# An evaluation of the South African CFC rules with a specific focus on multi-layered transactions


**M Wessels**

**orcid.org/0000-0002-6826-4083**



Mini-dissertation accepted in partial fulfilment of the requirements for the degree Master of Commerce in Taxation at the North-West University

Supervisor: Prof DP Schutte

Graduation: June 2021

Student number: 33103135

**DECLARATION**

I declare that:

**"An evaluation of the South African CFC rules with a specific focus on multi-layered transactions"**

is my own work and that all the sources I have used or quoted have been indicated and acknowledged by means of complete references, and that this mini-dissertation has not previously been submitted by me for a degree at any other university.

Marissa Wessels

November 2020
Johannesburg

## LANGUAGE EDITOR CERTIFICATION

Matthew de Beer

Masters in Education

English Instructor

083 274 0970

Matthewdb.10@gmail.com

5 November 2020

To whom it may concern

This is to confirm that I, the undersigned, have language edited the completed research of Marissa Wessels for the Master of Commerce in Taxation mini-dissertation entitled: **An evaluation of the South African CFC rules with a specific focus on multi-layered transactions**.

Yours truly,

Matthew de Beer

## ACKNOWLEDGEMENTS

I would like to thank the following people for their contributions to the completion of this mini dissertation:

My family and friends for always providing me with their unfailing support and continuous encouragement both in my studies and in my career. This accomplishment would not have been possible without them.

Prof Danie Schutte for his guidance through this process and for his technical expertise, support and direction while supervising this mini-dissertation and its supporting research proposal.

Matthew de Beer for his language editing services.

## TABLE OF CONTENTS

**DECLARATION** ..... I

**LANGUAGE EDITOR CERTIFICATION** ..... II

**ACKNOWLEDGEMENTS** ..... III

**ABSTRACT OF MINI-DISSERTATION** ..... VII

**LIST OF KEYWORDS** ..... VIII

**LIST OF DIAGRAMS** ..... IX

**LIST OF TABLES** ..... IX

**LIST OF ABBREVIATIONS** ..... X

**CHAPTER 1: INTRODUCTION** ..... 1

1.1 Background and motivation of topic actuality ..... 1

1.2 Problem statement ..... 3

1.3 Research objectives ..... 3

1.4 Research design and methodology ..... 4

1.5 Overview of chapters ..... 7

**CHAPTER 2: DISCUSSION OF THE PROBLEMS ASSOCIATED WITH CFCS - THE NEED FOR OECD INTERVENTION AND BEPS** ..... 9

2.1 Introduction ..... 9

2.2 The need for anti-diversionary rules in respect of CFCs ..... 9

2.3 OECD intervention in response to abuse of CFCs ........................................... 10

2.4 Multi-layering of CFCs in order to circumvent diversionary rules....................... 12

2.5 Summary ........................................................................................................ 15

**CHAPTER 3: ANALYSIS OF THE DEVELOPMENT AND CURRENT STATE OF SOUTH AFRICAN CFC LEGISLATION INCLUDING RECENT AMENDMENTS .......... 16**

3.1 Introduction........................................................................................................ 16

3.2 Development of key CFC anti-diversionary measures in South Africa .............. 16

3.3 The problem with substance over form and GAAR in context of multi-layered CFC transactions ...................................................................................................... 20

3.4 Extension of the CFC rules to both direct and indirect transactions .................. 26

3.5 Conclusion........................................................................................................ 28

**CHAPTER 4: AN EVALUATION OF SOUTH AFRICA'S CFC LEGISLATION IN CONTEXT OF ITS ACTUAL BEPS EXPOSURE AND THE CFC LEGISLATION OF COMPARABLE FOREIGN JURISDICTIONS .................... 29**

4.1 Introduction........................................................................................................ 29

4.2 South African CFC legislation in context of the real risk of BEPS...................... 29

4.3 Foreign-to-foreign stripping.................................................................................. 31

4.4 The UK: Motive test, Diverted Profits Tax and General Anti-Abuse Rule .......... 34

4.5 Ireland: Non-genuine arrangements put in place for the essential purpose of tax avoidance ........................................................................................................ 37

4.6 The Netherlands: An argument for the relaxation of CFC rules......................... 39

4.7 Conclusion........................................................................................................ 41

**CHAPTER 5: SUMMARY AND CONCLUSION ..................................................... 43**

5.1 Introduction ........................................................................................ 43

5.2 Summary of research objectives ...................................................... 43

5.3 Final observations and recommendations ........................................ 46

5.4 Suggestions for future study ............................................................ 47

5.5 Conclusion ........................................................................................ 49

**REFERENCE LIST ........................................................................................ 51**

## ABSTRACT OF MINI-DISSERTATION

Prior to 2019, it had become increasingly prevalent for taxpayers to interpose additional (arguably unnecessary) Controlled Foreign Companies (CFCs) into their international supply chains between South African resident taxpayers and independent non-resident suppliers or customers. Often this was done in order to circumvent CFC anti-diversionary rules by diverting profits to group companies that are subject to tax at a lower rate and that are not subjected to the South African specific anti-diversionary rules.

The question that arises is thus whether the current South-African CFC legislation read with the 2019 amendments thereto (particularly insofar these relate to direct and indirect transactions between various parties involved in multi-layered transactions) is sufficient as a deterrent against such abusive multi-layered structures and transactions without going so far as to discourage legitimate business and investment into or from South Africa.

Making use of interpretive and qualitative research methodologies, this study analyses the South African CFC legislation relating to multi-layered structures and transactions in context of the actual risk posed by such structures to the South African tax base, the South African tax legislative trends which have paved the way for the 2019 amendments, the views of local and international industry experts and the treatment of similar transactions and/or structures in comparable foreign jurisdictions.

## LIST OF KEYWORDS

section 9D;

controlled foreign company (CFC);

foreign business establishment (FBE);

diversionary rules;

multi-layered transactions;

indirect transactions

## LIST OF DIAGRAMS

Diagram 1: BEPS in context of direct transactions[2] ...... 10

Diagram 2: BEPS in context of indirect or multi-layered transactions...... 13

Diagram 3: The effect of section 9D (as amended) on indirect or multi-layered transactions ... 33

## LIST OF TABLES

Table 1: Quantifying the estimated loss of tax revenue due to profit shifting, 2009 – 2014 (in %)...... 30

## LIST OF ABBREVIATIONS

| Abbreviation | Meaning |
|---|---|
| AD | Appellate Division |
| ATAD | Anti-Tax Avoidance Directives |
| BEPS | Base Erosion and Profit Shifting |
| CFA | Controlled Foreign Affiliate |
| CFC | Controlled Foreign Company |
| CFE | Controlled Foreign Entity |
| CITA | Dutch Corporate Income Tax Act 1969 |
| Companies Act | Companies Act (71 of 2008) |
| CSARS | Commissioner for the South African Revenue Service |
| DPT | Diverted Profits Tax |
| DTC | The Davis Tax Committee, appointed by the Minister of Finance on 17 July 2013, tasked with undertaking a tax review to assess South Africa's tax policy framework and its role in supporting the objectives of inclusive growth, employment, development and fiscal sustainability |
| EU | European Union |
| FAPI | Foreign Accrual Property Income |
| FBE | Foreign Business Establishment |
| FOE | Freedom of Establishment |

| Abbreviation | Meaning |
|---|---|
| G20 | Group of 20, an informal international forum for the finance ministers and central bank governors of 19 countries (including South Africa) and the European Union |
| GDP | Gross Domestic Product |
| HMRC | Her Majesty's Revenue and Customs |
| IFRS 10 | International Financial Reporting Standards on Financial Statements |
| ITA | Income Tax Act (58 of 1962) |
| GAAR | General Anti-Avoidance Rules |
| Katz Commission | Commission of inquiry into certain aspects of the tax structure of South Africa, appointed by the Minister of Finance on 22 June 1994 |
| OECD | Organisation for Economic Co-operation and Development |
| RSA | The Republic of South Africa |
| SAICA | South African Institute of Chartered Accountants |
| SAIT | South African Institute of Tax Professionals |
| SARS | South African Revenue Service |
| SCA | Supreme Court of Appeal (previously the Appellate Division) |
| TAA | Tax Administration Act (28 of 2011) |
| TLAA | Taxation Laws Amendment Act |

| Abbreviation | Meaning |
| --- | --- |
| TLAB | Taxation Laws Amendment Bill |
| UK | United Kingdom |

# CHAPTER 1: INTRODUCTION

## 1.1 Background and motivation of topic actuality

In its 2019 Budget Review, National Treasury indicated that, as part of its tax amendments for the upcoming legislative cycle, it intended to review the rules applicable to Controlled Foreign Companies ("CFC") and to put in place measures to address the circumvention of anti-diversionary rules by CFCs (National Treasury, 2019b:133).

This is in line with the Organisation for Economic Co-operation and Development's ("OECD") Inclusive Framework on Base Erosion and Profit Shifting ("BEPS"). In its 2015 Final Report on Designing Effective Controlled Foreign Company Rules (OECD, 2015:3), the OECD emphasised that *"[i]nternational tax issues have never been as high on the political agenda as they are today. The integration of national economies and markets has increased substantially in recent years, putting a strain on the international tax rules... Weaknesses in the current rules create opportunities for base erosion and profit shifting..., requiring bold moves by policy makers to restore confidence in the system and ensure that profits are taxed where economic activities take place and value is creat*ed." (sic)

The OECD initially, in 2013, published its Action Plan on Base Erosion and Profit Shifting in which it called for an overhaul of the design of CFC rules world-wide (OECD, 2013a: 16). In its 2013 report entitled Addressing Base Erosion and Profit Shifting, the OECD also acknowledged that *"[a] comprehensive solution cannot be developed without the contribution of all stakeholders"* and, as such, requested that all of its interested member countries as well as non-member countries, in particular G20 economies (such as South Africa), contribute to the development of the action plan (OECD, 2013b:9).

Although the member countries to the OECD / G20 Inclusive Framework (the latter of which includes South Africa) have since made significant strides towards realising the BEPS Action Items (as set out in OECD, 2013a) since 2013, the OECD's BEPS Progress Report for July 2018 to May 2019 illustrates that there is still a long way to go in order to fully achieve the BEPS Action Items. The latter report once again emphasises that there is a need to *"ensure the taxation of certain categories of income of a multinational enterprise in the jurisdiction of the parent company in order to counter popular offshore structures that result in no or indefinite deferral of taxation."* The report further emphasises that *"Comprehensive and effective CFC rules have the effect of reducing the incentive to shift profits from a market country into a low-tax jurisdiction"* (OECD, 2019:21).

A recent landmark judgement delivered by the Supreme Court of Appeal ("SCA") on 9 November 2018 in the case of Sasol Oil v CSARS (2018) may serve to illustrate the concerns of the OECD as well as South Africa's National Treasury. At the risk of oversimplifying the undoubtedly complex facts of the case, the SCA was called upon to determine whether various contracts for the sale of crude oil by one entity within the Sasol Group to another and the subsequent back to back sale of the same oil to yet another entity in the group was a simulated transaction or, alternatively, whether it was entered into solely or mainly for purposes of avoiding the payment of tax.

The minority of the SCA found that trade functions had been duplicated by Sasol Group subsidiary companies, in order to evade the clutches of section 9D of the Income Tax Act (58 of 1962) ("ITA") as it relates to CFCs. The majority, on the other hand, ruled in favour of Sasol Oil and found that there were good commercial reasons for the transactions entered into between the various Sasol Group companies and that the transactions were therefore not entered into solely or mainly for the avoidance of tax, nor were they simulated. In so doing, the majority also arguably set a precedent which will increase SARS' evidentiary burden in similar cases going forward.

It therefore comes as no surprise that National Treasury, finding itself on the back foot when it comes to the collection of its dues from international group companies, has opted to review its legislative standing. However, rather than amending the rules and legislation in relation to the General Anti-Avoidance Rules ("GAAR") or the substance over form doctrine, National Treasury has opted to once again review South Africa's CFC legislation.

In its 2019 Budget Review, National Treasury states that *"[g]overnment has identified schemes where controlled foreign companies (that are part of a group) are interposed in the supply chain between South African connected parties and independent non-resident customers or suppliers"* (National Treasury, 2019b:133). Although the aim of the existing CFC rules, as contained in section 9D of the Act is to prevent South African taxpayers from moving income that would ordinarily have been taxed in South Africa to offshore jurisdictions with more favourable tax regimes, it has now become apparent that the existing CFC rules are inadequate to address multi-layered transactions (National Treasury, 2019b:133), presumably like those encountered in the Sasol Oil SCA matter.

In terms of the 2019 Taxation Laws Amendment Act ("TLAA") (34 of 2019), National Treasury now attempts to address such schemes (i.e. transactions achieved by the imposition of additional CFCs in the supply chain between a South Africa resident and an independent non-resident supplier or customer, thereby circumventing the existing CFC rules in their current form). Briefly put, per the Explanatory Memorandum on the Draft Taxation Laws Amendment Bill (2019) (National Treasury 2019a:40), the 2019 Taxation Laws Amendment Bill (“TLAB”) proposed

amending section 9D of the ITA to extend its application to include both direct and indirect transactions between the various parties involved in so-called "*multi-layered transactions*". This amendment has now been brought into effect by the 2019 TLAA (34 of 2019).

This amendment, the efficacy of the South African CFC regime as a whole (particularly in light of the BEPS Action Items) as well as a comparison between the South African CFC regime and that of comparable foreign jurisdictions will follow in more detail in subsequent chapters.

## 1.2 Problem statement

It has become increasingly prevalent for taxpayers to interpose additional (arguably unnecessary) CFCs into their international supply chains between South African resident taxpayers and independent non-resident suppliers or customers. Often this is done in order to circumvent CFC anti-diversionary rules by diverting profits to group companies that are subject to tax at a lower rate and that are not subjected to the South African specific anti-diversionary rules (National Treasury 2019a:40).

The question that arises is thus whether the current South-African CFC legislation read with the recent amendments thereto (particularly insofar these relate to direct and indirect transactions between various parties involved in multi-layered transactions) is sufficient as a deterrent to abusive tax structuring without going so far as to discourage legitimate business and investment into or from South Africa (when compared to comparable jurisdictions and the "ideal" CFC regime as contemplated in BEPS, Action 3).

## 1.3 Research objectives

The following research aims, and objectives were formulated to address the research question:

### 1.3.1 Main objective

The main objective is to analyse the current South-African CFC legislation and, specifically, the 2019 amendments thereto (particularly insofar these relate to direct and indirect transactions between various parties involved in multi-layered transactions) in order to determine the effectiveness thereof as a deterrent against abusive tax structuring and, more generally, as a tool to protect and bolster the South African tax base (refer to Chapter 3).

As part of the abovementioned analysis, this study also seeks to analyse the 2019 amendments to the South African CFC legislation (particularly insofar as these relate to multi-layered transactions) against National Treasury and the OECD's (and by implication the international tax

community's) goal of curbing the circumvention of anti-diversionary rules in respect of CFCs in context of multi-layered transactions (refer to Chapter 3 and 4).

### 1.3.2 Secondary objectives

To achieve the main objective the following secondary objectives are formulated:

Describing and considering the concerns raised by CFCs and multi-layered structures generally, and which necessitated the intervention of the OECD via the introduction of BEPS, (refer to Chapter 2).

Describing and considering the various iterations and certain notable applications of the South African CFC legislation to date (as influenced by case law, rulings and international commentary) as a backdrop against which to evaluate the South African CFC regime in its current form (refer to Chapter 3).

Analysing the South African CFC regime against the OECD's "ideal" CFC regime as contemplated by BEPS (refer to Chapter 4).

Analysing the legislation of comparable foreign countries (specifically other G20 member countries who subscribe to BEPS) to determine how other countries manage to curb the circumvention of anti-diversionary rules in respect of CFCs or, alternatively, why such rules may be absent (refer to Chapters 4).

The CFC regimes of the UK, Ireland and the Netherlands will be used in this study for purposes of comparison to the South African CFC regime. The aforementioned countries are comparable to the South African tax system, have contributed to the development of the South African CFC regime (Croome, 2013:5), or otherwise follow approaches so demonstrably different as to be notable.

## 1.4 Research design and methodology

The research will be conducted as follows:

### 1.4.1 Literature review

According to Hutchinson & Duncan (2012:112–113) a literature review essentially involves asking what has been said about a topic previously. This is achieved through a critical analysis of the existing research literature, theoretical and empirical, related to the research topic. The literature review thus informs us of 'what is known and what is not known' about the topic.

Several resources will be consulted as part of this study's literature review, which resources include inter alia the South African ITA, the CFC legislation of other countries, and relevant OECD publications and guidelines. The development of South Africa's CFC legislation will be studied with reference to amendments to the South African Income Tax Act, relevant case law and notable international influences. Other resources such as journal articles and databases will also be used.

