

An analysis of the South African income tax treatment of interests in loop structures

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ABSTRACT

The overall purpose of the South Africa's exchange control regulations is to regulate the outflow of capital from the country and to protect the domestic economy from capital movement. Historically exchange controls have been applied as part of the policy armoury to counter various base erosion and profit shifting (BEPS) arrangements including loop structures. Loop structures pose a risk to the South African tax base as they present an opportunity for abusive tax planning as they can be used as a vehicle to facilitate the avoidance or deferral of taxation by accumulating income abroad.

Over the last two decades trends towards globalisation and economic liberalisation, have necessitated the phasing out of exchange controls. The recent shift to a capital flow management framework, coupled with National Treasury's aims of attracting foreign direct investment (FDI), and promoting international competition have culminated in lifting of exchange control restrictions on loop structures. The lifting of these restrictions were accompanied by amendments to the ITA aimed at protecting the tax base by refining the tax treatment of capital flows and to restrict the artificial reduction of dividends and capital gains tax where a foreign company is used in a loop structure to avoid or defer tax.

The aim of this study was to analyse the principles that underpin the controlled foreign company (CFC) regime both globally and in South Africa to determine the appropriateness of the recent changes to CFC rules as contemplated in section 9D and paragraph 64B of the Income Tax Act as it relates to loop structures to ensure they are accommodating to investors investing back into South Africa on the one hand and still protect the South African tax base efficiently on the other hand.

This study revealed that National Treasury did not target all loop structures, but only those where South African shareholders interpose a CFC between themselves and their interests in South Africa. Based on the analysis performed it was determined that the amendments appear to be effective as an anti-tax avoidance measure where a CFC forms part of a loop structure, which is its main purpose. However, the amendments do have wider implications for South African shareholders of a CFC that holds South African interests and would in particular instances go beyond its purpose as an anti-tax avoidance measure.

It was revealed that the amendments were introduced to ensure that, where South African residents implement loop structures, the tax treatment of the South African interest held via the loop structure would be the same as the tax treatment that would have applied, if the South African resident directly held those interests. This study indicates that when the impact of the

amendments is considered, the principle of equity and neutrality is not achieved with all loop structures. International competitiveness is vital to attract FDI, and the amendments should not inadvertently hinder otherwise legitimate commercially driven transactions, nor should it cause problems for the meaningful protection of the fiscus.

Keywords: Loop structures, controlled foreign company, CFC, CFC rules, South African Reserve Bank, SARB, exchange control regulations, exchange control, cross-border

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 |
| CMA | common monetary area |
| Excon | exchange control |
| FDI | foreign direct investment |
| FinSurv | Financial Surveillance Department |
| IFRS | International Financial Reporting Standards |
| ITA | Income Tax Act 58 of 1962 |
| MNE's | multinational enterprises |
| NDP | South Africa's National Development Plan |
| OECD | Organisation for Economic Co-operation and Development |
| SARB | South African Reserve Bank |
| SARS | South African Revenue Service |
| South Africa | Republic of South Africa |
| TLAB | Taxation Laws Amendment Bill |
| VDP | voluntary disclosure programme |

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CHAPTER 1 INTRODUCTION

1.1. Background to the research area

In the case *South African Reserve Bank and Another v Shuttleworth* (2015) Moseneke J explained that during the Great Depression in the 1930s, South Africa's currency and economic conditions were on a downward trajectory, and amidst the depression South African authorities were concerned about the decline of direct foreign investment and significant capital outflows from the country. As a result, measures were sought to avoid a complete economic collapse in South Africa and in 1933 the Currency and Exchanges Act 9 of 1933 was passed by Parliament in order to protect foreign currency reserve and exchange rate fluctuations (Valodia, 2019:3).

In 1960, after the Sharpeville shooting, the threat of economic recession emerged again and in 1961 the Exchange Control Regulations were promulgated under the Currency and Exchanges Act 9 of 1933 (*South African Reserve Bank and Another v Shuttleworth*, 2015).

In practice, the exchange control regulations place restrictions on persons (natural and juristic) externalising capital abroad, whilst also affecting the flow of funds into South Africa (Valodia, 2019:3). Regulation 10(1)(c) specifically provides that:

No person shall, except with permission granted by the Treasury or by an authorised dealer and in accordance with such conditions as the Treasury or the authorised dealer may impose enter into any transaction whereby capital or any right to capital is directly or indirectly exported from the Republic.

The regulation effectively restricted (subject to certain exceptions) the formation of loop structures (Bagraim, 2021). According to Olivier and Honiball (2011:734) a loop structure is typically created when a South African resident person (whether natural or juristic) enters into a transaction or a series of transactions whereby capital or any right in capital are directly or indirectly exported from South Africa which have the effect of directly or indirectly exporting capital or any right to capital from South Africa. This is typically achieved using an offshore structure. The offshore structure would then reinvest the funds back into a Common Monetary Area (CMA) country, i.e. eSwatini, Lesotho, Namibia and South Africa, thereby creating a loop structure (Olivier & Honiball, 2011:734).

The reinvestment into South Africa could be through shares, a loan, or an interest in a South African asset or company (Department of National Treasury, 2021a:36). In some instances, the South African resident would then export returns on the investment by way of, for example, the payment of dividends, profits, interest and/or loans to the offshore structure (Department of National Treasury, 2021a:36). In this regard, using a loop structure would result in the accumulation of returns on South African investments in the offshore structure over and above the initial capital invested in that structure (Department of National Treasury, 2021a:36).

The Financial Surveillance Department (FinSurv) of the South African Reserve Bank (SARB) generally regarded these types of transactions as a risk because it could potentially result in the direct or indirect export of capital abroad to an offshore structure to the benefit of a South African resident (Department of National Treasury, 2021a:36). At face value, loop structures posed a risk to the South African tax base as it created abusive tax planning opportunities, specifically as regards to dividends tax and capital gains tax (CGT) (McLeod & Wessels, 2021). As a result, these loop structures were only permitted by the SARB in limited circumstances (Department of National Treasury, 2020a:137). Consequently, there was no need to adopt appropriate tax legislation or anti-avoidance measures to curb potential abusive tax planning opportunities using a loop structure.

The election of a new Government in 1994, and the subsequent relaxation of South Africa's exchange control regulations expedited the reintegration of South African businesses into the global economy and provided South African residents with access to offshore investment and business operations previously unavailable due to restrictions and sanctions (Katz Commission, 1997:par. 2.2.1). However, the South African Revenue authorities (SARS) expressed concerns that the combination of increased offshore access and relaxed exchange controls could result in the erosion of the South African tax base (Holliday, 2020:1). Effectively taxpayers could devise ways to undermine the South African tax base by deferring or reducing their South African tax liabilities by either rerouting passive income through an offshore structure or by accumulating income (and thus deferring tax) in an offshore structure (Katz Commission, 1997:par. 8.1.1). To prevent this, South Africa required new rules that would protect its tax base whilst it remained competitive on the international stage. This necessitated a new set of rules to balance the country's need to remain competitive on the international stage with its need to protect the tax base (Holliday, 2020:20). As a result, the South African tax system moved from a source-based to a residence-based system on 1 March 2001 to bring it more in line with international tax principles (Department of National Treasury, 2000:1). The effect of this is that South African residents are subject to normal tax on their worldwide income (Department of National Treasury, 2000:1).

A principal element of the residence-based tax system is the ability to regulate income earned by South African-owned companies and other foreign entities of a similar nature (Department of National Treasury, 2002:1). The Katz Commission recommended the introduction of the controlled foreign company (CFC) rules as an anti-avoidance measure to prevent the shifting of passive income from CFCs that were excluded on the introduction of the residence-based tax system (Katz Commission, 1997:par. 8.3.1.1). In 2001 comprehensive CFC rules were introduced by which a CFCs net income (subject to applicable exemptions) would be taxed. (Singh, 2014:352).

However, over the last couple of years, the SARB has relaxed the restrictions on loop structures many times. On 21 February 2018, the SARB (2018:1) announced that South African companies would be permitted to acquire up to 40% in aggregate of the equity shares and/or voting rights in a foreign entity which reinvests into a CMA country. Following this relaxation, prior Finsurv approval was only required on structures which exceeded the 40% limit. On 31 October 2019, a similar dispensation was granted to South African resident individuals (SARB, 2019:1).

In line with the SARB undertaking to implement a new capital flow management system, the SARB issued Exchange Control Circular No.1/2021, which announced that all restrictions on loop structures of South African tax resident companies, individuals, and private equity funds would be lifted in its entirety, effective 1 January 2021 (SARB, 2021:1).

In its 2020 Budget Review, National Treasury acknowledged that one of the purposes of the exchange control restrictions relating to loop structures was to protect the tax base and that with the relaxation of exchange control restrictions tax planning opportunities may arise (Department National Treasury, 2020a:137). According to the National Treasury (2020a:137), in the absence of loop structure restrictions or other appropriate legislation, it would in theory be possible to implement a structure where a CFC owns a South African company, with any dividends flowing from that South African company to a resident natural person through the CFC being exempt in the hands of the resident natural person or trust. Using this structure, South African resident natural person or trusts could thus reduce their dividend tax liability from the standard rate of 20 percent to a reduced rate, or in some instances to zero percent depending on the relevant double taxation agreement (Department of National Treasury, 2020a:137). Furthermore, a South African resident could also qualify for the capital gains tax participation exemption if the resident disposed of shares in a CFC that owned South African assets (Department of National Treasury, 2020a:137).

In the wake of the relaxation of loop structures, it was necessary to introduce new rules to protect the tax base where loop structures were involved while balancing the country's need to remain competitive on the international stage. As a result, amendments were proposed to certain sections of the Income Tax Act 58 of 1962 (ITA).

Considering that if the focus of the tax amendments is to reduce the potential negative effect of loop structures on the South African tax base, it would be expected that the tax legislation that was introduced to ensure that where a South African resident implement a loop structure, the tax treatment of the South African interest held via the loop structure would be the same as the tax treatment that would have applied, had the South African resident held the interest directly (Berger, 2021).

However, it seems as if these amendments have been targeted specifically at CFCs making inward investments into South Africa. These proposed amendments have been enacted as part of the Taxation Laws Amendment Act 23 of 2020 (TLAB) and came into effect on 1 January 2021 (Department of National Treasury, 2021b). The changes affect the dividend exemption enjoyed by CFCs as well as the disposal of shares in a CFC to a non-resident third party.

1.2. Literature review of the topic

The literature review was guided by the research problem statement and provided the basic direction for this study. The review was structured to first consider studies that address the evolution of exchange control and the impact the relaxation of exchange control regulations will have on South Africa and its tax base. Thereafter studies that address the global and South African CFC regime and in particular section 9D of the ITA were considered.

1.2.1. Exchange control

Historically South Africa's strict exchange control regime has prevented profits from being shifted abroad, thereby limiting South Africa's appeal as an investment destination for foreign investors (Schutte & Loots, 2002:684). The relaxation of exchange control creates opportunities for investment, however the process, timing, and the approach followed to achieve the liberalisation is paramount and, if not managed well, is likely to cause harm, especially in emerging economies like South Africa (Singh, 2007:2). The Katz Commission (1997:par. 3.1.7.1) believe that exchange control should be determined independently of its tax consequences, meaning that the tax system should be able to protect its tax base independently without reliance on the exchange control regime.

As Singh (2007:3) pointed out one of the main reasons for exchange controls is the protection of emerging economies against capital flight. While it does offer some protection in this regard, it conversely presents obstacles to direct foreign investments, which hampers the growth of businesses with legitimate offshore interests, dissuade inward listings on the Johannesburg Stock Exchange, and act as an obstacle to Black Economic Empowerment (BEE) entities by preventing the ownership of shares in foreign-listed companies with South African assets. Singh (2007:94) concludes that all exchange controls should be phased out in a gradual manner.

Exchange control in South Africa has transformed since its inception, specifically in recent years where a gradual relaxation of exchange control regulations have been observed (Valodia, 2019:43). In her study Valodia (2019) critically analysed exchange control in a South African context. Exchange control and tax are not mutually exclusive but works together, and exchange control has played a big part in tax collection by SARS (Valodia, 2019:23). In support of the view

that exchange control and tax are connected, there are several influential case law which addresses both exchange control and tax matters in South Africa (Valodia, 2019:23). Consequently, the relaxation and abolishment of South Africa's exchange control regulations is likely to have an impact on the domestic tax system and potentially affect the tax base and related tax collection by SARS (Valodia, 2019:24). One of these relaxations, as explained in paragraph 1.1, is the abolishment of the loop structure restrictions.

Although her study addressed the significance of exchange control in South Africa and the potential consequences of repealing the regulations, including the implications on the collection of taxes by SARS, it had a broader focus and considered the South African exchange control regime in its' totality. While this study considers the evolution of exchange control, it focusses primarily on the evolution of the relaxation of the loop structure restrictions and subsequent changes to tax legislation adopted to curb potential abusive tax planning opportunities using a loop structure.

1.2.2. CFC rules

Globalisation has increased at an exponential rate over the years (OECD, 2013:7). As a result, the volume of cross-border trade and investments has grown significantly which required the introduction of CFC rules in the tax legislation of many countries, including South Africa (De Abreu, 2010:2). Since the adoption of CFC rules into South African tax legislation there has been several amendments to these rules, some of them material (De Abreu, 2010:2). The South African CFC rules have developed into one of the more advanced and complex adaptations of these rules amongst the member countries of the Group of Twenty organisation (G20) (Holliday, 2020:2). It also appears that it is largely in line with the Organisation for Economic Co-operation and Development (OECD) BEPS Action 3 recommendations (Holliday, 2020:20). It has been the subject of a vast number of research studies and articles. Consequently, a great deal of research has been conducted with literature written on several topics relating to South Africa's CFC rules. In preparation for this study relevant sections of the literature and studies were reviewed and will be addressed in further detail below.

As mentioned in the introduction paragraph, the CFC rules are aimed at tax avoidance structures. For that reason, amounts that do not present a risk for avoidance should be excluded from the net income that is to be included in the taxable income of a tax resident (Stiglingh *et al.*, 2022:872). Valid commercial structures should not be encumbered by the CFC rules as this will place South African owned commercial operations on an uncompetitive and unequal footing in the global market (Stiglingh *et al.*, 2022:872). In this process it is a fine balancing act to ensure that the scope of the CFC rules is wide enough to protect its base against erosion but that it does not influence legitimate cross-border activities (Olivier & Honiball, 2011:559). Sight should not be lost

of the relative ease with which corporations can relocate in response to changes in anti-avoidance measures and tax rates (Olivier & Honiball, 2011:559). Although National Treasury has on several occasions considered including structures involving foreign trusts in this regime, the CFC regime currently only applies to foreign companies (Swart, 2021:3).

South Africa's CFC legislation is contained in the provisions of section 9D of the ITA (De Abreu, 2010:1). Several commentators provide insight on the purpose of section 9D. For instance, Olivier and Honiball (2011:559) note that significant tax benefits may arise from earning foreign income in a separate taxpayer if there is a lack of remedial legislation and observed that in order to counter the avoidance or deferral of tax, countries aim to pull income accrued to or received by foreign companies into their tax nets .

In his study Potgieter (2012) addresses the consequences of section 9D that can be anticipated by existing and prospective South African resident investors in a CFC. Two potential measures for effectiveness of CFC rules were identified (Potgieter, 2012:1). The first measure considers to what degree tax avoidance or deferral is prevented by the rules. The second measure considers to what extent legitimate business undertakings and investments for which tax avoidance or deferral is not the primary purpose or effect are impeded by the application of the CFC rules. His study focussed primarily on the second measure and highlighted that section 9D is complex and contains several ambiguities and potential pitfalls which may introduce risk and compliance costs for resident investors and, if measured against the extent to which business is impeded and complicated, it may fall short. Although it seems that section 9D is effective in the prevention of tax avoidance it has a wider application for resident taxpayers and historically it appears as if the South African legislature has faced difficulty in its attempts to alleviate certain consequences of section 9D (Potgieter, 2012:4).

While contributing to addressing the consequences of section 9D and measuring its effectiveness, Potgieter's study was conducted in 2012 and there have been subsequent changes to this section. This study focuses on addressing the consequences of section 9D on existing and potential South African resident investors looking to invest in South Africa via a loop structure. It also measures its effectiveness against the international policy framework for CFC rules as set out in the OECD 2015 Action 3 Report.

In his study De Abreu (2010) interpreted section 9D and provided guidance on its practical application through practical examples and citations of relevant international case law, the result being a proposed interpretation note on section 9D. According to De Abreu (2010:5) South African CFC rules only contain an objective test. Whether or not the prevention of tax avoidance was the sole or one of the purposes is impertinent when section 9D is applied, even though section 9D is

fundamentally anti-avoidance legislation. Whilst his study interpreted section 9D, the interpretation was done in 2010 and the section has been amended several times since.

Singh (2014) conducted a study to assess if South Africa's CFC regulations were sufficient as domestic anti-avoidance measures and relevant in the international fiscal arena. The study's primary objective was to compare the South African CFC tax legislation to international practices as set out in the directives and advisories of the OECD and UN, and tax regimes of some of the world's leading economies, with a specific focus on the United Kingdom and United States. The study highlighted where the South African CFC tax legislation aligned with, diverged from, or fell short in comparison to the stated systems. While his study contributed to the research done in this study, the study by Singh was done in 2014, and subsequent to his study the OECD issued its 2015 Action Plan Report and various changes to South African CFC rules were implemented which were considered in this study.

The study of Holliday (2020) was also reviewed wherein she assessed the purpose of the South African CFC rules and whether the anti-tax avoidance embedded within the CFC rules could be achieved in a simpler way. Her study further assessed the extent of the adoption of the BEPS Action 3 in a South African context, and whether such adoption assists in preventing tax avoidance. Finally, the study also considered whether items addressed in BEPS Action 13 and incorporated into South African legislation overlapped with the purpose of the CFC rules and if this purpose could instead be achieved through transfer pricing and country-by-country reporting. An overlap between transfer-pricing and CFC rules was established. Holliday (2020:67) concluded that there appeared to be a simpler way to achieve the anti-avoidance purpose embodied within South Africa's existing CFC rules and deterring tax avoidance does not necessarily require complexity, but rather efficiency. Holliday (2020:68) recommends that simplicity will be achieved through relying on the transfer pricing provisions in section 31 of the ITA only and that the CFC rules should be repealed.

While her study analyses the BEPS Action 3 policy framework for CFC rules, the extent of the adoption of the BEPS Action 3 in a South African context, and whether such adoption assists in curbing tax avoidance, it also focuses on the analyses of the amendments to the CFC rules against the policy framework for CFC rules to determine its appropriateness and assesses if the aim of these amendments to curb tax avoidance by loop structures is achieved.

Other studies addressing CFC rules also reviewed were the studies of Swart (2021), Kau (2021) and Viviers (2014), but these studies were found to have limited relevance to the topic of this study. Swart (2021) addresses the South African tax treatment of interests in foreign companies held through foreign trusts. Kau (2021) addresses the South African CFC rules within the digital economy. Viviers (2014) addresses the question whether any aspects of the amended United

Kingdom CFC legislation could be incorporated in the South African CFC rules to ensure that they are more accommodating to investors on the one hand while still protect the South African tax base efficiently on the other hand.

Although other researchers have reviewed the CFC rules governed by section 9D of the Act, hardly any research has been done to analyse the tax implications for South African residents with interests in loop structures. This is primarily due to the fact that these changes were only recently introduced to legislation.

In consideration of the above, it is believed that this study would assist in understanding the consequences of the amendments to the CFC rules as it relates to loop structures in order to evaluate the appropriateness of these rules in the context of the principles that underpin CFC legislation.

1.3. Motivation of topic actuality

In the 2020 Budget Review the Minister of Finance emphasised that the exchange control restrictions were lifted as a means to encourage investment into South Africa during a time when such investment were more crucial than ever and to assist in the modernisation and improvement of the onerous SARB approval process for cross-border flows (Department of National Treasury, 2020b:153).

Although the relaxation of exchange control on loop structures is embraced by many – as it is argued that it will likely improve cross-border trade, which is expected to strengthen South Africa’s struggling economy (PKF, 2021:3) – others argue that it remains to be seen if the relaxation would have the desired effect and result in increased investment into South Africa through a loop structure (Bouwer, 2021).

There are contradictory views with regards to the abolishment of the loop structure prohibition with some hailing it as a significant relaxation, while others noted that the exchange control prohibition had simply been replaced with punitive tax laws (Horak *et al.*, 2020). Concerns were raised that the amendments go beyond the stated intention of preventing tax abuse and ensuring loop structures don’t provide a tax benefit or planning opportunity for South African residents (Bouwer, 2021) As an example, the new tax rules apply to all CFCs with investment in South African assets, irrespective of whether this was previously permissible or not (Bouwer, 2021).

As mentioned in paragraph 1.1 above, if the objective of these tax amendments is to reduce the negative impact a loop structure may have on the South African tax base, one would expect that the tax legislation that was introduced to ensure that where South African residents implement loop structures, the tax treatment of the South African assets held through the loop structure

would match the treatment that would have applied, had the South Africans owned those assets directly (Berger, 2021).

This raises the question as to whether the attempt to include a portion of any dividend received or accrued from the South African resident company in the CFC's net income in terms of a formula is enough to protect the South African tax base where a loop structure is involved. As pointed out by Swart (2021:4) earlier research studies have established that CFC rules is an important measure for any country to increase its tax net and that the absence of CFC rules may have far reaching implications for a country.

On the other hand, the result of the tax amendments appears to be one sided and not the result of a holistic approach (Brown *et al.*, 2020). Instead of balancing the scales to make sure that the fiscus is no worse off than it otherwise would have been in the absence of a loop structure, it appears that in some instances the amendments penalise loop structures by adding an additional tax burden (Brown *et al.*, 2020). According to Potgieter (2012:76) the CFC rules are essential for both the resident and non-resident investors when considering South Africa as a potential place of investment (Potgieter, 2012:76). It is important for a country to balance its need to remain internationally competitive with its obligation to protect its tax base (OECD, 2015:9). The question that should be raised is whether the new CFC rules are accommodating to investors looking to invest back into South Africa on the one hand while still protecting the South African tax base efficiently on the other hand. It is possible to deduce that, if the South African CFC rules result in unfair tax outcomes for investors looking to invest back into South Africa, then international competitiveness and cross-border trade is set at risk.

It is therefore submitted that it will be of value to identify and obtain a better understanding of the consequences of the amendments to section 9D(2A) and paragraph 64B(6) of the ITA as it relates to loop structures to consider the appropriateness of these rules and the potential impact they may have on the South African tax base, and on South African residents with interests in existing or prospective new loop structures. An understanding of such consequences is essential when making investment decisions regarding such structures, in determining the optimal corporate structures, as well as in considering how legislation might in future be improved on. When the differing views of the public is also considered, the need for this study increases and confirms that there is a possible gap in the literature.

1.4. Problem statement and research question

The dynamics of exchange control restrictions involving transactions whereby capital or any right to capital is directly or indirectly exported from South Africa (so-called loop structures) has

changed drastically since 1961 when the current exchange control regulations were first introduced.

The recent relaxation of the exchange control restrictions on loop structures and subsequent amendments to the CFC rules could result in an increased number of these structures. From the above the following problem statement can be formulated: It has become clear that the income tax consequences for South African residents with interests in loop structures have changed recently and must be analysed. It should be considered whether the amendments introduced to the ITA to address the taxation of interests in loop structures are appropriate to ensure that they are accommodating to investors investing back into South Africa on the one hand and still protect the South African tax base efficiently on the other hand.

The research question for this study can thus be stated as the following:

Are the recent amendments to the CFC rules appropriate to address the taxation of interests in loop structures in the context of the principles that underpin CFC legislation?

1.5. Research objectives

1.5.1. Main objective

The main research objective is a critical analysis of the recent amendments to the CFC rules as it relates to South African residents' interests in loop structures to determine its application and appropriateness within the context of the principles that underpin CFC legislation (theoretical research objective).

To address the main research problem, specified above, the secondary objectives set out below will be addressed as part of this research report.

1.5.2. Secondary objectives

- (i) To perform an overview of the history and evolution of exchange control with a specific focus on loop structures. This objective is addressed in detail in Chapter 2 (theoretical research objective).
- (ii) To perform an analysis of the South African CFC rules, particularly in the context of loop structures. This objective is addressed in detail in Chapter 3 (theoretical research objective).
- (iii) To perform a detailed analysis of the principles that underpin the CFC regime both globally and in South Africa to determine the appropriateness of recent changes to CFC rules as

contemplated in section 9D and paragraph 64B of the ITA as it relates to loop structures. This objective is addressed in detail in Chapter 4 (theoretical research objective).

1.5.3. Epistemology

Epistemology, or the theory of knowledge, is the study of the nature, origin and limits of human knowledge and is in particular concerned with the validation of the methods used to obtain knowledge (Ejnavarzala, 2019:94). It deals with questions such as what knowledge is, how knowledge claims are justified and what we may regard as acceptable knowledge in a discipline (Walliman, 2011:16). Epistemology focuses on determining the correct methods to seek the truth with an emphasis on the connection between the researcher and knowledge (Mulisa, 2021:120). There are two basic approaches for acquiring knowledge, namely using inductive or deductive reasoning (Walliman, 2011:16).

Researchers who base their studies on data collected from experts, academic journals and books have an epistemology grounded on authoritative knowledge (Kivunja & Kuyini, 2017:27). This study was based on current literature, local statutory laws, and case law.

1.6. Research methodology

There are various research paradigms and research methods applicable to research performed in the field of taxation. The different research paradigms and associated research methodologies, as well as their application to the research conducted was briefly considered.

1.7. Research paradigms

The concept of “paradigm” is regarded as a helpful tool for classifying methodologies (Madill & Gough, 2008:259). As indicated below, the overarching paradigm that will be followed by this study based on the research question is “interpretivism”. A research process should be based on three elements, namely ontological perspective, epistemological consideration, and methodological approach (Antwi & Hamza, 2015:218).

1.7.1. Ontology

Ejnavarzala (2019:94) explains that ontology is concerned with the existential conditions related to material, social, cultural, and political contexts. Ontology assists you to conceptualise the form and nature of reality, which is determined by the researcher’s basic ideology about the nature of existence (Kivunja & Kuyini, 2017:27). A distinction must be drawn between two elements of ontology: objectivism and subjectivism. An objectivist view can be explained as the researcher and research existing independently from one another and without influencing one another

(Saunders *et al.*, 2019:135). A subjectivist view holds that social reality is made from the perceptions and actions of different individuals and that it is possible for more than one reality to exist, therefore, evidence is gathered from different perspectives (Saunders *et al.*, 2019:137).

In this study a subjective approach was followed, as a detailed understanding of current laws and legislation such as the CFC regime and exchange control regulations in South Africa must be understood.

1.7.2. Methodology

Kuada (2012:59) describes “methodology” as how researchers go about gaining the knowledge they desire. McKerchar (2008:6) explains that two core research philosophical paradigms guide researchers, namely interpretivism and positivism.

