

South African Controlled Foreign Companies' Rules and the Digital Economy

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Abstract

South Africa's controlled foreign company ("CFC") rules were enacted more than two decades ago before most of today's business models existed. These are anti-avoidance rules that ensure the South African taxation of profits diverted offshore by South African residents. In terms of the CFC rules, the profits of a non-resident company may also be subject to tax in South Africa at the hands of its South African resident shareholder if such non-resident company is considered to be a CFC. Advances in technology developments and the use of information communication and technology ("ICT") have given rise to what is referred to as the digital economy. The term refers to economic activities hinged on the use of ICT and the internet. Digitalisation has made it possible for a business to carry on economic activity without the need for a multitude of offices, staff, equipment, and other resources. As a result, new business models like Uber and Shien have emerged. This paper argues that the current South African CFC rules have not kept pace with these new business models and do not effectively regulate the new business models and the digital economy. This paper recommends that the CFC rules be updated to address the digital economy and new business models by amending the rules, incorporating the provisions of *Electronic Communications and Transactions Act* 25 of 2002 into the rules, using country-by-country reporting, and even considering implementing a regime alternative to CFC rules.

Keywords

Digitalisation; anti-avoidance; controlled foreign company; digital economy; foreign business establishment exemption; deemed source; direct tax.

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1 Introduction

Advances in technology developments and the use of information communication and technology ("ICT") have given rise to what is referred to as the digital economy. The term refers to economic activities hinged on the use of ICT and the internet.¹ Digitalisation has changed how businesses around the world operate. They no longer need to be "physically" present in a jurisdiction but can operate digitally or virtually anywhere in the world.² New business models such as e-commerce, payment services, app stores, online advertising, cloud computing, and participative network platforms have emerged.³ Tax rules were developed more than a century ago, at a time when the digital economy and the various new business models still did not exist. Controlled foreign company ("CFC") rules were enacted in South Africa more than two decades ago. These are anti-avoidance rules that ensure the taxation of profits in South Africa diverted offshore by South African residents.⁴ The South African CFC rules have mostly remained unchanged since their initial formulation.

This paper analyses whether the South African CFC rules have kept up to date with modern businesses arising from the digital economy and as such are still effective as anti-avoidance rules for new digital business models. The paper first discusses the digital economy, new business models, and their key features. It then analyses the current South African CFC rules to determine whether the rules are sufficient to address the new business models of the digital economy and the challenges digitalisation poses to the rules. The paper ends with recommendations and conclusions on the design of CFC rules in South Africa where the rules are ineffective in regulating the digital economy.

2 The digital economy

2.1 Definition

The Organisation for Economic Co-operation and Development ("OECD")⁵ has defined the digital economy as

a broad range of economic activities that include using digitised information and knowledge as the key factor of production, modern information networks

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¹ See G20 2016 <https://www.mofa.go.jp/files/000185874.pdf>.

² OECD *Action 1 54*.

³ OECD *Action 1 54*.

⁴ Stiglingh *Silke* 871.

⁵ The OECD is an international organisation that works to develop policies and finding solutions to a range of social, economic, and environmental challenges. See OECD date unknown <https://www.oecd.org/about>.

as an important activity space, and the effective use of information and communication technology as an important driver of productivity growth and economic structural optimization.⁶

The digital economy is a by-product of the transformative process created by ICT and is fast becoming the economy itself.⁷

2.2 New business models

The first major digital players initially emerged from the traditional business models. For example, online retail emerged from the selling of physical goods from physically located stores.⁸ Retailers have evolved to now even selling digital products and offering digital services such as streaming music and movies, downloading games, and online advertising.⁹ Online services have evolved and increased and include the offering of platforms that enable people to rent out their homes and vehicles.¹⁰ New business models such as e-commerce,¹¹ payment services, app stores,¹² online advertising,¹³ cloud computing¹⁴ and participative network platforms¹⁵ have emerged.¹⁶ All of these business models operate differently and value is generated differently. The common features of the business models are their reliance on servers, software, user data, and the use of the internet.¹⁷ Some of the key features of the digital economy business models are discussed below.

2.3 Key features of the digital economy business models

The key features of the digital economy business models include mobility in respect of intangibles, users and business functions, heavy reliance on data and network effects,¹⁸ the use of multi-sided business models in which the

⁶ G20 2016 <https://www.mofa.go.jp/files/000185874.pdf>.

⁷ OECD *Action 1* 142.

⁸ OECD *Action 1* 52.

⁹ OECD *Action 1* 53.

¹⁰ OECD *Action 1* 53. See also OECD *Interim Report 27*.

¹¹ E-commerce is the sale of goods and services online. An example of E-commerce business is Alibaba.

¹² App stores are online retail platforms from which consumers can purchase or download applications, games, music, etc. An example of an App store is the Apple App store.

¹³ Online advertising is advertising of products and services virtually. Online platforms such as Facebook and Instagram could be used for online advertising.

¹⁴ Cloud computing is the use of standardised, configurable online computer services such as software, storage and data management using shared physical and virtual resources. I-cloud is an example of a cloud computing business.

¹⁵ These are virtual platforms that allow users to use themselves for communication and creating content. An example of a participative network platform is Facebook.

¹⁶ OECD *Action 1* 54.

¹⁷ Also see Mochusi *Analysis of Tax Challenges* 12.

¹⁸ This entails that the decision of a user can have a direct impact on the benefit derived by other users. For example, the use of a cell phone network can create congestion of the network and slow down its efficiency for other users. See OECD *Action 1* 143.

sides of the markets may be in different jurisdictions, the use of the internet and ICT, a tendency toward monopoly or oligopoly in certain business models, and volatility because of low barriers to entry and evolving technology.¹⁹ Companies in the digital economy rely heavily on intangibles to create value and produce income.²⁰ Intangible assets can be defined as assets that derive their value from intellectual property²¹ or other intangible assets such as digital space, data, and software. The use of intangible assets such as software and algorithms supporting business platforms and websites are vital to most highly digitalised businesses such as participative network platforms like Twitter and Facebook.²² Intangible assets can easily be moved around different jurisdictions because they do not have physical substance.

