

An evaluation of the South African controlled foreign company rules within the digital economy

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ABSTRACT

South Africa has controlled foreign companies (CFC) rules aimed at combating South African residents from shifting their taxable income outside the South African tax net by investing or transacting through South African-owned/controlled foreign companies. South African multinational enterprises (hereafter referred to as MNE's) have become companies with a worldwide presence and operate internationally through businesses that pose a negligible risk of tax avoidance to the South African fiscus due to avoidance measures included in the South African tax law. Electronic commerce (hereafter referred to as an e-commerce) allows for substantial business to be conducted in a country without having a fixed place of business in that country. South Africa's CFC rules have remained predominantly unchanged and it has been argued that they have over time, become less flexible. This is particularly so in relation to meeting the *foreign business establishment* test.

This study analysed the South African CFC rules within the context of e-commerce businesses to establish whether there are grounds to review the rules to cater for e-commerce businesses. The background to the CFC rules was given and the challenges that e-commerce poses to the South African CFC rules were discussed. The design of the UK, Australian and German CFC rules was studied, as well as responses by international organisations to the challenges posed by e-commerce.

The results of this study indicate that, due to the design approach followed, the South African CFC rules are highly mechanical compared to rules in certain developed countries on which the prescripts of the South African CFC legislation are based. This study found that the current design of the regime does not cater for certain income generated by e-commerce businesses, considered as active income and therefore not targeted by the CFC rules. It was further revealed that the South African CFC rules approach to defining CFC income by targeting all income of a CFC and then only excluding income regarded as active income captures income generated by legitimate e-commerce businesses. These aspects of the South African CFC legislation are grounds for the rules to be reviewed. The paper recommends how the challenges identified can be addressed.

KEYWORDS: Anti-avoidance; Controlled foreign companies; E-commerce; Foreign business establishment; Multinational enterprises; Profit shifting; Residence based tax; Resident; Tax avoidance

LIST OF ACRONYMS AND ABBREVIATIONS

The following abbreviations and acronyms were used in this document

BEPS	base erosion and profit shifting
CFC	controlled foreign company
e-commerce	electronic commerce
HMRC	Her Majesty's Revenue and Customs
HPC	high powered committee
Income Tax Act	Income Tax Act 58 of 1962
MAAL	multinational anti-avoidance law
MNE's	multinational enterprises
OECD	Organisation for Economic Co-operation and Development
SARS	South African Revenue Service
TAG	Technical Advisory Group
UK	United Kingdom

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CHAPTER 1: INTRODUCTION

1.1 Introduction

For over twenty years, advances in technology have been changing the way business is done and many tax authorities across the world are considering how these changes affect their tax collection (PWC, 2016b: 01). According to the United Nations (2019a: 142), these advances in technology have created opportunities for MNE's in the e-commerce sector to avoid paying their share of taxes. CFC rules are anti-tax avoidance measures designed to prevent taxpayers from artificially moving their taxable profits abroad to foreign countries with more favourable tax rates (Henderson, 2019). E-commerce poses certain challenges to the design of CFC legislation which are discussed in this paper.

1.2 Background to study

The income tax system in South Africa changed from a source-based system of taxation to residence-based taxation, with effect from the years of assessment commencing on/after 1 January 2001. A source-based system enables the *source* country to tax the income that is earned within its borders. In contrast, a country maintains jurisdiction to tax the worldwide income of its residents regardless of its source under a residence-based system (Sweet, 1998:1949). What this means is that South African residents are subject to tax on income derived both inside and outside South Africa (SARS, 2002:1). It can, therefore, be said that it is important to establish whether a person is considered a resident for purposes of determining their tax liability (Farrand & Dachs, 2012:4).

According to section 1 of the Income Tax Act 58 of 1962 (hereinafter referred to as the *Income Tax Act*), any person except a natural person will be regarded to be a resident when it is incorporated, established or formed in South Africa or has its place of effective management in South Africa. According to Reynolds and Wier (2016), a significant part of tax revenue in developing countries is collected from large companies. However, there is a common level of fear that this tax revenue is being eroded by international tax avoidance.

South African MNE's can shift their profits from South Africa to a low-tax country to lower their tax liabilities, a concept referred to as *profit shifting* (Reynolds & Wier, 2016:1). Multiple countries have adapted their international tax policy rules with measures designed to curb profit shifting and one of the most important examples of such legislation is known as the *CFC rules* (Clifford, 2019:1). The CFC rules were introduced into South African tax legislation in 2001 as part of South Africa's shifting of its tax system from a *source-based* to a *residence-based* tax system to bring the South African tax system more in line with international tax principles. South Africa's CFC

rules are aimed at combating South African residents from shifting their taxable income outside the South African tax net by investing or transacting through South African-owned/controlled foreign companies (Kraamwinkel & Grimm, 2018b:1). One important aspect of the residence-based system of taxation is how to deal with income earned by South African-owned companies and other South African-owned foreign entities of a similar nature (Department of National Treasury, 2002b:1).

According to section 9D(2) of the Income Tax Act, a proportional amount of the net income of the CFC must be included in the income of the South African resident who directly or indirectly holds any participation rights in a CFC. The South African controlled foreign company (CFC) rules are not applicable where the net income of a CFC is attributable to a foreign business establishment of that CFC (Oguttu, 2008a:361). It can, therefore, be said that the foreign business establishment concept is of great significance when applying the South African CFC rules (Van Schaik & Van Schalkwyk, 2012:64). The objective of the foreign business establishment exemption is to grant exclusion from the South African tax net of income derived from legitimate and real business activities, while artificial business undertakings remain subject to the CFC rules (Olivier & Honiball; 2011).

The term *foreign business establishment* is defined in section 9D of the Income Tax Act. The detailed explanation to section 9D provided by the National Treasury explains that a foreign business establishment constitutes a business with some permanence, economic substance, and a reason that is not tax-related for operating abroad rather than in South Africa (Department of National Treasury, 2002b:9). The criteria for the determination of a foreign business establishment are mainly based on geographical location, and this poses a challenge when trade is conducted electronically (Oguttu, 2008a:362).

Current tax policies are characterised by transactions which involve the exchange of tangible goods (for example, royalties from the sale of traditional books) (Basu, 2008:16). According to Bach *et al.* (2000:659), as far-reaching electronic information and communication networks become increasingly comprehensive, value-add is switching over to intangible goods and electronically provided services. In the 2015 final Organisation for Economic Co-operation and Development (hereafter referred to as OECD) report on addressing the tax challenges of the digital economy, it was determined that there is a growing reliance on intangible assets and it is becoming more difficult to determine the country in which value is created.

1.3 Motivation for the study

The OECD emphasises that considerations for tax policy should include neutrality and flexibility. A neutral tax system seeks to be neutral between forms of business activities and contributes to

efficiency (OECD, 2014b:2). The Katz Commission report (Department of National Treasury, 1997: para 3.1.2.4) explains tax neutrality from an international tax perspective as a system that relies on maintaining an equal competitive tax basis on all local businesses, regardless of where they operate on an international base. The OECD adds that taxation systems should be flexible and dynamic enough to ensure they keep pace with technological and commercial developments (OECD, 2014b:2).

It was noted in the OECD's draft public discussion on strengthening CFC rules that, in designing CFC rules, there must be a balance between maintaining international competitiveness and taxing foreign income (OECD, 2015b:9). The commentary from the draft public discussion goes on to mention that the above concern is addressed by many CFC rules' containing an exemption for active income linked to real economic activity, which is less likely to have been shifted from the parent company (OECD, 2015b:9). According to Potgieter (2012:76), section 9D of the Income Tax Act is integral for both the resident and non-resident investors when considering South Africa as a potential place of investment. It follows that, if the South African CFC rules create tax practices unfair to MNE's, then international competitiveness is set at risk (Potgieter, 2012:76).

The National Treasury's detailed explanation of section 9D (South Africa, 2002:12) clarifies that the business establishment (now referred to as the *foreign business establishment*) exemption, which is only applicable to income that presents no threat to the South African tax base, was introduced to promote international competitiveness. Basu and Jones's (2002:40) views are that taxpayers in similar situations who carry out similar transactions should be subject to tax at the same levels. The current foreign business establishment exemption does not include foreign e-commerce businesses that do not pose a threat to the South African tax base.

According to the Davis Tax Committee report on addressing Action Plan 1 (Department of National Treasury, 2014:26), there is restricted scope for South African residents to shift profits to foreign tax haven jurisdictions via e-commerce transactions. It is in the best interest of the country to limit the negative impact of anti-avoidance provisions relating to investments undertaken to the benefit of the country (Potgieter, 2012:15). It is expected that this study will echo the views of South African companies with foreign companies conducting business electronically. Furthermore, recommendations from the results of the study may assist in drafting CFC policies that are flexible, fair, and may benefit potential and current investors.

1.4 Problem statement

According to Oguttu (2008b:465), it was pointed out in the Green Paper on e-commerce that the current legal framework of South Africa should be tailored to accommodate transactions that are conducted electronically. South African MNE's have become companies with a world-wide

presence and operate internationally through businesses that pose a negligible risk of tax avoidance to the South African fiscus as these businesses are characterised by transparency and transfer pricing systems aimed at combating tax avoidance (Kraamwinkel & Grimm, 2018b:2). E-commerce allows for substantial business to be conducted in a country without having a fixed place of business in that country (Oguttu, 2008a:362).

Since inception, South Africa's CFC rules have remained predominantly unchanged and it has been argued that they have over time, become less flexible. This is particularly so in relation to meeting the foreign business establishment test (Kraamwinkel & Grimm, 2018b:29).

1.5 Research question

In light of the above, the question is: To what extent is the South African CFC rules still applicable in the digital economy (e-commerce)?

1.6 Research objectives

1.6.1 Primary objective

This study seeks to analyse the South African CFC rules within the context of e-commerce businesses.

1.6.2 Secondary objectives

The secondary objectives of this research aim to address the main objective:

- (i) To discuss the background to the South African CFC rules and the foreign business establishment exemption. This objective is addressed in detail in Chapter 2.
- (ii) To describe the challenges that e-commerce poses to South African CFC rules. This objective is addressed in Chapter 3.
- (iii) To gain an understanding of international responses to e-commerce within the context of CFCs and make recommendations based on the results of the study. This objective is addressed in Chapter 4.

1.7 Research scope and limitations

The study was conducted from the perspective of taxpayers that are not natural persons or a trust, and normally referred to as MNE's. The study focused on the corporate direct tax implications of the business profits and excluded value-added tax and similar consumption taxes.

This study also did not consider the details of double tax agreements in relation to section 9D or other anti-avoidance provisions in the Income Tax Act.

1.8 Research methodology

1.8.1 Research paradigm

Makombe (2017:3363) is of the view that any research should be guided by a paradigm. The overarching paradigm that is followed by this study based on the research question is interpretivism. According to Lincoln and Guba (cited by Kivunja & Kuyini, 2017:26), a paradigm comprises three elements, namely epistemology, ontology and methodology (axiology).

1.8.1.1 Epistemology

Epistemology is the theory of knowledge, especially about its validation and the methods used. It deals with how we know things and what we may regard as unacceptable (Walliman, 2011:16). If a person relies on information gathered from experts and books, then it follows that the epistemology is grounded on authoritative knowledge (Kivunja & Kuyini, 2017:27). This study was based on current literature, international and local statutory laws, and international and local case law. Although South Africa is not bound by international cases and statutory law, these may have persuasive value.

1.8.1.2 Ontology

Kuada (2012:58) communicated that *ontology* is a term used to describe the nature of what the researcher wants to know, which is determined by the researcher's perception of reality. Ontology helps you to conceptualise the form and nature of reality (Kivunja & Kuyini, 2017:27). Neuman (cited by Antwi & Hamza, 2015:218) holds that there are two broad positions with ontology: objectivism and constructionism. Antwi and Hamza (2015:218) explain that *objectivism* is based on the assumption that there is an independent reality and that *constructionism* assumes that reality is the product of social processes. As the current study was based on existing literature, it follows that the constructionism position was followed.

1.8.1.3 Methodology

In their article, Antwi and Hamza (2015:220) refer to *methodology* as how researchers go about finding out what they believe can be known. McKerchar (2008:6) explains that two organising frameworks guide researchers, namely interpretivism and positivism. McKerchar goes on to express the view that the organising framework choice is a reflection of the researcher's ontology and epistemology. A researcher who follows the interpretivism organising framework is expected to employ the qualitative research method (McKerchar, 2008:7). Qualitative researchers immerse themselves in a culture by observing its people and their interactions, taking life histories, and analysing existing documents (Antwi & Hamza, 2015:220). Antwi and Hamza (2015:220) explained that when inadequate information is known about a topic or aspect then qualitative

research is used when one wants to discover or learn more about it. This study followed a qualitative approach.

The doctrinal research method is described as the traditional approach which can be identified by the structured process of identifying, analysing, organising and combining statutes, judicial decisions and commentary (McKerchar. 2008:18-19). According to Hutchinson and Duncan (2012:84), the word *doctrine* is derived from the Latin noun *doctrina*, which means instruction, knowledge or learning. McKerchar (2008:19) is of the view that the doctrinal type of research is focused on reading and conducting in-depth, scholarly scrutiny. With the above being said, the doctrinal research method was believed to be suitable for this particular study.

It was recommended through the Katz Commission report (Department of National Treasury, 1997: para 8.3) that the design of South African CFC rules follows some prescripts of the German, Australian and UK CFC rules. Because they are some of the leading economies of the world, the CFC rules of these three countries were seen to have representative approaches to tax anti-avoidance measures (Department of National Treasury, 1997: para 8.2). This research consequently investigated the design of the prevailing UK, Australian and German CFC rules, with a specific focus on how they define CFCs and the nature of the income that they target with their CFC rules.

According to McKerchar (2008:7), qualitative research requires inductive reasoning to be employed rather than logic, and which often calls for more creative and indirect means of collecting data or evidence such as observations and experiences. As a qualitative research method is pursued, it follows that inductive reasoning was employed for this study.

1.9 Chapter summary

The chapters in this mini dissertation are presented as follows:

Chapter 1: Introduction

This chapter is an introduction to the research and sets out the context and the objectives of the research. It includes the motivation for selecting the topic, the problem statement, and the methodology.

