ANNEXURE 3

ADDRESSING BASE EROSION AND PROFIT SHIFTING IN SOUTH AFRICA DAVIS TAX COMMITTEE INTERIM REPORT*

SUMMARY OF DTC REPORT ON OECD ACTION 3: STRENGTHENING CONTROLLED FOREIGN COMPANY[1] RULES

The main purpose of controlled foreign company ("CFC") rules is to combat base erosion and profit shifting (BEPS) by targeting foreign investments made by residents, via foreign entities, in an attempt to shift income from the local residence country tax base to low-tax countries.

This is generally achieved through identifying the relevant companies by determining a specified level of shareholding/voting rights held by the residents (in South Africa, where there has been some form of controlled foreign company legislation since 1997, this is currently more than 50% of the participation rights i.e. rights to participate in the income), and where there is insufficient real activity taking place in that company, the income of the company is attributed to the resident shareholders.

OECD Principles and Relevant Recommendations

The OECD provides "common approaches and best practice" in its Action 3 recommendations on CFCs. It advises that a number of policy considerations (some relating to all jurisdictions and some which follow different policy objectives, linked to the overall domestic systems of individual jurisdictions) need to be addressed when designing CFC rules. These considerations consist of shared considerations and specific jurisdictional considerations:[2]

Shared considerations[3]:

- The role of the CFC rules as a deterrent measure;
- How the CFC rules complement transfer pricing rules;
- The need to balance effectiveness with reducing administrative and compliance burdens; and
- The need to balance effectiveness with preventing or eliminating double taxation.

These considerations are prioritised differently by different jurisdictions depending on whether they have a worldwide or territorial system.

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1 Prepared with the assistance of the South African Institute of Tax Practitioners.

2 OECD/G20 2015 Final Report on Action 3 at 11.

3 OECD/G20 2015 Final Report on Action 3 at 11.

Specific Jurisdictional considerations:

- How to strike a balance between taxing income and maintaining competiveness; and
- Preventing base stripping[4].

The OECD identifies six constituent elements (termed by it as “building blocks”, numbered 1-6) required for the design of effective CFC rules, which should be considered by countries with existing CFC rules, and addressed by those which currently do not:

1. Rules for defining a CFC (including a definition of control);
2. CFC exemption and threshold requirements;
3. Definition of CFC income;
4. Rules for computing income;
5. Rules for attributing income; and
6. Rules to prevent or eliminate double taxation.[5]

The OECD advises that the success of the Action 3 proposals on strengthening CFC legislation will depend on the willingness of the larger OECD member countries to adopt the proposals.

One particular structure of continuing and imminent concern to tax authorities is the existence of a group of companies that indirectly “control” further foreign subsidiaries via an offshore discretionary trust (or foundation). This trust, and the subsidiary shares owned by the trust, are economically part of the same group and are even consolidated under internationally accepted accounting principles (International Financial Reporting Standards (‘‘IFRS’’) 10)[6], but often fall outside of the CFC regime. It is contended that these lower-tier foreign subsidiaries should be brought into the CFC net.[7]

The OECD Action 3 report[8] recommends that the foreign companies which are consolidated in terms of IFRS, should be treated as CFC’s, despite true control lying with an intermediary trust.

The BEPS Action 3 Report also sets out considerations with respect to CFC exemptions and threshold requirements i.e. (i) *de minimis* amount below which the CFC rules would not apply; (ii) an anti-avoidance requirement which would focus CFC rules on situations where there was a tax avoidance motivation or purpose; and (iii) a tax rate exemption, where CFC rules would only apply to CFC’s resident in

4 OECD/G20 2015 Final Report on Action 3 at 15 and 16.
5 OECD/G20 2015 Final Report on Action 3 at 11.
6 Based on various determinants of “control”, as defined for accounting purposes.
7 OECD/G20 2015 Final Report on Action 3 at 24.
8 OECD/G20 2015 Final Report on Action 3 at 24.

countries with a lower tax rate than the country[9] (this could be combined with a list such as a white list.[10]).

Complementary to this, the BEPS Action 3 report provides a number of options for testing substance.[11] These are as follows:

- One option would be a threshold test which looks at facts and circumstances to determine whether the employees can factually demonstrate a "substantial contribution" to the CFC income earning activity.
- A second option would look at all the significant functions performed by entities within the group to determine whether the CFC is the entity that would be most likely to own particular assets and / or undertake particular risks, if the entities were independent. Either all the income would be imputed if the CFC fell below the threshold test or only assets and risks that would not otherwise be owned by an independent foreign entity would result in imputation.
- A third option would look to determine if the CFC has sufficient business premises and *nexus* to the country of residence and whether enough skills are being employed to undertake the CFC's core functions. Again, the income could be attributed on and all or partial basis.
- A fourth option would be a variation on the third and would use the *nexus* approach (used in Action 5) to ensure that preferential IP regimes require substantial activity. Income would be attributed to the extent that it could not be shown that the CFC met the requirements of the *nexus* approach.

A further option- the excess profits approach, which attempts to determine what profit levels a third party business would achieve in similar circumstances to the CFC, and imputes the excess to the resident shareholder thereof is not currently a feature of any existing CFC rules.

South African CFC rules and recommendations

The DTC Report on Action 3 evaluates each of these policy and design considerations, together with the proposals made in relation thereto, against South Africa's prevailing CFC legislation, and makes certain recommendations:

- ➢ CFC rules are the subject of much international debate and the prospects of major change on the international front. South Africa should adopt the position of protecting its own interests. It should follow and not lead or set the trend. South Africa's CFC legislation is also very sophisticated and comparable to other G20 countries; there is thus no need to strengthen this legislation at this stage. In summary, since South Africa already has robust CFC legislation, the

9 OECD/G20 2015 Final Report on Action 3 in para 52.
10 OECD/G20 2015 Final Report on Action 3 in para 51.
11 OECD/G20 2015 Final Report on Action 3 at 48.

DTC recommends that it should not be significantly changed until it is clear what other countries intend to do.

The recommendations, set out below, thus only deal with further recommendations where action is recommended in relation to a specific aspect, and not where the recommendation in the detailed DTC Report on Action 3 is to leave the legislation as is:

- In the past, South Africa treated trusts as controlled foreign entities for purposes of legislation relating to controlled foreign companies. However, given the inability to neatly establish a legal connection in terms of the CFC legislation's imputation methodology, despite the *de facto* control, the legislation, which included foreign trusts as controlled foreign entities, was removed soon after its insertion.[12] Given that certain companies held by foreign trusts are consolidated for accounting purposes under IFRS, it is recommended that consideration be given to imputing the income of these companies to the 'parent' South African company, based on the IFRS methodology for consolidation (i.e. in terms of a defined method of imputation). However, prior to implementing this recommendation, reference should be had to the Final DTC Estate Duty report[13] for its recommendations, in order to ensure that any such recommendations are consistent.
- The South African CFC regime currently applies both a tax rate threshold - the 75 per cent comparable South African tax exception, which applies to all forms of CFC income-and a *de minimis* form of relief.[14] The current *de minimis* relief is largely limited to alleviating otherwise tainted passive income from triggering section 9D imputation, when it likely relates to working capital attendant on an operating business (activities of a foreign business establishment, as defined). More specifically, this exception applies only to remove section 9D imputation in the case of financial instrument income not exceeding five per cent of a CFC's total receipts and accruals excluding passive type income.[15] It is thus considered that the current South African regime covers this aspect satisfactorily, and follows the recommendation of BEPS Action 3, through adopting the combined *de minimus* approach and low effective tax rate rules, and should be maintained. It is recommended,

12 'The initial CFC legislation in 2001 referred to "controlled foreign entities" (CFEs) as opposed to CFCs, since it included foreign trusts as entities, whose income required attribution. The definition was changed to refer to CFC in 2002 and, thus, trusts were removed from the section, which then referred to companies. The first version of the 2011 Tax Laws Amendment Bill once again attempted to include trusts in the CFC regime, but the wording was poor and it was removed prior to promulgation'(p668: International Fiscal Association *Cahiers de droit fiscal international* Volume 98a-The taxation of foreign passive income for group companies-South Africa Branch Reporter: Deborah Tickle.

13 See First DTC Estate Duty Report (accessed 10 April 2016) at http://www.taxcom.org.za/docs/20150723%20DTC%20First%20Interim%20Report%20on%20Estate%20Duty%20-%20For%20public%20comment%20by%2030%20September%202015.pdf. Final Report to be accessed on this site, once released.

14 Section 9D(9A)(a)(iii).

15 Section 9D(9A)(a)(iii).

however, that consideration be given to the method adopted by South Africa for determining the effective tax rate, as set out in the final Action 3 Report. Furthermore, consideration needs to be given to whether the exemption provided when the actual tax paid by the CFC in its country of residence exceeds 75% of the South African tax that would have been paid applying South African tax principles to the CFC's income, is appropriate given the global trend of reducing tax rates, for example, the UK plans to reduce the statutory tax rate to 16% by 2020, and the average rate of corporate tax in 2015 for Europe was 20.24% e.g. Ireland 12.5%, Hungary19%, and Asia 21.91% e.g. Singapore 17%,and Thailand 20%,[16] unless the South African tax rate is likewise reduced.