Businesses are able to choose the location of their resources, clients and business functions. They can move their business functions such as finance, marketing, sales, customer support and logistics across various jurisdictions in a way that is most profitable and efficient for the business.²³ It is possible for a business to carry on economic activity without the need for personnel present.²⁴ Certain tasks that were previously performed by local personnel can now be performed by automated equipment on a cross-border level. Distance is not a deterrent to trade and increases the number of customers a business can target and reach.²⁵ Thus, the growth of customers for a business in a jurisdiction does not always require the level of local infrastructure and personnel that would have been needed in a pre-digital age.²⁶ This means that businesses have flexibility in choosing the location where their substantial business activities will take place.²⁷ Businesses are then able to interact with customers anywhere in the world remotely through various types of online or web-based platforms.²⁸

Businesses in the digital economy rely heavily on data and network effects. Businesses collect data about their customers, users, suppliers, and operations and monetarise the data.²⁹ For example use data to improve their services or to sell to advertising companies that will be able to use the data to target their advertisements.³⁰ The use of a multisided market is

¹⁹ OECD *Action 1* 55-73. See also OECD *Interim Report* 24-25.

²⁰ OECD *Action 1* 145.

²¹ Intellectual property such as copyrights, trademarks and patents are examples of intangible assets.

²² Also see OECD *Interim Report* 24.

²³ Oguttu and Van der Merwe 2005 *SA MERC LJ* 314.

²⁴ OECD *Action 1* 66. Also see Harpaz 2021 *Yale J Int'l L* 58.

²⁵ OECD *Action 1* 100. Also see OECD *Interim Report* 24.

²⁶ OECD *Action 1* 100. Also see OECD *Interim Report* 24.

²⁷ OECD *Action 1* 100. Also see OECD *Interim Report* 24.

²⁸ OECD *Interim Report* 30.

²⁹ See OECD *Action 1* 71.

³⁰ See also OECD *Interim Report* 53.

another key feature of the digital economy business models because the advances in technology and ICT have allowed for business to reach a global base of customers, users and suppliers from different jurisdictions virtually using websites, online platforms and mobile applications.³¹ A multi-sided business model is one that is based on a market with various different groups of people who interact through an intermediary or platform.³²

Businesses in the digital economy also rely heavily on the use of the internet and ICT, which creates anonymity. Users can transact and even communicate with each other without information about each other such as their physical location and sometimes even their real identities.³³ Accordingly, digitalisation and the digital economy create various tax challenges such as making it difficult to identify taxpayers and the location of taxpayers because of the anonymity of the internet, the verification of taxable transactions and the ability to establish a tax nexus between taxpayers and their taxable income. This creates opportunities for taxpayers to defer and avoid taxes.

3 Controlled foreign company rules

3.1 The rules

In 1994 South Africa transitioned into a new political order which also brought about the abolition and introduction of certain laws. The Katz Commission was appointed in 1994 with the goal of investigating South Africa's tax regime under the apartheid system against the backdrop of the economic, social and political goals of the democratic political system.³⁴ Effective from 1 July 1997, many exchange control rules were either abolished or relaxed.³⁵ This included the exchange control rule that restricted the ability of residents to invest outside South Africa. In order for residents to invest outside South Africa they had previously needed approval from the South African Reserve Bank. The purpose of the restriction had been to ensure that income earned by South African residents was kept within the borders of the country. From 1997 South African residents could move income from South Africa to offshore countries.

CFC legislation was introduced in South African legislation in 1997 (and expanded on in 2001). This was a time before businesses like Facebook,

³¹ OECD *Interim Report* 28.

³² OECD *Action 1* 71.

³³ See also Schulze 2006 *SA Merc LJ* 33.

³⁴ Manuel 2002 https://www.treasury.gov.za/comm_media/speeches/2002/2002102501.pdf.

³⁵ See Manuel and Stals 1997 https://www.treasury.gov.za/comm_media/press/1997/1997031201.pdf.

Uber and Airbnb were in operation. National Treasury had not envisioned such business models at the time of enacting the rules.³⁶ CFC rules are anti-avoidance rules to ensure the taxation of profits diverted offshore by South African residents.³⁷ The rules are concerned about avoidance schemes and are not meant to deter real cross-border transactions.³⁸ The rules try to strike a balance between, on the one hand, creating an environment for South African Multinational Enterprises ("MNES") to compete on a global scale, and on the other hand, deterring the diverting of profits offshore.³⁹ In terms of the rules, the profits of a non-resident company may also be liable for tax in South Africa at the hands of its resident shareholder/s if the company is considered to be a CFC of such resident shareholder/s.⁴⁰ A CFC is defined in section 9D of the *Income Tax Act*⁴¹ ("Act") as a foreign company⁴² where more than 50% of the total participation rights⁴³ or voting rights in that company are directly or indirectly held or exercisable by one or more residents⁴⁴ (except headquarter companies)⁴⁵ or the financial results of that foreign company are reflected in the consolidated financial statements (prepared in terms of International Financial Reporting Standards 10 ("IFRS 10")) of a resident company. Section 9D will not apply to a resident who holds less than 10% of the shares in a CFC.

³⁶ See also Kraamwinkel and Grimm 2018 <https://www.withoutprejudice.co.za/free/article/6281/view>.

³⁷ Stiglingh *Silke* 871.

³⁸ Stiglingh *Silke* 872.

³⁹ See Olivier and Honiball *International Tax* 559; Stiglingh *Silke* 890.

⁴⁰ Section 9D of the *Income Tax Act* 58 of 1962 (the Act) will not apply to a resident who holds less than 10% of the shares in a CFC.

⁴¹ Section 9D of the Act.

⁴² A foreign company is defined with reference to ss 1 and 9D of the Act as being a non-resident company, a protected cell company or a cell thereof. By virtue of the meaning of foreign company, trusts and partnerships would fall outside the ambit of CFC rules.

⁴³ Participation rights in respect of a foreign company refers to the right to participate in the benefits of the rights (other than voting rights) flowing from a share, or any interest of a similar nature in the foreign company; or in the case where no person has any such rights in that foreign company or no such rights can be determined for any person, the right to exercise any voting rights in that company. See s 9D(1) of the Act. According to National Treasury, convertible debentures and options do not qualify as participation rights until they are converted into shares. See National Treasury 2002 <https://www.treasury.gov.za/divisions/tfsie/tax/legislation/Detailed%20Explanation%20to%20Section%209D%20of%20the%20Income%20Tax%20Act.pdf>.

