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Does section 9D achieve the objectives of the BEPS action 3 in the ever changing business environment?

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SCHOOL OF ACCOUNTANCY

University of the Witwatersrand, Johannesburg

DOES SECTION 9D ACHIEVE THE OBJECTIVES OF THE BEPS ACTION 3 IN THE EVER CHANGING BUSINESS ENVIRONMENT?

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

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Abstract

The Organisation for Economic Co-operation and Development (OECD) Action 3 in the Base Erosion and Profit Sharing Project (BEPS) outlines a roadmap on the formulation of the controlled foreign company rules. Countries can elect to adopt the recommendations or may even expand on them. South Africa (SA) has adopted the BEPS action 3 even though it is not a member state.

The research report will examine whether section 9D (which codifies the South African controlled foreign companies rules) addresses the BEPS action 3 objectives and how some provisions of the section 9D interact with other parts South African tax legislation (transfer pricing) to address these objectives in the ever changing business environment.

The methodology adopted in this report is of a qualitative, interpretive nature, based on a detailed interpretation and analysis of the literature. The literature review will mainly focus on the OECD documentation and South African statutes. The other sources are supporting material to help answer the main research question and to achieve the aim of the study.

Keywords: Base Erosion and Profit sharing, South Africa, tax resident, section 9D, Organisation for Economic Co-operation and Development, Controlled foreign company, BEPS Action 3, passive income, double taxation.

Declaration

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

Lungile Nosibusiso Gloria Maesela

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Abbreviations

SA	South Africa
OECD	Organisation for Economic Co-operation and Development
BEPS	Base erosion profit shifting
CFC	Controlled foreign companies
DTA	Double tax agreement
FBE	Foreign business establishment
UK	United Kingdom
US	United States of America
PE	Permanent establishment
IFRS	International Financial Reporting Standards
IP	Intellectual property
MNE	Multinational enterprise
SARS	South African Revenue Services
The Act	Income Tax Act 58 of 1962 (as amended)
CGT	Capital gains tax
AFS	Annual financial statements

Chapter 1: Introduction

1.1. Background

When South Africa transitioned into the new political dispensation in 1994, it introduced the relaxation of exchange control regulations. Effective as from 1 July 1997, more exchange control measures were abolished or relaxed. Prior thereto, a resident who wanted to invest outside of SA had to obtain South African Reserve Bank approval through an authorised dealer. The exchange controls enabled the South African government to restrict outflows of cash or investments from SA. This was done to ensure, to the extent possible, that income earned by South Africans was kept within the borders of South Africa.

From 1997 South African residents were able to move funds from SA to invest in foreign countries. National Treasury was concerned about the effect this will have on the South African tax base. According to National Treasury, this opened a possibility for South African residents to move funds and put them in other jurisdictions as a way to avoid/ reduce/ postpone tax, resulting in the reduction of the South African tax base (South African Revenue Service 1997:3). Andersson (2006:4) explains how this reduction or postponement of tax is achieved:

> When a person invests in a foreign company the tax base of his residence country is temporarily reduced because income, or in reality the returns on the investments, that should have been taxed in the investor's residence state is transferred to a foreign company.5 The tax base of the shareholder state is reduced until the foreign company pays dividends, which may be taxed in the shareholder state. However, if the shareholder state does not tax dividends or if the company never pays dividends the income will never be taxed in the shareholder state.

National Treasury decided to introduce sections 9C and 9D as an interim measure. This was described in the Explanatory Memorandum to the Taxation Laws Amendment Bill, 1997 as an overhaul of the tax system to a residence basis (SARS, 1997:3). Sections 9C and 9D were introduced as anti-avoidance measures to prevent South African taxpayers from shifting income to other jurisdictions by means of controlled foreign companies (SARS,1997). The provisions were introduced on 1 July 1997 to address the National Treasury concerns. Schmidt (2016:2) summarised these concerns by stating that the profits of a foreign company can be insulated from tax of

the shareholder state until repatriation, therefore resulting in postponement of tax. Schmidt (2016:2) elaborated that this postponement was beneficial only if the foreign tax is lower than the amount of domestic tax.

When the basic provisions of section 9D were introduced in 1997 it was interacting with section 9C, which regarded "any investment income is received by or accrued to a resident from a country other than the Republic, …. shall be deemed to have been received by or accrued to the resident from a South African source." (SARS 1997:4). The two sections, sections 9C and section 9D, were introduced to work hand in hand. Section 9C was focusing on taxing 'investment income' received by a resident from a country other than SA (SARS, 1997:4) and deeming it to be from a South African source. This investment income refers to 'passive income', which includes annuity, interest, royalty, rental or income of similar nature. Section 9D was focused on controlled foreign entities and income from certain donations, settlements or other dispositions (SARS, 1997) and the plan was to phase in section 9D over a period of three tax years with regard to investment income of certain taxpayers and immigrants (SARS, 1997:7).

When section 9D was introduced in 1997, it initially referred to controlled foreign entities section 9D. It was later amended to refer to controlled foreign companies (CFC's). Section 9D can also be referred to as CFC rules. When SA introduced CFC rules many countries had CFC rules as part of their legislation for years. According to Arnold (2019:631) the United States (US) was one of the first countries to introduce the CFC rules and then many more other countries followed suit. The Organisation of Economic Co-operation and Development (OECD) released the 1998 OECD Report on Harmful Tax Competition, which recommended that countries introduce controlled foreign corporations to curb harmful tax practices (OECD, 1998:40). Since the release of the report many changes have been made to section 9D to align it with global changes. The OECD has been one of the leading organisations in making recommendation on how to address base erosion and profit shifting that has been aided by globalisation. In 2013 the OECD started a base erosion profit shifting project (BEPS) project and this was finalised in 20015. SA was one of the first countries that adopted the recommendations as per BEPS action 3. Subsequently Section 9D was also amended to take these changes into account.

1.2. Amendments to section 9D

When the residence-based tax system was introduced in 2001, major amendments were affected to section 9D. Over the years section 9D has been amended owing to many reasons. One of the reasons has been to counter the use everchanging anti-avoidance tactics as the concerns around the world regarding tax avoidance mounted in the recent years. As mentioned above, SA adopted the BEPS action 3. The CFC rules are detailed under BEPS Action 3, it gives the guidelines or recommendations on how to formulate the CFC rules. This chapter tracks the amendments that have been made to section 9D since the overhaul in 2001 when residence minus tax system was introduced.

1.2.1. Residence minus tax system

The definition of 'gross income' in section 1 of the Income Tax Act was amended with effect from years of assessment commencing on or after 1 January 2001. Prior to that, South Africa's income tax system was based on the concept of source, and the general rule was that all taxpayers, whether resident (as defined) or non-resident, were taxed only on income which had its source in the Republic; conversely, income which had its source outside the Republic was, subject to only a few exceptions, not subject to normal tax in the Republic. With effect from years of assessment commencing on or after 1 January 2001, the amended definition of 'gross income' has the result that residents are taxed on *all* income (that is to say, on their world-wide income), irrespective of its source, whilst non-residents are subject to tax only on receipts and accruals of income derived from sources in or deemed to be within the Republic, subject to certain exceptions. This basis of taxing non-residents relies therefore on a connecting factor of which the referent is the character of the income, rather than the person who earns it. This is commonly referred to as 'source taxation'. At the same time, capital gains tax (CGT) was introduced and that resulted in further changes to section 9D. As per the Preface in the National treasury detailed explanation of section 9D, it was stated that to widen the tax base and reduce the tax rates, the tax system was moved from source plus to residence-minus (National Treasury, 2002:iii). This was done by introducing the Revenue Laws Amendment Act 59 of 2000. What the residence-minus meant was that a tax resident as defined will be taxed in terms of the

South African tax legislation less the foreign sourced incomes (SARS 2000). The changes in the tax system necessitated the overhaul of section 9D because the section before 2001 was geared towards the source plus tax system. The changes that were made in 2001 were to ensure that as the tax system transitioned to residence -minus system section 9D is not left behind, therefore no longer effective as an anti-avoidance provision. This was an alignment of section 9D to residence minus tax system (National treasury 2002:2).

When section 9D was amended in 2001 it was divided into three parts (National treasury, 2002):

- Determining which foreign entities fall within section 9D;
- Determining which South African residents must include a portion of foreign entity income under section 9D; and
- Determining which forms of foreign entity income potentially create an inclusion under section 9D.

According to National Treasury (2002:5) a definition was included to define what constitutes a controlled foreign entity and what types of formation were not to be included in section 9D. This was to ensure that the section is not too wide to include formations that are taxed in other parts of the Income Tax Act 58 of 1962 (The Act). These included for example the foreign trusts, foreign partnerships, etc. A general rule was added for the listed entities and the unit trusts, that any person having less than 5% participation (taking into account connected person) will be regarded as foreign. This was to avoid ownership tracking problems when an entity is widely held (National Treasury 2002:5)

Secondly, South African residents must include a portion of the CFE income under section 9D. Only South African resident with participation rights exceeding 10 % after taking into account connected persons (National treasury 2002:5) must include the CFE income into their taxable income. This rule was ensuring that only South African residents with significant ownership rights, which can be regarded as ownership that has an impact, were taxed (National Treasury 2002). In 2001 the rules referred to a controlled foreign entity not a CFC.

The third point regarding what forms of income are to be included encompass provisions referring to how the income that will be proportionally included must be calculated. National treasury explains that two sets of tax records (National Treasury 2002:6) had to be kept for the CFE to ensure that the requirements for section 9D calculation of the CFE taxable income are adhered to. One set for the CFE home country and one in SA to comply with section 9D rules. Capital gain provisions were also included in section 9D when determining the CFE income that must be included in the SA resident. (National Treasury, 2002:8).

The revamped section 9D also had a wider list of exemptions. These exemptions were regarded as important because they excluded income that was not viewed as prone to anti-avoidance. These were as follows (National Treasury 2002:8):

- the Business Establishment Exception;
- the Concurrently Taxed Exception;
- the Related and Intra-Group Exceptions; and
- the Share Participation Exception.

The business establishment exemption was regarded as ‘promoting international competitiveness’. The income from the business establishment was regarded as ‘of no threat to the South African tax base’ (National treasury 2002:8). There were exceptions to the business establishment rule:

- the income is attributable to a ‘business establishment’ (i.e., is not Mobile Foreign Business Income);
- the income does not involve sales and services with a related South African resident (i.e. is not Diversionary Foreign Business Income); and
- the income is not of a passive nature (i.e., is not Mobile Foreign Passive Income).

The definition of the CFE net income was also introduced. The ‘diversionary’ transactions and ‘passive income’ concept was included in the section 9D. The diversionary income relates to income generated by the CFE from sales of good or provision of services to a South African resident (National Treasury 2002:8). These changes were necessary to streamline the section and to ensure that anti-avoidance

transactions are caught in the net. However, National Treasury (2002:iii) notes that the process of making these changes were a complex balancing act.

Treasury and SARS documents state anti-avoidance as the main reason for section 9D. (National Treasury 2002:1) 'Section 9D is designed to prevent deferral through South African owned foreign entities.' The anti-avoidance can be achieved by shifting the income of an SA resident to a foreign entity, the income will only be taxed in the hands of the resident when dividend is declared by the foreign entity to the South African resident (National treasury 2002:1). This will result in a 'deferral' of tax (National treasury 2002:1). Section 9D deems all the income of the CFC, after the exemption, to be income of the South African resident.

1.2.2. Subsequent changes to section 9D

Year 2006 - Changes as per Revenue Laws Amendment Act 20 of 2006

A few significant changes were made in 2006. There was clarification of the country of resident definition and definition of Foreign Business Establishment (FBE) was refined. SARS introduced the ruling that a taxpayer can disregard certain provisions on diversionary rules and mobile income. In this regard, an election was introduced to choose a deduction and income between group CFC's.

Year 2007 – Changes as per Taxation Laws Amendment Act 8 of 2007

Section 9D was amended to refine definitions and correct grammar. There were no fundamental changes or amendments to the application of section 9D.

Year 2008 - Changes as per Taxation Laws Amendment Act 3 of 2008

Losses or gains from debt forgiveness between CFC were also brought in as part of the exclusions from the attributable CFC income.

Year 2009 – Changes as per Taxation Laws Amendment Act 17 of 2008

There was a further refinement of FBE definition and high tax exemption. The ruling mechanism that was inserted earlier in 2006 was removed during 2009.

Year 2010 – Changes as per Taxation Laws Amendment Act 7 of 2010

The Headquarter regime was introduced in 2010. Section 9D was then modified to take this into account.

Year 2011 – Changes as per Taxation Laws Amendment Act 24

A major overhaul of section 9D was made in 2011. Certain provisions were deleted, new ones were introduced and some extended. This was all done to both strengthen and simplify section 9D.

Some new definitions were inserted, these were to refine the old definitions:

- Foreign company
- Protected cell company

The FBE income exclusion from CFC income amended and simplified.