#### 1.4.2 Research Methodology

According to Gaffikin (2014:2) "*methodology is usually taken to be a discipline bordering on philosophy, whose function is to examine the methods which are used or should be used to produce valid knowledge.*"

As a starting point, this study will consider the need for CFC legislation and the tax consequences sought to be avoided through the enactment of such legislation both internationally and locally under the guidance of the OECD and BEPS.

Thereafter, and in light of the foregoing, this study will consider the development of South African CFC legislation to date as well as the proposed amendments thereto. This will be done by studying the relevant CFC provisions of the South African Income Tax Act and considering notable changes to such provisions since their inception. This study will also consider relevant South African case law and international commentary such as that on BEPS which drove such legislative change.

This study will endeavour to compare the CFC legislation of South Africa with that of comparable jurisdictions including the United Kingdom ("UK"), Ireland and the Netherlands. This comparison will be conducted by means of a functional approach, primarily focussing on the legislative treatment of specific tax scenarios in different jurisdictions. In respect of the relevance of the UK, it is noted that the first income tax legislation enacted in South Africa was based on English income tax legislation (Croome, 2013:6) and that English law has also significantly influenced South African legislation and legal interpretation in general to the extent that English case law and legal writing is often used by South African judges in deciding cases where South African law is ambiguous or untested (Schreiner, 1967:11). The Katz Commission's Fifth Interim Report (1997:56) also acknowledges that, in introducing specific anti-avoidance measures (such as CFC legislation, aimed at countering tax avoidance) to South Africa, the measures applicable in the UK and other relevant foreign countries have often been considered as guidelines.

Insofar as the South African tax authorities were almost exclusively reliant on GAAR prior to the introduction of legislation dealing specifically with multi-layered transactions, this study considers

the positions of Ireland and the UK, both of which also heavily rely on their own versions of GAAR in order to counteract abusive CFC practices.

Finally, the less restrictive approach of the Netherlands in respect of its CFC legislation will also be discussed in contrast with the stricter and more onerous South African CFC regime.

This study will further endeavour to compare the CFC legislation of South Africa with the BEPS recommendations in order to finally draw a conclusion regarding the standing of the South African CFC legislation in relation to its international counterparts.

The foregoing is in line with traditional legal research methodologies in which, according to Langbroek et al (2017:2) authoritative texts like legislation, case law and doctrinal literature are considered the main formal sources of information for understanding positive law. Researchers can then build on such information in order to organise, analyse and re-present the information in such a way as to persuade their colleagues, legislators, judges and practitioners to follow their line of thought.

#### 1.4.3 Assumptions and perspectives

This research will rely on the following assumptions and perspectives:

##### 1.4.3.1 Ontological assumptions

Wahyuni (2012:69) distinguishes between ontology and epistemology (discussed in more detail below) as the two main philosophical dimensions in respect of research paradigms. According to Ryan, Scapens & Theobold (2002:13) ontology is the study of existence and is concerned with what we discern to be 'real'. Put differently, ontology can be said to be the philosophical assumptions that a researcher makes about reality (Olalere, 2011:29).

The above noted, this study will be interpretive in nature in that the goal of the researcher operating within this paradigm will be to decipher empirical patterns or regularities (Olalere, 2011:29-30). Interpretivism is also in line with the qualitative research strategy to be used in this study. Ultimately this study seeks to provide the reader with an objective view of the various considerations both in favour of and against strict regulation of multi-layered and transactions.

##### 1.4.3.2 Paradigmatic assumptions and perspectives

According to Hutchinson & Duncan (2012:114) quantitative research involves "the collection and analysis of data that can be presented numerically or codified and subjected to statistical testing". On the other hand, qualitative research, according to Wahyuni (2012:75) is normally used in the

first phase of the study as the aim is mainly to record the current state of play. Performing data analysis on qualitative data basically involves dismantling, segmenting and reassembling data to form meaningful findings in order to draw inferences.

This study will make use of a qualitative approach in order to analyse and evaluate South African and, to a very limited extent, international CFC legislation.

#### 1.4.3.3 Epistemological assumptions

According to Bisman (2010:3) epistemology concerns the theory of knowledge, its nature and limits and how people acquire and accept knowledge about the world. Thus, researchers' ontological viewpoints shape their epistemological beliefs in terms of how knowing and understanding reality can be developed, and of the relationships between the researcher and that which is researched. Essentially epistemology questions the relationship between the knower and what is known and asks, how do we know what we know (Tuli, 2010:99)?

This study will endeavour to objectively consider the origins the South African CFC legislation in its current form and will evaluate how such legislation has developed. This study will also contain an international comparison between South Africa's and other countries' tax legislation and relevant BEPS principles in order to review whether South Africa's CFC legislation is in line with that of other relevant countries and the BEPS recommendations for such legislation. The foregoing further serves to illustrate the qualitative nature of this study. According to Leung (2015) the reliability of a qualitative study cannot be determined simply by evaluating the replicability of the relevant processes and results (as would be the case with quantitative research). Leung proposes instead that the reliability of qualitative studies may be assessed based on their consistency in context of both the methodology and epistemological assumptions applied (Leung, 2015). The reliability of this study should thus be evaluated in light of the latter.

## 1.5 Overview of chapters

### 1.5.1 Chapter 1: Introduction

This chapter will be the starting point of the study and will provide the reader with background relevant to the South African CFC regime. This chapter will also contemplate the relevance of the study as defined. This chapter will end with a problem statement, an outline of the relevant research objectives aimed at addressing the problem statement and an overview of the research methods to be used.

### 1.5.2 Chapter 2: Discussion of the problems associated with CFCs, the need for OECD intervention and BEPS

This chapter will focus on the need for CFC legislation, the tax consequences sought to be avoided / mitigated through the use of CFC legislation and the OECD's role in remodelling CFC legislation on a global scale.

### 1.5.3 Chapter 3: Analysis of the development and current state of South African CFC legislation including recent amendments

This chapter will focus on how South Africa's CFC legislation has developed to its current state, taking into account local and international influences as well as relevant case law. This chapter will also evaluate the most recent amendments to the South African CFC legislation and their explanatory memoranda.

### 1.5.4 Chapter 4: An evaluation of South Africa's CFC legislation in its current form in context of BEPS and the CFC legislation of G20 member subscribing to BEPS

This chapter will provide an evaluation of the South African CFC legislation in context of the guidelines and recommendations for such legislation as envisaged by BEPS. This chapter will also consider the CFC legislation of other relevant countries including the UK, Ireland and the Netherlands (under BEPS) in order to evaluate how such countries have dealt with challenges similar to those faced by South Africa.

### 1.5.5 Chapter 5: Summary and conclusion

This chapter will serve as the executive summary of the study and a conclusion from the research will be drawn. This chapter will also identify areas in which the South African CFC legislation may be lacking or inconsistent when analysed against similar legislation of comparable jurisdictions as well as international guidelines and, where relevant, will highlight aspects which may benefit from further study.

# CHAPTER 2: DISCUSSION OF THE PROBLEMS ASSOCIATED WITH CFCs - THE NEED FOR OECD INTERVENTION AND BEPS

## 2.1 Introduction

International taxation has become a critical issue for revenue authorities both in South Africa and world-wide. One simply needs to consider some of the most recent amendments to the South African tax legislation to see the South African revenue authority's attempts to maintain and grow its dwindling tax base. Such amendments include, for example, the capping of the Foreign Employment Income Exemption in terms of section 10(1)(o)(ii) of the ITA and the alignment of certain South African tax concepts and principles with the global standards as prescribed by the OECD (e.g. the amendment of the definition of "permanent establishment" and the addition of "associated enterprises" in context of the transfer pricing rules, both of which fall outside the scope of this discussion) (Act 58 of 1962).

The ease with which businesses and individuals can conduct business across the globe and the resulting global financial integration has put significant strain on the existing international tax rules world-wide. Weaknesses in existing international tax rules, coupled with legislators' failure to keep pace with financial and business innovation thus often result in the erosion of the tax base of affected jurisdictions and the shifting of profit from said jurisdiction (i.e. where economic activities take place and value is created) to low- or no-tax jurisdictions (OECD, 2015:3, 9).

## 2.2 The need for anti-diversionary rules in respect of CFCs

CFCs in particular have been and are still being used as a means to shift profits from one jurisdiction to another, often with the view of subjecting such profits to a less onerous tax regime. Diagram 1[1] below illustrates in its most basic form the shifting of profits from a high-tax jurisdiction to a low-tax jurisdiction in the absence of effective CFC and transfer pricing rules to prevent such conduct.

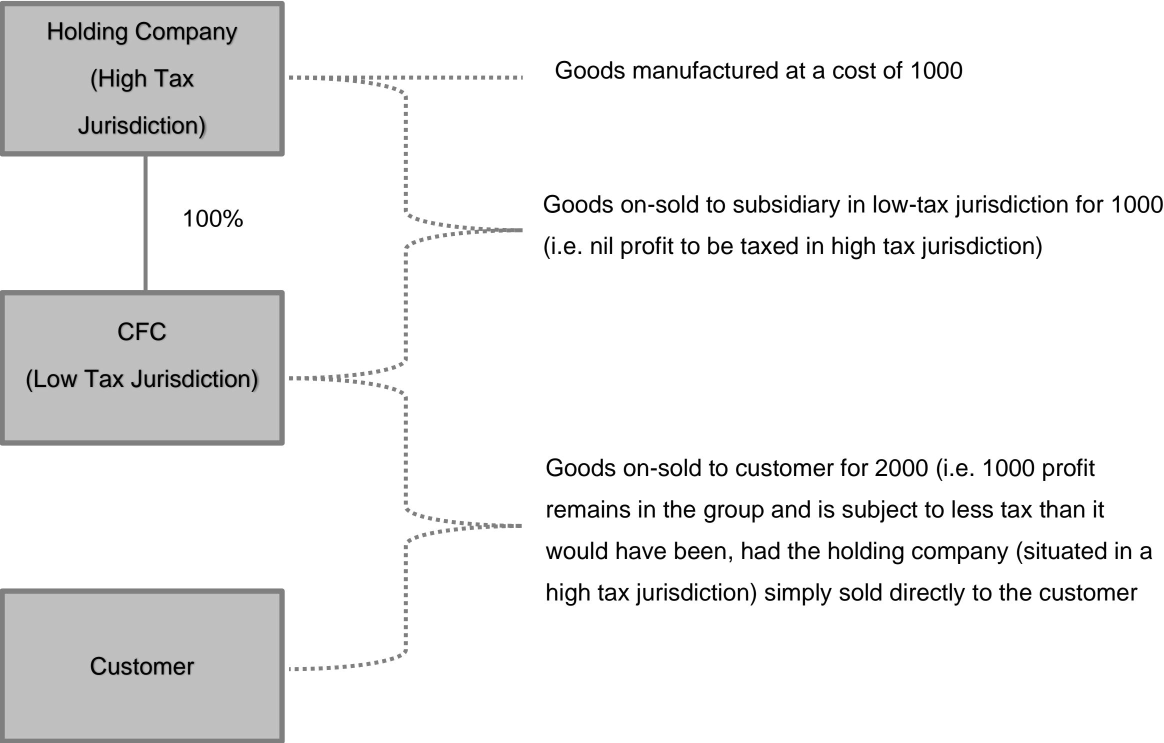
Several jurisdictions had already, prior to the OECD's intervention, put in place legislation aimed at reducing or mitigating the abuse of CFCs, however, such localised legislation often still left significant leeway for abuse by virtue of the gaps or mismatches arising from its flawed interaction with other jurisdictions' domestic tax laws. Although many jurisdictions are party to double taxation treaties, these also were not comprehensive enough to address so-called "*cases of no or low taxation associated with practices that artificially segregate taxable income from the activities that*

---

[1] This diagram is merely for illustration purposes and does not take into account the effect of transfer pricing, foreign exchange or other considerations not specifically mentioned.

*generate it*". The need thus arose for the OECD member countries and the G20 Inclusive Framework (including South Africa) to collaborate in determining new international tax standards aimed at ensuring the coherence of corporate income tax at an international, as opposed to domestic level (OECD, 2013a:13).

**Diagram 1: BEPS in context of direct transactions[2]**




Having identified the challenges faced by various jurisdictions in light of their existing CFC regimes, or lack thereof, as a significant contributor to BEPS globally, the OECD, in its *Action Plan on Base Erosion and Profit Shifting* (OECD, 2013a), called for the development of recommendations regarding the design of more efficient CFC rules (OECD, 2015:9).

## 2.3 OECD intervention in response to abuse of CFCs

After extensive consultation with its member nations, the OECD published its final report titled "Designing Effective Controlled Foreign Company Rules, Action 3" in 2015. Rather than prescribing set minimum standards, the aforementioned report listed several recommendations, referred to as building blocks, designed to ensure that taxpayers are effectively prevented from

[2] Diagram based on author's own research.

shifting profits to offshore subsidiaries for tax purposes (OECD, 2015:9-10). Each of these so-called building blocks are briefly discussed under separate headings below.

### 2.3.1 Building block 1: CFC definition

In order to qualify as a CFC, the OECD recommends that two factors should be considered. The first consideration relates to whether the entity is of a type that could qualify as a CFC. Despite the term "controlled foreign *company*", many different types of entities could be used to achieve BEPS, not all of which can necessarily be defined as companies (emphasis added). Failure to extend the CFC anti-diversionary rules to such entities (e.g. permanent establishments, branches and partnerships) would significantly compromise their effectiveness (OECD, 2015:21).

Secondly, in defining the concept of CFCs for purposes of domestic tax laws, the OECD recommends that both legal and economic control tests be implemented in order to ascertain whether a controlling entity has sufficient control over a CFC (whether directly or indirectly) to be able to shift profits to that CFC. Presently the recommended sub-minimum control requirement is 50% (OECD, 2015:21, 25).

### 2.3.2 Building block 2: Exemptions and threshold requirements

In order to increase the efficiency of CFC rules, whilst simultaneously reducing the administrative and compliance burdens resulting therefrom, the OECD has recommended the inclusion of a tax rate exemption. Therefore, where a CFC is located in a jurisdiction with an effective tax rate comparable to that which applies in the country where the controlling company is tax resident, thus reducing the risk of BEPS, it is recommended that such CFC should be exempted from the CFC rules (OECD, 2015:33).

### 2.3.3 Building block 3: CFC income definition

In order to ascertain whether the income of a CFC may be attributed to a controlling company, the OECD has provided a range of factors for consideration rather than an exhaustive list. For the purpose of this discussion, it is sufficient to take note of the two main approaches to determining CFC income as recognised by the OECD. On the one hand, a jurisdiction may simply elect to deem all income earned by a CFC, regardless of its character, as being CFC income for attribution purposes (OECD, 2015:44). This option, although likely to discourage profit shifting, may increase the likelihood of double taxation.

On the other hand, a jurisdiction may flag certain "high risk" transactions or classes of income which pose particular BEPS concerns for inclusion as CFC income (OECD, 2015:44-45). A notable South African example of defined income which is specifically excluded from the CFC

income attribution rules is that of Foreign Business Establishment (FBE) income earned by a CFC (Haupt, 2020: 613).

This distinction will be discussed in more detail against the backdrop of the South African CFC rules in Chapter 4 below.

#### 2.3.4 Building block 4: Computation of income

As a general rule, the OECD recommends that the CFC rules of the controlling entity be applied in order to determine the appropriate amount of CFC income to be attributed to such entity. To prevent abuse of CFC rules in order to reduce the tax payable in a controlling entity's jurisdiction, the OECD also recommends that any losses sustained in a CFC only be capable of set-off against the profits of that CFC or, alternatively, the profits of CFCs in the same foreign jurisdiction (OECD, 2015:10).

#### 2.3.5 Building block 5: Attribution of income

Once a CFC's income has been quantified, it must then be determined how much of that income is attributable to each of its shareholders. The OECD recommends that the CFC income attributed to a controlling entity should be proportionate to the ownership or control held by the controlling entity in a CFC and that such attribution should be subject to a subminimum control threshold (OECD, 2015:10, 61).

#### 2.3.6 Building block 6: Prevention and elimination of double taxation

It goes without saying that instances of double taxation may negatively impact on international competitiveness, growth, and economic development (Croome, 2013:559). The OECD therefore recommends firstly that the CFC rules of its member countries make provision for foreign tax credits (e.g. for use in instances where attributed CFC income is also subject to foreign corporate taxes or where the CFC rules of more than one jurisdiction apply to a specific CFC). Secondly, it is recommended that certain classes or sources of income be exempt from attribution entirely (e.g. in situations where a CFC distributes dividends out of income already attributed to and taxed in the hands of its controlling entity) (OECD, 2015:10, 65).