⁴⁴ Section 1 of the Act provides that natural persons are resident in South Africa if they are ordinarily resident in South Africa or meet the physical presence test, and a person other than a natural person is resident in South Africa if it is incorporated, formed or established in South Africa or its place of effective management is located in South Africa.

⁴⁵ Subject to a few qualifications such as voting rights of a listed company should be disregarded. See s 9D(1)(a)(i) of the Act.

A proportionate net income of the CFC shall be included in the income of a resident shareholder who directly or indirectly holds participation rights⁴⁶ in the CFC according to the total participation rights the shareholder holds in the CFC or IFRS10 net percentage consolidated.⁴⁷ Net income of the CFC is defined in section 9D(2A) of the Act, subject to certain qualifications, as an amount equal to the taxable income of that company determined in accordance with the provisions of the Act as if the CFC had been a taxpayer, and as if that CFC had been a resident.⁴⁸ In order to avoid or eliminate double taxation when implementing CFC rules, section 9D(2A) of the Act provides that where CFC attributed income was also subject to foreign tax, the South African resident could claim a section 6quat rebate.⁴⁹ All attributable income should first be dealt with pursuant to any applicable double tax treaty.

In terms of section 72A(1) of the Act, a South Africa resident shareholder of a CFC that holds directly or indirectly alone or together with a connected person⁵⁰ at least 10% of the participation rights in a CFC must submit a return to the Commissioner of the South African Revenue Service ("Commissioner"). The South African resident shareholder must be ready to submit the financial statements of the CFC in a relevant year to the Commissioner if requested to do so.⁵¹ Failure to submit the financial statements without a reasonable ground for the failure will result in only

⁴⁶ A shareholder that holds less than 10% participation and voting rights does not need to impute. Also excluded are participation rights held indirectly by residents through a South African resident company and qualifying participations held by an insurer as defined. See proviso in s 9D(2) of the Act.

⁴⁷ Section 9D(2) of the Act.

⁴⁸ In calculating the net income, the CFC will be considered a resident for the purposes of the definition of gross income, ss 7(8), 10(1)(h), 25B and 28 of the Act and paras 2(1)(a), 24, 70, 71, 72 and 80 of the Eighth Schedule to the Act.

⁴⁹ Section 6quat of the Act provides South African residents with a rebate against their normal South African tax for any foreign taxes paid on any income from foreign sources and includes proportional amount of net income of a CFC under s 9D. See s 6quat(1)(b) of the Act.

⁵⁰ Section 1 of the Act defines a connected person in relation to a company: "as any other company that forms part of the same group of companies (as defined in section 1 of the Act if the expression 'at least 70 per cent of the equity shares in' in paragraphs (a) and (b) of the definition of 'group of companies' were replaced by the expression 'more than 50 per cent of the equity shares or voting rights in') as that company; any person, other than a company as defined in section 1 of the Companies Act 71 of 2008 that alone or together with any connected person in relation to that person, holds, directly or indirectly, at least 20 per cent of the equity shares in the company, or the voting rights in the company; any other company if at least 20 per cent of the equity shares or voting rights in the company are held by that other company, and no holder of shares holds the majority voting rights in the company; any person who or which is a connected person in relation to such company; or any person who or which is a connected person in relation to the former."

⁵¹ Section 72A(2) of the Act.

receipts and accruals being used to calculate the net income of the CFC to be imputed to the resident shareholder and no exemptions will be taken into account. Section 6quat rebates in respect of any amount considered in calculating the net income of the CFC will also not be available.

Not all income of the CFC is imputed to the resident shareholder. Section 9D of the Act contains certain exemptions which exclude the net income of a CFC from the ambit of section 9D. The exemptions available are the high tax exemption,⁵² foreign business establishment ("FBE") exemption, exemption for amounts attributable to certain long-term insurance policyholder exemption, exemption for amounts subject to royalty/interest withholding taxes, exemption for amounts included in the taxable income of the CFC, exemption for amounts attributable to foreign dividends declared by any other CFC out of amounts imputed or imputable less tax credits or exemptions, inter-CFC income exemption,⁵³ and exemption for assets attributable to the FBE of another CFC forming part of the same group of companies.⁵⁴ This paper does not discuss all the other exemptions and exclusions but focusses solely on the FBE exemption, as it has not really kept up with new business models.

The FBE exemption states that income attributable to a FBE is exempted from imputation.⁵⁵ Income attributable to a FBE is deemed as nil. The income attributable to a FBE is determined as if the FBE were a distinct and separate enterprise dealing independently with the CFC under arm's length principles.⁵⁶ An FBE is defined in section 9D(1) of the Act as

- (a) a fixed place of business located in a country other than the Republic that is used or will continue to be used for the carrying on of the business of that controlled foreign company for a period of not less than one year, where—
- that business is conducted through one or more offices, shops, factories, warehouses or other structures;
 - that fixed place of business is suitably staffed with on-site managerial and operational employees of that controlled foreign company who conduct the primary operations of that business;
 - that fixed place of business is suitably equipped for conducting the primary operations of that business;

⁵² The high tax exemption entails that the net income of a CFC shall be deemed to be nil where the aggregate amount of tax payable "to all spheres of government" by the CFC for the relevant foreign tax year is at least 67,5% of the amount of normal tax that would have been payable in South Africa had the CFC been a South African resident in the relevant tax year. See s 9D(2A) of the Act.

⁵³ See s 9D(fA) of the Act.

⁵⁴ See s 9D(fB) of the Act.

⁵⁵ Section 9D(9)(b) of the Act.