Amending subsection (9)(f) of section 9D by removing section 10(1)(k)(ii)(dd) and replacing it with section 10B(2) because foreign dividend have been moved to section 10B(2).

The outbound diversionary rules for the sale of goods by CFC were removed. The inbound diversionary rules for sale of goods were trimmed down. The reason cited by treasury (Explanatory memorandum 2015) was that transfer pricing rules can address profit shifting done through such transactions. Changes were made to passive or mobile income provisions.

Year 2012- Changes as per Taxation Laws Amendment Act 22 of 2012

An exemption of amounts that were subject to withholding tax in terms of interest and royalties was inserted. There was correction of grammar. The tainted intellectual property rules in section 9D (9A) were amended for the purpose of strengthening them.

Year 2013- Changes as per Taxation Laws Amendment Act 31 of 2013

Ship involved in international ship business was added as part of FBE list.

The insurance premiums and captive insurance was specifically included as part of the passive income list. This was after the time when SARS noticed a surge in the formation of captive insurers within group of companies' formations.

A CFC that is in a hyperinflationary country having exchange items denominated in a currency other the functional currency of that country, will not account for income/ loss from that exchange item.

Exemption for amounts that are subject to withholding tax in terms of service fees was added:

In 2013 a change was made to the 5% working capital exemption. The exemption was made not applicable to the treasury operations and captive insurer business. These amounts will be taxable in full. Treasury cited that income from Treasury operations and CFC captive insurer are regarded as 'passive' income, for that reason they must not be excluded from section 9D imputed income (Explanatory memorandum 2013:71). The 5% working capital limit must not be applicable to such income.

The calculation of the working capital 5% limit will also specifically exclude amounts attributed to non-resident policyholders and amounts previously subject to withholding taxes on interest and royalties.

Year 2014 - Changes as per Taxation Laws Amendment Act 43 of 2014

A rule that deemed the income of the CFC which was a FBE to be nil was inserted. This was inserted to eliminate the administrative exercises of doing the high tax exemption when the CFC is an FBE and has no income in terms of subsection 9A of section 9D. (Explanatory memorandum 2014:60).

Some definitions were deleted.

Year 2015 - Changes as per Taxation Laws Amendment Act 25 of 2015

The Diversionary rules for outbound sale of goods by CFC and inbound sale of goods by the CFC were re-instated as they were in before 2011. The reason for the reinstatement as per National treasury was that even though transfer pricing rules as per 31 can be used to address profit shifting, the transfer pricing audit take a while to

finalise (Explanatory memorandum 2015:53). On the other hand, section 9D can be applied to prevent profit shifting immediately in the year concerned.

Year 2016 - Changes as per Taxation Laws Amendment Act 15 of 2016

A provision was inserted that the CFC income will not be attributed if the participation rights are held by a portfolio of collective investment. This CFC income must be regarded as vesting trusts in terms of section 25B (explanatory memorandum 2016:63).

Another provision was included stating that the losses are not to be accounted for when calculating aggregate tax payable by the CFC in relation to the high tax exemption.

Year 2017 as per Taxation Laws Amendment Act 17 of 2017

Definition of CFC was amended. The main change was the inclusion of IFRS10 consolidated entities as a CFC.

When the IFRS10 consolidated entities are to be included as CFC, the percentage participation rights are determined according to the net percentage of financial results included in consolidated AFS.

This was done to extend the provisions of CFC rules to CFC's held through foreign trusts (Explanatory memorandum 2017:75). Foreign trusts are not an issue if it is a vested trust because the income is taxed on the South African resident's hand. The same applies with foreign partnerships, the income of the trust is taxed in the hands of the South African residents. This loophole for foreign trusts was created by the changing of rules to CFC when the provisions were moved from section 9E which referred to controlled foreign entities (CFE).

Year 2018 as per Taxation Laws Amendment Act 23 of 2018

Grammatical corrections were made to section 9D. In section 24I a provision was included as to what local currency means in relation to section 9D. Local currency means functional currency.

Section 78, section 25B, para 72 and para 80 of the eighth schedule were amended to cater for foreign trusts held by individual residents however, section 9D was not amended.

Year 2019 as per Taxation Laws Amendment Act 34 of 2019

The CFC definition was amended to exclude headquarter company. Grammatical corrections were made to some parts of section 9D to remove ambiguity.

Reducing the percentage to 67.5 % because the global trend of lowering corporate tax rates (Explanatory memorandum 2019:38):

The diversionary rules for services and sale of goods were amended to include the word directly and indirectly. National treasury identified a loophole that CFC's were being imposed between South African resident connected person and the independent non-resident supplier or customer to avoid the diversionary rules (Explanatory memorandum 2019: 39). The transactions were entered into indirectly not directly with the South African resident.

Year 2020 – Changes as per Taxation Laws Amendment Act 23 of 2020

An exemption in terms of section 10(1)(k) will not apply to dividend received by CFC which have a deduction linked to them. Natural person and special trusts terms were removed from subsection 2A(f) of section 9D.

In summary CFC rules have been amended a few times since the adoption. Over the years FBE definition and impact of it on CFC income inclusion or exclusion has changed drastically. In 2011 diversionary rules were deleted and then reinstated in 2015 because the section 9D without the rules were much weaker. Insurance premium and insurer income for captive insurers, 5% working capital was also adjusted. These amendments were done soon after the BEPS action 3 was finalised by OECD. SA also adopted the OECD BEPS action 3.

The high tax exemption has been removed at some point and then re-instated. Amendments to the high tax exemption provisions were made in 2019. The required percentage has been reduced to 67.5%. The major changes in section 9D over the years was the inclusion of the consolidated companies in terms of IFRS10. This closed the loophole of an SA resident holding a CFC through a trust. All these changes

were made in to strengthen section 9D in the light of the ever shifting and changing landscape of the business environment.

This research paper will review whether the current amended section 9D is adequate to address the objectives as set out in OECD BEPS action 3, taking into consideration the policy objectives. The objectives of CFC rules, in case of SA section 9D, is to prevent tax base erosion and profit shifting (OECD 2015b:11). The objectives of the BEPS action 3 will be discussed in chapter 2 of this study. The OECD believes that the recommendations as per BEPS action 3 are not minimum standard but their implementation will result in rules that are effective in combating tax base erosion and profit shifting. Section 9D will therefore be analysed against OECD CFC rules to determine if section 9D achieved the purpose set out in BEPS action 3.

Chapter 2 will discuss the main objective the CFC rules and the policy objectives. OECD sets policy objectives which have an impact on the recommendations that are chosen to formulate section 9D. In achieving the main objective, section 9D must adhere to these policy objectives.

Chapter 3 is about the definition of CFC and what is included and what is excluded. An analysis of which recommendations of section 9D incorporates and whether these weakens or strengthen the section to achieve the main objective of CFC rules. If the definition is too wide or too thin, it will have an impact on section 9D effectiveness in achieving the objective of BEPS action 3.

Chapter 4 focuses on the detailed analysis of the 'CFC net income' and the exclusions/ exemptions. Once a decision has been made regarding an entity is a CFC or not, section 9D sets out what income items must be included as income. These will be reviewed against the OECD recommendations to determine if section 9D is equipped to combat base erosion and profit shifting.

Chapter 5 is about computing of CFC income and attribution to parent entity. It is important to compute CFC income in a manner that will deter base erosion and profit shifting. The attribution must provide an equitable taxation of the CFC in the taxpayers' hands.

Chapter 6 reviews the relationship between transfer pricing and section 9D, as a CFC rule regime. It is important to determine whether section 9D is relevant when we have transfer pricing rules.

Chapter 7 will tackle double taxation. Section 9D taxes the income of CFC in the hands of the taxpayer before the CFC distributes the income. This may result in double taxation because the CFC is taxed at the same time on that income. Tax relief measures are reviewed to determine whether they are adequate to prevent double taxation whilst not interfering with the rules that prevent BEPS.

Chapter 8 concludes on whether section 9D meets the objectives of CFC rules as per BEPS action 3 whilst considering the policy objectives in fast changing business environment.

Chapter 2: Objectives of the BEPS action 3

2.1. Main objective of BEPS action 3

The OECD highlights that in the recent past the economies of different countries have become integrated to an extent that the international tax rules are not adequate to combat base erosion and profit shifting (OECD 2015b:3). According to OECD this was because some country's domestic tax rules existing at the time in 2013, were designed more than a century ago (OECD 2015b:3). This led the OECD and the G20 through BEPS project, to identify 15 Action plans (OECD 2015b:3) to help strengthen the domestic tax rules that govern international transactions. When the measures as per the BEPS Action plans are adopted into domestic rules, it is believed that profits will be reported when economic activities are carried out to generate them and where value is created (OECD 2015b:3). The OECD expressed concerns that the CFC rules 'often not kept pace with changes in the international business environment, and many of them have design features that do not tackle BEPS effectively' (OECD 2015b). BEPS action 3 was one of the plans and its focuses was on CFCs.

The OECD believes that if the recommendations as per BEPS action 3 are implemented, the CFC rules will effectively prevent base erosion (OECD 2015b:9). The main purpose or objective of the CFC rules, same as other BEPS action plans, is to prevent profit shifting and base erosion. It is the view of OECD (2015b:15) that when designing the CFC rules to achieve the main objective of the BEPS action 3, consideration must be given to policy objectives. The BEPS action 3 sets out building blocks for formulating the CFC rules. In each building block recommendations are made to assist in achieving this goal. The OECD (2015b:9) lists the following as the building blocks:

- rules defining CFC,
- CFC exemptions and threshold,
- definition of CFC income,
- rules for computing income,
- rules for attributing income,
- rules preventing double taxation

2.2. Policy Objectives considerations

The design of the CFC rules using BEPS action 3 is greatly affected by the prioritized policy objective. The decision regarding which policy objective to prioritise depends on whether the country uses worldwide or territorial tax system (OECD 2015b:11). In this sense, the policy objectives aids section 9D in achieving the objective of BEPS action 3.

These policy considerations are as follows (OECD 2015b:13):

(i) their role as a deterrent measure;
(ii) the need to balance effectiveness with reducing administrative and compliance burdens; and
(iii) the need to balance effectiveness with preventing or eliminating double taxation
(iv) Interaction with transfer pricing

2.2.1. Deterrent measures

For the CFC rules to discourage profit shifting and base erosion they must be designed with a measure of deterrent (OECD 2015b:13). This can be achieved by raising tax on the income earned by CFC on the parent at the parent's jurisdiction irrespective of the fact that it is the CFC's income. This means the parent is taxed on the artificial income, which is the income shifted to the CFC by the parent in the same year. The CFC will not be taxed but the parent will be taxed as would have been the case if the income was not shifted. This is in line with the statement as per the National Treasury (2015b:1) 'International law does not allow South Africa to directly tax foreign entities on their foreign source income, even if those foreign entities are completely owned by South African residents.'

The aim is to account and tax the profits made by the CFC, in parent's jurisdiction and not to tax the actual CFC (OECD 2015b:13). If the reason for creating the CFC and moving the income is to defer tax or avoid tax in the parent jurisdiction, then the objective will not be met if the income will still be taxed in the parent jurisdiction.

2.2.2. Effectively preventing avoidance while reducing administrative and compliance burdens

The CFC rules can be mechanical or flexible by design. The mechanical rules are regarded as creating more certainty. To illustrate, there is a definition of a CFC and it clearly states what entity is regarded as a CFC. The problem is that mechanical rules may not be as effective as flexible rules (OECD 2015b:14). They may not prevent profit shifting as intended because of their rigidity or may end up taxing income that is not intended for CFC rules. The mechanical rules may also be complex, therefore creating a greater administrative burden (OECD 215b:14). A balance needs to be attained between mechanical rules and flexible rules for the CFC rules to be effective. CFC rules are viewed as the only way to strike this balance (OECD 2015b:14). BEPS action 3 recommends that to reduce the administrative burden and achieve flexibility, exemptions to the rules can be introduced.

2.2.3. Double taxation

The CFC rules are created to prevent profit shifting and base erosion but not to impose double taxation. The CFC rules are there to ensure that the tax base is not reduced and not to unfairly increase it. Double taxation arises in instances where a taxpayer is taxed twice on the same income.

The main intention of the CFC rules is to impute the CFC income to the parent and tax on the parents' hands in the same year the CFC makes the income. In most jurisdictions when the CFC declares the dividend to the parent/ shareholder, dividend tax is imposed. When a jurisdiction has CFC rules and the dividend withholding tax is imposed in the CFC jurisdiction, the income will be taxed twice in the hands of the shareholders. The jurisdiction designing the CFC rules should consider including exemptions provisions in the CFC rules to avoid double taxation (OECD 2015b:15).