1.7.2.1. Positivistic or quantitative method

Positivism is normally adopted by researchers who pursue objectivity, and the researcher is regarded as detached from the research subjects (McKerchar, 2008:7). Positivists assume that knowledge is objective and quantifiable (Antwi & Hamza, 2015:218).

A distinction can be seen between quantitative and qualitative research predicated on the kind of data applied. The quantitative research method typically uses various forms of questionnaires, surveys, and experiments on a sample basis to obtain information relevant to the study (Antwi & Hamza, 2015:221). Variables in the samples are compared and the effect of the experiments is used to draw conclusions on a greater population (Kivunja & Kuyini, 2017:33). This research method might be subject to statistical testing and the information gathered are most likely of a numerical nature (Antwi & Hamza, 2015:221). It follows that the researcher, whose philosophical paradigm is best described as “positivist”, is more likely to adopt a quantitative methodology (McKerchar, 2008:7).

The positivist approach was not well suited to this study as this approach takes a narrow line based on the outcome of plausible quantifiable evidence. Given the qualitative nature of the analysis of the provisions of CFC regime and the exchange control regulations, it was concluded that a quantitative paradigm would not be relevant or appropriate for this study.

1.7.2.2. Interpretive or qualitative method

Interpretivism relies on the subjective interpretation of the researcher, and the researcher cannot be detached from the research subjects (McKerchar, 2008:7). Interpretivists assume that knowledge is an act of interpretation, therefore there is no objective knowledge which is independent of thinking and reasoning (Antwi & Hamza, 2015:218).

Pure qualitative research is typically based on a vast number of data and is guided by a greater degree of reasoning and flexibility (Mulisa, 2021:116). It follows that the researcher, whose philosophical paradigm is best described as “interpretivist”, is more likely to adopt a qualitative methodology (McKerchar, 2008:7).

McKerchar (2008:7) notes that qualitative research requires the application of inductive reasoning instead of logic, whereas quantitative research is rooted in the empirical and depends on deductive reasoning. As a qualitative research method was employed, inductive reasoning was applied in this study.

The primary focus of this study was to analyse the recent amendments to the CFC rules to determine its function and appropriateness within the context of the principles that underpin CFC legislation. The research includes the study of the CFC rules as it pertains to loop structures. The rules were analysed and interpreted against the South African and global CFC framework to measure its appropriateness. As the researcher’s personal insights and background knowledge would influence the interpretation of the subject matter, the study contains some degree of qualitative or interpretive research. Given the qualitative nature of the study, a quantitative research method was deemed incompatible and the specific qualitative research method applicable to this study was considered next.

1.7.2.3. Doctrinal research method

According to Hutchinson and Duncan (2012:84), the word “doctrine” is derived from the Latin noun *doctrina*, which serves as the base for science, teaching, knowledge, instruction, learning, and education. The doctrinal research method is known by the structured process of identifying rules that govern a particular legal category (McKerchar, 2008:18). It analyses the relationship between the rules, organising, and combining statutes, judicial decisions, and commentary. It demonstrates areas of concern and can possibly predict future growth and development (McKerchar, 2008:18; Hutchinson & Duncan, 2012:101). McKerchar (2008:19) noted that the doctrinal type of research is focused on reading and conducting in-depth, scholarly scrutiny.

McKerchar (2008:19) explains that doctrinal research seeks to achieve more than simply a description of the law. Normally the doctrinal method is a two-part process where the first part involves the location of the sources of the law and the second part involves the interpretation and analysis of the text (Hutchinson & Duncan, 2012:111).

In studying the field of taxation, specific tax concepts are defined in legislation. The interpretation of this legislation is subject to change depending on the researcher’s investigation of the facts. Therefore, multiple sources, interpretations and opinions need investigation to reach a conclusion and to avoid a narrow focus. This may change the outcome of the final conclusion.

All things considered, the doctrinal research method was believed to be suitable for this study and was used to address the problem statement.

1.8. Chapter overview

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: Overview

An overview of the history and evolution of exchange control with a specific focus on loop structures. This chapter will address the secondary research objective set out in 1.5.2.(i).

Chapter 3: Analysis of South African CFC rules

An analysis of the South African CFC rules particularly in the context of loop structures. This chapter will address the secondary research objective set out in 1.5.2 (ii).

Chapter 4: Analysis of current tax legislation

A detailed analysis of the principles that underpin the CFC regime both globally and in South Africa to determine the appropriateness of the recent changes to CFC rules as contemplated in section 9D and paragraph 64B of the Income Tax Act as it relates to loop structures. This chapter will address the secondary research objective set out in 1.5.2. (iii).

Chapter 5: Conclusion

Chapter 5 summarises the research findings and the conclusions reached, demonstrating how the objectives of the research are addressed.

CHAPTER 2 AN OVERVIEW OF THE HISTORY AND EVOLUTION OF EXCHANGE CONTROL IN SOUTH AFRICA

2.1. Introduction

Some countries, including South Africa, have exchange controls in place to limit and control cross-border capital flows. Most South African residents and foreign investors do not fully comprehend the application and impact of exchange control regulations (Oguttu, 2022:90). This is in part due to the complexity of these regulations and the notion that it is onerous to transfer capital in and out of South Africa (Oguttu, 2022:90).

In recent years there has been a gradual relaxation of exchange control in South Africa and the National Treasury has advised that they intend to continue in this direction. In 2020 a new risk-based capital flow management framework (CFM framework) was introduced and one of the risk-based listed measures introduced was the relaxation of loop structure restrictions. This decision by the South African government seems to indicate their intention to rely on tax legislation to prevent tax-erosion and profit shifting in lieu of exchange control regulations.

This chapter will focus on explaining the role of capital controls globally and provide an overview of the history and evolution of South African exchange control and its impact on income tax. This chapter will clarify what a loop structure is and explain how the exchange control regulations on loop structures have evolved over the years. It will provide clarity on the types of arrangements that would constitute a loop and the risks associated with these transactions. Lastly it will explain the implications of the 2021 removal of the exchange control restrictions on loop structures to understand the impact it will potentially have on the tax base. The chapter addresses the secondary research objective identified in paragraph 5.2.1 (i).

2.2. The role of capital controls

Capital moves faster and wider around the world than almost anything else (Mercurio *et al.*, 2021:60). Corporates involved in cross-border trade or investment prefer the freedom to transfer capital between different countries to optimise their business activities (Coppola, 2019:1). However, individual countries at times see the need to implement controls limiting the free cross-border flow of capital in order to manage the growth and stability of their domestic economies.

The regulation of cross-border capital movement and the applicable exchange rate has been a core component of numerous countries' economic management toolkit for many years (Coppola, 2019:1).

Capital controls are measures adopted by governments, central banks or other relevant regulatory organisations to regulate the outflow and/or inflow of capital to maintain financial stability and prevent or mitigate the impact of economic crises and to preserve the independence of national policies (Ndemera, 2016:7). Capital controls are also described as a set of financial regulation tools that govern cross-border movement connected to both foreign investors and resident companies and banks (Prates & Fritz, 2016:187). These controls come in many forms and contain expansive measures that are often jurisdiction specific. Generally, these control actions and restrictions are either in quantitative forms i.e. taxes, exchange rate controls and tariffs or qualitative forms, i.e. legislative (Ndemera, 2016:14). Restrictions on capital flows are broadly designed as direct (administrative) controls which includes approval processes and absolute prohibitions, and indirect (market based) controls that try to discourage capital movements through increased costs (Mercurio *et al.*, 2021:61).

According to Mercurio *et al* (2021:60) current evidence suggests that capital controls is a principal element of a governments policy toolkit, particularly during critical times and especially for developing countries which generally endures increased capital outflows, and serious currency as well as asset price downturns during difficult times. In this regard, capital controls are used by developing countries as a mechanism to protect them from the impact of adverse external shocks, whereas developed countries see the value of exposure to global markets and free movement of capital globally.

The intention behind these controls would be to mitigate the reduction of foreign reserves through capital outflows whilst giving regulatory authorities time to reform and implement suitable policy measures (Edison & Reinhart, 2000:1). In the South African context, the primary purpose of capital controls is to restrict the purchase and sale of the national currency, reduce any adverse impact on South Africa's exchange rate and ultimately protecting foreign exchange reserves from capital outflows (Ndemera, 2016:20).

Historically, exchange controls have been the most widely used capital control measure (Coppola, 2019:1). Exchange controls can be defined as restrictions on the value of foreign currency that may be transferred into a country, or of domestic currency that may leave a country, and can generally be categorised as direct controls or indirect controls (Sithole, 2008:24). Sithole (2008:24) explains that direct controls regulate capital transactions and the cross-border flow of funds through complete disallowance, which includes restrictions on capital account and current account transactions, conditions for repatriation and regulation of the use of funds. On the other hand, indirect controls include multiple exchange rate systems, taxation of cross-border flows, and other indirect regulatory controls (Asiedu & Lien, 2004:4). Indirect controls impact the

movement of capital through the increased costs linked to the capital movements and related activities (Asiedu & Lien, 2004:4).

Exchange controls became an important policy measure for most developing countries. It was used to support external stability, and serve as a cushion against adverse external shocks, with South Africa as no exception (Theron, 2005:21).

From a South African perspective, exchange controls are governed by the regulations promulgated under the Currency and Exchanges Act No. 9 of 1933. Regulation 10 (1) (c) has a wide application to ensure that all cross-border transactions are treated under the exchange control regulations. It addresses aspects linked to restrictions placed on the export of capital by South African residents, which includes the restriction on loop structures (Ndemera, 2016:20).

South African policymakers have been occupied with the interactions and relationship between capital flows and exchange control regulations for decades (Oguttu, 2007:421). One example is the capital account outflows in the late 1950s which resulted in stricter and more extensive foreign exchange controls, initially on residents, but extended to non-residents after 1961. In turn these controls on non-residents resulted in a parallel exchange rate system which was only abolished in the 1990s (Farrell & Todani, 2006:84). Another example of the exchange control mechanisms used to protect against capital flight is the restrictions placed on transactions where loop structure were involved.

2.2.1. Relaxation of exchange controls and the risk of capital flight

The relaxation of exchange controls increases international competition and promotes capital flight as corporates diversify offshore and therefore it creates more incentives for countries to improve domestic investment conditions (Angermann, 2005:3).

According to Kar and Cartwright-Smith (2009:iii) the term “flight capital” is generally applicable in relation to funds shifting from developing countries, usually into developed economies or tax neutral jurisdictions. Motivations for such shifts are usually potential economic or political instability, portfolio diversification, taxation, inflation, or expropriation. Capital flight can be explained as unauthorised capital flows that are connected with either illegal activities, tax avoidance or a need for the secret accrual of capital offshore (Ashman *et al.*, 2011:10).

Between the 1960s and 1990s the occurrence of occasional capital flight from South Africa had reflected the suppressed need from residents to move funds offshore (SARB, 2011:56). Elevated levels of crime, raised taxes, currency weakness and protracted political uncertainties continued to support the shifting of funds offshore (SARB, 2011b:156). In this regard one of the exchange

control mechanisms used to protect against capital flight was the restrictions placed on transactions where a so-called “loop structure” was involved.

2.3. The history of exchange control in South Africa

South Africa has seen marked changes and amendments to exchange control policies, with a steady relaxation of exchange control regulations noted by the National Treasury, particularly in the last 30 years. Over the years South African policymakers have followed a gradual and phased approach to exchange control relaxation. The gradual repeal of exchange controls was necessitated by trends towards globalisation and economic liberalisation, which is incompatible with exchange controls restrictions.

The most significant changes were implemented when National Treasury followed through with their plans outlined in the 2020 Budget Review and started to phase out longstanding exchange control regulations. Amongst others was the relaxation of the restrictions on loop structures.

For the sake of understanding the measure of easing of exchange controls over time to where we are at today, it is important to be cognisant of where we came from previously with respect to exchange control in South Africa and the many iterations of it since its introduction.

Exchange controls have an extensive history in South Africa that dates back to the Second World War when it was introduced as a means to protect South Africa’s foreign exchange reserves (Sithole, 2008:35). After the Second World War exchange controls were gradually being phased out (BIS, 1998:1). Until 1961, South African exchange controls were primarily applicable to transactions by residents (Theron, 2005:21). The political crisis of 1961 necessitated that government extend these exchange controls to non-residents. This was also the first time that non-residents were restricted by exchange controls to repatriate funds from South Africa (Sithole, 2008:35).

The objectives of the exchange control regulations were to provide the domestic economy with a degree of protection from the deterioration of the internal political situation, the negative effects of non-economic developments in South Africa and the resulting international reactions to said developments (Theron, 2005:21).

As explained by the Governor of the then South African Reserve Bank (BIS, 1998:1), in the early nineties when the major social and political reforms were being enacted, South Africa already had a very comprehensive exchange control system in place that controlled cross-border flows of certain current accounts transactions of resident and non-resident investment funds. To attract

foreign investment South Africa had to gradually relax its exchange controls over time since 1994 (Sithole, 2008:35).

2.3.1. The phasing out and liberalisation of exchange controls in South Africa

After the democratic election in 1994 the new democratic government took over an economy which was not over-indebted, but there were limited opportunities for residents to diversify their investment portfolios (Oguttu, 2007:421). The transformation to democracy resulted in the nature of the relationship between capital flows, exchange control regulations and foreign exchange policies changing once more as a total restructuring of the South African economy, was in progress as it, once again, became reintegrated into global financial markets (Farrell & Todani, 2006:84). The process of financial reintegration included the lifting of exchange controls on non-residents and the re-evaluation of its remaining exchange controls (SARB, 2011b:148). This provided opportunities for liberalising exchange controls, which in turn created new challenges for South African policymakers (Farrell & Todani, 2006:85). The liberalisation process was initiated by National Treasury and the SARB, and as part of this process, the country had to re-evaluate its existing exchange control system and debate the preconditions, nature, timing and speed of this liberalisation process (Farrell & Todani, 2006:109). The result of this debate on exchange control has had significant implications for the subsequent policy direction in South Africa (Farrell & Todani, 2006:109).

The South African government opted for a gradual and phased approach to the abolishment of exchange controls in South Africa. This would, amongst others, encompass the following:

- The relaxation of exchange control restrictions on the import and export of goods and services.
- The exchange control restrictions on non-residents being lifted.
- More leniency in the approval of application for direct foreign investments by South African corporates.
- Allowing foreign asset acquisitions by institutional investors to diversify their portfolios.
- The release of emigrant “blocked accounts”.

Several steps were taken over time to eliminate these controls (SARB, 2011b:157).

2.3.2. Exchange controls, tax amnesty and voluntary disclosure

It appears from international experience that there are two general reasons for countries to implement amnesties (Farrell & Todani, 2006:118). The first reason is where amnesty is used with the intention to repatriate flight capital in order to cultivate national development. The second

reason is where amnesty is used to "regularise" undisclosed assets held abroad in order to bring it into the domestic tax net (Farrell & Todani, 2006:118).

The South African amnesty was based on the second reason for an amnesty, also described as the "regularisation of undisclosed offshore funds". In this regard, despite the fact that the funds for these investments were legitimately obtained, the manner in which they were moved abroad and remained undisclosed criminalised them (Farrell & Todani, 2006:120). This created a hurdle for repatriation of these funds, even after the conditions that encouraged the capital flight had improved. In addition, because the funds were not disclosed, it remained out of the tax reach in residence-based tax systems. In this context the objective of amnesty was to regularise these funds by legitimising it and bringing it into the tax net (Farrell & Todani, 2006:120).

During the 2003 Budget Review the Minister of Finance incorporated some material changes that accelerated the process of gradually liberalising the established exchange control regime (Gidlow, 2010:124). As a result, the joint tax and exchange amnesty was introduced on 15 May 2003 (Valodia, 2019:37). The Minister of Finance assured South Africans that if they applied for amnesty, they would achieve the regularisation of their affairs in respect of foreign-held assets (Brunton, 2017:4). This was the first amnesty of its kind to be introduced in South Africa (Gidlow, 2010:124).

The amnesty allowed for the repatriation of capital previously transferred abroad mainly through illegal actions in contravention of the Exchange Control Regulations (Gidlow, 2010:124). Amnesty was provided for unregularised offshore assets in terms of both the exchange control regulations and certain tax acts. To be considered, applications had to be submitted within the window period which ran from the beginning of June 2003 to the end of February 2004 (Gidlow, 2010:127). The timing of the amnesty was suitable as there was an increased need amongst South Africans to voluntarily regularise their personal affairs to achieve international co-operation, specifically with regards to tax compliance (Valodia, 2019:37). The amnesty also provided the opportunity for persons involved in unauthorised loop structures to regularise their affairs (SARB, 2003:5).

After the success of the 2003 amnesty, with around 43 000 applications received, there were good reasons to contend that once the amnesty process was completed, the full abolition of exchange controls in South Africa would be desirable (Gidlow, 2010:135). Even though the amnesty speeded up the broadening of the tax base, it can be argued that this was happening in any event with revenue collections consistently exceeding forecasts (Gidlow, 2010:136). Furthermore, the plan of action for liberalisation of exchange controls was delayed by the amnesty process because the abolishment of the controls on residents were delayed as long as the amnesty process affecting residents was in force. According to Gidlow (2010:136) this was

unfortunate because the abolishment of exchange controls had become particularly suitable from 2003 onwards (Gidlow, 2010:136).

In 2010 the SARB announced the introduction of another amnesty for illicit capital flight and a combination of the 2003 amnesty and the exchange control circular was developed which resulted in what is known as the Exchange Control Voluntary Disclosure Programme (excon VDP). The excon VDP was offered in terms of the provisions of Exchange Control Regulation 24. The SARB regarded the VDP and amendments to the exchange control regulations as the first step in the gradual relaxation of exchange controls (Ashman *et al.*, 2011:9). It provided another opportunity to South African residents and former South African residents to regularise their exchange control affairs through voluntary disclosure to the FinSurv of any contraventions of the exchange control regulations (SARB, 2010:1). These contraventions included the direct or indirect ownership of any unauthorised foreign assets or structures of whatever nature, such as unauthorised loop structures (SARB, 2010:1). This amnesty only applied to exchange control contraventions committed on or prior to 28 February 2010 and closed on 31 October 2010

A long-term measure was introduced to improve voluntary tax compliance through the introduction of the Tax Voluntary Disclosure Programme (tax VDP) under Chapter 16 of the Tax Administration Act 28 of 2011. The objective of the tax VDP was to motivate non-compliant taxpayers to disclose their defaults and give them the chance to regularise their own tax affairs.

More than a decade after the introduction of the 2003 joint tax amnesty and with the global introduction of the OECD's Common Reporting Standards (CRS) initiative, the Special Voluntary Disclosure Programme (SVDP) for exchange control and/or tax transgressions was introduced (Brunton, 2017:5). The SVDP was only operative for a limited time period from 1 October 2016 to 31 August 2017 and gave an opportunity for non-compliant taxpayers to voluntarily disclose offshore assets, thereby regularising both their tax and exchange control affairs (Brunton, 2017:5). As part of the exchange control SVDP the SARB issued a policy document entitled "Exchange Control Special Voluntary Disclosure Programme Policy dealing with loop structures" which explained its policy regarding the regularisation of loop structures. The SARS permanent tax VDP remained available during the SVDP window period and ran concurrent to the SVDP.

2.3.3. Exchange control and the impact on income tax

Pressures to abolish exchange controls progressively also originated from the constitution which was adopted in April 1994. The notion of exchange control was constitutionally challenged based on the grounds that it is thought to infringe on human rights. The abolishment of exchange controls was perceived by some as a concession that would only benefit the rich, and that under the new

constitution in a non-discriminatory society, everyone was deemed to be equal (SARB, 2011b:157). However, exchange controls could be regarded as inherently discriminatory in nature. In this regard it was argued that once individuals have paid their taxes, they have fulfilled their commitments to the state and should have the right to transfer or repatriate their capital or interest in capital as and when they want to (SARB, 2011b:157).

It is argued that without exchange controls it would be easier for persons to escape the exploitation of a particular government, thereby checking such a government's power to exploit its citizens, for example through tax policy (SARB, 2011b:150).

The purpose of South Africa's exchange controls was explained by the Constitutional Court (CC) in *South African Reserve Bank v Shuttleworth* (2015) where the court stated that its purpose was to curb or regulate the export of capital from South Africa and to protect the domestic economy from capital movement. It was designed to regulate and discourage capital outflows and supplied a framework for the repatriation of foreign currency.

Despite this, it was well known that some exchange controls were in place to support compliance with the Income Tax Act, given that SARS did not have the capacity to do so in that specific area at that particular time (Mazansky, 2021:38). Most of these controls have been removed and is now administered by SARS, however, some controls remain.

The Katz Commission (1997:par. 3.1.7.1) has commented on more than one occasion that the tax and exchange control regimes should detach themselves from one another, and that the exchange control regime should be determined independently of its tax implications. Protecting the South African tax base from base erosion without relying on exchange controls would assist in unlocking the tax and exchange control regimes, in order that important decisions on exchange controls could be made without considering the impact it would have on the tax base (Katz Commission, 1997:par. 3.1.7.1). However, exchange controls continue to support compliance with anti-tax avoidance legislation as it regulates the outflow of capital from South Africa which could erode the tax base (Oguttu, 2015:657).

Mazansky (2021:138) argues that privately FinSurv would concede that its prohibition against loop structures was not of great concern to them in relation to the need to regulate capital flows, being the purpose as put forward in *South African Reserve Bank v Shuttleworth*, but rather that this was upheld at the request of SARS because it prevented tax avoidance. Nevertheless, this prohibition against loop structures remained in place as part of the exchange control regime.

The Department of National Treasury (2021a:36) acknowledged that exchange control restricts the use of loop structures, in part to protect the tax base. It further commented that tax legislation

is a more appropriate tool to combat tax avoidance where a loop structure is involved, as opposed to the exchange control policy.

2.3.4. Review of exchange controls announced in 2017 budget

In 2017 National Treasury took on the review and benchmarking of the capital flow management (CFM) system (exchange controls) against best practices in other developing economies and fast-growing markets (Department of National Treasury, 2017a:170)

During the review process the SARB enlisted the services of the OECD to benchmark South Africa's CFM system against the OECD code of Liberalisation of Capital Movements (Department of National Treasury, 2017b:153). The OECD code provides a balanced framework for the gradual removal of restrictions or barriers for the free movement of capital while providing flexibility to manage problems of economic and financial instability (OECD, 2023:4).

2.3.5. New Capital Flow Management Framework

In the 2019 Medium Term Budget Policy Statement the Minister of Finance announced that “in order to promote investment into South Africa and reduce unnecessary burdensome approvals, the SARB will propose a more modern, transparent and risk-based approval process framework for cross-border flows (Department of National Treasury, 2019:1)”.

During his Budget Speech in February 2020, he subsequently announced several exchange control reforms. A new CFM system would come into effect over the next 12 months that would allow all foreign currency exchange transactions, except for a risk-based list of capital flow measures. The changes would aim to promote transparency, decrease the administrative burden by reducing unnecessary approval processes, and promote certainty. Some macroprudential and capital management measures would remain, inter alia, the exchange control requirements pertaining to loop structures until the relevant tax provisions could be amended to address the risk, ensuring the protection of the South African tax base. (Department of National Treasury, 2020b:153).

Circular 2/2020, published on 27 February 2020 by the FinSurv of the SARB (2020:1), announced the new risk-based CFM framework, which introduced a whole new direction in controlling capital flows and cross-border foreign currency transactions, with the following words: “This involves a shift from the current negative bias framework to a positive bias framework where all cross-border transactions will be allowed, except for those that are subject to the capital flow management measures and/or pose a high risk in respect of illegitimate cross-border financial flows”.

The negative bias framework makes foreign currency ownership and transactions unlawful unless an exception exists in the regulations to allow for such ownership or transaction, whereas in the case of a positive bias framework any foreign currency or transaction is lawful unless it is specifically restricted (Venter, 2020). The new capital flow measures take account of the OECD best practice Code of Liberalisation of Capital Movements and are aligned with similar approaches in other developing countries (Department of National Treasury, 2020b:153).

The intention was also to abolish the exchange control restrictions on loop structures. However, this was only possible once National Treasury and SARS were both satisfied that adequate measures have been introduced into the South African Income Tax Act to address any concerns about potential tax leakage arising from the removal of this restriction.

2.4. Loop structures

Loop structure restrictions were one of the largest exchange control roadblocks for South African resident investors and has over the years likely prevented more South African residents from entering cross-border transactions than any other exchange control or tax policy (ENS, 2008:20).

2.4.1. What is a loop structure?

There is no formal or statutory definition or description in the Authorised Dealer Manual or Exchange Control Regulations for a “loop structure”. According to the SARB frequently asked questions page, South African resident individuals with authorised foreign assets may invest in South Africa, provided that where South African assets are acquired through an offshore structure (loop structure), the investment is reported to an AD as and when the transaction is finalised as well as inter alia, an annual progress report is submitted by an AD to the Finsurv (SARB,2023)

The policy document entitled "Exchange Control Special Voluntary Programme policy dealing with 'loop structures' (including 74/26 structures)" that was released by the Finsurv on 17 November 2016, now revoked, was the most recent formal guidance provided to define the term “loop structure” (SARB, 2016:1). According to the policy document, loop structures entail the formation by a South African resident of a foreign structure which, by reinvestment into South Africa, acquires shares, loan accounts or some other interest in a South African resident company or a South African asset (SARB, 2016:1). These transactions, contravene, inter alia, Regulation 10(1)(c) of the Exchange Control Regulations, 1961.

As discussed in Chapter 1, Regulation 10(1)(c) of the Exchange Control Regulation is essentially a catch-all provision which determines that no person is allowed, without the necessary exchange control approval, to enter into any transaction whereby capital or any right to capital is directly or

indirectly exported from South Africa. Therefore, South African exchange control residents are not allowed to use funds or authorised foreign assets to enter into a transaction or transactions, with the purpose and/or effect to export capital directly or indirectly from South Africa and through any structure or scheme of arrangement, invest back into a CMA country by acquiring shares or any other assets or interests.

However, the FinSurv took the interpretation one step further. Its view was that, if a resident individual or company remitted funds from South Africa and invested them in an offshore structure which in turn reinvested back into South Africa, that arrangement facilitated an indirect export of capital without approval and, therefore, was a breach of that Regulation. This is colloquially known as a “loop” (Mazansky, 2021:1).

Generally a loop structure is created when a South African resident individual, trust or company enters into a transaction or a series of transactions whereby authorised or unauthorised funds are directly or indirectly exported from South Africa. This is typically achieved using an offshore structure such as a trust or company. The offshore structure would then reinvest the funds back into South Africa thereby creating a loop structure (Olivier & Honiball, 2011:734). The reinvestment could be in the form of shares, a loan, or an interest in a South African asset or company (Department of National Treasury, 2021a:36). In some instances, the South African resident would then export returns on the investment by way of, for example, the payment of dividends, profits, interest and/or loans to the offshore structure (Department of National Treasury, 2021a:36). The result of the loop structure could be the accumulation offshore of the profits from investments by the offshore structure into South Africa. The returns that amass in the foreign company or trust from the South African investments could result from dividends, interest, or other amounts.