Chapter 2: Background to South African CFC rules

This chapter provides background on South African CFC rules. The discussion of the background includes the reasons for introducing the CFC rules and background to the foreign business establishment exemption. The chapter addresses the secondary research objective identified in paragraph 1.6.2(i).

Chapter 3: E-commerce challenges to South African CFC rules

This chapter provides a discussion of emerging issues resulting from South African CFC rules where businesses trade electronically. A discussion of what constitutes e-commerce and the business models arising from e-commerce, is investigated with the objective of providing an understanding of the e-commerce business environment in which taxpayers operate. The chapter addresses the secondary research objective identified in paragraph 1.6.2(ii).

Chapter 4: International responses to e-commerce taxation within the context of CFC rules

This chapter seeks to gain an understanding of how international tax organisations and the governments of other countries have responded to the taxation of e-commerce limited to CFC rules. The chapter addresses the secondary research objective identified in paragraph 1.6.2(iii).

Chapter 5: Conclusion and recommendations

This chapter summarises the research findings and the conclusions reached, demonstrating how the goals of the research are addressed. It will provide recommendations to the South African National Treasury based on the findings of the study.

CHAPTER 2: BACKGROUND TO THE CFC RULES

2.1 Introduction

This chapter provides background on South African CFC rules which includes reasons for introducing the CFC rules and background to the foreign business establishment exemption. The chapter addresses the secondary research objective identified in paragraph 1.6.2(i).

2.2 Reasons for introduction to CFC rules

Exchange controls were relaxed with effect from 1 July 1997 (Department of National Treasury, 2000:2). The relaxed exchange controls increased the freedom of South African investors to invest in the rest of the world, which led to increased opportunities for MNE's to design their business operations in a manner that reduced their South African tax liability by shifting their profits away from the South African tax net (Seonath, 2003:2). As a result, in its fifth report, the Katz Commission (Department of National Treasury, 1997:82) recommended that South Africa should consider changing its income tax system from a source-based system of tax to a residence-based system of tax to protect the South African tax base from the effect of the relaxed exchange controls. According to Seonath (2003:4), other reasons for introducing the residence-based taxation system included the need to place the South African tax system with international principles, and to effectively provide for the taxation of e-commerce. The residence-based taxation system was implemented in South Africa in January 2001 (Department of National Treasury, 2000:2).

Reynolds and Wier (2016:4) are of the view that there is a tax incentive for base erosion and profit shifting (hereafter referred to as BEPS) and it is driven by the different corporate tax rates across tax jurisdictions. These views may be supported by statements in the Katz Commission report (Department of National Treasury, 1997: para 3.1.3.1) that, under the residence-based system of taxation, the relatively high South African tax rate may be a contributing factor to the emigration of financial capital and human skills. The commonly used means of shifting profits used by MNE's include strategic shifting of income-generating assets, in particular, intellectual property (Reynolds & Wier, 2016:5).

South African MNE's can defer the taxation of their profits by accumulating them in foreign low-tax countries (Department of National Treasury, 1997: para 8.1.1). In the case of Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue (2006), it was stated that CFC rules are precisely targeted at wholly non substantial arrangements that do not reflect the economic reality and whose only purpose would be to obtain a tax advantage. It is important to note that the Cadbury Schweppes plc and Cadbury Schweppes

Overseas Ltd v Commissioners of Inland Revenue case originated in the United Kingdom (hereafter referred to as UK); however, the fundamental principle determined in that case is applicable in South Africa (Department of National Treasury, 2002b:7).

According to the OECD (2015b:35), highly mobile and passive income is likely to be diverted into foreign company jurisdiction. In determining whether income is highly mobile, one would need to establish from whom the income is earned, and where it is earned. Income earned from a related party and income earned from a country outside the CFC jurisdiction is regarded as more likely to be shifted (OECD, 2015b:40). The South African National Treasury (Department of National Treasury, 2002a:8) explains mobile foreign business income as income from paper shell businesses without economic substance. Passive income, similar to mobile business income, is income generated from assets that can be shifted around easily. As a result, no active business is involved in generating such income, and no issues regarding international competitiveness arise from the passive income and mobile business income generated (Jooste, 2001:487).

The Katz Commission report (Department of National Treasury, 1997: para 8.3.1.1) made recommendations on anti-avoidance measures that South Africa could take to counter actions under the residence-based tax system that could lead to profit shifting. The recommendations made by the Commission included the introduction of CFC rules to counter shifting of passive income from CFCs that was excluded on the introduction of the residence-based tax system. The Income Tax Act includes various rules aimed at controlling the avoidance of tax. Amongst them are the CFC rules currently contained in section 9D of the Income Tax Act (Becker, 2017:1).

Singh (2014:18) argues that the CFC legislation was, to a small degree, introduced into the South African legislation during 1987 through the revoked section 9A of the Income Tax Act. The CFC rules were extended to include all foreign entities and foreign jurisdictions because the CFC rules contained in section 9A applied only to neighbouring countries (Department of National Treasury, 1997: para 6.2.1.2). According to the Explanatory Memorandum on the Revenue Laws Amendment Bill (Department of National Treasury, 2000:2), section 9D of the Income Tax Act was introduced in 1997 to tax the passive income of certain controlled foreign entities in the hands of South African residents who controlled the entities. After the introduction of the residence-based system of taxation, the scope of section 9D was expanded in 2001 to include not only the passive income of controlled foreign entities, as mentioned above, but also their active income (Van Heerden, 2009:151).

2.3 South African CFC rules

2.3.1 Definition of a CFC

The definition of a CFC in section 9D(1) of the Income Tax Act is important in the application of CFC rules. A CFC is:

- (a) a foreign company where one or more South African residents directly or indirectly hold a total of more than 50 per cent of the total participation rights or can directly or indirectly exercise a total of more than 50 per cent of the voting rights in that foreign company; or
- (b) a foreign company which has its financial results disclosed in the consolidated financial statements of any resident company in accordance with IFRS 10.

2.3.1.1 Foreign company

According to Olivier and Honiball (2011:562), in determining whether a company is a CFC, it must be primarily established whether the company is a foreign company. The *foreign company* definition in section 9D(1) of the Income Tax Act defines a foreign company as any cell or segregated account, protected cell company or any foreign company (other than a protected cell company) as defined in section 1 of the Income Tax Act. A foreign company was formerly referred to as a *foreign entity* upon the introduction of section 9D in 1997. Section 9D(1) of the Income Tax Act 28 of 1997 defined a foreign entity at that stage as any person except a natural person that had its place of effective management outside South Africa.

The term *foreign entity* was replaced with the term *foreign company* in 2002 through the Revenue Laws Amendment Act (74 of 2002). The Department of National Treasury (2002a:14) explained that the new term excluded trusts from the application of CFC rules, and furthermore was determined to be more consistent with the international description used by the OECD. A *foreign company*, as defined in section 1 of the Income Tax Act, is any company that is not a resident. It can be concluded from the above discussion that a CFC can, therefore, not be a South African resident company. The CFC rules are specifically aimed at foreign companies and not natural persons because foreign companies, under the residence-based system of taxation, are presented with an opportunity to change the character of income or defer the accrual of income by accumulating it in the foreign company (Department of National Treasury, 1997: para 8.2.1).

2.3.1.2 Participation and voting rights

The definition of participation rights is also important in determining whether a company is a CFC. Section 9D(1) of the Income Tax Act currently defines *participation rights* as a right to participate in the benefits attaching to a share or interest of a similar nature in that company or, if a person has no right to participate in the benefits, the right to exercise voting rights in the company. In its detailed explanation of section 9D, the Department of National Treasury (2002b:3) expressed the

view that convertible debentures, options and any similar interest do not qualify as participation rights except if they are converted into shares. From the above definition, it can be noted that voting rights are only considered when the foreign company does not have equity. The term *voting rights* is not defined in the Income Tax Act; however, according to Olivier and Honiball (2011:568) *voting rights* means any form of control over the distribution of capital or profits exercised by a South African resident, whether as a shareholder, director or otherwise.

The OECD (2015b:27) recommended that countries should treat foreign companies as *controlled* if residents hold more than 50% control. The OECD further explained that control can be established legally or economically, where *legal control* generally looks at voting rights and *economic control* looks at rights to the profits, capital and assets. The definition of a CFC in section 9D(1) requires a resident to hold more than 50% of the total participation rights or voting rights. One can, therefore, argue that the South African legislation followed the recommendations of the OECD to determine when a foreign company would be controlled. This argument is supported by the recommendation from the Katz Commission report (Department of National Treasury, 1997: para 8.3.1.4) that attribution of net income should only be done where a South African resident controls 50% or more of voting or participation rights of the foreign company.

The phrase *directly or indirectly* included in the CFC definition means that the interests of both registered and beneficial shareholders should be taken into account (Oguttu, 2007:116). The rationale detailed in the Katz Commission report (Department of National Treasury, 1997: para 8.3.1.3) for the inclusion of the above phrase was that the definition of a CFC is wide so as to eliminate any manipulation.

2.3.2 Imputation of income of a CFC

Section 9D(2) of the Income Tax Act requires a resident who holds participation rights in a CFC to include in their income a proportional amount of the CFC's net income in relation to their total participation rights in that CFC. The intention of the National Treasury of including the net income was to avoid any possible override of double tax agreements (Department of National Treasury, 2002a:2) because the net income is determined as if the foreign company were a resident. The above basis for the determination of the net income is in line with the recommendation made by the OECD (2015b:55) in Action Plan 3. The OECD views this basis as logically consistent with the concerns of BEPS addressed by the resident's jurisdiction.

According to Potgieter (2012:28), there are various provisos to section 9D(2A) of the Income Tax Act that need to be considered over and above the definition of net income under that specific section. The said provisos include:

- the limitation of deductions or allowances to income (section 9D(2A)(a)),

- restriction on assessed losses (section 9D(2A)(b)),
- the non-deduction of interest, royalties, rental or similar income paid or payable by the company to another CFC (section 9D(2A)(c)),
- the valuation date for capital gains tax (CGT) purposes is the date the company became a CFC where a foreign company became a CFC after introduction of CGT on 1 October 2001, (section 9D(2A)(e)),
- the inclusion rate for CGT purposes is 40% where the resident is a natural person, special trust or insurer, (section 9D(2A)(f)),
- for the purposes of section 24I and paragraph 43 of the eighth schedule, the *local currency* of a CFC that is not attributed to a permanent establishment of the CFC means the functional currency used by the CFC for its financial reporting (section 9D(2A)(k)),
- where the functional currency of a CFC was abandoned due to its being hyperinflationary and a new functional currency was adopted, the cost of an asset of a CFC will be determined using the newly adopted currency (section 9D(2A)(l)).

In the National Treasury's detailed explanation of section 9D (Department of National Treasury, 2002b:7), it was confirmed that a number of exemptions are available to a resident who is required in terms of section 9D(2) to include the net income of a CFC in their income. However, of these exemptions, the most important is the foreign business establishment exemption contained in section 9D(9)(b) of the Income Tax Act.

2.4 The foreign business establishment exemption

2.4.1 Introduction

Section 9D(9)(b) of the Income Tax Act exempts a resident from including the net income of their CFC in income if that net income is attributable to the foreign business establishment of the CFC. One of the recommendations included in the Katz Commission report (Department of National Treasury, 1997: para 8.3.1.5) was that CFC rules should not apply to a CFC that carries on an active business. The foreign business establishment exemption seeks to exclude from the provisions of section 9D(2) income of the CFC that is legitimate and is generated from substantive business activities (Van Schaik & Van Schalkwyk, 2012:68).

In its detailed explanation of section 9D, the Department of National Treasury (2002b:8) confirmed that the foreign business establishment exemption served to promote international competitiveness. The Department of National Treasury (2002b:8) simplifies the reason for introducing the foreign business establishment exemption to the exclusion of companies that do not pose a threat to the South African tax base.

2.4.2 Development of the foreign business establishment exemption

2.4.2.1 Introduction of the substantive business enterprise exemption

On its introduction in 1997, section 9D(9) of the Income Tax Act stated that the CFC rules would not apply, where the investment income results from and is effectively connected to the business activities of a substantive business enterprise carried on through a permanent establishment that is suitably equipped in a foreign country. The terms *suitably equipped* and *substantive business enterprise* was not defined. However, according to Singh (2014:46), they meant that the business must have been well resourced with in-office operational managers and employees, equipment and other facilities necessary for the core operations of the substantive business enterprise.

2.4.2.2 Insertion of the term business establishment

Through the Revenue Laws Amendment Act 59 of 2000, the definition of a *business establishment* was inserted into section 9D of the Income Tax Act. All references to a *permanent establishment* in section 9D(9)(b) that had existed since introduction in 1997 were replaced with the business establishment definition and the explanatory memorandum on the revenue laws amendment (Department of National Treasury, 2000) provides no explanation of the rationale for this replacement.

A *business establishment* was defined as a place of business with an office, store, factory, storeroom, farm or other structure that the controlled foreign entity uses for a period of not less than one year; a mine, oil or gas well, a quarry or any other place of extraction of natural resources or a site for the erection or installation of buildings, bridges, roads, pipelines, heavy machinery or other projects of a similar nature which lasts for a period of not less than six months, whereby the business of the foreign entity is carried on (Department of National Treasury, 2000).

It was a requirement according to the Revenue Laws Amendment Act 59 of 2000 that the place of business be well resourced with in-office operational management, employees, equipment and other facilities for the purpose of conducting the core operations of such business; and such place of business is effectively used outside the Republic for a *bona fide* business purpose (apart from the avoidance, postponement or reduction of any liability for payment of any tax, duty or levy imposed by this Act or by any other law administered by the Commissioner).

The Department of National Treasury (2002b:9) summarises a business establishment as a business with locational permanence, economic substance and business purpose. *Locational permanence* is met if geographic coherency exists. *Geographic coherency* is described as the operation of business activities at a prescribed place, a single place of business at a particular location or specific geographical location (Van Schaik & Van Schalkwyk, 2012:71). Singh (2014:108-109) expressed the view that the locational permanence as a requirement provides

assurance that the business of the company is not purely a paper company. A construction site located outside the Republic, a CFC with a mine, oil, gas well or other exploration operations carried on outside the Republic, as well as a CFC that carries on farming activities on agricultural land that is not situated in the Republic, satisfy the locational permanence requirement because of the nature of these business activities. It is as a result of the above that the focus of the discussion of the foreign business establishment exemption is based on paragraph (a) of the definition of the foreign business establishment.