(It should also be noted that, should South Africa significantly lower its corporate tax rate to compete with other lower tax jurisdictions, the risk of diversionary profits is, in any event, reduced).

- At a mechanical level, the question is whether the current South African CFC regime requires enough substance under the foreign business establishment test to meet the policy objective of having meaningful CFC local activity. At a technical level, the "foreign business establishment" test generally requires the business: (i) to be conducted through a physical structure, (ii) to be suitably staffed with on-site managerial and operational employees, (iii) to be suitably equipped to conduct primary operations, (iv) to have suitable facilities, and (v) that the business be located outside South Africa for a purpose other than the avoidance of South African tax.[17] Although the numerical size of these tests can sound intimidating, more aggressive taxpayers may appear to satisfy the test with as little as one managerial employee, one operational employee, a small fixed office (which may even be shared) and a modest amount of office equipment. It is therefore recommended that a review of the substance requirement may be appropriate. It is further recommended, in this regard, that a further inquiry of the tax base risks associated with outsourcing needs to be explored before some form of automatic tainting could be legislatively imposed to this practice.
- A side issue involving intellectual property may be the artificial labelling of certain portions of intellectual property income as ancillary services in order to avoid CFC imputation. This form of artificial labelling works best when the local countries involved treat services preferentially vis-à-vis royalties, but in some cases local royalties may be preferred. Given the flexible characterisation of these amounts as ancillary services or royalties, it is recommended that ancillary services should be classified as royalties under the South African tax provisions relating to CFCs (section 9D) (or at least if the amounts are characterised as royalties for local country tax purposes).

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16 KPMG Corporate Tax Rate Survey.

17 See section 9D(1) definition of "foreign business establishment".

CLOSING REMARKS/RECOMMENDATIONS

- As indicated above, the South African CFC regime is largely in line with CFC systems used by many developed countries in Europe, North America, East Asia and the Pacific. Like all CFC systems, the regime is trying to protect the tax base without unduly interfering with the global competitiveness of South Africa's global listed multinationals. This balance is a core reason for the regime's complexity. Although the regime can be theoretically tightened, competitive constraints have been a very limiting factor.
  Many European systems have softened their CFC systems since 2000. Countries such as the UK and Netherlands (major competitors in the region) have fairly light CFC regimes. Given South Africa's limited status on the global stage, South African cannot afford to be a leader in this field but must follow the practice set by others.
  Consideration could be given to adopting a regime similar to that of the UK or Netherlands in order to improve South Africa's tax competitiveness in the long term. This step or approach should, however, be taken with caution, as simplification at this late stage of a long protracted period of development of CFC legislation may open loopholes in the regime that could compromise the fiscus.
- South Africa's CFC rules are very stringent, particularly in respect of anti-diversionary rules which create practical anomalies especially with respect to the limitation relating to foreign dividend participation. This make rules difficult to enforce practically. Care should be taken to ensure that the CFC rules are not made so onerous that they pose excessive compliance burden to South African based companies.
- Care should also be taken to ensure that the rules are not so rigid that they hinder legitimate business establishments. This is particularly so with regard to service income anti-diversionary rules for the foreign business exemption. The legislators should therefore consider refining the anti-diversionary rules as necessary.
- South African CFC rules are some of the most sophisticated and complicated within the G20. A trend that needs to be curtailed is the fact that over the last few years the legislators have resorted to explaining the working of complex legislation in Explanatory Memoranda that have no legal effect, but the law is not clear. Efforts should be made to ensure that the legislation itself is clear. Consideration should be given to simplifying the legislation so as to reduce the cost of administration for business.

It should, however, be borne in mind that policy considerations other than tax (e.g. political stability, labour laws, immigration rules, access to electricity, investment security, etc.) need to be dealt with in order to improve South Africa as a country *to* which companies wish to migrate rather than *from* which they wish to migrate. Thus, the considerations set out above merely ensure that the legislation serves its purpose as an anti-avoidance measure and a deterrent for diverting income in line with the recommendations set out in the OECD Action 3 report and go no further than this.

Should South Africa seriously wish to embark upon a programme of attracting foreign direct investment as one of the means of fulfilling its goals, as set out under the National Development Plan, to create employment and improve the opportunities for the poor to be uplifted, these other policy matters need first to be addressed. The tax regime will then, in its current form, naturally provide increased taxes for other social spending. In line with this overall objective, though, and once the other policies have been attended to, a more competitive tax rate and CFC regime (similar to that in the UK or Netherlands) might well support such initiatives.

DTA REPORT ON ACTION 3: STRENGTHENING CONTROLLED FOREIGN COMPANY RULES*

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1 RELEVANCE OF CONTROLLED FOREIGN COMPANY RULES

1.1 INTRODUCTION

The main purpose of the controlled foreign company (“CFC”) rules is to combat base erosion and profit shifting by targeting foreign investments made by residents, via foreign entities, in an attempt to shift income from the local residence country tax base to low-tax countries.

This is generally achieved through identifying the relevant companies through determining a specified level of shareholding/voting rights held by the residents (in South Africa this is currently more than 50% of the participation rights i.e. rights to participate in the income), and where there is insufficient real activity taking place in that company, the income of the company is attributed to the resident shareholders. Many countries identify a ‘white list’ of countries in which the CFC can be located, such that attribution is not required, where the tax rate is such that the likelihood of profit diversion is low. In South Africa such countries are identified through a determination of the tax that would be payable if the CFC’s tax were calculated using South African tax rules, and measuring this against the tax that is actually payable in the CFC country of residence. If the latter is equal to or exceeds 75% of the former, attribution will not apply.[1]

2 INITIAL OECD THEORECTICAL CONSIDERATIONS

2.1 BEPS CONSIDERATIONS FOR ADOPTING CFC RULES AS STATED BY THE OECD

The OECD advises that a number of policy considerations (some relating to all jurisdictions, and some which follow different policy objectives, linked to the overall domestic systems of individual jurisdictions) need to be addressed when designing controlled foreign company (“CFC”) rules. These considerations consist of shared considerations and specific jurisdictional considerations:[2]

Shared considerations:

- The role of the CFC rules as a deterrent measure;
- How the CFC rules complement transfer pricing rules;
- The need to balance effectiveness with reducing administrative and compliance burdens; and
- The need to balance effectiveness with preventing or eliminating double taxation.[3]

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1 More detail on the South African legislation is set out in part 3 of this document.
2 OECD/G20 2015 Final Report on Action 3 at 11.
3 OECD/G20 2015 Final Report on Action 3 at 11.

These considerations are prioritised differently by different jurisdictions depending on whether they have a worldwide or territorial system.

Specific Jurisdictional considerations:

- How to strike a balance between taxing income and maintaining competiveness; and
- Preventing base stripping[4].

The OECD identifies six constituent elements (termed by it as "building blocks", numbered 1-6) required for the design of effective CFC rules, which should be considered by countries with existing CFC rules, and addressed by those which currently do not:

1. Rules for defining a CFC (including a definition of control);
2. CFC exemption and threshold requirements;
3. Definition of CFC income;
4. Rules for computing income;
5. Rules for attributing income; and
6. Rules to prevent or eliminate double taxation.[5]

These policy considerations and building blocks are each looked at below,[6] in light of the Action 3 considerations. The OECD, however, further emphasises, that these considerations need to be evaluated together with certain of the other Actions.[7] Equally, certain of the other Davis Tax Committee ("DTC") reports need to be aligned with the recommendations below, for example the Report on Estate Duty, as it pertains to the tax treatment of offshore trusts.

Firstly, the policy considerations raised are evaluated, as they pertain to the South African CFC rules and policy objectives.

2.2 THE OVERALL BALANCE BETWEEN TAX NEUTRALITY AND COMPETIVENESS

In designing CFC rules a balance must be struck between taxing foreign income, and global competitiveness.[8] In the absence of harmonised global tax systems, this balance must achieve both capital export neutrality[9] and capital import neutrality.[10]

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4 OECD/G20 2015 Final Report on Action 3 at 15 and 16.
5 OECD/G20 2015 Final Report on Action 3 at 11.
6 See 2.4 onwards.
7 Actions 1, 2, 4, 5, 8-10, 11, 14 and 15. See OECD/G20 2015 Final Report on Action 3 at 12.
8 OECD/G20 2015 Final Report on Action 3 in para 14.
9 Residents are taxed equally regardless of whether they invest in South Africa or another country.
10 Income earned from investments in a particular country is taxed at the same rate regardless of the investor's residence.

In seeking this balance, poorly designed CFC rules run the risk of distortions. Weak systems may result in artificial outflows while over-zealous systems may leave resident country multinationals at a competitive disadvantage. The latter disadvantage arises, for example, if a global multinational operates an active business operation, through a CFC, in a low-taxed foreign country, with the multinational being subject to higher-taxes in its country of residence via CFC imputation. This competition comes from both low-taxed local foreign persons, as well as competitor global participants that similarly enjoy local low-tax country rates without CFC imputation in their home countries.