These transactions were considered to directly contravene Regulation 10(1)(c), this is because they resulted in and/or had the potential to result in the direct or indirect export of more capital than is permitted for individuals or companies. In this regard, Oguttu (2022:96) explains that this regulation has been applied to prohibit residents from entering into a loop structure. Notwithstanding, there are opposing opinions on the application of Regulation 10(1)(c) to loop structures (Oguttu, 2007:436). There are no reported case law where the courts have expressed the view that a loop structure is illegal (Bouwer, 2021). While the case of *Pratt v Firstrand Bank Ltd* (2014) involved a loop structure, the court did not give an opinion on the legality of loop structures.

When individuals are involved in a loop structure it often includes the use of a foreign trust, while in the venture capital context, it often includes an investment in a foreign fund holding shares in

a South African company (Bouwer, 2021). A South African shareholder in such a loop structure would not receive their profits (for example dividends or capital gains) directly from the South African company, but would receive it through the foreign structure.

A simplified loop structure can be illustrated as indicated in Figure 1:

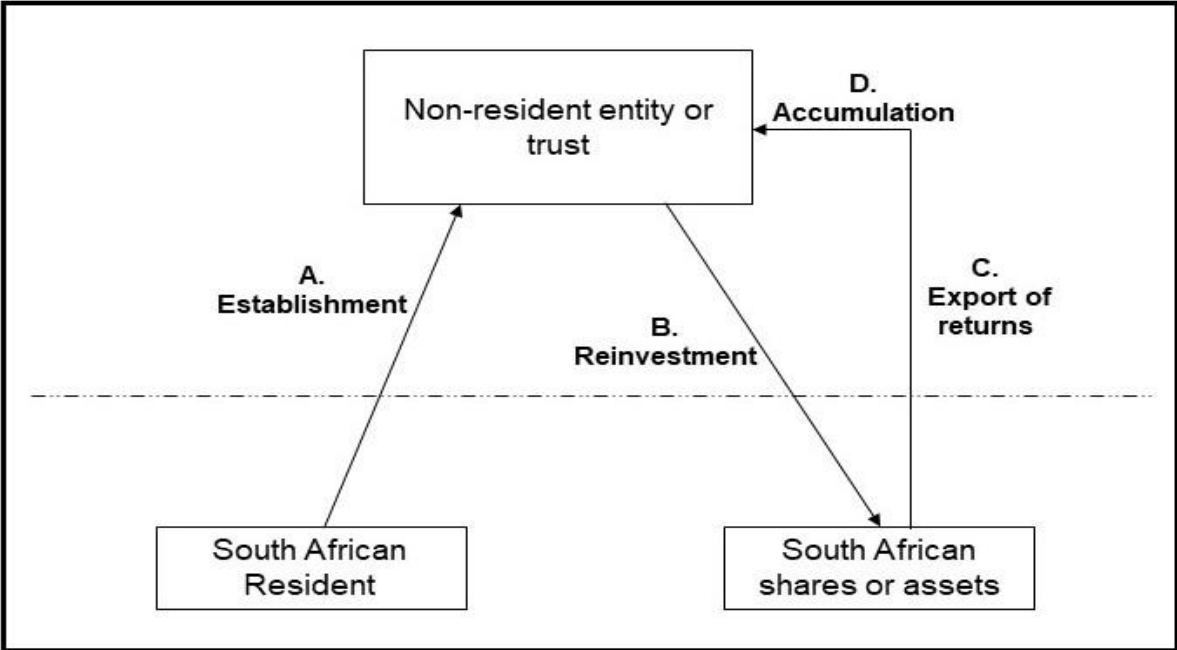


Figure 1: Transactions involved in establishing a loop structure (Adapted from SARB, 2016:2)

A: Establishment. A South African resident individual, trust or corporate entity transfers authorised or unauthorised funds abroad (could also be existing offshore funds or a combination thereof) to an offshore structure, for example, a foreign entity or trust.

B: Reinvestment. The foreign entity involved would then directly or indirectly (via another foreign entity) reinvest its authorised or unauthorised funds in South Africa (or other CMA country), in doing so create a loop structure. The reinvestment could be in various forms, e.g., South African shares, assets or loan accounts.

C: Export of Returns. Thereafter the South African resident would export the returns on the South African investments in the form of, e.g., dividends, profits, interest and/or loans repaid to the offshore structure.

D: Accumulation of value. The funds referred to in A above and the returns referred to in C above may have resulted in or potentially result in an accumulation offshore of value (growth) over and above the nominal value from the investment by the foreign entity or trust into South Africa.

2.4.2. Risks of these types of arrangements

The FinSurv generally regard loop structure arrangements as a threat because it creates or potentially creates the opportunity for direct or indirect export of capital offshore to a foreign entity for the eventual benefit of a South African resident (Department of National Treasury, 2021a:36). The capital that is derived from South African growth assets and that are exported could consist of dividends declared from profits, revenue reserves or capital reserves (Department of National Treasury, 2021a:36).

Loop structures pose a risk to the South African tax base as the structure presents an opportunity to undermine the tax base through abusive tax planning as they can be used as a vehicle to facilitate the avoidance or deferral of taxation by accumulating income abroad (Department of National Treasury, 2020a:137). In this regard it is possible to foresee where tax may be avoided, specifically dividends tax and capital gains tax. For instance, in the context of capital gains tax if the shares in a South African company are owned by a South African resident, the profit on disposal will give rise to capital gains tax under the ITA. However, with certain limited exceptions, a tax non-resident is not subject to capital gains tax on the disposal of South African assets and, therefore, holding the same investment through an offshore structure makes it possible to escape capital gains tax in South Africa (Department of National Treasury, 2020a:137). Similarly, in the context of dividends tax, if loop structures are no longer restricted by an exchange control policy, it would be possible to set up a structure where a CFC owns a South African resident company, and any dividends flowing from the South African resident company to the resident individual or trust through the CFC are tax-exempt for the individual or trust (Department of National Treasury, 2020a:137). That would enable the resident individual or trust to reduce – where there is a favourable double tax agreement (DTA) – their dividend tax liability in respect of dividends declared by a resident company from 20 per cent to a significantly lower rate, and in some instances to zero.

From the above examples, one can conclude that a loop structure has the effect of reducing South Africa's tax base and could reduce any taxes that the foreign structure would have to pay in South Africa. In this regard, National Treasury explains that exchange control policy restricts loop structures or else it might present a mechanism for tax avoidance (Department of National Treasury, 2020a:137). National Treasury (2020a:137) further expressed the view that tax legislation is a more appropriate tool to curb tax avoidance through the refinement of the tax treatment of capital flows (specifically dividends and capital gains) where a loop structure is involved.

2.4.3. The evolution of loop structure restrictions and exceptions

One important aspect of the removal of exchange controls on non-residents in the mid-1990s is that it resulted in the free movement of foreign capital. In other words, since 1995, inward FDI financed by an inflow of foreign capital was permitted without exchange control approval (Department of National Treasury, 2011:13). Further liberalisation had subsequently enabled FDI to be supported by local capital. Inward investments that were structured and financed in more complex ways, like cross-border acquisitions, required formal Finsurv approval. Thus, cross-border acquisitions of local entities financed wholly or in part by the exchange of shares in the foreign company or mergers that create domestic shareholdings in a new merged foreign entity fell under an approval process (Department of National Treasury, 2011: 14).

Exchange control policy also restricted all forms of loop structures and where loop structures were deemed unavoidable for the transaction, formal approval was required from the Minister of Finance (Department of National Treasury, 2011:14). Even though there was no systematic framework under which prospective inward FDI transactions were assessed, this approach meant that large and involved cross-border investments were subject to prior authorisation (Department of National Treasury, 2011:14). It follows that the requirement for approval was strongly linked to the specific layout and structure of the transaction (Department of National Treasury, 2011:14).

The relaxation of loop structure restrictions formed part of the liberalisation of the established exchange control regime. Over the last decade, the Finsurv has gradually relaxed the restrictions pertaining to loop structures. In 2011 Exchange Control Circular 19/2011 was issued announcing the relaxation of restrictions on corporate loop structures. Consequently, South African companies were allowed to obtain between 10 per cent to 20 per cent equity and/or voting rights, whichever is higher, in a foreign target entity which owned assets and/or made loans into any CMA investment (SARB, 2011a:1). As a result, it provided South African companies with the opportunity to make legitimate new outward foreign direct investments outside their current line of business, thereby diversifying their offshore operations utilising their domestic base. However, this concession was not available to South African companies with an equity interest and/or voting rights of more than 20 per cent in the foreign company. South African individuals remained prohibited from engaging in a loop structure.

In the 2017 Budget Review the Minister of Finance proposed that the loop structure restriction for all intellectual property transactions be abolished, on condition that they were at arms-length and at a fair market value (Department of National Treasury, 2017b:170).

In 2018 FinSurv relaxed its policy in relation to loop structures reinvesting into the CMA by South African companies with approved offshore funds (SARB, 2018:5). Consequently, South African companies were allowed to obtain a maximum of 40 percent equity and/or make loans into any CMA country. This relief did not apply to FDI and foreign portfolio investments where the South African company on its own, or where a number of South African companies collectively held an equity interest and/or voting rights in the foreign target entity that in total exceeded 40 per cent (SARB, 2018:5). Prior FinSurv approval was required for loop structures above the prescribed threshold of 40 per cent, duly considering transparency, tax, equivalent audit standards and governance. In view of the aforementioned, various changes were made to section B.2 (C) of the Currency and Exchange Manual for Authorised Dealers.

More recently, FinSurv issued Exchange Control Circular No. 18/2019, which advised that restrictions on loop structures pertaining to private individuals have also been relaxed (SARB, 2019:1). The relaxation was applicable to loop structures formed after 30 October 2019, and allowed private individuals to individually, or collectively acquire up to 40 per cent equity and/or voting rights, whichever is the highest, in a foreign target entity, which entity may, in turn, hold investments in, and/or make loans to, any CMA country (SARB, 2019:1). Existing loop structures which were implemented by individuals before to 30 October 2019 and/or loop structures with a shareholding of more than 40 percent shareholding still had to be regularised with the FinSurv.

The circular further advised that as an exception, and only in respect of loop structures implemented after 30 October 2019, South African private, public, and listed companies were permitted to, on application to an Authorised Dealer, acquire up to 40 per cent equity and/or voting rights (whichever is the highest) in a foreign target entity, where the entity may, in turn, hold investments in, and/or make loans to, any CMA country. This relief did not apply to loop structures where the South African company by itself, or where more than one South African company collectively, held an equity interest and/or voting rights in the foreign entity that in total exceeded the 40 per cent threshold. This relaxation did also not extend to foreign trusts, and it follows that foreign trusts with South African resident discretionary beneficiaries were not permitted to invest back into South Africa or any CMA country through a loop structure. Effectively this resulted in South African residents being penalised for retaining a majority share in their business, while raising fund abroad from foreign investors (Berger, 2021). This restriction in loop structures often resulted in the establishment of complex structures such as parallel or mirror shareholding structures where South African residents hold shares in a foreign company and separately own shares in a South African company or assets in the context of the same business unit or group of companies (Berger, 2021).

In line with the SARB undertaking to implement a new CFM system, and in order to support South Africa’s growth as an investment and financial hub for Africa, changes to the exchange control framework began to come through in early 2021. In Exchange Control Circular 1/2021, issued on 4 January 2021, the FinSurv (SARB, 2021:1) announced that with effect from 1 January 2021 “in order to support South Africa’s growth as an investment and financial hub for Africa, it is advised that the full ‘loop structure’ restriction has been lifted to encourage inward investments into South Africa”.

This reform applies to private individuals and companies, including private equity funds that are tax resident in South Africa (SARB, 2021:1). As a result, South African resident individuals, companies and private equity funds with authorised foreign assets are now permitted to invest back into South Africa without restriction. However, where the investment is made through an offshore structure the transaction must be reported to an Authorised Dealer (SARB, 2021:1). It follows that South African resident trusts are not allowed to invest into South Africa via a loop structure as the regulations only allow foreign direct investment to be done by a South African company or natural person (Oguttu, 2022:114).

The structure can be illustrated as indicated in Figure 2:

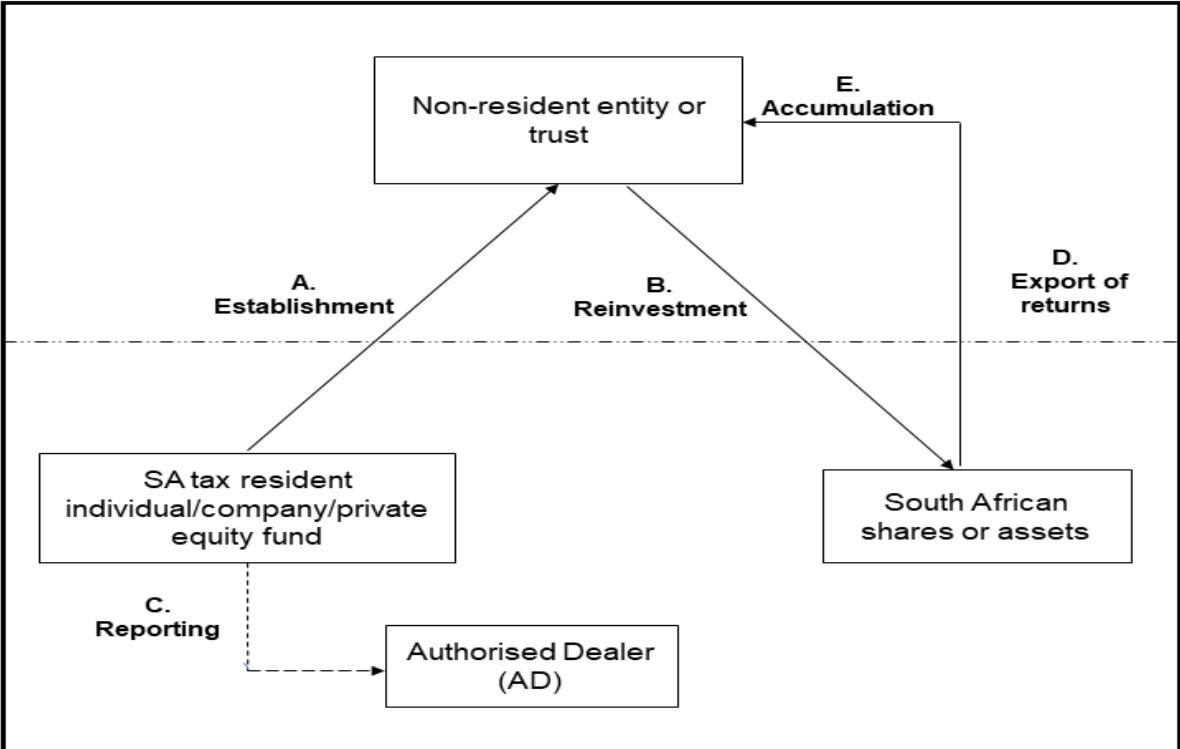


Figure 2: Transactions involved in a typical loop structure (Source: own compilation)

A: Establishment. A South African tax resident individual, company, private equity fund transfers authorised funds abroad (could also be existing authorised offshore funds) to an offshore structure, for example, a foreign entity or trust.

B: Reinvestment. The foreign entity or trust involved would then directly or indirectly (via another foreign entity) reinvest its authorised funds in South Africa (or other CMA country), in doing so create a loop structure. The reinvestment could be in various forms, e.g., South African shares, assets or loan accounts.

C: Reporting. The investment into South Africa through a loop structure must be reported to an AD as and when the transaction is finalised, and an annual progress report must be submitted to FinSurv via an AD.

D: Export of Returns. Thereafter the South African resident would export the returns on the South African investments in the form of, e.g., dividends, profits, interest and/or loans repaid to the offshore structure.

E: Accumulation of value. The funds referred to in A above and the returns referred to in D above may result in, or potentially result in an accumulation offshore of value (growth) over and above the nominal value from the investment by the offshore entity into South Africa.

It is noted that loans into South Africa by South African connected foreign investors must still comply with the current exchange control rules that applies to inward foreign loans (Botha, 2021:7). Furthermore, existing unauthorised loop structures created prior to 1 January 2021, including loop structures where the 40% threshold has been exceeded, must still be regularised by way of application to FinSurv (Botha, 2021:7).

2.4.4. Reporting requirements

As a result, from 1 January 2021, no upfront SARB approval will be required for investment of authorised foreign assets into a loop structure by a South African resident. There must, however, be a report back to the SARB in respect of transactions concluded (SARB, 2021:1).

Although loop structures are no longer strictly prohibited, these structures created on or after 1 January 2021 will still have to comply with a range of SARB requirements in order to be validly constituted. Information will, inter alia, be required on transaction finalisation as well as an annual progress report (SARB, 2021:1).

The SARB (2021:1) has published the following regulations in this regard:

- “Resident individuals, corporates and private equity funds with authorised foreign assets (being assets taken or accumulated offshore with the necessary SARB approvals in place) may invest in South Africa on condition that, where South African assets are acquired through a loop structure, the investment is reported to an Authorised Dealer as and when the transaction is finalised.
- Annual progress reports must be submitted to the SARB’s Financial Surveillance Department via an Authorised Dealer.
- The Authorised Dealer must have had sight of an independent auditor’s written confirmation or other suitable documentary evidence which verifies that the transaction was concluded on an arm’s length basis, for a fair and market-related price.
- All inward loans from South African-affiliated foreign investors must comply with the directives issued in section I.3(B) of the Authorised Dealer Manual (residents borrowing abroad).
- Once a transaction is completed, the Authorised Dealer must submit a report to the SARB’s Financial Surveillance Department setting out:
 - the name(s) and information of the South African affiliated foreign investor(s);
 - a description of the assets to be acquired (including inward foreign loans, the acquisition of shares and the acquisition of property);
 - the name of the South African target investment company, if applicable;
 - the date of the acquisition; and
 - the actual foreign currency amount introduced, including a transaction reference number.”

The phrasing of the circular appears to indicate that the restrictions with regards to loop structures have only been lifted on existing authorised foreign assets of applicable exchange control residents (Geldenhuys *et al.*, 2021). A South African resident would therefore not be able to create a loop structure without prior exchange control approval where it does not have authorised foreign assets (Botha, 2021:7). It should be acknowledged that the investment into an offshore structure that invests into South Africa will potentially create an additional reporting requirement (Botha, 2021:7). These reporting requirements set out above seem to be extensive, and that as a result the administrative burden placed on South African companies involved in loop structures has increased significantly. In this regard the reporting of the particulars of the group structure creates an additional compliance and reporting burden on South African companies.

2.4.5. Opportunities created by lifting of loop structure restrictions

As a result of the relaxation, private individuals and companies no longer need to obtain approval should their shareholding in a foreign entity exceed 40% as was previously required. Furthermore,

foreign trusts can be used in the foreign structure investing back into South Africa, which was previously not allowed.

It is submitted that the allowance of loop structures will aid in the simplification of international ownership arrangements, which as a result of the previous dispensation have been complex given the limitations imposed by the restrictions (Smit, 2020). The lifting of the restrictions is also important for South African start-up businesses seeking to attract foreign investors. As an example, following the relaxation of loop structure restrictions and in order to raise foreign capital a South African company can establish a foreign company (first half of the loop) where the foreign investors will acquire equity. In turn the foreign company will acquire shares in the South African company (second half of the loop). As a result, the foreign investors will hold equity in the South African company. Before the relaxation of the restrictions foreign investors were unable to obtain control in a South African company through equity unless they were willing to purchase shares in the South African company directly. This is a positive step forward in seeking to attract foreign investors to South Africa and these cross-border arrangements should be considered by South African companies looking to raise capital abroad.

2.5. Conclusion

The objective of this chapter was to do an overview of the history and evolution of exchange control in South Africa with a specific focus on loop structures. It can be noted that exchange control in South Africa has seen significant changes and has evolved since its initial inception and shows that with the transformation of the economy the exchange controls too have evolved (Valodia, 2019:36). Since 1995, South Africa has followed a gradual and phased approach to the exchange control liberalisation process, and it continues till today, with the recent announcement of a new CFM framework.

Before the shift to a new CFM framework, Regulation 10(1)(c) prohibited residents from entering into a transaction or a number of transactions that result in the direct or indirect export of capital from South Africa. As a result, the regulation effectively restricted (subject to certain exceptions) the implementation of loop structures (Bagraim, 2021).

The recent shift to a capital flow management framework, coupled with National Treasury's aims of attracting foreign direct investment (FDI), and promoting international competition have culminated in lifting of exchange control restrictions on loop structures

The shift to a CFM framework, coupled with National Treasury's aim of encouraging FDI, promoting international competition and improving the onerous SARB approval process for cross-border transactions, have thus culminated in the complete abolition of loop structure restrictions

on South African tax resident individuals, companies, and private equity funds, subject to reporting requirements to the FinSurv, via their Authorised Dealers (SARB, 2021:1). As a result, individuals and companies no longer need to obtain SARB approval should their shareholding in a foreign entity in aggregate exceed 40%.

It was further noted that loop structures pose a risk to the South African tax base as they present an opportunity for abusive tax planning as they can be used as a vehicle to facilitate the avoidance or deferral of taxation by accumulating income abroad (Department of National Treasury, 2020a:137). As a result, in order to protect the tax base against possible tax avoidance arrangements using loop structures National Treasury introduced new amendments to the ITA. These new changes were inserted in section 9D of the ITA that contains South Africa's CFC rules and paragraph 64B of the Eighth Schedule to the ITA. It is for this reason that the next chapter will analyse the South African CFC rules and the capital gains participation exemption with a specific focus on the changes as it relates to loop structures.

CHAPTER 3 AN ANALYSIS OF THE SOUTH AFRICAN CFC RULES

3.1. Introduction

As Chapter 2 indicated, the relaxation of loop structure restrictions was accompanied by amendments to section 9D of the ITA that contains South Africa's CFC rules and paragraph 64(B) of the Eighth Schedule of the ITA.

Sandler (1998:4) explains that with increased opportunity and ease for a country's residents to move capital abroad, the potential to defer or avoid taxation in their resident country increases proportionally. To counter the shift of profit, many countries including South Africa have broadened their international tax policy rules and introduced anti-tax-avoidance measures to curb cross-border profit shifting. One of the most important examples of these anti-avoidance measures is the CFC rules (Clifford, 2017:1).

This chapter will explain the development and spread of CFC rules and consider the reasons for the introduction of CFC rules in South Africa. It will then analyse the fundamental principles of the South African CFC rules particularly in the context of loop structures. The aim of the analysis is to determine the income tax implications of the provisions that were introduced to address the potential tax avoidance that could arise from lifting the exchange control restriction on loop structures. This chapter addresses the secondary research objective identified in Chapter 1 paragraph 1.5.2 (ii).

3.2. Development and spread of CFC rules

The United States was the first country that adopted CFC legislation in 1962 and focussed on limiting tax deferral using offshore tax-haven structures (Schmidt, 2016:89). Since then, many countries have adopted CFC rules into their domestic legislation (OECD, 2015a:11). By 1996, 14 OECD member countries had adopted CFC legislation and on 1 July 1997 South Africa became the nineteenth country to incorporate CFC legislation (OECD, 1998:41).

During the 1970s and 1990s many OECD countries liberalised their exchange control regulations which resulted in a worldwide adoption of CFC rules (Holliday, 2020:10). The removal of these exchange controls allowed for increased cross-border capital flow (Sandler, 1998:1). Sandler (1998:2) noted that in addition to enhancing the cross-border activities of many multinational enterprises (MNEs), the removal of these capital controls allowed MNEs to setup their operational structures in such a manner that it could be perceived as engaging in harmful tax practices. The implementation of aggressive tax planning schemes by MNEs caused renewed international and

political interest in these schemes, which was also amplified by the global financial crisis (Schmidt, 2016:90).

By 1998, the OECD recommended that countries without CFC legislation consider adopting such rules. Countries with existing CFC legislation were advised to ensure that the rules applied in a manner consistent with the intention of curbing harmful tax practices (OECD,1998:41). Based on this recommendation, more countries adopted CFC rules and by 2015 the number of countries who had introduced CFC rules into their domestic legislation had increased to more than 30 (OECD, 2015b:9).

3.3. Reason for the introduction of CFC rules in South Africa

As discussed in Chapter 2, a relaxation of South African exchange controls has taken place over the last three decades and has resulted in easier cross-border capital movement. This presented greater opportunities for new or expanding businesses to set up CFCs in low tax jurisdictions to divert profits and avoid South African tax. Seonath (2003:139) noted that as the mobility of capital increases the easier it will become for residents to avoid its country's domestic tax rules.

With the new ease of cross-border capital movement, coupled with the change from a source-based to a residence-based system of taxation and South Africa's comparatively high individual and corporate tax rates, the need for South Africa's own CFC legislation was prompted (Seonath, 2003:6). Furthermore, in the absence of international co-operation, countries must preserve the integrity of their local tax systems through unilateral action (Seonath, 2003:6).

According to the Davis Tax Committee (2016a:1) the main purpose of the South African CFC rules is to combat base erosion and profit shifting (BEPS) by targeting foreign investments made by South African residents, through foreign entities, in an attempt to shift income-earning assets and activities from the South African tax base to low or no-tax countries. National Treasury has amended the CFC rules numerous times over the past two decades in an effort to close all perceived loopholes. These rules were once again amended in 2020 to counter tax avoidance using a loop structures.

3.4. Fundamental aspects of South African CFC rules

3.4.1. Introduction

One key element of the residence basis of taxation is section 9D of the ITA which contains the South African CFC rules and provides for South African taxation of certain foreign sourced income generated by a South African CFC.

Section 9D is designed to prevent deferral through South African owned foreign entities. Nevertheless, international law only allows South Africa to tax foreign residents on their South African sourced income (Department of National Treasury, 2002:1). International law does not allow South Africa to directly tax foreign entities on their foreign source income, even if those foreign entities are completely owned by South African residents (Department of National Treasury, 2002:1). However, in order to solve the problem of deferral while complying with international law, section 9D acts as a look-through measure that lifts the corporate veil by taxing South African shareholders on the foreign income earned by the foreign entities as if those foreign entities immediately repatriated their foreign income when earned. The application of section 9D is similar to other internationally used regimes of its kind. The objective of the provision is to effectively impute and tax the income of a controlled foreign company in the hands of its South African shareholders as if the income of the foreign company (the CFC) had accrued to the shareholders directly (Department of National Treasury, 2002:1). The net income of a foreign company will only be included in the taxable income of a South African resident taxpayer if it is concluded that the foreign company relating to that taxpayer is a CFC (Olivier & Honiball, 2011:572).

3.4.2. Defined terms in Section 9D

Section 9D consists of many defined terms which should be considered together.

3.4.2.1. Foreign company

According to Singh (2014:68) one of the main requirements of CFC rules is the identification of a foreign company to which the rules apply. Therefore, a definition for determining whether a company is a foreign company is essential, which will also establish the relationship between the residents of the country applying the CFC rules and the foreign company (Singh, 2014:68).

