The Challenges that E-commerce Poses to International Tax Laws: ‘Controlled Foreign Company Legislation’ from a South African Perspective (Part 1)

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1 Introduction

Faced with high rates of tax in their countries of residence, taxpayers involved in international trade are increasingly developing global tax avoidance strategies,1 in order to maximise profits. For most businesses, the possibility of reducing tax costs by basing a business offshore in a low tax jurisdiction is an inherent aspect of international tax planning.2 Where a company is based in an offshore jurisdiction, it is not subject to domestic tax until its income is distributed to the shareholders as dividends.3

With the growing use of international intermediaries and the increase in tax-haven jurisdictions and preferential tax regimes,4 a number of countries have been prompted to enact specific anti-tax avoidance legislation to reduce the risk of losing domestic tax revenue from international investment. This legislation includes ‘controlled foreign company’ (CFC) legislation. Without this legislation, it would be easy for a resident taxpayer to defer domestic taxation on its foreign income by simply interposing a foreign company in a territory with a lower level of taxation to receive such income, instead of

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1 Tax avoidance refers to the use of legal methods of arranging one’s affairs so as to pay less tax. Tax avoidance involves utilising loopholes in tax laws and exploiting them within legal parameters. This is contrasted with tax evasion, which is illegal and usually involves the non-disclosure of income, the rendering of false returns, and the claiming of unwarranted deductions (see Organisation for Economic Co-operation and Development (OECD) International Tax Avoidance and Evasion: Four Related Studies Issues in international taxation, no 1 (1987) at 1; David Meyerowitz Meyerowitz on Income Tax (2007-2008) in par 29.1; Silke: South African Income Tax (2007) by Alwyn de Koker in par 19.1.
4 A tax haven can be described as a jurisdiction actively making itself available for the avoidance of tax that would have been paid in high-tax countries. A preferential tax regime is usually characterised by having no or low effective tax rates on income; the regimes are ring-fenced, and there is a general lack of transparency and effective exchange of information with other countries (see Organisation for Economic Co-operation and Development Harmful Tax Competition: An Emerging Global Issue (1998) in par 75; OECD International Tax Avoidance and Evasion op cit note 1 at 20).
remitting it to the home country. CFC legislation ensures that the undistributed income of a controlled foreign company is not deferred, but is taxed in the hands of its domestic shareholders on a current basis.

However, the effectiveness of CFC legislation in curbing the deferral of taxes faces challenges from the current developments of technology. This is especially so with e-commerce, which encourages taxpayers to access offshore facilities without the confines of geographical boundaries. CFC legislation was designed to work in the world before e-commerce when the jurisdiction to tax was based on where transactions or activities took place. This legislation may thus not be adequate to deal with new technological developments. E-commerce increases the opportunities for CFCs to be incorporated in low-tax or no-tax jurisdictions and it makes it difficult to assign a place of performance, a factor that is relevant with respect to CFC rules. This article analyses the working of South Africa’s CFC legislation and points out the challenges that this legislation faces in the e-commerce era. The responses of other countries to similar challenges in their CFC legislation are also discussed, and recommendations for the reform of the South African legislation are pointed out.

2 What Is E-Commerce?

‘E-commerce’ is a term used to describe the wide array of commercial activities carried out by electronic means that enable trade without the confines of geographical boundaries. This technology enables the transmission of voice, data, images and video information to take place in cyberspace (sometimes called the ‘information highway’) by the use of the Internet. The Internet can be described as a network of computers that allows people to communicate with other people from all over the world. It has also been described as ‘the world-wide network of networks that are connecting each

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6 Lynette Olivier & Michael Honiball International Tax: A South African Perspective 4 ed (2008) at 429; Arnold op cit note 2 at 131; Richard Jooste ‘The Imputation of Income of Controlled Foreign Entities’ (2001) 118 SALJ 473 at 474; see also Silke op cit note 1 in par 8.10.2; Arnold & McIntyre op cit note 3 at 91.
other into one single logical network all sharing a common addressing
scheme'.