Oguttu (2008a:362) explained that persons must be present who manage the day-to-day running of the foreign business for it to be regarded as having *economic substance*. The persons who are required to manage the day-to-day running of the foreign business are described by Singh (2014:109) as on-site operational managers and employees. The said employees need to be employed on a full-time basis by the CFC.

Oguttu (2008a:362) regards the *business purpose* requirement as a measure to confirm the locational permanence and economic substance because the foreign business establishment exemption will not apply where business activities are conducted mainly to obtain a tax benefit.

2.4.2.3 Replacement of the term business establishment

The business establishment definition was amended in 2006 through the Revenue Laws Amendment Act 20 of 2006 by replacing the previous *business establishment* term with the term *foreign business establishment*. The reason for this change, according to the Department of National Treasury (2006:53), was that the previous business establishment definition was too rigid, and it failed to account for the country in which active business income should be conducted. In terms of paragraph (a) of the amended foreign business establishment definition in section 9D of the Income Tax Act, a foreign business establishment means–

- (a) a place of business with an office, store, factory, storeroom or other structure which is used the CFC for a period of not less than one year to carry on its business activities, and where that place of business–
 - (i) is well resourced with on-site managerial and operational employees of that CFC who are required to render their services on a full-time basis for the purposes of conducting the core operations of that business;
 - (ii) is suitably equipped and has appropriate facilities for such purposes; and
 - (iii) is located in foreign country and is used for bona fide business purposes (apart from the avoidance, postponement or reduction of any liability for payment of any tax, duty or levy imposed by this Act or by any other Act administered by the Commissioner).

The replaced definition clarifies that the place of business for a foreign business establishment must have a nexus in a single country outside South Africa. It further extends the requirements of the place of business of the foreign business establishment. The place of business is required to be appropriately resourced with managerial and operational employees who are required to render services on-site on a full-time basis for the purposes of conducting the primary operations

of that business. The aforementioned requirement was an extension to the requirement that the place of business must be suitably equipped, which might come across as contradictory to the reasons for the amendment provided by the Department of National Treasury (2006:53). Potgieter (2012:52) is of the view that staff premises and equipment are inputs to a business process that can be procured in a number of ways, including by way of procurement from a third party through a contractual agreement. Potgieter further goes on to argue that the requirement that the place of business must be suitably staffed and equipped is unsuitable in a world where business models can be non-tangible.

2.4.2.4 Amendment of the definition of a foreign business establishment

The Taxation Laws Amendment Act 17 of 2009 replaced paragraph (a) of the definition of a foreign business establishment. The reason for the replacement was, according to the Explanatory Memorandum on the Taxation Laws Amendment Bill (Department of National Treasury, 2009:74), that the determination of a foreign business establishment contains ambiguities giving rise to potential tax avoidance. It was also explained that the foreign business establishment test required clarification with regards to the sharing of structures, staff, equipment and facilities in a group company scenario.

The revised definition, as currently contained in the Income Tax Act, provides that a **foreign business establishment** means –

- (a) a fixed place of business located in a foreign country that is used for the carrying on of the business of a CFC for a period of not less than one year, where-
 - (i) that business is conducted through one or more offices, shops, factories, warehouses or other structures;
 - (ii) the fixed place of business is appropriately staffed with on-site managerial and operational employees of a CFC who conduct the primary operations of that business;
 - (iii) that fixed place of business is appropriately equipped for conducting the fundamental operations of that business;
 - (iv) that fixed place of business has satisfactory facilities for conducting the fundamental operations of that business; and
 - (v) that fixed place of business is located in a foreign jurisdiction solely or mainly for a purpose other than the postponement or reduction of any tax imposed by any sphere of government in the Republic:
 - For the purposes of determining whether there is a fixed place of business as contemplated in the above revised definition, a CFC may take into account the utilisation of structures as contemplated in subparagraph (i), employees as contemplated in subparagraph (ii), equipment as contemplated in subparagraph (iii), and facilities as contemplated in subparagraph (iv) of any other company-
 - (aa) if that other company is subject to tax in the country in which the fixed place of business of the CFC 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 CFC; 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 CFC.

The first change noted from the above revised foreign business establishment definition was that the place of business must be a fixed place outside the Republic that will be utilised for carrying

on the business for a period of at least a year. According to Oguttu and Tladi (2009:214), for a place of business to be fixed, two tests (namely a locational test and a duration test) have to be met. In terms of the *location test*, there must be a link between the place of business and a specific geographical point, however the place of business does not necessarily need to be physically connected to the ground. The *duration test* requires that the business not be temporary in nature. The one-year test, according to the Department of National Treasury (2009:75), was to allow for a one-year back or forward determination. A fixed place of business was regarded as evidence of economic allegiance when the source-based system of taxation was developed in a different technological era (Thorpe, 1997:695).

The second change noted was that a business outside the Republic was required to meet five requirements in order to qualify as a fixed place of business. According to Olivier & Honiball (2011:582), four of the five requirements relate to the nature of the business. Subparagraph (i) – (iv) in paragraph (a) of the revised definition of a foreign business establishment requirements relate to the nature of the business, while subparagraph (v) is a requirement relating to the purpose of the business.

The third change noted was that employees of the foreign controlled company were no longer required to be employed on a full-time basis.

Section 9D(9A) of the Income Tax Act provides for certain circumstances in which, even though the CFC might meet the foreign business establishment test, the foreign business establishment exemption will not apply. The said relevant circumstances with regards to this study are discussed below.

2.5 Exclusions from the foreign business establishment exemption

2.5.1 Introduction

The foreign business establishment exemption was introduced as a bid to achieve a balance between granting an exemption to income derived by CFCs from legitimate business activities and income from non-substantive business activities (Olivier & Honiball, 2011:581). To protect the South African tax base from potential profit shifting, the foreign business establishment exemption does not apply to certain transactions, referred to as *diversionary transactions*, between the CFC and a person connected to the CFC as defined in section 1 of the Income Tax Act (Department of National Treasury, 2002b:11). According to Oguttu (2007:129), diversionary transactions can be divided into two categories, with the first being transactions that are subject to transfer pricing rules, and the second category being transactions not subject to transfer pricing rules but where price manipulation still exists. Oguttu (2007:129), adds that transactions in the second category will not be subject to transfer pricing rules; however, the foreign business

establishment exemption is not applicable and therefore the provisions of section 9D(2) are applicable.

2.5.2 Development of the exclusions from the foreign business establishment exemption

2.5.2.1 Introduction of exclusions from the foreign business establishment exemption

The exclusions from the foreign business establishment exemption were introduced into the Income Tax Act in 2000 through the Revenue Laws Amendment Act (59 of 2000). The amendment excluded from the foreign business establishment exemption diversionary transactions, business income regarded as mobile, and certain passive income.

According to the National Treasury's detailed explanation of section 9D (Department of National Treasury, 2002b:8), the nature of business activities from which mobile foreign income is generated is such that there is no real reason for their existence except a tax reason. Jooste (2001:487) further explains mobile income as income generated by businesses that are no more than paper shells whose only real economic activity is the maintenance of a post office box or postal address, or an electronic website. It could, therefore, be said that businesses that generate mobile foreign income, due to their nature, would not qualify for the business establishment exemption as they do not meet the criteria discussed.

Diversionary transactions are transactions conducted between the CFC and a resident connected person. These transactions generally result in active business income that involves artificial pricing and, where artificial pricing is non-existent, transactions where the possibility for price manipulation exists (Seonath, 2003:73). The diversionary transactions addressed provided for four different scenarios, namely:

1. transactions between South African resident connected persons and the CFC that involve the supply of goods or services not at arm's length (section 9D(9)(b)(i));
2. transactions which involve goods sold by the CFC to connected South African residents (section 9D(9)(b)(ii)(aa));
3. the sale of goods by any non-resident connected person where the goods were purchased from a South African resident connected person (section 9D(9)(b)(ii)(bb)); and lastly
4. services performed by the CFC for a South African resident connected person (section 9D(9)(b)(ii)(cc)).

The first diversionary rule accordingly served as an increased penalty for artificial pricing because transfer pricing rules were already in existence (Jooste, 2001:490). The sale of goods by the CFC to a South African resident connected person was subject to the application of the CFC rules, except in circumstances where the CFC purchased the goods from a place outside South Africa,

where it has its place of effective management or the CFC significantly produces the goods in the CFC country, or the CFC sells significant goods of a similar nature at comparable prices to unconnected persons.

The Department of National Treasury (2002b:13) explained that the above exceptions are applicable because countries that have the capacity to produce goods probably have good infrastructure and they would most likely not tax local sales at low rates. In instances where similar goods are sold at comparable prices, the Department of National Treasury (2002b:11) was of the view that little transfer pricing would occur as independent outside pricing is available, and sales to unconnected persons are an indication of suitable business operations outside South Africa.

Similar to the second diversionary rule addressed above, income arising from a CFC sale of goods that were initially purchased from a South African connected person does not qualify for the foreign business establishment exemption, unless the goods or tangible inputs acquired from the South African connected person are insignificant in relation to the total tangible inputs of the goods or the CFC is involved in significant production activities or, lastly, the CFC sells and delivers goods to customers within the CFC country of residence (Department of National Treasury, 2002b:11).

The exception relating to insignificant purchases of tangible goods was effected as a result of the independent value added by the significant purchases that, according to the Department of National Treasury (2002b:11), was an indicator of an offshore structure that is less likely to have non-tax business reasons.

The reasons for the significant production and local sales and delivery exemptions were similar to the ones provided for the second diversionary rule discussed previously, in that the foreign country is seen to have adequate infrastructure (Department of National Treasury, 2002b:11).

Income generated from services performed by a CFC to a South African resident connected person is subject to the application of the CFC rules, unless the service provided related to the creation, extraction, production, assembly, repair or improvement of goods utilised outside South Africa, or the service relates to the sale and marketing of goods produced by the South African resident connected person that will be sold and delivered to unconnected persons in the CFC's country of residence (Department of National Treasury, 2002b:11).

Services provided relating to goods utilised outside have no relation to South Africa and are therefore less likely to represent significant transfer pricing. Similarly, if the service provided relates to goods that are sold to unconnected persons in the CFC country, a non-tax business reason exists for the CFC. The Department of National Treasury (2002b:15) explained that CFC services like management fees, internal accounting fees and fees to guarantee loans are prone

to price manipulation due to their mobile nature. The National Treasury added that there is an insignificant non-tax reason for a CFC to be providing the above-mentioned services to their South African connected persons.

Despite satisfying the foreign business establishment and the diversionary rules, the income of a CFC from dividends, interest, royalties, rents, annuities, insurance premiums, and similar income does not qualify for the foreign business establishment exemption because no direct competitive concerns are at stake (Department of National Treasury, 2002b:15).

Passive income is generated from assets that can be easily shifted without economic consequences and does not involve active income (Seonath, 2003:81). A CFC's passive income from the principal trading activities of a bank, financial services, insurance or rental business that is derived mainly from non-connected persons is not subject to the application of the CFC rules as it represents core business activity (Department of National Treasury, 2002b :19).

The principal trading activities exception is not applicable to income from royalties or other similar income from the use of intangible assets as making a distinction between an active royalty business and passive income could not be structured (Department of National Treasury, 2002b :19).

2.5.2.2 Amendments of the scope of diversionary transactions

Further exclusions from diversionary transactions were provided in 2003 through the Revenue Laws Amendment Act 45 of 2003 to take into account certain genuine transactions of a CFC that were previously not taken into account by the legislation. The said transactions include the purchases by a CFC of the same or similar goods mainly within the country of residence of the CFC, and the sale by a CFC to local customers, with lesser sale amounts to customers from nearby countries. These transactions were seen as posing no risk to the South African tax base and transfer pricing (Revenue Laws Amendment Act 45 of 2003:43).

The diversionary rules were further revised in 2006 by the Revenue Laws Amendment Act 20 of 2006 to clarify that the term *delivery* required physical delivery to the client's premises situated in the CFC's country of residence, even if the actual delivery is not effected by the CFC itself. It was explained in the Explanatory Memorandum to the Revenue Laws Amendment Bill (Department of National Treasury, 2006:56) that services performed by the CFC predominantly for clients situated in the same country of residence as the CFC are not subject to the diversionary rules as no reason exists to tax these services if they are rendered for genuine client use in that foreign country.

The amendments also indicated that CFC services are exempt from the diversionary treatment if they do not result in South African deductions by a South African resident holding a participation

interest in that CFC, as no potential for avoidance exists without a corresponding South African deduction that directly erodes the tax base (Department of National Treasury, 2006:56).

In 2011, the diversionary rule relating to resident exportation of goods to a CFC was removed from the legislation because enforcing transfer pricing is more manageable if the activities largely occur in South Africa (Department of National Treasury, 2011:105). It was further made clear in 2011 that the mobile income targeted by the CFC rules is covered under four categories, namely financial instrument income, rentals and sales of tangible movable property, royalties and disposals of intellectual property and, lastly, insurance premiums. The underlying principle in the financial instrument and insurance premiums category was that CFC income is subject to the application of the CFC unless an active business exists. The rentals and sales arising from immovable property do not raise mobility concerns; hence this type of income is exempt from the diversionary rules. The opposite can be said for income arising from rental and sale of movable assets; as a result, this type of income is subject to the diversionary rules. The income derived by a CFC from royalties and disposals of intellectual property is not subject to the diversionary rules unless the intellectual property was once within the South African tax net (Department of National Treasury, 2011:108).

Another diversionary rule that was removed related to goods imported from a CFC by a resident connected person (hereafter referred to as *CFC inbound sales of goods*). A CFC that sells goods to a resident connected person is subject to the application of the CFC rules only when CFC is located in a high tax jurisdiction, or income from the sale of goods is attributable to the activities of a permanent establishment of the CFC. The reason provided by National Treasury for the removal of the CFC inbound sale of goods diversionary rule was that the rules caused problems for legitimate commercial activities because the rule is mechanical and too rigid (Department of National Treasury, 2011:104).

In 2015, through the Revenue Laws Amendment Act 23 of 2015, the removed rules in respect of CFC outbound and inbound sales of goods were reinstated in their form before 2011 because the removal was regarded by Treasury to be less effective in applying the CFC rules. Treasury explained that the sole reliance on transfer pricing rules prior to the amendment left the South African tax base vulnerable to profit shifting because it takes a long time to audit transfer pricing processes (Nortje & Brown, 2015:69).