### 2.4 Multi-layering of CFCs in order to circumvent diversionary rules

Notably, the building blocks as outlined above, although instrumental in the development of CFC legislation globally, do not specifically contemplate a scenario where multiple CFCs are introduced into the same value chain, whether artificially or for a legitimate business purpose,

thus breaking the link between the controlling entity and the ultimate supplier or customer (hereafter simply referred to as a multi-layered transaction).

In its 2015 report, the OECD does, however, briefly note certain additional policy considerations which may be considered in the drafting of CFC legislation. One such consideration, which may hint at the need for CFC rules to encompass both direct and multi-layered transactions, is that of foreign-to-foreign tax base stripping (OECD, 2015:16). Essentially, CFC rules in their most basic form ordinarily define CFC income as income that has been diverted by a CFC from a controlling entity, thus excluding certain income earned in other entities outside of the CFC jurisdiction from taxation in the hands of the controlling entity. The OECD therefore recommends that, particularly developing countries such as South Africa which have higher than average corporate tax rates (i.e. where tax resident entities may be more compelled to structure through low tax jurisdictions), should consider the addition of anti-foreign-to-foreign BEPS provisions to their CFC rules (OECD, 2015:16).

**Diagram 2: BEPS in context of indirect or multi-layered transactions**

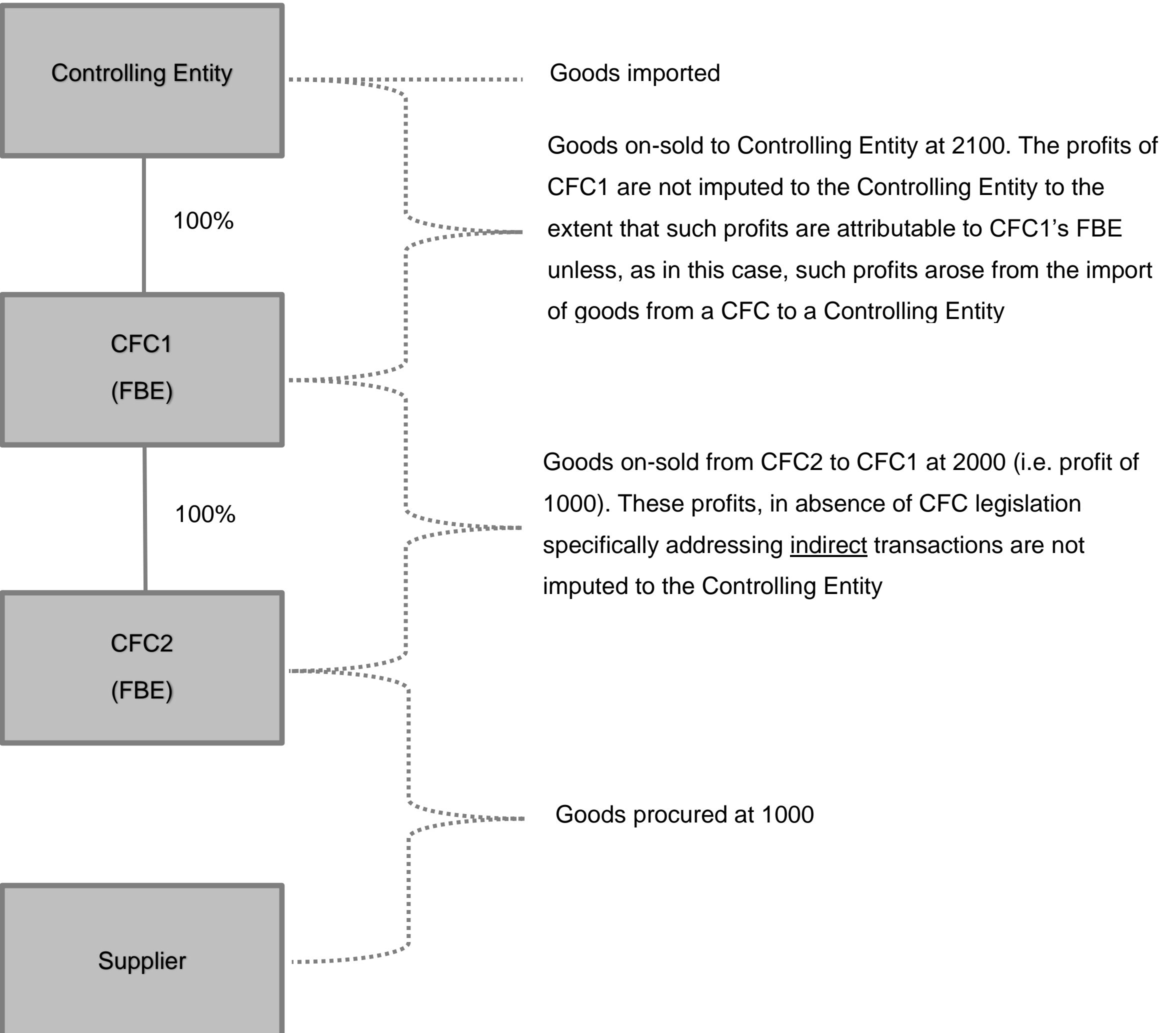


Diagram 2[3] above illustrates an indirect or multi-layered transaction as contemplated above and further makes clear the need for the extension of, at the very least, South Africa's CFC rules to address such schemes (PWC, 2019:3).

Considering that the CFC rules of different jurisdictions globally vary to a large extent despite theoretically being based upon the same building blocks as discussed above, Diagram 2 should be read specifically in the context of the South African CFC rules as they applied prior to the enactment of the 2019 TLAA (34 of 2019) (i.e. prior to the extension of these rules to both direct and indirect transactions).

Therefore, for purposes of Diagram 2, to the extent that the relevant CFCs therein seek to rely on the FBE exemption to the CFC income attribution rules (i.e. that any income attributable to a legitimate FBE may not be attributed to and taxed in the hands of the South African controlling entity) additional anti-diversionary rules applied, thus allowing the attribution of certain types of income despite said income originating from a legitimate FBE (Haupt, 2020: 613).

In terms of section 9D(9A)(a) of the ITA (58 of 1962), the following classes of income had to be included as part of the net income of a CFC (i.e. the income attributable to the South African resident controlling entity) despite originating from the CFC's legitimate FBE:

a) Inbound sales directly between a CFC and a South African resident controlling entity;
b) Outbound sales directly between a South African resident controlling entity and a CFC; and
c) Services provided directly by a CFC to a South African resident controlling entity (Haupt, 2020: 613).

In this context, it therefore becomes clear that a multinational group of companies could conceivably circumvent the South African anti-diversionary rules as contained in section 9D(9A)(a) of the ITA (58 of 1962) through the interposition of additional CFCs into its value chain, and may thus fall outside of the provisions of section 9D(9A)(a) of the ITA (58 of 1962) by virtue of there being no direct transactional link between the South African resident entity and its ultimate customer or supplier.

The aforementioned concepts and their South African legislative development to date are discussed in detail in Chapter 3 below.

---

[3] This diagram is merely for illustration purposes and does not take into account the effect of transfer pricing, foreign exchange or other considerations not specifically mentioned.

## 2.5 Summary

This chapter has contemplated the need for CFC rules generally as well as the need for such rules in a global, as opposed to merely a domestic context. By their nature, CFC rules demand a certain measure of international coherence and collaboration in order to avoid both instances of double taxation in the hands of the affected entities as well as BEPS in the hands of the host jurisdictions and their revenue authorities.

The various building blocks for effective CFC rules as recommended by the OECD have been briefly considered in this chapter. In light thereof, this chapter has also identified one notable instance (i.e. the interposition of multiple CFCs into a structure, thus resulting in multi-layered transactions) where the OECD's building blocks may require further development. These building blocks and their relevant underlying policy considerations are revisited in Chapter 4, where they are evaluated and weighed against the backdrop of the South African CFC rules, and specifically the recent amendments thereto aimed at expanding the reach of such rules to both direct and indirect transactions.

Finally, this chapter illustrated the theoretical need for anti-diversionary rules relating to multi-layered transactions in South Africa specifically and contemplated the consequences that could arise in absence of such rules. Chapter 3 below will consider the development of the South African CFC rules generally and specifically in the context of multi-layered transactions, whilst Chapter 4 will *inter alia* consider how other comparable jurisdictions have addressed similar concerns in relation to multi-layered transactions.

# CHAPTER 3: ANALYSIS OF THE DEVELOPMENT AND CURRENT STATE OF SOUTH AFRICAN CFC LEGISLATION INCLUDING RECENT AMENDMENTS

## 3.1 Introduction

Although limited CFC measures have formed part of the South African tax legislation as early as 1997 (Act 28 of 1997), the groundwork for South Africa's CFC legislation in its current form was first put in place in 2001, in respect of years of assessment commencing on or after 1 January 2001 (Haupt, 2020: 551). The introduction of the latter went hand-in-hand with South Africa's shift from a source- to a residence-basis of taxation, which had the effect of subjecting South African tax residents to South African tax on their worldwide income (subject to certain exceptions) (Kraamwinkel & Grimm, 2018).

The change to South Africa's tax base in and of itself had the effect of creating various opportunities for abuse. For example, South African tax residents would theoretically have been able to move their taxable income offshore, often into lower tax jurisdictions, by investing in or transacting through foreign companies (tax resident in jurisdictions other than South Africa) (Kraamwinkel & Grimm, 2018). In order to provide for a smooth transition with minimal tax leakage, it was therefore necessary for various new pieces of anti-avoidance legislation (including CFC legislation) to be put in place.

This Chapter will consider the development and extent of the South African CFC anti-avoidance measures specifically in relation to indirect or multi-layered transactions as well as the various considerations taken into account by key role players in their attempts to prevent the types of tax abuse outlined in Chapter 2. The purpose of this chapter is not to provide a general account of the development of CFC legislation in South Africa, a topic which has already been exhaustively discussed in a plethora of other academic works.

## 3.2 Development of key CFC anti-diversionary measures in South Africa

Arguably the most pressing concern for legislators when formulating CFC legislation, or any tax legislation for that matter, is the need to strike a balance between the often competing ideals of protecting a country's tax base on the one hand, whilst, avoiding undue interference with the global competitiveness of its multinationals on the other hand (Davis Tax Committee, 2016:34). As will be illustrated below, this ostensible conflict is the golden thread that runs through the South African CFC legislation.

At the advent of the South African CFC regime, or rather the Controlled Foreign Entity ("CFE") regime as it was known at the time, legislators contemplated adopting a "worldwide tax police"

approach that would effectively allow for section 9D income imputation, where the South African base or even the tax bases of other countries were at risk of BEPS (DTC, 2016:37). This is strongly reminiscent of what the OECD would later come to term ‘foreign-to-foreign’ stripping, the remedy for which, in essence, includes as CFC income any income that could have been earned in any jurisdiction other than the CFC jurisdiction (arguably from both direct and indirect transactions), as opposed to only income that has been diverted or shifted from the CFC’s parent jurisdiction (OECD, 2015:16). Legislators, however, ultimately rejected this approach based on the considerations that most of the CFC regimes existing at the time were not as onerous and that the adoption of such an onerous system in South Africa could therefore place South African multinationals at a strong competitive disadvantage (DTC, 2016:37-38).

It can thus be said that, at least at the outset, legislators sought to balance the diametrically opposed principles of anti-diversionary rules and international competitiveness by seeking neither complete taxation nor complete exemption (National Treasury 2002:2). According to the National Treasury, legislators sought to achieve this balance by favouring international competitiveness in cases where income arose from active operations, while favouring anti-diversion in respect of income arising from passive investments or from other limited transactions identified as posing a high tax avoidance risk (National Treasury 2002:2). It appears however that, in the years since the coming into effect of the South African CFC regime, the scales have tipped somewhat in favour of taxation.

A keen example of the shifting focus of legislators can be found in the various iterations of the section 9D diversionary income rules, the latest of which are the *raison d'être* of this mini dissertation. Prior to 2011, section 9D contained various and far reaching diversionary income rules, similar to those which exist today. In its Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011, National Treasury (2011:103) recognised that, although the CFC regime existing at the time had succeeded to a large extent in addressing the offshore movement of passive income and use of shell companies to divert income offshore, various problems still remained. One such concern was that the overly rigid nature of the diversionary income rules at the time could trigger anti-diversionary measures in respect of non-tax driven commercial income while also allowing taxpayers to artificially manipulate problematic income so as to avoid anti-diversionary measures (National Treasury, 2011:103). In order to remedy its concerns, National Treasury proposed aligning the diversionary income test more closely with transfer pricing in order to obviate the need for reliance on overly objective (and misdirected) criteria, as had been the case up to that point. This change was aimed at ultimately closing structural deficiencies in the diversionary income rules whilst making the rules more targeted and without undermining the international competitiveness of South Africa’s multinationals (National Treasury, 2011:103-104).

As part of the Taxation Laws amendment Act, 2011 (24 of 2011), and with effect from years of assessment commencing on or after 1 April 2012, diversionary income rules in relation to CFC inbound sales were therefore substantially simplified, while diversionary rules associated with outbound sales were completely scrapped in favour of transfer pricing rules as an effective alternative taxing method (Nortje & Brown, 2015).

Not long after these amendments, National Treasury made a reversal and proposed in its Explanatory Memorandum on the Taxation Laws Amendment Bill, 2015 that both the diversionary rules in respect of CFC outbound sales and CFC inbound sales as they applied prior to 1 April 2012, be reinstated with effect from years of assessment commencing on or after 1 January 2016 (Nortje & Brown, 2015). In motivating for this reinstatement, National Treasury noted that, while transfer pricing rules can be applied to prevent BEPS, the diversionary income rules as they had previously applied, were more expedient (National Treasury, 2015:53). According to National Treasury (2015:53) the scrapping of the diversionary income rules in respect of outbound sales had the effect of rendering the South African CFC regime less effective in immediately addressing profit shifting by South African resident companies as, by their nature, transfer pricing auditing processes tend to be onerous and time consuming, thus leaving the South African tax base exposed to abusive tax practices if it were to rely solely on these rules. Of further interest is that, although National Treasury acknowledged in 2011 that the diversionary income rules (which it was at that time seeking to overhaul) were overly complex and prone to uncertainties, these same rules were simply reinstated as part of the Taxation Laws Amendment Act, 2015 (25 of 2015) in the exact form that they applied prior to 1 April 2012 (Nortje & Brown, 2015).

Perhaps the most recent noteworthy amendment of South Africa's CFC legislation as it relates to indirect transactions, and a key indicator of National Treasury's mounting concerns relating to multi-layered international structures and transactions (prior to the 2019 amendments) came about in 2017. As part of its Explanatory Memorandum on the Draft Taxation Laws Amendment Bill 2017 (2017), National Treasury addressed the fact that the CFC rules at the time did not capture foreign companies held by interposed trusts or foundations (National Treasury 2017:75).

The 2017 TLAA (17 of 2017) thus amended the section 9D definition of 'controlled foreign company' and the proviso to section 9D(2), as follows with effect from years of assessment commencing on or after 1 January 2018:

> ***"'controlled foreign company'*** *means-*
> *(a) …*
> *(b) any foreign company where the financial results of that foreign company are reflected in the consolidated financial statements, as contemplated in IFRS 10, of any company that is a resident"*

and

*"(2)*

*…*

*Provided further that for purposes of applying this subsection to a foreign company that is a controlled foreign company only in terms of paragraph (b) of the definition of 'controlled foreign company', the percentage of the participation rights of a resident in relation to that controlled foreign company is equal to the net percentage of the financial results of that foreign company that are included in the consolidated financial statements, as contemplated in IFRS 10, for the year of assessment of the resident, that is a holding company, as defined in the Companies Act;"*

The effect of this amendment was that a foreign company being held through a non-resident trust or foundation and whose financial results form part of the consolidated financial statements, as contemplated in IFRS 10, of a group of which the parent company is resident in South Africa, could be regarded as a CFC for purposes of section 9D.

According to National Treasury, this amendment was in line with BEPS Action 3, which recommended that subscribing countries adopt a broad definition of entities that fall within the scope of their CFC legislation, particularly in instances where certain types of entities earn income that raises BEPS concerns (National Treasury 2017:76). While the OECD does suggest a control test based on the consolidation status of companies in order to determine whether a specific entity qualifies as a CFC, it also cautions that such a test should be supplementary to legal and/or economic control tests, and warns that the use of such a test could significantly increase the complexity and cost of compliance for affected entities (OECD, 2015:25).