2.2.4. Interaction with transfer pricing

Transfer pricing rules are targeted at prices or terms of transactions between connected parties or persons which will not occur in the event that there is no relation between the parties (OECD 2015b:14). CFC rules are designed to tax the income of the CFC in the hands of parent jurisdiction in the year earned by CFC. It is geared

towards moving taxation of the CFC income back to the parent's jurisdiction irrespective of whether the income was between related parties. The type of interaction will be discussed further in Chapter 7.

2.2.5. Other policy objectives

There are two other factors that can affect the design of the CFC rules (OECD 2015b:15). OECD refers to them as specific policy objectives, which are not common amongst jurisdictions. These factors are as follows:

(i) whether a jurisdiction has a worldwide tax system or a territorial tax system; and
(ii) whether a jurisdiction is a Member State of the European Union.

South Africa is not a member of the European Union and therefore point (ii) above will not affect the design of section 9D. The only other factor that is applicable in South Africa is whether we use a worldwide tax system or a territorial tax system.

The CFC rules are to be designed and incorporated as part of the jurisdiction's domestic tax rules. This means their design will be affected by which system a country uses. Until 2001, South Africa used a source-based system. This source-based tax system was a territorial system because it focused on where the taxpayer's income was earned, therefore were the income originated. The income was then taxed in the jurisdiction where it was earned. Late in 2001, South Africa adopted a resident-minus tax system, as mentioned above. This system focuses on the income earned by the resident irrespective of where it is earned. There was a clear impact on section 9D when SA change from the source-based tax system and adopted resident-minus system. This resulted in an overhaul of section 9D that was first introduced in 1997.

As previously stated, the intention of the CFC rules are not to tax the CFC but to tax the parent on the CFC income. Even though that is the case, the tax is still on the income produced by the CFC, therefore resulting in more tax on that income. This will put that parent investor at a disadvantage against the other investors whose parent jurisdiction do not have CFC rules. The tax arising from CFC rules may be regarded as an extra cost.

The main objective of BEPS action 3 is achieved if the policy considerations are embedded in formulating section 9D. To answer the research question, the next chapters reviews which policy objectives were considered in designing section 9D and do they assist in achieving the objectives of section 9D.

Chapter 3 - Detailed analysis of the definition of the CFC and exemptions from CFC rules

3.1. Definition of CFC

The CFC rules only apply when there is a CFC. Chapter 2 of the BEPS action 3 details important factors to consider when formulating the definition of the CFC. The crucial factors to consider are (OECD 2015b:21):

> (i) whether a foreign entity is of the type that would be considered a CFC; and
> (ii) whether the parent company has sufficient influence or control over the foreign entity for the foreign entity to be a CFC.

When section 9D was introduced in 2001, the South African National Treasury drafted an explanation for section 9D. This was to assist taxpayers understand section 9D. National Treasury explained that the definition of a CFE is in two parts (National Treasury 2015b:3), 'foreign entity' and 'control'. In the current legislation, there is no longer a foreign entity definition but a foreign company. The structure of the definition still has two parts, "foreign company' and 'control'. The definition is structured according to the OECD recommendation.

3.1.1. Foreign entity

OECD (2015b:21) recommends that the definition includes other types of entities, such as trusts, partnerships and PE's (OECD 2015b:21) . If these entities do not form part of the definition, it will be easy for the companies in the parent jurisdiction to use these formations as a way of avoiding the application of the CFC rules. The OECD elaborates further and indicates that this will not occur in the event that transparent entities are taxed currently by the parent jurisdiction under domestic law.

When section 9D was introduced in 1997, the definition of a foreign entity was:

> 'foreign entity' means any person, other than a natural person, which has its place of effective management in a country other than the Republic;

The current definition, however, refers to foreign company as a:

> (*a*)

cell or segregated account contemplated in the definition of "protected cell company";

(*b*) protected cell company to the extent that—

(i) specified assets of that company are not segregated into structurally independent cells or segregated accounts as contemplated in paragraph (*a*) of the definition of "protected cell company"; or

(ii) specified assets and liabilities of that company are not linked or attributed to cells or segregated accounts as contemplated in paragraph (*b*) of the definition of "protected cell company"; or

(*c*) foreign company, as defined in section 1, other than a protected cell company

The definition of a foreign company as per current section 9D no longer includes the description of person and place of effective management but directs us to the definition of a foreign company as per section 1. The definition of a foreign company as per section 1 is defined as follows:

"foreign company" means any company which is not a resident

This definition of a foreign company refers to two aspects, company and resident. This is similar to the definition of a foreign company from the initial section 9D in 1997 even though it is worded differently. To understand what a company and a resident is, section 1 is referenced. Section 1 has definitions for a resident and company. Company is defined as follows in section 1:

"company" includes—

(*a*) any association, corporation or company (other than a close corporation) incorporated or deemed to be incorporated by or under any law in force or previously in force in the Republic or in any part thereof, or any body corporate formed or established or deemed to be formed or established by or under any such law; or

(*b*) any association, corporation or company incorporated under the law of any country other than the Republic or any body corporate formed or established under such law; or

(*c*) any co-operative; or

(*d*) any association (not being an association referred to in paragraph (*a*) or (*f*)) formed in the Republic to serve a specified purpose, beneficial to the public or a section of the public; or

(*e*) any—

(i)
. . . . . .

(ii)
portfolio comprised in any investment scheme carried on outside the Republic that is comparable to a portfolio of a collective investment scheme in participation bonds or a portfolio of a collective investment scheme in securities in pursuance of any arrangement in terms of which members of the public (as defined in section 1 of the Collective Investment Schemes Control Act) are invited or permitted to contribute to and hold participatory interests in that portfolio through shares, units or any other form of participatory interest; or

(iii)
portfolio of a collective investment scheme in property that qualifies as a REIT as defined in the listing requirements of an exchange approved in consultation with the Minister and published by the Prudential Authority, as defined in section 1 of the Financial Markets Act, in terms of section 11 of that Act; or

(*f*)
a close corporation,

but does not include a foreign partnership;

The definition of a company in section 1 is comprehensive but specific in the description.

The definition of a foreign company as per section encompasses three aspects:

- protected cell,
- foreign company as defined in section 1. A definition derived from resident and company definition in section 1.

The current section 9D includes a protected cell company due to the fact this is another company formation used mainly by insurance companies. It is submitted that the foreign company definition must be able to encompass different formations in order to capture any person, other than a natural person, that might not be used as a foreign company for section 9D purposes.

This means that if other jurisdictions have formations that do not fit the definition of a company defined in section 1 of The Act or protected cell company in as per section 9D, such formations will not be captured by section 9D. This provides certainty because the definition is very specific. It assists in reducing the administrative burden for SARS of not including many formations. The problem with the definition is that it is not flexible. The entity has to be one of the entities listed above, this might make it less effective in capturing all entities that are used for base erosion and profit shifting.

A foreign partnership is specifically excluded from the company definition. The definition of a company does not specifically exclude partnership, however National Treasury mentioned that partnerships are not part of the definition because they are taxed in terms of other sections of the Income Tax Act (National treasury 2002:3). The definition was amended in 2018 and an exclusion of a foreign partnership from the definition of a company was inserted. A partnership includes a similar flow-through regime (National treasury 2002:3). The Act does not have a definition of a partnership. A partnership is a flow through formation, where income of the partnership is not a separate legal person but is taxed on the hands of the investor taxpayer.

A private binding ruling No.61 was issued on 30 October 2009, this was attempting to deal with a foreign limited partnership. This ruling illustrates the fact that the name of a formation is not what should be scrutinised but the mechanisms of the formation (SARS 2009). This limited partnership was incorporated formation. The ruling concluded that the partnership is an incorporated association. The current definition of a company includes any association that is incorporated in other countries. This private ruling is still relevant even though it is no longer valid. The definition of a company was subsequently amended in 2010 to specifically exclude partnership.

The trusts were not specifically included in the definition of a CFC because they are taxed under s 7 (National Treasury 2002:3). Taxation of trusts has also been expanded in section 25B. OECD recommends that the CFC definition must also address PE if they are not addressed in another part of the domestic legislation (OECD 2015b:22). When a CFC has a PE in another jurisdiction, section 9D still regards that as a CFC and it does not affect CFC income as will be discussed in chapter 4. The last formation that the OECD mentions is the PE. In South African legislation, a PE is only mentioned in the double tax agreement (DTA). Once a PE is formed, the DTA between South Africa and the specific country determines which jurisdiction has the right to tax the PE.

The definition of a foreign company also refers to a resident. A resident is defined in section 1 as follows (The Act):

> **"resident"** means any—
>
> (*a*) …
>
> (*b*)

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

but does not include any person who is deemed to be exclusively a resident of another country for purposes of the application of any agreement entered into between the governments of the Republic and that other country for the avoidance of double taxation: Provided that where any person that is a resident ceases to be a resident during a year of assessment, that person must be regarded as not being a resident from the day on which that person ceases to be a resident: Provided further that in determining whether a person that is a foreign investment entity has its place of effective management in the Republic, no regard must be had to any activity that—

(*a*)
constitutes—

(i)
a financial service as defined in section 1 of the Financial Advisory and Intermediary Services Act, 2002 (Act No. 37 of 2002); or

(ii)
any service that is incidental to a financial service contemplated in subparagraph (i) where the incidental service is in respect of a financial product that is exempted from the provisions of that Act, as contemplated in section 1 (2) of that Act; and

(*b*)
is carried on by a financial service provider as defined in section 1 of the Financial Advisory and Intermediary Services Act, 2002 (Act No. 37 of 2002), in terms of a licence issued to that financial service provider under section 8 of that Act;

This first part of paragraph (*b*) of the resident definition is clear and specific, as it refers to incorporation, established or formed. When a company, as defined, is not formed, incorporated or established in South Africa, then it is not regarded as a resident. The second part of paragraph (*b*) refers to place of effective management. In The Act there is no definition for 'effective place of management', however, there is an interpretation note 6 that provides guidance. The broadness of this term, when attempting to determine whether the company is foreign, may result in compliance burden for taxpayers and administrative burden for SARS because it is subjective. One will have to gather and provide facts to assist with a more accurate answer. This will then affect the effectiveness in preventing base erosion and profit shifting.

The definition as per s 1 of The Act states that this 'does not include a person who is deemed to be a resident of another country in terms of the double tax agreement (DTA)'.This situation arises when a person or company is a South African resident based on paragraph (*a*) and (*b*) but the person or company is also regarded as a resident in another country/ jurisdiction. When we end up with a non-resident, section 9D will apply because this will be a foreign company.

Another recommendation is that jurisdictions use a hybrid mismatch rule to prevent entities from circumventing CFC rules through different tax treatment in different

jurisdictions (OECD 2002). Section 9D covers this topic under calculation of CFC income. How this is applied in section 9D will be discussed under chapter 4.

Section 9D follows all the OECD recommendations for the foreign entity definition. The definition is as wide as possible to capture all possible formations that can be used to avoid the CFC definition in terms of BEPS action 3. This is irrespective of the fact that it is very prescriptive and there are concerns as to what happens if an entity does not fit within the definition. Transparent entities and trusts are addressed by other part of The Act. The definition is also flexible enough to act as a deterrent measure whilst not resulting in a tax administrative burden for SARS.

3.1.2. Control

The second part of the CFC definition is the word ‘controlled’. The OECD discussed control and the level of control that needs to be considered for CFC definition. This will be expanded on below.

A. Type of control

There are two types of control (OECD 2015b:24):

1. legal; and
2. economic.

There is also an additional type of control called De facto control.

Legal

The legal control is determined by the voting rights (OECD 2015b:24). In terms of the definition, voting rights are normally included in the corporate law that is used to form the entity. Therefore, making it easy to determine who has enough voting rights to exert control in the entity. The voting powers are ascertained by the number of shares held. In some cases, voting rights are not the only determination for control. Certain structures can be introduced that can distort control through the voting powers for example a share might not have a voting rights or they might hold higher voting rights.

Economic

Economic is another type of control. The OECD (2015b:24) explains this control as follows:

> [the] resident can control an entity through an entitlement to the underlying value of the company even where they do not hold the majority of the shares.

This may relate to the assets of the entity or the income distributions. The economic control is easy to determine, one needs to look at the rules that govern the rights of the underlying asset or income distribution. Economic control can still be manipulated by changing the group structure, tampering with the economic control through legal control (OECD 2015b:24).

De facto control

This is another type of control that can be analysed (OECD 2015b:24). This focuses on the person who is responsible for making final decisions for the foreign entity. Sometimes the contracts between the foreign entity and the parent company can be used to control the foreign entity. This type of control is not easy to determine and requires an extensive analysis of the foreign entity's affairs. The information that can assist in this regard is not easily accessible to tax authorities as opposed to legal and economical control. Using this type of control as a yardstick can be subjective because one will have to argue whether certain clauses in contracts amount to control. Analysing who the actual decision makers can also be very subjective depending on what outcome one wants to achieve.