The Internet is growing faster than all communication technologies that
preceded it. In the world today, there are very few businesses remaining,
mostly small and locally focussed, that have no Internet component. These
businesses are often referred to as ‘bricks and mortar businesses’. With the
Internet, another category of business, commonly referred to as ‘dot-coms’,
has become recognised. These are businesses that are involved in e-commerce
on the Internet and do not have a physical presence. The Internet provides
an environment in which automated functions can undertake significant
business with little or no physical activity. These functions can be moved
quickly and easily from one jurisdiction to another. E-commerce can ensure
fast, efficient and relatively cheap distribution of resources. The nearly
instantaneous transmission of information, the speed at which transactions are
concluded, and the increase in the bulk of transactions concluded can
courage even the smallest e-commerce enterprise owned by an individual to
sell not only in national but also in international markets.

The Internet has created a new route for the exchange of goods and
services, however, and the accessing of offshore facilities that has not been
fully regulated. Global computer-based communications cut across territo-
rial borders, creating a new realm of human activity and undermining the
feasibility and legitimacy of laws based on geographic boundaries. As the
Internet ignores international boundaries, ‘place’ has little meaning in the
networked world. It is thus feared that e-commerce may change the
distribution of taxable activities, alter the balance of taxing authority, and
result in the erosion of countries’ tax bases. In addition, the highly mobile
nature of e-commerce and the ability of residents to establish offshore
companies could lead to a tax-driven migration of businesses to low-tax

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10 J Benzin & B Gardand Accessing and Using the Internet (1995) at 26; see also Cindy Chen
‘United States and European Union Approaches to Internet Jurisdiction and their Impact on
11 Howard B Stravitz ‘Personal Jurisdiction in Cyberspace: Something More is Required on the
12 York & Chia op cit note 7 at 27.
13 Mark E Plotkin, Bert Wells & Kurt Wimmer (eds) E-Commerce Law and Business vol II (2003) in
International Fiscal Documentation 286; Annet Wanyana Oguttu ‘Transfer Pricing and Tax Avoidance:
14 Sher op cit note 8 at 172.
Sovereignty’ (2002) 11 Information & Communications Technology Law 241 at 244-5; Melvin op cit
note 9 at 52.
16 Doernberg & Hinnekens op cit note 7 at 341-3; York & Chia op cit note 7 at 255; Julian JB Hickey,
jurisdictions. The anonymous nature of e-commerce also brings new challenges to tax compliance. E-commerce creates difficulties in the identification and location of taxpayers, the identification and verification of taxable transactions and the ability to establish a link between taxpayers and their taxable transactions, thus creating opportunities for deferring and avoiding taxes.

As stated above, the development of e-commerce has opened up a new route of accessing offshore facilities that challenges current jurisdictional requirements that are based on geographical location. This is the case with the CFC legislation that is used to curb the deferral of taxes. In order to determine how e-commerce poses challenges to South Africa’s CFC legislation, it is necessary to explain the working of this legislation.

3 The Challenges that E-Commerce Poses to South Africa’s CFC Legislation

The CFC provisions are contained in s 9D of the Income Tax Act (the Act). In order to explain how e-commerce poses challenges to the working of the CFC provisions, it is important to consider the meanings of certain terms in this section. An understanding of these terms is relevant in order to determine whether CFC legislation applies in a given situation. The starting-point in this regard is to establish whether there is a foreign company. Then one has to determine whether the foreign company qualifies as a CFC. After that, the ‘net income’ of the CFC and the exclusions to the ‘net income’ of the CFC have to be considered. There are also exemptions to the CFC rules, certain elections and CFC disclosure requirements that have to be considered. The discussion below explains how e-commerce poses challenge to the above issues that are relevant to the application of South Africa’s CFC provisions.

3.1 ‘Foreign Company’

A ‘foreign company’ is defined in s 1 of the Act as any association, corporation, company, arrangement or scheme (as provided for in pars (a), (b), or (e) of the definition of ‘company’ in s 1) that is not resident in South Africa, or if it is resident, it is treated as a non-resident in terms of an applicable double taxation treaty entered into by the Republic.
3.1.1 The Challenges that E-Commerce Poses in Determining the Geographical Location of the Foreign Company

The workings of CFC legislation are rooted in concepts of physical location or presence. In order to attribute the income of a CFC to South African residents, the starting-point is to determine whether a foreign company exists in a particular situation. Determining where a transaction is ‘sited’ and identifying key taxing points are both important to the administration of CFC legislation. These concepts, however, may be difficult to analogue to transactions occurring in cyberspace.22 Traditionally, proof of the existence and the location of a foreign company can be verified from the documents that relate to its incorporation in the foreign country.