In 2002, the term “controlled foreign company” was introduced in section 9D of the ITA and replaced the term “controlled foreign entity”. The new term also removed foreign trusts from the scope of the CFC rules because the imputation of section 9D is predicated on ownership and the discretionary trust does not exactly fit that design (Davis Tax Committee, 2016a:17). This change was aligned with other anti-avoidance measures in the ITA, whereby foreign trusts have been dealt with separately in another way (Swart, 2021:21). Furthermore, the new term was more consistent with the international description used by the OECD (Kau, 2021:10).

Section 1 of the ITA defines a foreign company as “any company which is not a resident”. This is a company that has its place of effective management outside of South Africa (Haupt, 2091:595). The term “resident company” and “place of effective management” is briefly discussed in 3.5.3.

Furthermore, the term “foreign company” is specifically defined for the purpose of section 9D(1) as follows:

“Resident company” means -

- a) a cell or segregated account contemplated in the definition of a protected cell company;
- b) a protected cell company to the extent that:
 - i. specified assets of that company are not segregated into structurally independent cells or segregated accounts as contemplated in paragraph (a) of the definition of “protected cell company”; or
 - ii. specified assets and liabilities of that company are not linked or attributed to cells or segregated accounts as contemplated in paragraph (b) of the definition of protected cell company; or
- c) a foreign company, as defined in section 1, other than a protected cell company”.

A company that is situated in a foreign country, but that is effectively managed in South Africa where South African residents directly or indirectly control those assets, will be excluded from the South African CFC rules, because the company will be regarded as resident in South Africa irrespective of where the company is situated (Olivier & Honiball, 2011:561). It follows that a company that is resident in South Africa can therefore not fall within the definition of a controlled foreign company in section 9D(1), even if it was incorporated in another country (Potgieter, 2012:25). Therefore, a company will only be regarded as a CFC if the company is a foreign company. Furthermore, under the residence-based system of taxation foreign companies are afforded an opportunity to change the character of income or defer the accrual of income by accumulating it in the foreign company (Katz Commission, 1997:par. 8.2.1). As a result, the design of the CFC rules specifically targets foreign companies and not natural persons. From the above it can be concluded that, for South African CFC legislative purposes, the entity or person concerned, must be a foreign company.

3.4.2.2. Definition of a CFC

The definition of a CFC is important in the application of the CFC rules. It follows that the next step is to establish whether a foreign company is regarded as a CFC. A foreign company is regarded as a CFC where:

- more than 50 per cent of the total participation rights in that foreign company are directly or indirectly held by one or more South African residents; or
- more than 50 per cent of the total voting rights in that foreign company are directly or indirectly exercisable by one or more South African residents; or

- International Reporting Standards (IFRS) 10 require the foreign company's financial statements to be consolidated into a South African company's financial statements, other than a headquarter company (Stiglingh, 2022:874).

According to Oguttu (2007:116), the phrase "directly or indirectly" included in the CFC definition means that the interests of both registered and beneficial shareholders should be considered. The rationale detailed in the Katz Commission report (1997:par. 8.3.1.3) for the inclusion of the above phrase was that the definition of "control" over a CFC should be broad in order to prevent any potential manipulation in order to escape the CFC rules.

3.4.2.3. Defining control of a foreign company

When a tax resident has influence over the actions of a foreign company it controls such actions, including the flow of capital and profits, and the foreign company can be regarded as an extension of the tax resident (Holliday, 2020:13). The OECD (2015a:25) recommended that countries should regard foreign companies as controlled if residents hold at minimum more than 50 per cent control in that foreign company. The OECD (2015a:24) further argues that control can be established legally or economically, where legal control generally considers voting rights and economic control considers the rights to the profits, capital and/or assets. Whether a foreign company will be regarded as a CFC in terms of South African CFC rules is conditional on the participation and voting rights and it is therefore necessary to clarify the meaning of these two terms.

3.4.2.3.1. The meaning of participation rights

In terms of section 9D(1) participation rights in relation to a foreign company means the right to participate directly or indirectly in a portion or all of the economic benefits of the rights that is assigned to the ownership of a share, or any interest of a similar nature, in that company (apart from voting rights). For example, equity shares with the right to participate in share capital, current or accumulated profits, or reserves, and other types of shares (Oguttu, 2007:115).

Haupt (2015:596) explains that the meaning of participation rights is critical for two reasons:

- 1) A foreign company is regarded as a CFC if more than 50 per cent of the total participation rights are directly or indirectly held by South African residents.
- 2) When the income of a CFC is attributed to the South African resident shareholder, that resident's participation right in relation to the total participation rights is used as the basis for imputation. In other words, a proportional amount of the net income of the CFC is

imputed to a South African resident shareholder based on the percentage of their participation rights held in the CFC.

The definition of the term “participation rights” is very broad and careful consideration is required when determining whether “more than 50 per cent” of the participation rights held in a foreign company are held by South African residents (De Koker & Williams, 2023:par. 5.43). The CFC rules determine that participation and voting rights in a foreign company can be held or exercised by more than one South African resident and if their participation and voting rights exceed 50 per cent in aggregate, the foreign company may still meet the definition of a CFC (Swart, 2021:21). A resident that holds less than 5 per cent of the participation rights in the foreign company, will not be regarded a resident for the purposes of aggregating other residents’ ownership in a foreign company to meet the 50 per cent control requirement (Holliday, 2020:17). There is no requirement that these residents who will in aggregate hold more than 50 per cent of the participation and/or voting rights have to be connected persons in relation to each other for the CFC rules to be applicable (Van Heerden, 2009:152).

Oguttu (2007:118) explains that the right to exercise any voting rights to determine control should only be considered where it is concluded that no person has any participation rights in the foreign company as considered above, or such a right cannot be decided.

3.4.2.3.2. The meaning of voting rights

Voting rights can be used as an alternative test to participation rights to determine whether a foreign company is a CFC (De Abreu, 2010:20). The ITA determines that a foreign company will be regarded as a CFC if the aggregate of directly or indirectly exercisable voting rights in the foreign company held by one or more South African residents amount to more than 50 per cent.

While it can be argued that it can with relative certainty be determined whether a resident holds participation rights or not, the term “voting rights” is noted to be much vaguer as the term is lacking a precise definition in section 9D or in any other section of the ITA (De Abreu, 2010:19).

The term voting rights gains relevance in instances where no person has any right in the foreign company, or a person’s rights in the foreign company cannot be determined or, when the criteria as defined for participation rights have not been met (Olivier & Honiball, 2011:567). According to Olivier and Honiball (2011:568) it can be argued that voting rights refer to any form of control over the allocation of profits or capital held by a South African resident. Voting rights will be considered, for example, where the company has no shares in issue and only has voting rights, or no rights attach to the shares in issue.

3.4.2.3.3. Additional considerations included in the CFC definition

An additional control consideration was included in the CFC definition, effective from 1 January 2018. The definition includes a consideration of control, that is based on consolidation in terms of International Reporting Standards (IFRS) 10 (Department of National Treasury, 2017a:59). In other words, if financial accounting standards require a foreign company's financial statements to be consolidated into a South African company's financial statements, that specific foreign company is a CFC, even if less than 50 per cent of its participation rights are held. The amount of the CFC's net income to be included in the South African company's income for tax purposes must be calculated based on the net percentage of the financial results of the foreign company that must be included in the consolidated financial statements, as contemplated in IFRS 10 (Department of National Treasury, 2017a:59). The rationale behind adding this additional consideration was to include other types of entities, other than companies, that are consolidated for accounting purposes (Holliday, 2020:17). This was implemented to address SARS' concern that the CFC rules did not capture other types of entities such as foreign trusts or foundations that were being used to artificially sever the connection between a South African resident and a CFC (Department of National Treasury, 2017a:58).

From the above one can therefore argue that the consideration of economic control, legal control and control based on consolidation provided for in section 9D, is aligned with the OECD's recommendations to determine when a foreign company would be regarded as controlled.

3.4.3. Income targeted by CFC rules

The CFC rules were enacted with the objective that a taxpayer that shifts income to a foreign company will be left in a similar position than if that income had accrued to the taxpayer directly (Stiglingh *et al.*, 2022:872).

The primary target of the CFC rules are structures that are deliberate avoidance schemes used by South African residents who diverts their foreign activities and income-earning assets to a foreign company to reduce their taxable income (Haupt, 2019:592). It is aimed at highly mobile passive income pursuant to the traditional "categorical analysis approach" in which listed passive forms are viewed as tainted subject to specific mechanical exceptions. In general, tainted income includes passive investment income (Arnold, 2019:637). More specifically dividends are considered tainted unless previously taxed or qualify for the participation exemption in section 10B of the ITA (Davis Tax Committee, 2016a:28). It also targets suspect business structures or schemes that involve income being diverted abroad by South African residents (Stiglingh *et al.*, 2022:872).

Passive income is generated from assets that can be easily shifted without economic consequences and does not involve active income (Seonath, 2003:81). Passive income comprise of dividends, interest, royalties, rentals, annuities, exchange differences, insurance premiums, other similar income, and associated capital gains (Haupt, 2019:592).

Diversionsary income is income which SARS considers to be derived from suspect activities and transactions between a CFC and a South African resident. These are transactions which are likely to create opportunities for transfer pricing and therefore tax avoidance (Haupt, 2019:592).

Swart (2021:23) explains that it is not the purpose of the CFC rules to bring income of a foreign company that arises from bona fide business activities between the foreign company and a South African resident within the tax net of South Africa.

3.4.4. Imputation of income

3.4.4.1. Introduction

Once it has been established that a foreign company meets the requirements of a CFC, the next step would be to determine whether the net income of the CFC as calculated should be imputed to the South African resident shareholder and a portion included in the shareholder's taxable income (Section 9D(2A)).

3.4.4.2. Exemptions

In a number of situations, the imputation rules are subject to exemptions and the net income is not imputed to the South African residents concerned. In National Treasury's detailed explanation of section 9D, it was confirmed that there are exemptions available to a South African tax resident who is required in terms of section 9D(2) to impute the net income of a CFC in their income (Department of National Treasury, 2002:7).

South African tax residents that hold less than 10% of the participation rights in the CFC and less than 10% of the voting rights in the CFC qualify for the *de minimus* exemption and do not have to impute the net income of the CFC in their income (Haupt, 2019:599).

There are further exemptions for imputation within the CFC rules namely the "high-tax exemption" or the "foreign business establishment". Generally, these exemptions are considered before the net income of the CFC is calculated (Stiglingh *et al.*, 2022:879). If the CFC adheres to the requirements of either of the two possible exemptions, the net income of the CFC can be deemed to be zero and may not be taxed in the South African residents' hands, or may be partially included (Stiglingh *et al.*, 2022:879).

In terms of the second proviso to the definition of “net income” in section 9D(2A) of the ITA, the high-taxed exemption applies where the CFC is liable for foreign tax that is equal to at least a minimum of 67 per cent of the tax that would have been due under South African law, had the CFC been a South African tax resident (Stiglingh *et al.*, 2022:879). This exemption was introduced to remove the obligation to apply the CFC rules in instances where there is not much tax at risk for South Africa because of the section 6quat rebate that will be given to the CFC for taxes paid in the foreign country and it is unlikely that the structure was motivated by tax benefits.

Where a CFC meets all of the requirements of an FBE, the exemption contained in section 9D(9)(b) of the ITA would apply. In essence, the FBE exemption would apply where receipts and accruals of the CFC are attributable to legitimate business or commercial activities with proof of substance outside South Africa, and provided none of the diversionary rules are applicable (Olivier & Honiball, 2011:581). The primary target of the CFC rules are structures that are deliberate avoidance schemes and not income from normal business activities with substance carried on outside South Africa (Stiglingh *et al.*, 2022:880). This exemption was therefore implemented to strike a balance between income derived from legitimate business activities compared to income derived from fictitious business activities (Olivier & Honiball, 2011:581).

When performing the net income calculation of a CFC, it should first be determined whether the high-tax exemption applies, before potentially proceeding with disregarding the relevant amounts excluded in terms of section 9D(9) of the ITA from net income.

Should neither of the above exemptions apply, the net income of the CFC must be determined. In this regard, it can be concluded that the CFC rules will only be applicable to loop structures where neither of these exemptions apply.

3.4.4.3. Net income inclusion

Unless one of the exemptions apply, SARS can “look through” the foreign company and impute the notional net income of the CFC in the hands of the South African resident shareholder, where it will be subject to tax in South Africa.

The notional amount that a qualifying tax resident should include in its net income is based on the percentage of the participation rights in the CFC held by the resident. This notional amount is also referred to as the proportional amount that a tax resident includes in its taxable income in respect of a CFC (Haupt, 2019:598). Thus, resulting in the resident being subject to tax on such notional income imputed to it and the taxation takes place when the income is realised and is not postponed until repatriation (Clifford, 2017:8).

As discussed in 3.4.2.2 a foreign company may in some cases only be a CFC because it is treated as a subsidiary of a resident company (holding company) in terms of IFRS 10, instead of on the basis of voting or participation rights. In these cases, the percentage of the participation rights in the CFC, for purposes of determining the proportional amount, is equal to the net percentage of the financial results of the foreign company that is included in the consolidated financial statements of the holding company (Stiglingh *et al.*, 2022:877)

Section 9D(2)(A) contains specific rules regarding the calculation of net income. The “net income” of a CFC in respect of a foreign tax year is “an amount equal to” the taxable income of the CFC determined in accordance with the ITA as if the CFC had been a taxpayer and treating the CFC as if the company had been:

- a resident for purposes of the definition of “gross income” and certain specified sections of the ITA (section 7(8), 10(1)(h), 25B, 28 and paragraphs 2(1)(a), 24, 70,71, 72 and 80 of the Eighth Schedule to the ITA; and
- a taxpayer for provisions that do not refer to the resident status of a taxpayer.

In essence the “net income” is a calculation of taxable income as if the CFC was a South African tax resident (Haupt, 2019:601). National Treasury’s objective for including the net income was to prevent any potential DTA override because the net income is calculated as if the foreign company is a South African tax resident (Department of National Treasury, 2002:2). The above basis for calculating the net income is aligned with the OECD recommendations in Action Plan 3 (OECD, 2015c:55). The OECD (2015c:55) views this basis as logically consistent with the concerns of BEPS addressed by the resident’s jurisdiction.

3.4.4.4. Provisos to the calculation of net income

Over and above the definition of a CFC, there are also provisos to section 9D(2A) of the ITA that require evaluation when the net income of a CFC is calculated. The provisos mentioned include:

- deductions or allowances may not exceed income (Section 9D(2A)(a)),
- limitation of assessed losses (Section 9D(2A)(b)),
- no deductions are allowed for certain passive transactions between the foreign company and another CFC (Section 9D(2A)(c)),
- dividends received from resident companies by a CFC may not be treated as fully exempt from normal tax in terms of section 10(1)(k)(i). A formula is applied to determine the amount of the dividend to be included in net income (Section 9D(2A)(d)),
- the valuation date for CGT purposes is the date the foreign company became a CFC on or after 1 October 2001 (Section 9D(2A)(e)),

- the inclusion rate for CGT purposes is 40% where the resident is an insurer in respect of its policyholder fund. In all other instances, an inclusion rate of 80% applies. (Section 9D(2A)(f)),
- for the purposes of Section 24I and paragraph 43 of the Eighth Schedule, the functional currency of a CFC is deemed to be its local currency (Section 9D(2A)(k)),
- where hyperinflationary currency of a CFC was abandoned and a new functional currency was adopted, the cost of an asset of a CFC will be determined using the new currency (Section 9D(2A)(l)).

The relaxation of the exchange control restrictions on loop structures as discussed in 2.4.3 above was accompanied by the amendment of proviso (d) and (f) of section 9D(2A) of the ITA. The purpose of this amendment is to protect the tax base by refining the tax treatment of capital flows and to restrict the artificial reduction of dividends and capital gains tax where loop structures are used to avoid or defer tax.

3.5. CFC rules and local dividends – amendment to Section 9D(2A)(d)

3.5.1. Introduction

Dividends are regarded by the CFC rules as tainted income unless previously taxed or qualify for the participation exemption in section 10B of the ITA (Davis Tax Committee, 2016a:28).

3.5.2. Dividends tax

A dividend can be defined as follows:

“Dividend” means any dividend or foreign dividend as defined in Section 1, including any amount contemplated in Section 31(3)(i), that is –

- a) paid by a company that is a resident; or
- b) paid by a foreign company –
 - i. if the share in respect of which that foreign dividend is paid is a listed share; and
 - ii. to the extent that that foreign dividend does not consist of a distribution of an asset in specie;”

Dividends tax came into operation on 1 April 2012 and applies to any dividend declared and paid by a company on or after that date. Dividends tax is currently levied at a rate of 20 per cent on any dividend paid by a company, subject to certain exemptions and reduced rates in terms of a DTA (Stiglingh *et al.*, 2022:726). The SARS Comprehensive Guide to Dividends Tax (SARS, 2022:20) explains that the company pays normal tax on its profits and withholds a further amount

of dividends tax on behalf of its shareholders, subject to certain exemptions that apply, when a cash dividend is distributed to the shareholders. By contrast, subject to exemptions that apply, the company is subject to dividends tax on any dividend in specie paid by it.

The dividend withholding tax is referred to as dividends tax and will be levied on dividends paid by South Africa resident companies (other than headquarter companies) or by foreign companies listed on a South African stock exchange (Olivier & Honiball, 2011:77). Dividends tax is also payable on a foreign dividend to the extent that the foreign dividend does not constitute the distribution of an asset *in specie*, and is paid to residents by foreign companies in respect of listed shares. Dividends paid to non-residents may be subject to a reduced rate of tax under any applicable DTA between South Africa and the country of residence of the non-resident investor (SARS, 2022:127). Generally, when a beneficial owner of a dividend is a foreign company, the foreign company will, subject to the applicable treaty, be entitled to a lower rate of dividends tax than a beneficial owner other than a company (SARS, 2022:128).

Dividends tax is not a contribution towards a person's normal tax liability but is a stand-alone tax. In general, a dividend will be subject to either dividends tax or normal tax, but not both (SARS, 2022:6). Normal tax is levied on taxable income and tax will therefore be paid on a dividend or foreign dividend received or accrued which has been included in gross income and is not exempt from normal tax.

Dividends or foreign dividends received by or accrued to a person are specifically included in such a person's gross income by paragraph (k) of the "gross income" definition in section 1(1) of the ITA and subject to normal tax, unless an exemption under section 10(1)(k)(i) or 10B apply (Olivier & Honiball, 2011:77). Dividends declared by South African resident companies are generally exempt from normal tax under section 10(1)(k)(i) in the hands of the South African resident shareholders, subject to certain exceptions (Stiglingh *et al.*, 2022:88).

In terms of the CFC imputation rules as discussed in 3.4.4, the "net income" of a CFC must be determined and an amount equal to a pro rata share of such net income must be included in the income of the resident shareholder, subject to the detailed provisions of section 9D of the ITA.

3.5.3. Exemption from dividends tax

A dividend may in certain circumstances be exempt from dividends tax. As Stiglingh *et al.* (2022:371) explain, the exemption is subject to/dependent on the characteristics of the beneficial owner, i.e. the person entitled to the benefit of the dividend attaching to the share, the characteristics of the company paying the dividend, or specific features of the dividend itself.

A dividend may under certain circumstances qualify for exemption from dividends tax under more than one of the paragraphs of section 64F(1). Should more than one exemption apply, the dividend will be exempt only once from dividends tax.

A dividend will be exempt from dividends tax under section 64F(1)(a) of the ITA if the beneficial owner is a resident company (SARS, 2022:99). The exemption applies regardless of whether the company paying the dividend and the company receiving the dividend as the beneficial owner are within the same group of companies (SARS, 2022:99). The following are examples of companies that fall within the definition of “company” in section 1(1) of the ITA:

- A state-owned company, a private company, a personal liability company, a public company and a non-profit company incorporated under the Companies Act (paragraph (a) of the definition of “company”). This may include –
 - a body corporate established under Section 36 of the Sectional Titles Act 95 of 1986; and
 - a share block company established under the Companies Act.

A resident company

Under section 1(1) of the ITA a company is regarded as resident in South Africa if it is incorporated, established, or formed in South Africa or has its place of effective management in South Africa. However, a company that is deemed to be exclusively resident in another country in terms of a double taxation agreement (DTA) is excluded from SA residency.

The term “place of effective management” is not defined in the ITA and therefore it must be assigned its ordinary meaning, considering international precedent and interpretation (SARS, 2023:3). According to SARS Interpretation Note 6 (Issue 3) (2023:5) the place of effective management is regarded as “the place where key management and commercial decisions that are necessary for the conduct of its business as a whole are in substance made and is in line with the OECD’s commentary on place of effective management”.

As a result, a dividend declared by a resident company to a beneficial owner that is a resident company is exempt from dividends tax. This exemption avoids dividends tax from being levied more than once on the same profits when the company that receives the dividends transfers it to its ultimate shareholders through multiple layers of companies (Stiglingh *et al.*, 2022:732). Furthermore, this exemption will apply regardless of the extent of the resident company’s shareholding in the company declaring the dividend.

3.5.4. Tax treatment of dividends declared by a South African resident company to a CFC.

Before the amendments to section 9D(2A)(d) of the ITA, for purposes of the net income calculation of CFCs that owns South African shares, the standard income tax exemption in section 10(1)(k) of the ITA applicable to South African dividends would have applied (Bouwer, 2021). Considering that dividends are included in gross income under paragraph (k) of the definition of “gross income”, but may qualify for exemption under section 10(1)(k)(i), such dividends would thus not be included in the net income of the CFC that owns South African shares (Department of National Treasury, 2020:38). The dividends declared by the South African target company to the CFC would already have been subject to dividends tax at a rate of 20 per cent unless the rate was reduced in terms of a relevant DTA. As Horak *et al.* (2020) explain, the South African corporate shareholders who have invested through a CFC were thus not in as favourable a position as they would have been had they held the shares in the South African target company directly, as there is tax leakage in the form of dividends withholding tax.

When a South African resident individual invests cash and acquires shares in a CFC that then acquires shares in a resident company, it would give rise to a loop structure (Oguttu, 2022:109). As discussed in 2.4.2 the existence of a non-resident company in the loop structure creates a tax planning opportunity for the South African resident with respect to dividends tax. Should loop structures no longer be restricted by exchange control policy, it would be possible for a resident to set up a structure where a CFC owns a South African resident target company, and any dividends flowing from the South African resident target company to the resident individual shareholder or trust through the CFC will be tax-exempt for the individual or trust. That would enable the resident individual or trust to reduce their dividend tax liability in respect of dividends declared by a resident company (Department of National Treasury, 2020a:137). It follows that this would result in or have the potential to result in the direct or indirect export of capital abroad to a foreign company or other relevant foreign trust or entity for the ultimate benefit of a South African resident.

Section 9D(2A)(d) of the ITA was introduced as a measure to address any concern arising from the removal of the exchange control restrictions on loop structures. With effect from 1 January 2021, dividends received from South African resident companies must not be treated as fully exempt where such dividends are received by or accrue to a CFC (Department of National Treasury, 2021a:38). It requires a CFC to include a portion of any dividend received or accrued from the South African company in its net income in terms of a formula (Department of National Treasury, 2021a:38). The portion of the dividend that is included in the CFC’s income is equal to the amount of the dividend, reduced on a sliding scale, with reference to the rate of dividend tax

imposed in South Africa (Bagraim, 2021). The result is then multiplied by the ratio of the number 20 to the number 28.

The rule established by proviso (d) requires a portion of any dividend received or accrued by the CFC from a South African resident company to be included in the net income of a CFC.

The formula used to calculate the portion of the dividend is as follows:
A = B × (C – D)

- A:** represents the portion of the dividends to which the exemption (Section 10(1)(k)(i)) must not be applied.
- B:** represents the ratio of the number 20 to the number 28.
- C:** represents the aggregate of dividends received by or accrued to the CFC during the foreign tax year.
- D:** represents an adjustment to reflect the effect of any dividends tax already paid by the CFC as dividends tax deducted in respect of the dividend. This adjustment aims to ensure that the dividend is ultimately subject to tax at a rate of approximately 20% if the aggregate of the inclusion in net income and dividends tax withheld are considered. “D” in the formula must be determined by applying the following percentages to the amount of dividends, depending on the rate at which dividends tax was paid (Stiglingh *et al.*, 2022:882):

The effective tax rate attributable to a dividend can be illustrated as indicated in Table 1:

| Dividends tax rate | Percentage deduction to determine “D” |
|---------------------------|--|
| 20% | 100% |
| 15% | 75% |
| 10% | 50% |
| 8% | 40% |
| 7,5% | 37,5% |
| 5% | 25% |

Table 1: The effective tax rate attributable to a dividend (Adapted from Stiglingh *et al.*, 2022:882)

The proportion is 20/28, which means that where a South African company is the shareholder of a CFC, the effective tax rate becomes 20 percent (28 per cent of 20/28), which is the same as the dividends withholding tax on South African dividends and the effective tax rate attributable to foreign dividends where the participation exemption does not apply (Mazansky, 2021:140). It should further be noted that the corporate tax rate has since been reduced from 28% to 27% effective 1 April 2022. As a result, in the 2023 Draft Taxation Laws Amendment Bill it is proposed that factor B is adjusted to the ratio of the number 20 to the number 27. This change comes into operation on 1 January 2024 and applies in respect of foreign tax years of CFCs ending on or after that date (Department of National Treasury, 2023:12). This will allow the formula to align with the dividends tax rate.

Mazansky (2021:140) explains that the approach used has the following three effects: (i) a portion of the dividend is included in the notional net income of the CFC; (ii) an equal amount is included in the income of the shareholder to be taxed at ordinary income tax rates; and (iii) the amount of this tax plus any withholding tax borne by the CFC on the dividend represents an amount equal to 20 per cent of the gross dividend.

The formula considers the impact of dividends tax withheld by the South African resident company when it paid the dividend to the CFC (Brink & Mazibuko, 2020:5). Recognising that the dividend from a resident South African company would have been subject to dividends tax at 20 per cent, or possibly less under a DTA, proviso (d) establishes an adjustment mechanism to ensure that, to the greatest extent possible, the tax liability by the shareholder (for a corporate shareholder in the CFC) on the CFCs profits, together with the dividends tax withheld on the South African dividend, will not exceed an effective rate of 20 per cent (Brink & Mazibuko, 2020:6).

Therefore, it follows that if, for example, the full 20 per cent was withheld on the South African dividend, there would be no adjustment required to the CFC's net income. However, if the withholding tax was reduced to, for instance, 5 per cent under a relevant DTA, it would result in the shareholder of the CFC paying an effective 15 per cent tax on the portion of the CFC's net income comprising that dividend, attributable to that shareholder. If the dividend was subject to dividends tax at a reduced rate of 5 per cent, the formula should ensure that the dividend is subject to income tax at a rate of 15 per cent. For a South African resident corporate shareholder being taxed at 28 per cent, this formula will result in an effective rate of 20 per cent on South African dividends received by a CFC. On the other hand, the inclusion rate is not adjusted where the South African resident shareholder is an individual. As a result, an individual shareholder in the CFC will pay income tax at a rate of up to 24,11 per cent, plus the 5 per cent dividends tax that was withheld by the South African resident company declaring the dividend (Bouwer, 2021).