The diversionary transactions, as they currently stand in the Income Tax Act, address the sales of goods by a CFC to a resident connected person (section 9D(9A)(a)(i)), sale by a CFC of goods that were purchased from a South African resident connected person to any person who is not a South African resident connected person (section 9D(9A)(a)(iA)), services performed by the CFC for a connected person who is a South African resident (section 9D(9A)(a)(ii)), income from

financial instruments (section 9D(9A)(a)(iii)), rental from movable property unless the rental is as a result of an operating lease or a lease that constitutes a financial instrument (section 9D(9A)(a)(vi)), income from intellectual property (section 9D(9A)(a)(v)), capital gains from the disposal or deemed disposal of intellectual property (section 9D(9A)(a)(vi)) and, lastly, insurance premiums (section 9D(9A)(a)(vii)).

2.6 Conclusion

The objective of this chapter was to discuss the background to the South African CFC rules and the foreign business establishment exemption. From the above discussion of the background to the South African CFC rules and the foreign business establishment exemption, it can be noted that the main exemption from the application of CFC rules, which is the foreign business establishment exemption, is largely based on geographical location. Another theme noted from the discussion relating to the diversionary rules is that the character of the income is important. According to Bach *et al.* (2000:659), international electronic communication networks have become more comprehensive, and value added is shifting in favour of intangible goods and electronically provided services for which suppliers need not be present at the point of sale, which may be a challenge when it comes to the determination of the geographical location of the performance, as well as the character of the income.

The next chapter discusses the emerging issues that result in the application of the CFC rules in an era of global electronic communication networks.

CHAPTER 3: E-COMMERCE CHALLENGES TO SOUTH AFRICAN CFC RULES

3.1 Introduction

It was noted in the Katz Commission report (Department of National Treasury, 1997: para 7.4.1) that international trade would soon become a function of global electronic communications such as the internet. This prediction has become a reality because, according to the Green Paper on Electronic Commerce for South Africa (Department of Communications, 2000:15), the increasing absorption of technological innovations into about every field of business has resulted in new ways of communicating and conducting business.

Businesses across all sectors are now able to design and build their operating models around technological capabilities in order to improve flexibility and efficiency and extend into global markets (OECD, 2015a:53). As a result, technological advancements have transformed business models and operations by facilitating easier communication between the transacting parties.

This chapter, in accordance with the secondary objective in paragraph 1.6.2(ii) of this paper, discusses e-commerce with the aim of providing an understanding of what constitutes e-commerce, and debates the issues emerging from the determination of a foreign business establishment in businesses that trade electronically.

3.2 What is e-commerce?

3.2.1 The definition

E-commerce is defined in the Green Paper on Electronic Commerce for South Africa (Department of Communications, 2000:16) as transactions which involve the exchange of information, products, services and payments using electronic networks for economic and communication purposes. The OECD (2015a:55), on the other hand, defines e-commerce as transactions of buying or selling of goods or services, conducted over computer networks by methods specifically designed for the purpose of receiving or placing of orders. The payment and the eventual delivery of the goods or service do not have to be conducted online despite the goods or services being ordered by those methods. Both the above definitions can be simplified as the use of improved technology in the sending of voice, data, images and video information over the internet to enable persons to trade without being confined by traditional geographical boundaries (Young, 2012:12).

E-commerce can be used either to order goods or services that are then delivered through traditional channels or to order and deliver goods or services (intangible) completely online.

3.3 The features of e-commerce

According to Azam (2012:647), three categories of e-commerce can be distinguished: e-commerce in tangible products, e-commerce in intangible products and e-commerce in services. Azam (2012:647), explains that, despite this distinction, all three types of e-commerce have similar features in that they are global, anonymous and virtual. These features are described below:

3.3.1 Global reach

E-commerce technologies allow businesses to easily reach across geographical boundaries as the internet connects everybody who has access to it (Oguttu; 2008a:348). The internet connectivity arising from e-commerce technologies brings about mobility in businesses, and the OECD (2015a:64) identifies a few features that are prominent in e-commerce relating to mobility with respect to (i) intangibles (ii) business functions and, lastly, (iii) users and customers.

3.3.1.1 Mobility with respect to intangibles

According to Naicker (2003:122), an *intangible* is an asset that has value independent from the services of any person and that derives its value, not from its physical attributes but from its intellectual content or other intangible properties. Patents, trademarks, customer lists, and copyrights are some of the intangible assets that one would be correct to argue are important in determining firm value (Dischinger & Riedel, 2011:691). Data provided by customers of e-commerce businesses are also often seen as an intangible asset in some countries as these data can be analysed and some value created (OECD, 2018: para 167–169). Intangible assets like patents and intellectual property can be easily transferred between enterprises across the globe (Peng, 2016:346). According to Medus (2017:38), this ease of transfer is encouraged by countries that provide low tax rates for digital companies to locate their intellectual property.

3.3.1.2 Mobility with respect to business functions

Improved information technology has created opportunities for businesses to decentralise and to spread their functions (such as financial, administrative, marketing, sales, delivery and customer support) across multiple jurisdictions to yield the greatest return on investment (Oguttu & Van der Merwe, 2005:314). As a result, businesses have a heightened ability to manage their international operations on a unified basis from a central location that may be removed geographically from both the locations in which the operations are carried out and the locations in which their suppliers or customers are located (OECD, 2015a: para 159).

According to Li (2014:21), *dematerialisation* means the transformation of any material object (tangible item) into something virtual or digital and, once information has been digitalised, it can be sold/delivered digitally, which often renders suppliers in digital businesses irrelevant. Sectors

relying heavily on technology, research and development, design and production can be managed centrally, while the assembly can take place across different countries to take advantage of skilled labour and local resources (OECD, 2014a: para 4.1). Advances in technology have made it possible for businesses to carry out economic activities with an insignificant need for personnel presence, and have further created multiple options for businesses to select the optimal location for productive activities and assets (OECD, 2015a: para 162-163).

Factors that businesses consider in selecting optimal locations for productive activities and assets due to improved technology include costs, infrastructure, labour characteristics, government and political issues. When seeking new sites, digital businesses generally strive to keep operating and start-up costs low. They also seek to move into new facilities more quickly than in the past and, therefore, tend to focus more on leasing facilities rather than purchasing land and building new facilities (Heil, n.d). Leasing facilities for businesses also increases their mobility as they can relocate every few years based on market requirements. Businesses that provide digital services often require a significant investment in infrastructure components and the location of the infrastructure may be heavily influenced by access to inexpensive and reliable sources of power. Telecommunications technology has created an environment of employees who can work from remote locations. The growth of this type of environment has impacted the location strategy, in that most digital companies do not require a large workspace because many employees work from remote sites (Heil, n.d).

3.3.2 Mobility with respect to users' anonymity

Many internet transactions can take place with little information being required. The internet enables transactions between parties who do not know each other's physical location (Schulze, 2006:33). The data transmitted in electronic transactions is often not sufficient to identify the identity or location of the user or customer. A certain portion of an internet address (or domain name) is only indicative of the person responsible for maintaining the website. It has no relationship with the computer or user corresponding to that address or even where the machine is located (Choudhary, 2011:34). In its report, the OECD (2015a:65) adds that the improvements in information communication technology have increased the ability to carry on commercial activities remotely while travelling across borders. The above facts can serve as proof that determining the location and identity of both users and customers of an e-commerce transaction can be difficult.

3.3.3 The conversion of tangible goods into digital products

Improved information technology has led to the replacement of physical goods by virtual or digital products through the manipulation of information (Cohen, 2000:18). The internet allows companies to deliver digital goods immediately and without any of the physical constraints posed

by tangible goods. According to Hui & Chau (2002:73), several companies are remodelling their products in order to create digital products. Unlike traditional businesses, services and products provided by e-commerce businesses are related to the data stored in their server or system (Peng, 2016:346).

3.3.4 Reliance on data

Connectivity and the ability to record and digitise everyday life means that users produce trails of information almost continuously as they consume goods and services. The use, collection and analysis of data is an essential part of e-commerce business models, according to the OECD (2018: para 139). The data generated and harvested from users is an integral part of the business models of most digitalised businesses as it allows the services offered to be better refined for new and existing users (Aslam & Shah, 2020:8). E-commerce businesses collect data about their customers, users, suppliers and their business operations, and use the data collected for various reasons. One relevant reason for this paper is that e-commerce businesses analyse and potentially monetise this data collected.

3.3.5 Heavy reliance on intangible assets

According to Ondari-Okemwa (2011:138), e-commerce businesses rely heavily on intangible assets, such as research and development, patents, software, human resources and data. The OECD (2018: para 34) adds that there is heavy reliance on intangible assets, such as software support platforms, websites and other important functions that are central to e-commerce business models. E-commerce businesses are dependent on these intangible assets for value creation (Medus, 2017:36).

3.4 CFC issues when businesses trade electronically

From the above discussion of what e-commerce is, it can be deduced that businesses have evolved until they currently operate in a fundamentally different manner. Businesses, particularly those in the digital economy, can sell to certain countries without any physical presence in that country, and they can manage their functions centrally due to advances in information technology. This form of trading became popular globally due to easy access to computers and the internet (Othman & Hanefa, 2006:1).

As fewer and fewer businesses required a physical presence in the digital economy, certain challenges emerged relating to the application to e-commerce transactions of the existing South African CFC rules, as contained in section 9D of the Income Tax Act. These challenges are discussed in detail below.

3.4.1 Issues from applying the foreign company definition

CFC rules are embedded in determining whether a foreign company exists and, in accordance with the discussion in Chapter 2, the definition of a *foreign company* in terms of the South African tax law is dependent on where the company was incorporated. Determining the residence status of companies where transactions are conducted through the internet is difficult: It can be complicated to authenticate the geographical location of the company, which is important in establishing the existence and location of a foreign company (Oguttu, 2008a: 351). According to Azam (2012:643), the global reach of the internet results in large volumes of transactions being spread among several locations. This, coupled with the anonymity of users, further intensifies the challenge of determining the geographical location of e-commerce companies. Electronic addresses have no significance to a geographical connection, which makes it difficult to link a business to any transaction in a single country. Consequently, e-commerce businesses may intentionally not create a presence in any country so as to avoid the application of the CFC rules.

3.4.2 Issues in determining whether a foreign company is controlled

Once a company is regarded as a foreign company, the next important element in applying the CFC rules is to determine whether the foreign company is controlled. This involves an analysis of the participation or voting rights held (directly or indirectly) in that foreign company by a South African resident. Due to the anonymity of users in a virtual environment, there is usually no paper trail that could be used to recognise the identity of shareholders nor the type of share arrangement in order to conclude on the status of shareholders' residence, as well as to determine whether the shares held constitute participation rights (Oguttu, 2007:170). In the e-commerce era, information available to assist in determining whether a foreign company is controlled may not be reliable because it can be easily altered without leaving a trace if there is a motive to avoid tax. The opportunity to alter information is increased by section 102 of the Tax Administration Act 28 of 2011, which places the onus of proof on the South African shareholder to prove indirect shareholding (Oguttu, 2015, 524).

3.4.3 Issues resulting from the determination of a foreign business establishment

In Chapter 2, it was noted that CFC rules do not apply to certain foreign business establishments. E-commerce businesses pose certain challenges in determining whether the foreign business establishment exemption is applicable. These challenges, which are discussed below, can be classified into two main categories, namely the determination of the fixed place of business and the proper characterisation of income.

3.4.4 Fixed place of business

The key characteristic of a foreign business establishment is that it must be a fixed place of business where business is conducted through a fixed structure (i.e., office, warehouse, factory) and that business must be suitably equipped, staffed with on-site managerial and operational staff, have suitable facilities for primary operation and, lastly, the business should not be located outside South Africa for purposes of postponement or reduction of tax. A fixed place of business requires a specific geographical point, and this was also discussed in section 2.4 of chapter 2 of this paper. Identifying a place of business proves to create difficulties where trade is conducted electronically because it is conducted in cyberspace (Department of National Treasury, 2014:2).

3.4.4.1 Fixed place of business issues arising from mobility with respect to users

E-commerce involves trade over the internet through websites that appear on computer screens and allow businesses to interact with their customers (Choudhary, 2011:40). Consequently, customers/users may be spread among multiple jurisdictions. This ability to trade anywhere in the world does not reflect the activity of the business in the countries where target markets are located (Zondo, 2017:18). According to Pinto (1999:231), determining the location and identity of the user/customer may be difficult for e-commerce businesses. The difficulty is as a result of the weak identity tracing mechanisms that come with the use of internet websites. Determining or verifying a party's identity online is not easy, especially where the parties involved have the intention of concealing certain information. Moving a website from a server in one physical location to another is a task that can be easily accomplished without any effect on the online service (Oguttu, 2015:525).

One challenge that would result from the issue of applying the foreign business establishment exemption could be with respect to identifying whether the user/customer in an e-commerce transaction is a resident or not, as this is important in determining whether the customer/user is a foreign company.

Another challenge that can result from the issue is in terms of applying the diversionary rules. It is difficult to determine the relationship between the e-commerce business and the user/customer if identity cannot be proven. According to the Income Tax Act, the imported services diversionary rule for example, provides that the foreign business establishment exemption will not apply where a CFC provides services to a South African connected person unless the services are performed outside South Africa. The anonymity of e-commerce may result in difficulties where tax administrators have to ascertain whether parties to an e-commerce transaction are connected and are involved in diversionary activities. Consequently, e-commerce can be used to avoid application of the CFC rules by taking advantage of the foreign business establishment exemption.

CFC rules do not apply to a resident that, together with its connected persons, holds in aggregate less than 10% of the participation rights or voting rights in a CFC (section 9D(2)). In e-commerce, a CFC may be resident in an offshore tax haven where banks have strict secrecy provisions that present difficulties when the connection of a resident to a particular CFC needs to be determined. Apart from determining a connection between the parties, it may be difficult to identify parties who own shares, thus making it possible to manipulate this exemption to avoid the CFC charge.