Although the growth of electronic commerce may not pose major problems with regard to which companies are classified as CFCs,23 e-commerce may make it difficult to prove the existence and location of a foreign company. Unlike traditional companies, often referred to as ‘bricks and mortar businesses’ in that they are located at a certain location, businesses that are involved in e-commerce on the Internet lack a physical presence.24 With e-commerce, significant business activities can be undertaken with little or no physical activity,25 and electronic functions can be moved quickly and easily from one jurisdiction to another without detection.26 An Internet address (a domain name) does not necessarily prove that a given businesses is located in a certain jurisdiction.27 Although the domain name initially assigned to a given computer may be associated with an Internet address that corresponds to that machine’s physical location (eg, a ‘.za’ domain name), the machine may be physically moved without affecting its domain name. The owner of a domain name may also have it associated with an entirely different computer, in a different location. A server with a ‘.za’ domain name need not be located in South Africa; and a server with a ‘.com’ domain name may be anywhere.28 Since electronic addresses do not necessarily signify a geographical connection, this makes it difficult to localise a business transaction in any single country.29 This implies that many e-commerce enterprises can avoid the CFC rules if they take care not to create any taxable presence in any country.

22 Melvin op cit note 9 at 52.
23 Doernberg, Hellerstein & Li op cit note 7 at 331.
24 Pappas op cit note 12 at 326-7; Melvin op cit note 9 at 13.
25 York & Chia op cit note 7 at 27.
29 Schulze op cit note 28 at 33.
The portability of e-commerce may also result in the setting up of more CFC arrangements that circumvent the legislation. 30

Even where it may be possible to ascertain that a foreign company exists, for the CFC legislation to apply to a foreign company it must qualify as a ‘controlled foreign company’ in terms of s 9D of the Income Tax Act.

3.2 A ‘Controlled Foreign Company’

In terms of s 9D (1) of the Act, CFC rules will apply to a foreign company if it is classified as a ‘controlled foreign company’ (CFC). Section 9D defines a CFC as a foreign company in which one or more South African residents, directly or indirectly, hold more than 50 per cent of the total participation rights31 of the company, or more than 50 per cent of the voting rights32 of that foreign company are held (or exercisable) directly or indirectly by one or more residents.

3.2.1 Challenges that E-Commerce Poses In Determining a Shareholder’s Control Or Interest in the Foreign Company

In traditional commerce, determining the percentage of participation rights or voting rights may not be very difficult, because a paper trail of the necessary records can be consulted and these are normally reliable and cannot easily be altered without detection. Sometimes, however, relevant information may not be easily accessible or it may be difficult to interpret. And some of the information may not be easily obtainable because of confidentiality concerns or geographical reasons, or it may simply not exist.33 In the e-commerce era, these matters are complicated further by the fact that there is usually no paper trail of e-commerce transactions. Moreover, the information available may not be as reliable, since it can easily be altered without leaving a trace if the object is tax avoidance. For instance, taxpayers could alter information regarding participation or voting rights in a CFC and their percentage holding in a CFC, to avoid being caught by the CFC rules.34

The reference to ‘indirect’ participation rights or voting rights in a foreign company is another aspect that can be manipulated in e-commerce to avoid