In the South African context this type of analysis is used in the definition of a resident, which is the first part of the CFC definition. The part that defines a foreign company, as discussed above includes the aspects on 'top-level decisions' control analysis (OECD 2015b:24). It is the place of effective management. This process, however, is complicated and costly depending on the group structure. If one includes this analysis under control, there will be a duplication of what is already in the definition of a foreign company.

Control based on consolidation

The OECD recommends that consideration must be given to whether an entity is consolidated in terms of International Financial Reporting Standards, (IFRS) (2015b:25). The IFRS requires that for an entity to be consolidated there must be some dominant influence on the entity. The criteria for determining influence is similar to the legal and economic control requirements where voting rights or other rights are taken into account.

When South Africa introduced CFC rules in 1997 and modified them in 2001, the country was not using IFRS as accounting standards for preparing annua financial statements (AFS). IFRS was only adopted from 1 January 2005 for listed entities. Section 9D was only modified in 2018 to include any foreign company that is consolidated in terms of IFRS in the CFC definition.

The OECD suggests that the first two types of control should be combined and be supplemented with de facto and IFRS consolidation control. The first two, being legal and economic control, can be determined very objectively. De facto as explained above is not an easy one to apply as it is very subjective. Combining these methods will assist in closing all possible ways of circumvention. Section 9D has incorporated all four types of control. Section 9D of The Act, defines a CFC as follows:

> **"controlled foreign company"** means—
>
> (*a*) any foreign company where more than 50 per cent 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 that are headquarter companies: Provided that—
>
> (i) no regard must be had to any voting rights in any foreign company—
>
> (*aa*) which is a listed company; or
>
> (*bb*) if the voting rights in that foreign company are exercisable indirectly through a listed company;
>
> (ii) 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 purposes of this definition to be exercisable directly by that resident; and

(iii)
a person is deemed not to be a resident for purposes of determining whether residents directly or indirectly hold more than 50 per cent of the participation rights or voting rights in a foreign company, if—

(*aa*)
in the case of a listed company or a foreign company the participation rights of which are held by that person indirectly through a listed company, that person holds less than five per cent of the participation rights of that listed company; or

(*bb*)
in the case of a scheme or arrangement contemplated in paragraph (*e*) (ii) of the definition of "company" in section 1 or a foreign company the participation rights of which are held and the voting rights of which may be exercised by that person indirectly through such a scheme or arrangement, that person—

(A)
holds less than five per cent of the participation rights of that scheme or arrangement; and

(B)
may not exercise at least five per cent of the voting rights in that scheme or arrangement,

unless more than 50 per cent of the participation rights or voting rights of that foreign company or other foreign company are held by persons who are connected persons in relation to each other; or

(*b*)
any foreign company where the financial results of that foreign company are reflected in the consolidated financial statements, as contemplated in IFRS 10, of any company that is a resident, other than a headquarter company;

The IFRS consolidation is a good tool to ensure all entities that are not covered by the other paragraphs but raise BEPS concerns are included. Subsequent to the 2001 and 2008 financial crisis, more especially the 2008 financial crisis, the IFRS were amended to include all possible controlled entities that were held off the balance sheet. These entities, special purpose vehicles, may have resulted in accounting distortions but in some cases also used for tax avoidance (Castleden 2009).

Paragraph (a) of the CFC definition refers to voting and participation rights. The definition has incorporated both the legal and the economic control. The voting rights represent legal control as explain in the OECD documents, the participation rights represent economic control.

Paragraph (b) regards a foreign company that is consolidated in terms of IFRS10 into a company that is a resident. De facto control is indirectly incorporated through the

foreign company definition when assessing the place of effective management. The definition also includes control based on consolidation, which is contrary to the OECD recommendation. The explanation above indicates that the CFC definition as per section 9D incorporates all the aspects affecting type control as recommended by OECD in BEPS action 3. OECD recommends that the control based on consolidation must be included in a separate provision (OECD 2015b:25). Section 9D does not include this determination but it is indirectly included via definition of a resident that gives guidance as to whether a company is a resident or not.

B. Level of control

In order to determine the amount of control that has been identified and whether these are legal and economic control. According to the BEPS Action 3, the next step is to determine at what level a resident will be regarded as having legal or economic control. The minimum recommended is 50% or more of legal or economic control, which OECD believes is needed to shift income to another jurisdiction (OECD 2015b:25). Caution is suggested that a parent owning a percentage less than 50% may still be able to exert influence and in this regard a jurisdiction can use a lower percentage to measure control (OECD 2015b:25).

Parent companies or residents can always find ways to avoid the 50% by splitting it into smaller percentages per shareholder. Then these shareholders can work together to exert influence in the foreign company (OECD 2015b:25). BEPS Action Plan document recommends using ‘acting-in-concert’ rule which ‘applies a fact-based analysis to determine whether the shareholders are in fact acting together to influence the CFC.’

CFC exclusion of 5% participation rights is not applicable in case of connected persons. OECD states that if you chose the related party option it eliminates the need for acting-in-concert test. Section 9D refers to connected persons and the term is defined in section 1 of The Act. This term is incorporated in paragraph (a)(ii) and (a)(iii) of the CFC in section 9D. Section 9D specifically excludes minority shareholders owning less than 5% in determining the 50 % for control. It is used to prevent companies from escaping the CFC definition by splitting voting or participation rights amongst connected parties resulting in many minority parties. When the connected

party rule applies, the definition may capture many structures that raise BEPS concerns.

The OECD also highlights that both direct and indirect control must be addressed (OECD 2015b:29). It is the view of the OECD that if this is not addressed, a resident can hold a subsidiary interest through an intermediary company trying to circumvent the controlling percentage requirement (OECD 2015b). A definition without indirect control consideration will open a possibility very creative group structures to avoid CFC rules. The entire definition of CFC in section 9D includes the 'direct and indirect control' provision. It is also noted that inclusion of this term can increases the chance of double taxation (OECD 2015b). The OECD recommends that rules must be included to eliminate double taxation. South African tax law includes exemption rules that address double taxation as set out in section 6quat. Section 6quat is applicable to all residents that may suffer double taxation.

The definition of a CFC covers almost all the aspects of control indicated BEPS Action 3 that might be used to circumvent inclusion under section 9D. These are as follows:

1. legal and economic control. These are described in section 9D as voting and participation rights;
2. the de facto test is address by the definition of a resident. Where the 'place of effective management' is based;
3. control through indicated by consolidation of the entity into the parent in cases of group companies;
4. related persons and acting-in-concert. Section 9D included the connected persons term; and
5. Indirect control, which is an integral part of CFC definition.

The definition is inclusive of all possible scenarios that strengthen section 9D and it becomes more effective to prevent base erosion. Arnold raised a concern that entities with percentage voting or participation rights between 10% and 50% might escape from dividend tax and may also not be taxed for CFC (2019:635).

3.2. Exemptions from CFC

One of the important policy factors to consider, as mentioned above, is the effectiveness of the rules without exerting too much of an administrative burden on the fiscus. The exemptions assist in reducing administrative burden whilst not weakening the prevention of tax base erosion. It assists the rules to be targeted to the high-risk entities (OECD 2015b:35).

The OECD suggests that a tax rate exemption be applied. This means that once the rate at which the CFC is subject to tax is below the tax rate in the parent's jurisdiction, the CFC is excluded from the CFC rules. This can be applied in different ways (OECD 2015b:35):

1. *De minimis* rules;
2. Analysing why the CFC was formed; was there an anti-avoidance motive; and
3. CFC rules only apply to countries with lower rate than the parent country.

3.2.2 *De minimis* rule

The OECD states that there are different ways in which the *de minimis* rule can be applied. The first way provides that if attributable income of the CFC is less than a certain percentage of the CFC's entire income or fixed amount, then the attributable CFC income will not be subject to tax (OECD 2015b:33). BEPS Action 3 document provides an example using 5% *de minimis* rule for the attributable income. Section 9D applies this rule for passive income as per section 9A (a)(iii).

The concern raised is that the attributable income can be split between CFC's, resulting in a lower percentage (OECD 2015b:35). As we are living a global world, with technology that allows movement of income, this might not make the CFC rules ineffective. The process of stream-lining the rules makes it possible to circumvent CFC rules. The OECD provides an example of the United States CFC anti-fragmentation rules. In applying this rule, the CFC rules are streamlined but still have the deterrent element in them. Section 9D does not have the anti-fragmentation rule, this may make section 9D less effective in combating base erosion and profit shifting.

3.2.3. Anti-avoidance requirement

This threshold targets transactions and structures that are regarded as susceptible to anti-avoidance in a CFC (OECD 2015b:35). The OCED does not elaborate much on this and sees the application of these anti-avoidance rule as narrowing the effectiveness CFC rules as a deterrent. Section 9D has not adopted this rule as well.

3.2.4. Tax rate exemption

The tax rate exemption exempts CFC's income when the CFC is subject to a tax rate at a certain level (OECD 2015b:36). The tax rate exemption normally applies to a CFC whose tax rate is above the parent's jurisdiction. This demonstrates that the income from those CFC is not taxed. Setting a tax rate exemption for a tax rate below the parent's jurisdiction is on the basis that the shifting of income to a different jurisdiction is only beneficial if it is to lower tax rate jurisdiction. Shifting of income to higher tax jurisdiction is regarded as lower risk. (OECD 2015b). The risk of base erosion to higher or medium tax rate jurisdiction does exist. Applying the tax rate exemption also has a benefit of reducing an administrative burden as the focus is on the lower tax jurisdiction.

There are two options for applying this exemption (OECD 2015b:36),:

- Firstly this may require taxpayers to apply a comparative approach on a case by-case basis, or
- this may use a black list or white list to simplify the process.

The use of the list brings certainty and reduces tax compliance burden for the taxpayers. Section 9D uses the comparative approach, which is on a case by case basis. Tax on CFC income is calculated as if the CFC is a resident of that jurisdiction and subsequently compared to the CFC tax in the other jurisdiction. A calculation of this nature ensures accuracy for the tax rate and this process creates an administrative tax compliance for a taxpayer because the tax rate discrepancy between the jurisdictions is calculated for the CFC.

Determination of the level of the tax rate

It is recommended that a jurisdiction sets a benchmark rate against which the CFC's tax will be compared. If the CFC's tax is below that benchmark, CFC income will not be included in the parent jurisdiction (OECD 2015b:36).

OECD recommends that the benchmark must be compared to either (OECD 2015b:36):

(i) the nominal (or statutory) tax rate in the CFC jurisdiction; or
(ii) the effective tax rate of the CFC

The method of calculating the effective tax rate of the CFC is the ratio of actual tax paid in the CFC jurisdiction to the total taxable income either computed according to the rules of the parent/shareholder's country or according to an international accounting standard such as IFRS (OECD 2015b:39). BEPS action 3 recommends the effective tax rate over the nominal tax rate to be adopted as it will result in a more accurate comparative tax amount to taxes actually paid. It is beneficial to calculate the CFC tax rate as this will result in an effective comparison. The parent's jurisdiction may have tax rebates that are different from the CFC jurisdictions. In some cases the rebates may result in a lower effective tax rate in the CFC jurisdiction. There may also be an instance where the CFC jurisdiction appeared to be a low tax jurisdiction when using nominal tax rate, but the calculation reveals that the rates are almost at the same level. The chance of a higher effective tax rate in the CFC jurisdiction is slimmer as indicated by OECD (2015b:39). It is not expected for a group to structure its business in a jurisdiction with a higher effective tax rate.

Section 9D (2A) requires that all the taxes paid or payable by the CFC to other spheres of government other than the Republic of South Africa for that tax year be at least 67.5% of the normal tax that would have been payable had the CFC been a resident. The percentage was reduced to 67.5% from 75% recently, after tax practitioners have complained that cost and the effort of calculating this effective tax rate outweigh the benefit of revenue by SARS (Deloitte 2018). Section 9D adopted the recommendation by OECD as this is worded similar to BEPS action 3 for the effective tax rate method. Section 9D goes further to include taxes paid by the CFC in any other jurisdiction not

just in the CFC jurisdiction. Another important factor is that the taxes paid by the CFC to the other jurisdiction must have proof of the tax payments (OECD 2015b:39). Section 6quat is applied to account for section 9D tax credits. In addition, section 6quat requires that the tax credits must not be refundable.

Many entities can be a CFC as defined in section 9D but their income might not raise BEPS concerns. If these are subject to the provisions of section 9D, no income will be attributed to the resident taxpayer when the application is finalised. This will increase the tax compliance for a taxpayer and the tax administration burden without any deterrent impact. Section 9D uses the high exemption tax and de minimis rule in exempting the CFC income. The said rules are not inserted as an exclusion from the CFC definition but as an exclusion of their income from the section 9D rules.

Chapter 4. Detailed analysis of the 'CFC net income' and the exclusions/ exemptions

Subsection 2A entails what must be included in the CFC income. Exemptions are set out in subsection (9) of section 9D with the exceptions to the exemption detailed in section 9D(9A).