While this formula will result in an effective 20 per cent tax rate where the South African shareholder is a corporate, it is concluded that the formula is not adjusted where the resident shareholder is an individual or a trust. As a result, the dividend could be taxed at an effective rate of up to 32,14 per cent (45 per cent of 20/28) where the shareholder is an individual or trust, which is greater than the rate at which tax on South African or foreign dividends is imposed (Horak *et al.*, 2020). It follows that if the domestic rate for dividends is 20 per cent for all shareholders, then the formula for individuals and trust shareholders should be 25/45, resulting in a flat rate of 20 per cent, not 20/28 as per the current formula.

It is concluded that the amendment to section 9D(2A)(d) of the ITA has the effect that dividends paid by the South Africa company to the foreign company will suffer both local dividends tax (at 20 per cent unless the rate was reduced in terms of an applicable DTA) and also income tax under the CFC rules.

The amendment does not affect existing permissible loop structures established in terms of previous exchange control policy restrictions which allowed South African resident companies to use their foreign investment allowance to acquire up to 40 per cent of equity interest and/or voting rights in a foreign company that invested back into South Africa (Oguttu, 2022:112). This is due to the fact that South African residents that jointly hold up to 40 per cent of shares or voting rights in the foreign company would not constitute a CFC as defined in section 9D (Smit, 2020).

3.6. CFC rules and capital gains

3.6.1. Introduction

South African residents are taxed on their worldwide income (Income Tax Act, 58 of 1962). Section 26A and the Eighth Schedule to the ITA provide that a taxable capital gain must be included in a taxpayer's taxable income. Therefore, a capital gain derived from the sale of shares held by a South African resident in a foreign company will be subject to South African tax provided no exemption applies, or a DTA determines differently (Musviba, 2013). Section 9D makes specific provision for the way in which the taxable capital gain or assessed capital loss of the CFC is to be determined when calculating the net income of the CFC (SARS, 2020:816).

3.6.2. Application of the capital gains tax participation exemption

As discussed above, section 9D(2A) of the ITA provides that a CFC must be regarded as a taxpayer and as a South African resident for specific sections of the ITA when determining the net income of that CFC. Furthermore, it requires that there shall be included in the income of a resident holder of participation rights (other than a headquarter company) "an amount equal to"

the proportional amount of the “net income” of a CFC. The words “an amount equal to” indicate that when the shares in a CFC are disposed of it is not the taxable capital gain that is included in the South African resident’s income but an amount equal to such a taxable capital gain (SARS, 2020:83). Therefore, the separate character of a CFC’s capital gains is lost (SARS, 2020:83). Consequently, the receipt or accrual of amounts from the disposal of shares held by that CFC need to be included as part of the net income of that CFC, but subject to the application of the high tax jurisdiction and foreign business establishment (FBE) exemptions. On the basis that the high tax jurisdiction and FBE exemptions do not find application, one must determine the net income of that CFC in terms of the provisions of the ITA, as if that CFC is a taxpayer and a resident under specific provisions of the ITA. For this purpose, the opening words of section 9D(2A) make paragraphs 2(1)(a), 24, 70, 71, 72 and 80 of the Eighth Schedule applicable in determining the CFC’s taxable income (SARS, 2020:83).

Similar to many European countries, South Africa utilises a participation exemption in the case of dividends and capital gains (Department of National Treasury, 2003b:90). Accordingly, it should be considered whether the participation exemption from capital gains and losses in paragraph 64B of the Eighth Schedule to the ITA could result in the gain or loss from the disposal of shares by that CFC being disregarded when determining the net income of that CFC (SARS, 2020:816).

3.6.3. Disposal of equity shares in foreign companies

Paragraph 64B of the Eighth Schedule to the ITA came into operation on 1 June 2004 and contains the participation exemption for the disposal of equity shares in a foreign company on or after that date. Over the years the provision has been changed multiple times to integrate, amongst other things, the reduction in the percentage holding required to qualify for the exemption, to insert and later replace very complex anti-avoidance measures and to keep pace with the changes in the manner in which returns of capital are treated (SARS, 2020:540).

In broad terms the participation exemption allows South African resident shareholders to make tax-exempt disposals of foreign shares in a foreign company in which they hold an interest of at least 10 per cent, subject to the disposal being made to non-residents (SARS, 2020:541). The latter requirement encourages the repatriation of foreign funds to South Africa. In essence, paragraph 64B(1) of the Eighth Schedule to the ITA provides that a person must disregard any capital gains and losses, provided that all of the following requirements are met:

- the disposal must constitute a disposal of equity shares;
- the equity shares being disposed of must be in relation to a foreign company;

- the South African tax resident shareholder held an interest of at least 10% of the equity shares and voting rights in that foreign company; and
- held that interest in the shares for at least 18 months prior to that disposal; and
- the interest is disposed of to a non-resident other than a CFC or a connected person in relation to the shareholder disposing of the interest; and
- the proceeds on disposal are equal to or exceed the market value of the interest.

National Treasury in its Explanatory Memorandum on the Draft TLAB (2021a:37) commented that the paragraph 64B provision have the effect that gains on the sale of shares in a foreign company to a tax non-resident are not taxed because of the participation exemption in section 10B(2)(a) of the ITA. Singh (2014:124) explains that the intention of the participation exemption in paragraph 64B(1) is to assist with internal restructuring of foreign subsidiaries. The exemption also allows for the sale of certain foreign shareholdings to tax non-residents with the expectation that the loss of foreign shareholdings would be replaced with valuable consideration (Department of National Treasury, 2005:57).

However, over the years it had become apparent that some MNEs were looking to employ the exemption as a mechanism to disinvest from their foreign subsidiaries – with foreign subsidiary ownership transferring abroad with little or no consideration remaining within South Africa (Department of National Treasury, 2005:57). Simultaneously, the exemption created tax planning opportunities as some of these transactions further contained tax avoidance schemes, in an effort to accomplish a completely tax-free disinvestment (Department of National Treasury, 2005:57).

3.6.4. Rationale behind the capital gains tax participation exemption

In the 2003 Budget Review (Department of National Treasury, 2003a:88), the Minister of Finance announced his intention to allow the tax-free repatriation of foreign dividends to South Africa, through the removal of tax on foreign dividends from foreign subsidiaries. This dividend participation exemption, was introduced into section 10(1)(k)(ii)(dd) of the ITA and later moved to section 10B(2)(a) of the ITA (SARS, 2020:540). Under the participation exemption system in section 10B(2)(a), foreign dividends distributed by foreign companies are exempt from tax if a South African tax resident directly or indirectly owns at least 10 per cent of the total equity shares and voting rights in the foreign company declaring a foreign dividend (SARS, 2021b:22). The South African tax resident qualifying for the exemption under section 10B(2)(a) could, amongst others, be a natural person, a trust or a company and in most instances a CFC. The policy objective for the participation exemption is to promote the flow of capital into South Africa and to provide an incentive for South African tax residents to repatriate foreign dividends to South Africa and avoid economic double taxation (De Koker & Williams, 2023:par. 24.110A).

The purpose of the capital gains participation exemption is to complement the dividends participation exemption as they exist alongside each other. Capital gains arguably stem from accrued profits normally associated with future dividends (Department of National Treasury, 2003b:90). Paragraph 64B of the Eighth Schedule gives effect to the capital gains tax participation exemption. The policy rationale for the participation exemption follows the notion behind the participation exemption in section 10B(2) for foreign dividends in that the profits realised from the sale of shares represent unrealised dividends and that such profits would in any event have qualified for the participation exemption in section 10B(2)(a) had they been declared as a dividend to the South African resident shareholder (Govindasamy, 2021:6). Therefore, if foreign dividends are exempt, it is argued that comparable capital gains should be exempt. It is also probably best described as a “participation exclusion” since it applies to both capital gains and losses (SARS, 2020:541). Another purpose of this rule was to exempt these capital gains so that the South African tax laws do not discourage the repatriation of funds back to South Africa (Department of National Treasury, 2012:95).

Most taxpayers view the participation exemption as an important planning tool available to multinationals of most worldwide taxing regimes. The problem has been the misuse of the exemption to facilitate indirect corporate migrations or disinvestment from core business activities (Department of National Treasury, 2012:95).

As discussed in 2.4.2 if loop structures are no longer restricted by exchange control policy, it creates a risk for the tax base as it would be possible for a South African resident to dispose of shares in a CFC that owns South African assets tax-free (Department of National Treasury, 2021a:37). The unrealised gains attributable to the South African assets may not be taxed in South Africa if the resident qualifies for the participation exemption in paragraph 64B of the Eighth Schedule to the ITA (Department of National Treasury, 2021a:38).

3.6.5. Capital gains tax participation exemption and local assets

Following the relaxation of exchange controls in relation to loop structures a new paragraph 64(B)(6) was introduced to the capital gains tax participation exemption.

With effect from 1 January 2021, the participation exemption on capital gains does not apply to the disposal of any shares in a CFC to the extent that the value of the assets of that CFC is attributable to assets directly or indirectly located, issued or registered in South Africa (Bagraim, 2021). Paragraph 64B provides as follows:

- “(1) Subject to subparagraph (4), a person other than a headquarter company must disregard any capital gain or capital loss determined in respect of the disposal of any equity share in any foreign company (other than an interest contemplated in paragraph 2 (2)).
- (4) A person must disregard any capital gain determined in respect of any foreign return of capital received by or accrued to that person from a “foreign company” as defined in Section 9D (other than an interest contemplated in paragraph 2 (2)) where that person (whether alone or together with any other person forming part of the same group of companies as that person) holds at least 10 per cent of the total equity shares and voting rights in that company.
- (6) This paragraph must not apply in respect of any capital gain or capital loss determined in respect of the disposal of any share in a controlled foreign company to the extent that the value of the assets of that controlled foreign company is attributable to assets directly or indirectly located, issued or registered in the Republic”.

This amendment is only applicable where the shares in a CFC are disposed of. As a result, it should not be applicable on existing permissible loop structures established before January 2021 and within the ambit of the exchange control regulations (Smit, 2020). Therefore, the participation exemption will only apply to loop structures where the paragraph 64(B) requirements are met.

The Department of National Treasury (2021:38) commented that the amendment to the participation exemption will result in equal tax treatment of residents holding South African assets directly versus South African assets held indirectly through a CFC.

3.6.6. Change to look-through rate for CFC capital gains

The ITA includes capital gains in taxable income where they are taxed at the relevant tax rate (e.g. 27 per cent for companies, 18 per cent to 45 per cent for natural persons). However, the amount of the capital gain so included varies depending on the profile of the taxpayer. A net capital gain is multiplied by the inclusion rate to arrive at a person’s taxable capital gain which must be included in taxable income for the year of assessment.

Section 9D(2) requires that there shall be included in the income of a resident holder of participation rights (other than a headquarter company) “an amount equal” to the proportional amount of the “net income” of a CFC. The section defines “net income” as “an amount equal to” the taxable income of the CFC. A capital gain or loss of a CFC is determined as if the CFC had been a resident, and for this purpose the opening words of section 9D(2A) make paragraphs 2(1)(a), 24, 70, 71, 72 and 80 of the Eighth Schedule applicable in determining the CFC’s taxable income. The effect of the words “an amount equal to” is that what is included in the resident’s income is not a taxable capital gain but an amount equal to such a taxable capital gain (SARS,

2020:83). The separate character of a CFC's capital gains is thus lost (SARS, 2020:83). The inclusion rate in determining a taxable capital gain is contained in section 9D(2A)(f) (SAIT, 2020:7). It is also referred to as the look-through rule for CFC capital gains.

Before the amendments to section 9D(2)(A)(f) the inclusion rate was 40 per cent where capital gain had to be included in net income and the South African resident shareholder was a natural person or a special trust, and 80 per cent where the South African resident shareholder was a company (SARS, 2020:818). Paragraph (f) of the proviso to section 9D(2A) provided that where the resident is a natural person, special trust, or an insurer in respect of its individual policyholder fund, the taxable capital gain of the CFC shall, for the purposes of paragraph 10 of the Eighth Schedule, be 40 per cent of that company's net capital gain for the relevant foreign tax year. This ensured that a natural person benefited from the lower effective capital gains tax rate (up to a maximum of 18 per cent) applicable to natural persons, while corporate shareholders paid capital gains tax at a rate of 22,4 per cent (Bouwer, 2021). The net effect of this was that, in applying the CFC rules, the resident shareholder (natural person and/or corporate) paid CGT at the same rate as if that shareholder had earned the capital gain directly.

The 2020 Taxation Laws Amendment Bill (TLAB) proposed that the look-through rule for capital gains in paragraph (f) of the proviso to section 9D(2A) be removed for natural persons and special trusts. However, this provision will only be retained for long-term insurers to cater for the impact on the individual policyholder fund (Department of National Treasury, 2021a:38). The Explanatory Memorandum on the TLAB 2020 (Department of National Treasury, 2021a:38) explained that the amendment to the look-through rule for individuals is intended to ensure that CFC structures are not used as tax planning opportunities for South African individuals.

These amendments came into operation on 1 January 2021 and is applied in respect of any net capital gain of any CFC during any foreign tax year commencing on or after that date (Department of National Treasury, 2021a:38). As a result of the amended provisions, an inclusion rate of 80 per cent will now apply in all instances, regardless of whether the shareholder is a natural or juristic person (Bouwer, 2021).

Section 9D(2A)(f) reads as follows:

“(f) where the resident is an insurer in respect of its individual policyholder fund, the taxable capital gain of the controlled foreign company shall, for the purposes of paragraph 10 of the Eighth Schedule, be 40 per cent of that company's net capital gain for the relevant foreign tax year”.

Consequently, the inclusion rate for capital gains is no longer 40 per cent, but 80 percent where the resident shareholder of the CFC is a natural person. This means that when the shareholder

sells his shares in the CFC to a non-resident, 80 per cent of the company's net capital gain is to be added to the resident shareholders taxable income for the relevant year and will be taxed at the individuals' marginal rate of tax. If we assume the individuals marginal tax rate is 45 per cent, then the effective capital gains tax payable will be 36 per cent. Therefore, it can be concluded that the removal of a natural person from the proviso (f) could result in a higher capital gains tax burden where the resident shareholder of a CFC is a natural person.

Thus, in terms of the amended provisions, an inclusion rate of 80 per cent will now apply in all instances, irrespective of whether the shareholder is a natural or juristic person. The reason provided by National Treasury (2021a:38) in the proposed Taxation Laws Amendment Bill 2020 for the amendment was that the attribution of an amount of net income of a CFC to residents does not retain the character or nature of the underlying elements of net income for the residents.

3.7. Conclusion

The objective of this chapter was to analyse the South African CFC rules particularly in the context of loop structures. From the above discussion it can be noted that countries across the world have over time made many changes to its domestic CFC rules in an attempt to curb tax avoidance through the use of CFCs. Section 9D of the ITA which contains South Africa's CFC rules have also undergone numerous changes over the last couple of years. The relaxation of the restrictions on loop structures was accompanied by further changes to the CFC rules and the capital gains participation exemption in paragraph 64B. It is noted that the changes to the ITA as it relates to loop structures do not directly prevent a South African resident from investing in such a structure.

The income tax exemption on a South African dividend was partially removed. It means that if a CFC reinvests back into South Africa by acquiring shares in a South African company, the dividends declared by the South African company would be subject to dividends withholding tax at 20%, or a reduced rate under a favourable DTA. Before 1 January 2021, the CFC profits attributable to the South African resident shareholder excluded dividends received from South African companies. Following the amendments introduced to section 9D, the dividends paid by the South African company to the CFC are now included in the South African resident shareholders income under the CFC rules. In other words the dividends will be subject to a combination of local dividends tax and income tax under the CFC rules. It is noted from the discussion that when the South African resident shareholders of the CFC are either individuals or companies, the dividends declared will be subject to more South African tax than if the South African resident shareholders had received the South African dividend directly. In addition, the capital gains tax participation exemption in respect of shares in a foreign company that holds South African interests has been removed. In essence the amendment has the effect that the

participation exemption does not apply to any capital gain arising on the sale of any shares in a CFC to the extent that the value of the assets of the CFC is attributable to assets directly or indirectly located, issued, or registered in South Africa. Furthermore, the look-through rule for capital gains was removed for natural persons and special trusts. In terms of the amended provisions, an inclusion rate of 80% will now apply in all instances. Another theme noted from the discussion above is that the removal could result in a higher maximum effective capital gains tax burden where the resident shareholder of a CFC is a natural person compared to if a natural person holds the assets directly in his/her personal name.

The next chapter discusses the principles that underpin the CFC regime both globally and in South Africa to determine the appropriateness of these changes to the CFC rules to address the taxation of interests in loop structures.

CHAPTER 4 A DETAILED ANALYSIS OF THE PRINCIPLES THAT UNDERPIN THE CFC REGIME BOTH GLOBALLY AND IN SOUTH AFRICA

4.1. Introduction

As Chapter 2 indicated, the relaxation of South Africa's exchange controls on loop structures necessitated that the country strengthen its measures to address the effects of profit shifting to a foreign company in a loop structure (Department of National Treasury, 2021a:37). This was done through the implementation of amendments to the CFC rules as discussed in Chapter 3.

For a number of years there have been debates across the world on how to abolish base erosion, profit shifting, and tax deferral (Duenas, 2019:6). Base erosion and profit shifting (BEPS) refer to tax avoidance strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low tax jurisdictions (OECD, 2015b:3). Many countries have introduced anti-avoidance measures into their international tax policy rules to counter such profit shifting (Clifford, 2017:1). Enacting CFC legislation is regarded as international best practice to guard against domestic tax-base erosion through the export of capital to foreign entities (Holliday, 2020:11). The Davis Tax Committee in its Interim Report on BEPS in South Africa (2016a:1) explains that the key objective of CFC rules is to combat BEPS by targeting foreign investments made by residents, through foreign entities, in an attempt to shift income from the domestic residence tax base to low tax jurisdictions. Across the world CFC rules more or less follow a similar framework, however the design and objectives of CFC rules can vary between different jurisdictions because they reflect different policy choices (Duenas, 2019:1). It is important that CFC rules should fit within a jurisdiction's overall domestic tax system (OECD, 2015a:13).

The secondary objective of this study, addressed in this chapter, is focussed on analysing the principles that underpin the CFC regime to determine the appropriateness of the recent changes to the South African CFC rules as contemplated in section 9D and paragraph 64B of the ITA as it relates to loop structures (see paragraph 1.5.2 (iii)).

At a first instance this chapter explains the international tax rules and standards, including the design of CFC rules according to the BEPS Project. Thereafter the chapter considers the overarching international principles of tax policy and how the South African CFC rules align with the CFC rules according to BEPS Action 3. It will then consider South Africa's fiscal and economic policy and the role of the tax system therein. This is performed to identify the overarching principles that should be reflected in the South African CFC rules. Once the principles are

established the amendments in relation to the loop structures are assessed against these principles.

4.2. International tax rules and standards

Each country has the autonomy to design its tax system in the way it considers most appropriate (OECD, 2013:15). However, globalisation has resulted in an integrated economy which implies that a countries' domestic policies, including tax policies, should not be designed in isolation (Davis Tax Committee, 2014a:17). Most countries tax the profits from trade and investment within its national borders following its domestic tax policy (Holmes, 2014:23). In principle the same applies to international trade and investment. With the globalisation of trade and investment the taxation of cross-border transactions has become even more important. Once an entity (both natural person and legal persons) extends its reach beyond its national borders, there is a strong probability that it will fall within the reach of another country's tax laws (Holmes, 2014:23). The impact of the foreign country's tax policy will have consequences for the domestic policies and should be considered (Davis Tax Committee, 2014a:17). As a result, the tax laws of the different country's become interrelated. Therefore, it emphasises the need for a country to have the appropriate tax policy tools in place in order to collect revenue from a growing number of persons located outside its jurisdiction that generate income within its borders. On the other hand, a country requires a tax policy framework to determine how it should tax income generated outside its borders by its own residents (Holmes, 2014:23). As a result, South African policymakers need to ensure that tax does not produce unintended and distortive effects on cross-border trade and investment or that it distorts competition and investment within the borders of South Africa by prejudicing domestic investors (Davis Tax Committee, 2014a:17). This has increased international tax competition due to the expectations of investors who are allowed to relocate to countries where profitability is greatest and their tax burdens are reduced (Edwards & Mitchell, 2008:15).

International tax rules and standards seek to prevent the reduction of a global entities' tax liability through aggressive tax planning (Bunn & Asen, 2020:32). These standards can take several forms, one of which is the CFC rules. These standards can result in making countries with uncompetitive tax regimes even less competitive. It can also place substantial burdens on taxpayers and can require them to use valuable resources to comply with the tax rules instead of its business operations in order to expand their business to other jurisdictions (Bunn & Asen, 2020:32).

4.2.1. OECD's BEPS project

Currently there are several international institutions involved in regulating international tax matters (Li & Pidduck, 2019:17). They include the OECD, the United Nations (UN), the International Monetary Fund (IMF), the World Bank and the European Union (EU). Groups of countries, such as the G20 and BRICS (Brazil, Russia, India, China and South Africa) countries, are also involved (Li & Pidduck, 2019:17).

The OECD has been at the forefront of the design of the international tax standards while focussing on promoting and designing policies, advice and guidelines that will enhance the economic development and social wellbeing of countries worldwide, particularly developing countries (Li & Pidduck, 2019:17). The OECD is the only organisation that has published specific international tax-related policies or guidelines (Li & Pidduck, 2019:17). However, these standards developed by the OECD have been regarded as favouring wealthier countries, such as the OECD member states (Brauner, 2016:981). After the global financial crisis in 2008, however, geopolitical changes saw the power of influence shift towards the G20, such that these countries, together with the BRICS countries, played an active role in the development of the OECD's Base Erosion and Profit Shifting (BEPS) project (Brauner, 2016:984). The BEPS project transpired as a result of the efforts of the world's major and emerging economies to modernise and enhance the tax rules on corporate taxation, and to reduce the BEPS activities of multinational entities in the current growing global economy (OECD, 2013:11). As a result of this effort, the OECD devised an action plan with fifteen actions along three key pillars as part of the OECD's 2013 Action Plan to address BEPS (OECD, 2015a:3).

In July 2013, the OECD commenced work on 15 BEPS actions designed to ensure international coherence of corporate income taxation, and on 5 October 2015, the OECD published thirteen final reports outlining thirteen of the project's fifteen agreed upon actions, one of them dealing with the design of effective CFC rules (Deloitte, 2019). The action plan was developed to provide countries with domestic and international tools to assist in aligning the right to tax with the location where the economic activity is taking place (OECD, 2015a:3). In broad terms the BEPS project establishes a non-binding body of standards and rules, which includes distinctive methods to eliminate BEPS (Davis Tax Committee, 2014a:18). These OECD recommendations have become globally accepted tax standards (Davis Tax Committee, 2014a:18). Furthermore, the BEPS Action Plan involves different matters that confers international law (Davis Tax Committee, 2014a:17).

South Africa is not one of the member countries of the OECD. It was, however, awarded OECD observer status in 2004, and is a member of the OECD BEPS Committee (Davis Tax Committee, 2014a:18). The OECD guidelines have become an international standard that is accepted by

countries across the world (Oguttu, 2007:47). Observing these guidelines is an impactful manner in which to support South Africa to curb tax avoidance. As a result, South Africa has associated itself with the recommendations on removing and preventing harmful tax practices (Oguttu, 2007:47).

4.2.2. Action Plan 3 - The design of CFC rules according to the BEPS project

The objective of the 15-point BEPS Action Plan is to ensure that profits are subject to tax where economic activities that produce the profits are performed and value is created (Davis Tax Committee, 2014a:15). Action 3 of this plan highlight the need to use CFC rules to address BEPS. Many countries already have CFC rules in place, but these rules do not always effectively identify and prevent BEPS in a comprehensive manner.

OECD BEPS Action 3 report (2015c:6) introduced potential methods to implement CFC rules and include a framework that consists of recommendations in the form of building blocks that are needed for CFC rules to perform as effective preventative measures. Those building blocks are (i) exemptions and threshold provisions, (ii) defining CFC income, (iii) rules for calculating income, (iv) rules for imputing income, and (v) rules to avoid or remove double taxation. These building blocks enable countries that do not have CFC rules to implement these recommended rules and assist countries with existing CFC rules to enhance its rules where it does not align with the recommendations (OECD, 2015c:6).

The aim of these recommendations is to discourage shareholders of CFCs to engage in tax-avoidance behaviour, such as eroding its domestic tax base to reduce taxation and deferring a resident shareholder's domestic tax liability (OECD, 2015a:6). The OECD (2015a:6) views the global adoption of these recommendations as a plan that would greatly assist in reducing the artificial shifting of profits for the purposes of such avoidance.

According to Holliday (2020:16) the structure of South Africa's CFC rules, as contained in section 9D of the ITA and discussed in Chapter 3, to a great extent follow the building blocks laid out in the OECD Action Plan 3, namely section 9D:

- Defines the control considerations to determine what constitutes control of a CFC.
- Defines the CFC income to be imputed to resident shareholders.
- Determines how income calculations should be carried out.
- Interacts with the foreign-tax credit provisions in section 6*quat* to prevent double taxation.

4.3. Overarching principles of international tax policy

There are several broad tax policy principles that have traditionally steered the evolution of tax regimes globally (OECD, 2014:30). These well-recognised principles include neutrality, efficiency, certainty and simplicity, effectiveness and fairness, flexibility and equity (OECD, 2014:30). The Davis Tax Committee in its Macro Analysis Final Report (2016e:4) describes a good tax system as one that demonstrates efficiency, equity, fairness, transparency and certainty, and revenue adequacy. It supports the view that a tax system is likely to be of a higher standard if it is simple to understand and comply with, neutral, and certain. In this regard, the tax policy that a country adopts will generally consider decisions by policy makers on the corresponding importance of each of these principles and will also reflect broader economic and social policy considerations outside the scope of taxation (Holmes, 2014:23). Nevertheless, those decisions must be informed by proper consideration for different and often opposing international tax policy alternatives (Holmes, 2014:23).

It is therefore important that countries design its CFC rules in a manner that is compatible with both their international legal duties and the policy objectives of their own domestic tax systems (OECD, 2015a:12). The Davis Tax Committee in its Interim Report on addressing BEPS in South Africa (2014a:28) stresses that designing tax rules to prevent BEPS requires that those rules follow the principles of a good tax system being equity, efficiency, certainty, and simplicity. In this regard, an analysis of these tax principles is important in light of recent amendments to the CFC rules to address challenges of cross-border tax avoidance as a result of the reform of South Africa's exchange control policies as it relates to loop structures.

4.4. Policy objectives of CFC rules according to BEPS Action 3

Countries around the world that have introduced CFC rules generally pursue different policy objectives (Schmidt, 2016:89). According to the OECD BEPS Action 3 report (2015a:13) all CFC rules share some general policy objectives, which include:

- i. " its role as a deterrent measure;
- ii. how they complement transfer pricing rules;
- iii. the need to balance effectiveness with reducing administrative compliance burdens; and
- iv. the need to balance effectiveness with preventing or eliminating double taxation".