The CFC amendments in the 2017 TLAA, which effectively served to further strengthen the South African CFC regime, are especially noteworthy considering that these amendments followed hot on the heels of the DTC's Second and final report on Base Erosion and Profit Shifting (2016). In its 2016 review of South Africa's CFC legislation the DTC (2016:3) recommended that, while South Africa should adopt a position of protecting its own interests, for the time being, South Africa would be better suited to observe and follow international trends (where appropriate) rather than to pave its own way forward. At the time of issue of its report in 2016, the DTC was also of the view that South Africa's CFC legislation was already very sophisticated and comparable to other G20 countries and that, as a result, there was no need to strengthen the South African CFC legislation at that stage (DTC, 2016:3). The DTC suggested, in fact, that although the South African CFC regime could theoretically be strengthened, this should not be done without due regard to international trends, the increased compliance burden to South African based companies, the possibility that such a change could have the effect of hindering legitimate

business establishments and the likely competitive constraints which South Africa may experience as a result (DTC, 2016:6).

An apt example of a change in the South African CFC rules in line with the considerations and recommendations outlined by the DTC is that of the recent lowering of the high tax exemption threshold from 75% to 67.5%. According to Mollagee (2020), this amendment was effected directly in response to the global downward trend of corporate tax rates and, considering South Africa's relatively high corporate tax rate, should come as a welcome change for multinationals with a presence in South Africa. Perhaps somewhat less clear cut is the 2019 extension of the CFC rules to include both direct and indirect transactions (discussed in more detail below).

### 3.3 The problem with substance over form and GAAR in context of multi-layered CFC transactions

On 9 November 2018, the SCA delivered its landmark judgement it the case of Sasol Oil v CSARS (2018). In that case, the SCA was required to rule on two main issues. The first issue in dispute was whether two contracts for the sale of crude oil sourced in the Middle East, acquired by a company in the Sasol Group in the Isle of Man, sold to another company in the Sasol Group based in London, and in turn sold and shipped to Sasol Oil (the appellant) based in South Africa, were simulated transactions and should be disregarded by the CSARS (the respondent), in assessing Sasol Oil's tax liability for its 2005, 2006 and 2007 years of assessment. The second issue to be determined by the SCA was whether, if the transactions were not simulated, they fell within the anti-avoidance provisions of the ITA (contained in section 103(1) of the ITA at the time), and were thus to be disregarded for the purpose of assessing liability for income tax in the hands of Sasol Oil.

Notably, during the years of assessment in question, the relevant portions of section 9D of the ITA read as follows (Sasol Oil v CSARS, 2018):

> *"**Net income of controlled foreign companies***
> *(1) For the purposes of this section—*
>
> *'business establishment' in relation to a controlled foreign company, means-*
> *(a) a place of business with an office, shop, factory, warehouse or other structure which is used or will continue to be used by the controlled foreign company for a period of not less than one year …*
>
> *'controlled foreign company, means any foreign company where more than 50 per cent of the total participation rights in that foreign company are held, or more than 50 per cent of the voting rights in that foreign company are directly or indirectly exercisable, by one of more residents' …*

*(2A) For the purposes of this section the 'net income' of a controlled foreign company in respect of a foreign tax year is an amount equal to the taxable income of that company determined in accordance with the provisions of this Act as if that controlled foreign company had been a taxpayer, and as if that company had been a resident for purposes of the definition of 'gross income'…*

*(9) In determining the net income of the controlled foreign company in terms of subsection (2A) there must not be taken into account any amount which –*

*…*

*(b) is attributable to any business establishment . . . of that controlled foreign company in any country other than the Republic: Provided that the provisions of this paragraph shall not apply to any net income that is attributable to –*

*…*

*(ii) any amounts derived from –*

*(aa) any sale of goods by that controlled foreign company to any connected person (in relation to that controlled foreign company) who is a resident, unless –*

*(A) that controlled foreign company purchased those goods within the country of residence of that controlled foreign company from any person who is not a connected person in relation to that controlled foreign company;"*

It is apparent from the above wording that South Africa's CFC legislation at the time did not cater for multi-layered transactions such as that encountered in the Sasol Oil v CSARS matter. Section 9D as it read at the time catered only for direct transactions between a CFC and a connected resident company and could therefore be avoided simply by the interposition of an additional entity between the two transacting entities (i.e., an indirect transaction). The CSARS therefore had no recourse other than to argue that the transactions had been simulated and structured in such a way so as to avoid the application of section 9D and, by implication, taxation in South Africa. The CSARS therefore argued that, based on the substance over form principle, sales from the Isle of Man entity to the London entity ought to be disregarded and that the Isle of Man entity should instead be deemed to have sold directly to Sasol Oil in South Africa (Sasol Oil v CSARS, 2018). As an alternative to this argument, the CSARS also sought to rely on the general avoidance provisions which were at the time contained in section 103 of the ITA (Sasol Oil v CSARS, 2018).

### 3.3.1 Substance over form

At its core, substance over form is a common law principle which applies where it can be said that a written agreement between parties (or the form of a transaction) differs from the true intention of the parties (being the substance of a transaction). In that event, the transaction would be taxed based on the true intention of the parties as opposed to the written terms of the transaction (Haupt,

2020:638). Substance over form is not to be confused with the statutory anti-avoidance rules (discussed below).

In context of Sasol Oil v CSARS (2018), it fell to the SCA to determine whether the parties to the transaction truly intended the back-to-back sales of oil from the Isle of Man entity to the London entity and finally to Sasol Oil in South Africa and whether there was commercial rationale for concluding the transaction in this way, as opposed to simply entering into direct sales from the Isle of Man entity to the South African entity. Ultimately, in applying the substance over form principle, the SCA found that the transactions in question had a legitimate purpose and that they were therefore not merely "*false constructs created solely to avoid residence based taxation*" (Sasol Oil v CSARS, 2018).

What follows is a brief discussion of the confines and scope of application of the substance over form principle. For the avoidance of doubt, the aim of this mini-dissertation is not to suggest that the SCA failed in either its interpretation of the facts at hand, or in its application of the tax legislation and common law as it existed at the time. The purposes of this discussion is rather to consider and understand the limitations of the substance over form principle in context of multi-layered CFC transactions.

In the case of Zandberg v Van Zyl (1910), now considered the *locus classicus* when it comes to matter of substance over form (Erf 3183/1 Ladysmith (Pty) Ltd and Another v Commissioner for Inland Revenue, 1996), the then Appellate Division stated the following:

> *"Now, as a general rule, the parties to a contract express themselves in language calculated without subterfuge or concealment to embody the agreement at which they have arrived. They intend the contract to be exactly what it purports; and the shape which it assumes is what they meant it should have. Not infrequently, however (either to secure some advantage which otherwise the law would not give, or to escape some disability which otherwise the law would impose), the parties to a transaction endeavour to conceal its real character. They call it by a name, or give it a shape, intended not to express but to disguise its true nature. And when a Court is asked to decide any rights under such an agreement, it can only do so by giving effect to what the transaction really is; not what in form it purports to be. The maxim then applies plus valet quod agitur quam quod simulate concipitur.[4] But the words of the rule indicate its limitations. The Court must be satisfied that there is a real intention, definitely ascertainable, which differs from the simulated intention. For if the parties in fact mean that a contract shall have effect in accordance with its tenor, the circumstances that the same object might have been attained in another way will not necessarily make the arrangement other than it purports to be."* (emphasis added)

[4] What was actually done is more important than what seems to have been done.

It is clear from the above that, in order for SARS to succeed on the basis of substance over form, it will be required to demonstrate the presence of intent and dishonesty in the mind of the parties to a transaction. Arguably, the case of Commissioner of Customs and Excise v Randles, Brothers and Hudson Ltd (1941), further increased SARS' burden of proof by essentially requiring that SARS proves the presence of an element of fraud which existed as an unexpressed agreement or tacit understanding between the parties to a transaction. The relevant *dictum* in Commissioner of Customs and Excise v Randles, Brothers and Hudson Ltd (1941) provides as follows:

> *"I wish to draw particular attention to the words "a real intention, definitely ascertainable, which differs from the simulated intention", because they indicate clearly what the learned Judge meant by a "disguised" transaction. A transaction is not necessarily a disguised one because it is devised for the purpose of evading the prohibition in the Act or avoiding liability for the tax imposed by it. A transaction devised for that purpose, if the parties honestly intend it to have effect according to its tenor, is interpreted by the Courts according to its tenor, and then the only question is whether, so interpreted, it falls within or without the prohibition or tax.*
> *A disguised transaction in the sense in which the words are used above is something different. In essence it is a dishonest transaction: dishonest, in as much as the parties to it do not really intend it to have, inter partes, the legal effect which its terms convey to the outside world. The purpose of the disguise is to deceive by concealing what is the real agreement or transaction between the parties. The parties wish to hide the fact that their real agreement or transaction falls within the prohibition or is subject to the tax, and so they dress it up in a guise which conveys the impression that it is outside of the prohibition or not subject to the tax. Such a transaction is said to be in fraudem legis and is interpreted by the Courts in accordance with what is found to be the real agreement or transaction between the parties. Of course, before the Court can find that a transaction is in fraudem legis in the above sense, it must be satisfied that there is some unexpressed agreement or tacit understanding between the parties. If this were not so, it could not find that the ostensible, agreement is a pretence."*[5]
> (emphasis added)

The waters were then somewhat muddied in 2011 when the SCA published the following dictum as part of its judgement in the case of CSARS v NWK Ltd (2011), which ostensibly imposed the further requirement of commercial substance for the successful application of substance over form:

> *"… the test to determine simulation cannot simply be whether there is an intention to give effect to a contract in accordance with its terms. Invariably where parties structure a transaction to achieve an objective other than the one ostensibly achieved they will intend to give effect to the transaction on the terms agreed. The test should thus go further, and require an examination of the commercial*

[5] As an aside, the aforementioned *dictum* is also valuable, in that it draws a clear distinction between the scope of application of substance over form and the GAAR respectively, with the latter not necessarily requiring the presence of an element of dishonesty or fraud.

> *sense of the transaction: of its real substance and purpose. If the purpose of the transaction is only to achieve an object that allows the evasion of tax, or of a peremptory law, then it will be regarded as simulated. And the mere fact that parties do perform in terms of the contract does not show that it is not simulated: the charade of performance is generally meant to give credence to their simulation."* (emphasis added)

In this regard, Legwaila (2012:122) noted that, although the CSARS v NWK Ltd (2011) judgement was not an entirely *"new departure"* from existing substance over form case law, it did somewhat amend or extend the court's understanding of the substance of a transaction. Where previously substance simply referred to the real form of the transaction, it could now necessarily require an investigation into whether a transaction possessed the commercial substance ordinarily observed in similar transactions (Legwaila, 2012:121).

This position was later clarified and rectified in the Sasol Oil v CSARS (2018) case where the SCA held, in relation to CSARS v NWK Ltd (2011), that *"[t]he judgment in that matter was apparently thought to have changed the law. It did not. It pointed out merely that in order to establish simulation one could not look only at the terms of the disputed transaction. And it suggested that simulation was to be established not only by considering the terms of the transactions but also the probabilities and the context in which they were concluded."*[6]

With this in mind, the majority of the SCA found that, having regard to the commercial reasoning behind the introduction into the group supply chain of the UK entity, the transactions were not false constructs created solely to avoid residence-based taxation (Sasol Oil v CSARS, 2018). Ponnan JA on behalf of the majority, also noted that, in order for SARS to have succeeded in its substance over form argument, it would have had to prove on a balance of probabilities the existence of an elaborate fraud perpetrated by the employees, directors and auditors of the Sasol Group spanning over many years (Sasol Oil v CSARS, 2018).

It must be noted that, even after clarification by the SCA that the substance over form doctrine as applied in CSARS v NWK Ltd (2011) and Sasol Oil v CSARS (2018) did not change the law, industry experts were still somewhat concerned about the impact of these cases on SARS' ability to pursue taxpayers on the basis of substance over form. In this regard, PWC (2018:6) noted that *"[u]nless the surrounding circumstances are overwhelmingly in his favour, it is submitted that the Commissioner's task in pursuing the argument that the substance differs from the form will always be a daunting one."*

---

[6] The SCA in Sasol Oil v CSARS (2018) also noted that this interpretation had already been applied by the court in both Roshcon (Pty) Ltd v Anchor Auto Bodybuilders CC (2014) and CSARS v Bosch (2014).

Where ordinarily under the provisions of the TAA (28 of 2011), the burden of proof in tax litigation would rest on the taxpayer, substance over form requires SARS to demonstrate and lead evidence regarding the state of mind of a taxpayer upon entering into a transaction and specifically whether fraudulent intentions were present. This arguably places SARS at a significant disadvantage, as it would not have access to or insight into the inner workings of taxpayers. Interestingly this issue was raised by Ponnan, JA in the Sasol Oil v CSARS (2018) judgement, where he stated as follows:

> *"As Lewis JA points out, no evidence was led for the Commissioner. She adds 'but that is hardly surprising as it would not have had access to the internal workings of the Sasol Group'. Whilst that may be so, the fact that no evidence was led for the Commissioner is not without its consequence. It means that there was nothing to gainsay the evidence of Sasol ..."* (emphasis added)

Arguably the SCA's approach as quoted above could have extremely prejudicial consequences for SARS. It is therefore not surprising that National Treasury, in its next legislative cycle, enacted legislation (discussed below) that may effectively ensure that an outcome similar to that in Sasol Oil v CSARS (2018) could not materialise again in future.

### 3.3.2 General Anti-Avoidance Rules

During the relevant years of assessment (i.e., 2005, 2006 and 2007), the GAAR were contained in section 103 of the ITA. In coming to its decision, the SCA in Sasol Oil v CSARS (2018) had regard specifically to section 103(1), which read as follows:

> *"**Transactions, operations or schemes for purposes of avoiding or postponing liability for or reducing amounts of taxes on income***
> *Whenever the Commissioner is satisfied that any transaction, operation or scheme (whether entered into or carried out before or after the commencement of this Act, and including a transaction, operation or scheme involving the alienation of property) –*
> *(a) has been entered into or carried out which has the effect of avoiding or postponing liability for the payment of any tax, duty or levy imposed by this Act or any previous Income Tax Act, or of reducing the amount thereof; and*
> *(b) having regard to the circumstances under which the transaction, operation or scheme was entered into or carried out –*
> *(i) was entered into or carried out -*
> *(aa) in the case of a transaction, operation or scheme in the context of business, in a manner which would not normally be employed for bona fide business purposes, other than the obtaining of a tax benefit; and*
> *(bb) in the case of any other transaction, operation or scheme, being a transaction, operation or scheme not falling within the provisions of item (aa), by means or in a manner which would not*

*normally be employed in the entering into or carrying out of a transaction, operation or scheme of the nature of the transaction, operation or scheme in question;*
*(ii) has created rights or obligations which would not normally be created between persons dealing at arm's length under a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; and*
*(c) was entered into or carried out solely or mainly for the purposes of obtaining a tax benefit,*
*the Commissioner shall determine the liability for any tax, duty or levy imposed by this Act, and the amount thereof, as if the transaction, operation or scheme had not been entered into or carried out, or in such manner as in the circumstances of the case he deems appropriate for the prevention or diminution of such avoidance, postponement or reduction.'*[7] (emphasis added)

The SCA, in applying section 103(1), concluded that SARS failed to prove that Sasol Oil had reason to anticipate any tax liability as a result of the application of section 9D and that, as a result, *"[t]he Commissioner has not shown that the impugned transactions had the effect of avoiding liability for tax or that there was anything abnormal about them"* (Sasol Oil v CSARS, 2018). However, even if SARS had succeeded in this part of its argument, it would still have had to disprove the taxpayer's contention that it did not enter into the back-to-back transactions solely or mainly for the purposes of obtaining a tax benefit. Arguably therefore, in applying the GAAR argument, SARS would have been faced with many of the same challenges that it encountered with substance over form, particularly insofar as it would have been required to establish and present evidence regarding the internal workings and intentions of the taxpayer.

### 3.4 Extension of the CFC rules to both direct and indirect transactions

With effect from 1 January 2020 and applying in respect of years of assessment ending on or after that date, subparagraphs (i), (iA) and (ii) of section 9D(9A)(a) were amended to read as follows:

*"(9A) (a) Any amount which is attributable to a foreign business establishment of a controlled foreign company as contemplated in subsection (9) (b) must, notwithstanding that subsection, be taken into account in determining the net income of that controlled foreign company if that amount—*
*(i) is derived from the sale of goods by that controlled foreign company directly or indirectly to any connected person (in relation to that controlled foreign company) who is a resident, unless—*
*…*
*(iA) is derived from the sale of goods by that controlled foreign company directly or indirectly to a person, other than a connected person (in relation to that controlled foreign company) who is a resident, where that controlled foreign company initially purchased those goods or any tangible*

[7] Section 103 is quite similar in substance to the GAAR which today reside in sections 80A to 80L of the ITA.