⁵⁶ Section 9D(9)(b) of the Act.

that fixed place of business has suitable facilities for conducting the primary operations of that business; and

that fixed place of business is located outside the Republic solely or mainly for a purpose other than the postponement or reduction of any tax imposed by any sphere of government in the Republic:

Provided that for the purposes of determining whether there is a fixed place of business as contemplated in this definition, a controlled foreign company may take into account the utilisation of structures as contemplated in subparagraph (i), employees as contemplated in subparagraph (ii), equipment as contemplated in subpara-graph (iii), and facilities as contemplated in subpara-graph (iv) of any other company—

- (aa) if that other company is subject to tax in the country in which the fixed place of business of the controlled foreign company is located by virtue of residence, place of effective management or other criteria of a similar nature;
- (bb) if that other company forms part of the same group of companies as the controlled foreign company; and
- (cc) to the extent that the structures, employees, equipment and facilities are located in the same country as the fixed place of business of the controlled foreign company;

(b)

From the above definition of an FBE, it can be seen that a "fixed place of business" that is or will continue to be used for the carrying on of the business of the CFC is a key component of the existence of a FBE. What constitutes a "fixed place of business" is not defined in the Act. The same phrase is used for defining a permanent establishment ("PE"). A PE is defined *inter alia* as a fixed place of business through which the business of an enterprise is wholly or partly carried on. It includes *inter alia* a place of management, an office or a factory, but excludes the use of facilities for activities of a preparatory nature such as storage, display or delivery.⁵⁷ The OECD Model Tax Convention Commentary ("OECD MTC Commentary") provides that the following requirements should be met in order for there to be a fixed place of business in respect of a PE:

- (a) there must be a physical place of business such as an office, warehouse, etc.;⁵⁸

⁵⁷ See Art 5 of the *OECD Model Tax Convention on Income and on Capital* (2017) (the OECD MTC).

⁵⁸ It is not material whether the premises are rented or owned by the enterprise. See para 1 of the commentary to Art 5 of the OECD MTC 81; Oguttu 2008 (Part 1) SA *Merc LJ* 316.

- (b) that the place of business must be fixed i.e. established at a physical place with some form of permanency;⁵⁹ and
- (c) the business of the enterprise must be carried on from such fixed place of business.⁶⁰

The OECD MTC Commentary considered if a website or the location of server may be considered for the physical presence test element. A website is a virtual location on the World Wide Web. It is a combination of software and electronic data.⁶¹ A server is equipment on which a website is stored and made accessible.⁶² In respect of a website, the OECD MTC Commentary provides that a website is not a tangible asset and as such cannot be a fixed place of business for the purposes of the meaning of the PE concept.⁶³ In respect of a server, the OECD MTC Commentary states that a server has a physical location which could create a PE if used to conduct the business of the enterprise subject to the activities deemed to be excluded from creating a PE.⁶⁴ The server must be established at a physical location for sufficient duration of time in order to satisfy the "fixed place of business" requirement.

Section 232 of the *Constitution of the Republic of South Africa, 1996* ("Constitution") provides that customary international law is law in South Africa unless it is inconsistent with the Constitution or South African legislation. Section 232 of the Constitution provides that when interpreting any legislations, the courts must prefer any reasonable interpretation of the legislation that is consistent with international law over any alternative interpretation that is inconsistent with international law. The court in *CIR v Downing*,⁶⁵ where the court held that South Africa should consider interpretation guidelines on concepts used in OECD MTC. On the basis of section 232 and the *CIR v Downing* case, the interpretation of "fixed place of business" could be used to interpret the phrase in the FBE definition. Using the OECD MTC Commentary on a "fixed place of business" as an aid to interpret the "fixed place of business" as contained in the CFC rules, it can be argued that for an FBE to exist the company must have some

⁵⁹ The business should not be temporary. Para 1 of the commentary to Art 5 of the OECD MTC 81; Oguttu 2008 (Part 1) *SA Merc LJ* 318.

⁶⁰ Paragraph 1 of the commentary to Art 5 of the OECD MTC 81; Oguttu 2008 (Part 1) *SA Merc LJ* 318.

⁶¹ See para 42.2 of the commentary to Art 5 of the OECD MTC; Oguttu 2008 (Part 1) *SA Merc LJ* 318.

⁶² See para 42.2 of the commentary to Art 5 of the OECD MTC; Oguttu 2008 (Part 1) *SA Merc LJ* 318.

⁶³ See paras 42.2-42.3 of the commentary to Art 5 of the OECD MTC; Oguttu 2008 (Part 1) *SA Merc LJ* 318.

⁶⁴ See paras 42.2-42.3 of the commentary to Art 5 of the OECD MTC; Oguttu 2008 (Part 1) *SA Merc LJ* 318.

⁶⁵ *CIR v Downing* 1975 4 SA 518 (A) 524.

physical presence in a country outside of South Africa. This makes sense, considering that when the CFC rules were enacted, the businesses at the time were of brick and mortar and digital businesses were not prevalent.

The FBE definition also includes the possibility of outsourcing, provided the outsourcing is to a company in the same group of companies as the CFC and it is tax resident in the same country as the CFC.⁶⁶ The Supreme Court of Appeal in *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd*⁶⁷ ("Coronation case") had to determine whether the net income of Coronation Global Fund Managers (Ireland) Limited ("CGFM"), a company tax resident in Ireland, was attributable to its indirect South African shareholder, Coronation Investment Management SA (Pty) Ltd ("CIMSAs") or whether the income would fall within the ambit of the FBE exemption in terms of section 9D of the Act. CGFM used an outsourcing business model where certain of its operations were outsourced to companies outside Ireland. The court held that the primary operations of CGFM were outsourced outside Ireland and as such CGFM did not have a FBE in Ireland. The court held that

The essential operations of the business must be conducted within the jurisdiction in respect of which exemption is sought. While there are undoubtedly many functions which a company may choose to legitimately outsource, it cannot outsource its primary business.⁶⁸

The FBE rules thus did not consider digitalised business models and do not include them in its ambit. The FBE exemption was created to protect income from legitimate businesses falling within the ambit of the CFC anti-avoidance provisions.⁶⁹ On the rigid application of the FBE rules, many business models in the digital economy may not qualify for the exemption, albeit being real businesses merely because they are not based on the old "bricks and mortar" model.

The FBE exemption is subject to certain rules that can result in income from certain transactions and circumstances that is attributable to a FBE to still be imputable to the resident shareholder of the CFC in terms of section 9D of the Act, despite the income forming part of the FBE. These transactions and circumstances include:⁷⁰

⁶⁶ Section 9D(1) of the Act.

⁶⁷ *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd* [2023] SCA 10.

⁶⁸ *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd* [2023] SCA 10 54.

⁶⁹ Olivier and Honiball *International Tax* 447. Also see Oguttu 2008 (Part 1) SA Merc LJ 361.

⁷⁰ See s 9D(9A) of the Act.