Chapter 4 of the OECD document (Designing effective controlled foreign company rules) sets out the recommendations of what type of CFC income must be included in the shareholder's taxable income in the parent's jurisdiction. It is expected that the income to be included is income that is able to raise BEPS concerns. In accordance with OECD, these are the types of income that raise BEPS concern, although it is not an exhaustive list (OECD 2015b:43):

- income earned by CFCs that are holding companies,
- income earned by CFCs that provide financial and banking services,
- income earned by CFCs that engage in sales invoicing,
- income from IP assets, income from digital goods and services,
- and income from captive insurance and re-insurance.

It is also indicated that many factors may be used to identify income that is susceptible to BEPS concern (OECD2015b:45). The above list of income was identified according to these factors:

- income geographic mobility,
- whether the income was earned from or with the assistance of related parties;
- source of the income;
- the level of activity in the CFC.

It is recommended that a jurisdiction can also use full inclusion rather than selective inclusion (OECD 2015b). Full inclusion means that the jurisdiction can include all CFC income that raises BEPS concerns. The OECD CFC rules sets out different categories of income. The income can be analysed according to:

- categories
- substance
- excess profit

4.1. Categorical analysis

CFC income can be classified and attributed based on which category is being analysed. There are three categories that have been set out (OECD 2015b:44):

1. legal classification,
2. relatedness of parties, and
3. source of the income.

4.1.1. Legal classification

Legal classification is when the income is classified according to legal names of the income, for example dividends, interest, insurance, royalties and intellectual property ("IP"), income sales and services income. CFC income is mainly classified in this manner because of the concerns regarding mobility.

Section 9D uses a combination of legal classification together with other forms to determine the CFC income. In subsection (9A)(a) of section 9D income is included using the abovementioned legal classifications contained within para (iv) to (vii). Income is exempted as per subsection (9) of section 9D using the legal classification for some of the paragraphs. These legal classifications include rental income, IP, foreign dividend, interest, royalties, insurance premium and foreign exchange differences.

Dividend

BEPS concerns regarding dividends arise because dividends are believed to be an easy tool when attempting to move passive income (OECD 2015b:44). Passive income is described as income that does not arise from any underlying business activity. The entity or company does is not involved in any active trade to earn such income. This concern is however reduced if the following circumstances exist (OECD 2015b:44):

- the dividends are paid out of active income of an affiliate;
- the dividends earned by the CFC are exempt from tax and the dividend is exempt if earned by the shareholder company in the parent jurisdiction,

- if the CFC is a securities trader.

Dividend is exempt from income tax in terms of South African domestic law. Even though dividend is exempt from income tax, it is subject to dividend tax in terms of a 64B. In terms of section 64B, companies are exempt from dividend tax. Consequently, dividend income must not raise BEPS concern unless it is used to change the form of income that will otherwise be taxed.

Interest

BEPS concern arises because this type of income is easy to move around (OECD 2015b:44). OECD give two examples of when this can be a concern:

- when the activities contributing to the interest were located outside the CFC jurisdiction,
- or when the income was not earned from an active financing business.

The location of the CFC income is no effect for section 9D because the CFC is taxed on its worldwide income in South Africa. Subsection (9A)(a)(iii)(aa) of 9D includes income from financial instruments unless that income is from principal trading activities. This subsection addresses the BEPS concern when income has not been earned from an active financing business.

Insurance premium

Insurance premium is viewed as most likely to raise BEPS concerns in the following scenarios (OECD 2015b:45):

- the CFC was overcapitalised relative to comparable companies in the business of providing insurance;
- the policy holder, annuitant, beneficiary, or location of the risks insured are outside the jurisdiction; or
- the insurance income was derived from contracts or policies with a related party, particularly if the related party also received a deduction for the payment of the insurance premium.

Bullet point two above can be implemented easily due to the nature of insurance activities. It is not a service that needs to be delivered physically. An insured asset can be located in South Africa and the insurance company based outside South Africa. In most cases, insurance companies have tended to provide insurance cover for assets

that are based in the same country as them. With globalisation, insurance companies can now cover assets that are not based in the same country as them, mainly if the holding company insures all the group companies' assets with one service provider. Group companies normally do this for administrative purposes and economies of scale. In recent times many groups have created captive insurance companies instead of using third parties. These insurance companies are wholly owned by the group for which the insured assets, profits, etc are captive insurers (Captive.com 2018).

The captive insurers have become popular because the group can decide where in the world the captive insurer will be formed and based. The captive insurance companies are popularly based in low tax jurisdictions but insure assets in companies based in higher tax jurisdiction. The income flows to a CFC that is in a low tax jurisdiction whilst the deduction is allowed in the entity based in South Africa. This BEPS concern is addressed by subsection (9A)(a)(vii)(aa) of section 9D. This subsection includes the insurance premiums received by a CFC that is a captive insurance company.

Point three is addressed in section 9D. Subsection (2A)(c) of section 9D allows a deduction for the expense and subsection (9)(fA) of section 9D provides an exemption for income. This is to prevent the abuse of shifting income to a lower tax jurisdiction or applying the deduction in a higher tax jurisdiction.

Royalties and Intellectual Property (IP) income

BEPS action 3 raised this as BEPS concern because of its mobility. Once income is mobile it can be shifted to a low tax jurisdiction. Examples of how IP can be manipulated (OECD 2015b:45):

- income from IP could be embedded in income from sales and therefore treated as active sales income under the CFC rules of some countries.
- IP assets are often hard to value because there are often no exact comparables, and the cost base of these assets may be an inaccurate measure of the income they can generate.
- Income that is directly earned from the underlying IP asset is often difficult to separate from the income that is earned from associated services or products.

Intellectual property is a 'know how' asset. These are not physical assets nor are they assets that are difficult to move from one country to the next, since they are intangibles.

The ‘know how’ can be detailed in documents and then sold off. Section 9D(2A)(c) addresses the deduction element and section 9D(9)(fA) covers the income element if the IP is paid by one CFC to another CFC. In this subsection the IP referred to is royalties. This is to prevent instances where IP is moved to a CFC to take advantage of the low tax jurisdiction.

Subsection (9A)(a)(v) of section 9D is inserted for instances where companies try to circumvent the FBE exemption by moving IP to another company that creates IP when the IP is regarded as tainted intellectual property in terms of section 23I.

The mobile income or passive income in section 9D is mainly classified according to its legal classification. Passive income is attributed to a SA resident in terms of subsection (9A)(a) of section 9D.

Sales and services income

The types of sales and services income regarded as of concern by OECD (2015b:45) are as follows:

- invoicing companies; and
- IP income.

Invoicing companies are regarded as adding no value to the goods, they buy goods and sell them without any form of modification (OECD 2015b:46). Section 9D addresses this concern under subsection (9A). Income is attributed to the resident taxpayer if the CFC income is derived from goods that were bought from a connected person who is a SA resident.

Section 9D(9A)(a) covers a wide spectrum of transactions for an invoicing company. These include instances where the CFC sells goods to a connected person that is a South African resident and where services are performed by the CFC to connected party who is a South African resident.

4.1.2. Relatedness of parties

It is also suggested that CFC income can be analysed based on transactions between related parties. This type of analysis slightly resembles transfer pricing because it focuses on related parties.

Section 9D(9A)(a) combines the related invoicing company concept, as detailed above, with the relatedness of parties. This ensures that the inclusion of income covers all possible BEPS concerns with less provisions.

4.1.3. Source of income

The BEPS concern requires taxing CFC income where the CFC generated income. If it is generated in the country of the CFC, it is regarded as less likely to give rise to profit shifting. When the CFC income is mainly generated from another jurisdiction, then it must be regarded as CFC income for CFC rules.

Section 9D(9A)(a) did not just address invoicing companies, transactions and relatedness of parties but also incorporates the source of the income. Section 9D(9A)(a) is set out as follows:

> (9A) (*a*) Any amount which is attributable to a foreign business establishment of a controlled foreign company as contemplated in subsection (9) (*b*) must, notwithstanding that subsection, be taken into account in determining the net income of that controlled foreign company if that amount—
>
> (i)
> is derived from the sale of goods by that controlled foreign company directly or indirectly to any connected person (in relation to that controlled foreign company) who is a resident, unless—
> …
>
> (iA)
> is derived from the sale of goods by that controlled foreign company directly or indirectly to a person, other than a connected person (in relation to that controlled foreign company) who is a resident, where that controlled foreign company initially purchased those goods or any tangible intermediary inputs thereof directly or indirectly from one or more connected persons (in relation to that controlled foreign company) who are residents, unless—
> …
>
> (ii)
> is derived from any service performed by that controlled foreign company directly or indirectly for the benefit of a connected person (in relation to that controlled foreign company) who is a resident, unless that service is performed outside the Republic and—
> …

All three paras (i), (ii) and (iii) emphasise the link to the term “connected person”. The link is either through sales or purchases of goods to the resident. This implies that if the invoicing ends up in a parent jurisdiction, referring to resident in all the paragraphs, then the CFC income is attributed to the parent or shareholder. CFC income is attributed if it raises BEPS concerns in term of the OECD document.

The paragraphs extracted above from section 9D(9A)(a) are anti-base-stripping rules. They are primarily focused on preventing stripping of income generated from the parent jurisdiction (OECD 2015b: 46). OECD CFC rules also suggests foreign-to-foreign stripping rules and not only rules one sided to parent stripping (OECD 2015b). This broader approach is regarded harder to manipulate but may also attack genuine business transactions that are not linked to base erosion.

Hybrid mismatch might result in some avoidance of tax because some entities can be ignored for tax purposes. Section 9D does not apply this recommendation.

4.2. Substance analysis

Substance analysis reviews the business of the CFC to determine if there is substance to it; that the business is not just a tool to shift profits. The business of the CFC needs to be genuine. The substance analysis is applied alongside other types of analysis (not as a standalone OECD 2015b:47). It is applied as a threshold test or proportionate test. A threshold test is when a ceiling percentage is set. If the activities do not reach that threshold, the entire income of the business activity is classified as CFC income (OECD 2015b:47). The Apportionment method calculates a percentage of what is genuine business and what is not. The income is apportioned between genuine business, which will be exempt from CFC rules, and BEPS CFC income to be attributed to the shareholder.

Examining the business of the CFC and using the proportionate test requires vast information analysis. Obtaining facts and circumstances of the CFC may result in extra compliance costs to make a determination on what percentage of business income relates to genuine business and what percentage relates to CFC income rules. It is a challenge to determine which proportion of income relates to passive income or active income given the advancement of globalisation and technology. This process is a qualitative measure rather than a quantitative measure.

Another option used under substance analysis is detailed as follows (OECD 2015b:48):

> a third option would consider whether the CFC had the necessary business premises and establishment in the CFC jurisdiction to actually earn the income and whether the CFC had the

> necessary number of employees with the requisite skills in the CFC jurisdiction to undertake the majority of the CFC's core functions. If applied as a threshold test, this would attribute all the income of a CFC that did not have the necessary people and premises (or exclude all the income of a CFC that did have the necessary people and premises). If applied as a proportionate test, this would treat as CFC income all the income that the CFC did not have the people and premises to earn.

Section 9D applies the substance analysis third option. Section 9D has a definition of an FBE that details out items similar to the ones in line with the third option to determine the substance of the CFC and its income. The threshold test is used for the FBE because the income of the FBE is regarded as nil in section 9D(2A)(ii). This FBE exemption is in accordance with section 9D(9)(b). Subsection (9A) of section 9D has exceptions to the FBE nil income exemption. These exceptions use a mixture of all three types of CFC income that is categorically analysed.

Even though South Africa has adopted the BEPS action 3 there are still concerns that section 9D is rigid and has not kept pace with technology and globalisation (PWC South Africa n.d.). The third option was more focused on the FBE exemption, which has been modified a few times to consider instances where a company might not be using its own staff to perform duties. The company can be fully functional but does not have employed staff or management. It is easy for base erosion to occur if the local legislation is not coherent with the international activities, as highlighted in (OECD 2015b:5).

4.3. Profit analysis

The OECD also advocates for the profit analysis method. A return of capital is set at a certain percentage considered normal. Any income earned by the CFC above this percent is regarded as CFC income in terms of CFC rules (OECD 2015b:49). The problem with this method of analysis is that it does not consider where the income was earned, from whom and all other important factors when examining income for BEPS concern. Income which has no BEPS concerns will end up being included as CFC income as this method is very mechanical. Section 9D does not adopt this type of analysis.

The entity approach determines whether the entity falls under CFC rules or not. It is an all or nothing rule. This approach reduces the administrative burden for the tax

authorities because in many cases it reduces the number of entities regarded as CFC if the threshold is not set too high (OECD 2015b:51). This approach also reduces the compliance costs for taxpayers because once they have ascertained this, they know the entity is not subject to CFC rules. Entity approach normally requires a threshold to be set. The all or nothing implications of the entity approach may result in certain income that raises BEPS concerns to be excluded as the entire entity's income is not taxed (OECD 2015b:51). In other instances, income that is of no BEPS concerns might be included and taxed under CFC rules. Section 9D applies entity approach on the FBE exemption. Once an entity is regarded an FBE its income is regarded as nil.