To address these competitiveness concerns, the current paradigm for global CFC systems exempts active income linked to real economic activity in the foreign subsidiary, as long as that income is perceived not to be an artificial shift of income from elsewhere. At issue is whether this relief goes too far, so as to be ineffective at combating BEPs. To address this the OECD advises that more countries need to adopt similar CFC systems.[11]

Of particular concern is the United States (USA) CFC (subpart F) rules,[12] which are commonly circumvented through the 'check the box' Regulations of 1996. However, the EU is also of concern since it regulated that EU-member tax havens and low tax countries cannot be blacklisted as tax havens. This undermines the principle of preventing companies from 'fobbing off' mobile passive income to tax havens. Other countries, such as the UK have recently[13] adopted rules which are far less aggressive than South Africa's.

Thus, the success of the Action 3 proposals on strengthening CFC legislation will depend on the willingness of the larger OECD member countries to adopt the proposals.

- It is thus recommended that South Africa should not significantly change its already robust CFC legislation until it is clear what other countries intend to do. The principles of the Action 3 proposals are nevertheless reviewed below.

An additional consideration is the risk of double taxation, which can equally erode competitiveness. However, this is generally dealt with through implementing low tax rate threshold rules as well as ensuring the availability of foreign tax credits.[14] Both are currently present in the South African legislation (see 1.1 above).

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11 OECD/G20 2015 Final Report on Action 3 in para 16.

12 The purpose of the Subpart F provisions is to eliminate deferral of USA tax on some categories of foreign income by taxing certain USA persons currently on their pro rata share of such income earned by their controlled foreign corporations (CFCs). See further on Subpart F https://www.irs.gov/pub/int_practice_units/DPLCUV_2_01.PDF accessed on 25 January 2016.

13 The revised CFC legislation was promulgated in the UK in 2012.

14 OECD/G20 2015 Final Report on Action 3 in para 11.

2.3 ADMINISTRATION

Effective CFC regimes should not be unduly burdensome in terms of tax enforcement and tax compliance. CFC regimes must strike a balance between the need for reduced complexity inherent in mechanical rules and the effectiveness of more subjective rules, for example, in the rules that define income. Mechanical rules are simple but prone to distortions. Subjective rules are more theoretically accurate, but can be harder to enforce and create more uncertainty in terms of compliance. A combined approach appears to find favour.[15]

As indicated above, we now look at the policy considerations set out by the OECD in its final Action 3 BEPS report in more detail.

2.4 CFC RULES AS A DETERRENT MEASURE

CFC rules admittedly raise some revenue, but their main focus is to protect the domestic tax base from artificial erosion i.e. to act as a deterrent for tax avoidance.[16] The goal is to keep taxable profits onshore, in line with domestic economic profits, so as to sustain the local corporate tax base. As a result, the benefit of revenue streams raised by CFC regimes cannot be measured by looking solely to taxable CFC revenue.

2.5 SCOPE OF BASE STRIPPING

According to the OECD, CFC rules should be designed to protect both the resident country's tax base as well as the tax base of other countries[17] (i.e. also to cover 'foreign-to-foreign stripping').[18] In effect, the CFC regime of one country may effectively protect the source country taxation of another. Indeed, much of the debate in the first world is the European implicit request for the USA to increase the strength of its CFC regime so as to protect the tax base of various European countries against base erosion caused by USA multinationals[19].

It should be noted that one of the early draft versions of the South African CFC regime sought to adopt a "worldwide tax police" approach that triggered section 9D

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15 OECD/G20 2015 Final Report on Action 3 in para 10.

16 OECD/G20 2015 Final Report on Action 3 in para 7.

17 OECD/G20 2015 Final Report on Action 3 in para17.

18 This covers income that has been in any jurisdiction as well as the CFC jurisdiction.

19 Since enacting section 954(c)(6) in 2005 with an original expiration date of 2009, the US Congress has acted several times to extend the benefits of the provision to US multinationals, which significantly diminishes the effect of its CFC rules by allowing many cross-border interest and dividend payments to fall outside the scope of its subpart F rules. Also, the IRS has contributed to the diminished effect of the subpart F rules by expanding the scope of some regulatory exceptions to the rules. At the same time, lawmakers have proposed various tax reforms, a number of which would significantly expand the scope of the CFC rules by imposing immediate US income tax on a much broader category of foreign earned income.

imputation when both the South African base and the tax base of other countries were at risk of base erosion. This version, however, was roundly (but unofficially) rejected given that most global CFCs systems do not go this far in practice. It was believed that a South Africa “worldwide tax police” role would place South African multinationals at a strong competitive disadvantage vis-à-vis other global competitor CFC regimes (almost all of which take a more parochial approach).[20]

2.6 CFC RULES AND TRANSFER PRICING

Transfer pricing rules are meant to restore the taxing rights of all jurisdictions. While the CFC rules can act as a partial supplement (often termed as “backstops”[21]) only a pure capital export neutrality system could achieve significant protection (i.e. full imputation of CFC income without competitive offsets).[22] However, even this full inclusion system would not capture all transfer pricing arbitrage. The CFC rules can only capture transfers between the parent company and its lower-tier subsidiaries. Countries receiving in-bound investments must still rely on transfer pricing as their core method of protecting their local tax base (e.g. in addition to withholding taxes).[23] Thus, CFC rules can be said to complement transfer pricing rules and *vice versa*.

3 BASIC SOUTH AFRICAN CONSIDERATIONS

3.1 SOUTH AFRICAN POLICY THRUST

South Africa introduced the full CFC regime in 2000 with the core provision being section 9D of the Income Tax Act, 58 of 1962.[24] This regime was introduced along with residency (i.e. worldwide) taxation of South African residents. Without this regime, South Africans could effectively avoid the breadth of worldwide tax by placing foreign income generating assets into a foreign company, while indirectly retaining South African control and the economic benefit of those foreign-placed assets. Like other countries that have adopted CFC regimes, South African taxation of foreign sourced income of foreign companies can only occur by way of imputation to the South African shareholders, because South Africa does not have any direct taxing jurisdiction over a foreign company in terms of residence or source.

Like many European countries, which introduced CFC regimes in the 1980’s, the overall changes to South Africa’s cross-border tax system came into effect roughly in tandem with the steady relaxation of the exchange control rules that began to emerge in the late 1990s.[25]

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20 SAIT submission to DTC (23 August 2015).
21 OECD/G20 2015 Final Report on Action 3 in para 8.
22 SAIT submission to DTC (23 August 2015).
23 SAIT submission to DTC (23 August 2015).
24 South Africa had had a version of CFC legislation that covered only specific passive income since 1997.
25 SARS Explanatory Memorandum (1997:3).

The South African CFC regime (like all CFC regimes) is complex because the CFC regime is intended to balance the need for protecting the South African tax base against the need for international competitiveness. Although many academics have justified this complexity on the basis that the key global businesses involved are sufficiently sophisticated to handle this capacity, it must be borne in mind that this legislation has been introduced by countries with more advanced tax systems like the United Kingdom and the United States of America.[26]

At present, South Africa is the only Southern African Development Community (SADC) State and also the only African country which has introduced CFC legislation.[27] Expatriates from developed countries were called in assist in drafting this legislation. Thus the legislation was largely tailored around the way it worked in these developed countries and minimal consideration was given to the peculiar conditions South Africa was going through.[28] It is reasoned that since CFC rules are largely prophylactic in nature, taxpayers are generally better off arranging their affairs in order to avoid the application of the legislation rather than risk an assessment under it.[29] The complexity of this legislation, however, also hinders foreign direct investment

3.2 MECHANICAL FRAMEWORK

The South African CFC rules as set out in section 9D of the Income Tax Act, require the following three analytical parts:

- Determining whether a foreign entity, as well as South Africa resident control of that foreign entity (referred to as the entity and control tests), falls within the ambit of the CFC regime;[30]
- Determining whether certain foreign income of a CFC is viewed as “tainted” so as to create section 9D imputed income;[31] and
- Computing and imputing “tainted” CFC income to South African shareholders, reduced by foreign tax credits to prevent double taxation.[32]

In terms of the entity and control tests, the South African CFC regime applies solely to companies – not to other organisations such as partnerships and trusts (the latter of which have their own forms of imputation (e.g. conduit or specific attribution treatment)). In order for a foreign company to qualify as a CFC, South African

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26 AW Oguttu *Curbing Offshore Tax Avoidance: The Case of South African Companies and Trust* (UNIDA LLD Thesis, 2007) at 196.
27 Olivier & Honiball at 560.
28 Oguttu at 196.
29 Sandler at 54. (Sandler D: Tax Treaties and Controlled Foreign Company Legislation- Pushing the Boundaries- Second Edition.)
30 Building blocks 1, 2 and 3 as set out in the Action 3 draft Report.
31 Building block 4 as set out in the Action 3 draft Report.
32 Building blocks 4, 5 and 6 as set out in the Action 3 draft Report.

residents must directly or indirectly hold more than 50 per cent of the rights to participate in the share capital/profit of the foreign company or, in certain circumstances, more than 50 per cent of the voting rights in that foreign company. It should be noted that South African residents do not need to be connected to one another (or even be aware of one another's participation) for the more than 50 per cent participation test to be satisfied.[33][34]

If a foreign company qualifies as a CFC, the 'tainted'[35] income of that CFC is imputed back to South African participation rights holders, where they hold at least 10% of the participation rights (alone or together with connected persons, as defined). Tainted income falls roughly into two categories:

(i) mobile income, that mainly includes passive income, such as interest, dividends, royalties, rentals, annuities, exchange differences, insurance premiums, similar income and associated capital gains; and

(ii) certain income from active sources, such as sales and services that have little economic connection to the CFC's country of residence and that involve a South African connected participant that acquires from, or sells to, the CFC (often referred to as South African diversionary transactions).