The diversionary rules relating to the sale of goods by a CFC to a resident connected person bring about two issues that may be challenging to determine in e-commerce businesses or transactions. The first issue is linked to establishing whether there is a connection between a CFC and a resident. As discussed above, the anonymity of users in e-commerce transactions and the strict secrecy laws in tax haven jurisdictions may pose a challenge to proving the connection. Similarly, this challenge provides an increased opportunity for taxpayers to manipulate information available, with the aim of avoiding the CFC charge. The second issue that can be deduced from the application of the diversionary rules to digital businesses relates to the character of income. Dematerialisation has created challenges relating to the character of income, which is discussed in detail in section 3.4.5 of this paper.

3.4.4.2 Fixed place of business issues arising from mobility with respect to business functions

Mobility with respect to business functions is one of the key features of e-commerce because e-commerce ignores international boundaries and, as a result, place has little meaning (Schulze, 2006:33). An internet website does not provide a connection to a specific geographic location (Choudhary, 2011:40). As a result of its being intangible, an internet website is commonly referred to as a *virtual office* (Oguttu, 2008a: 316). The need for e-commerce businesses to have on-site operational and managerial staff at a fixed location is minimal because staff can perform their duties remotely from anywhere in the world (OECD, 2015a: para 158).

The enhanced ability to carry out business activities remotely due to technological advances increases the flexibility of businesses' choice of where substantial business activities take place, as noted under the discussion of the Features of e-commerce (section 3.3). Consequently, like customers/users, business functions may be spread among multiple jurisdictions. As employees generally perform their duties from remote sites, determining whether the fixed place of business is suitably staffed is a challenge: The employees will not be found on-site conducting the primary operations of the business.

The sub-requirement that a foreign business establishment should consist of a fixed place of business that is suitably staffed was included in the CFC rules, according to the National Treasury detailed explanation of section 9D (Department of National Treasury, 2002b:9), to ensure the

economic substance of the business. This sub-requirement was relevant before the advances in technology. However, as new business models seek to reduce the costs of office space rental; for example, there might be a need to revisit the CFC laws that test economic substance. Further, the increased ability of e-commerce businesses to select an optimal location for productive assets and activities, even if distant from the location of its customers, as well as the heightened possibility of outsourcing certain functions for primary operation of an e-commerce business, brings about a challenge with respect to the criteria that a foreign business establishment should be suitably equipped and have suitable facilities.

As discussed in Chapter 2 of this paper, South African tax law includes in the definition of a foreign business establishment, a fixed place of business where business is conducted through a fixed structure (i.e., office, warehouse, factory). Since a website is a virtual office, it is intangible property and cannot be regarded as a foreign business establishment (Oguttu, 2015:528). Goel and Goel (2018:34) are of the view that an internet website cannot be regarded as a place of business because there is no resource, such as premises or machinery or equipment. A different argument is raised in the OECD (2010: para 42.2) commentary on article 5 that an internet website is electronic data that is combined with software and stored on a server. A server is a piece of automated equipment on which an internet website is stored and through which the website can be accessed. The argument is that, since a server is a piece of equipment, it can be regarded as having a physical location under certain circumstances, which are discussed below.

According to the OECD (2010: para 42.3), where the taxpayer carries on a business through a website and they operate the server (either through a lease arrangement or ownership) on which the website is stored and used, then the place where the server is located could constitute a fixed place of business. The commentary further clarified that, in order for the server to constitute a fixed place of business, it will need to be stationed at a specific place for a sufficient period of time to meet the definition of *fixed*. From the above commentary, a server may be regarded as a place of business. However, according to the South African CFC rules, for a place of business to qualify as a foreign business establishment, it should be appropriately resourced with on-site managerial and operational staff. The implication is, therefore, that, if a server is located in a remote location that does not require the presence of staff, it does not constitute a foreign business establishment.

A further requirement for the foreign business establishment exemption to be satisfied is that, once the *fixed place of business* requirement has been met, it must be used by the CFC for a period of at least one year (Oguttu, 2015:529). A server can be easily moved between countries due to its highly mobile and flexible nature. It can therefore be concluded that, even in cases where a server may be regarded as a fixed place of business, it may be a challenge to establish a specific location, due to its mobile nature.

One of the key requirements for applying the foreign business establishment exemption discussed in section 2.3 of this paper is that the foreign business establishment should not be located outside South Africa for reasons of postponing or reducing tax. It can be gathered from all the issues raised above relating to the *fixed place of business* requirement that determining the location of an e-commerce business is challenging. As a result, proving that digital businesses are involved in real business activities, as opposed to tax avoidance schemes to escape CFC rules, is a challenge.

The challenge of determining the location of an e-commerce business will also result in difficulties in terms of determining whether a company is a foreign company or not because the determination in this regard is to a certain extent based on the geographical location. The continued increase in digital technologies and the diminishing need for businesses to have a physical presence in order to carry on its core operations raises questions as to whether the current *fixed place of business* rules that determines the existence of a foreign business establishment is appropriate.

3.4.4.3 Fixed place of business issues arising from mobility with respect to intangibles

In terms of the OECD's Action 5 Final Report (2015d:11), the provision of intangibles is a geographically mobile activity because it is easy to shift the intangibles from one country to another due to their nature. The mobility of the intangibles is further enhanced by technological advances and globalisation. The location in which an entity's intangible assets are controlled/managed can have a material impact on where profits are subject to tax (OECD, 2018: para 135). Currently, tax law attributes profits generated from intangible assets primarily to the jurisdiction where the parent company or regional operating centres are located and, most importantly, where intangible assets are legally owned (Olbert & Spengel, 2017:45).

The issue with the current tax law is that, as already discussed above, the fixed location in the e-commerce environment is challenging to prove. Currently, the exclusions from the application of the CFC rules, as discussed in section 2.5 of this paper, include income from intellectual property and capital gains from disposals of intellectual property by the CFC, except if the CFC actively develops the underlying CFC. This exclusion from the CFC rules does not apply if the intellectual property largely involves intellectual property that was once included in the South African tax net (Oguttu, 2015:149). The resulting issue with this exclusion is that, in an e-commerce environment, there is an opportunity for businesses to transfer intangible assets or rights to the intangible assets. The mobility of intangibles makes it difficult for these transfers to be identified. There is an incentive for MNE's in high tax jurisdictions to avoid claiming ownership of the intangibles to reduce economic returns associated with the intangibles and to shift the associated income from the intangibles to low-tax jurisdictions (OECD, 2015a: para 187–188).

There is also an opportunity to change/manipulate the nature of the income, which then leads to characterisation issues affecting the application of diversionary rules of the foreign business establishment exemption, as discussed in section 3.4.5 below.

3.4.4.4 *Fixed place of business issues arising from reliance on data*

Often, in the digital economy, the data collected is a primary input into the value creation (OECD, 2015a: para 262). However, according to Olbert & Spengel (2017:36), the mere collection of data does not contribute much to value creation: What has been a success factor for many e-commerce businesses that collect large amounts of data is the processing and analysing of the data. As already highlighted in the Features of e-commerce in section 3.3.4 of this paper, digital businesses collect data from their users. The users from whom the data is collected can be spread across multiple locations, and the spread poses a challenge to determining a fixed place from which the data is collected (Aslam & Shah, 2020:23). The growing role of data in e-commerce businesses raises questions about whether the fixed place of business rule is appropriate, and whether the profits attributable to the remote gathering of data should be taxable and by which country (OECD, 2015a: para 379).

3.4.5 Characterisation of income

Chapter 2 of this study provides a discussion of the circumstances under which the foreign business establishment exemption will not apply. As can be deduced from the discussion, the said circumstances largely depend on the character of the income generated by the CFC. For example, if the CFC earns income from the right of use of intellectual property, the foreign business establishment exemption does not apply. The way in which income is taxed is based on the type of income or the ability to characterise a specific type of income (Oguttu & Van der Merwe, 2005:312). Domestic and international tax rules assign different categories of income to different jurisdictions (Hellerstein & Shackelford, 2002:13). According to the OECD (2015a: para 269), new business models brought about by e-commerce raise questions about how to characterise certain transactions and payments for domestic and tax treaty law purposes.

3.4.5.1 *Characterisation issues resulting from conversion of tangible goods into digital/intangible goods*

The goods sold by e-commerce businesses can be tangible (books) or intangible (e-books). Advances in technology have brought about an increasing transformation of tangible goods into intangible goods (Li, 2014:21). According to the Davis Tax Committee report on addressing Action Plan 1 (Department of National Treasury, 2014:22), the development of modern digital products or means of delivering services creates uncertainties regarding the proper classification or characterisation of payments made. E-commerce transactions complicate the determination of whether a transfer of goods has occurred, whether services have been performed, or whether an

intangible product has been licensed (Cockfield, 1999:154). A CFC may, through e-commerce, modify its electronic product so that income from it is characterised as active rather than passive, so that it is not caught by CFC rules (Oguttu, 2015:530). Determining the characterisation in this regard would be a challenge when it comes to the application of the foreign business establishment diversionary rules because these rules make a distinction between goods and services.

3.4.5.2 Characterisation issues resulting from heavy reliance on intangible assets

The main problem in the characterisation of income, according to Oguttu & Van der Merwe (2005:312), is the distinction between royalty income and business income. As e-commerce businesses place heavy reliance on intellectual property like software, there is an opportunity for CFCs that operate within this environment to manipulate the income generated from the provision of software. This opportunity presents itself because the diversionary rules relating to the provision (either through sale or use or right of use) of intellectual property provide that the foreign business establishment exemption may not apply, depending on the character of the income resulting from the provision of the intellectual property (Oguttu, 2015:530). Where the income from the provision of the intellectual property is a royalty, the foreign business establishment exemption will not be granted unless the CFC modifies the intellectual property. If, on the other hand, the income is characterised as income from the provision of services, the foreign business establishment exemption may be granted after consideration of the diversionary rule relating to the provision of services by the CFC in terms of section 9D(9A)(a)(i) of the Income Tax Act. As a result, it is necessary to discuss below the definition of a royalty for application of the foreign business establishment exemption.

Royalties, for South African domestic tax purposes, are defined similarly to the definition of a *royalty* in article 12 of the OECD model treaty, and both definitions are based on the use or right of use of certain properties (intellectual property) or rights (Oguttu & Van der Merwe, 2005:313). Both South African domestic tax law and the OECD do not define what *use or right of use* means. However, three comments were noted from the commentary on article 12 of the OECD model treaty: The first comment noted was that payments made to persons that do not own intellectual property or the right to use it are not likely to be regarded as royalties (OECD, 2010: para 8.1). Second, payment for the transfer of full ownership of intellectual property cannot be regarded as a royalty as it is not payment for the right of use or use (OECD, 2010: para 8.2). And lastly, an amount received for the granting of a right to distribution of a product or service would not constitute a royalty as it does not result in the use or right of use of intellectual property (OECD, 2010: para 10.1). It can be concluded from the noted comments that there is an emphasis that an amount will only be regarded as a royalty if it is for the use of or right to use intellectual property.

The current issue, despite the definition of a royalty provided in both domestic and international tax law, is that e-commerce businesses have services, such as the furnishing of a database, online subscriptions or the downloading of software, that may result in either income for the rendering of a service, a royalty for the use of a protected intangible, or profit from the sale of a product. Despite the comments on article 12 of the OECD model treaty noted above, they did not provide clarity with regard to the classification of the examples of income generated from services provided by e-commerce businesses above. In an attempt to provide the necessary clarity, in 1999, the OECD committee set up a Technical Advisory Group (hereafter referred to as TAG) on treaty characterisation issues arising from e-commerce, with the mandate of examining characteristics of various electronic payments (OECD, 2001: para 1).

In its report to the OECD (2001: para 14), TAG concluded that, in any given transaction, the deciding factor when it comes to determining whether a payment results in a royalty is the identification of the consideration for the payment. According to Yu (2001:9), this identification of the consideration for payment does not involve any copyright law but, rather significantly, relies on the economic substance of the transaction. The report clarified that, where payment is for the acquisition of digital content for the personal use or enjoyment of a customer, it would constitute business profits and not royalties (OECD, 2001: para 15). The TAG final report reveals three categories of e-commerce transactions that may give rise to royalties: the electronic ordering and downloading of digital products for commercial exploitation; the provision of concealed technical information; and the use of copyrighted content (Pinto, 2002:163).

3.4.5.3 Characterisation issues resulting from customer data

Another characterisation issue that also results in a challenge when making a distinction between royalty income and business income is personal data provided by customers of e-commerce businesses (OECD, 2018: para 141). Customers in e-commerce businesses provide personal information before they can obtain access to digital platforms. The issue that stems from this inherent undertaking is whether it should be regarded as a barter transaction between the users and the business (Kjaersgaard & Schmidt, 2018:155). Aslam and Shah (2020:9) are of the view that there is an exchange transaction with users in digital businesses, stemming from the provision of users' information about their activities and preferences in exchange for a digital service. The issue with this that is not addressed by the current South African CFC rules is whether digital businesses should attach a value to the data they collect from customers and, if so, what the nature of this income is: Will it be regarded as passive income if the view that data are intellectual property is followed, or will it be regarded as active business income if the view that a service is being provided is followed?

3.5 Conclusion

The objective of this chapter was to describe the challenges that e-commerce poses to South African CFC rules. It can be noted from the above description of the challenges that e-commerce poses that although the OECD (among other international tax organisations) has commentary for international tax purposes on the distinction between business income and royalties for e-commerce businesses, South Africa's domestic tax law still has unclarified issues regarding the characterisation of income from e-commerce. The relevance of the *fixed place* requirement in applying the CFC rules to e-commerce businesses also remains unaddressed in the South African Income Tax Act. It is for this reason that the next chapter considers international responses to the above issues.

CHAPTER 4: INTERNATIONAL RESPONSES TO E-COMMERCE TAXATION WITHIN THE CONTEXT OF CFC RULES

4.1 Introduction

The challenges of e-commerce discussed in Chapter 3 are a global issue and are not unique to South African CFC legislation. CFC legislation around the world is all meant to target MNE's' ability to shift their passive or mobile income to low taxed jurisdictions; however, there is variance among countries in the design of their CFC legislation (Duenas, 2019a:01). The objective of this chapter is to gain an understanding of international responses to e-commerce in the context of CFCs in order to formulate appropriate recommendations to address challenges identified in chapter 3. The approach followed in this regard is to begin by examining countries' design of CFC rules, and to continue by probing leading international organisations' responses to the challenges identified. In considering how countries have responded to the challenges that e-commerce poses to their CFC rules, the design of other countries' CFC legislation of targeted income and how tax authorities protect themselves against base erosion is reviewed.