The transactional approach income is analysed to determine if it raises a BEPS concern (OECD 2015b:51). This can result in a larger number of entities being included under the CFC rules and thus increasing the administrative burden for a jurisdiction. This approach is more accurate because it analyses each income stream. It is also suggested that the threshold must be set for transactional approach to avoid, for example, treating surplus cash as CFC income (OECD 2015b:51). Section 9D has adopted a threshold test for income arising from financial instruments as per section 9D(9A)(a)(iii).

In conclusion the OECD suggests that a jurisdiction may need to decide which approach to use (OECD 2015b:50). They may use a transactional approach or entity approach. The categorical analysis can be regarded as a transactional approach and the substance analysis is mainly an entity approach. The transactional approach allows analysis of the income and therefore can identify mobile income that is susceptible to BEPS concerns. The OECD states that the transactional approach is more consistent with the goals of BEPS action 3 (OECD 2015b:51).

Section 9D is a combination of the entity approach and transactional approach. Section 9D (9)(b) excludes income from a CFC that is regarded as an FBE, as discussed above. The income of a CFC that qualifies for an effective tax rate above 67.5% in terms of section 9D (2A) is regarded as nil. Both these subsections apply the entity approach. In the later part of the section 9D, as mentioned above, a categorical analysis is applied in some paragraphs as per subsection (9A) of section 9D. A combination of these approaches makes section 9D broad and flexible, allowing it to catch all possible income that is susceptible to BEPS concerns whilst streamlining

CFC rules. In a global and technologically advanced world, where digital services can be provided from any part of the world, a combination of these approaches ensures that income with BEPS concern does not easily escape section 9D.

A company can be formed for example in India meeting all the requirements of a controlled foreign company that is an FBE as described above in section 9D. The CFC provides call centre services to a South African entity's customers. If this is the case, this CFC will fall foul of subsection (9A(a)(ii) of section 9D.

Chapter 5 – Computing of CFC income and attribution to parent entity

The CFC rules are built on the premise of preventing profit shifting and base erosion from the parent's jurisdiction. Section 9D must therefore be formulated to prevent base erosion, making sure that the tax base of SA is maintained at the same level as if there was no CFC. This is achieved by attributing the CFC income to the parent to which the income is shifted. The CFC's income that is attributed to the parent must be the same as if it is earned by the parent in the parent's jurisdiction.

Before the income is attributed to the parent, it needs to be computed. This chapter focuses on the rules of computing income and attributing income as a deterrent to prevent profit shifting.

5.1. Computing of CFC

Computing of the CFC income has two parts (OECD 2015b:57):

(i) which jurisdiction's rules should apply; and
(ii) whether any specific rules for computing CFC income are necessary

The second point relates to whether there must be specific rules for limiting losses in the CFC rule (OECD 2015b:57).

5.1.1. Jurisdiction tax laws applicable on CFC

The OECD recommends that the CFC's income be calculated by applying the parent's tax law (OECD 2015b:57). The CFC's income that will be attributed to the parent, will have similar outcomes in the parent's jurisdiction. It will also be easier for the parent jurisdiction to administer the CFC rules because the parent's tax laws will apply to the CFC income. The compliance costs will also be low for the taxpayer (parent) as they will be calculating the CFC's income using tax law provisions they are familiar with.

Section 9D(2A) requires that the calculation of the 'net income' of the CFC be calculated using the provisions of The Act as if the CFC was a taxpayer and a tax resident .This is in line with the recommendation by the OECD.

5.1.2. CFC tax losses

Another recommendation is that the losses of the CFC must only be set off against profits of the CFC or other CFC's in the same jurisdiction (OECD 2015b:58). This limitation is to prevent manipulation and shifting of losses or income if the losses can be utilised against the parent's income or in other jurisdictions.

Section 9D(2A) states that the CFC income is calculated as if the CFC is a taxpayer and a resident in accordance with the provisions of The Act. Section 24 of The Act provides that losses must carried forward and only be set off against the taxable income of the taxpayer in the preceding years. This is in line with the OECD recommendations.

The rule on CFC losses can also be made more stringent. The losses can only be set off against the same type of passive income (OECD 2015b:58). The Application of such a stringent rule requires monitoring of the losses and keeping records of how the losses are split between the different types of passive income. This will add to the compliance burden of the taxpayer. Section 9D does not have such a provision relating to the splitting of the losses according to the type of income. The existing rules in The Act relating to the losses are regarded adequate because the calculated income or losses of the CFC will only relate to income that raises BEPS concern.

Another concern is the potential for imported losses (OECD 2015b:59). Importation of losses occurs when the activities of the CFC change immediately after it is classified as a CFC resulting in losses or income depending on whether the CFC is currently on a loss status. Section 20 for the tax losses does not allow for set-off of the losses generated before the person or taxpayer is regarded as a resident for tax purposes. This can prevent any possibility of changing the business activities of a CFC and moving some business activities of the parent company to the CFC with a loss in order to utilise the loss. This is done with an intention of utilising the tax loss.

5.2 Attributing CFC income

The attribution of income is a four to five step process according to OECD rules (OECD 2015b:61):

(i) determining which taxpayers should have income attributed to them;

(ii) determining how much income should be attributed;
(iii) determining when the income should be included in the returns of the taxpayers;
(iv) determining how the income should be treated; and (v) determining what tax rate should apply to the income.

5.2.1. Which taxpayer to attribute to

The attribution of income is highly influenced by the control level (OECD 2015b:61) of the CFC. It is regarded that once a taxpayer with influential control is determined, income will be attributed to them. The step of ascertaining control is a prerequisite to attribution. Once taxpayers who have control have been identified, then it simplifies the process for assessing whom to tax. It reduces the compliance burden as well (OECD 2015b).

It is recommended that CFC income must not only be attributed to the taxpayer with control influence but also to taxpayers with minimum control that is considered when calculating the overall control threshold (OECD 2015b:62). Excluding minority shareholders with influence will lead to under attribution, therefore attributing less income back to the parent jurisdiction. Reducing the attribution to below control level for CFC definition will result in a wider inclusion of income into the parent's tax base and a higher tax administration burden.

Section 9D explains control as per CFC definition section 9D(1). A minority control of 5% is used when calculating the total control threshold. In section 9D (2) a different percent of minority control is used for attribution, which is 10%. In section 9D the 5% shareholding is not regarded as having sufficient influence over the business decisions that can affect base erosion (OECD 2015b:62). South Africa is one of those jurisdictions that apply a far broader attribution rule and want to deter even minority investments in CFCs as a lower threshold than control threshold is used (OECD 2015b:62).

5.2.2. How much income to attribute

Subsections (2)(a) and (b) of section 9D allocate a proportion based on each taxpayer's ownership as on the last day of the year. If ownership was acquired during the year, the amount will be proportionally accounted for during the period of ownership. Treating the income in this manner 'results in taxpayers being taxed on an amount

that is similar to their actual share of the CFC profits' (OECD 2015b:62). This method adopted in section 9D is regarded as the best practice (OECD 2015b:62).

5.2.3. When must CFC income be included in tax return and how must it be treated

The OECD does not recommend any specific time for including the CFC income in the parent's jurisdiction. Section 9D includes the CFC's income in the taxpayer's taxable income for the taxable year in which CFC's accounting record ends. This is appropriate in combating the postponement of tax because this is taxed in the same year the CFC accrues the income.

The OECD recommends two methods in determining how the income must be treated when it is attributed. It can be treated as a dividend or as if earned directly by the shareholder. Both are regarded as adequate in addressing concerns of BEPS (OECD2015b:63). When including the CFC income as a dividend, the existing dividend rules may need to be modified to include the CFC income. Section 9D (2) treats CFC income as if it is directly earned by the taxpayer.

> (2) There shall be included in the income for the year of assessment of any resident (other than a resident that is a headquarter company) who directly or indirectly holds any participation rights in a controlled foreign company—

5.2.4. The rate to apply on the CFC income

The CFC income can be taxed using the parent's jurisdiction tax rate or a top-up tax (OECD 2015b:63). The top up tax is the difference between the tax paid by the CFC and the set tax threshold. This threshold tax rate can be the one used to determine whether the CFC rules must apply to the CFC as an entity or CFC income. The top-up tax method allows the CFC to be competitive with other entities or companies in the same jurisdiction with it. Applying the top-up tax method, effectively means that the CFC income is included at a threshold tax rate in the taxpayer's income. The threshold tax rate will be below the actual tax rate in the parent's jurisdiction still leaving a possibility of shifting income.

In section 9D the parent's jurisdiction tax rate is used in taxing the repatriated CFC income at the parent's jurisdiction. This results in restoration of the tax revenue that was being eroded to another tax jurisdiction.

Chapter 6 –Interaction between transfer pricing and Section 9D, especially the diversionary rules, in achieving the objectives of Action 3 of the BEPS project

6.1. Relationship between CFC rules and transfer pricing

Transfer pricing rules are included as part of the action plans in the BEPS project that was finalised in 2015. They are included as a separate BEPS action items 8-10. The OECD describes the transfer pricing rules as follows (OECD 2015a:9):

> Transfer pricing rules, which are used for tax purposes, are concerned with determining the conditions, including the price, for transactions within an MNE group resulting in the allocation of profits to group companies in different countries.

Transfer pricing is included as part of the BEPS project because OECD identified weaknesses in the international standards for transfer pricing existing in 2013. The main weakness was that it could lead to profit allocation that is not aligned with the economic activity taking place. The misallocation of profits can be easily achieved when there is a group of companies. Transactions with 'unfair' terms can be instituted, then profits can be transferred between these groups of companies without difficulty because the companies are connected persons and can be consolidated for reporting purposes. This transfer of profits will not prejudice the overall group as the group still maintains the same amount of profit as a group but with favourable taxed outcomes. Normally, but not all the time, the profits will be transferred to jurisdictions with low tax rates. When profits have been transferred to another jurisdiction, this will erode the tax base of other jurisdiction.

The BEPS transfer pricing rules are created to prevent tax base erosion. An arm's length principle is used in transfer pricing rules. This principle requires that terms of transactions between connected persons must have the same terms as when the transaction is with a third party. International group of companies referred to as multinational enterprises (MNEs) are required to prepare transfer pricing documents and submit it to ultimate holding company tax authorities. The transfer pricing documents detail the transactions between the members of the connected group of companies, whether they are at arm's length and how this conclusion was arrived at. The tax authorities will review the document and decide whether the terms of the connected party transactions are indeed at arm's length.

In The Act, transfer pricing is governed by section 31. Section 31(1) describes an affected transaction, which is the basis for transfer pricing as follows:

> **"affected transaction"** means any transaction, operation, scheme, agreement or understanding where—
>
> (*a*) that transaction, operation, scheme, agreement or understanding has been directly or indirectly entered into or effected between or for the benefit of either or both—
>
> (i)
> (*aa*) a person that is a resident; and
>
> (*bb*) any other person that is not a resident;
>
> (ii)
> (*aa*) a person that is not a resident; and
>
> (*bb*) any other person that is not a resident that has a permanent establishment in the Republic to which the transaction, operation, scheme, agreement or understanding relates;
>
> (iii)
> (*aa*) a person that is a resident; and
>
> (*bb*) any other person that is a resident that has a permanent establishment outside the Republic to which the transaction, operation, scheme, agreement or understanding relates; or
>
> (iv)
> (*aa*) a person that is not a resident; and
>
> (*bb*) any other person that is a controlled foreign company in relation to any resident,
>
> and those persons are connected persons in relation to one another

The transfer pricing rules encompassed in section 31 focus on determining the arms' length price for affected transactions that are between connected parties, where one of the connected parties is a South African resident. Section 9D on the other hand focuses on attributing CFC income. A company becomes a CFC if it is controlled as defined in section 9D by a South African resident or residents. In section 9D the CFC can be regarded as a connected party. The common factor between section 9D and transfer pricing is that both require the relevant persons to be connected parties and both are anti-avoidance measures to deter base erosion and profit shifting.

To understand the differences between the aims of section 31 and section 9D, one must analyse how transfer pricing transactions and CFC structures can shift profits. Transfer pricing achieves shifting profit to another jurisdiction through a no-arms' length price between connected parties. A legitimate business transaction can be entered into but because the parties involved are connected. The terms of the transaction are manipulated to shift income for tax purposes. An example of this can be when an entity is charged a exaggerated price for services rendered by a subsidiary company thereby reducing the entity's taxable income and increasing that of its subsidiary which is located in a jurisdiction with a lower tax rate. This would effectively lower the group's aggregate tax rate. Transfer pricing rules address this by adjusting the price of the transaction back to an arm's length price or what the entity would have paid for the services at market price. The difference between the arms' length price and the manipulated price is added back to the entity whose income was reduced or shifted. In terms of section 31(3) this is treated as a dividend in specie for companies and as a donation for persons other than a company.