If specific CFC income is viewed as tainted, section 9D requires calculation of the CFC 'net income'[36] to determine the amount required to be imputed.

4 OECD ACTION PLAN 3 RECOMMENDATIONS

4.1 RULES FOR DEFINING A CFC

The final OECD Action 3 BEPS report seeks to define entities that are to be within the CFC scope and raises the question whether the CFC regime should also apply to partnerships, trusts and permanent establishments ("PE") (where the latter are either owned by CFC's or treated as separate to their owners).[37]

In the main, however, the overall BEPS reports are concerned about hybrid entities (e.g. limited liability companies treated as separate taxable companies for one country and as a conduit for another) i.e. it also seeks to include a modified hybrid mismatch rule. While this form of arbitrage could potentially pose a problem in

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33 See Jooste "The Imputation of Income of Controlled Foreign Entities" *South African Law Journal* (2001) 475-476. It should, however, be noted that where a resident (together with connected persons) hold less than 5% of the participation rights in a listed offshore company, that holding is not taken into account to determine whether the 50% threshold has been exceeded.

34 Headquarter companies are, however, specifically excluded from the attribution regime of section 9D (section 9D(2)).

35 Income falling within the section 9D regime without any of the exemptions applying is often termed 'tainted income'.

36 Determined using South African tax rules.

37 OECD/G20 2015 Final Report on Action 3 in paras 26 and 28.

theory, the factual evidence for this concern is unknown.[38] The OECD indicates that a possible approach to prevent arbitrage would be to take an intergroup payment into account if the payment is not included in CFC income and it would have been included if the parent jurisdiction had classified the entities and arrangements in the same way as the payer or payee jurisdiction.[39]

4.1.1 THE SOUTH AFRICAN POSITION

The South African CFC regime, currently, only requires attribution of income only from foreign companies (as defined) as opposed to partnerships, trusts and other conduit entities.[40]

It should also be noted that in terms of the definition of "foreign partnership" in section 1 of the Income Tax Act, foreign partnerships, associations and similar bodies are treated as conduits under South African tax law if those bodies are treated as conduits for foreign tax purposes in their country of formation/establishment. In essence, South African conduit treatment follows foreign conduit treatment in order to prevent the arbitrage raised by BEPs. This rule also applies to single member bodies treated as a branch.[41]

A more immediate issue within the South African context is the taxation of offshore trusts. The CFC regime initially included foreign trusts (then known as the "controlled foreign entity" regime). However, offshore trusts were removed in the early 2000's because section 9D imputation is based on ownership, and the discretionary trust model does not neatly fit that model. The preferred route was to solve the offshore trust problem under section 7(8) of the Income Tax Act which provides that where there has been a donation, settlement of other disposition (which includes an interest free loan) made by a South African resident to a foreign trust, the income received by or accrued to that trust will be taxed in the hands of the South African resident 'donor'. Section 7(8) still appears to need improvement and requires an independent analysis, as indicated in the Davis Committee report on the Estate Duty.[42]

One trust structure of continuing and imminent concern, under section 9D, is the existence of a group of companies that indirectly "control" further foreign subsidiaries via an offshore discretionary trust (or foundation). This trust, and the subsidiary shares owned by the trust, are economically part of the same group and are even consolidated under internationally accepted accounting principles (International

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38 Refer to discussion on hybrid mismatches dealt with in the DTC Report dealing with BEPS Action 2.

39 OECD/G20 2015 Final Report on Action 3 in para 30.

40 Section 9D requires a foreign *company.* See also National Treasury Detailed Explanation to section 9D. June 2002.

41 I.e. under the worldwide taxation system branches of South African companies are taxed in South Africa as part of the main company.

42 Davis Tax Committee 1st Interim Report, 2015:45.

Financial Reporting Standards (''IFRS'') 10)[43], but often fall outside of the CFC regime e.g. in South Africa. It is contended that these lower-tier foreign subsidiaries should be brought into the CFC net[44].

However, as is noted above, prior attempts to bring such structures into the CFC net failed, given the inability to neatly establish a legal connection in terms of section 9D imputation despite the *de facto* control, and, as indicated above, the legislation including foreign trusts as controlled foreign entities was thus removed soon after its insertion.[45]

The OECD Action 3 report[46] recommends that the foreign companies which are consolidated in terms of IFRS, should be treated as CFC's, despite true control lying with an intermediary trust.

- Consideration could be given to imputing the income of these additional CFCs to the parent South African company in terms of a defined method of imputation. However, reference should be had to the Final DTC Estate Duty report[47] for its recommendations in order to ensure that any such recommendations are consistent.

The OECD discusses 'control' in chapter 2[48] and this is discussed in more detail below (Part C) and it is recommended that South Africa considers these options in order to be in line with international norms. This is critical in order to honour the principle that as many countries should adopt CFC rules and such rules should follow similar building blocks.

It is recommended, however, that South Africa does not adopt any of these suggestions until it has evaluated the level of adoption by other countries in order to ensure that it does not become uncompetitive.

4.2 CFC EXEMPTIONS AND THRESHOLD REQUIREMENTS

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43 Based on various determinants of "control", as defined for accounting purposes.

44 OECD/G20 2015 Final Report on Action 3 at 24.

45 'The initial CFC legislation in 2001 referred to "controlled foreign entities" (CFEs) as opposed to CFCs, since it included foreign trusts as entities, whose income required attribution. The definition was changed to refer to CFC in 2002 and, thus, trusts were removed from the section, which then referred to companies. The first version of the 2011 Tax Laws Amendment Bill once again attempted to include trusts in the CFC regime, but the wording was poor and it was removed prior to promulgation'(p668: International Fiscal Association *Cahiers de droit fiscal international* Volume 98a-The taxation of foreign passive income for group companies-South Africa Branch Reporter: Deborah Tickle.

46 OECD/G20 2015 Final Report on Action 3 at 24.

47 See DTC Estate Duty Report (accessed 10 April 2016) at http://www.taxcom.org.za/docs/20150723%20DTC%20First%20Interim%20Report%20on%20Estate%20Duty%20-%20For%20public%20comment%20by%2030%20September%202015.pdf.

48 OECD/G20 2015 Final Report on Action 3 in paras 34-46.

4.2.1 BEPS ACTION BREAKDOWN

The BEPS CFC Report has an action break-down for possible consideration with respect to CFC exemptions and threshold requirements: (i) *de minimis* amount below which the CFC rules would not apply; (ii) an anti-avoidance requirement which would focus CFC rules on situations where there was a tax avoidance motivation or purpose; and (iii) a tax rate exemption, where CFC rules would only apply to CFC's resident in countries with a lower tax rate than the country[49] (this could be combined with a list such as a white list.[50]).

- *De minimis* threshold: Under the *de minimis* relief category, small levels of otherwise tainted income are ignored due to the administrative burden of imputing such small amounts. The danger in this mechanism is the fragmentation, or re-adjustment, of CFC group income to artificially enhance this form of *de minimis* relief. Passive income can also be used to maximise the caps. Thus, no general recommendation is made for or against this proposal, but if jurisdictions adopt it best practice would be to combine it with an anti-fragmentation rule.[51]

- Anti-avoidance requirement: Some CFC regimes provide full relief for CFCs based on a good business purpose or motive – the old United Kingdom rules being most notable in this regard: Under the United Kingdom rule (section 747(1) of the Income and Corporation Taxes Act 1988), a resident company satisfied the "motive test" by establishing the following: (i) the main purpose of the transactions of the accounting period in question was not a reduction in United Kingdom tax; and (ii) the main reason for the CFC's existence was not a reduction in United Kingdom tax by means of a diversion of profits (i.e. a situation where, in the absence of the CFC, the receipts would have been taxable in the hands of a United Kingdom resident). These rules now fall largely under the Diversionary Profits Tax legislation in the UK as the UK substantially relaxed its CFC rules in 2013 in order to increase competitiveness. The OECD advises that such a rule should not be necessary if the rules defining income within the scope of the regime are properly targeted, and thus do not deal with it further. However, it is stated that this does not mean that rules can never play a role.[52]

- Tax rate exemption: Given that low-taxed countries pose the greatest risk to the tax base, relief often exists when the CFC foreign tax rate is higher or only slightly lower than the tax rate of the resident shareholders of the CFC. This relief should simplify the CFC computation. This relief can be based on statutory or effective rates, or even on a country list. This form of relief eliminates tainted

[49] OECD/G20 2015 Final Report on Action 3 in para 52.
[50] OECD/G20 2015 Final Report on Action 3 in para 51.
[51] OECD/G20 2015 Final Report on Action 3 in para 59.
[52] OECD/G20 2015 Final Report on Action 3 in para 60.

income for the entire CFC. The OECD discusses the possibility of calculating the exemption based on a company by company approach and a country by country approach (which may reduce administrative complexity but increase the complexity of the calculation). No specific recommendation is made.