*intermediary inputs thereof directly or indirectly from one or more connected persons (in relation to that controlled foreign company) who are residents, unless—*

*…*

*(ii) is derived from any service performed by that controlled foreign company* *directly or indirectly* *for the benefit of a connected person (in relation to that controlled foreign company) who is a resident, unless that service is performed outside the Republic…"* (emphasis added)

Although not confirmed by National Treasury, many experts agree that the SCA's judgement in the Sasol Oil v CSARS (2018) case was the catalyst for the amendment of the South African CFC legislation as it reads today (PWC, 2019:3).

The effect of these amendments, specifically the extension of the CFC rules to both direct and indirect sales and services (such as the multi-layered transactions observed in Sasol Oil v CSARS (2018)) is essentially that SARS no longer has to rely on the statutory or common law anti-avoidance rules to recover its dues in respect of multi-layered international transactions. Where the successful application of the anti-avoidance rules is critically dependent on establishing the motives and intentions of a taxpayer, the new amendments to section 9D do not include any motive test (PWC, 2019:3), thus significantly easing SARS' evidentiary burden going forward.

That being said, many industry players were quick to point out the possible draw-backs and likely unintended consequences which may arise as a result of the amendment of subparagraphs (i), (iA) and (ii) of section 9D(9A)(a) as quoted above. According to SAICA (2019) the amended wording of section 9D(9A)(a)(ii), which applies if, as a result of services rendered, there is any direct or indirect benefit to a connected resident in relation to a CFC, is far too broad and unclear. As the term "benefit" has not been defined for purposes of this section, the rules of legal interpretation provide that it must necessarily be given its ordinary meaning subject to the context of the legislation in which it appears (Botha, 2011:68). Therefore, in the absence of National Treasury's indication to the contrary, the term "benefit" will likely be ascribed its dictionary definition, being *"something that provides an advantage or gain"* (Merriam-Webster's Legal Dictionary, 2020). In its current form, this section could thus apply to any benefit derived whatsoever and is not limited only to contractual, tax or other benefits.

In fact, the DTC in its 2016 report, specifically cautioned legislators not to make CFC rules rigid to the point that they hinder legitimate business (DTC, 2016:6, 36). In illustrating this point, the DTC specifically used the example of the service income anti-diversionary rules as contained in section 9D(9A)(ii) as it applied prior to the 2019 amendment, and recommended that these rules be refined in such a way that they do not impede legitimate business practices (DTC, 2016:6, 36). It would appear, however, that the 2019 amendments have had quite the opposite effect, in that

it further widened the scope of application of section 9D(9A) as a whole to include both direct and indirect transactions and, by implication, multi-layered structures and transactions.

The SAIT (2019) also shares this sentiment and questions whether sufficient safeguards are in place to prevent the general body of amended section 9D anti-diversionary rules from applying to legitimate transactions. According to the SAIT (2019), the ambit of the section 9D anti-diversionary rules should be clear and targeted and any offending transactions and/or scenarios should be explicitly defined for the benefit of both SARS and taxpayers.

Quite interestingly, despite having received several submissions similar to those discussed immediately above, National Treasury elected not to address these concerns in its Final Response Document on Draft Rates and Monetary Amounts and Amendment of Revenue Laws Bill, 2019, Draft Income Tax Amendment Bill, 2019, Draft Taxation Laws Amendment Bill, 2019 and Draft Tax Administration Laws Amendment Bill, 2019 (National Treasury, 2020b). SARS has also yet to issue any guides or interpretation notes to clarify how the amended section 9D will apply in practice.

### 3.5 Conclusion

Although the rationale behind the extension of the South African CFC rules to both direct and indirect transactions seems clear, at least from a tax collection perspective (i.e. the prevention of BEPS that may otherwise have been achieved through the implementation of multi-layered transactions and structures), if not necessarily from a business perspective, it is not immediately clear what the effect of this change may be in a global context. Even prior to the 2019 amendments, industry experts already agreed that the South African CFC regime was inflexible and created arduous compliance obligations (Kraamwinkel & Grimm, 2018).

The 2019 amendments also appear to be in direct contrast to the recommendations issued by the DTC just 3 years prior. According to Mollagee (2020), the 2019 amendments have elevated industry concerns that, if some countries, such as South Africa, continue to strengthen and refine their CFC rules while other countries become more lenient, these mismatches will present increasingly uneven playing fields for multinational enterprises.

Chapter 4 will consider whether other comparable jurisdictions have also seen fit to fortify their CFC regimes against tax leakages which may result from indirect or multi-layered transactions and, if so, how those jurisdictions went about achieving this objective. Where comparable jurisdictions have elected not to guard against possible tax leakages which may result from indirect or multi-layered transactions, Chapter 4 will also consider the risks and benefits of this approach as experienced by those jurisdictions.

# CHAPTER 4: AN EVALUATION OF SOUTH AFRICA'S CFC LEGISLATION IN CONTEXT OF ITS ACTUAL BEPS EXPOSURE AND THE CFC LEGISLATION OF COMPARABLE FOREIGN JURISDICTIONS

## 4.1 Introduction

Although the term "multi-layered" has not been defined for purposes of South African tax law, the meaning ascribed thereto by National Treasury may be gleaned from its explanatory memoranda. Specifically, National Treasury (2019a:39) when putting forward the view that the South African CFC rules do not adequately address multi-layered structures, notes that "[c]*ertain multinational enterprises are circumventing CFC anti diversionary rules by diverting profits to members of the group that are subject to tax at a lower rate and are not subject to the specific anti-diversionary rules. This is achieved by the imposition of additional CFCs in the supply chain between the South Africa resident connected person and the independent non-resident supplier or customer."*

This chapter aims to evaluate the South African treatment of multi-layered transactions, firstly with reference to South Africa's BEPS risk and, secondly, to the comparable CFC regimes of other relevant jurisdictions.

Finally, this chapter will also contemplate relevant instances where jurisdictions have opted not to regulate multi-layered transactions and/or structures. In this regard, the DTC (2016:6), in its second and final report on Base Erosion and Profit Shifting found that the South African CFC regime is one of the most sophisticated and complex regimes within the G20. That being said, the DTC also noted that, should South Africa seriously wish to embark upon a programme of attracting foreign direct investment, it may be better suited to implement more competitive tax rates and a more lenient CFC regime similar to that which applies in the UK or the Netherlands (DTC, 2016:7). To the extent that comparable jurisdictions have therefore opted for less onerous CFC regimes which do not guard, or guard only to a lesser extent against the BEPS that may arise from multi-layered transactions, this chapter will also consider the justification and objectives put forward by the revenue authorities of such jurisdictions.

National Treasury's understanding (as quoted above) of what constitutes a multi-layered transaction or structure will be used as a point of departure from which to identify and evaluate comparable foreign rules or lack thereof.

## 4.2 South African CFC legislation in context of the real risk of BEPS

As noted in Chapter 3, at the time of issue of the DTC's second and final report on Base Erosion and Profit Shifting in 2016 (i.e. prior to the extension of the South African CFC regime to include

multi-layer transactions), the DTC was already of the view that South Africa's CFC legislation was very sophisticated and comparable to other G20 countries and that, as a result, there was no need to strengthen the South African CFC legislation at that stage (DTC, 2016:3). The DTC suggested, in fact, that although the South African CFC regime could theoretically be strengthened, this should not be done without due regard to international trends, the increased compliance burden to South African based companies, the possibility that such a change could have the effect of hindering legitimate business establishments and the likely competitive constraints which South Africa may experience as a result (DTC, 2016:6).

Despite the fact that SARS in its revenue collection data does not delineate an amount or percentage of overall collections arising from the taxation of CFCs, Kraamwinkel and Grimm (2018) speculate that the actual tax revenue collected as a result of the South African CFC rules is relatively insignificant when compared to SARS' total revenue collections. In the absence of concrete CFC revenue collection data, this topic is further explored with reference to a 2016 study undertaken by the OECD in conjunction with the South African National Treasury, which attempted to estimate the loss of South African tax revenue as a result of BEPS (Reynolds & Wier, 2016).

Reynolds and Wier (2016:12) studied South African corporate income tax returns for the years from 2009 to 2014 in order to determine a so-called "ball-park" figure indicative of the relevance of BEPS in South Africa. Table 1 (below) prepared by Reynolds and Wier (2016:13) illustrates their thought process and ultimate conclusion that BEPS likely only results in a loss of 0.2% of South Africa's total tax revenue, which equates to a 0.05% reduction in South Africa's GDP.

**Table 1: Quantifying the estimated loss of tax revenue due to profit shifting, 2009 – 2014 (in %) (Reynolds and Wier, 2016:13)**

| | |
|---|---|
| Tax revenue as a share of GDP | 25 |
| Corporate tax revenue as a share of total tax revenue | 20 |
| Subsidiary tax income as a share of corporate tax revenue | 20 |
| Tax income shifted to low-tax parents as a share of total subsidiary taxable income | 7 |
| Hypothetical subsidiary taxable income as a share of corporate tax revenue if no profit shifting to parents | 21 |
| Estimated loss of corporate tax base due to profit shifting to low-tax parents | 1 |
| Estimated loss of total tax revenue due to profit shifting to low-tax parents | 0.2 |
| Estimated loss of total tax revenue due to profit shifting to low-tax parents as a share of GDP | 0.05 |

Reynolds & Wier (2016:12) summarised their findings as follows:

> *"…the estimated loss of subsidiary profits due to profit shifting amounts to 7 per cent of subsidiary income and 1 per cent of the total corporate tax base. This, in turn, implies that profit shifting removes 0.2 per cent of the total tax base in South Africa or lowers the tax–GDP ratio by 0.05 percentage points. While there is no doubt that an increase in the tax–GDP ratio of 0.05 percentage points could do tremendous good in South Africa, this estimate implies that profit shifting may only be a moderate problem in South Africa."* (emphasis added)

In interpreting their conclusion that, at least up to and including 2016, BEPS was only a moderate problem in South Africa, Reynolds and Wier (2016:14) advance various theories. One such theory is that South Africa has already derived significant benefits from its relatively early introduction of CFC legislation and transfer pricing policies (compared to other developing countries) and therefore is not currently faced with more severe BEPS concerns (Reynolds & Wier, 2016:14). Another theory put forward is that the issue of BEPS in developing countries generally may have been overstated in the past (Reynolds & Wier, 2016:14).

Forstater (2015:1) also subscribes to the latter theory and notes that *"[i]nternational debates on taxation and development have been informed by a popular narrative that there is a 'pot of gold' for development funding which could be released by cracking down on the questionable tax practices of multinational enterprises"* while in fact the perceived tax revenue at stake has become inflated as a result of various misconceptions and misunderstandings. Forstater (2015:1), much like the DTC (2016:6), also cautions that "*the potential for countries to raise more from taxing international business is limited by actual level of activity by foreign companies within each country, and that changes to the effective tax burden may also have impacts on investment".*

The above studies and their contributing theories are used as a backdrop against which to consider the rationale of the South African National Treasury in further expanding the scope of the South African CFC legislation to encompass the indirect or multi-layered transactions entered into by companies forming part of multi-layered structures. The effect of the abovementioned factors on the decision-making processes of relevant foreign jurisdictions is also considered below.

### 4.3 Foreign-to-foreign stripping

The OECD (2015:16) draws a distinction between ordinary CFC rules aimed at protecting only the tax base of the country where a CFC's parent company is based, and CFC rules which also protect against so-called foreign-to-foreign stripping. The latter essentially implies that CFC rules are designed in such a way as to protect not only the tax base of the country where a CFC's parent company is based, but also the tax bases of other third-party countries (OECD, 2015:16).

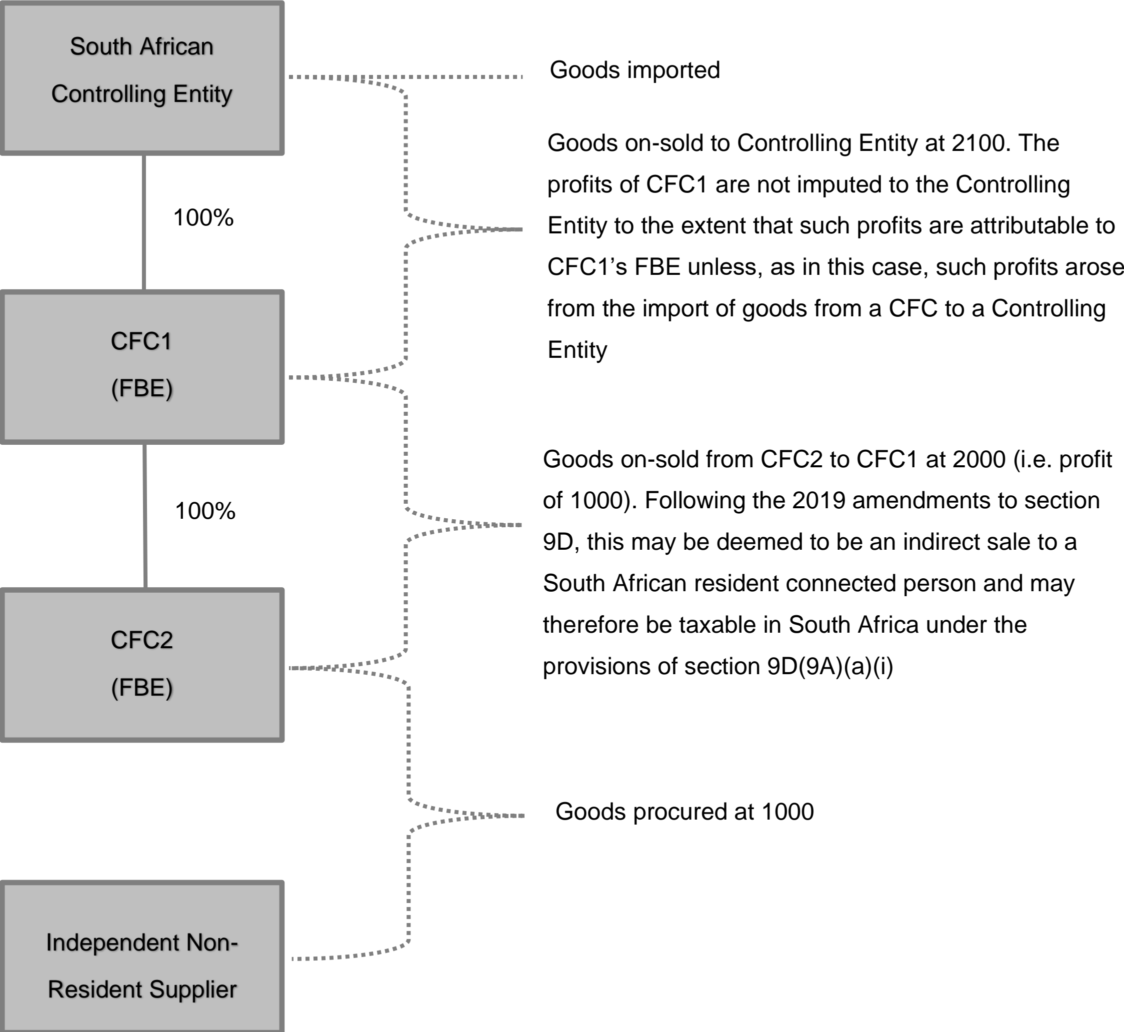
If having no CFC legislation can be seen as one side of the proverbial coin, the adoption of CFC legislation which also addresses foreign-to-foreign stripping can arguably be seen as the other extreme. Being an extreme solution, it therefore goes without saying that anti-foreign-to-foreign stripping rules come with a unique array of risks and benefits. Particularly, with reference to developing countries, Dourado (2015:355) notes that *"such a broad configuration of CFC rules will exclude any possibility of a more competitive tax policy … and it will not be in their interest as long as there is (genuine) business activity in their territories. In other words, if competitive tax policy by a developing country manages to attract active investment, there is no reason for the application of a broad CFC rule in the parent country, based on an irrebuttable presumption of abuse."* Dourado (2015:355) also cautions that *"[t]aking into account that CFC rules will strengthen the role of residence countries…, when adopted and applied domestically to all income (active and passive), they will restrict tax competition worldwide, especially when they are automatically applicable."* (emphasis added)

The extension of the South African CFC legislation to multi-layered structures and transactions, although not quite as restrictive as the anti-foreign-to-foreign stripping rules proposed by the OECD, have several features in common with said rules. In terms of the amended section 9D, South African revenue authorities may now essentially look to and impose tax on the income of entities located in third-party jurisdictions to the extent that they may be involved in the sale of goods or the provision of services whether directly or indirectly to a South African resident person. This taxing right is not discretionary and will apply automatically in all instances where the conditions described in section 9D(9A)(a) are met. Therefore, to use the words of Dourado (2015:355), National Treasury has arguably created an "*irrebuttable presumption of abuse"* which will apply to both direct and indirect transactions between:

> *"a) the South African connected person and an independent non-resident customer for the export of goods;*
> *b) an independent non-resident supplier and the South African connected person for the import of goods; and*
> *c) the controlled foreign company and the South African connected person for the rendering of services."* (National Treasury, 2019a:39)

The effect of these rules may be illustrated in context of the scenario contemplated in Diagram 2 in Chapter 2. Relying on the provisions of section 9D(9A)(a)(i), the profits of CFC2 may arguably now be taken into account when determining its net income for South African tax purposes seeing that such income is derived from the indirect sale of goods by CFC2 to a connected person who is a South African resident, i.e. the South African Controlling Entity.