A CFC can shift income by moving the ability to earn certain types of income that are mobile from a resident to a CFC, thereby postponing taxation of the parent. A simple example of this can be demonstrated with cash in the bank. The cash in the bank account that earns interest can be moved to a CFC because the tax rate in the CFC's jurisdiction is low. When the interest is accumulated in the CFC's bank account increasing the CFC's taxable income that is taxed at a lower rate.

6.2. Diversionary rules

Section 9D(9A)(a) regards tainted income as fully taxable. Tainted income consists of passive or highly mobile income and well as diversionary income (Explanatory memorandum 2011:103). Passive income includes (Explanatory memorandum 2011:103):

> Interest, dividends, royalties, rentals, annuities, exchange differences, insurance premiums, similar income and associated capital gains.

The diversionary rules that are set out in subsection (9A)(a) of section 9D, mainly target income earned between connected parties. The rest of the paragraphs in subsection (9A)(a) address passive or highly mobile income even if it is not within a group of connected parties. The first three provisions of section 9D(9A)(a) classify income that a CFC earns through services rendered or sale of goods to the connected or non-connected SA residents as CFC income to be imputed. These transactions can be regarded as loop transactions. An example of this is when a South African resident forms a foreign company in a different jurisdiction. The South African parent sells goods to that foreign entity, which are then sold back to a connected South African resident with the foreign company adding little to no value to the goods. The intention by the South African is to shift the revenue to a foreign resident where there is a lower tax rate

Section 9D was amended in 2011 removing the outbound diversionary rule and trimming the inbound rules. The national treasury cited that the reason for the change was that transfer pricing adequately addressed tax avoidance concerns. In 2015 the full set of diversionary rules were reinstated because the transfer pricing process took long, and therefore defeating what section 9D was trying to achieve i.e. preventing the postponement of taxation until a dividend is declared.

There are differences in the approaches or targets of section 9D and transfer pricing rules, even though there is an overlap of the connected persons requirement and the aim to combat profit shifting.

6.3. CFC and transfer pricing rules do not eliminate the necessity of the other

It has been indicated that if transfer pricing fails to catch a transaction that has some form of transfer pricing, the CFC rules are the last leg of the anti-BEPS rules that can prevent base erosion (Burkadze 2016:373). CFC rules will recoup all the income that has been shifted to the CFC. Burkadze (2016:367) calls CFC rules a backstop of transfer pricing rules. The only concern is that CFC rules will not be able to address the transfer pricing that occurs between CFCs because the CFC rules attribute income to the parent not to other CFCs. If there is transfer pricing which shifts income from the parent to the CFC, when the CFC income is attributed to the parent entity, the shifted income is reversed. In instances where income is shifted from CFC A to CFC

B through transfer pricing, this means jurisdiction A will have reduced tax revenue. The CFC B income imputed to the parent jurisdiction will not compensate CFC A jurisdiction.

Burkadze (2016:374) sets out why CFC rules and transfer pricing rules do not eliminate the need for the other:

- different types of CFC legislation;
- CFC legislation restores the taxation right of the parent company' s jurisdiction only;
- the lower tax rate in the parent company' s jurisdiction compared to the tax rate in the jurisdiction of the subsidiary;
- a loss in the jurisdiction of the parent company or of the subsidiary;
- the possibility for cross-crediting;
- multinational enterprises might be based in a jurisdiction without CFC legislation; and
- as a general rule, CFC legislation is applicable to the relationship between the parent company and its subsidiaries. Therefore, it does not apply to the relationship between sister companies (i.e. where there is no controlling interest).

Each of these reasons will be explained in detail below.

6.3.1. Different types of legislation

Burkdaze (2016) also states that the type of CFC legislation has an impact on the relevance to have CFC rules and transfer pricing rules in domestic tax legislation. The type of CFC legislation refer to whether a jurisdiction uses the full inclusion or partial inclusion CFC rules. Some CFC rules are partial inclusion rules, for example, they may exclude active income. The CFC rules will only capture transfer pricing amounts within the CFC income that is included in the parent company. Section 9D is not a fully inclusive because it has an FBE exclusion rule and a tax rate exclusion for CFC income. If the transactions that are affected by transfer pricing are part of the FBE exclusion, the CFC income attributed will not be addressed as it will have been excluded.

6.3.2. CFC legislation restores the taxation right of the parent company's jurisdiction

In general CFC rules attribute income to the parent company, therefore restoring taxing rights to the parent company's jurisdiction (Burkadze 2016: 373). Section 9D is no different. In cases where the income was shifted between two CFC's using transfer pricing, CFC rules will not be able to prevent that profit shifting. Section 9D is focused

on the relationship between resident taxpayer and the CFC. Section 9D in subsection (9) excludes some transactions that occur between related CFCs, therefore transfer pricing rules are required.

6.3.3. The lower tax rate in the parent company's jurisdiction compared to the tax rate in the jurisdiction of the subsidiary

In cases where the rate of the parent company has a lower tax rate, the inclusion of the CFC income will not correct base erosion or profit shifting that transfer pricing rules is not able to capture. The reason being that the CFC income that has transfer pricing impact will be attributed to the parent company at lower tax rate (Burkadze 2016:374). Section 9D is no different as there are no provisions that counter such an impact. Section 9D even excludes CFC income of a CFC from a high taxed jurisdiction. Section 31(6) does the same: it exempts transactions that are involve a CFC from high tax jurisdiction. Once CFC income generated from an affected transaction escapes taxation in terms of section 31, section 9D will also not capture it.

6.3.4. Loss in the jurisdiction of the parent company or of the subsidiary

When a parent company has a tax loss and the group manages to shift income from CFC to the parent company using non-arms' length price, CFC rules are not capable of addressing this if the transfer pricing rules were not adequate (Burkadze 2016:375). This means the taxable income of the CFC in the CFC country will be reduced, resulting in lesser tax. Section 9D does not assist in adjusting the price, it simply attributes the CFC income to an SA resident. Attributing a reduced CFC income will not address the manipulated price. The transfer pricing rules as per section 31 will have to be applied to address that profit shifting created by the transaction.

6.3.5. Possibility of cross tax credit

Burkadze (2016) gives an example of cross crediting as when a jurisdiction has a credit system that does not factor in that tax on an item-by -item basis (Berkadze 2016:376). This is mostly when there is a passive income bucket and a general income bucket. This may result in tax credits utilised even though they may relate to other income bucket that does not fall under CFC rules. Burkadze (2016) states that this may encourage practice of transfer pricing especially where the transfer pricing rules are not stringent enough to prevent profit shifting. Section 9D targets certain types of

income or business activity. Only that targeted CFC income is attributed to a South African resident. Section 6quat provides tax credits for the total foreign taxes paid on the attributed CFC income as detailed in Chapter 7. The foreign tax credits are limited to the tax payable in SA on the income attributed to SA, the calculation as contemplated in subsection (1B) of section 6quat.The limitation as per section 6quat(1B) prevents the occurrence of cross-crediting alluded to by Burkadze (2016).

Mostly, section 9D and the transfer pricing rules complement each other rather than eliminate each other. In some cases when transfer pricing rules have not been applied, section 9D will prevent or address the tax base erosion and profit shifting.

6.4. Transfer pricing and CFC income analysis

According to the OCED, income earned by a CFC can be determined and analysed using substance analysis to determine if it qualifies as CFC income described in the CFC rules (OECD 2015b:47). Substance analysis using apportionment method to derive CFC income can be assisted by the details of transactions in the transfer pricing document. The description of the business and income as per the transfer pricing document provides qualitative information needed to make a substance determination but may be difficult obtain in certain instances.

6.5. Transfer pricing and double taxation

The OECD (2015b:68) recognises that double taxation can occur in instances when CFC rules and transfer pricing are applied simultaneously. A perfect example is when income has been transferred to a CFC through the manipulation of prices. A transfer pricing review is performed by a tax authority which adjust the price according to the section 31. The taxable income will then be adjusted in the resident taxable income and the entire CFC income will be attributed to the residence as a result. The income relating to transfer pricing may be accounted for twice if the transfer pricing is applied in terms of section 31 and CFC rules are applied in terms of section 9D. If SARS identifies that there has been transfer pricing, the amount will be adjusted for in terms of section 31(3)(b). If the CFC income is also attributed to the resident by applying

section 9D, double taxation will result because the amount adjusted in terms of section 31 will also be in the CFC income.

Burkadze (2016:376) indicates that the double taxation the results from applying CFC rules and transfer pricing rules will not arise if it is the parent company whose tax base is being eroded. Even though the shifted income will be accounted for twice, the parent's jurisdiction will put measures in place to eliminate double taxation. Double taxation can be eliminated by relief provisions provided for in the domestic tax legislation (OECD 2015b:68). Section 6quat caters for tax credits relating to section 9D double taxation, however it does not take into account the possibility of double taxation due to the same income being taxed in sections 9D and 31.

As per the OECD, in cases where the transfer pricing transaction occured between a CFC and another CFC, it indicates that there was tax erosion and in one of the CFCs there will be double taxation' (OECD 2015b). This double taxation will be on the same income but applied to separate taxpayers in different tax jurisdictions. This type of double taxation is not the typical double taxation for which DTAs provide relief. The parent would have been taxed on the CFC income if no transfer pricing transaction took place, and when transfer pricing rule are applied, transfer pricing adjustments will affect the CFC's in their different tax jurisdictions.

In conclusion section 9D and transfer pricing complement each other. Section 9D in its current form is adequate to combat BEPS in terms of BEPS action 3. Any BEPS not caught by section 9D will be caught by section 31.

Chapter 7– Double taxation

The prevention of double taxation must be balanced with the need to prevent BEPS activities when formulating CFC rules. (OECD 2015b:15). CFC rules will not be fully effective if they do not incorporate this policy objective.

In international tax, there are two types of double taxation: economic and juridical double taxation.

Juridical double taxation occurs in the flowing circumstances:

- When a person is regarded as a tax resident in two jurisdictions. The word person includes a company and any formation that is regarded as a legal persona. This is when both states use the resident-based tax system, or
- Two or more tax jurisdictions deem the income of a person to be sourced within their state, or
- One jurisdiction taxes the income of the person on a source basis and the other regards the person as a tax resident.

Economic double taxation is when the income from the same transaction is taxed in one or two jurisdictions but in the hands of two separate taxpayers. Juridical double taxation is the one that mostly concerns different taxpayers and jurisdictions. Juridical double taxation is the only one that is truly problematic because it is taxation on one person, while economic double taxation is tax on two separate people. The most common way to address double taxation is through double tax agreement (DTA) or domestic law including foreign tax credit rules.

Many countries have signed DTAs to allocate the right to tax between the different jurisdictions. Once income has been allocated to one state through the DTA, then double taxation is eliminated. In most cases economic double taxation is not eliminated by the double tax agreements.

The OECD mentions different instances of how double taxation when applying CFC rules can arise (OECD 2015b:65):

- situations where the attributed CFC income is also subject to foreign corporate taxes;
- situations where CFC rules in more than one jurisdiction apply to the same CFC income; and

- situations where a CFC actually distributes dividends out of income that has already been attributed to its resident shareholders under the CFC rules or a resident shareholder disposes of the shares in the CFC.

7.1. CFC income subject to foreign corporate taxes

The CFCs which the OECD BEPS action 3 covers are foreign entities that might be taxed in the foreign jurisdiction because they are formed in that foreign jurisdiction. Concerns may then arise that the income of the CFC may be taxed twice, once in the foreign jurisdiction and once in the parent jurisdiction, resulting in double taxation. CFC rules tax income by attributing it to the parent. The CFC does not get taxed in the parent jurisdiction but its income is attributed to the parent. This clarification was emphasised by the National Treasury (2002:6):

> The CFE legislation taxes the resident shareholders of the CFE, and not the CFE itself. As the same resident is not being taxed twice on the same amount, no double taxation arises. It therefore cannot be said that the CFE legislation overrides any double taxation agreements.

The attribution of CFC income to a resident may give rise to double economic taxation as the CFC income is taxed in the hands of two taxpayers. The parent will be taxed on the attributed CFC income in the parent jurisdiction and the CFC taxed in the foreign jurisdiction on its income as a company. Since this is a form of economic double taxation, a DTAs therefore will not provide relief.

The OECD (2015b:65) presents two ways to eliminate double taxation arising in this manner. An indirect foreign tax credit or deduction method can be used. The OECD recommends the use of foreign tax credits as this does not reduce the taxable income but still appropriately addresses double taxation concerns. The only concern with this method is that it seems to undermine the CFC rules which are there to address the profit shifting concern. It is therefore recommended that relief must be limited to the lesser of domestic tax calculated on the income and the actual taxes paid by the CFC to other jurisdictions. The tax credit will be applicable to taxes paid, where there is no other refund or potential reimbursement.