4.2.2 SOUTH AFRICAN PARADIGM

The South African CFC regime currently applies both a tax rate threshold - the 75 per cent comparable South African tax exception, which applies to all forms of CFC income-and a *de minimis* form of relief.[53]

The current *de minimis* relief is largely limited to alleviating otherwise tainted passive income from triggering section 9D imputation, when it likely relates to working capital attendant on an operating business (activities of a foreign business establishment, as defined). More specifically, this exception applies only to remove section 9D imputation in the case of financial instrument income not exceeding five per cent of a CFC's total receipts and accruals excluding passive type income.[54]

Although the OECD is not opposed to this type of relief, it suggests that this test may be manipulated by dividing up entities as stated above. However, the division of entities solely for this purpose is considered to be unlikely when looking at the current South African regime, given the small percentage involved and the fact that there must be genuine trading income against which the passive income is measured. Dividing foreign entities solely to expand this five per cent tax threshold would be much harder to engineer in practice than in theory.

The first set of relief, for CFCs subject to comparable tax rates, is far more significant. Under this relief mechanism, South Africa disregards all section 9D imputation in respect of a CFC, if the CFC is subject to an overall foreign effective tax rate of at least 75 per cent of the tax that would have been computed had South African tax rules been applied (proviso to section 9D(2)). Stated differently, if the tax rules in both countries were the same, CFC income subject to a 21 per cent foreign effective tax rate would be entirely free from section 9D imputation. Although most taxpayers welcome this exception, the 75 per cent calculation is said to be overly complex because the calculation requires a hypothetical South Africa tax calculation (including a determination of exemptions and deductions which may not be the same in the CFC country). In order to resolve this problem, two solutions have been recommended:

- Many taxpayers have requested relief if a CFC is subject to 21 per cent foreign statutory tax rate (versus an effective rate determination) on the basis of compliance simplicity. These requests have repeatedly been rejected

53 Section 9D(9A)(a)(iii).
54 Section 9D(9A)(a)(iii).

because a simple statutory approach may deviate significantly from the effective rate, due to a variety of unique foreign statutory provisions (e.g. local tax incentives) and other issues relating to local enforcement.[55]

- The use of a "good country"/"bad country" list of countries to simplify enforcement, which existed when the CFC regime was initially adopted in South Africa[56], and is also cited as an option by the OECD,[57] was ultimately repealed (despite this method's seeming simplicity) because of international politics. A good/bad country list approach is bound to offend certain countries, with adjustments eventually being made on the basis of political grounds as opposed to sound tax principles.

Notwithstanding the above, a reasonable case can be made for placing all countries on a "good" list if they are, for example, located on the African mainland. Most countries on the African continent tend to impose tax at rates at or above the South African corporate rate of 28 per cent rate, and tend to place significant enforcement emphasis on multinationals.[58] While many of these countries do indeed have incentive regimes, these regimes are almost entirely limited to mining, manufacturing and other "brick and mortar" businesses likely to fall outside section 9D, in any event, due to them being attributable to a "business establishment".[59] A relief mechanism of this nature would possibly assist South Africa's intention of being a gateway to the region, outside the headquarter regime (which excludes the CFC rules, in any event). One issue may be the existence of financial centre regimes, such as the Botswana International Financial Services Centre[60] or Mauritius Global Business Company regime,[61] which seek to provide special incentives for regional treasury operations and international companies, respectively. In cases such as these, National Treasury should be given the regulatory authority to exclude/include CFCs utilising regimes of this nature, as considered appropriate.

As for the anti-avoidance requirement, South Africa has consistently rejected this escape hatch because the CFC rules are designed to be objective, not discretionary.

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55 Submissions by SAICA to SARS and Treasury on recommended Annexure C inclusions (Annual Budget Review suggestions called for in the preceding November).

56 'Between 1997 and 2001 the controlled foreign entity legislation did not apply where the foreign tax actually paid or (without any right of recovery) was more than 85 per cent of the normal tax payable in the Republic and in 2000 this exemption was changed to refer to the receipts, accruals and capital gains of a CFC where 'such receipts and accruals have been or will be subjected to tax in a designated country at a statutory rate of at least 27%' (13.5% for capital gains). A list of designated countries was compiled for this purpose and included in a Government Gazette. The designated countries (non-low-tax jurisdictions) exemption prevailed in various forms until 2004, when the exclusion was removed completely' (p674: International Fiscal Association *Cahiers de droit fiscal international* Volume 98a-The taxation of foreign passive income for group companies-South Africa Branch Reporter: Deborah Tickle.

57 The Banking Association of South Africa favours this method for its simplicity.

58 SAIT submission (August 2015).

59 CFC income satisfying the requirements under this heading falls outside the attribution regime.

60 Refer www.gov.bw/en/News/IFSC-BOTSWANA-MAKES-STRIDES-TO-IMPROVE-GLOBAL-COMPETITIVENESS for details.

61 Refer www.fscmauritius.org.

Anti-avoidance rules like the motive/business purpose tests are easy to assert and hard to maintain as an administrative matter because the focus eventually shifts the debate onto the matter of international competition, as opposed to sound tax principles. That said, the United Kingdom's motive/purpose[62] escape hatch creates a gateway competition issue for South Africa because the resulting CFC regime is so light that most global multinationals would prefer to work through that regime in terms of a regional gateway, than working through the more objective and income-by-income analysis of the South African CFC regime.

4.2.3 LOW TAX ALTERNATIVE

An alternative approach, to the complexities of distinguishing between foreign business establishment income and other income, is to simply determine section 9D imputation based on the local foreign tax rate (effective or statutory). Under this approach, all CFCs with a rate falling below a set percentage (e.g. 10 or 15 per cent) would be subject to section 9D without regard to any other facts and circumstances. The obvious benefit of this approach is simplicity.

At first blush, it could be argued that a simple flat threshold as a trigger for section 9D imputation would be unfair because all low-taxed active and passive income would be targeted. However, from a South African perspective, all of the countries of concern with low rates seemingly have little or no sizable active operating businesses from an aggregate South African country perspective. A dual effective and statutory tax rate threshold would mean that "subtle" and explicit low-taxed jurisdictions would be subject to section 9D imputation.

The most probable contrary argument would be one of international competitiveness because this method may be more effective in triggering imputation than most other CFCs regimes (meaning that South African multinationals would be in a less competitive position than their international competitors). For instance, this approach would require section 9D imputation even for subsidiary manufacturing operations operating in an African tax holiday zone, when the manufacturing subsidiaries of other competitor country multinationals would fall outside CFC imputation (the latter being excluded due to the active nature of the business involved).

- It is thus recommended that the current regime covers this aspect satisfactorily, and follows the recommendation of BEPS Action 3, through adopting the combined *de minimus* approach and low effective tax rate rules, and should be maintained.
- It is recommended, however, that consideration be given to the method adopted by South Africa for determining the effective tax rate, as set out in the final Action 3 Report. Furthermore, consideration needs to be given to

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[62] Refer UK 2012 CFC legislation.

whether the exemption provided when the actual tax paid by the CFC in its country of residence exceeds 75% of the South African tax that would have been paid applying South African tax principles to the CFC's income, is appropriate given the global trend of reducing tax rates, for example, the UK plans to reduce the statutory tax rate to 16% by 2020, and the average rate of corporate tax in 2015 for Europe was 20.24% e.g. Ireland 12.5%, Hungary19%, and Asia 21.91% e.g. Singapore 17%,and Thailand 20%,[63] unless the South African tax rate is likewise reduced.
(It should also be noted that, should South Africa significantly lower its corporate tax rate to compete with other lower tax jurisdictions, the risk of diversionary profits is, in any event, reduced).

4.3 DEFINITION OF CONTROL

According to the BEPS action report, there are two determinations for control: (i) the type of control; and (ii) the level of control.[64]

Types of control can be determined in various ways: – legal control,[65] economic control[66] (currently most jurisdictions use a combination of these two), *de facto* control[67] and control based on consolidation.[68] The OECD recommends that legal and economic control rules potentially be supplemented with *de facto* or consolidation types rules.[69]

Once a CFC regime has established what actually confers control the next question is how much (the level) control is enough for the CFC rules to apply.[70] The most common threshold is the more than 50% level (although 50% may also be used). However, the question of whether minority shareholders are acting together is always a concern. To address this concern, three methods may be adopted: The "acting in concert" test (not often used); a test which looks at the relationship of the parties; or a "concentrated ownership" test.
The South African system is fairly standard in this regard. Foreign companies are viewed as CFCs only if more than 50 per cent of the participation rights[71] or voting

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63 KPMG Corporate Tax Rate Survey.
64 OECD/G20 2015 Final Report on Action 3 in para 34.
65 Holding of share capital to determine percentage of voting rights.
66 Focuses on rights to profits, capital and assets of the company.
67 Based on who takes the top level decisions or who has the ability to influence or direct its day to day activities.
68 Based on whether the company is consolidated based on accounting principles. See OECD OECD/G20 2015 Final Report on Action 3 in para 35.
69 OECD/G20 2015 Final Report on Action 3 in para 36.
70 OECD/G20 2015 Final Report on Action 3 in para 37.
71 Broadly defined as the right to participate directly or indirectly in the benefits attaching to a share.

rights are directly or indirectly[72] held by South African residents (excluding certain categories as indicated above).