**Diagram 3: The effect of section 9D (as amended) on indirect or multi-layered transactions**




Unlike anti-foreign-to-foreign stripping rules, however, the amended section 9D only applies in the limited circumstances as outlined above, as opposed to general instances where the tax base of a third-party jurisdiction may be at risk of BEPS. The purpose of the extension of the South African CFC rules to multi-layered transactions is also not an altruistic one aimed at protecting the tax bases of third-party jurisdictions, but is rather to prevent the circumvention of CFC anti-diversionary rules by interposing *"additional CFCs in the supply chain between the South Africa resident connected person and the independent non-resident supplier or customer"* (National Treasury, 2019a:39).

Arguably these amendments now prevent a scenario which Picciotto (2005:5-6,17) refers to as "creative compliance" or a "cat-and-mouse game" between taxpayers and revenue authorities where, essentially, a transaction or structure could be recategorized (i.e. by multi-layering via the introduction of additional CFCs into a supply chain) in order to avoid the purpose of the CFC rules whilst still complying with the letter of these rule.

As will be illustrated below, various other jurisdictions have also adopted measures reminiscent of or comparable to anti-foreign-to-foreign stripping rules, albeit under different guises and with somewhat less altruistic intentions.

### 4.4 The UK: Motive test, Diverted Profits Tax and General Anti-Abuse Rule

Rather than relying on specific anti-avoidance measures to mitigate against the possible BEPS consequences of multi-layered structures and transactions, as is the case in South Africa, the UK has over the years relied on more general anti-avoidance measures, often taking into account the intent of the taxpayer.

Interestingly, prior to 1 January 2013, the UK relied on a set of general CFC anti-diversionary measures dubbed the "motive test" which was quite similar to the GAAR provisions which currently apply in South Africa. According to the HMRC's manual entitled 'Controlled Foreign Companies: exemptions - the motive test: Introduction to the motive test', *"[t]he motive test was introduced because it proved impractical to devise comprehensive objective tests that ensured that all United Kingdom controlled overseas subsidiaries with profits derived from genuine overseas activities were excluded from the controlled foreign companies' charge"* (HMRC, 2020).

Essentially, the motive test consisted of two legs, and provided that no apportionment of CFC income would be required in respect of a specific year of assessment:

a) where a transaction (or two or more transactions taken together) forming part of the CFC's profits for a specific year of assessment has achieved a reduction in UK tax, either
    i. the reduction in tax was minimal; or
    ii. the reduction in tax was not the sole or main purpose of the transaction(s) in question;
b) The sole or main reason for the CFC's existence in a specific year of assessment was not to achieve a reduction in UK tax by diverting profits from the UK. (HMRC, 2020)

The motive test, however, came under fire from the European Union Court of Justice on 12 September 2006 as part of its ruling in the case of Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue C-196/04 ("Cadbury Schweppes"). In Cadbury Schweppes the court was charged with determining whether the motive test forming part of the UK's CFC rules could be applied to a UK parent company where it held a subsidiary in low tax jurisdictions within the EU (in this case Ireland), bearing in mind that the Treaty on the Functioning of the European Union, specifically provides for Freedom of Establishment ("FOE") within the EU (Dueñas, 2019:14).

Dueñas (2019:14) aptly summarises the court's determination that *"a community national* [of the EU] *seeking profit from tax advantages in force in a member state cannot itself be deprived of the right to rely on the treaty provisions despite the existence of tax motives if the controlled company is actually established in the host member state and carries on genuine economic activities there. Also, in its judgment, the Court mentions that a company established in a member state with a more favorable* (sic) *tax treatment cannot be considered to be in abuse of the FOE".* (emphasis added)

The court thus concluded that the relevant provisions of the Treaty on the Functioning of the European Union "*must be interpreted as precluding the inclusion in the tax base of a resident company established in a Member State of profits made by a CFC in another Member State, where those profits are subject in that State to a lower level of taxation than that applicable in the first State, unless such inclusion relates only to wholly artificial arrangements intended to escape the national tax normally payable. Accordingly, such a tax measure must not be applied where it is proven, on the basis of objective factors which are ascertainable by third parties, that despite the existence of tax motives that CFC is actually established in the host Member State and carries on genuine economic activities there"* (Cadbury Schweppes, 2006). (emphasis added)

In a determination, quite reminiscent of that of the South African SCA in the case of Sasol Oil v CSARS (2018), the court further held that an arrangement can only be said to constitute a "wholly artificial arrangement" where, for example, a CFC has been established only for purposes of obtaining a tax benefit and does not possess the required premises, staff, equipment etc. to carry on the activities for which it was purportedly established (Dueñas, 2019:14). Moreover, the mere fact the activities of a CFC could have been carried out directly by its parent company, save that in that instance no tax benefit would have been achieved is not sufficiently indicative of the existence of a wholly artificial arrangement (Cadbury Schweppes, 2006).

Experts have dubbed the so-called artificiality test as adopted by the EU as being naive and have suggested that a hybrid approach be adopted in terms of which certain of the recommendations of BEPS Action 3, including anti-foreign-to-foreign stripping rules, may be applied on a case-by-case basis, as opposed to merely relying on an irrebuttable presumption of avoidance when dealing with certain types of entities or transactions (Dourado 2015:356). Be that as it may, the UK revised its CFC rules with effect from 1 January 2013, following both the outcome of the Cadbury Schweppes case and increasing pressure to align its CFC rules with the EU's Anti-Tax Avoidance Directives ("ATAD").

In respect of years of assessment commencing on or after 1 January 2013, the UK now relies on a number of so-called "gateway provisions" (mitigated by entity level exemptions) aimed at

identifying classes of CFC profits which are often subject to abuse or artificiality and allowing for the taxation of such profits in the UK (Van der Jagt *et al.*, 2019).

Essentially, under the current UK CFC regime, CFC profits are automatically exempt from UK tax when any of the following entity-level exemptions apply:

a) Exempt Period Exemption: Usually available only for a period of 12 months to CFCs which have come under UK control;
b) Excluded Territories Exemption: Available to qualifying CFCs posing a low risk to the UK corporate tax base whether due to their territory of residence or the type of CFC income generated;
c) The Low Profits Exemption: Available to CFCs which pose little risk of diversion as a result of the fact that their profits are relatively low;
d) Low Profit Margin Exemption: Available to CFCs with accounting profit (or profit margin) of 10 per cent or less compared to operating expenditure; and
e) Tax Exemption: Available where a CFC's jurisdiction already levies a normal or high tax rate, being at least 75% of the comparable UK tax (HMRC, 2020).

Where no entity level exemptions apply, CFC profits must pass through one of the so-called charge gateways in order to be subject to tax in the UK. These gateways allow for UK taxation of CFC profits only in instances where such profits constitute either business profits attributable to UK activities, non-trading finance profits, certain trading finance profits and captive insurance profits (Dueñas, 2019:14). The UK CFC rules in their current form therefore do not provide for CFC charges in the event of multi-layered transactions specifically.

Although not exclusively forming part of the UK CFC legislation, the UK has also put in place a so-called Diverted Profits Tax ("DPT") with effect from 1 April 2015 which does, to an extent, cater for tax abuse resulting from multi-layered transactions, although only in very limited circumstances. According to the HMRC's Diverted Profits Tax Guidance the DPT allows HMRC to look at the entire global supply chain of relevant multinational companies that either:

> *"(i) seek to avoid creating a UK permanent establishment that would bring a foreign company into the charge to UK Corporation Tax, or*
> *(ii) use arrangements or entities which lack economic substance to exploit tax mismatches either through expenditure or the diversion of income within the group."* (HMRC, 2018a:3)

Regarding the interaction between the DTC and the UK's CFC rules HMRC has, however, made the following clarification:

> *"The DPT legislation is not designed to apply where a non-resident company, other than one that has a UK PE or an avoided PE, diverts profits to another non-resident company, but it is conceivable that such a company may be a CFC of a UK company and that the diversion of profits results in a liability to tax in the second non-resident company that is less than 80% of the CFC charge that would otherwise be payable by the UK parent company. Although this scenario is not addressed in the DPT legislation, if a company sought to employ such arrangements to avoid a liability to DPT HMRC would consider those arrangements to be potentially within the scope of the General Anti-Abuse Rule and would seek to apply it."* (HMRC, 2018b:100) (emphasis added)

The above considered, it would appear that the majority of multi-layered CFC transactions would only be capable of being addressed using the provisions of the UK General Anti-Abuse Rules, also referred to as "GAAR", which came into effect from effect from 17 July 2013. Similar to the South African GAAR, these rules may be applied in instances where taxpayers go beyond "*what could reasonably regarded as a reasonable course of action*" in order to decrease or nullify their tax liability (HMRC, 2018b:5). Essentially the UK GAAR applies to *inter alia* any amounts chargeable as if they were UK Corporation Tax, including CFC charges and takes effect where an abusive tax arrangement exists with its main purpose, or one of its main purposes being to obtain a tax advantage (HMRC, 2018b:11). Upon successful application of the UK GAAR, HMRC is empowered to make any adjustments that it considers to be just and reasonable, taking into consideration how an arrangement would have been carried out had it not included abusive features (HMRC, 2018b:33). Although the provisions of the UK GAAR would undoubtedly be available to the HMRC in the context of multi-layered transactions, it would arguably be faced with many of the same challenges experienced by SARS in Sasol Oil v CSARS (2018).

It remains to be seen how, if at all, the UK CFC legislation will change (particularly in relation to its effect on the remaining EU member nations) following its departure from the EU on 31 January 2020.

### 4.5 Ireland: Non-genuine arrangements put in place for the essential purpose of tax avoidance

Relevant to the discussion of general anti-avoidance rules and the extent to which such rules cater for abusive multi-layered transactions, is section 835R of the Irish Taxes Consolidation Act (1997). According to the Irish Tax & Customs, Tax and Duty Manual for Controlled Foreign Company Rules (2019:37), "*[f]or a CFC charge to arise on a chargeable company in respect of its CFC, nongenuine arrangements must be in place and those arrangements must exist for the essential purpose of a tax advantage*".

Essentially the Irish definition of "arrangement" (including *"any transaction, action, course of action, course of conduct, scheme, plan or proposal, any agreement, arrangement,*

*understanding, promise or undertaking whether express or implied and whether or not enforceable or intended to be enforceable by legal proceedings and any series of or combination of [such] circumstances"* (Irish Tax & Customs, 2019:38)) is quite similar to that which applies in South Africa. Notable, however is the following additional clarification provided by Irish Tax & Customs (2019:38), which specifically includes multi-layered transactions within the scope of what is considered an "arrangement":

> *"Arrangement is widely defined and includes the various actions and activities which can be considered to be an arrangement for the purposes of identifying a non-genuine arrangement.*
>
> *It includes arrangements entered into by one or two or more persons, whether acting in concert or not, whether or not entered into or arranged wholly or partly outside the State or whether or not entered into or arranged as part of a larger arrangement or in conjunction with other arrangements. Double Tax Treaties are excluded from the definition of 'arrangement'."* (emphasis added)

The proverbial nail in the coffin, when it comes to the successful application of section 835R of the Irish Taxes Consolidation Act (1997) may however be found in its definition of "essential purpose". In order to meet the essential purpose requirement, the Irish tax authorities are required to demonstrate what the decisive factor was, that was taken into account by a taxpayer upon entering into an arrangement (Irish Tax & Customs, 2019:43). Irish Tax & Customs (2019:43) also emphasises that this latter portion of the test is much less stringent (to the benefit of taxpayers), than similar legislation which applies elsewhere in the EU, by virtue of the fact that a tax benefit must be the essential purpose of an arrangement rather than just one of the main purposes.

According to Deloitte (2018:6), the Irish essential purpose test is strongly reminiscent of the concept of wholly artificial arrangements, as considered by the European Court of Justice in the case of Cadbury Schweppes (2006) and refers to paragraphs 63 to 69 of that judgement to illustrate the intrinsic difficulty faced by tax authorities in applying these tests. One cannot help but be reminded of the SCA's finding in Sasol Oil v CSARS (2018) and, ultimately, the South African revenue authorities' perceived need for bespoke legislation aimed at addressing the harmful effects of multi-layered transactions when reading the following conclusions of the European Court of Justice:

> *"63 As stated by the applicants in the main proceedings …, the fact that none of the exceptions provided for by the legislation on CFCs applies and that the intention to obtain tax relief prompted the incorporation of the CFC and the conclusion of the transactions … does not suffice to conclude that there is a wholly artificial arrangement intended solely to escape that tax.*
>
> *64 In order to find that there is such an arrangement there must be, in addition to a subjective element consisting in the intention to obtain a tax advantage, objective circumstances ...*

*65 In those circumstances, in order for the legislation on CFCs to comply with Community law, the taxation provided for by that legislation must be excluded where, despite the existence of tax motives, the incorporation of a CFC reflects economic reality.*

*66 That incorporation must correspond with an actual establishment intended to carry on genuine economic activities in the host Member State…*
*67 As suggested by the United Kingdom Government and the Commission at the hearing, that finding must be based on objective factors which are ascertainable by third parties with regard, in particular, to the extent to which the CFC physically exists in terms of premises, staff and equipment.*

*68 <u>If checking those factors leads to the finding that the CFC is a fictitious establishment not carrying out any genuine economic activity in the territory of the host Member State, the creation of that CFC must be regarded as having the characteristics of a wholly artificial arrangement.</u> That could be so in particular in the case of a 'letterbox' or 'front' subsidiary…*

*69 On the other hand, as pointed out by the Advocate General in point 103 of his Opinion, <u>the fact that the activities which correspond to the profits of the CFC could just as well have been carried out by a company established in the territory of the Member State in which the resident company is established does not warrant the conclusion that there is a wholly artificial arrangement</u>."* (Cadbury Schweppes, 2006) (emphasis added)

## 4.6 The Netherlands: An argument for the relaxation of CFC rules

The Netherlands had no CFC legislation in place prior to 2019 when it was required to implement such legislation as a consequence of the adoption of the ATAD by the EU member nations (Dueñas, 2019:24). That being said and, as has been alluded to by the DTC, the Dutch CFC legislation is still significantly more simplistic and lenient than similar legislation currently in effect elsewhere, making the Netherlands quite an attractive investment destination (Dueñas, 2019:24).

For purposes of article 13ab of the Dutch Corporate Income Tax Act, 1969 ("CITA"), a CFC is defined as an entity in which a Dutch taxpayer, whether on its own or together with a related person, holds at least a 50% direct interest <u>and</u> which entity is either based in a country with a statutory income tax rate of less than 9%, or in a country included in the EU's so-called blacklist of non-cooperative jurisdictions[8]. Should an entity meet the requirements of the aforementioned definition, it may be at risk of having certain of its contaminated income taken into account for purposes of determining its Dutch tax liability. Under the current provisions of CITA (1969) such

[8] As at 18 February 2020, this list included American Samoa, the Cayman Islands, Fiji, Guam, Oman, Palau, Panama, Samoa, Seychelles, Trinidad and Tobago, the US Virgin Islands and Vanuatu (Enashe, 2020).

contaminated income only comprises of the following mostly passive income items (less the cost incurred in order to achieve each respective income item):

a) interest or other gains from financial assets;
b) royalties or other benefits from intangible assets;
c) dividends and gains from the disposal of shares;
d) benefits from finance lease activities;
e) benefits from insurance, banking or other financial activities; and
f) benefits from little or no economic value-adding billing activities consisting of sales benefits or service benefits derived from goods or services purchased from or sold to the taxpayer or an affiliated entity or natural person (CITA, 1969).

Despite the already limited scope of the Dutch CFC legislation, the CITA also creates certain irrebuttable presumptions against the existence of a CFC (CITA, 1969). In instances where an entity's qualifying passive income constitutes less than 30% of its total income, or where such entity can be said to carry on substantial economic activities in its home jurisdiction, that entity automatically falls outside the scope of the Dutch CFC rules (Dueñas, 2019:24). As regards the question of what constitutes substantial economic activity, a further irrebuttable presumption exists that, where an entity incurs labour costs in excess of EUR100 000 per annum and has the requisite premises available to it for a minimum of 24 months (Dueñas, 2019:24). The above considered, it goes without saying that the Netherlands have not enacted specific CFC legislation in response to the BEPS which may result from multi-layered transactions and, in fact, have left many transactions commonly perceived as "high risk" in other jurisdictions unaddressed.