According to Arnold (2019:635), CFC rules are designed around two fundamental features important to this study: how a CFC is defined, and the nature of the income targeted. The review of countries' design of CFC rules that follows is based on these fundamental features. The review studies the responses, first of governments and then of international bodies, to CFC issues identified in e-commerce transactions. There is a global presumption that applying the present tax rules to e-commerce transactions will cause tax loss to the government, and this raises a concern for many governments (Othman & Hanefa, 2006:2).

4.2 The UK's design of CFC rules

4.2.1 Foreign company

Section 371AA (3) of schedule 20 of the UK's Finance Act 14 of 2012 defines a CFC as a non-UK resident company that is controlled by a UK person(s). In the UK, a company is considered a resident if it is incorporated in the UK or it is primarily managed and controlled in the UK. A company that is incorporated outside the UK, which is also not centrally managed nor controlled in the UK, and a company that is incorporated in the UK but primarily managed outside the UK would therefore both be considered as a non-UK resident company (Singh, 2014:215). The UK's definition of a non-UK resident company is similar to the definition of a foreign company in the South African CFC rules as they are both embedded in where a company is incorporated. As a result, the issue identified in Chapter 3 relating to the application of the foreign company definition where transactions are conducted electronically is likely to be an issue of the UK CFC rules too.

4.2.2 Control

In establishing whether a non-UK company is controlled by UK person(s), the legal control, economic control, joint venture test and the accounting standards are taken into consideration (HMRC, 2018c). *Legal control* is a test that uses shareholding and legal documents to determine whether a non-UK resident company is controlled (HMRC, 2020). According to Duenas (2019a: 25), *economic control* refers to a person's entitlement to a majority of the proceeds or the disposal of the shares of the company. The accounting definition of a parent is also used to determine whether there is a parent/subsidiary relationship between a UK holding company and a foreign subsidiary. According to Viviers (2014:28), where it is proven that a parent/subsidiary relationship exists between a UK holding company and a foreign subsidiary, the foreign subsidiary will be deemed to be a CFC. The *joint control test* in the UK CFC rules is a test of how many controlling or voting shares a UK resident owns in a non-UK resident company where UK companies have joint control.

From the brief explanation of the tests used in the UK CFC rules to establish control, it can be concluded that these tests rely on a paper trail to identify the shareholders and the type of share arrangement. The issue emerging from the determination of whether a foreign company is controlled according to the South African CFC rules is as a consequence of the anonymity of users in a virtual environment. It follows that this issue could also possibly exist in the application of the UK CFC rules based on their tests of establishing control.

4.2.3 Exemptions

The UK implemented new CFC rules from 1 January 2013 that specifically target income that is artificially diverted from the UK, thereby excluding legitimate businesses from the application of CFC rules (Wright, 2012:12). According to Wright (2012:12), the UK CFC rules are designed to better reflect modern business structures. Under these rules, a UK controlling company is subject to tax on the undistributed profits of its CFC only if the CFC does not satisfy any of the five exemptions, referred to as *entity level exemptions*, or if the CFC's profits pass through the gateway test.

Entity level exemptions included in the UK CFC rules include certain conditions that, if satisfied, entirely exempt a CFC from the application of the CFC charge (Wright, 2012:14). According to Joscelyne and Wentworth-May (2012), the entity level exemptions are designed to exclude the application of the CFC charge to CFCs that pose a low risk to the UK tax base. Once it has been established that none of the entity level exemptions applies, a series of charge gateways are applied to different types of profits to identify profits that are artificial and must be taxed in the UK (Duenas, 2019a: 25). The gateway mechanism applies each gateway in sequence and results in a CFC being liable to UK tax if there is significant activity that derives profits in the UK (Wright,

2012:12). The important gateway for the purpose of this study is the first in the sequence, which deals with all trading profits, except for trading finance profits, and profits that arise from a property business.

The trading profits gateway applies certain OECD concepts to determine whether the CFC profits have a connection with the UK. It must be noted that there will not be any CFC charge applicable if assets or risks resulting in the profits of a CFC are not managed by connected parties in the UK or if the said assets or risks can be easily replaced by unconnected parties (Saferry Champness Chartered Accountants, 2016:1). Simply put, trading profits are only subject to the UK CFC charge if they are targeted income. This approach is different from the approach that South Africa follows, which includes all income in the scope of the CFC rules and then only exempts income generated by a foreign business establishment (Viviers, 2014:56).

To establish whether a connection exists between the UK and the CFC's profits, the trading profits gateway first requires an analysis of the ownership of the assets and risks that have generated profits for the CFC (Joscelyne & Wentworth-May, 2012). The approach followed by the UK CFC rules to confirm ownership is through reference to and analysis of legal rights and contractual agreements (HMRC, 2014). According to the HMRC (2016b), these legal rights and contractual agreements are assessed for situations where their management is exercised to a significant extent from the UK because this is seen as an indicator of arrangements driven by tax considerations. The analysis required to establish ownership of assets and risks alludes to the anonymity of users discussed in Chapter 3, which reveals that it might prove challenging to establish legal or contractual ownership of assets and risks where a business trades electronically.

Once a connection has been established between a CFC and the UK, a number of mechanical conditions are imposed to exclude CFCs with insignificant connections, and with substance in their resident territories from a CFC charge. The business premises condition, income condition, management expenditure condition, export of goods condition and intellectual property condition must all be met for the trading profits exclusion to apply (Menzies, 2014).

Joscelyne and Wentworth-May (2012) explain that the business premises condition is met if the CFC has premises, with some reasonable degree of permanence, in the territory in which it is resident. In addition, the CFC's activities in that territory need to be mainly carried on from those premises (HMRC, 2020b). Premises, in terms of section 371DG of schedule 20 of the UK's Finance Act 14 of 2012, include an office, shop, factory, any other building or part of a building, a mine, oil or gas well, a quarry or other place of extraction of natural resources, a building site or a construction site. It can be derived from the above description of the UK's business premises exemption that it requires the CFC to have a physical presence in its resident territory. Issues

emerging from determining a foreign business establishment per the South African CFC rules, as discussed in Chapter 3, will still be relevant where the business premises condition needs to be tested because the condition relies on the physical presence of a CFC. The design of the business premises exemption does not address e-commerce businesses that can have their business functions spread across multiple jurisdictions; nor does it address businesses, for example, that do not need to occupy a building to conduct business. It can also be concluded that it will remain a challenge to determine whether or which activities of the CFC are mainly conducted at a specific territory as these can be spread out in multiple territories.

The income condition included in the trade profits exemption of the UK CFC rules limits the income of the CFC that can arise, directly or indirectly, in the UK to not more than 20% of its trading income. Also, no more than 20% of the CFC's goods used to generate its income may be sourced from the UK in terms of the export of goods condition. The HMRC (2016a) explains that the export of goods condition was included in the rules with the intention of excluding income linked to UK activity from the trade profits exemption. Both the income and the export of goods conditions are dependent on ascertaining a geographical location. The challenges resulting from determining a fixed place, as discussed in Chapter 3 of this paper, are therefore likely to apply in testing these conditions.

The 20% limitation applies in terms of the CFC's management expenditure that relates to management activity in the UK. A CFC with UK management expenditure of more than 20% will not qualify for the trade profits exemption. The management expenditure condition is based on identifying the total amount of expenditure incurred in relation to management activities and determining how much of that is UK related. In establishing how much of the management expenditure is UK related, a determination of the location of staff members and individuals carrying out management activities needs to be made (HMRC, 2020c). Advances in technology have created opportunities for the remote performance of duties, and staff members and other individuals performing management activities can be spread across multiple locations. It can therefore be concluded that the challenges relating to determining a fixed place may be applicable, where the location of staff members has to be determined in order to verify whether or not management expenditure is UK related.

In summary, from the above discussion on the design of the UK's CFC rules, there are certain challenges that remain unaddressed by the UK CFC rules, despite their being reformed to adapt to a more open and global economy. In its report (HMRC, 2014:3), the UK government acknowledged that these challenges do exist and the discussion that follows talks to the approach the government followed in response to the identified issues.

4.2.4 UK's government approach to CFC issues identified in e-commerce businesses

A joint report was issued by the UK's treasury and revenue and customs (HMRC, 2014:15) in which it was noted that, in relation to tax and the digital economy (Action 1), the UK acknowledged that businesses are using digital technologies to underpin growth strategies. The report further noted that, although digitisation has changed the ways in which traditional businesses are conducted, ring-fencing the digital economy from the rest of the economy is not feasible. In this regard, the UK report recommended that an analysis should be conducted of how value is created in businesses that rely on digital technologies and complex systems, or where computing-related intangibles are central to revenue models, and, instead of ring-fencing the digital economy, it must be considered how existing rules can be updated to take this into account. The key objective, according to the report, is to achieve consistent tax treatment.

In its 2017 autumn budget brief (HMRC, 2017a: para 4), the UK's government expressed the view that the emergence of the digital economy has created imbalances between companies with and without physical presence. The solution to this challenge, according to the UK's government, is to reform the international corporate tax framework to reflect the value of user participation (HMRC, 2018a:3). *User participation* is viewed by the UK's government (HMRC, 2018a:3) to be the process by which users can create value for certain types of digital businesses through their engagement and active contribution. The UK's government (HMRC, 2018b:1) acknowledged that, although this solution can only be successfully addressed in the long run through multilateral reforms, interim action was needed to ensure that the corporate tax system is sustainable and fair across different types of businesses, pending the global reform.

The interim action taken by the UK government was the announcement of a tax referred to as the *digital services tax* in the 2018 budget, whereby revenues of specific digital business models with revenues linked to participation by UK users would be subject to tax at 2% from 1 April 2020 (HMRC, 2018b:1). The digital services tax was designed to ensure that digital businesses that create value in the UK are taxed in the UK (Geringer, 2020:6). The approach followed with regards to this digital services tax, according to the UK government, is to describe business activities that derive the most value from user participation and impose a tax on them. The objective of the digital services tax, as announced, is said to align the place where profits are taxed and the place where value is created (HMRC, 2019). The exemptions of the digital services tax are regarded to be beyond the scope of this paper. It must be noted that the basic aim of the UK CFC legislation is to identify profits of a non-resident UK company that should be taxed as a UK resident, as opposed to the digital services tax, which aims to tax businesses on the value derived from UK users.

4.3 Australia's design of CFC rules

4.3.1 Foreign company

A CFC is broadly defined as a company that is not a resident of Australia and is controlled by five or fewer Australian entities (Department of the Treasury, 2020:6). A resident company, for Australian tax law purposes, is defined similarly to the UK tax law and means any company that meets either of the following criteria: The first criterion requires that the company be incorporated in Australia; and the second criterion is that the company should conduct business in Australia and either have its main management and control in Australia or have its voting power controlled by shareholders who are Australian residents. The Income Tax Assessment Act 27 of 1936 defines a non-resident, for Australian tax purposes, as a person who is not a resident of Australia.

From the above definitions, it can therefore be deduced that a non-resident company in Australian tax law means any company that is not incorporated in Australia or any company that does not carry on business in Australia, does not have its central management and control in Australia and is not controlled through voting power by shareholders who are Australian residents. It can further be deduced that the determination of whether a company is a non-resident is highly dependent on the geographical location and the physical presence of the specific company, which has made it a challenge to determine where companies operate in a digital environment. This challenge was noted by the Australian government (Department of the Treasury, 2018: para 2.2) as a consequence of digital businesses that have significantly increased their global reach and often operate in multiple countries with no physical presence. It follows that the South African CFC issues emerging from the foreign company definition, as discussed in section 3.3.1 of this paper, are also likely to apply in determining whether a company is a non-resident company for the purposes of Australian CFC rules.

4.3.2 Control

The Australian CFC rules use three tests, namely the strict control test, the assumed control test and the de facto control test, to determine whether a foreign company is controlled (Department of the Treasury, 2020:12). It is worth noting that only one of the three tests need be satisfied for a foreign company to be regarded as controlled. In terms of the strict control test, a foreign company will be treated as controlled if there is a group of five or less Australian entities who either own or qualify to purchase a controlling share of at least 50% in the foreign company. The group of Australian entities considered in the strict control test should hold a share of at least 1% in the foreign company. A foreign company will be considered to be controlled in terms of the assumed control test if a single Australian entity owns or is entitled to purchase at least 40% controlling share in the foreign company and no other unrelated group controls that foreign

company (Deloitte, 2017a:17). Under the de facto control test, a company will be treated as controlled if five or less Australian entities effectively control the foreign company.

A common factor in the Australian control tests is that there must be a clear identification of existing and potential entities that have an interest in the foreign company. This identification would require detailed analysis of arrangements between the foreign company and the entities. The anonymity of users, coupled with the global reach resulting from the digital environment, would remain a challenge for applying all the three control tests contained in the Australian CFC rules. In addition, it should be determined whether or not the said entities are Australian, which is largely based on the geographical location. It follows that the issues emerging from determining the geographical location, as discussed in Chapter 3, would possibly remain a challenge in determining whether an entity is an Australian entity.

4.3.3 Exemptions

Australian CFC rules are designed to specifically target passive income, income from sales transactions between the CFC and related entities (hereafter referred to as *tainted sales income*), and income from services provided to Australia (hereafter referred to as *tainted services income*). The Australian CFC rules exclude genuine businesses from the application of the CFC rules by applying the active business test (Deloitte, 2017a:17). A CFC must satisfy five conditions in order to pass the active business income test and thereby be exempt from applying the CFC rules. Before a discussion of the five conditions is entered into, it should be noted that all five of the conditions need to be met for the test to be passed.

The first condition is that the CFC must be a resident of a foreign country. The challenges relating to determining whether a company is a resident of a foreign country according to Australian tax law have already been discussed in detail.

The second condition is that the CFC has to carry on business through a permanent establishment in its country of residence. A permanent establishment was defined in section 6 of the Income Tax Assessment Act 27 of 1936 and it includes a fixed place of business through which a CFC carries on business operations. The challenges of determining a fixed place of business arising from mobility with respect to users, business functions, intangibles and reliance on data have been discussed in sections 3.3.1 to 3.3.4 of this paper. Based on that discussion, it can be concluded that the same issues as discussed, will remain a challenge in applying the second condition of the active income test. The Australian government (Department of the Treasury, 2013: para 169-172) has acknowledged that its determination of the existence of a permanent establishment dates to a time when economic activity took place in a physical location and needs to be modified for the changing digital environment.