Section 9D does not have a provision relating to foreign tax credits or a deduction method. A rebate is included in section 6quat which allows foreign tax credits relating to section 9D. Section 6quat states as follows:

> (1) Subject to subsection (2), where the taxable income of any resident during a year of assessment includes—
>
> …
>
> (*b*)
> any proportional amount contemplated in section 9D; or
>
> …
>
> in determining the normal tax payable in respect of that taxable income there must be deducted a rebate determined in accordance with this section.
>
> (1A) For the purposes of subsection (1), the rebate shall be an amount equal to the sum of any taxes on income proved to be payable to any sphere of government of any country other than the Republic, without any right of recovery by any person (other than a right of recovery in terms of any entitlement to carry back losses arising during any year of assessment to any year of assessment prior to such year of assessment) by—
>
> …
>
> (*b*)
> any controlled foreign company, in respect of such proportional amount contemplated in subsection (1) (*b*), subject to section 72A (3);
>
> …
>
> (1B) Notwithstanding the provisions of subsection (1A)—
>
> (*a*)
> the rebate or rebates of any tax proved to be payable as contemplated in subsection (1A), shall not in aggregate exceed an amount which bears to the total normal tax payable the same ratio as the total taxable income attributable to the income, proportional amount, taxable capital gain or amount, as the case may be, which is included as contemplated in subsection (1), bears to the total taxable income:
> …
>
> (2) The rebate under subsection (1) and the deduction under subsection (1C) shall not be granted in addition to any relief to which the resident is entitled under any agreement between the governments of the Republic and the said other country for the prevention of or relief from double taxation, but may be granted in substitution for the relief to which the resident would be so entitled

Section 6quat as per above states that for any CFC income included in the taxable income of a resident, a rebate will be allowed when calculating normal tax payable. This rebate is allowed for any tax that is proved to be payable in any other jurisdiction and is non-refundable. This type of rebate is in line with the tax credit regime recommended by the OECD. Section 6quat further states that the rebate will only be applicable if there is no relief for the CFC income under any DTA or the rebate may be substituted by the DTA relief.

Section 6quat limits the amount of foreign tax credit that can be utilised as per para (1B) of section 6quat. This paragraph is similar to the OECD recommendation that the relief must be limited to the lesser of domestic tax and foreign tax paid. Not limiting the tax relief might lead to tax base erosion which the CFC rules are designed to combat.

The OECD also recommends that tax credits can be allocated according to the type of income. Applying tax credits without allocating it to the specific income it relates to can lead to taxes paid for FBE income or active income being utilised against passive income tax. Section 6quat does not address this concern. This is a weakness in the South African tax credits provisions which impairs the effectiveness of the deterrent. Applying the recommendation can result in more tax compliance costs for taxpayers.

7.2. CFC taxation in multiple jurisdictions

It is possible for a CFC to be included under CFC rules of two different jurisdictions because the CFC rules of control may differ from one country to another depending which recommendations are implemented. The inclusion of a CFC in two jurisdictions is similar to where a person is regarded as a tax resident of two jurisdictions and qualifies as juridical double taxation. The difficulty with a CFC is that it may not be as resident in terms of the DTA. The rules of a DTA will therefore not apply like they do for a natural person that is subject to juridical double taxation.

The inclusion of the CFC income in two jurisdictions resulting in double taxation that is not remedied by a DTA can only be eliminated by the foreign tax credits or deduction method included in domestic tax law. The foreign tax credit method is still recommended (OECD 2015b:66). Section 6quat allows for tax credits for taxes paid in any other ‘sphere of government’. This type of double taxation is then eliminated by section 6quat. There is no hierarchy of tax credits in this and all the tax credits are included in no specific order except that there is a limitation, as explained above. As stated above, not limiting the tax relief will lead to tax base erosion for which the CFC rules are designed. This weakness should be addressed to avoid abuse.

7.3. Relief for subsequent dividends and capital gains

As the resident holds voting rights or participation rights, at some point in time the resident will receive dividend from the CFC or the resident might dispose of the rights. Many jurisdictions, SA included, have domestic tax laws that include these amounts as part of the taxable income at the time that they accrue to the taxpayer. These domestic tax laws are separate from the CFC tax rules. Tax is levied on the transactions, that being the accrual of the dividend or the taxpayer's disposal of their rights. A question then arises as to whether this will result in the double taxation of the resident as the resident was already taxed on attributed income from which the CFC is declaring the dividend or the value of shares are being disposed of.

7.3.1. CFC distributes income

When a CFC distributes income that has already been attributed to a resident, it is recommended that tax relief must be provided (OECD 2015b:68). The tax relief for dividends is provided for under section 10B of The Act, which states as follows:

10B. Exemption of foreign dividends and dividends paid or declared by headquarter companies.

(2) Subject to subsection (4), there must be exempt from normal tax any foreign dividend received by or accrued to a person—

(*a*)
if that person (whether alone or together with any other company forming part of the same group of companies as that person) holds at least 10 per cent of the total equity shares and voting rights in the company declaring the foreign dividend;

(*b*)
if that person is a foreign company and the foreign dividend is paid or declared by another foreign company that is resident in the same country as that person;

(*c*)
who is a resident to the extent that the foreign dividend does not exceed the aggregate of all amounts which are included in the income of that resident in terms of section 9D in any year of assessment, which relate to the net income of—

(i)
the company declaring the foreign dividend; or

(ii)
any other company which has been included in the income of that resident in terms of section 9D by virtue of that resident's participation rights in that other company held indirectly through the company declaring the foreign dividend,

reduced by—

(*aa*)

the amount of any foreign tax payable in respect of the amounts so included in that resident's income; and

(*bb*)
so much of all foreign dividends received by or accrued to that resident at any time from any company contemplated in subparagraph (i) or (ii), as was—

(A)
exempt from tax in terms of paragraph (*a*), (*d*) or (*e*); or

(B)
previously not included in the income of that resident by virtue of any prior inclusion in terms of section 9D:

Provided that for the purposes of this paragraph, the net income of any company contemplated in subparagraphs (i) and (ii) must be determined without regard to subsection (3);

Paragraph (a) of section 10B(2) uses 10% which is the same as the participation of voting rights with minimum threshold for attribution in section 9D. It must be noted that if the CFC income was attributed to a resident in terms of section 9D, the exemption will be according to paragraph (c). This paragraph usually applies when the entity is not a CFC as defined in section 9D.

Paragraph (b) exempts dividend income received by a foreign company from another foreign company. This paragraph can also be used to address a situation where a CFC is held indirectly through a foreign company that does not attribute CFC income. When a is dividend accrues to a foreign company it becomes difficult to determine if the dividend was declared out of CFC income that was attributed in terms of CFC rules (OECD 2015b:68). Section 10B(2)(b) broadly applies to dividends declared by a foreign company that accrue to another foreign company and it does specifically apply to dividends declared by a CFC to another foreign company.

Paragraph (c) deals with dividends that accrue to a South African resident, which might have been subject to section 9D. The OECD recommends that the jurisdiction apply a mechanical approach that assumes the dividend is declared out of attributed income (OECD 2015b:65). Paragraph (c) limits the exemption of dividend tax by taking into account CFC income that has been attributed and when there is foreign company that does not attribute CFC income.

Section 6quat addresses double taxation and encourages competitiveness for parent companies whilst protecting the tax base.

7.3.2. Resident taxpayers of a CFC dispose of their CFC shares

When shares are disposed of, capital gains tax may apply. This may give rise to double taxation because the resident shareholder would have already been taxed on the undistributed CFC income. It is recommended that the subsequent capitals gain on the sale of the resident shareholder interest must be exempt (OECD 2015b:68). This recommendation is not regarded as a crucial one to consider. In the South African tax law, this recommendation is implemented. The tax relief measures are included in paragraph 64B (4) of the eighth schedule as follows:

> (4) A person must disregard any capital gain determined in respect of any foreign return of capital received by or accrued to that person from a "foreign company" as defined in section 9D (other than an interest contemplated in paragraph 2 (2)) where that person (whether alone or together with any other person forming part of the same group of companies as that person) holds at least 10 per cent of the total equity shares and voting rights in that company.

The 10% in paragraph 64B(4) is the same as the minimum threshold percentage used in section 9D (2A) for attributing the CFC income. The capital gain is only exempted if the CFC income was attributed to a resident. This paragraph exempts the whole amount relating to the capital gain. There is no exception, limitation nor formula applying to the exemption of the capital gain. This means both the exemption in terms of section 10B(2) for dividend received from CFC and the exemption in terms paragraph 64B (4) for capital gains will be applied if a resident has been liable for tax attributed from CFC income.

In conclusion the provisions as per The Act have incorporated the recommendations by BEPS action 3. This assists in preventing double taxation that might result from section 9D.

Chapter 8: Conclusion

The OECD (2015b:9) believes that the recommendations contained in action 3 are not minimum standards but that their implementation will result in rules that are effective in combating tax base erosion and profit shifting. Section 9D's definition of a CFC is in keeping with the recommendations of the OECD. The only concern is that certain entities that have a percentage of control between 10% and 50% might escape tax. Entities that are not included in the definition, for example trusts and partnerships, are taxed in other parts of The Act. The definition of a company is very rigid, this may result in a trend of other entities being used for base erosion profit shifting activities. The amendment of section 9D to include of consolidated entities widened the section to include other formations aside from companies as defined in section 1.

The FBE CFC income exclusion may be regarded as an all or nothing rule. It assists in reducing the compliance costs burden which is one of the policy objectives. The exclusion makes section 9D flexible but this is not to the detriment of section 9D's effectiveness against base erosion and profit shifting. Section 9D is still effective because of subsection(9A) of section 9D. The FBE exclusion, like all the other exclusions in section 9D(9), is subject to section 9D(9A).

The high tax exemption is not applied to the CFC definition but to the CFC income like FBE. The high tax exemption complies with the OECD recommendations. The tax is calculated according to South African laws and then compared to tax rates outside SA. The recommendation is to compare to CFC jurisdiction tax but section 9D goes further by including all taxes that relate to CFC income. This assists in reducing the tax burden and eliminating double tax whilst addressing the BEPS action 3 objective.

The CFC income inclusion and exemptions are in accordance with the exemptions recommended by the OECD. The inclusions focus on tainted income even if the entity is an FBE because this is the income that has BEPS concerns according to action 3. The implementation of rules to eliminate double taxation adheres to the OECD recommendations. They prevent base erosions whilst also preventing double taxation. Section 6quat was implemented to allow tax credits for CFC income subject to section

9D. The calculation of the tax credits has a formula which only allocates the tax credits that relate to tainted income that is attributed to a South African taxpayer.

It appears that section 9D in the current form might not comprehensively prevent profit shifting in the digitised economy based on the work the OECD is currently doing. Duenas (2019:1) states that the OECD has been searching for a solution to taxation in the digitalised economy. Section 9D might not address taxation issues that arise in the digitised economy. The diversionary rules and the passive income rules in subsection (9A) of section 9D are based on a simplified business transaction model that is very linear. The business transaction model does not take into account the effect of digitisation. The OECD is now considering a minimum tax to address this concern (Duenas 2019:1). This may be an expansion of CFC rules to capture income with BEPS concerns that current CFC rules might not capture. Arnold (2019:642) explains that this proposed expansion is set out in the 'Inclusive Framework'. The inclusive framework proposes Pillar one ad Pillar Two to address this. Pillar one allows countries to tax where the consumer of the digital good or service is based in their country, but where those goods are provided for remotely by suppliers/ sellers in other countries with limited or no physical contact in source country. As per OECD (2020:27) 'Pillar Two (also referred to as the "GloBE" proposal) focuses on the remaining BEPS issues and seeks to develop rules that would provide jurisdictions with a right to "tax back" where other jurisdictions have not exercised their primary taxing rights or the payment is otherwise subject to low levels of effective taxation.' It is proposed that this will be done using income inclusion rules where a low-taxed CFC will be taxed in the shareholder country at a minimum rate (Arnold 2019:643). All countries will be expected to adopt the same minimum tax rate. This is not the similar method applied for high-taxed exemption. Another proposal as per Pillar two is that 'deductible payments made to low-taxed related parties will be made non-deductible' (Arnold 2019:643) .This proposal will assist in the prevention of BEPS activities that action 3 CFC rules failed to prevent.

The OECD believes that if the recommendations of BEPS action 3 are implemented, the CFC rules will effectively prevent base erosion (OECD 2015b:9). In conclusion section 9D does meet the objectives of BEPS action 3 because the recommendations as set out in the action plan have been adopted, however, section 9D might in certain

circumstances not be adequate for the current business environment to prevent BEPS by MNE's. This is when considering what the recent proposals as per 'The inclusive Framework' (Arnold 2019:642) discusses the addition of the minimum tax rate to supplement current CFC rules.

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