These objectives are prioritised differently depending on whether a country has a residence or source-based tax system (OECD, 2015a:13). There are also certain objectives that are unique to a specific jurisdiction. Furthermore, the contrasts between the CFC regimes that are in place globally, are partly because of the fact that some follow the principle of capital export neutrality,

while others follow the principle of capital import neutrality (Schmidt, 2016:89). It appears that the South African CFC rules corresponds with the Action 3 recommendations (Holliday, 2020:16). However, it is recommended that in addressing the BEPS concerns, the particular circumstances of South Africa must be taken into consideration. The need to attract new FDI in light of the National Development Plan and the promotion of international competitiveness of South Africa should be considered and is fundamentally connected to the design of South African CFC rules (Davis Tax Committee, 2016d:34).

4.5. South Africa's fiscal and economic policy and the tax system

The role of the tax system in South Africa cannot be separated from the broader fiscal and economic policy of the country (Davis Tax Committee, 2016e:2). South Africa's National Development Plan (NDP) provides a broad framework for the country's overall economic strategy and policy and to guide key choices (Davis Tax Committee, 2016c:11). The NDP calls for the development of fiscal and economic policies that encourage FDI to promote economic growth in South Africa (Davis Tax Committee, 2016d:26).

Gutuza (2013:308) views tax legislation as one of the tools a government can use to implement its policy approach and objectives to cross-border trade and investment. Therefore, it should follow that for the sake of strengthening economic growth in line with NDP, South Africa should develop a tax system that will aid its economic and constitutional objectives. In this regard it is important that the tax policy of South Africa should not negatively impact South Africa as an attractive destination for both local and foreign investors. The Final Macro Analysis of the Davis Tax Committee (Davis Tax Committee, 2016c:10) highlights the interactions between taxation and economic policy with political values also performing an important role. Economic and political priorities and values prescribes the advancement of an income tax system that is considered as being fair (Kalideen, 2019:114).

The recent reform of the exchange controls regulations was done as a way of promoting investment into South Africa at a time when such investment is critical (Department of National Treasury, 2020b:153). Accordingly, the amendments to the ITA to prevent tax avoidance or deferral using loop structures should not be harmful to the fiscal and economic objectives of the government. It is submitted that South Africa's tax policymakers are faced with the challenging task of constantly seeking the delicate balance between protecting the domestic tax base, not creating obstacles to economic growth, and contributing to global coherence (Davis Tax Committee, 2016d:34).

4.6. Principles relevant to the South African CFC rules

It can be established from the discussion above that the amendments to section 9D and paragraph 64B(6) of the ITA should reflect the principles which underlie a good tax system while adopting the design and structure of CFC rules globally and in South Africa. As a result, the section aims to assess the amendments against the following objectives:

1) Effectiveness:

It was explained in paragraph 4.3 that effectiveness is a well-recognised principle of any good tax system. In this regard paragraph 4.4 highlighted that one of the general policy objectives of CFC rules according to the OECD BEPS Action 3 Report is its role as an effective anti-tax avoidance measure. Accordingly, the effectiveness of the CFC rules as an avoidance measure will be analysed in paragraph 4.7.

2) Equity and neutrality:

It was explained in paragraph 4.3 that equity and neutrality are well recognised principles of any good tax system and that in designing South African tax rules to prevent BEPS these principles should be followed. Accordingly, the principle of equity and neutrality will be analysed in paragraph 4.8.

3) International competitiveness:

In paragraph 4.4 it was stressed that the need to attract FDI in light of the NDP and the promotion of international competitiveness of South Africa is fundamentally connected to the design of South African CFC rules (Davis Tax Committee, 2016d:34). Accordingly, international competitiveness will be analysed in paragraph 4.9.

4) Certainty and simplicity:

It was explained in paragraph 4.3 that certainty and simplicity are well recognised principles of any good tax system and that in designing South African tax rules to prevent BEPS these principles should be followed. Accordingly, the principle of certainty and simplicity will be analysed in paragraph 4.10.

5) Prevention of double taxation:

As discussed in paragraph 4.2 the prevention of double taxation is an important element of section 9D and is to a large extent aligned to the BEPS Action 3 recommendations (Holliday, 2020:19). Accordingly, the effectiveness of the amendments to prevent double taxation will be analysed in paragraph 4.11.

What follows in paragraph 4.7 to 4.11 is an analysis of each of the above principles individually and to evaluate the impact of the amendments to the ITA as it relates to loop structures against each of these principles.

4.7. Effectiveness – Protection of South African capital base

4.7.1. Introduction

Companies and its shareholders are regarded as separate persons for tax purposes as such their individual revenue flows are taxed separately (Sandler, 1998:4). As a result, a foreign company would generally (subject to the applicable tax rules in different jurisdictions) be taxed on its foreign-source income while shareholders would be taxed on distributions received from the foreign entity (either in the foreign jurisdiction, the shareholders' resident country or both) (Sandler, 1998:5). Therefore, it could result in cases where shareholders and the foreign entity pay low or no tax compared to the taxes that would've been paid if the foreign entity was incorporated in the same jurisdiction as its shareholders, or shareholders could avoid tax altogether if the foreign entity was incorporated in a low-tax jurisdiction (Oguttu, 2015:518). Long-term deferral could also follow when a foreign company decides not to declare dividends to its shareholders.

It is important to understand that a taxpayer's freedom to legally arrange his/her affairs to pay less taxes, also known as tax avoidance, is not the same as tax evasion, which is illegal activities involving non-compliance with tax legislation and regulations (Oguttu, 2015:518). As a result, the freedom to move capital abroad could give rise to a legal arbitrage which may greatly improve taxpayers' methods to defer or avoid tax in their domestic countries.

The South African CFC rules are designed to primarily focus on serving as a deterrent for tax avoidance (Davis Tax Committee, 2016a:13). This is an objective that is shared by the OECD. Generally, CFC rules are focussed on changing taxpayer behaviour by acting as a deterrent measure and may result in the removal of certain structures and transactions entirely (OECD, 2015a:13). It follows that CFC rules are not primarily designed to raise significant revenue in the form of additional corporate taxation (OECD, 2015a:13). Instead, its main aim is to prevent taxpayers from moving income into CFCs from the start and retain taxable profits onshore. As a result, they protect the fiscus by curbing tax avoidance (OECD, 2015a:13). Oguttu (2009:100) is of the view that it would be more beneficial for taxpayers to arrange their transactions and activities in such a manner as to avoid the application of the CFC rules instead of risking an assessment under it.

Taxing the income of CFCs will raise some revenue, however, it is possible that CFC rules will reduce income shifted to CFCs in the first place (OECD, 2015a:13). It follows that the revenue streams raised by CFC rules cannot be measured by only considering taxable CFC revenue. Holliday (2020:24) argues that if the CFC rules are turned into a tax collection mechanism, this

would be counter to both the purpose of the rules and the country's tax policy and damage the economic growth of corporate South Africa.

According to Potgieter (2012:3) there are two potential measures to determine the effectiveness of CFC rules as anti-avoidance measure, which includes both:

- the degree to which the tax avoidance or deferral is averted; and
- the degree to which legitimate business arrangements and investments, for which tax avoidance or deferral is not the primary or sole purpose or objective, are complicated or exposed to disincentives.

4.7.2. Anti-deferral considerations

CFC rules primarily tax the income of the CFC in the hands of resident shareholders. Most countries use these rules to preclude tax planning that result in shifting of income from either the domestic jurisdiction or the domestic and another jurisdiction (OECD, 2015c:8). Countries like South Africa that have worldwide tax systems, may also be concerned about income that are retained offshore for an indefinite period of time and therefore their CFC rules may have further policy objectives like discouraging long-term deferral (OECD, 2015c:8). Over time the CFC rules have proved to be a useful deferral tool, however not consistently robust enough to achieve the intended outcome.

Section 9D is designed to impose an immediate and direct tax on income earned by CFCs in foreign low tax jurisdictions where certain conditions are met and the income originate from passive type investments or from transactions that satisfies the objective standards and pose a greater risk for tax avoidance (Clifford, 2017:2). The failure to levy immediate tax is known as "deferral". Taxpayers often delay taxation and as such imposing immediate tax is of significant importance (Department of National Treasury, 2002:1). One objective of this immediate tax is to preserve the South African tax base by removing incentives to transfer profits to foreign jurisdictions with lower tax rates (Clifford, 2017:2). Therefore, the provisions of section 9D(2A) are critical to the effectiveness of the CFC rules to prevent deferral of income tax by residents (De Abreu, 2010:114).

4.7.3. The impact of uncoupling the tax and exchange control regime

Although the Exchange Control Regulations do not make any specific provision to prevent BEPS, it has played an important role in reducing BEPS in South Africa (Davis Tax Committee, 2016d:43). In this regard, exchange controls supplement the tax legislation intended to counter BEPS by preventing capital outflows from South Africa that could result in base erosion (Oguttu,

2007:420). Accordingly, the Minister of Finance has mandated that the relaxation of exchange controls should aim to result in protection of the tax base, support efforts to reduce money laundering and advance prudential regulation (Davis Tax Committee, 2016d:43).

Over the years, exchange control regulations have been enforced in South Africa to counter various BEPS arrangements, including loop structures. As discussed in Chapter 2, these regulations prohibited South African residents from interposing an offshore structure between themselves and their domestic assets or from placing their authorised foreign assets at the disposal of another South African resident. National Treasury have long held the view that exchange control policy should be determined independently of the tax consequences, meaning that the country's tax legislation should be able to protect itself from BEPS without leaning on exchange control policy by enacting and enforcing its own avoidance measures (Katz Commission, 1997:par. 3.1.7.1). It follows that the amendments to section 9D(2A) and paragraph 64B(6) of the ITA as it relates to loop structures should be able to protect the tax base and counter any potential tax avoidance through these arrangements without any reliance on exchange controls.

4.7.4. Possible tax avoidance and deferral considerations before the 2020 amendments to the ITA

National Treasury were concerned that the allowance of loop structure arrangements may cause revenue loss to the fiscus, particularly in respect to dividends paid by a South African resident company to a foreign holding company as opposed to directly to the ultimate South African resident shareholders, and capital gains made by the South African shareholders on the disposal of their shares in the foreign company, when formerly they would have been disposing of domestic shares (Department of National Treasury, 2020a:137).

Oguttu (2022:108) explains that “the effectiveness of CFC rules would likely be affected by the removal of the exchange control restrictions on loop structures”. It is conceivable that certain loop structures can be used as a tax avoidance mechanism or be used to facilitate the deferral of taxation by accumulating income offshore (Department of National Treasury, 2020a:137). Consider the following scenario:

A group of South African individuals establish a foreign company in an offshore jurisdiction to hold an investment comprising 50 per cent of the shares in a South African operating company. Each South African shareholder in the foreign company holds a minimum of 10 per cent of the equity shares and voting rights. From time to time the South African company declares substantial dividends and the foreign company retains some for further investment purposes and on-

distributes the balance to the South African shareholders. As a result of the DTA between South Africa and the foreign jurisdiction under which the withholding tax on the dividends is reduced from 20 per cent to 5 per cent, and because the foreign dividend participation exemption applies, the dividends distributed by the foreign company to the South African resident shareholders are exempt from tax in South Africa (Mazansky, 2021:139).

In addition, the CFC rules have no application, as to the extent that the source of income is a South African dividend, exempt from income tax, and provided that the investment by the foreign company in the new foreign investments represented a holding of more than 10 per cent of the equity shares, those dividends would have enjoyed the participation exemption. Accordingly, under the old CFC rules, they would not have been taxable in the hands of the South African shareholders either.

Should the South African shareholders want to sell the foreign company to an unrelated non-resident third-party purchaser, 60 per cent of the sale price is attributable to the shares held in the South African company and 40 per cent is attributable to other foreign investments made by the foreign company outside South Africa. Once again, under the participation exemption, the sale is exempt from capital gains tax.

As a result, the net effect has been that dividends tax on the South African company shares has been reduced from 20 per cent to 5 per cent, furthermore what is economically a sale of the South African company shares has been rendered free of capital gains tax. Neither of these situations would have applied had the investors held their interest in the South African company directly.

Once profits can escape the ambit of domestic tax legislation it threatens the enforceability and effectiveness of these tax laws and essentially the capability of revenue authorities to collect taxes (Clifford, 2017:2). From the above example, one can conclude that a loop structure has the effect of reducing South Africa's tax base and could reduce or defer any taxes the foreign entity would have to pay in South Africa.

4.7.5. Limiting the application of the dividend and capital gains tax exemptions in loop structures

The purpose of the amendments enacted as part of the Taxation Laws Amendment Act No. 23 of 2020, is to protect the tax base by refining the tax treatment of capital flows and to restrict the artificial reduction of dividends and capital gains tax where loop structures are used to avoid or defer tax, thus allowing for the relaxation of exchange control restrictions on loop structures (Department of National Treasury, 2020b:137).

Firstly, section 9D(2A) of the ITA has been amended to ensure that CFCs include a portion of dividends received or accrued from a South African resident company in its net income. The CFC rules now include a formula to calculate the non-exempt portion of the dividend that should be included in the net income of a CFC. Accordingly, the outcome of the amendment is that dividends paid by the South African company to the foreign company will be subject to both dividends withholding tax and income tax under the CFC rules.

The second amendment was the enactment of a new subparagraph (6) to paragraph 64B to the Eighth Schedule to the ITA which has the effect of removing the capital gains tax participation exemption in respect of any capital gains made as a result of the disposal of any share in a CFC to the extent that the value of the assets of that CFC is attributable to direct or indirect South African assets.

If one applies these amendments to the scenario set out in 4.7.4 it can be concluded that the dividends declared by the South African company to the foreign company would be subject to tax (i.e. dividend withholding tax and income tax). Furthermore, the sale of the foreign company shares to a non-resident will not be free of capital gains tax. Therefore, these amendments appear to be effective in its prevention of avoidance or deferral of tax in relation to transactions where a loop structure is involved as discussed above, which is its main purpose.

It is important to be reminded that the CFC rules are only of relevance to a foreign company where none of the exemptions from the CFC rules, i.e. the high-tax jurisdiction exemption and the FBE exemption, are available. As such, it will only be of relevance to loop structures where none of the exemptions apply. Similarly, the participation exemption applies when a person holds 10% or more of the equity shares and voting rights in that foreign company. As a result, this will likely be applicable to transactions with low tax gains on smaller passive investments.

Furthermore, the look-through rule in respect of capital gains, as contained in paragraph (f) of the proviso to section 9D(2A) of the ITA was removed for natural persons and special trusts (Department of National Treasury, 2021a:38). As a result, an inclusion rate of 80 per cent for capital gains will now apply in all instances, regardless of whether the shareholder is a natural or juristic person. While the amendment does not affect a corporate shareholder of the CFC, a natural person is penalised as a higher maximum effective tax rate will be applicable where the resident shareholder of a CFC is a natural person compared to if the resident shareholder holds the assets directly without interposing a CFC. According to the Explanatory Memorandum on the Draft TLAB (2021a:37), the amendment is intended to ensure that CFC structures are not used as tax planning opportunities for South African individuals. However, this amendment seems to have a broader application, as this provision removed the look-through rule for all natural person

shareholders of CFCs and not just CFCs that hold South African interests. It is evident that it goes beyond addressing tax avoidance where loop structures are involved.

In addition, when one considers the impact of the higher effective rate for natural persons as a result of the removal of the look-through rule for capital gains, it appears that the amendments do have a broader implication for South African natural person shareholders of a CFC. Holliday (2020:24) explains that if the CFC rules develop into a tax collection mechanism, it would be counter to both the purpose of the rules as a tax-avoidance measure and the country's overall tax policy and could harm the growth of South Africa's corporate sector. The higher effective rate for natural persons is in direct contrast to the objective of the provision articulated by SARS in the Final Response Document on the 2020 Draft Taxation Laws Amendment Bill (SARS, 2021a:57) that in relation to the paragraph 64B amendment, that its objectives was not to raise revenue, but that the amendments were introduced because of the proposed lifting of restrictions on loop structures. If this is the argument, the amendments should merely serve its purpose as an anti-avoidance measure and a deterrent for diverting income in line with the recommendations set out in the OECD Action 3 report and should not extend further than this (Brown *et al.*, 2020). However, the amendments significantly increase the tax burden for South African resident shareholders in a CFC with South African assets and creates the potential for over-taxation, which could create a disincentive for legitimate business arrangements and investments for which tax-avoidance or deferral is not the primary objective.

4.7.6. Summary

The amendments to the CFC rules and paragraph 64B seem to be effective in its aim to prevent avoidance or deferral of tax in relation to transactions where CFCs make inward investments into South Africa, which is its primary purpose. However, it appears that the amendments do have greater implications for South African resident shareholders of a CFC that holds South African interests and would in some instances go beyond the scope as an anti-avoidance measure. In addition, the removal of the capital gains look-through rule for natural persons could have a broader impact as it will affect all CFCs with natural person shareholders and not just CFCs that own South African interests. In this regard it could be argued that business arrangements with a primary objective other than tax avoidance or deferral could be complicated by the amendments to the CFC rules.

4.8. Approach to equity and neutrality

4.8.1. Introduction

The principles of equity and neutrality must be considered when designing tax policy to ensure it follows the governments overall policy strategy concerning cross-border trade and investment (Gutuza, 2013:2). A country's international tax policy should be clear as to who should be treated equitably and who or what is to be neutral (Gutuza, 2013:9).

4.8.2. Equity

Equity is one of the foundational elements of any tax policy, yet there is no global consensus in the application of equity in cross-border trade and investment (Gutuza, 2013:3). In principle equity ensures taxpayers of equitable treatment when engaging in cross-border trade or investment (Gutuza, 2013:307). There are two standards of equity, namely the benefit principle and the ability-to-pay principle which is applied to assess the fairness of the impact of a tax.

The benefit principle calls for all tax burdens to be distributed to taxpayers in an equitable manner in accordance with the support or benefits received from the country in which the income was generated (Salis, 2007:4).

The ability-to-pay principle, has two measurable elements, namely horizontal equity and vertical equity. Jones and Basu (2002:40) are of the view that tax rules should be "fair in both their horizontal and vertical dimensions". Horizontal equity suggests that people who are in similar economic situations or who incur similar transactions should be subject to equal tax levels (Jones & Basu, 2002:40), while vertical equity involves differentiation among unequal taxpayers, or the equitable treatment of taxpayers with differing pre-tax incomes. (Jones & Basu, 2002:40). In other words, individuals who have more, can afford more and should pay more taxes (Salis, 2007:4).

In the international context, the Davis Tax Committee in its Second Interim Report on BEPS in South Africa (2016d:38) explains that "international equity requires that a country should ensure that it gets its fair share of revenue from cross-border transactions. This entails: (i) protecting a country's tax base by developing domestic laws that are fair and impartial; (ii) imposing equal tax burdens on taxpayers with equal income, without reference to the source of the income; (iii) and by making those burdens commensurate with the ability of taxpayers to pay". This means that a group of related companies should be charged the same tax as a single company employed in similar activities (Davis Tax Committee, 2016d:38). It goes further to explain that "equity requires just and equal treatment of domestic and foreign companies".

4.8.3. Neutrality

According to Mirrlees *et al.* (2011:333) a neutral tax system treats comparable economic activities in a similar manner for tax purposes and will avoid baseless discrimination between persons and economic activities. The Katz Commission Report (1997:par. 3.1.2.2) explains that internationally there is a distinction between capital import neutrality and capital export neutrality. In the international context a country's tax policy can comply with either the principle of "capital export neutrality" or "capital import neutrality".

4.8.3.1. Capital import neutrality

Capital import neutrality suggests that tax rules should not favour domestic investment over foreign investment (OECD, 2015c:9). Import neutrality calls for all income earned in a particular country to be taxed at the same rate regardless of the investors' tax residence, thus ensuring that capital originating in various jurisdictions compete on equal footing in the capital market of the particular country (Davis Tax Committee, 2014a:28). Both domestic and foreign investors' behaviour and reactions will be influenced by the way a country taxes investment. If the taxation of the income earned on the same investment were to differ between domestic and foreign investors investing into a country, the tax system would be regarded as unfairly biased and distort investment behaviour (Holmes, 2014:29). Therefore, capital import neutrality implies that all investors in a country, i.e. domestic and foreign, should be subject to the same effective tax rate on income earned on their investments (Holmes, 2014:29).

4.8.3.2. Capital export neutrality

Holmes (2014:23) explains that capital export neutrality is concerned with making sure that a country imposes the same amount of tax on the income earned on investments by foreign investors and domestic investors. At the same time the investment behaviour of domestic investors, which have the freedom to invest locally or abroad, will be influenced by the way in which their investments are taxed domestically (Holmes, 2014:32). From the perspective of the country of residence, a countries' international tax laws should be designed in such manner as to ensure that domestic investors are subject to the same effective domestic tax rate whether they invest domestically or abroad (OECD, 2015c:9). Therefore, the international tax laws of a country should neither discourage nor encourage cross-border capital flows (Davis Tax Committee, 2014a:28). In other words, the tax laws must be neutral between resident investors investing locally or offshore because the investors are taxed domestically the same, regardless of where they decide to invest (Holmes, 2014:32). It follows that foreign- and domestic-sourced income are taxed in the same way.

The design of South Africa's tax legislations to comply with the principle of capital export neutrality and the CFC rules are regarded as part of these outbound tax policies (Davis Tax Committee 2014a:29). Kadet and Picciotto (2015:1) view CFC rules as central to balancing residence and source-taxing rights. Effectively CFC rules assign the primary taxing rights of business profits to the jurisdiction where the activities take place, i.e. to the source country, therefore ensuring neutrality between domestic and foreign-owned entities, but a secondary taxing right to the foreign owners' country of residence, to ensure neutrality between domestic and foreign investments (Kadet & Picciotto, 2015:1).

The Katz Commission Report (1997:par. 3.1.2.4) describes tax neutrality from an international tax perspective as a system that relies on maintaining an equal competitive tax basis on all domestic businesses, regardless of where they operate. Tax neutrality is also accepted by the Davis Tax Committee (2014a:28) as an objective for FDI and foreign investors should not be discriminated against, nor should they be favoured over domestic investors. The OECD (2014:30) shares the view emphasising that tax policy considerations should include neutrality. A tax system should aim to be neutral and equitable between forms of business activities and should promote efficiency (OECD, 2014:30). Therefore, it can be interpreted that the objective of neutrality is that domestic entities competing offshore, and foreign entities competing domestically, should in all cases do so on the premise that the tax obligation is neutral in the jurisdiction of direct investment.

Tax neutrality would illustrate that investment decisions should not be dictated by tax considerations (Katz Commission, 1997:par. 3.1.7.1). Exchange control reform will likely increase the movement of passive investment. An example of the absence of neutrality would be the ability to avoid the higher South African tax rates through easy offshore passive investment. (Katz Commission, 1997:par. 3.1.7.1).

Gutuza (2013:11) explains that horizontal equity and capital export neutrality is exercised through the taxation of residents on their worldwide income s and giving them a tax credit for foreign taxes paid in the country of investment or trade.

4.8.4. Equity and neutrality achieved through amendments to the CFC rules

The objective behind the implementation of the CFC rules as mentioned in 3.4.3 is to ensure that a taxpayer that reroutes income to a foreign company will be left in a similar position than if that income had accrued to the taxpayer directly (Olivier & Honiball, 2011:574).

In the Explanatory Memorandum to the DTLAB the National Treasury (2021a:38) articulated that the amendment to the capital gain participation exemption in paragraph 64B(6) to the Eighth Schedule of the ITA will result in equal tax treatment of residents holding South African assets

directly versus South African assets held indirectly through a CFC. It is submitted that paragraph 64B(6) achieves this objective. The participation exemption on capital gains does not apply to the disposal of any shares in a CFC in as far as the value of the assets of that CFC is attributable to assets directly or indirectly situated in South Africa. The net effect of this is that, in applying this provision, residents holding South African assets directly in their own name versus residents holding South African assets indirectly through a CFC are treated the same.

As discussed in 4.7.5 above, section 9D(2A)(d) was amended to avoid any dividends tax loss to the South African fiscus as a result of a loop structure. Therefore if the objective of these tax amendments is to reduce the negative impact of loop structures on the South African tax base, one would expect that the tax legislation that was introduced to ensure that where South African residents implement loop structures, the tax treatment of the interest in the South African asset held through a CFC would be the same as the treatment that would have applied, had the South African tax resident held those assets directly. However, when the impact of the provision is considered, it is evident that the tax treatment of the interest in a South African asset held through a loop structure does not match the tax treatment that would have applied, had the South African residents held those South African interests directly (Berger, 2021). As an example, if the shareholder of a South African resident company holds shares directly in another South African resident company, dividends paid between the two South African companies would be exempt from dividends tax and no income tax would be payable on the dividend paid between the two companies (SAIT, 2021:3). However, where a CFC is interposed between the two South African resident companies, dividends paid by the South African resident company to the CFC would be subject to dividends tax in South Africa (likely at a reduced rate depending on the applicable DTA). Therefore, the presence of the CFC would result in an increased amount of tax being payable (SAIT, 2021:2). In addition, the amendment requires a CFC to include a portion of any dividend received or accrued from the South African resident company in its net income in terms of a formula (Department of National Treasury, 2021:38). This has the effect that dividends declared by the South African resident company to a CFC will now be subject to a combination of dividends withholding tax and income tax at a rate of 20 percent where the South African shareholder in the CFC is a South African corporate. As mentioned above, no income tax would be payable on dividends paid between two South African resident companies. The tax treatment should not be different simply because a CFC is interposed between the two South African resident companies.

In contrast, where the shares of a South African company are held by a South African resident natural person, ordinarily dividends tax at a rate of 20 per cent would be payable on any dividends paid by the South African company to the South African natural person shareholder (SAIT, 2021:4). However, if a CFC is interposed between the South African company and a South African

natural person shareholder it would result in an effective tax rate greater than 20 per cent. Consequently, the tax burden for South African natural person shareholders in a CFC with South African assets has increased significantly compared to if the South African natural person shareholders had received the South African dividend directly (Bouwer, 2021).

In this regard when the provision in section 9D(2A)(d) of the ITA is assessed against the principles of equity and neutrality it is evident that the tax treatment of taxpayers in similar situations will not be the same and will not pay tax at the same levels. According to the researcher the increased tax burden placed on South African natural person and company shareholders of CFCs with South African assets is unfair. It can further be argued that these provisions could likely influence the investment decisions of domestic and foreign investors investing in South Africa and if this were the case it would illustrate the absence of neutrality.

When the implications of the removal of a natural person from proviso (f) to section 9D(2)(A) is considered, it is evident that a higher maximum effective capital gains tax rate will be applicable where the resident shareholder of a CFC is a natural person, compared to if the resident shareholder holds the assets directly in his/her personal name. A South African natural person shareholder will be taxed at an effective rate of 36 per cent, instead of 18 per cent if the person held the assets directly. The net effect of this is that, in applying the CFC rules, the South African natural person shareholder would not pay CGT at the same rate as they would have had they earned the capital gain directly. Therefore, it can be concluded that in this regard the taxpayer will not be left in a similar position than if the income had accrued directly to the taxpayer.