The third condition of the active income test is that the CFC must have kept proper accounting records; and the fourth condition is that the CFC should be able to substantiate that it has met the active income test (Department of the Treasury, 2020:33). According to the OECD (2004: para 19), both these conditions pose an administrative challenge in the e-commerce environment as businesses trade on a global scale, spread across multiple jurisdictions, and are therefore subject to different regulatory requirements in each jurisdiction. Increased opportunities to centralise functions created by improved technologies have also made it common for records relating to transactions in a particular jurisdiction to be held outside that jurisdiction. Traditional barriers to international cooperation, including the strict secrecy laws adopted by many tax havens, can create significant administration and enforcement problems (Pinto, 2009:58).

The last condition of the active income test is that the tainted income of the CFC should be less than 5% of the gross turnover of the CFC. The tainted income referred to in this condition is broad and includes passive income, tainted services income and tainted sales income (Hall & Wilcox, 2019:22). It can be concluded that characterisation issues resulting from converting tangible goods into digital/intangible goods discussed in section 3.3.3 of this paper remain in the application of the Australian CFC rules. The rationale behind this conclusion relates to the fact that the tainted income ratio test relies significantly on the character of the income generated, which has proven to be a challenge because of the difficulties in determining where businesses trade electronically. An example of the characterisation issues that can arise where the tainted income ratio test has to be applied is whether certain fees paid by customers could be considered to be royalties and therefore classified as passive income.

According to Pinto (2009:58), the effective application and enforcement of CFC rules depend on the ability of tax authorities to locate activities and gather information regarding the income of foreign companies.

In summary, the above discussion on the design of Australia's CFC rules has identified issues that result in challenges in locating activities and gathering information in the e-commerce environment.

4.3.4 Australia's response to CFC issues identified in e-commerce businesses

In 2013, the Australian treasury noted in a scoping paper (Department of the Treasury, 2013:3) that, while acting within the law, several multinationals were taking advantage of dated international tax laws to reduce the taxation contribution they made to the countries in which they operated. The paper observed that developments in the digital economy meant that transactions and business functions that previously relied on physical location could now be undertaken anywhere (Department of the Treasury, 2013: para 54). The scoping paper proposed exploring the option of changing the tax rules to rely on economic activity rather than on physical presence

(Department of the Treasury, 2013: para 172). The Australian government did not commit to any action on the issues identified in the scoping paper but did point out that the taxation issues stemming from e-commerce businesses could not be resolved by a single country acting on its own but would require effective multilateral action (Department of the Treasury, 2013: para 172).

In 2018, a discussion paper (Department of the Treasury, 2018) was released by the Australian government, where it was considered if and how the corporate tax rules should be developed to tackle electronic business models. The discussion paper highlighted the necessity to consider which businesses benefited most from user interaction, avoiding taxation overburden and complexity while reducing the impact on small businesses. Most importantly, the discussion paper questioned whether Australia should pursue interim options to address the effect of digitalisation on the international tax system.

In 2019, the Australian treasurer announced in a press release that the country would not proceed with the digital services tax as an interim measure to address the challenges arising from e-commerce business (Department of the Treasury, 2019). The treasurer confirmed Australia's continued commitment to possible multilateral solutions aimed at addressing the tax challenges posed by the digital economy.

In addressing the issues relating to the existence of a permanent establishment, which was important in applying the active income test, the Australian government introduced the multinational anti-avoidance law (hereafter referred to as MAAL) from 1 January 2016 (PWC, 2016:35). The MAAL was introduced to ensure that companies are subject to taxation in Australia if they make sales in Australia and divert that revenue offshore (Department of the Treasury, 2015).

As a further response to e-commerce issues that pose opportunities for tax avoidance, a penalty tax rate of 40%, referred to as *diverted profits tax*, was introduced from 1 July 2017 on entities that diverted their profits outside Australia. The diverted profits tax was designed with the intention to ensure that the tax paid by MNE's reflects the economic substance of their activities in Australia; and to prevent the diversion of profits to foreign jurisdictions through arrangements involving connected parties (Department of the Treasury, 2018: para 3.2). The objective of the Australian CFC regime is to tax certain income earned by foreign companies controlled by Australian residents. It can therefore be concluded that the diverted profits tax addresses certain related-party income-earning activities that may not be captured by the Australian CFC rules.

4.4 Germany's design of CFC rules

4.4.1 Foreign company

Under the German CFC regime, a CFC is a foreign company where more than 50% of its capital or voting rights are, either directly or indirectly, held by German residents (Duenas, 2020). A foreign company in German tax law is any company with a registered office and place of effective management and control in a foreign country (Lampert *et al.*, 2013:22). This definition of a foreign company indicates that a fixed place with a permanent structure is required to conclude that a company has a registered office in a foreign country. The same can be said for the *place of effective management*, which is largely dependent on the geographical location.

E-commerce enables the effortless manipulation of the principle of *place of effective management* as this principle was developed in an era where physical presence in a jurisdiction was necessary and where international transactions involved tangible products. Due to improved telecommunications, senior managers of a company may take up conferencing through the internet as their main channel for making management and commercial decisions. A board of directors may also arrange to meet in different places throughout the year to make these management and business decisions. These managers may be in various countries and it may be a challenge that is applicable to German tax law to determine a single place where the key commercial and management decisions are made (Oguttu, 2015:519).

4.4.2 Control

A CFC is considered to be controlled if German residents hold more than 50% of the shares or voting rights in a foreign company. The share ownership in the foreign company of all German residents, regardless of whether they are related, is added together and, if it exceeds 50%, the foreign company is controlled (Weiss, 2015:440). A lower ownership percentage of 1% or less applies where the CFC almost exclusively earns passive income. If the foreign company does not have any capital or voting rights, the proportion of ownership interest in the assets of the foreign company will be used in deciding control (Wenzel, 2019:33). Voting rights, shares and ownership interest held through another company are also considered in establishing whether a foreign company is controlled. According to Wenzel (2019:34), the anonymity of users in the digital environment often makes it difficult for minority shareholders to determine whether the control level is met.

4.4.3 Exemptions

The German CFC rules apply if two conditions are met. First, the CFC must generate passive income; and second, the passive income generated is subject to an effective income tax charge of less than 25% of the German tax charge (Duenas, 2019a: 22). The two conditions must be met

simultaneously for the CFC rules to apply (Weiss, 2015:440). German law differentiates between active income and passive income through an exhaustive list of the type of income that is considered to be active income. Any income of the CFC that cannot be allocated to one or more of the income types in the list is regarded as passive income. The German Federal Ministry of Finance views active income as income that does not lead to adverse tax consequences; hence, it is necessary, according to the rules, to make the distinction between active and passive income (Weiss, 2015:440).

The list providing the types of income that are active is said to exclude new business models, resulting from improved technologies, as it is not regularly updated. Wenzel (2019:129) explains that the classification of digital transactions, such as data analytics (analysis of customer data to improve marketing, sales, pricing, production), digital distribution and 3D printing, is difficult under the German CFC rules. The classification of CFC income as active or passive is cumbersome and subject to legal uncertainty because these digital transactions have to be classified on a case-by-case basis. It follows that the characterisation issues identified and discussed in section 3.4.5 of this paper are likely to be applicable to the German CFC rules. Under German tax law, these issues are exacerbated where income from services, which is generally classified as active income, can be reclassified as passive income (Albena, 2012:9).

Income from services, according to the German tax law, is generally regarded as active income but may be reclassified as passive income if the CFC carries out its activities with the assistance of a German related company and does not have sufficient economic substance to carry out its activities on its own (Deloitte, 2017b:19). The sufficient economic substance will be demonstrated if the foreign company maintains commercially equipped offices for performing the said services, takes part in general commerce and performs the work included in its services without the participation of a German resident taxpayer or any related party (Deichmann, 2009:16). The first issue that can be noted from the above discussion on the classification of income from services can be linked to the discussion in section 3.4.5.1 of this paper, where it was noted that the development of new digital products or means of delivering services has uncertainties regarding the proper classification or characterisation of payments made. The second issue noted relates to the *sufficient economic substance* test which similar to the South African foreign business establishment definition and refers to fixed structures (offices) that are not necessarily prerequisites for digital businesses to carry out their core activities.

The CFC rules do not apply if the CFC is based inside the European Union or European Economic Area and a German taxpayer can prove that the CFC pursues genuine economic activities. This exception stems from the principle established in the Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue case to allow businesses to be established anywhere so long as they are not artificial (Lampert *et al.*, 2013:25). A CFC that is

based inside the European Union or European Economic Area satisfies the genuine economic activities test if the taxpayer can prove that the CFC has its registered office or place of effective management or control in a member state of the European Union or European Economic Area. According to Albena (2012:11), several criteria must be taken into account when a taxpayer provides evidence of genuine economic activity, and the significant criteria include the presence of a fixed establishment set up for an indefinite period in the foreign state, the employment of adequate management and the presence of skilled personnel.

As the digital economy has led to innovative business models that can thrive in an environment where personnel and management perform their functions in centralised remote areas, it has increased the flexibility of businesses to choose where substantial business activities take place. These business activities may be spread across multiple jurisdictions and it may be a challenge for the German taxpayer to prove or pinpoint an exact location where these activities take place. It is also worth noting that, where the CFC's business activities are carried out with the assistance of a related party, the German taxpayer should also prove that the CFC is involved in value-adding activities. From an administrative point of view, because the resident taxpayer must obtain the information to prove genuine economic activities, it may be impossible for minority German shareholders to obtain the required information (Wenzel, 2019:143).

In terms of the second condition for the application of the German CFC rules, where the passive income generated by the CFC must be subject to an effective income tax charge of less than 25% of the German tax charge, this may be an administrative overburden on German taxpayers. The overburden is as a consequence of the information that the taxpayer needs to gather to calculate the effective tax rate. It must be noted, however, that this challenge is not specifically related to digital business (Duenas, 2019a:22).

The German CFC rules have a de minimis threshold to exclude companies that generate low passive income as a consequence of their active business activities. In terms of the de minimis threshold, the German CFC rules do not apply where the passive income of a single CFC or German taxpayer does not exceed 80 000 euros and does not exceed 10% of the CFC's overall gross turnover (Deichmann, 2009:27). The de minimis threshold is designed to ensure that companies with an overall active character are not subject to CFC taxation (Wenzel, 2019:73). A CFC may still be subject to CFC rules if the threshold is exceeded by adding up all a German taxpayer's shareholdings in several CFCs (OECD, 2015b: para 46). The challenge with the design of this exemption/exclusion for e-commerce businesses lies with the distinction of income into passive and active income, as already discussed above. As a result, it may be a challenge for German taxpayers to determine whether the threshold of 80 000 euros or 10% has been exceeded. Another challenge that has been discussed lies in how taxpayers determine whether the foreign companies they have an ownership interest in are CFCs according to German tax law.

4.4.4 Germany's response to CFC issues identified in e-commerce businesses

In September 2018, the Advisory Board to the German Federal Ministry of Finance (2018:2) cautioned against proposals by the European Union to introduce a digital services tax as an interim measure. The Advisory Board explained that the proposed interim tax had a risk of unintended double taxation and reduced flexibility of businesses. The German government has committed itself to an up-to-date redesign of CFC taxation (Brauninger, 2018:9). The Advisory Board to the German Federal Ministry of Finance (2018:2) also proposed that unilateral international measures be prioritised.

4.5 Responses by international bodies

International organisations play a significant role in international tax policy and, therefore, the responses to e-commerce issues by the OECD, the United Nations and the European Union as leading international bodies are discussed next.

4.5.1 OECD

In 2015, the OECD released Action Plan 1 to address the challenges of the digital economy. In this action plan, the OECD noted that it would be difficult to ring-fence the digital economy from the rest of the economy for tax purposes (OECD, 2015a:11). The action plan (OECD, 2015a: para 7.6) outlined several options to tackle the tax challenges posed by the digital economy, as outlined in Chapter 3 of this paper. The said options included the development of new rules relating to establishing a connection between companies and specific jurisdiction based on the concept of significant economic presence, including the determination of income attribution once significant economic presence has been established, a withholding tax on digital transactions and the introduction of the equalisation levy.

An agreement with regard to the adoption of the above options could not be reached by the OECD member countries, but it was agreed that further work on the options should be performed. The continued work resulted in an interim report in 2018, which analysed the business models of the digital businesses and their relevance in the international income tax system, and provided some proposals (OECD, 2019b: para 05). Again, no agreement on the results of the analysis in the interim report could be reached; however, a further commitment to continued work to produce a final report in 2020, with an update in 2019, was made by the members (OECD, 2019b: para 06).

In 2019, through a policy note (OECD, 2019a: para 1.2), the proposals from the interim report above were grouped into two pillars, namely pillar one and pillar two. Pillar one focused on the allocation of taxing rights, seeking to undertake a coherent and concurrent review of the profit allocation and nexus rules (OECD, 2019b: para 07). The OECD is currently involved in a programme of work on pillar one to specifically address the new profit allocation rules, the new

nexus rules and the implementation of new taxing rights (OECD, 2019b: Chapter 2). As mentioned above, the OECD seeks to agree among countries on how to appropriately tax the digital economy by the end of 2020.

4.5.2 United Nations

A subcommittee of the United Nations, named Committee of Experts on International Cooperation in Tax Matters (hereafter referred to as the United Nations subcommittee), was formed in 2017 to address the tax challenges of the digitalised economy. The United Nations subcommittee has outlined its own programme on the tax issues arising from the digital technology, which includes considering various approaches for allocating profits and the prospect of withholding taxes as a mechanism to support the new profit allocation rules. The United Nations committee is continuing work on the above areas; however, they have noted that whatever solution is proposed should be simple to administer (United Nations, 2019b: para 22–23).

4.5.3 European Union

The European Commission is the decision-making directorate of the European Union that is responsible for presenting legislation, implementing decisions, maintaining the EU treaties and managing the day-to-day business of the EU. On 21 March 2018, the European Commission made two proposals to ensure that digital business activities are taxed in a fair and growth-friendly way in the European Union. The first proposal sets out the Commission's preferred permanent solution to taxing digital businesses by laying down the rules for establishing a taxable nexus for digital businesses; and laying down the principles for attributing the profits of a digital business to satisfy the new criteria for establishing a taxable nexus (European Commission, 2018a:02). According to Bunn (2018), this proposal is the Commission's preferred permanent solution for taxing digital businesses.