Although Dutch tax law also makes provision for a catch-all anti-avoidance measure dubbed *Fraus Legis,* this too is significantly more favourable to taxpayers than the general anti-avoidance measures in place in the other jurisdictions considered in this Chapter. *Fraus Legis* is essentially comprised of two steps, being an objective and a subjective test (Nederveen, 2019:21). In order to succeed on the basis of *Fraus Legis,* Dutch revenue authorities will therefore have to demonstrate firstly, that the sole purpose of a structure or transaction was to obtain a tax benefit (objective test) and secondly, that the structure or transaction breached the object or purpose of the law (Nederveen, 2019:21).

Having to prove that a tax benefit was the sole purpose of a structure or transaction already places an onerous burden on Dutch revenue authorities, however, as Nederveen (2019:21) points out, the subjective test may prove to be even more problematic when considered in context of multinational structures involving the tax laws of different jurisdictions having different objects and purposes. When considering the difficulty of the South African revenue authorities in establishing

that a tax benefit was simply a main (if not *the* sole) object of a multi-layered transaction in Sasol Oil v CSARS (2018), bearing the limited taxpayer information available to it (PWC, 2018:6), it seems unlikely that *Fraus Legis* will prove an effective deterrent against abusive multi-layered transactions.

The simplistic nature of the Dutch international tax rules has cemented the Netherlands' status as a preferred conduit country for foreign-direct investment (Lejour *et al*, 2019:27). Clearly, by providing a preferential tax regime for multinationals, the Netherlands earn less in CFC tax revenue than otherwise may have been the case (Wagner, 2019:58). However, the Centre for Research on Multinational Corporations or Stichting Onderzoek Multinationale Ondernemingen, (SOMO), as it is known in the Netherlands, suggests that the Netherlands also derives significant benefits by virtue of being a conduit country "*from attracting financial flows to its territory by increasing the tax yield it enjoys from corporate income* (approximately EUR1.7 billion) *and from employment generated in the trust and tax consultancy sector* (approximately 2 500 direct jobs)" (SOMO, 2007:3). That being said, although the balance sheet of the Netherlands itself may not ultimately be severely prejudiced as a result of its own generous CFC legislation, the use of the Netherlands as a conduit country likely contributes significantly towards tax avoidance on a global scale (Wagner, 2019:57). In fact, Wagner (2019:57) concludes that this form of structuring by multinational enterprises annually results in developing countries losing tax revenue totalling approximately USD100 billion[9]. This view is also supported by SOMO (2007:3). From the perspective of a developing country such as South Africa, CFC legislation addressing multi-layered transactions and structures may therefore be all the more relevant.

### 4.7 Conclusion

This Chapter has investigated and considered a wide representative array of tax measures which may serve to combat the negative effects that multi-layered transactions may have on a specific country's tax base. Interestingly, although the OECD has put forward measures such as anti-foreign-to-foreign stripping rules which, although admittedly onerous, would undoubtedly protect against the BEPS which may arise from abusive multi-layered structures and transactions both in the parent company jurisdiction and in CFC jurisdictions, member nations have not jumped at the chance to incorporate such provisions in their domestic legislation.

In evaluating the South African CFC regime specifically, the question arises whether the severity of said regime firstly, has the desired effect of increasing tax revenue or rather preventing tax

[9] Prior to the introduction of the Netherlands' limited CFC regime in 2019.

leakage and, secondly, whether the severity of the regime will possibly have the opposite effect of discouraging investment and thus, by implication, reducing tax revenue.

The latter point is neatly summarised by Pieretti and Pulina (2015:19) in their conclusion *"…that anti tax-planning regulations can induce multinational firms to use other ways to mitigate their tax liabilities, like shifting real activities to tax havens. As a result, the removal of tax-motivated profit shifting increases tax revenue in the onshore region only if the low-tax jurisdiction is not too efficient in providing attractive infrastructure."*

Chapter 5 provides a general summary of the topics discussed in this mini-dissertation and is aimed at identifying questions and uncertainties such as the above, where further study, research or investigation is required.

## CHAPTER 5: SUMMARY AND CONCLUSION

### 5.1 Introduction

Much has been said in this study about the tax related risks, consequences and legislative treatment of multi-layered transactions. The aim of this Chapter is to summarise and consider the findings made in this study in the context of the various research objectives as listed in Chapter 1. Furthermore, this chapter highlights certain recommendations made by industry experts which may be of relevance to the South African tax authorities and legislators in relation to their treatment of multi-layered structures and transactions. Finally, this Chapter also identifies certain areas which may benefit from further academic study.

### 5.2 Summary of research objectives

#### 5.2.1 Main objective

The main objective of this study was to analyse the current South-African CFC legislation, including the 2019 amendments thereto (particularly insofar these relate to direct and indirect transactions between various parties involved in multi-layered transactions) in order to determine the effectiveness thereof as a deterrent against abusive tax structuring and, more generally, as a tool to protect and bolster the South African tax base (refer to Chapter 3).

The 2019 amendments represent the most recent culmination of South Africa's increasingly strict CFC legislation. Essentially, with effect from 1 January 2020, the CFC income attribution rules contained in section 9D(9A)(a) of the ITA (58 of 1962) have been extended to apply to both direct and indirect sales and services and now contemplates scenarios where multiple CFCs are introduced into the same value chain, whether artificially or for a legitimate business purpose, thus breaking the link between the controlling entity and the ultimate supplier or customer (also referred to as multi-layered transactions or structures).

Although the legislation does not specifically define the term "multi-layered", industry experts opine that, due to the close proximity of the introduction of the 2019 amendments to the Sasol Oil v CSARS (2018) SCA judgement (which notably was not decided in CSARS' favour)[10], this case is a good example of the types of structures sought to be addressed by National Treasury (PWC, 2019:3). The effect of the 2019 amendments is that SARS is no longer reliant on the statutory or common law anti-avoidance rules, as was the case in Sasol Oil v CSARS (2018), to recover its perceived dues in respect of multi-layered international transactions or structures. Where the

[10] The 2019 amendments were introduced in the legislative cycle directly following the Sasol Oil v CSARS (2018) SCA judgement.

successful application of the anti-avoidance rules is critically dependent on establishing the motives and intentions of a taxpayer, the 2019 amendments do not include any motive test (PWC, 2019:3), thus significantly easing SARS' evidentiary burden.

As part of this analysis, this study also sought to analyse the 2019 amendments to the CFC legislation (particularly insofar as these relate to multi-layered transactions) against National Treasury and the OECD's goal of curbing the circumvention of anti-diversionary rules in respect of CFCs in context of multi-layered transactions (refer to Chapter 3 and 4). If one takes the structure encountered in Sasol Oil v CSARS (2018) as an example of a multi-layered structure or transaction, there is no question that SARS' prospects of success would have been significantly increased had it been able to rely on the 2019 amendments rather than the statutory or common law anti-avoidance provisions (PWC, 2019:3).

That being said, it is noted that the wording of the 2019 amendments is exceedingly broad and non-specific (perhaps intentionally so), and no guidelines have yet been published to indicate SARS' intended approach to the application of these provisions. The 2019 amendments have also yet to be interpreted and applied by the courts.

### 5.2.2 Secondary objectives

This study also adopted several secondary objectives as a means of contextualising its main objective. Firstly, this study sought to describe and consider the concerns raised by CFCs and multi-layered structures generally, which necessitated general legislative intervention as well as the intervention of the OECD via the introduction of BEPS (refer to Chapter 2). In a nutshell, CFCs have been and are still being used as a means to shift profits from one jurisdiction to another, often with the view of subjecting such profits to a less onerous tax regime. Businesses and individuals are increasingly engaging in global business ventures and the resulting global financial integration has put significant strain on existing local and international tax rules world-wide. Local legislators have also been hard-pressed to keep pace with financial and business innovation, not to mention the creative tax structures adopted in the process (including multi-layered structures and transactions, whether adopted artificially or for legitimate business purposes), thus leaving their jurisdictions at risk of BEPS (OECD, 2015:3, 9).

Secondly, this study sought to describe and consider the various iterations and certain notable applications of the South African CFC legislation to date (as influenced by case law, rulings and international commentary) as a backdrop against which to evaluate the South African CFC regime in its current form (refer to Chapter 3). This investigation has brought quite an interesting quandary to the fore. Whilst legislators and National Treasury appear to be engaged in a continuous effort

to increase the strength and severity of the South African CFC legislation, most recently via the extension of the CFC rules to multi-layered structures and transactions, academics seem to suggest an entirely opposite approach. Even prior to the 2019 amendments, industry experts already agreed that the South African CFC regime was inflexible and created arduous compliance obligations (Kraamwinkel & Grimm, 2018). The DTC also advised a cautionary approach to CFC legislation in its 2016 report wherein it suggested that, although the South African CFC regime could theoretically be strengthened, this should not be done without due regard to international trends, the increased compliance burden to South African based companies, the possibility that such a change could have the effect of hindering legitimate business establishments and the likely competitive constraints which South Africa may experience as a result (DTC, 2016:6). Interestingly none of the explanatory memoranda to the various amendments to the CFC rules effected in the years after the publication of the DTC's recommendations make mention of such recommendations or of the thought processes leading to the non-implementation thereof in specific instances.

Thirdly, this study sought to analyse the South African CFC regime against the OECD's "ideal" CFC regime as contemplated by BEPS (refer to Chapter 4). In this regard, the DTC, in its second and final report on Base Erosion and Profit Shifting, found that the South African CFC regime is one of the most sophisticated and complex regimes within the G20 (DTC, 2016:6) and cautioned, in fact, that such a severe regime may run the risk of discouraging foreign-direct investment (DTC, 2016:7). Although not one of the so-called OECD BEPS building blocks, this study also briefly considered the OECD's additional recommendations in relation to foreign-to foreign stripping, essentially referring to CFC rules that are designed in such a way as to protect not only the tax base of the country where a CFC's parent company is based, both also the tax bases of other third-party countries (OECD, 2015:16). Although, admittedly, the South African CFC regime does not have the altruistic aim of protecting the tax bases of third-party jurisdictions, the extension of the South African CFC rules to include multi-layered structures and transactions may, in theory, allow South African Revenue authorities to look to and tax the income of entities located in third-party jurisdictions (not directly engaged in a transaction or structure with a South African company or CFC). By virtue of having these features, arguably, it may be said that the South African CFC regime goes over and above what the OECD considers to be adequate protection against BEPS.

The final secondary objective of this study was to analyse the legislation of comparable foreign countries to determine how other countries manage to curb the circumvention of anti-diversionary rules in respect of CFCs or, alternatively, why such rules may be absent (refer to Chapter 4). The CFC regimes of the UK, Ireland and the Netherlands were used for comparison to the South African CFC regime. The aforementioned countries are comparable to the South African tax

system, have contributed to the development of the South African CFC regime (Croome, 2013:5) or, in the case of the Netherlands, follows an approach so demonstrably different as to be notable. Much of Europe, including the UK and Ireland, have not seen it fit to adopt CFC legislation specifically aimed at multi-layered structures and transactions, opting instead to rely on anti-avoidance provisions similar to the South African GAAR and/or substance over form provisions. As illustrated by the judgement in Cadbury Schweppes (2006), the various European tax authorities are also faced with many of the same challenges as experienced by the South African tax authorities in Sasol Oil v CSARS (2018), but it appears that this has been accepted as part of the cost of seamlessly doing business in Europe (Dueñas, 2019:14). The Netherlands have adopted an even less onerous approach in an effort to establish itself as a preferred conduit country for foreign-direct investment (Lejour *et al*, 2019:27) whereby it arguably sacrifices what it could otherwise have earned in CFC tax revenue in order to derive other benefits in the form of, for example, increased financial flows and employment (SOMO, 2007:3).

The approaches of the aforementioned countries are quite informative, particularly in light of the DTC's 2016 recommendation that South Africa would be better suited to observe and follow international trends (where appropriate) rather than to pave its own way forward (DTC, 2016:3). As noted above, National Treasury, for reasons not disclosed, has opted not to follow the DTC's advice in this regard.

### 5.3 Final observations and recommendations

This study has considered CFC rules addressing multi-layered transactions somewhat in isolation. It goes without saying, however, that other tax policy avenues may also contribute to the desired outcome of curbing the BEPS which may arise as a result of abusive multi-layered structures and transactions. Brauner (2017:69) notes, for example, that the goals of transfer pricing and thin capitalisation rules are largely similar to those of CFC rules. That being said, Brauner (2017:69-70) also expresses the view that, despite their similarities, CFC, transfer pricing and thin capitalisation rules *"…usually operate in parallel, with little to no coordination or hierarchy"* and even in instances where coordination exists, the application thereof tends to be challenging and onerous.

The South Africa National Treasury has recently, following the 2019 amendments to the CFC rules, taken steps in an apparent effort to align the outcomes and objectives of the South African transfer pricing rules with the CFC rules in their current form. In its Draft Explanatory Memorandum on the Draft Taxation Laws Amendment Bill, National Treasury (2020a:36-37) notes that although the ITA makes provision for transfer pricing rules aimed at *"…preventing the reduction in South African taxable income as a result of mispricing or incorrect characterisation*

*of transactions"*, there are instances involving CFCs where the current scope of application of said rules are limited. National Treasury provides the following example:

> *"…in the case of a transaction between a controlled foreign company in relation to a resident and a non-resident connected person, a tax benefit may not be derived by the foreign company, but may be derived by a South African resident shareholder as a result of a lower inclusion of an amount equal to a portion of the controlled foreign company's net income for the resident."*

In their current form, the South African transfer pricing rules[11], insofar as these rules extend to CFCs, apply only to "affected transactions" between a person that is not a resident and any other person that is a controlled foreign company in relation to any resident (ITA, 58 of 1962). National Treasury (2020a:37) therefore proposes extending the application of the transfer pricing rules to any *"…tax benefit that may be derived by any resident in relation to a controlled foreign company."*[12] (emphasis added)

Although not specifically stated, this proposed amendment seems to have the effect of somewhat extending the scope of the South African transfer pricing rules to multi-layered structures and transactions. It remains to be seen whether this proposed amendment will be enacted in its current form and, if so, whether this will be the start of greater harmonisation between the South African CFC rules and other rules also aimed at combating BEPS.

### 5.4 Suggestions for future study

This study has placed much emphasis on the interplay and inherent conflict between the need for effective CFC legislation aimed at preventing BEPS on the one hand and, the resulting compliance and cost burdens placed on businesses on the other hand. In the author's view, this conflict may be seen as the "golden thread" that runs through any discussion regarding CFC legislation both in South Africa and internationally. With that in mind, further study in respect of the following topics is therefore recommended in order to more accurately evaluate the efficacy of South Africa's increasingly severe CFC rules:

#### 5.4.1 Analysis of South Africa's actual BEPS exposure

As noted by Kraamwinkel & Grimm (2018), SARS in its revenue collection data does not delineate an amount or percentage of overall collections arising from the taxation of CFCs, thus giving rise to speculation that the actual tax revenue collected as a result of the South African CFC rules is

---

[11] Contained in section 31 of the ITA (58 of 1962).

[12] The proposed amendments are envisaged to come into operation on 1 January 2021 and will apply in respect of years of assessment commencing on or after that date.

relatively insignificant when compared to SARS' total revenue collections. The latter point is somewhat supported by a 2016 study undertaken by the OECD in conjunction with the South African National Treasury, which attempted to estimate the loss of South African tax revenue as a result of BEPS (Reynolds & Wier, 2016). In that study it was found that, under the CFC legislation in place at the time, BEPS likely only resulted in a loss of 0.2% of South Africa's total tax revenue, which equated to a 0.05% reduction in South Africa's GDP (Reynolds & Wier, 2016:12).

With this in mind, it is therefore recommended that further study be undertaken in order to quantify the actual tax revenue currently being lost as a result of abusive CFC practices generally and as a result of abusive multi-layered structures and / or transactions in particular. It is further recommended that such findings be considered in light of the outcomes of 5.4.2 and 5.4.2 below.

### 5.4.2 Analysis of the effects of the CFC compliance burden

Chapter 3 of this study noted various concerns raised by industry experts in relation to the South African CFC regime. These concerns can be summarised into two broad categories. Firstly, even prior to the 2019 extension of the South African CFC rules to multi-layered structures and transactions said rules were already inflexible and created arduous compliance obligations (Kraamwinkel & Grimm, 2018) and, arguably businesses are in an even more onerous position now, following the 2019 amendments. This appears to be especially true for smaller businesses where tax compliance costs account for a large part of business expenses (Picciotto, 2005:19). Secondly, the 2019 amendments have elevated industry concerns that, if some countries, such as South Africa, continue to strengthen and refine their CFC rules while other countries become more lenient, these mismatches will present increasingly uneven playing fields for multinational enterprises (Mollagee, 2020).