In this regard when the provision in section 9D(2A)(f) of the ITA is assessed against the principles of equity and neutrality it is evident that taxpayers in similar situations carrying out similar transactions will not be subject to tax at the same levels. It could be argued that in this instance the higher tax burden placed on natural person shareholders of CFCs is unfair. A higher effective tax rate on the gains of CFCs may have an influence on investment decision of South African natural persons and have an adverse impact on investments made through a CFC and therefore neutrality would not be achieved.

4.8.5. Entity restriction

It is evident that National Treasury, in drafting the amendments, was only concerned with addressing the perceived avoidance or deferral where CFCs are concerned and did not target all loop structures, but only those in which the South African shareholder interposes a CFC between themselves and their South African interests (Brown *et al.*, 2020). As a result, this creates possible

tax planning opportunities for resident shareholders to arrange their loop structures in such a way as to avoid the application of the CFC rules.

Where a South African resident shareholder holds less than a significant interest (i.e. not more than 50 per cent of the participation or voting rights) in the foreign company that invests into a South African company, with the remaining 50 per cent held by non-residents, will necessarily result in the avoidance of CFC imputation. It appears that the National Treasury is not concerned with the fact that the shareholders are allowed to have the full benefits of the dividend and capital gains participation exemption (Mazansky, 2021:140).

One of the main shortcomings of the current South African CFC rules is that it only includes foreign companies. However, the BEPS Action 3 Report recommends that a wide definition should be given for entities to be included in the scope of CFC rules and generate profits that pose BEPS concerns (OECD, 2015c:15). Examples of foreign non-company types of structures include trusts, foundations, partnerships, hybrid entities, etc.

There are some commentators that suggest that because the Exchange Control Circular 1/2021 allows investments into South Africa through “offshore structures”, the phrase “offshore structure” could be construed to mean that a foreign trust investing back into South Africa, either directly or indirectly through a foreign company, is no longer prohibited, subject to FinsSurv reporting requirements (Mazansky, 2021:140). Other commentators suggest that trusts will continue to be prohibited from entering into loop structures (Oguttu, 2022:116). If the view is supported that a foreign trust is not prohibited from investing directly or indirectly into South Africa, i.e. creating a loop, it could be used as a mechanism to avoid the CFC rules. This is due to the fact that the current CFC rules do not cover foreign companies held by interposed foreign trusts and foundations (Department of National Treasury, 2017:40). Bagraim (2021) explains that where the foreign company is held by an interposed foreign trust, the connection between the foreign company and the South African resident beneficiary is effectively severed. As a result the returns of the foreign company will not be taxable in South Africa under the CFC rules (Bagraim, 2021). Whether or not they will be subject to tax will depend on other anti-avoidance rules or indirect participating rights the trust beneficiary may hold in the foreign company (Swart, 2021:3). As a result, residents can potentially avoid the CFC rules making use of a non-resident trust or an offshore investment vehicle other than a company to directly hold the participating and/or voting rights in a CFC (Swart, 2021:3). As Oguttu (2022:115) has commented that there have been no amendments to the ITA regarding South African resident individuals investing in a foreign trust that is part of the loop structure. It follows that a loop structure arrangement where a non-resident trust is used as an intermediary between a resident and a CFC that invests into South Africa will not be subject to the amendments applicable to loop structures. This would potentially create an

opportunity for a resident shareholder to defer tax and receive a potential tax benefit using a non-resident trust. From a tax neutrality perspective, it could be argued that it is unfair to shareholders of CFCs to be subject to a strict regime as is evidenced in the provisions of the CFC rules, while South African shareholders with offshore interests held in foreign non-company entities are not subject to such strict rules that impose immediate taxation on foreign income (Singh, 2014:135).

In essence where the foreign company is not a CFC (i.e. the shares are held through a non-resident trust), the provisions in section 9D(2A)(d) and paragraph 64B will not apply (Bagraim, 2021). This observation remains valid notwithstanding the fact that it is a loop structure. In other words, not all loop structures would be taxed in the same way.

4.8.6. Summary

Instead of balancing the scales to protect the fiscus and make sure it is no worse off than it otherwise would have been in the absence of a loop structure, it could be argued that the tax amendments will, in some instances, result in more tax being imposed than was the case before the removal of the loop structure restriction. In other words, more tax is charged on certain forms or arrangements of loop structures (Brown *et al.*, 2020). The application of the amendments is much wider and penalise resident shareholders of a CFC that holds South African assets and significantly increase the tax burden for these shareholders compared to if they held these assets directly (Bouwer, 2021). Therefore, it can be concluded that it would in certain circumstances, discriminate against taxpayers that are in a similar situation and hold the same assets. These amended provisions could likely influence the investment decisions of domestic and foreign investors investing in South Africa and if this applies it would illustrate a lack of neutrality.

In addition, it was concluded that National Treasury was only concerned with addressing tax avoidance where CFCs are concerned and did not target all loop structures but only those in which the South African shareholder interposes a CFC between themselves and their South African interests. It can be concluded that there are certain types of loop structures that will not be affected by the amendments to section 9D and paragraph 64B of the ITA. As a result, it could be argued that from a tax neutrality perspective, it is unfair to those South African resident shareholders who are currently subject to CFC rules.

4.9. International competitiveness

4.9.1. Introduction

South Africa is a developing country with a relatively small and open economy. As such, it faces stringent international competition and challenges to protect its tax base from erosion and profit

shifting (Davis Tax Committee, 2016e:10). To remain competitive on the world stage, it can be expected that international competitive considerations constitute a matter of importance for government and investors alike.

On the one hand, tax incentives that favour foreign investment compromise international competitiveness, while on the other hand governments should steer clear of tax laws that compromise its competitive position in the global economy by adopting tax rules that export resources from the country or discourage the import of resources into the country (Holmes, 2014:26).

4.9.2. Taxation and international competitiveness

For a country to be an attractive investment location in a globally integrated economy, its tax system must be competitive (Davis Tax Committee, 2016e:28). The Tax Foundation in its 2020 International Competitiveness Index (2020:1) explains that it views a competitive tax system as one that keeps marginal tax rates low. In practice most taxes, including corporate income tax, can have an impact on a country's competitiveness (Davis Tax Committee, 2016d:34). In the era of globalisation capital is highly mobile and it has created a competitive environment for both large multinationals and small business corporations which can elect to invest in any country across the world to achieve the most favourable rate of return (Bunn & Asen, 2020:1). It implies that investors would likely consider countries with lower tax rates to maximise their after-tax return (Bunn & Asen, 2020:1). If a country's marginal tax rate is too high, it would be a strong motivator for businesses to invest somewhere else, which may result in negative pressure on a country's economic growth (Bunn & Asen, 2020:1). Furthermore, high marginal tax rates may also result in tax avoidance.

In its International Corporate Tax Reform Report the International Monetary Fund (2023:22) regards one of the key deficiencies of the BEPS project the fact that tighter avoidance measures under BEPS make real investment more responsive to corporate tax rate differentials and thereby creates the risk of increasing tax competition. To encourage investment competitiveness and curb avoidance, South Africa's corporate income tax rate was reduced by one percentage point to 27 per cent (Department of National Treasury, 2020a:38). However, it still exceeds the OECDs average of 23 per cent. As a developing country South Africa's competitiveness is contingent on the tax rates of its developed trading counterparts (Gutuza, 2013:321). Considering that many countries with established investment and trading ties to South Africa have notably lower tax rates, it may be a powerful motivator for domestic businesses to shift their profits to these lower tax jurisdictions. It follows that for South Africa to remain competitive as regards outward trade and investment by domestic businesses and inward investment by foreign entities, it has to limit

its tax rates, specifically the corporate tax rates (Gutuza, 2013:321). National treasury and other relevant government departments should make sure that South Africa's tax rates are aligned to our trading counterparts, which could add an extra administrative burden on them (Gutuza, 2013:321). Furthermore, it may impact the total revenue that can be raised from taxing business.

CFC rules are regarded an important part of South Africa's outbound tax policies, and its aim is to promote the competitiveness of South African outbound investments by preventing double taxation, whilst simultaneously curbing cross-border tax-avoidance schemes (Li & Pidduck, 2019:21). When domestic and foreign investors consider South Africa as a potential place of investment, CFC rules are important factors to consider in their decision making (Potgieter, 2012:67). Olivier and Honiball (2011:560) express the opinion that "the impression is gained that South Africa's CFC rules are not part of a well thought-through policy, but rather a piecemeal effort to close loopholes," noting that "constant legislative amendments undisputedly discourage foreign investments." This could to some degree limit the growth of the economy and the domestic tax base. It follows that, if the South African CFC rules give rise to tax practices that is unfair to multinational companies and global business structures, then international competitiveness is expose to risk (Potgieter, 2012:67). The potential risk is that both domestic and foreign investors faced with a global choice of jurisdictions, can potentially structure their affairs in such a way as to avoid the South African CFC rules (Potgieter, 2012:67). In this regard tax neutrality would illustrate that investment decisions should not be dictated by tax considerations (Katz Commission, 1997:par. 3.1.7.1). Therefore, the provisions relating to loop structures should not be a disincentive for South African companies looking to raise capital abroad as this would distort investment decisions for potential investors. A higher effective rate on dividends declared by a South African target company to the CFC where the shareholder is an individual or corporate compared to if the shares were held directly, could be viewed as a disincentive, and could distort investment decisions (Horak *et al.*, 2020). Similarly, the higher effective tax rate on the capital gains of CFCs may influence the investment decisions of South African natural persons.

It should however be regarded that tax may in many instances not be the sole and primary factor in investment decisions and that there are other non-tax factors that both domestic and international investors consider like political stability, infrastructure, economic prospects, and labour relations (Davis Tax Committee, 2016d:34). Depending on the industry, the location for business activities will be influenced by factors like operating requirements, marketing issues and global strategic considerations (Wilson, 1993:229). Wilson (1993:229) noted, however, that when non-tax considerations are insubstantial, taxation will impact investment decisions. In this instance it could tilt an investor's decision for or against a country as a location for FDI (Davis Tax Committee, 2016d:34). Ultimately, where new opportunities arise for major direct investment into

any given country, it is reasonable to expect that tax considerations would form part of the decision process (Wilson, 1993:212). It is important to emphasise that South African tax laws are not just a factor considered by foreign investors, but also by domestic investors when they assess if they should invest in South Africa or elsewhere (Davis Tax Committee, 2016d:34).

The amended provisions will not only have an impact on South African residents with existing permissible loop structures that were in place before these amendments came into effect, but it will also impact the decisions of foreign and domestic investors' on how to optimally structure and manage new inward investments into South Africa, part of which may include decisions on whether to invest through foreign companies. Following the relaxation of the exchange control restrictions on loop structures, it is now possible for South African companies to look to raise foreign capital. However, some foreign investors may only want to invest in a company established in the investor's domestic country in order to mitigate its risks. It is now possible for a South African company to establish a foreign company where foreign investors could purchase equity. This foreign company could in turn purchase shares in the South African company. The foreign investors would have equity in the South African company. Previously it was impossible for foreign investors to gain control through equity unless they purchased the shares in the South African company directly. Using a loop structure makes it possible and significantly simplifies the remittance of capital back to the South African company. This change is a necessary step forward in unlocking South Africa to foreign investment and such loop structures should be considered by South African companies seeking to attract foreign investors.

Therefore, it follows that these anti-avoidance measures should not be adopted without considering the demand for FDI into South Africa and the need to preserve the competitiveness of South Africa's economy on the international stage (Davis Tax Committee, 2016d:34). A balance needs to be struck.

4.9.3. Striking a balance between tax neutrality and maintaining international competitiveness

According to the Katz Commission Report (1997:par. 3.1.2.1) the principle of neutrality in the international context has a distinct competitive element which is important to South Africa. The part that the neutrality principle plays in the concept of economic efficiency is to ensure that a taxpayer's decision is not influenced by taxes, under the premise that a taxpayer's decisions would "lead to the most efficient allocation in the society", where the market in which such traders or investors operate is an efficient market (Gutuzu, 2013:7).

The taxation under the CFC rules requires a complex balancing approach where on the one hand the rules will apply where failure to tax CFC income will likely lead to an artificial flow of funds to a foreign jurisdiction, but not where taxation will likely be harmful to South African international competitiveness (Department of National Treasury, 2002:iii). The 2007 Budget Tax Proposals presented by SARS (2007:24) also confirm this view when it states that “the CFC rules require a careful balance between capital export neutrality, i.e. equal tax treatment for all South African owned operations and the opposing need for international competitiveness”. It also states that any future amendments should not deviate from the core philosophy developed over the years. Therefore, it follows that the amendments to the ITA as it relates to loop structures should also look to carefully balance the capital export neutrality and the opposing need for international competitiveness. However, it can sometimes be efficient to discriminate between different activities for tax purposes (Mirrlees *et al.*, 2011:333).

It was made clear in the *Cadbury Schweppes* (2006) case that CFC rules should be applied equally to both domestic subsidiaries and cross-border subsidiaries. The difference in treatment creates a tax disadvantage for the resident company to which the CFC rules are applicable. Therefore, if a CFC rule treats domestic subsidiaries the same as cross-border subsidiaries, it arguably should not be treated as discriminatory, and no justification is needed. Such an approach would attribute income of any controlled company, whether foreign or domestic to its resident shareholders (OECD, 2015c:10). The focus is to ensure competitive equality by limiting opportunities for foreign-owned subsidiaries to shift profits, which gives them an unfair advantage over their competitors which has less opportunity or propensity to engage in such activities (Kadet & Picciotto, 2015:3).

4.9.4. Striking a balance between anti-deferral and international competitiveness.

CFC rules should strike a balance between curbing the potential erosion of the domestic tax base on the one hand, while not distorting the competitive position of domestic companies in international markets on the other (Seonath, 2003:27). The OECD (2015a:15) views this balance as intrinsic to the rules that tax the income of foreign subsidiaries.

National Treasury's Detailed Explanation to section 9D (2002:1) comments that “a pure anti-deferral regime would immediately deem back all the South African owned foreign company income so that none of this foreign income receives any advantage over domestic income”. Section 9D, like other similar international regimes, take international competitiveness into account and therefore lacks this purity (National Treasury, 2002:1). In contrast to this, international competitiveness dictates that income earned by the foreign company should be ignored so that South African corporates can fully compete on an equal basis with their foreign

local competitors on the international stage. It follows that the principles of anti-deferral and international competitiveness are conflicting. Section 9D follows international norms favouring a balanced approach (Department of National Treasury, 2002:2).

The amendments to section 9D as it relates to loop structures specifically target passive income, i.e. dividends and capital gains (Department of National Treasury, 2021a:38). As mentioned before assets that generate passive income can be shifted around easily. As a result, these assets can easily be shifted abroad without economic consequence to CFCs. Therefore, immediate taxation of CFC passive income is consistent with international practice, and it can be argued that no direct competitiveness concerns arise if no active business is involved (Department of National Treasury, 2002:18). Consequently, it can be deduced that the amendments that is designed to immediately deem back the passive income is in line with international practice and no direct competitive concerns arise in this regard.

In addition, 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 designed to directly target arrangements without economic substance with the main aim to receive a tax advantage. The SARB (2021:1) made it clear that the relaxation of the loop structure policy was primarily targeted at supporting South Africa's growth as an investment and financial hub for Africa by encouraging new inward investment into South Africa. It is deduced that the intention was not to merely allow South African residents (natural persons and/or corporates) to export capital from South Africa and re-invest the same capital back into the CMA while externalising control over or beneficial ownership of their existing locally owned investments to a foreign jurisdiction. Accordingly, the amendments are intended to ensure that CFC structures are not used as tax planning opportunities where South African residents enter into loop structure arrangements with no economic substance with the aim to receive a tax advantage while externalising beneficial control. In this regard it can be concluded that the rules should be effective to tax dividends and capital gains that will likely lead to an artificial flow of funds to a foreign jurisdiction, which it does, but not to the extent where taxation will likely be harmful to South Africa's international competitiveness. This remains to be seen.

4.9.5. Summary

The removal of the loop structure restrictions is a big step forward in unlocking South Africa to foreign investment and such loop structures should be considered by South African companies looking to raise capital abroad. When investors consider South Africa as a potential place of investment the CFC rules are an important factor to consider in their decision making (Potgieter, 2012:67). In this regard if the amended provisions create unfair tax practices where loop

structures are involved, then international competitiveness is set at risk. Accordingly, the amendments should balance the need to encourage FDI into South Africa and the need to preserve the competitiveness of South Africa's economy on the international stage. Furthermore, CFC rules should strike a balance between curbing the potential erosion of the domestic tax base on the one hand, while not distorting the competitive position of domestic companies in international markets (Seonath, 2003:27). In this regard, the CFC rules are effective to tax the artificial flow of funds (i.e. dividends and capital gains) to foreign jurisdictions where a loop structure is involved. However, the taxation should not be to the extent that it distorts the competitive position of corporate South Africa.

4.10. Certainty and simplicity of the tax rules

4.10.1. Introduction

Li and Pidduck (2019:6) explain that tax complexity can be understood to include legal complexity (technical, statutory or substantive) and effective complexity (administrative and compliance or operational) and that both are present in the South African tax environment. A well-designed and effective tax system is easier for taxpayers to comply with and can promote economic development while raising sufficient revenue for a governments' priorities (Bunn & Asen, 2020:1). Simplifying tax has been noted to be critical in accomplishing broader policy objectives (Li & Pidduck, 2019:7). South Africa employs the tax system to carry through multiple policy objectives; in particular, attracting foreign investment, assisting outbound investment, generating tax revenues and tax base protection which adds to its complexity (Li & Pidduck, 2019:40). As noted above, a tax system that is neutral will likely be simpler, therefore simplicity and neutrality are viewed as interrelated concepts (Davis Tax Committee, 2016e:7).

When the amendments are assessed against the principles of certainty and simplicity it is submitted that the specific provisions that were amended should not be assessed in isolation, but that the application of the broader section 9D and paragraph 64B provisions as it relates to a loop structure arrangement should be considered to determine its legal and effective complexity.

4.10.2. Legal complexity

Certainty of tax rules are intricately connected with administrative efficiency and lower compliance and administrative costs (Davis Tax Committee, 2014a:29). It follows that certainty of the tax rules is important for local and foreign investors investing into South Africa through a loop structure. Another consideration is the complex technical structure of the amendments to the CFC rules as it relates to loop structures. A simple tax system makes it easier for taxpayers to understand and comply with (OECD, 2014:30).

Tax avoidance schemes and policy concerns that surface lead to constant amendments of the tax laws to address these concerns. As Li and Pidduck (2019:43) explain, these new changes should ideally “form part of the organic whole of the ITA”. However, in reality they may appear to be just patchwork. The amendments to the ITA to address the concern of tax avoidance through the use of loop structures may be an illustration of this.

In general section 9D which contains the CFC rules is regarded as one of the more complicated provisions in the South African tax legislation as well as those of other countries that have enacted CFC rules into their tax regimes (De Abreu, 2010:11; Li & Pidduck, 2019:23). Li and Pidduck (2019:24) explain that reliance is placed on technical rules to create boundaries between “the legitimate use of foreign companies and other uses in order to protect South Africa’s tax base without impeding outbound investments or causing over taxation of foreign income”. On the other hand, the design of the South African CFC rules is regarded as highly mechanical (Kau, 2021:ii). This can also be said for the amended provisions as it relates to loop structures. CFC rules that are entirely mechanical reduce the complexity which in turn reduces the cost of applying and complying with CFC rules. CFC rules that are more flexible on the other hand can create uncertainty, which may increase the costs to apply and comply with the rules (OECD, 2015c:12). CFC rules have to balance the need for reduced complexity that is inherent in mechanical rules versus the efficacy of rules that are more subjective (OECD, 2015c:12). When considering the amendments as it relates to loop structures it is submitted that it also has a mechanical substance which may reduce the compliance costs.

Similarly, it could be argued that the capital gains tax participation exemption is also burdensome to apply. Olivier and Honiball (2011:599) view paragraph 64B as one of the most complex capital gains tax provisions. The reason for the complexity could be due to the legislatures ambition to avoid abuse. Despite the complexity SARS is of the opinion that the paragraph is still abused and as such undermines the South African tax base, for example by shifting South African owned foreign companies outside the South African tax system, resulting in the limitation of the South African tax reach (Olivier & Honiball, 2011:599).

One of the public comments on the proposed amendment to paragraph 64B was that the proposed apportionment (i.e. the paragraph will not apply to capital gains or losses derived in respect of the disposal of shares in a CFC insofar as the value of the assets of the CFC is “derived from assets” in South Africa) was not suitable (Brink & Mazibuko, 2020:5). The reason being that the implementation of the proposed apportionment could result in an inequitable outcome for both the taxpayer and the fiscus. It was suggested that the method of apportionment should be based on the extent to which the capital gain or loss is “attributable” to assets in South Africa (Brink & Mazibuko, 2020:5). The response from SARS (2021a:57) to the comment was that “from a

practical point of view, it may be difficult to do valuations of capital gains on natural person assets and that the method may be difficult to apply where a CFC has a significant number of assets". The current amendment to paragraph 64B(6) now states that "paragraph 64B must only apply in respect of any capital gain or loss determined in respect of the disposal of any share in a CFC to the extent that the value of the assets of that CFC is attributable to assets directly or indirectly located, issued, or registered in the Republic".

The compliance cost which emanates from overcomplicated CFC rules should be weighed up against the direct and indirect revenue acquired from taxing a foreign entities' income (Olivier & Honiball, 2011:560). When designing South African CFC rules, both the tax rates and the compliance costs should be considered (Olivier & Honiball, 2011:560). Over and above the direct costs of paying taxes, there are indirect costs associated with complying with the CFC rules. Tax practitioners have over the years raised their concerns that efforts connected to complying with the administrative requirements far outweigh the benefits to the fiscus and that the rules should be simplified (Vosloo, 2018). Furthermore, complex tax laws compliment aggressive tax planning which may have a negative impact on the economy (OECD, 2014:30).

Therefore, care should be taken to ensure that the design of the CFC rules to fight tax avoidance through the use of loop structures is not too onerous and complicated that they create an excessive compliance burden to South African resident shareholders and CFCs. Considered in isolation it is submitted that the technical structure of the amendments would not be regarded as too complex and difficult to comply with. There could be an argument that the amendments did not consider the all the complexities of the CFC rules and are too simple.

4.10.3. Effective complexity

A country that wants to adopt sound international tax policies should formulate these policies within a framework that limits administrative and compliance costs for both the taxpayer and the revenue authorities once the policy becomes effective (Holmes, 2014:26). A well-designed CFC regime will be effective without requiring unnecessary increases in compliance costs and administrative obligations (OECD, 2015c:11). Accordingly, in designing and developing the South African CFC rules, consideration needs to be given to the cost of compliance as opposed to the benefit to the fiscus (Department of National Treasury, 2014:29). As an example, the documentation requirements should not place an unnecessary burden on taxpayers, nor should it disrupt the ease of doing business in South Africa (Department of National Treasury, 2014:29). Furthermore, these compliance requirements can place additional burdens on businesses and can require them to shift valuable resources away from production and toward tax compliance

and administration in order to expand their international trade and/or investment (Bunn & Asen, 2020:14).

The amendments to the ITA as it relates to loop structures impose tax consequences which necessarily implies a requirement for related operational compliance by South African resident shareholders and the CFCs which they are invested in, which could result in additional administrative burdens and compliance cost on both the taxpayer and SARS. Ideally the revenue collected by the fiscus should be proportionate to the costs associated with such collection. Accordingly, the design of the process should be carefully examined to ensure that the rules are not too burdensome and expensive that they hinder legitimate cross-border business transactions and present a major new administrative barrier to inward investment (Davis Tax Committee, 2016b:13).

It is also important to acknowledge that in addition to the tax compliance there is also exchange control compliance requirements that would have to be complied with. Notwithstanding that loop structures are no longer strictly prohibited by exchange control regulations, these structures created on or after 1 January 2021 will have a list of SARB reporting requirements and a higher burden of disclosure (SARB, 2021:1). This means that the investment into an offshore structure that invests into South Africa will introduce further reporting requirements (Botha, 2021:7). The reason for this is that any approved investment made under the foreign investment allowance is subject to a reporting requirement to the SARB on transaction finalisation as well as an annual reporting (Botha, 2021:7). These SARB reporting requirements seem to be extensive, and it is submitted that it could be expected to impose an additional administrative load on South African residents involved in loop structures. As a result, this could create further complexity and compliance cost concerns that could lead to further administrative inefficiency.

On the other hand, an argument can be made that when the additional administrative requirements and subsequent higher compliance cost is weighed up against the potential benefits and opportunities created by the relaxation of the loop structure restrictions, that these administrative requirements may be acceptable but must be borne in mind by investors considering investment into South Africa through a loop structure. This, however, remains to be seen.

4.10.4. Summary

Tax complexity results in a significant increase in administration and compliance and creates hurdles for corporate investment decisions. CFC rules are regarded as one of the most complex areas of tax legislation. On the other hand, the design of the CFC rules is considered to be highly

mechanical which reduces its complexity. The capital gains tax participation exemption is also regarded as complex and burdensome to apply. The amended provisions also have a mechanical substance which may reduce the compliance costs. In this regard it was concluded that the amendments to the ITA may be regarded as legislative patchwork to address the concern of tax avoidance using loop structures. The amendments are not intrinsically complex, and the concern is that it is too simple and does not consider all the complexities of the CFC rules.

When considering the effective complexity, the amendments impose tax consequences which inevitably suggests a need for associated operational compliance by shareholders and the CFCs which they invest in, which could result in further administrative burdens both on resident taxpayers and on SARS. It follows that the associated tax compliance and reporting requirements of loop structures should be simplified to ensure that it is not too onerous and costly to comply with to the extent that it hinders legitimate business transactions and introduce new hurdles for South African resident looking to raise capital abroad. In addition, the design of the SARB reporting process where a loop structure is involved should be carefully considered to make sure it does not add an additional layer of administrative complexity.

4.11. Prevention of double taxation

4.11.1. Introduction

International double taxation can be described as the levying of similar taxes in more than one jurisdiction on the same taxpayer in terms of the same income (Anderson, 2006:6). The issue of double tax occurs as a result of the distinct ways in which countries impose tax (Haupt, 2019:622). Horak (2023:par. 12.1) explains that when cross-border business activities are carried on, it is probable that the income derived from such activity or assets accumulated may be subject to conflicting tax claims by the countries involved, which may lead to potential double taxation. Accordingly, since the CFC rules tax the income of CFCs in the controlling shareholder's jurisdiction and the CFC may also be subject to tax in the foreign jurisdiction where the CFC is resident, it may result in double taxation. Therefore, the prevention of double taxation should be explored (OECD, 2015c:13).

As explained in the OECD in Action Plan 3 (2015a:65) there are specific circumstances that may result in double taxation because of the implementation of CFC rules, in particular when:

- i. the income imputed to the controlling shareholder is also subject to foreign tax,
- ii. multiple jurisdictions apply its CFC rules to the imputed income, and/or
- iii. imputed income is distributed as a dividend by the CFC (OECD, 2015a:65).