The second proposal is an interim solution aimed at addressing the problem that current corporate tax rules are inadequate for the digital economy (European Commission, 2018b:03) as the first proposal above would require some time to address the issue. The Commission proposed the introduction of a tax on revenue at a rate of 3%, which was referred to as the *digital services tax* (Bunn, 2018). The digital services tax targets revenue stemming from the supply of certain digital services, specifically, according to the Commission, revenue generated from activities where users play a major role in value creation (European Commission, 2018b:04). The council of the European Union has not reached an agreement in terms of the digital services tax to date; however, a number of European Union member countries have introduced national interim solutions (Geringer, 2020:04).

4.6 Conclusion

This chapter aimed to gain an understanding of how international tax organisations and the governments of other countries have responded to the taxation of e-commerce particularly in relation to CFC rules. This understanding was achieved through an analysis of the design of CFC rules of Germany, Australia, and UK as well as an analysis of these countries responses to CFC challenges resulting from e-commerce. A common trend in the discussion relating to the determination of whether a company is a foreign company across the three countries is that the challenges are mainly attributable to determining the geographical location of a company. The lack of audit trail and the considerable opportunity to manipulate information contribute to the challenge of establishing whether a foreign company is controlled, and this was a trend in the discussion of the three international bodies as well.

The difference in the design of the CFC rules of the discussed countries is notable when it comes to targeted income. Germany, Australia and the UK apply different approaches to their CFC law to ensure legitimate businesses are not subject to the CFC charge. From the discussion of the UK's design of CFC rules, the approach followed is to apply the charge only to specifically targeted income by employing gateways. Instead of having to find an exemption from CFC taxation, only those profits of foreign companies that pass through a charge gateway are potentially taxable. The UK CFC rules target the CFC charge on a narrower set of circumstances and there is greater flexibility to structure operations without risk of a CFC liability, or with a liability at a much-reduced level (Wright, n.d).

Also noted as a different approach to South Africa's 'all in' approach is that the Australian CFC rules target passive and tainted income generated by businesses that are not regarded as active businesses. The German CFC rules follow a similar approach to the Australian CFC rules in terms of target income; however, they go a step further and specifically distinguish between active and passive income by providing a list of income regarded as active. From all the above responses from countries and international bodies, it can be concluded that there is a common understanding that the current tax laws are not relevant to the digital economy and require multilateral action among jurisdictions to be modified appropriately. It was also acknowledged that a significant amount of time will be required to arrive at solutions that will be widely applicable; therefore, interim solutions are necessary while widely accepted solutions are being discussed.

According to Oguttu (2015:155), the initial drafting of the CFC provisions was poorly done. On the introduction of the rules in 1997, the South African National Treasury followed an approach that was similar to the UK's previous approach in terms of defining CFC income. However, as noted in the discussion above, the UK now follows an approach that considers various aspects of the transactions and motives of taxpayers (Viviers, 2014:8). The current South African CFC regime

is in line with CFC regimes of developed European countries, many of which have softened their CFC regimes (Kraamwinkel & Grimm, 2018a:31). Based on the challenges that have been identified and the trends noted in the legislation of the countries on which the prescripts of South African CFC rules are based, it can be said that there are grounds to review the current South African CFC rules to cater for e-commerce. The need to review the CFC rules was also highlighted in the Davis Tax Committee report on addressing Action Plan 1 (2014:26).

CHAPTER 5: CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

The purpose of this study was to analyse the South African CFC rules in the context of e-commerce by discussing the background to the South African CFC rules, describing the challenges that e-commerce poses to the application of the South African CFC rules and, lastly, by gaining an understanding of international responses to e-commerce challenges in the context of CFCs. This purpose was derived from the question 'to what extent is the CFC rules in South Africa applicable in e-commerce?', and the possible options to have legitimate businesses, which may not necessarily satisfy the criteria for the exemptions provided in the current CFC rules, excluded from the CFC charge. What follows in this chapter is a summary of the research findings based on the secondary research objectives set in Chapter 1, as well as recommendations to the South African National Treasury based on the experiences of the countries in Chapter 4.

5.2 Findings

The findings that fulfil Secondary Research Objective 1: To discuss the background to the South African CFC rules and the foreign business establishment exemption, are listed below:

- It was stated in the background to this study that CFC rules were introduced into South African tax legislation as part of South Africa's shifting of its tax system from a source-based tax to a residence-based tax. The shift provided increased opportunities for resident taxpayers to defer their domestic taxation on foreign income by establishing companies in foreign territories with little or no taxation charge and diverting such foreign income to the foreign company, thereby excluding it from the South African tax net (Oguttu, 2015:134). Introduction of the CFC rules was aimed at preventing South African residents from thus deferring South African tax on foreign income generated from foreign companies.
- The definition of a foreign company, as included in section 9D(1) of the Income Tax Act 28 of 1997, is an indication that the CFC charge is aimed at taxpayers that are companies and not natural persons. It can be concluded that the wide definition of control is subject to uncertainties and, consequently, complexities where a determination of whether a foreign company is controlled needs to be made (Oguttu, 2007:509). This is further complicated by the term *indirectly held*, which is open to multiple interpretations (Singh, 2014:133). The rationale for this wide term, as noted in the Katz Commission report (Department of National Treasury, 1997: para 8.3.1.3), was to eliminate any manipulation; however, it has resulted in administrative burdens for taxpayers (Olivier & Honiball, 2008:436).
- The discussion in Chapter 2 further highlighted that, in South Africa, the CFC charge is not only aimed at the passive income of a CFC but also at the CFC's active income. However,

the application of the current CFC rules is subject to certain exemptions, mirroring the principle established in the Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue (2006) case that CFC rules are specifically targeted at wholly artificial arrangements, which do not reflect the economic reality and whose only purpose would be to obtain a tax advantage. These exemptions, such as the foreign business establishment exemption, seek to strike a fair balance between protecting the tax base and the need for MNE's to be internationally competitive.

- The foreign business establishment exemption was designed to test the substance of foreign businesses. It was noted that this substance test includes a criterion that requires the CFC to carry on its business at a fixed place for a minimum period of 12 months. This criterion was deemed to be an indicator of the business' permanence. Additionally, to prove economic substance, the said fixed place should be suitably staffed with on-site employees and managers (PWC, n.d). It can be inferred from the findings that the foreign business establishment exemption is dependent on testing whether the CFC's business can conduct its primary business operations independently.
- It was also found that, despite satisfying the criteria for a foreign business establishment, a CFC may still be subject to the CFC charge if the income it generates resulted from a transaction regarded as a diversionary transaction. From the discussion in Chapter 2, it can be concluded that the classification of a transaction as a diversionary transaction is largely dependent on the character of the income that is generated, as well as the relation of the parties involved in that transaction. The large dependence on the character of income was also identified in targeted mobile income, such as royalties and intellectual property.

The findings that fulfil Secondary Research Objective 2: To describe the challenges that e-commerce poses to South African CFC rules, are listed below:

- The findings noted from the discussion in Chapter 3 relate to the practical ability to identify whether a company is a foreign company and whether it is controlled. According to Kraamwinkel & Grimm (2018a: 30), practical experience has proven that South African CFC rules are very time-consuming for taxpayers to comply with and for the South African Revenue Service (hereafter referred to as SARS) to review. The issues related to the identification of a foreign company result from the lack of physical presence that is inherent to digital businesses. Issues related to establishing control, on the other hand, are concluded to be linked to a limited audit trail and increased opportunities to manipulate or alter the little information that may be available. The significance of this challenge is, however, likely to reduce, based on the effectiveness of country-by-country reporting measures being implemented (Kraamwinkel & Grimm, 2018a:30).

- In designing the foreign business establishment exemption (previously referred to as the *business establishment exemption*), the National Treasury followed the *exempt activities* approach that was previously followed by the UK CFC rules. The UK has subsequently eased its CFC rules by abandoning the exempt activities approach (Kraamwinkel & Grimm, 2018a:29). Despite this, South Africa's CFC rules have predominantly maintained their nature since introduction and consequently have been argued to become less flexible overtime. This is notably so in relation to satisfying the foreign business establishment rule which, as concluded from the discussion in Chapter 2, is largely based on geographical location and the character of the income generated.
- In conclusion, because many countries have eliminated or relaxed their exchange control regulations over the years, and information communication technology has improved, South African companies operate across borders through businesses that pose little risk of circumventing South African tax. Improved information communication technology has brought about new business models that may not have the prescribed local permanence or economic substance as per the current foreign business establishment exemption but still manage to carry out their primary business operations. The current CFC rules have not been developed to consider the new ways in which business is conducted (PWC, n.d).

The findings that fulfil Secondary Research Objective 3: To gain an understanding of international responses to e-commerce within the context of CFCs, are listed below:

- Certain challenges prevail relating to establishing whether a company is a foreign company and if it is controlled. In the context of a foreign company, the principles among the UK, Australia and Germany are, to a large extent, based on geographical location, which has been established to have insignificant relevance in e-commerce environments. In the context of the establishment of control, the challenge relating to obtaining reliable information relevant to make this determination also remains prevalent; however, there might be an ongoing solution to address this challenge stemming from the outcome of international implementation of country-by-country reporting requirements.
- As a result of the approaches followed in the design of their rules, other countries face fewer challenges relating to income subject to the CFC charge than South Africa does. It was noted that South Africa targets all income of the CFC (after allowing for exemptions and net of expenses), while the UK, German and Australian CFC rules target specific income. The approaches followed by these countries can be said to reduce the administrative burden on taxpayers and on the administration of taxation in this regard. In analysing the three countries' approaches to determining the income subject to the CFC charge, the character of the income generated by the CFC can be concluded to be of significance.

- A common exemption from the application of the CFC charge among the UK, Australia and German relates to CFCs with genuine commercial activities. It was noted that the three countries rely heavily on geographical location and the establishment of physical presence in a country to make the determination of whether genuine business activities are carried on by a CFC. Consequently, the challenges relating to establishing a geographical location and establishing physical presence remain prevalent in the application of these countries' CFC rules. In conclusion, the responses by international bodies, as noted in Chapter 4, are an indication that there is a need to respond to the challenges that e-commerce poses to the CFC rules. The proposals provided by the international bodies for addressing the challenges identified have been considered in making the recommendations below.
- In summary, the discussion on the background to the CFC rules revealed that South African CFC rules were designed to address anti-avoidance by companies with traditional business models that are not as global as new business models. This was evidenced by the challenges that e-commerce poses to the application of the current South African CFC rules. It was further found that the challenges identified are not unique to South Africa; however, they are minimised in other countries. It is for this reason that the final part of this paper looks into recommendations to assist in addressing the challenges identified.

5.3 Recommendations

The way business is conducted continuously changes as a result of improved information communication technology, which necessitates the revision of tax legislation (Viviers, 2014:28). According to Zondo (2017:56), challenges from e-commerce and the obligation to protect the South African tax base were recognised initially in 1997 by the Katz Commission, which acknowledged the required protection of the South African tax base. Despite this, it has been reasoned that South Africa's CFC laws have not entirely maintained momentum with the pace of globalisation and technology (PWC, n.d). The CFC rules have been argued to be largely preventative in nature since taxpayers see themselves as better off arranging their affairs in order to avoid application of the rules, which may limit international competitiveness (Oguttu, 2015:155).

The current South African CFC system is complex and unclear in certain respects and, therefore, hinders tax certainty (Kraamwinkel & Grimm, 2018a:31). The current costs of compliance may be a substantial disincentive for small companies with international operations because these companies must invest a lot in the process of attempting to comply with the CFC rules (Oguttu, 2015:156). On the other hand, it is acknowledged that South Africa's involvement in international trade has exposed tax avoidance schemes that are not captured by the current rules. According to Potgieter (2012:15), it is in the best interests of the country to limit the negative impact of anti-avoidance provisions relating to investments undertaken to the benefit of the country. *It is*

therefore recommended that the current CFC rules be modified with the aim of striking a balance between the costs of compliance and the ease of application.

The general approach followed by the selected developed countries is to target specific income of a CFC by applying facts and circumstances relating to the transactions and motives of taxpayers. South African CFC rules, on the other hand, target all income of a CFC and then apply certain exemptions to exclude income deemed not to pose a risk of erosion. This approach followed by the South African CFC levels can be concluded to be the first layer of the challenges identified because it adds complexities to the application of the rules, and this challenge is not only unique to South Africa. Care should be taken to ensure that the rules are not so rigid that they hinder legitimate businesses.

The second layer of the challenges identified from the South African approach relates to the exemptions from the application of the South African CFC rules. As noted in the findings, the main difference in South Africa's CFC legislation compared to other countries lies in the exemptions from the CFC charge. The foreign business establishment has been noted to be the most important exemption to the CFC rules. The challenges relating to the foreign business establishment exemption are mostly that they do not cater for e-commerce businesses. In this context, *it is recommended that the current rules be revisited to address digital businesses that have genuine commercial activities abroad and that, if possible, an alternative regime be sought for this purpose.*

As possible options for addressing this, *the current 'all-in-unless-out' approach of net income should be withdrawn, and only specific income of the CFC should be targeted. The UK's CFC rules could be used as a precedent in this regard. The foreign business establishment criteria should be modified to include digital businesses that have a significant digital presence. The recommendations provided by the OECD (2014c: para 8.2.1.2) to include a set criterion intended for businesses that require a minimal physical presence in a jurisdiction to perform their core business activities should be explored further.*

It is recommended that South Africa work together with developed and developing countries to develop legislation that is feasible and closes the loopholes created by new business models resulting from improved technology. Care should be taken in working with these developed and developing countries to take into consideration South Africa's economic circumstances (SARS, 2003:7).

5.4 Suggestions for future research

The continuous evolution of information communication technology is likely to result in a need for extending the evaluation of the South African CFC rules as presented in this paper. The scope of

this study was limited to direct taxation and it may be worthwhile to evaluate the effect the digital economy has on value added tax in a South African context. This study can further be expanded by investigation of the effect of double tax agreements on the challenges e-commerce poses to CFC rules. Another area which may be subject to further research investigation is the impact of country by country reporting implemented to date on the challenges posed by e-commerce to CFC rules.

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