At this stage, there do not appear to be significant issues in this regard despite the BEPS theoretical concern about artificial structures designed to separate "the more than 50 per cent" trigger from economic or *de facto* control. The company governance challenges in achieving this split probably make this option non-viable for larger foreign subsidiaries indirectly held by listed entities or a group of truly independent investors.

- It is therefore recommended that more evidence of a factual problem should be pursued before complex adjustments are made to the CFC regime in this regard.

One ongoing technical issue is the determination of CFC status (and section 9D imputation) when a CFC has multiple classes of shares. In this circumstance, the question of what are the relative weights of participation rights – a concept established at a time before the Company Act (Act No. 71 of 2008) i.e. a time when distributions from shares were based on concepts such as share premium, share capital and profit reserves came into question.

- It is recommended that a cleaner approach would be to shift the focus from "participation rights" to one of economic value (being the whole bundle of dividend, liquidation, voting and selling rights).
- Alternatively, the concept of accounting consolidation could be added (or used in the alternative) using the predefined rules set out in IFRS 10 (see above). Such a change would ensure the inclusion of companies held through trust structures which are consolidated into the South African group, but bearing in mind the DTC Estate Duty report recommendations.
- It is, thus, recommended that the current South African definitions for control be retained, subject to any significant moves from other global players towards widening the definition based on the principle of consolidation, using IFRS 10 as the guideline.

4.4 DEFINITION OF CFC INCOME

4.4.1 BEPS ACTION REPORT ANALYSIS

There are various contrasting options for defining CFC income.[73] At one end, options can target complete or near worldwide/full inclusion. Various partial inclusion regimes can occur in the middle. For instance, the CFC regime could be limited to situations where the CFC has developed intangible property that the CFC exploits (e.g. through sales and services), dividends derived solely from related CFCs, and

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72 As recommended by OECD/G20 2015 Final Report on Action 3 in para 25.
73 Chapter 4 of OECD/G20 2015 Final Report on Action 3.

passive income.[74] A light touch approach, on the other hand, would solely target passive income, including business income not tied to substantive business operations.

The categorical analysis[75] (addressing specific categories of income, income earned from related parties and/or source of income), the full inclusion system (in terms of which all the CFC income is included) and the excess profits (which recognises and attributes profits in excess of a normal return) approaches are the approaches as explained by the OECD, that jurisdictions could use in defining which CFC income should be attributed, with none representing a consensus view.

Further, the BEPS Action 3 report provides a number of options for testing substance.[76] These options are as follows:

- One option would be a threshold test which looks at facts and circumstances to determine whether the employees can factually demonstrate a "substantial contribution" to the CFC income earning activity.
- A second option would look at all the significant functions performed by entities within the group to determine whether the CFC is the entity that would be most likely to own particular assets and / or undertake particular risks, if the entities were independent. Either all the income would be imputed if the CFC fell below the threshold test or only assets and risks that would not otherwise be owned by an independent foreign entity would result in imputation.
- A third option would look to determine if the CFC has sufficient business premises and nexus to the country of residence and whether enough skills are being employed to undertake the CFC's core functions. Again, the income could be attributed on and all or partial basis.
- A fourth option would be a variation on the third and would use the nexus approach (used in Action 5) to ensure that preferential IP regimes require substantial activity. Income would be attributed to the extent that it could not be shown that the CFC met the requirements of the nexus approach.

The excess profits approach is not a feature of any existing CFC rules.

4.4.2 SOUTH AFRICAN CONTEXT: FOREIGN BUSINESS ESTABLISHMENT THRESHOLD

The South African CFC regime broadly targets two sets of activities for deemed inclusion: (i) mobile income that mainly includes income of a passive nature (even if indirectly arising from or associated with a business operation); and (ii) diversionary income (income activities susceptible to transfer pricing). Mobile (passive) income includes dividends, interest and other financial instrument income, certain rental,

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[74] The so-called "form-based approach".
[75] OECD/G20 2015 Final Report on Action 3 in para 76.
[76] OECD/G20 2015 Final Report on Action 3 at 48.

insurance, as well as intellectual property income. In terms of the diversionary rules, South Africa seeks to target greater forms of active income (e.g. sales and services) but only when these activities lack any meaningful economic nexus to the local country of residency.

The starting point for determining whether CFC income is tainted (i.e. requires section 9D imputation) is the existence (or lack) of a foreign business establishment. The objective of the test is to determine whether real activity (and, thereby, value creation) is occurring in the CFC country. If not, section 9D imputation is required.

South Africa has chosen an option that is similar to the BEPS option of distinguishing between imputed and non-imputed income, although it does recognise aspects of the substance approach in defining this. While arguably less accurate, the mechanical business establishment test is far easier for SARS to audit and enforce (and for taxpayers to satisfy compliance) than the facts and circumstances nature of the looking at the substantial contribution and the independent entity analysis. Mechanical tests are more in sync with most current global CFC systems in existence (with the other methods apparently representing a shift in a new direction). At a mechanical level, the policy issue is whether the current CFC regime requires enough substance under the foreign business establishment test to meet the policy objective of having meaningful CFC local activity. At a technical level, the "business establishment" test generally requires the business: (i) to be conducted through a physical structure, (ii) to be suitably staffed with on-site managerial and operational employees, (iii) to be suitably equipped to conduct primary operations, (iv) to have suitable facilities, and (v) that the business be located outside South Africa for a purpose other than the avoidance of South African tax.[77] Although the numerical size of these tests can sound intimidating, more aggressive taxpayers may appear to satisfy the test with as little as one managerial employee, one operational employee, a small fixed office (which may even be shared) and a modest amount of office equipment.

- ➢ It is therefore recommended that a review of the substance requirement may be appropriate.

At a business establishment level, two common fact patterns appear to be of repeating concern. First is the use of CFCs to conduct marginal non-stand-alone activities; the second is the creation of mobile businesses that can easily shift from one country to the other.

- Non-viable stand-alone businesses: Certain CFCs are solely conducting "auxiliary and preparatory" activities that could never survive on their own.[78] All (or almost all) inputs and outputs involve domestic and foreign affiliates. These activities may be substantial in size with multiple employees and/or structures but

77 See section 9D(1) definition of "foreign business establishment".
78 SAIT Submission to DTC (August 2015).

amount to nothing more than an internal set of centralised activities. Some of these may even involve purchases and sales so as to constitute an intermediate step in the production process. Suitable transfer pricing in these circumstances may also be difficult because no actual specific comparables of an independent nature may exist for proper comparison.

- Mobile businesses: Certain CFC's have a few core administrative and supervisory employees. Much of the value in many of these CFCs stems from outsourced employment contracts with these outsourced employees conducting the bulk of the work, with the CFC claiming the value-added profit in respect of this employee outsourcing.[79] Many of these businesses have little or no nexus to the CFC country of residence other than nominal office space with small local staffing.

According to the OECD, a true employee establishment approach requires the local CFC to directly conduct its core functions with limited outsourcing. Management and oversight by themselves should be insufficient. The current test, however, does not appear to exclude outsourcing, and an outright exclusion of outsourcing may not be indicative of something that is artificial in a modern economy. Outsourcing to connected persons would indeed seem suspect, but genuine businesses do indeed outsource activities for a variety of non-tax reasons (e.g. risk, employee versus contractor cost, and flexibility) and outsourcing may indeed increase legitimate profitability of performance.

- ➢ It is therefore recommended that a further inquiry of the tax base risks associated with outsourcing needs to be explored before some form of automatic tainting could be legislatively imposed.

In summary, many of the above businesses would exist for reasons other than tax even though these operations satisfy the mechanical business establishment threshold. Given the widespread nature of these activities within the South African CFC and other countries' CFC systems, any Government crackdown could be argued as anti-competitive unless a fair number of countries similarly follow suit.

However, it should be noted that the mere existence of a foreign business establishment is not sufficient to free a CFC of having tainted income. The income at issue must be (economically) "attributable to" that establishment. Therefore, proof that income is attributable to a business establishment becomes much more difficult for taxpayers to prove as a practical matter if the business establishment has little factual substance. Given that little guidance exists in this regard, it is hard to say whether the "attributable to" test can be said to be successful.

[79] SAIT Submission to DTC (August 2015).

4.4.3 ANTI-BASE STRIPPING (I.E. ANTI-DIVERSIONARY) RULES

The OECD takes note of “anti-base stripping”[80] rules requiring imputation when CFCs engage in goods and service transactions with connected persons (either as inputs or outputs). The purpose of these rules is to trigger imputation for transactions that typically give rise to base erosion - a drain from the tax base in terms of transfer pricing. The mechanical nature of the CFC is such that a complex fair market transfer pricing analysis can be avoided.

South Africa falls in line with this approach by targeting CFC connected person transactions with South African residents. These targeted transactions include imported goods, exported goods and imported services. All of these activities are tainted unless some meaningful factual nexus to the CFC country of residence exists (i.e. mere invoice companies to connected parties will fail even if the minimum foreign business establishment standard is satisfied). This nexus can come in a variety of forms pertaining to inputs (e.g. production) and outputs (e.g. clientele). The benefit of these mechanical tests is to avoid the complex factual inquiry of transfer pricing as stated above; the down-side is that the mechanical nexus may be under-inclusive or over-inclusive.