- a) transactions that involve connected resident taxpayers and the FBE. These are commonly referred to as diversionary transactions and include –
- transactions which involve goods sold by the CFC directly or indirectly to connected South African residents;⁷¹
- i) transactions that involve the sale of goods by the CFC directly or indirectly to a resident that is not a connected person where the CFC initially bought those goods or tangible inputs from a South African resident connected in relation to the CFC);⁷² and
 - ii) transactions where a CFC renders services to a resident connected person;⁷³
- b) activities of the CFC's FBE that may be aimed at earning passive income regardless of its being earned by a business structure that qualifies as a FBE. These include –
- i) amounts arising from financial instruments;⁷⁴
 - ii) the rental of movable property;⁷⁵
 - iii) amounts that arise in respect of the use or right of use of or permission to use any intellectual property as defined in section 23I of the Act (unless certain exceptions are met);⁷⁶
 - iv) capital gain determined in respect of the disposal or deemed disposal of any intellectual property as defined in section 23I of the Act, unless that controlled foreign company directly and regularly creates, develops or substantially upgrades any intellectual property as defined in section 23I of the Act which gives rise to that amount; or⁷⁷
 - v) amounts derived in the form of insurance premiums.⁷⁸

These exclusions prevent the abuse of the FBE exemption.⁷⁹ However, some of the rules carving out the diversionary transactions have further exceptions that may apply to them, which if applicable will result in the

⁷¹ Section 9D(9A)(a)(i) of the Act.

⁷² Section 9D(9A)(a)(iA) of the Act.

⁷³ See s 9D(9A)(a)(ii) of the Act. Please note that in respect of this diversionary transaction, the FBE exemption may still apply if certain exceptions are met.

⁷⁴ See s 9D(9A)(a)(iii) of the Act.

⁷⁵ See s 9D(9A)(a)(iv) of the Act.

⁷⁶ See s 9D(9A)(a)(v) of the Act.

⁷⁷ See s 9D(9A)(a)(vi) of the Act.

⁷⁸ See s 9D(9A)(a)(vii) of the Act.

⁷⁹ Stiglingh *Silke* 886.

diversionary transactions being exempt from imputation and thus not subject to section 9D inclusion

3.2 OECD Action 3 recommendations

The OECD and the Group of Twenty("G20"),⁸⁰ in collaboration with over 125 countries, developed measures to address base erosion and profit shifting ("BEPS")⁸¹ strategies. Consequently, in July 2013 the OECD released an Action Plan with 15 comprehensive actions⁸² that serve to equip governments with domestic and international instruments to address BEPS strategies to ensure that profits are taxed where economic activities and value are created to generate those profits.⁸³ Action 3 is one of the 15 action points and it focusses on designing effective CFC rules. Action 3 is not a minimum standard but provides recommendations to assist countries with the development of the design of their CFC rules.⁸⁴ It recommends six building blocks to be included or expanded on in the CFC legislation of a country in order for countries to strengthen their CFC rules.⁸⁵ The building blocks are:

⁸⁰ The G20 is an international forum for the governments and central bank governors from 20 major economies. The members include amongst others, South Africa, China, India, the United Kingdom and the United States of America. The G20 was established with the aim of studying, reviewing and promoting discussions on policies in respect of the promotion of international financial stability. See Australian Government date unknown <https://www.dfat.gov.au/trade/organisations/g20>.

⁸¹ The OECD provides that "BEPS relates to arrangements that achieve low or no taxation by shifting profits away from the jurisdictions where the activities creating those profits take place or by exploiting gaps in the interaction of domestic tax rules where corporate income is not taxed at all". See OECD *Addressing Base Erosion and Profit Sharing* 14.

⁸² The Action plans are: Action 1: Address the tax challenges of the digital economy, Action 2: Neutralise the effects of hybrid mismatch arrangements, Action 3: strengthen controlled foreign companies rules, Action 4: Limit base erosion via interest deduction and other financial payments, Action 5: counter harmful tax practices more effectively, taking into account transparency and substance, Action 6: Prevent treaty abuse, Action 7: prevent the artificial avoidance of PE status, Action 8: Assure that transfer pricing outcomes are in line with value creation with respect to intangibles, Action 9: Assure that transfer pricing outcomes are in line with value creation with respect to risks and capital, Action 10: Assure that transfer pricing outcomes are in line with value creation with respect to other high risk transactions, Action 11: Establish methodologies to collect and analyse data on BEPS and the actions to address it, Action 12: require taxpayers to disclose their aggressive tax planning arrangements, Action 13: Re-examine transfer pricing documentation, Action plan 14: make disputes resolution mechanisms more effective, and Action 15: develop a multilateral instrument.

⁸³ OECD *Interim Report* 17.

⁸⁴ OECD *Action 3* 9.

⁸⁵ OECD *Action 3* 9.

- a) the first building block sets rules for defining what should constitute a CFC and includes the definition of control;⁸⁶
- b) the second building block lists various exemptions⁸⁷ and thresholds⁸⁸ that can excuse an entity from falling within the ambit of CFC rules;⁸⁹
- c) the third building block deals with what constitutes CFC income;⁹⁰
- d) the fourth building block provides for the requirements for computing income.⁹¹ The report recommends that CFC rules use the rules of the parent jurisdiction to compute the CFC income to be attributed to shareholders;
- e) the fifth building block deals with the attribution of income;⁹² and
- f) the sixth building block addresses the prevention of double taxation or the elimination thereof.⁹³

As discussed above, CFC rules were introduced into South Africa tax legislation in 2001. The South African CFC rules as contained in section 9D of the Act define what a CFC is, provide various exemptions and thresholds in determining whether an entity should fall within the ambit of CFC rules, it provides what should constitute CFC income, how to calculate the CFC income, how to deal with the imputation of CFC income, and that section 6quat of the Act or relevant provisions of a double tax agreement (DTA) (where applicable) can be utilised to avoid double taxation. In this respect South Africa has implemented most of the Action 3 recommendations.

When the Davis Tax Committee ("DTC")⁹⁴ compared South Africa's CFC rules to the building blocks suggested in the Action 3, it found that the South African CFC rules meet the requirements of the six building blocks to a large

⁸⁶ See OECD *Action 3* 21.

⁸⁷ For example, the OECD BEPS Action 3 recommends the use of a black and white list where countries are listed in a black list if they offer low or no tax liability for investors than in the country of residence, and the countries listed in a white list would be countries that charge tax to investors at a higher tax rate than the country of residence. CFC income from a country listed in the black list would be subject to imputation, whilst income from CFCs listed in the white list would be exempt from imputation. See OECD *Action 3* 36-37.