Taking into account the findings in 5.4.1 regarding the actual tax leakage prevented by virtue of the increasingly strict South African CFC rules, an in-depth viability study is required taking into account the operating costs of administering the CFC regime in its current form, the resulting compliance cost for taxpayers (Picciotto, 2005:19) and any foreign-direct investment which may be lost as a result.

### 5.4.3 Analysis of whether multi-layered transactions can be addressed by other, less onerous means

As noted above, various tax policy avenues (other than CFC rules) including, for example, transfer pricing and/or thin capitalisation rules, could likely be used in order to achieve the desired outcome of curbing the BEPS which may arise as a result of abusive multi-layered structures and

transactions. Particularly in light of the anticipated outcome of 5.4.2 above, regard should be had for whether there are less onerous means of protecting the South African tax base (Brauner, 2017:69).

### 5.4.4 Formalist versus generalist approaches to CFC rules

According to Picciotto (2005:5), a formalist approach to regulation may be defined as an *"…attempt to draw up rules which are precise and which anticipate every contingency, resulting in a highly complex tax code*". In Picciotto's opinion, an overly formalist approach may not necessarily prevent avoidance, but may rather incentivise taxpayers to formulate more creative avoidance strategies which comply with the letter of the law whilst still avoiding the ultimate aim of the law, often leading to so-called "cat-and-mouse games" between taxpayers and legislators (Picciotto, 2005:5-6).

A generalist approach, on the other hand, relies on more *"open-ended rules which focus on substance rather than form, and are expressed purposively or in policy-oriented terms*" (Picciotto, 2005:6). Such an approach, according to Picciotto (2005:6), is also not without its challenges, often resulting in uncertainty as a result of multiple possible interpretations.

The current approach to the South African CFC rules, insofar as these relate to multi-layered structures and transactions, appears to be quite formalistic in that these rules seem to extend to all direct and indirect transactions as contemplated in section 9D(9A)(a) of the ITA (58 of 1962) regardless of substance or intention. South Africa is, however, in the interesting position of also benefiting from overarching generalist legislation, in the form of the GAAR and substance over form rules. It would be quite interesting to compare the overall efficacy of South Africa's hybrid approach to primarily formalistic and general approaches, from both the view of the taxpayer (considering the cost and ease of compliance and the relative certainty of the law) and the tax authority (considering the overall success of the system in preventing tax leakage whilst not discouraging foreign-direct investment).

## 5.5 Conclusion

Undoubtedly the 2019 amendment of the South African CFC rules to encompass multi-layered structures and transactions will achieve National Treasury's goal of mitigating the tax leakage which may arise in the event that a taxpayer elects to interpose additional (arguably unnecessary) CFCs into their international supply chains between South African resident taxpayers and independent non-resident suppliers or customers. This likely will be the case regardless of whether such a multi-layered structure or transaction was entered into with the intention of

diverting profits to companies that are subject to tax at a lower rate and that are not subjected to the South African specific anti-diversionary rules.

The study has, however, contemplated the 2019 amendments in a more nuanced light, not limited merely to their objective effectiveness in reaching their stated purpose. Looking at the so-called "big picture", one has to consider the extent of the actual tax leakage being prevented, as well as the resulting administrative costs for the South African revenue authorities, the corresponding compliance costs for companies conducting business in South Africa or in connection with South African entities and the foreign-direct investment lost as a result of such increased compliance cost in order to determine whether the system as a whole is viable.

## REFERENCE LIST


Bisman, J. 2010. Postpositivism and Accounting Research: A (Personal) Primer on Critical Realism. *Australasian Accounting, Business and Finance Journal* 4(4).

Botha, C. 2011. Statutory Interpretation, An introduction for students. 4th ed. Cape Town, South Africa. Juta.

Brauner, Y. 2017. Transfer Pricing and Tax Avoidance. (*In* Dourado, AP., *ed.* Tax Avoidance Revisited in the EU BEPS Context. Amsterdam: IBFD. p.63-71).

Croome, B (ed.). 2013. Tax Law an Introduction. 1st ed. Cape Town, South Africa. Juta.

Davis Tax Committee ***see*** South Africa. Davis Tax Committee.

Deloitte. 2018. CFC Feedback Statement Deloitte Response September 2018. https://assets.gov.ie/7371/ea4e0f8323bd4b0288411cad91b15e1c.pdf Date of access: 16 August 2020.

Dourado, AP. 2015. The Role of CFC Rules in the BEPS Initiative and in the EU. *British Tax Review* 3(2015).

Draft bills ***see*** South Africa.

Dueñas, S. 2019. CFC Rules Around the World. Tax Foundation Fiscal Fact No. 659 Jun. 2019. https://files.taxfoundation.org/20190617100144/CFC-Rules-Around-the-World-FF-659.pdf Date of access: 6 August 2020.

Enashe, R. 2020. Cayman Islands, Palau, Panama and Seychelles added to the EU list of non-cooperative jurisdictions. KPMG Euro Tax Flash 424. https://home.kpmg/xx/en/home/insights/2020/02/etf-424-eu-blacklist-update.html#:~:text=On%20February%2018%2C%202020%20the,%2C%20Palau%2C%20Panama%20and%20Seychelles Date of access: 6 August 2020.

EU Law Reports ***see*** European Union.

European Union. 2006. Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue. European Court Reports 2006 I-07995.

Forstater, M. 2015. Can Stopping 'Tax Dodging' by Multinational Enterprises Close the Gap in Development Finance? Center for Global Development Policy Paper 069. Washington, D.C, USA. Center for Global Development.

Gaffikin, MJR. 2014. Accounting methodology and the work of R.J. Chambers. New York, USA. Routledge.

HMRC. 2018a. Diverted Profits Tax: Guidance. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/768204/Diverted_Profits_Tax_-_Guidance__December_2018_.pdf Date of access: 7 August 2020.

HMRC. 2018b. General anti-abuse rule (GAAR) guidance. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/695255/gaar_parts_a_b_c_2018.pdf Date of access: 7 August 2020.

HMRC. 2020. HMRC internal manual. Controlled Foreign Companies: Entity Exemptions: contents. https://www.gov.uk/hmrc-internal-manuals/international-manual/intm224000 Date of access: 7 August 2020.

HMRC. 2020. HMRC internal manual. Controlled Foreign Companies: exemptions - the motive test: Introduction to the motive test. https://www.gov.uk/hmrc-internal-manuals/international-manual/intm255160 Date of access: 7 August 2020.

HMRC. 2020. HMRC internal manual. Controlled Foreign Companies: exemptions - the motive test: The conditions of the motive test. https://www.gov.uk/hmrc-internal-manuals/international-manual/intm255170 Date of access: 7 August 2020.

Hutchinson, T & Duncan, N. 2012. Defining and describing what we do: Doctrinal legal research. *Deakin Law Review*, 17(1). https://ojs.deakin.edu.au/index.php/dlr/article/view/70/75 Date of access: 20 October 2019.

Haupt, P. 2020. Notes on South African Income Tax 39th Ed. Cape Town, South Africa. H & H Publications.

Income Tax Act ***see*** South Africa.

Ireland. 1997. Taxes Consolidation Act, 1997.

Irish Tax & Customs. 2019. Tax and Duty Manual, Controlled Foreign Company Rules Part 35b-01-01. https://www.revenue.ie/en/tax-professionals/tdm/income-tax-capital-gains-tax-corporation-tax/part-35b/35b-01-01.pdf Date of access: 16 August 2020.

Katz Commission. 1997. 5th Report - Basing the South African Income Tax System on the Source or Residence Principle – Options and Recommendations. http://www.treasury.gov.za/publications/other/katz/5.pdf Date of access: 27 October 2019.

Kraamwinkel, C & Grimm, W. 2018. Is it time to change South Africa's CFC rules? Without Prejudice, November 2018. https://www.withoutprejudice.co.za/free/article/6281/view Date of access: 28 April 2020.

Langbroek, P, Van Den Bos, K, Thomas MS, Milo, M & van Rossum, W. 2017. Methodology of Legal Research: Challenges and Opportunities. *Utrecht Law Review* 13(3).

Law reports ***see*** South Africa.

Legwaila, T. 2012. Modernising the 'Substance over Form' Doctrine: Commissioner for the South African Revenue Service v NWK Ltd. South African Mercantile Law Journal. 24:115-127.

Lejour, A, Möhlmann, J, Van't Riet, M & Benschop, T. 2019. Dutch shell companies and international tax planning. Tilburg University Discussion Paper 2019-024. https://research.tilburguniversity.edu/en/publications/dutch-shell-companies-and-international-tax-planning Date of access: 6 August 2020.

Leung, L. 2015. Validity, reliability, and generalizability in qualitative research. https://www.ncbi.nlm.nih.gov/pmc/articles/PMC4535087/ Date of access: 1 February 2020.

Merriam-Webster Legal Dictionary. 2020. Benefit. https://www.merriam-webster.com/dictionary/benefit#legalDictionary Date of access: 15 June 2020.

Mollagee, O. 2020. Corporate Tax Rates, BEPS and SA'S CFC changes. *Taxtalk Magazine January/February 2020.* https://www.thesait.org.za/news/485631/ Date accessed: 19 May 2020.

National Treasury ***see*** South Africa. National Treasury.

Nederveen, C. 2019. GAAR implementation in the Netherlands: does *fraus legis* suffice? Lund, Sweden: Lund University. (Thesis - Master's Programme in European and International Tax Law).

Nortje, L & Brown, N. 2015. Amendments to CFC diversionary income rules. *Tax Talk Magazine, November 2015*. https://taxtalk.co.za/ArticleDetail/Amendments-to-CFC-diversionary-income-rules/TaxTalk-Magazines/1236220/1236524 Date of access: 21 May 2020.

Nosikova, Y. 2016. The FAPI regime and CFC Rules under the BEPS Action Plan 3: Where Does the Business of "Managing Intellectual Property" Stand? Canadian Tax Journal / Revue Fiscale Canadienne 64:1.

OECD. 2013a. Action Plan on Base Erosion and Profit shifting. https://www.oecd.org/ctp/BEPSActionPlan.pdf Date of access: 19 October 2019.

OECD. 2013b. Addressing Base Erosion and Profit Shifting. https://read.oecd-ilibrary.org/taxation/addressing-base-erosion-and-profit-shifting_9789264192744-en#page1 Date of access: 27 October 2019.

OECD. 2015. Designing Effective Controlled Foreign Company Rules, Action 3 – 2015 Final Report, *OECD/G20 Base Erosion and Profit Shifting Project*. https://read.oecd-ilibrary.org/taxation/designing-effective-controlled-foreign-company-rules-action-3-2015-final-report_9789264241152-en#page1 Date of access: 26 February 2020.

OECD. 2019. OECD/G20 Inclusive Framework on BEPS Progress Report, July 2018 – May 2019. https://www.oecd.org/tax/beps/inclusive-framework-on-beps-progress-report-july-2018-may-2019.pdf Date of access: 19 October 2019.

Olalere, T. 2011. Methodology in Accounting Research: A Critique of Taxonomy. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1921192 Date of access: 20 October 2019.

Picciotto, S. 2005. Constructing Compliance: Game-Playing, Tax Law and the State. The Australian National University Centre for Tax System Integrity Working Paper 81, November 2005.

Pieretti, P & Pulina, G. 2015. Does eliminating international profit shifting increase tax revenue in high-tax countries? University of Luxembourg Center for Research in Economics and Management Discussion Paper 2015-13. https://ideas.repec.org/p/luc/wpaper/15-13.html Date of access: 7 August 2020.

PWC. 2018. Synopsis Tax Today November – December 2018. https://www.pwc.co.za/en/assets/pdf/synopsis-nov-dec-2018.pdf Date of access: 15 June 2020.

PWC. 2019. Synopsis Tax Today July 2019. https://www.pwc.co.za/en/assets/pdf/synopsis/synopsis-july-2019.pdf Date of access: 1 March 2020.

Reynolds H & Wier, L. 2016. Estimating profit shifting in South Africa using firm level tax returns. World Institute for Development Economics Research Working Paper No 2016/128. Helsinki, Finland. The United Nations University World Institute for Development Economics Research (UNU-WIDER).

Ryan B, Scapens RW & Theobold M. 2002. Research Method and Methodology in Finance and Accounting. 2nd ed. Padstow, UK. Academic Press Ltd.

SAICA. 2019. SAICA comments on the Draft Taxation Laws Amendment Bill and Tax Administration Laws Amendment Bill of 2019, 23 August 2019. (Unpublished).

SAIT. 2019. Draft Taxation Laws Amendment Bill, 2019 (draft TLAB), 23 August 2019. (Unpublished).

Schreiner, OD. 1967. The Contribution of English Law to South African Law and the Rule of Law in South Africa. 1st ed. Cape Town, South Africa. Juta & Company Limited.

South Africa. 1910. Zandberg v Van Zyl 1910 AD 302 (AD).

South Africa. 1962. Income Tax Act 58 of 1962.

South Africa. 1996. Erf 3183/1 Ladysmith (Pty) Ltd and Another v Commissioner for Inland Revenue (527/94) [1996] ZASCA 35; 1996 (3) SA 942 (SCA).

South Africa. 1997. Income Tax Act 28 of 1997.

South Africa. 2011. Commissioner, SARS v NWK Ltd 2011 (2) SA 67 (SCA).

South Africa. 2011. Taxation Laws Amendment Act 24 of 2011.

South Africa. 2014. CSARS v Bosch [2014] ZASCZ 171.

South Africa. 2014. Roshcon (Pty) Ltd v Anchor Auto Body Builders CC and others [2014] 2 All SA 654 (SCA).

South Africa. 2015. Taxation Laws Amendment Act 25 of 2015.

South Africa. 2017. Taxation Laws Amendment Act 17 of 2017.

South Africa. 2018. Sasol Oil v CSARS (923/2017) [2018] ZASCA 153.

South Africa. 2019. Taxation Laws Amendment Act 34 of 2019.

South Africa. 2019. Taxation Laws Amendment Bill (2019).

South Africa. Davis Tax Committee. 2016. Second and final report on Base Erosion and Profit Shifting, Annexure 3: Addressing Base Erosion and Profit Shifting in South Africa.

South Africa. National Treasury. 2002. National Treasury's detailed explanation to section 9D of the Income Tax Act.

South Africa. National Treasury. 2011. Explanatory Memorandum on the Draft Taxation Laws Amendment Bill 2011.

South Africa. National Treasury. 2015. Explanatory Memorandum on the Draft Taxation Laws Amendment Bill 2015.

South Africa. National Treasury. 2017. Explanatory Memorandum on the Draft Taxation Laws Amendment Bill 2017.

South Africa. National Treasury. 2019a. Explanatory Memorandum on the Draft Taxation Laws Amendment Bill 2019.

South Africa. National Treasury. 2019b. Budget Review 2019.

South Africa. National Treasury. 2020a. Draft Explanatory Memorandum on the Draft Taxation Laws Amendment Bill 2020.

South Africa. National Treasury. 2020b. Final Response Document on Draft Rates and Monetary Amounts and Amendment of Revenue Laws Bill, 2019, Draft Income Tax Amendment Bill, 2019, Draft Taxation Laws Amendment Bill, 2019 and Draft Tax Administration Laws Amendment Bill, 2019.

Stichting Onderzoek Multinationale Ondernemingen (SOMO). 2007. The global problem of tax havens: The case of the Netherlands. Tax Briefing Paper. https://www.somo.nl/wp-content/uploads/2007/01/The-Case-of-the-Netherlands.pdf Date of access: 6 August 2020.

The Netherlands. 1969. Corporate Income Tax Act, 1969.

Tuli, F. 2010. The Basis of Distinction Between Qualitative and Quantitative Research in Social Science: Reflection on Ontological, Epistemological and Methodological Perspectives. *Ethiopian Journal of Education and Sciences* 6(1).

Van der Jagt, R, Audrain, M, Enach, R & Eggert, J. 2019. CFC Rules under ATAD. KPMG. https://tax.kpmg.us/articles/2019/beps-cfc-rules-under-atad.html Date of access: 6 August 2020.

Wagner, TZ. 2019. Detrimental effects of tax havens and the case of the Dutch tax system. Pro Futuro 2019/3. https://ojs.lib.unideb.hu/profuturo/article/download/5766/5409 Date of access: 6 August 2020.

Wahyuni, D. 2012. The Research Design Maze: Understanding Paradigms, Cases, Methods and Methodologies. *Journal of Applied Management Accounting Research* 10(1).