It should be noted that the diversionary rules only target connected relationships with South African residents and CFCs – not CFCs vis-à-vis other CFCs. This limitation exists because the South African CFC system is designed solely to protect the South African tax base – not the tax base of other countries. On the other hand, intermediary CFCs can be used to hide the South African company and CFC diversionary relationship. The question is how to attack these indirect diversionary relationships without becoming a global tax police system (a CFC approach that few countries adopt in theory or in practice).

4.4.4 PASSIVE INCOME-CATEGORICAL ASPECTS

The South African CFC regime targets passive income pursuant to the traditional “categorical approach” in which listed passive forms are viewed as tainted but for specific mechanical exceptions. More specifically:

- Dividends are largely viewed as tainted unless previously taxed or eligible for the participation exemption (under section 10B of the Income tax Act for shareholdings of at least 10 per cent (common to most European CFC systems).
- Income from other financial instruments (e.g. interest, insurance, certain rental, currency gains and losses) are tainted unless they are part of certain active banking, financial service provider and similar businesses. As an exception to the exception, financial instrument income from treasury operations and captive

[80] OECD/G20 2015 Final Report on Action 3 in para 80.

insurers never fall within the relief for banks and financial service providers / similar businesses.

The above income may also fall outside tainted treatment if part of the 5 per cent working capital exemption (as discussed above).

The overall categories have generally raised little controversy but for isolated issues. The biggest issue seemingly relates to the denial of relief for treasury operations and captive insurers. The goal is to ensure that the active banking and financial service provider or similar business exception is utilised for business activities with outside independent parties. Treasury operations and captive insurers are essentially a larger form of savings vehicle for the benefit of a listed group. The principle is that if individuals and small businesses are not given exemption for placing their passive investments offshore, why should large corporates be effectively allowed to do the same?

The BEPS Action 3 report expresses a fair level of concern regarding intellectual property (a strong European concern). Under the South African CFC system, licensing income from intellectual property is tainted unless the CFC is regularly engaged in creating, developing or substantially upgrading intellectual property.[81] A similar system of tainting exists for capital gains arising from the disposal of intellectual property.[82] The BEPS Action 3 report raises concerns that the disposal of intellectual property is a problem in some jurisdictions because licensing income can easily be disguised as part disposals of intellectual property.[83] This concern presumably does not exist in the South African CFC system because both licensing and sales income are treated similarly. However, there may be an inadvertent escape hatch for the disposal of intellectual property qualifying as trading stock (where the CFC is not regularly engaged in the creation, development or substantial upgrading of intellectual property).

A side issue involving intellectual property may be the artificial labelling of certain portions of intellectual property income as ancillary services in order to avoid CFC imputation. This form of artificial labelling works best when the local countries involved treat services preferentially vis-à-vis royalties, but in some cases local royalties may be preferred.

- Given the flexible characterisation of these amounts as ancillary services or royalties, it is recommended that ancillary services should be classified as royalties under section 9D (or at least if the amounts are characterised as royalties for local country tax purposes).

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81 Section 9D(9A)(v).
82 Section 9D(9A)(vi).
83 OECD/G20 2015 Final Report on Action 3 at 45.

4.4.5 OECD EXCESS PROFIT ALTERNATIVE

The OECD Action Report raises an alternative option to the above tainting of categories used by South Africa and most other CFC regimes. Under this alternative, all CFCs with "excess profits" would trigger CFC imputation in terms of the proposed "excess". [84] This approach is a form of "risk engine" approach with "excess profits" being viewed as a statistical outlier that is suggestive of deviant economic activity or tax avoidance.

The problem with this approach is the determination of the "excess", which presumably requires an industry-by-industry comparative analysis. An analysis of this kind would require significant data, and essentially amounts to a different form of transfer pricing analysis (the type of analysis that CFC regimes are designed to avoid). At an economic level, the "excess" test seems to be targeting more successful businesses on the (probably false) assumption that tax avoidance is the cause. In effect, this approach could wrongfully target certain CFCs with "excess" profits that are simply operating in a more efficient way.

- As this approach is not currently used anywhere else in the world it is recommended that it not be considered at this stage.

4.4.6 THE SOUTH AFRICAN INTRA-GROUP CFC EXCEPTION

A seemingly unique aspect of the South African CFC regime is the intra-group relief mechanism of section 9D(9)(*f*A). Under this relief mechanism, interest, royalties, rentals, insurance premiums and income of a similar nature falls outside section 9D imputation despite their passive nature, if received or accrued from another CFC within the same group of companies. The price of this relief is the loss of any imputed deductions for the payer.

This mechanism essentially operates as a form of intra-group relief to nullify events between the same economic group, especially because both sides of the transactions will be attributed to the same taxpayers. This dual imputation should therefore create a neutralised tax result at the South African taxpayer level.

One issue could be the use of this s9D(9)(*f*A) exemption as a means to facilitate base stripping in respect of the tax systems of other countries. However, this theoretical point again falls outside the policy scope of the current South African CFC regime because the South African CFC regime is designed solely to protect the South African tax base – not to operate as a global tax police force. It should also be noted that this area is a sensitive one because intra-group payments will often simply shift funds between otherwise exempt amounts of CFC business establishments.

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84 OECD/G20 2015 Final Report on Action 3 at 49.

- It is thus, recommended, that more factual analysis is required in respect of the intra-group relief mechanism before any concrete action can be taken.

Transactional (categorical approach) versus entity analysis

A final note in terms of CFC imputation is the difference between a transactional approach and an entity (all-or-nothing) approach. South Africa applies a transactional approach. This approach is consistent with the categorical system of identifying tainted sources of CFC income. An entity (all-or-nothing) approach has the burden of being under-inclusive or over-inclusive.
Thus, the South African rules currently appropriately follow the recommended route, and it is considered that they are therefore adequate.

- It is therefore recommended that, other than to clarify or simplify the rules the South African rules need no amendment on this front.

4.5 COMPUTATION OF SECTION 9D IMPUTATION

South African CFC imputation is based solely on South African tax principles. While this hypothetical calculation in regards to CFC income adds another compliance calculation, this hypothetical calculation is the most consistent method from a policy standpoint.[85] The purpose of the South African CFC regime is to ensure that certain forms of foreign income are taxed at the same level as amounts wholly within the domestic South African income.

Given that section 9D is only a partial imputation system, one must arguably impute only CFC deductions or allowances associated with tainted CFC income. In other words, the rules of section 9D are designed to take into account tainted CFC activities regardless of whether the tainted CFC activities produce net income or net loss. Under section 9D, net tainted CFC losses can only offset income within the same CFC. While some argue that section 9D operates similar to a partnership model, the CFC regime creates only a limited partial inclusion system (meaning that deductions should similarly be limited). Direct excess foreign losses are somewhat limited under section 20 (which deals with assessed losses and the carry forward thereof) under the notion that the worldwide tax systems should always be an addition to the South African tax base (i.e. foreign net losses should not be subsidised by the South African tax system).

- In this regard, the South African rules comply with the recommendation in the OECD Action 3 report and do not, therefore require any amendment, in principle.

[85] SAIT submission (August 2015).

4.6 RULES FOR ATTRIBUTING INCOME

4.6.1 SOUTH AFRICAN TAXPAYERS SUBJECT TO IMPUTATION

According to the OECD, most CFC rules tie imputation to control or to a concentrated ownership in the CFC.[86] Best practice for imputation relies on either voting or *de* facto control, or economic influence over a CFC. The South African formulation of CFC income imputation is fairly standard. South African residents that own at least 10 per cent of the CFC's participation rights or voting rights will be subject to imputation (taking into account connected persons). This imputation includes indirect ownership through lower-tier CFCs.[87]

4.6.2 SOUTH AFRICAN ALLOCATION AND TIMING OF IMPUTATION

CFC rules attribute income in proportion to each taxpayer's participation rights, as defined. This allocation is generally straight-forward except where multiple classes of shares are involved (as discussed above) – an issue of little consequence for most offshore structures (except possibly for consortium groups such as private equity).

A more complicated issue is one of timing i.e. when the ownership of a CFC changes during the course of the year. South Africa (like many countries) typically looks at ownership of a CFC as of the close of the CFC's year.[88] While not ideal as a matter of purity, this year-end approach is a common method given its simplicity. Special allocation rules exist when a foreign company obtains or terminates CFC status during the tax year.[89]

Should control be determined on the consolidation basis (i.e. in terms of IFRS 10) the method for determining attribution will need to be made clear. The current legislation does not cater for this eventuality.

- It is recommended that reference be had to the DTC Estate Duty report for the treatment of offshore foreign trusts. Should separate specific rules, however, be required for offshore trusts falling within the CFC regime, it is recommended that the imputation be made to the company consolidating the income of the underlying companies in the 'group', in its annual financial statements.