⁸⁸ An example is the *deminimis* threshold, which entails that CFC income shall not be imputed if it falls below a certain threshold. See OECD *Action 3* 33.

⁸⁹ See OECD *Action 3* 33.

⁹⁰ OECD *Action 3* 43.

⁹¹ See OECD *Action 3* 57.

⁹² OECD *Action 3* 61.

⁹³ OECD *Action 3* 65.

⁹⁴ The DTC was a committee tasked with assessing South Africa's tax policy framework. See DTC 2013 <https://www.taxcom.org.za/aboutus.html>.

extent.⁹⁵ The DTC, however, also found South African CFC rules to be robust, complex, and unclear in certain areas. The DTC recommended that the rules be relaxed and consider changes in the international business environment before tightening up the rules further in order to protect South African homegrown MNEs and to avoid increasing the burden of compliance and administrative costs.⁹⁶ Action 3 does not directly provide recommendations on addressing challenges the digital economy poses to CFC rules. Of the 15 action plans, Action 1 deals with tax challenges posed by the digital economy, but Action 1 has not honed in on CFC rules.

South African CFC rules are quite rigid in comparison to some European CFC rules.⁹⁷ For example, the United Kingdom ("UK") in 2013 "lightened" its CFC rules.⁹⁸ The UK CFC rules specifically target profits artificially diverted from the UK.⁹⁹ Unlike South African rules, the UK rules are flexible in that not all income of the CFC fall within the CFC charge but a CFC charge will arise only if there is no applicable exemption and the profits pass through a "CFC gateway".¹⁰⁰ A "CFC gateway" is a test to determine if the profits are artificial and must be taxed in the UK and includes business profits (other than non-trade finance and property business profits) attributable to UK activities, and non-trade finance arising from certain UK funding.¹⁰¹ Although a comparative study with the UK rules is beyond the scope of this paper, South Africa could benefit from considering more flexible rules like those of the UK. However, it should be noted that the UK CFC rules also face challenges posed by the digital economy as discussed below.

4 Challenges the digital economy poses to CFC rules

The first step in determining a CFC is to establish if there is a foreign company. In addition to the options in section 9D(1) of the Act, a foreign company is a non-resident company. A company resident in South Africa is one that is incorporated in South Africa or that has its place of effective management ("POEM") in South Africa.¹⁰² Accordingly, a non-resident

⁹⁵ DTC date unknown https://www.taxcom.org.za/docs/New_Folder3/3%20BEPS%20Final%20Report%20-%20Action%201.pdf 28.

⁹⁶ See DTC date unknown https://www.taxcom.org.za/docs/New_Folder3/3%20BEPS%20Final%20Report%20-%20Action%201.pdf 31.

⁹⁷ Kraamwinkel and Grimm 2018 <https://www.withoutprejudice.co.za/free/article/6281/view>.

⁹⁸ HMRC 2016 <https://www.gov.uk/hmrc-internal-manuals/international-manual/intm190000>.

⁹⁹ Smith and Williamson 2013 <https://www.thesait.org.za/news/141049/United-Kingdom-Controlled-Foreign-Companies-CFC-Regime.htm>.

¹⁰⁰ Smith and Williamson 2013 <https://www.thesait.org.za/news/141049/United-Kingdom-Controlled-Foreign-Companies-CFC-Regime.htm>.

¹⁰¹ Section 371BB of Schedule 20 of the UK's *Finance Act* 14 of 2012.

¹⁰² See s 1 of the Act.

company would be one that is not incorporated in South Africa nor has its POEM in South Africa. The term incorporated is not defined in the Act. A company incorporated in terms of section 13 of the *Companies Act*¹⁰³ is resident in South Africa mainly because its formation and incorporation is in South Africa regardless of where the company operates or is managed. Therefore, it is possible for a company to choose its place of incorporation with no regard to where the company actually operates.

"POEM" is also not defined in the Act. Interpretation Note 6¹⁰⁴ regards POEM as the place where key management and commercial decisions necessary to the carrying on the business of the company as a whole are made in substance.¹⁰⁵ With the advancements in telecommunications, it is possible for the key management and commercial decisions of a company to be held solely or mainly virtually with the people attending the meetings located at different locations. This makes determining the POEM problematic. Companies can even choose to hold such meetings at different locations all the time and choose a location with favourable tax laws in order to have their POEM there.

South African Revenue Services (SARS) Interpretation Note 6 provides that the determination of POEM must be determined considering all facts and circumstances on a case by case basis.¹⁰⁶ The SARS Interpretation Note 6 provides a non-exhaustive list of all the facts and circumstances that can be considered in determining POEM, such as the location of the company's head office and the location where the board regularly meets.¹⁰⁷ SARS Interpretation Note 6 also provides that where other factors are inconclusive, the extent of the company's economic nexus within a jurisdiction should be given some weight in determining POEM.¹⁰⁸ Unfortunately, the Interpretation Note does not elaborate on what is meant by economic nexus or how such an economic nexus should be measured.

The guidance from SARS Interpretation Note 6 in determining POEM is still not satisfactory in relation to business models in the digital economy, and

¹⁰³ *Companies Act* 71 of 2008.

¹⁰⁴ SARS 2015 <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-IN-2012-06-IN-6-Resident-Place-of-effective-management-companies.pdf> (Interpretation Note 6). SARS interpretation notes are not binding to the courts and the Commissioner, as was held in *ITC 1675 (2000) 62 SATC 219 229A*.

¹⁰⁵ Interpretation Note 6 4. Also see *Oceanic Trust Co Ltd v CSARS* (unreported) (WCC) case number 22556/09 of 13 June 2011, where the court held that the place of effective management is the place where "key management and commercial decisions that are necessary for the conduct of the entity's business are in substance made". This definition is consistent with the OECD's commentary on Art 4 of the OECD MTC.

¹⁰⁶ Interpretation Note 6 7.

¹⁰⁷ See Interpretation Note 6 7-9.