In order to minimise the risk of double taxation taking place, countries with CFC rules could adopt a foreign-tax credit system that would provide a foreign-tax credit in jurisdiction of the controlling shareholders that would remove double taxation in the circumstances in (i) and (ii) above, while in (iii) a dividend participation exemption could be provided where the income imputed was already subject to tax in that jurisdiction (OECD, 2015a:65).

4.11.2. Methods

The methods to alleviate international double taxation may be available under domestic law or under a DTA (Olivier & Honiball, 2011:6). Gutuza (2013:322) argues that the methods that are applied to reduce or remove double taxation should not only be focussed on tax avoidance or widening the tax base but it should also consider the country's trade and investment policies. The chosen method will invariably affect the equity and neutrality of residents as regards cross-border trade and investment. Thus, when a country opts to change its anti-avoidance measures by amending their CFC rules, it is paramount that they remain cognisant of how these changes may affect cross-border trade and how it may impact on the tax principles of equity and neutrality as mentioned. (Gutuza, 2013:322).

One of the key objectives of section 9D is to prevent double taxation, which aligns with the OECD Action 3 recommendations (Holliday, 2020:19). This is evident in the section's reference to the DTA provisions and the unilateral tax credit under section 6*quat* where applicable:

- DTAs: Section 9D refers to the fact that the CFC attribution rules are subject to the application of the relevant DTA.
- Tax credits: Residents can reduce their South African tax liability through the use of the tax credit available under section 6*quat*, if the CFC's attributed income was also subject to foreign tax, and thus avoid double taxation of the same income.

4.11.2.1. Double tax agreements (DTAs)

The primary purpose of DTAs is to avoid international double taxation, determining the taxing rights between the contracting countries (Oliver & Honiball, 2011:269; National Treasury, 2002:2). It is not the purpose of DTAs to prevent contracting countries from preserving their tax base (Anderson, 2006:1). However, during recent years DTAs have become important tools to also counter international tax avoidance (Anderson, 2006:5). It has been noted that the interaction of differing domestic tax systems may lead to an overlap of taxing rights resulting in potential double taxation. As a result, principles to address double taxation were developed in a DTA context. The format of DTAs entered into by South Africa, whether prior to or after the introduction of the residence-based system, is, like most countries, primarily based on the OECD Model Tax

Convention. The DTAs concluded by South Africa does not provide relief for economic double taxation it only provides for juridical double taxation. In this regard, where a DTA does not provide relief for economic taxation, taxpayers have to seek relief under domestic law (Olivier & Honiball, 2011:277).

As discussed in Chapter 3 where the South African CFC rules apply, a notional calculation is performed to determine an amount equal to a pro rata share of the CFC's net income, which is broadly speaking the taxable income of the CFC as calculated under section 9D. It is not the net income that is imputed but an amount equal to the proportional amount of the net income of the CFC. The CFC rules do not tax the CFC itself, however it taxes the resident shareholders of the CFC. It is therefore argued that because the same resident taxpayer is not being taxed more than once on the same amount, double taxation does not arise and therefore the CFC rules will not set aside any applicable DTA provisions (National Treasury, 2002:2). Where any foreign tax is payable by the CFC on income, which is also imputed to the South African resident shareholder, it is submitted that in the absence of unilateral foreign tax credits granted in terms of section 6quat, this may lead to economic double taxation and not juridical double taxation (National Treasury, 2002:2). The OECD shares the view that CFC rules are not in conflict with the underlying principles of a DTA, but the matter is not settled law (National Treasury, 2002:2).

Considering the impact, the amended provisions have on the prevention of double taxation where a loop structure is involved, it is concluded that where a South African resident invests back into a South African target company through a CFC, which is tax resident in a jurisdiction with which South Africa has a DTA, the dividends declared would be subject to dividends withholding tax in South Africa at 20 per cent. However, dividends withholding tax could be reduced in terms of the applicable DTA from 20 per cent to between 5 percent and 15 percent depending on the jurisdiction where the foreign company is tax resident (Bagraim, 2021). Thereafter, to the extent that dividends tax was not imposed on the amount, a portion of that income will be included in the calculation of the net income of the CFC. As a result, the resident shareholder of the CFC will be taxed on the income as determined in terms of the CFC rules, to the extent that the amount has not been subject to dividends tax (Section 9D(2A)(d)). The specific rules regarding the calculation of net income contained in section 9D(2A) will only affect the notional amount calculated for CFC purposes. Consequently, no relief will be available under any applicable DTA for the tax cost suffered.

When South African tax resident shareholders dispose of any equity shares in a CFC to a non-resident, the South African shareholder will be subject to capital gains tax to the extent that the value of the assets of that CFC is attributable to assets directly or indirectly located, issued or registered in South Africa (paragraph 64B(6)). The capital gains tax payable by the South African

tax resident shareholders may be reduced depending on the jurisdiction of tax residence of the foreign company and the applicable DTA.

4.11.2.2. Tax credit system

Section 6quat(1) is a mechanism under South African domestic tax law that provides unilateral relief in the form of a tax credit referred to as a rebate, in respect of foreign taxes paid or payable on foreign income by South African taxpayers (Olivier & Honiball, 2011:449). Section 6quat(1)(b) provides South African taxpayers with a potential rebate in respect of foreign taxes paid by the CFC on its income earned by way of a deduction to the income tax payable where such resident's taxable income includes a proportionally attributed amount in regard to the net income of a CFC (SARS, 2022:11). The aim of the provision is to counter effective economic double taxation that result from CFC income, by preventing the CFC income from effectively being taxed twice, once by the foreign company and once by the South African shareholder.

The rebate under section 6quat is only available for foreign taxes proved to be payable on foreign sourced amounts and no credit is available for South African withholding taxes. As a result, dividends declared by the SA target company to the CFC will be regarded as South African sourced and the resident shareholder will not qualify for a rebate under section 6quat for the dividends withholding tax payable.

A rebate for foreign tax payable on a foreign dividend may be available to a holder of shares under section 6quat(1) of the ITA when a foreign dividend has been subject to normal tax in South Africa (SARS, 2022:7). As a result, foreign tax payable on a foreign dividend declared by a CFC to a South African resident shareholder may qualify for a rebate when the foreign dividend has been subject to normal tax in South Africa.

It would appear as if the prevention of double taxation has been sufficiently addressed through the tax credit system in section 9D although the possibility exist that excessive taxation may occur if CFC rules are applied too rigidly, ultimately resulting in a potential reduction of cash reserves that could undermine the competitiveness of South African MNEs (Holliday, 2020:24).

4.11.3. Summary

The prevention of double taxation is an important element of section 9D and is to a large extent aligned to the BEPS Action 3 recommendations (Holliday, 2020:19). The amendments to the ITA as it relates to loop structures will not impact on the methods available to a South African tax resident to prevent international double taxation.

4.12. Conclusion

The objective of this chapter was to analyse the principles that underpin the CFC regime both globally and in South Africa as it relates to loop structures. Considering this the amendments were assessed against the objectives of effectiveness, equity and neutrality, international competitiveness, certainty and simplicity, and double taxation.

The principle of effectiveness discussed in paragraph 4.7 articulated that the purpose of the amendments to section 9D and paragraph 64B, is to protect the tax base of South Africa by improving the taxation of capital flows and to restrict the artificial reduction of dividends and capital gains tax where loop structures are used to avoid or defer tax, thus allowing for the relaxation of exchange control restrictions on loop structures. According to Potgieter (2012:3) there are two potential measures to assess the effectiveness of tax laws as an anti-avoidance measure which includes both the degree to which the tax avoidance or deferral is averted; and the degree to which non-tax driven business arrangements and investments are exposed to disincentives. The amendments to section 9D(2A)(d) and paragraph 64B(6) appear to be effective in its prevention of tax avoidance or deferral in relation to transactions where a loop structure is involved. However, the look-through rule in section 9D(2A)(f) in respect of capital have a broader application, as this provision removed the look-through rule for all natural person shareholders of CFCs and not just CFCs that hold South African interests. This provision goes beyond addressing tax avoidance where loop structures are involved. In addition, CFC rules are intended to raise revenue, however in many instances the amendments will result in SARS collecting more tax rather than the same tax that would arise where the South African company is held directly by South African shareholders. As a result, these amendments could inadvertently hinder otherwise legitimate commercially-driven transactions and therefore impact its effectiveness.

The principle of equity was discussed in paragraph 4.8.2 and it suggests that people who are in similar economic situations who carry out similar transactions should be subject to tax at the same levels (Jones & Basu, 2002:40). The principle of neutrality was discussed in paragraph 4.8.3 and according to Mirrlees *et al.* (2011:333) treats comparable economic activities in a similar manner for tax purposes. International tax neutrality suggests that tax laws of a country should neither discourage nor encourage cross-border capital flows. The CFC rules were enacted with the objective that a taxpayer that diverts income through a foreign company will be left in the same position as if that income had accrued directly to the taxpayer (Olivier & Honiball, 2011:574). Section 9D(2A)(d) subjects the dividend received by a CFC which is held by a SA company to tax at an effective rate of up to 20 per cent, even though, in the absence of a loop structure, no income tax would have been payable on the dividend paid between two South African companies. In addition, the inclusion rate results in an effective tax rate which is greater than 20 per cent where

the shareholder of the CFC is an individual or trust. When the amendments are assessed against the principles of equity and neutrality it is evident that taxpayers in similar situations carrying out similar transactions will not be subject to tax at the same levels and therefore equity and neutrality is not achieved in all instances.

Competitive considerations are important for both investors and governments as discussed in paragraph 4.9 above. If a country's tax system is uncompetitive it would be a disincentive for investors' investing in that country. Taxation should not be to the extent that it distorts the competitive position of corporate South Africa. The amended provisions are effective to tax dividends and capital gains that will likely lead to an artificial flow of funds to a foreign jurisdiction, but it remains to be seen if the over taxation of certain loop structures will be harmful to South Africa's international competitiveness. A higher effective rate on dividends declared by a South African company to the CFC where the shareholder is a or corporate compared to if the shares were held directly, could be viewed as a disincentive for South African companies looking to raise capital abroad, and could distort investment decisions for potential investors (Horak *et al.*, 2020). Similarly, the higher effective tax rate on the capital gains of CFCs may influence the investment decisions of South African natural persons. There are however other non-tax factors that investors would consider, but all things equal tax would likely tilt an investor's decision for or against a country as a location for FDI.

The principle of certainty and simplicity of the tax system was discussed in paragraph 4.10 and it was highlighted that these are important considerations for investors investing into any country as it makes it easier for investors to understand and comply with. As discussed in paragraph 4.10.1 tax complexity can be understood to include legal and effective complexity, and both are present in the South African tax environment. From a legal complexity perspective section 9D and paragraph 64B is regarded as complex. The amended provisions to address the concern of tax avoidance through the use of loop structures may be regarded as an illustration of legislative patchwork which adds to the overall complexity of the legislation. The amendments itself does not make the CFC rules more complex. The concern with the amended provisions is that it is too simple and does not consider all the complexities of the CFC rules. On the other hand, the design of the South African CFC rules is regarded as highly mechanical (Kau, 2021:ii). The amended provisions also have a mechanical substance which may reduce the compliance costs. Effective complexity was discussed in paragraph 4.10.2 and can be understood as the compliance, administrative and operational complexity of a tax system that increases the cost of compliance, which can impede economic development and reduce revenue for the fiscus. The amendments impose tax consequences which necessarily implies a requirement for related operational compliance by South African resident shareholders and the CFCs which they invested in, which

could result in additional administrative burdens and compliance cost on both the taxpayer and SARS. In addition, there are also exchange control compliance and reporting requirements for loop structures to consider. The effective complexity associated with loop structures could thus create further compliance and cost concerns that could lead to administrative inefficiency.

The prevention of double taxation is an essential element of section 9D and is to a large extent aligned to the BEPS Action 3 recommendations as discussed in paragraph 4.11. Accordingly, the amendments to the ITA as it relates to loop structures will not impact on the methods available to a South African tax resident to prevent international double taxation.

CHAPTER 5 CONCLUSION AND RECOMMENDATIONS

5.1. Introduction

The main research objective of this study was to critically analyse the recent amendments to the CFC rules as it relates to South African residents' interests in loop structures to determine its application and appropriateness within the context of the principles that underpin CFC legislation both globally and in South Africa. This purpose was derived from the question "Are the recent amendments to the CFC rules appropriate to address the taxation of interests in loop structures in the context of the principles that underpin CFC legislation?"

In order to achieve the main research objective, the following secondary objectives were formulated (paragraph 1.5.2, page 10):

- (i) To perform an overview of the history and evolution of exchange control with a specific focus on loop structures (Chapter 2)
- (ii) To perform an analysis of the South African CFC rules particularly in the context of loop structures (Chapter 3)
- (iii) To perform a detailed analysis of the principles that underpin the CFC regime both globally and in South Africa to determine the appropriateness of recent changes to CFC rules as contemplated in section 9D and paragraph 64B of the Income Tax Act as it relates to loop structures (Chapter 4).

What follows in this chapter is a summary of the research findings based on the secondary research objectives set out in Chapter 1.

5.2. History and evolution of exchange controls

The first secondary objective, which was addressed in Chapter 2 of this study, performed an overview of the history and evolution of exchange control with a specific focus on loop structures.

It was stated in Chapter 2 that for much of history, the regulation of cross-border capital movement and the applicable exchange rate has been a core component of numerous countries' economic management toolkit. It was found that governments use different forms of capital controls, which are often country specific, to regulate the outflow or inflow of capital to maintain financial stability and prevent or mitigate the impact of economic crises and to preserve the independence of national policies. South African exchange controls are necessary policy measures that were designed to regulate and discourage capital outflows from South Africa and provide a framework for the repatriation of foreign currency. These exchange controls are governed by the regulations

promulgated under the Currency and Exchanges Act No 9 of 1933. Regulation 10(1)(c) has a wide application and covers aspects surrounding restrictions placed on South African residents entering into transactions with the purpose or effect of directly or indirectly exporting capital or an interest in capital from South Africa. As a result, the regulation effectively restricted (subject to certain exceptions) the formation of loop structures.

It was further stated that loop structures are generally created by South African resident individuals, trusts or company(s) that remit funds from South Africa to establish an offshore entity. The offshore entity would then directly or indirectly (via another offshore entity) invest the funds in South Africa, thereby creating a loop structure. The reinvestment could be in the form of South African shares, loans, or an interest in a South African resident company or other assets. Offshore accumulation of the profits from investments by the foreign entity into South Africa may result as a consequence of the loop structure. The returns that amass in the offshore entity from the South African investments could result from dividends, interest, or other payments.

It was further noted that the FinSurv generally regards loop structures as a threat because they may potentially cause the direct or indirect export of capital offshore to a non-resident entity to the benefit of a South African resident (Department of National Treasury, 2021a:36). Furthermore, it was highlighted that loop structures pose a risk to the South African tax base as they present an opportunity for abusive tax planning as they can be used as a vehicle to facilitate the avoidance or deferral of taxation by accumulating income abroad (Department of National Treasury, 2020a:137). However, it was found that tax legislation is viewed by National Treasury as a more suitable tool to limit tax avoidance where a loop structure is involved, rather than restricting the use of a loop structure through exchange control policy (Department of National Treasury, 2021a:36).

With increasing globalisation and economic freedom the need to abolish exchange controls was necessitated. It was found that the South African government adopted a gradual and phased approach to the abolishment of exchange control, and over the last two decades there have been significant changes to exchange control policies. Part of these changes was also the gradual relaxation of the loop structures restrictions. The most notable change happened in 2020 when the CFM framework was announced, and it introduced a whole new direction in controlling capital flows and cross-border foreign currency transactions. The shift to a new CFM framework, combined with National Treasury's objective to encourage investment into South Africa, and the modernisation and improvements to the cumbersome SARB approval process for cross-border flows, have led to the lifting of loop structure restrictions on South African tax resident individuals, companies, and private equity funds in its entirety. In this regard, the lifting of the restrictions is subject to the normal criteria applying to inward investments into South Africa and specific

reporting requirements to the SARB. As a result, South African resident individuals, companies, and private equity funds with authorised foreign assets may invest back into South Africa without restriction. It was found that the allowance of loop structures will potentially aid to simplify international shareholding structures, which have been complex given the limitations imposed by the restrictions under the previous dispensation.

From the discussion in Chapter 2, it was concluded that National Treasury introduced new amendments to the ITA in order to protect the tax base against possible tax avoidance or deferral arrangements through the use of loop structures that could result in the direct or indirect export of capital abroad to a non-resident entity for the subsequent enjoyment of a South African resident. The recent amendments were inserted in section 9D of the ITA which contains the South African CFC rules and paragraph 64B of the Eighth Schedule to the ITA.

5.3. South African CFC rules

The second secondary research objective to analyse the South African CFC rules particularly in the context of loop structures was addressed in Chapter 3 of the study.

The findings noted from the discussion in Chapter 3 relate to the tax amendments enacted as part of the Taxation Laws Amendment Act No. 23 of 2020, which aims to reduce the negative effects of loop structures on the South African tax base, thus allowing for the lifting of exchange control restrictions on loop structures.

The income tax exemption on a South African dividend was partially removed. Section 9D(2A)(d) of the ITA, has been amended to ensure that CFCs include portions of a dividend received or accrued from a South African resident company in their net income. The ITA now includes a formula with which to determine the non-exempt portion of a dividend (and therefore the portion required to be included in net income). It was found that this amount will be equal to the ratio of the number 20 to the number 28 of the dividend that is received or accrued from a resident company and may be further reduced to the extent that any dividends tax has already been paid. This means that dividends paid by the South Africa company to the foreign company will suffer both local dividends tax (at 20 per cent unless the rate was reduced in terms of an applicable DTA) and also income tax under the CFC rules. To the extent that the amount has not been subject to dividends tax, the resident shareholder of the CFC will be taxed on the income in terms of the CFC rules.

The discussion further determined that a new paragraph 64(B)(6) was introduced to the capital gains tax participation exemption. The CGT participation exemption contained in paragraph 64B of the Eighth Schedule to the ITA was removed in respect of any capital gains or losses realised

as a result of the disposal of any share in a CFC to the extent that the value of the assets of that CFC is attributable to assets directly or indirectly located, issued, or registered in South Africa.

Lastly it was determined that the look-through rule in respect of capital gains, as contained in paragraph (f) of the proviso to section 9D(2A) of the ITA was removed for natural persons and special trusts. The rationale behind National Treasury removing the proviso for natural persons and special trusts is that the attribution of an amount of net income of a CFC to a South African resident does not retain the character or nature of the underlying elements of net income for those residents. As a result, an inclusion rate of 80 per cent will now apply in all instances, regardless of whether the shareholder is a natural or juristic person.

5.4. Principles that underpin the CFC regime both globally and in South Africa

The second secondary research objective: To analyse the principles that underpin the CFC regime both globally and in South Africa to determine the appropriateness of the recent changes to CFC rules as contemplated in section 9D and paragraph 64B of the Income Tax Act as it relates to loop structures, was addressed in Chapter 4.

The study determined that the changes made to section 9D and paragraph 64B(6) of the ITA as it relates to loop structures should fit within the government's overall economic strategy and policy approach to cross-border trade and investment. It should also reflect the principles which underlie a good tax system while adopting the design and structure of CFC rules globally and in South Africa. In this regard it was concluded that in order to determine its appropriateness, the amendments should be assessed against the objectives of effectiveness, equity and neutrality, international competitiveness, certainty and simplicity, and double taxation.

5.4.1. Effectiveness

In order for section 9D(2A) and paragraph 64B(6) to be effective it should merely serve its primary purpose as an anti-tax avoidance measure and a deterrent for diverting income by improving the taxation of cross-border capital flows and to restrict the artificial reduction of dividends and capital gains tax where loop structures are used to avoid or defer tax, and should not extend beyond this. It was found that the amendments to section 9D(2A)(d) and paragraph 64B(6) appear to be effective in its prevention of avoidance or deferral of tax in relation to transactions where a loop structure is involved, but will in many instances extend beyond its purpose. It was determined that the amendments will in many instances result in increased revenue for the fiscus rather than the same revenue that would be collected if South African shareholders directly hold the South African target company. In this regard the effectiveness of the CFC rules will be impacted if the

amendments complicate otherwise legitimate commercially driven business arrangements and investments.

5.4.2. Equity and neutrality

South Africa's international tax laws should neither prevent nor promote cross-border capital flows. To achieve the objective of equity and neutrality the tax laws should regard similar economic activities in similar ways for tax purposes. Accordingly, taxpayers in comparable economic circumstances who conduct comparable transactions should be subject to the same levels of tax. As a result, the amended provisions were assessed against equity and neutrality, and it was determined that the amended provisions would in certain circumstances discriminate against taxpayers in a similar situation that holds similar assets since the treatment of the South African assets held through a loop structure does not in all instances correspond with the treatment that would have applied, had the South African residents owned those assets directly.

It was concluded that the amendment to the capital gain participation exemption in paragraph 64B(6) to the Eighth Schedule of the ITA has the net effect that residents holding South African assets directly versus South African assets held indirectly through a CFC receive equal tax treatment.

On the other hand, it was determined that the cumulative effect of the amendments to section 9D(2A)(d) is that dividends paid by the South African resident company to the CFC, will be subject to dividends tax at a rate of 20%, subject to a reduced rate under a relevant DTA. Subsequently a portion of that income will be included in the calculation of the net income of the CFC, to the extent that dividends tax was not imposed on the amount paid. However, when the shareholder of a South African company is another South African company, dividends paid between the two South African companies would be exempt from dividends tax and no income tax would be payable on the dividend paid between the two companies. Therefore, the presence of the CFC may result in an increased tax liability. It was concluded that the tax treatment should not be different just because a CFC is interposed. In addition, if a CFC is interposed between the South African company and a South African natural person shareholder, the effective tax rate may be greater compared to if the South African natural person shareholder had received the South African dividend directly.

The implication of the removal of a natural person from proviso (f) to section 9D(2A) results in a higher maximum effective rate where the resident shareholder hold South African assets through a CFC compared to if the resident natural person owned the South African assets directly. The net effect is that in applying the CFC rules, South African natural person shareholders would not

pay CGT at the same rate as they would have if they earned the capital gain directly. A higher effective tax rate on the gains of CFCs is unfair and may influence the investment decisions of South African natural persons and may have an adverse impact on investments made through a CFC and therefore neutrality would not be achieved.

It was concluded that taxpayers in similar situations conducting similar transactions will not in all instances be liable for tax at the same level and that the amended tax rules regulating loop structures, constitute over-taxing of certain loop structures. Accordingly, the balance between protecting the tax base on the one hand, and tax equity and neutrality for taxpayers on the other, is incongruous in favour of base-protection rules. It could likely influence the investment decisions of domestic and foreign investors investing in South Africa and if this is the situation it would demonstrate a lack of neutrality.

5.4.3. International competitiveness

In order for South Africa to attract domestic or foreign investment it must be viewed on the international stage as being competitive. Therefore, international competitiveness is a key consideration for both the South African government and potential investors (domestic and foreign) considering investment into South Africa. It was determined that the tax system is not the main driver of international competitiveness and that other non-tax factors exist that could impact a decision on investment destination. However, uncompetitive tax rules could tip the scales against South Africa as a preferred investment destination.

The exchange control restrictions on loop structures have been removed to support the growth of South Africa as financial and hub for Africa and is a necessary step forward in promoting South Africa as an attractive investment destination for foreign investors. In this regard if the amended provisions cause unfair tax practices where loop structures are involved, it may negatively impact South Africa as an investment destination and international competitiveness may be set at risk. One could argue that there are valid business reasons for parties to implement a loop structure, however, through the amended provisions National Treasury seek to avoid an instance where such a structure would undermine the South African tax base. In this regard it was determined that the rules are effective to tax the artificial flow of dividends and capital gains to foreign jurisdictions where a loop structure is involved. It was further concluded that a higher effective rate on dividends declared by a South African company to the CFC where the shareholder is a natural person or corporate compared to if the shares were held directly, may be viewed as a disincentive for South African companies looking to raise capital abroad, and could distort investment decisions for potential investors. Similarly, the higher effective tax rate on the capital gains of CFCs may influence the investment decisions of South African natural persons. It

remains to be determined if the excessive taxation of certain loop structures will be harmful to South Africa's international competitiveness.

5.4.4. Certainty and simplicity

A well-designed tax system should be simple to understand and easy to comply. It should also encourage economic development while raising appropriate revenue for the fiscus and protecting the tax base. The amended provisions were assessed against both legal complexity and effective complexity. It was determined that instead of it forming part of the organic whole of the ITA, the amendments may like other avoidance measures, be regarded as legislative patchwork which adds to the complexity of the CFC rules. On the other hand, the amended provisions also have a mechanical substance which may reduce the compliance costs. It was concluded that from a legal complexity perspective the amendments in itself do not make the CFC rules more complex. The concern with the amended provisions is that it is too simple and does not consider all the complexities of the CFC rules. From an effective complexity perspective, it was determined that the amendments impose tax consequences and SARS reporting requirements which undoubtedly involves related operational and administrative compliance which could result in further administrative burdens on both the taxpayer and on SARS. It was concluded that the additional compliance and reporting burden to establish and maintain a loop structure, coupled with the tax amendments, may lead an investor to pause and re-evaluate whether using a loop structure is worth the efforts.

5.4.5. Prevention of double taxation

CFC rules subject the income of CFCs to taxation in the controlling shareholder's jurisdiction, which can result in double taxation if the CFC is also subject to taxation in the jurisdiction where the CFC is resident. Accordingly, it was necessary to consider the impact the amendments would have on the prevention of double taxation where a loop structure is involved to ensure that it does not create an additional hurdle to cross-border trade and investment. It was concluded that the prevention of double taxation is an essential element of section 9D and largely aligns with the OECD Action 3 recommendations. It was further concluded that the amendments to the ITA as it relates to loop structures will not impact on the methods available to a South African tax resident to prevent international double taxation.

5.5. Overall conclusion

Within the context of the principles that underpin CFC legislation it was determined that the amended provisions as it relates to South African residents' interests in loop structures appears to be effective in curbing tax avoidance and deferral in relation to transactions where a CFC

participates in the loop structure, which is its primary purpose. However, the amendments do have wider implications for South African resident shareholders of a CFC that holds South African interests and would in particular instances go beyond its purpose as an anti-avoidance measure. It was further observed that the principle of equity and neutrality is not achieved with all loop structures. The tax treatment of South African assets held through loop structures would not in all instances match the tax treatment that would have applied if the South African resident directly held those assets. Contrary to the exchange control restrictions on loop structures which were outright prohibitive, it was revealed that the tax amendments may cause punitive tax outcomes for South African residents that have existing loop structures or for those who are exploring new loop structures. Promoting international competitiveness is key to attract FDI, and the amendments should not inadvertently hinder otherwise legitimate commercially driven transactions and adversely affect cross-border trade. It should also not create difficulties for the meaningful protection of the South African fiscus.

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