4.6.3 NATURE OF IMPUTATION

Imputation has two general forms. Section 9D imputation of CFC income can be treated as deemed dividends or as foreign income directly earned by the allocable

86 OECD/G20 2015 Final Report on Action 3 at 62.
87 Proviso to section 9D(2).
88 Section 9D(2)(a)(i).
89 Section 9D(2)(a)(ii).

owner. South Africa takes a direct income imputation approach. Under this approach, the net tainted income of the CFC is deemed to have been directly earned by the 10 per cent or greater participation rights holder in the CFC. The underlying income effectively retains its nature.

4.6.4 TAX RATE APPLICABLE TO CFC INCOME

Given the direct imputation system, applicable participation rights simply add CFC income to overall taxable income of the resident. No special rate calculation is required. The policy rationale for different rates, raised by the OECD report is not considered appropriate for South Africa as the administrative complexity of a different system of rates is hard to justify in terms of compliance.

4.7 CFC RULES ADDRESSING DOUBLE TAXATION

4.7.1 RELIEF FOR FOREIGN CORPORATE TAXES

South Africa has a foreign tax credit (rebate) system under section 6*quat* of the Income Tax Act, which that provides credits to prevent double taxation as suggested by the OECD.[90] This credit system allows a South African resident to directly reduce South African taxes otherwise owing in respect of foreign taxes, proved to be payable by the CFC in respect of imputed CFC income. Double tax relief is widely accepted international tax practice. The only issue of recurring controversy is the concept of "proved to be payable"[91] due to practices associated with foreign taxes imposed by certain African revenue authorities[92] (an issue outside the scope of this report).

A bigger issue for CFC systems is how to deal with dividends from CFCs in respect of amounts not previously subject to imputation. These dividends (not representing previously imputed income) also represent amounts subject to foreign taxes. Many countries provide offsets by way of indirect tax credits.[93] Nonetheless, this method of indirect credits is extremely complicated and was abandoned when the participation exemption was adopted as a more viable alternative.[94]

- It is therefore considered that the South African foreign tax credit regime adequately deals with this aspect and no further changes are recommended.

4.7.2 OFFSETS IN THE CASE OF CFCs SUBJECT TO MULTIPLE IMPUTATION CLAIMS

90 Article 23 of the OECD Model Tax Convention.
91 Section 6quat (1A).
92 Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011 page 100, para 4.3 II.
93 SAIT Submission (August 2015).
94 See below at 4.7.3(a)

In a world of growing CFC systems, it is possible that a single subsidiary can be subject to multiple country CFC imputation claims giving rise to possible multiple taxation of the same CFC income. For example, assume a USA company owns all of the shares South African company, and that South African company owns all the shares of offshore African subsidiaries. In this scenario, both the USA and South African CFC regimes would apply to the offshore African subsidiaries. This dual set of CFC regimes is extremely cumbersome, and is often a deterrent from using a country with a CFC regime as a regional gateway.

In theory, some form of offset will be required so that one CFC system provides a tax credit against the other. In the case of the scenario above, the country with the ultimate ownership should provide the credits against the lower-tier CFC system (i.e. the USA should provide credits against the South African taxes paid as a consequence of the South African CFC imputation in the above scenario). In the current global climate, precise rules dealing with this circumstance are either rare or non-existent. However, this issue will ultimately have to be addressed if more countries adopt CFC systems in line with the implicit mandate of the OECD.

South Africa has created the headquarter company regime (section 9I) which is exempt from CFC rules, deal with this circumstance. Under this approach, certain South African companies, controlled by foreign shareholders, can operate free of the CFC system. The goal is to eliminate the dual CFC regime problem where South African companies are used as a regional gateway by foreign multinationals.

4.7.3 RELIEF FOR SUBSEQUENT DIVIDENDS AND CAPITAL GAINS

Like many European countries, South Africa utilises a participation exemption in the case of dividends and capital gains.

a) Exempt dividends

Under the participation exemption system,[95] foreign dividends distributed by foreign companies are exempt from tax if a South African tax resident directly or indirectly owns at least 10 per cent of the equity shares and voting rights of the foreign company (which, in such instances, most often is a CFC). The purpose of this rule was to exempt these foreign dividends so that the South African tax system does not discourage the repatriation of funds back to South Africa. The 10 per cent threshold exists because only larger shareholders have an influence over the dividend decision. The participation exemption has the added advantage of eliminating the need for providing indirect tax credits for foreign taxes paid in respect of the underlying foreign profits – a system that is hard to track and highly complex.

[95] Section 10B(2).

The only concern associated with the participation exemption is the opportunity for abuse via round-tripping schemes. In these schemes, South African taxpayers make deductible payments offshore with essentially the same funds routed back to South African in the form of tax-free dividends (via the participation exemption[96]). These schemes should be closed via the general anti-avoidance rule of Part IIA of the Income Tax Act and by substance-over-form principles of judicial case law, together with the prevailing Exchange Control prohibition against such practices. However, section 10B does have some objective rules that seek to prevent this practice as well. Section 10B(2) is limited to equity shares because round-tripping most easily occurs via foreign debt-like instruments such as preference shares.

In addition, the exemption does not apply if funded via South African deductible payments.[97] In terms of this latter anti-round tripping rule for deductible payments, there is some concern by revenue enforcement about the ability to track deductible payment proceeds in relation to foreign dividends (especially when a dividend may have only incidentally and partially been funded by *de minimis* ordinary deductible amounts).

b) Exempt capital gains

South African residents disposing of foreign equity shares are similarly exempt from capital gains tax if the South African holds 10 per cent or more of the equity shares and voting rights in the company before the disposal.[98] This exemption exists as a matter of theoretical parity. Capital gains arguably stem from accrued profits normally associated with future dividends. Therefore, if foreign dividends are exempt, it is argued that comparable capital gains should be exempt. This approach is fairly standard for other systems, especially European, with participation exemptions.

The impact of the participation exemption is part of a different debate. Most taxpayers view the participation exemption as an important planning device available to multinationals of most global systems. The problem has been the misuse of the exemption to facilitate indirect corporate migrations.[99]

5 CLOSING REMARKS/RECOMMENDATIONS

- The South African CFC regime is largely in line with CFC systems used by many developed countries in Europe, North America, East Asia and the Pacific. Like all CFC systems, the regime is trying to protect the tax base without unduly interfering with the global competitiveness of South Africa's global listed multinationals. This balance is a core reason for the regime's

96 Section 10B(2).
97 Section 10B(4).
98 Paragraph 64B of the Eighth Schedule.
99 The participation exemption is dealt with in the DTC Report dealing with BEPS Action 4.

complexity. Although the regime can be theoretically tightened, competitive constraints have been a very limiting factor.

CFC rules are, thus, the subject of much international debate and the prospects of major change on the international front. Many European systems have softened their CFC systems since 2000. Countries such as the UK and Netherlands (major competitors in the region) have fairly light CFC regimes. Given South Africa's limited status on the global stage, South African cannot afford to be a leader in this field but must follow the practice set by others.

Consideration could be given to adopting a regime similar to that of the UK or Netherlands in order to improve South Africa's tax competitiveness in the long term. This step or approach should, however, be taken with caution, as simplification at this late stage of a long protracted period of development of CFC legislation may open holes in the regime that could compromise the fiscus.

- CFC rules are the subject of much international debate and the prospects of major change on the international front. South Africa should adopt the position of protecting its own interests. It should follow and not lead or set the trend.

- South Africa's CFC legislation is very sophisticated and comparable to other G20 countries; there is no need to strengthen this legislation at this stage.

- South Africa's CFC rules are very stringent, particularly in respect of anti-diversionary rules which create practical anomalies especially with respect to the limitation relating to foreign dividend participation. This make rules difficult to enforce practically.

- Care should be taken to ensure that the CFC rules are not made so onerous that they pose excessive compliance burden to South African based companies.

- Care should also be taken to ensure that the rules are not so rigid that they hinder legitimate business establishments. This is particularly so with regard to service income anti-diversionary rules for the foreign business exemption. The legislators should therefore consider refining the anti-diversionary rules as necessary.

- South African CFC rules are some of the most sophisticated and complicated within the G20. A trend that needs to be curtailed is the fact that over the last few years the legislators have resorted to explaining the working of complex legislation in Explanatory Memoranda that have no legal effect, but the law is not clear. Efforts should be made to ensure that the legislation itself is clear.

Consideration should be given to simplifying the legislation so as to reduce the cost of administration for business.

- South Africa should monitor the OECD recommendations and reform the CFC rules as necessary.

It should, however, be borne in mind that policy considerations other than tax (e.g. political stability, labour laws, immigration rules, access to electricity, investment security, etc.) need to be dealt with in order to improve South Africa as a country *to* which companies wish to migrate rather than *from* which they wish to migrate. Thus, the considerations set out above merely ensure that the legislation serves its purpose as an anti-avoidance measure and a deterrent for diverting income in line with the recommendations set out in the OECD Action 3 report and go no further than this.

Should South Africa seriously wish to embark upon a programme of attracting foreign direct investment as one of the means of fulfilling its goals, as set out under the National Development Plan, to create employment and improve the opportunities for the poor to be uplifted, these other policy matters need first to be addressed. The tax regime will then, in its current form, naturally provide increased taxes for other social spending. In line with this overall objective, though, and once the other policies have been attended to, a more competitive tax rate and CFC regime (similar to that in the UK or Netherlands) might well support such initiatives.