¹⁰⁸ Interpretation Note 6 12.

businesses are now able to operate digitally without a link to a physical location. Oguttu submits that even though the concept of POEM can be manipulated by digitalisation, the concept should not be replaced until a more feasible solution that provides legal certainty and is administratively practical is found. The writer proposes that the concept of POEM be made a factual enquiry with all the factors listed in SARS Interpretation Note 6 considered and weighed, based on where the economic activities of the company are taking place to determine the POEM, and other factors that can measure the digital presence of a company in a jurisdiction can be added to the list of factors. For example, the number of users/customers a company has in a particular jurisdiction and the amount of revenue a company generates in a particular jurisdiction.¹⁰⁹

Both incorporation and POEM require a company to have some form of physical presence before being considered tax resident and therefore liable for tax in South Africa. The incorporation and POEM of a company can easily be manipulated in the digital economy as companies can now conduct all their meetings virtually and choose the location where they would like to be incorporated. Therefore, the determination of whether a company is in fact a foreign company may not be an accurate determination. It may also be difficult to ascertain the location of digital companies as electronic addresses do not necessarily correspond with a specific geographical location, and then there is the anonymity of the internet.¹¹⁰

Once it is determined that there is a foreign company, the next step is to determine if more than 50% of the total participation rights or voting rights in that company are directly or indirectly held or exercisable by one or more South African residents. As shareholders of private companies are not listed in a public domain and the internet is anonymous, it would be difficult to verify the shareholdings of companies. Thus determining if the foreign company is "controlled" may be difficult in the digital economy. Once the existence of a CFC is determined, it should be considered whether the net income of the CFC should be imputed to the resident shareholder/s or if some exemption is applicable. It should be noted that it may be difficult to calculate the net income of a CFC in the digital economy due to the anonymity of the internet and transactions that may occur digitally and need to be considered.¹¹¹

As discussed above, the South African resident shareholder of a CFC with more than 10% participation rights in the CFC must comply with the provisions of section 72A of the Act regarding the submission of returns and

¹⁰⁹ The writer submits that the OECD Pillar One proposal could also be used to supplement the POEM concept.

¹¹⁰ Also see Oguttu 2008 (Part 1) *SA Merc LJ* 351.

¹¹¹ See Oguttu 2008 (Part 1) *SA Merc LJ* 359.

possibly the submission of the financial statements of the CFC. In order for a South African shareholder to comply with section 72A of the Act, they would need access to the financial statements of the CFC and knowledge of the CFC's transactions. Knowledge of certain transactions of CFCs operating in the digital economy may be compromised by anonymity, which would make it hard for the South African resident shareholder to comply with section 72A of the Act.¹¹²

A FBE in terms of section 9D of the Act requires the existence of a fixed place of business. The main criteria for determining a FBE depend on physical presence and the personnel in a location. A website is not a tangible asset and as such cannot be a fixed place of business.¹¹³ A server has a physical location which could create a fixed place of business if it is used to conduct business of the enterprise.¹¹⁴ However, in order for a server to qualify as a FBE it must be sufficiently staffed and resourced. This makes it difficult for a server to qualify as a FBE. Digitalisation makes it possible for a business to carry on economic activity without the need of a multitude of offices, staff, equipment and other resources. The FBE criteria do not take into account new business models and the digital economy that could be legitimate businesses that operate virtually. These challenges may have the effect that digital business with real economic activities and substances do not qualify for the FBE exemption. The purpose of the CFC rules was not to include businesses with real substance into the ambit of the rules.

Although the SCA decision correctly applied the current principles in the *Coronation* case, the author would like to highlight that the FBE definition and rules are outdated and have not kept pace with new business models such as digital businesses. The purpose of the CFC rules was not to include businesses with real substance into the ambit of the rules. It is possible for a real digital business to exist without the physical presence requirements contained in the FBE definition.

As mentioned above, even though an FBE may exist, there are certain income streams that will still be subject to CFC rules and not enjoy the FBE exemption, i.e. certain diversionary transactions between a CFC and its connected person as mentioned above. The anonymity of the digital economy may make the determination of whether a person connected to the CFC is a connected person as defined may be difficult to ascertain.¹¹⁵ Even if it was established that there is a connected person, determining if

¹¹² Also see Oguttu 2008 (Part 1) *SA Merc LJ* 366.

¹¹³ See paras 42.2-42.3 of the commentary to Art 5 of the OECD MTC; Oguttu 2008 (Part 1) *SA Merc LJ* 318.

¹¹⁴ See paras 42.2-42.3 of the commentary to Art 5 of the OECD MTC; Oguttu 2008 (Part 1) *SA Merc LJ* 318.

¹¹⁵ Also see Oguttu 2008 (Part 1) *SA Merc LJ* 366.

the price set between the CFC and the connected person is an arm's length price¹¹⁶ may prove difficult in the digital economy as transactions are usually anonymous and it is possible to use electronic money, which is hard to trace.¹¹⁷

The challenges mentioned here show that the CFC rules have not kept pace with the changes brought about by the digital economy and new business models, making them ineffective in regulating the digital economy business models. The challenges posed by the digital economy render the rules ineffective in achieving their aim in some respects, such as the aim not to include real businesses in the ambit of the rules.

5 Recommendations

It is suggested that the South African CFC rules (i.e. section 9D of the Act) should be amended to address the digital economy and the changes it has brought to business models in order to make them effective.¹¹⁸ It can be seen from the above discussion that most of the challenges posed by the digitalisation of the economy on CFC rules arise because of the anonymity of the internet. It is thus recommended that Treasury may try to alleviate this main challenge of the internet to CFC rules by using the provisions of the *Electronic Communications and Transactions Act*¹¹⁹ ("ECTA") to identify electronic transaction parties. These provisions can be incorporated into the Act.¹²⁰ ECTA is legislation enacted in South Africa in 2002 to regulate electronic communications and transactions.

Section 43 of ECTA provides that a supplier of electronic goods and services must display certain information, such as its full name and legal status, physical address and telephone number and, if it a legal person, its registration number, the names of its office bearers and its place of registration. Section 23 of ECTA determines the time and place of communications, and the dispatch and receipt of information. Section 25 of ECTA provides that a data message will be attributable to the originator¹²¹

¹¹⁶ An arm's length price refers to the price that can be determined from the market place between unrelated persons for the sale of goods or provision of services. See SARS 1999 <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-11-Income-Tax-Practice-Note-7-of-1999.pdf> para 7.1.

¹¹⁷ Oguttu 2008 (Part 2) *SA Merc LJ* 464.

