar Two Blueprint would not assist in ensuring that bona fide FBE were set up and that improvements in the current CFC rules would be more effective in combating BEPS.

Therefore, it was found that the substance requirements and OECD Pillar One and Pillar Two Blueprints are not the only answer in assisting with the prevention of non-bona fide FBEs being set up. While these may add some value and assist in a small way, to combat BEPS and ensure that bona-fide FBEs are being set up, the local CFC legislation should be remedied and improved. The legislation should clearly define and scope in what a FBE entails as well as what the term primary operations should mean. Owing to outsourcing becoming more prevalent in the business environment, this should also be factored into the FBE. By improving the definition of the FBE, this should act as an effective means of preventing non-bona fide FBE being set up as well as making the CFC rules simpler for taxpayers and SARS to comply with and review respectively.

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