30 Doernberg, Hellerstein & Li op cit note 7 at 331.
31 The term ‘participation rights’ as used in s 9D of the Act refers to the right to participate in the share capital, share premium, current or accumulated profits or reserves of the foreign company. It is not only shares that represent equity share capital that fall within the definition of ‘participation rights’ but also other forms of shares such as non-participating preference shares. The interests of both registered and beneficial shareholders have to be taken into account. See Olivier and Honiball op cit note 6 at 435.
32 In terms of SARS ‘Responses to Written Representations by Organisations to the Portfolio Committee on Finance on the Draft Revenue Laws Amendment Bill, 2005’, the attribution of net income of a CFC using ‘voting rights’ is applied where no person has any participation rights to the CFC’s capital, profits or other reserves. Voting rights are therefore applied only as a backup to attribute practical control and not legal control. Consideration is given not only to the direct voting rights but also to indirect voting rights.
34 Olivier & Honiball op cit note 6 at 435-6.
CFC legislation. At present, there is no clarity concerning the ambit of indirect participation rights. For example, it is not clear whether a creditor who holds debentures or a mortgage over the CFC’s property could be considered to have participation rights. The National Treasury holds the view that interests such as convertible debentures and options (such as a right to obtain shares) do not qualify as participation rights. The reason given is that such instruments do not qualify as participation rights until they are converted into shares.\(^3\) However, the use of the word ‘indirect’ in the definition of participation rights seems to mean that it is not limited to interests such as shares but also applies to indirect interests in the profits or reserves of a foreign company. A similar argument could be raised in relation to the unsecured creditors of a company. Although an unsecured creditor cannot be said to have a direct right to participate in the profits or reserves of the company, he does have an indirect right to do so.\(^3\) Does this then imply that s 9D of the Act also applies to such unsecured creditors? Parliament needs to deal with this issue and make it clear that the word ‘indirectly’ refers to holding through another company and not to conditional holdings. As e-commerce is anonymous, taxpayers could manipulate the lack of clarity in this aspect of the legislation to avoid the CFC rules. This is worsened by the fact that s 82 of the Act places the onus of proof on the South African shareholder to prove such indirect involvement.

3.3 Exclusions to the CFC Rules

Subclause (c) of the definition of a CFC in the Act sets out certain situations in which a person is deemed not to be a resident for the purposes of determining whether a resident ‘directly or indirectly’ holds more than 50 per cent of the participation rights or voting rights in a foreign company. The definition of a CFC excludes residents who are connected persons, who in aggregate hold more than 50 per cent of the participation rights or voting rights in a foreign listed company\(^3\) or a foreign collective investment scheme or arrangement, but individually hold less than 5 per cent of the participation rights or voting rights in the listed company or a foreign collective investment scheme or arrangement (or a so-called equity unit trust as contemplated in par (e)(ii) of the definition of ‘company’ in s 1 of the Act).

The purpose of this exclusion is to lessen the administrative burden on tax authorities, for it is often difficult to determine the identity of those who own shares in large-scale entities where the interest is less than 5 per cent.\(^3\) Also in terms of s 72 of the Act, which requires strict reporting of the participation

\(^3\) National Treasury’s Detailed Explanation to s 9D of the Income Tax Act (June 2002); see also Jooste op cit note 6 at 476.
\(^3\) Olivier & Honiball op cit note 6 at 436.
\(^3\) A listed company is defined in par (e)(ii) of the definition of ‘company’ in the Act.
\(^3\) Ibid.
rights or voting rights of South African residents in a CFC, it is not easy to obtain information in respect of a shareholding of less than 5 per cent. 39

3.3.1 Challenges to the Exclusions to the CFC Rules

E-commerce makes it much more difficult to determine the identity of those who own shares in large-scale entities where the interest is less than 5 per cent, thus making it possible to manipulate the exclusion to the CFC rules in order to avoid them.

E-commerce also makes it difficult to determine whether the residents for the purposes of this exclusion are connected persons. Section 1 of the Act defines the term ‘connected person’ in relation to a company to include its holding company, its subsidiary and any other company where both such companies are subsidiaries of the same holding company. Determining whether residents are connected to each other may not pose major challenges in traditional trade. In e-commerce, however, if a CFC is resident in a tax-haven jurisdiction where banks have strict secrecy provisions, it may be difficult to determine whether a resident has a connection to a particular CFC. 40 This may be manipulated to take advantage of the CFC rules. Currently, it is not easy to link activities on the Internet to the parties associated with such activities. Indeed, as one of the benefits of trading electronically is the ability to reach global markets, traders are seldom interested in their customer’s physical location. Determining or verifying a party’s identity online is an arduous task, especially if the parties wish to conceal certain information. 41 An Internet address only indicates who is responsible for maintaining that address; it provides no links to the computer, its user who is corresponding on that address, or even to the place where the computer is located. 42 Internet users often have no control over, and no interest in, the specific paths that their data travels in reaching other computers connected to the Internet, or in the physical location of the computer or computers from which they retrieve information. 43 Although users may connect to the Internet through telephone lines, they also may do so using cable systems and wireless forms of communication. Moreover, connecting computers to, or disconnecting them from, the Internet are tasks that are easily accomplished, as is moving a website from a server in one physical location to a server in another, without any appreciable effect on online service. 44 As e-commerce is anonymous, it may be difficult for tax administrators to prove that certain parties to an e-commerce transaction are