¹¹⁸ Also see Van Wyngaardt 2015 <https://www.engineeringnews.co.za/print-version/playing-field-for-digital-economy-needs-to-be-levelled-pwc-2015-05-12>.

¹¹⁹ *Electronic Communications and Transaction Act* 25 of 2002 (the ECTA).

¹²⁰ Also see Oguttu 2008 (Part 2) *SA Merc LJ* 477.

¹²¹ Section 1 of the ECTA defines an "originator" as a person who, or on behalf of whom a data message purports to be sent or generated prior to any storage. This does not include but does not include a person acting as an intermediary with respect to that data message. "Data message" is defined as "data generated, sent, received or stored by electronic means and includes voice, where the voice is used in an automated transaction; and a stored record".

if it was sent personally by the originator, on their behalf by someone with authority to act on their behalf, or an information system programmed by or on behalf of the originator to operate automatically unless it is proved that the information system did not properly execute such programming. Sections 80 and 81 of ECTA regulate the appointment of cyber inspectors who have the power to inspect any website activity and information in the public domain. The compliance and enforcement of the provisions of ECTA could assist in addressing the anonymity issues of the internet.

In respect of addressing challenges in the accurate determination of a foreign company because of the easy manipulation of the concept of incorporation and POEM, country-by-country ("CbC") reporting could be a useful tool. CbC is a OECD BEPS Action 13 minimum standard that requires MNEs to report annually on their key information on their activities and income in each tax jurisdiction in which they operate or conduct business.¹²² Another useful tool would be requiring South African MNEs to disclose public country-by-country reporting on tax that conforms with the Global Reporting Initiative ("GRI") 207. The GRI 207 is a global standard for tax transparency that supports the public disclosure of a company's business activities and tax payments on a country-by-country basis.¹²³ This reporting includes the reporting of an MNE's financial, economic and tax related information for each jurisdiction where the MNE operates.¹²⁴

The FBE exemption should be amended to include in the exemption genuine digital businesses in operation. It is recommended that the FBE exemption should be based on the economic activity of an entity in a jurisdiction, rather than the physical presence, in determining whether a real business with substance exists in a foreign jurisdiction. Income derived from genuine digital businesses with economic substance should be exempted from the application of the rules. An alternative regime could also be considered to address the challenges posed by the digital economy to the current South African CFC rules. The author of this paper does not support this option as it may create unnecessary admin and coordination for the tax legislature and administrators. It may also be uncoordinated and lead to double taxation. Back in 1997 the Katz Commission recommended that South Africa should not create a new tax regime to address the challenges brought by e-commerce to the tax rules but should rather internationalise its

¹²² See OECD *Action 13*.

¹²³ GRI 2019 <https://www.globalreporting.org/standards/media/2482/gri-207-tax-2019.pdf>.

¹²⁴ The disclosures include disclosures of the management approach and other specific topic disclosures i.e. Disclosure 207-1: Approach to tax, Disclosure 207-2: Tax governance, control, and risk management, Disclosure 207-3: Stakeholder engagement and management of concerns related to tax, and Disclosure 207-4: Country-by-country reporting.

tax laws.¹²⁵ The digital economy is global in nature and, therefore, policy actions dealing with the global economy would need a global approach.¹²⁶

The OECD has taken a leading role in developing new direct tax rules that will address the tax challenges posed by the digital economy and has agreed to develop a Two Pillar Solution that can be internationally consented to and implemented by countries.¹²⁷ Pillar One proposes a new tax nexus and profit allocation rules for large MNEs that meet certain revenue and profitability thresholds,¹²⁸ and Pillar Two proposes mechanisms to ensure large MNEs pay a minimum level of tax (currently set at 15%) regardless of where their headquarters are or the jurisdictions they operate in.¹²⁹ The OECD BEPS Project and Two Pillar proposals represent a substantial renovation of international tax rules.¹³⁰ South Africa has decided to not introduce any unilateral measures to address the challenges but to wait for the global consensus solution of the OECD.¹³¹ Should South Africa desire to opt for an alternative regime to address the digital economy challenges to the CFC rules, South Africa could wait and see how the implementation of the OECD Two Pillar solutions could alleviate some of those challenges. However, the FBE exemption challenges extending to digital companies will still remain, as the Two Pillar Solution does not address them.

6 Conclusion

CFC rules were enacted more than two decades ago in South Africa before most of today's business models existed. They were designed for brick-and-mortar business models. Digitalisation has made it possible for a business to carry on economic activity without the need of a multitude of offices, staff, equipment and other resources. As a result new business models like Uber and Shien have emerged. The current South African CFC rules have not kept pace with these new business models and do not effectively regulate the new business models and the digital economy. It has been recommended in this paper that the CFC rules be updated to address the digital economy and new business models by amending the rules,

¹²⁵ Katz Commission of Inquiry 1997 <https://www.treasury.gov.za/publications/other/katz/5.pdf> 31.

¹²⁶ OECD *Report on Pillar One* 3.

¹²⁷ OECD 2021 <https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf> 1.

¹²⁸ OECD *Report on Pillar One* 15.

¹²⁹ OECD *Report on Pillar Two*.

¹³⁰ OECD *Interim Report* 167.

¹³¹ Anon 2021 <https://businesstech.co.za/news/technology/468144/theres-a-big-problem-with-south-africas-plans-for-digital-tax>.

incorporating the provisions of ECTA into the rules, using CbC reporting, and even considering implementing an alternative regime to CFC rules.

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List of Abbreviations

BEPS	base erosion and profit shifting
CbC	country by country reporting
CFC	controlled foreign company
CGFM	Coronation Global Fund Managers
CIMSA	Coronation Investment Management SA
DTC	Davis Tax Committee
ECTA	Electronic Communications and Transactions Act 25 of 2002
FBE	foreign business establishment
GRI	Global Reporting Initiative
G20	Group of Twenty
HMRC	HM Revenue and Customs
ICT	information communication and technology
IFRS	International Financial Reporting Standards

MNE	multinational enterprise
MTC	Model Tax Convention
OECD	Organisation for Economic Co-operation and Development
PE	permanent establishment
POEM	place of effective management
SA Merc LJ	South African Mercantile Law Journal
SARS	South African Revenue Services
UK	United Kingdom
Yale J Int'l L	Yale Journal of International Law