39 Ibid.
40 Doernberg & Hinnekens op cit note 7 at 388-9; see also Reinhardt Buys (ed) Cyberlaw@SA: The Law of the Internet in South Africa (2006) at 246.
41 Melvin op cit note 9 at 53.
42 Hardesty op cit note 27 at 1-8; Ware & Roper op cit note 27 at 71.
43 Melvin op cit note 9 at 52.
44 Ibid.
connected persons. In this way, e-commerce can be used to take advantage of the exclusion to avoid the CFC rules.

3.4 ‘Country of Residence’

In relation to a CFC the ‘country of residence’ means the country where the company has its place of effective management.\(^{45}\)

The concept ‘place of effective management’ is used in s 1 of the Act\(^{46}\) as one of the tests for determining the residence of an entity,\(^{47}\) but the Act does not define the concept. However, this concept is also applied by the Organisation for Economic Cooperation and Development (OECD) Model Convention on Income and on Capital (‘the OECD Model Tax Convention’)\(^{48}\) as a tie-breaker test for dual resident entities.\(^{49}\) Under art 4(3) of the OECD Model Tax Convention, where a person other than an individual is a resident of both contracting states, it shall be deemed to be a resident (only) of the state in which its place of effective management is situated. Paragraph 24 of the Commentary on art 4(3) of the OECD Model Tax Convention states that

‘The place of effective management is the place where the key management and commercial decisions that are necessary for the conduct of the entity’s business are in substance made. The place of effective management will ordinarily be the place where the most senior person or group of persons (for example, a board of directors) makes its decisions, the place where the actions to be taken by the entity as a whole are determined.

Although South Africa is not a member of the OECD,\(^{50}\) the OECD’s interpretation of the term is relevant to South Africa since most of South Africa’s treaties follow the OECD Model Tax Convention to a large extent.\(^{51}\) Thus South African courts have to refer to the Commentary to the OECD Model Tax Convention in interpreting terms used in the Convention.

It is also worth noting that although the Income Tax Act in South Africa does not provide a meaning of the concept of ‘place of effective management’, the South African Revenue Service (SARS) provides some clarity on the meaning of the term. In this regard, SARS regards ‘effective management’ as the ‘regular, day-to-day management by directors or senior managers of the entity through implementation of the policy and strategic decisions of its board of directors’.\(^{52}\) If management functions are not

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\(^{45}\) This definition was inserted in the Act by the Revenue Laws Amendment Act 20 of 2006. For the meaning of the term ‘place of effective management’, see SARS’s Income Tax Interpretation Note 6 of 26 March 2002.

\(^{46}\) Act 58 of 1962.

\(^{47}\) The definition of ‘resident’ in s 1 of the Income Tax Act 62 of 1958.


\(^{49}\) When the two states treat the same person as ‘a resident’ for tax purposes under their domestic law, that person is said to be ‘dual resident’ and is thus liable for tax in both states. A company is, for instance, considered dual resident if it is incorporated in one state and yet it has a ‘place of effective management’ in another. If the two states have entered into a double taxation treaty, double taxation can be alleviated by making use of the treaty tie-breaker rules (see art 4(1) of the OECD Model Tax Convention).

\(^{50}\) Keith Huxham & Phillip Haupt *Notes on South African Income Tax* (2008) in par 16.9.4 at 357; Olivier & Honiball op cit note 6 at 8.

\(^{51}\) Huxham & Haupt op cit note 50 in par 16.9.4 at 355.

\(^{52}\) SARS’s Interpretation Note 6 op cit note 45 in par 3.2.
exercised in one place, because of global management by way of distance communication networks (such as telephones, the Internet or by means of videoconferencing\textsuperscript{53}), then the place of effective management will best be reflected 'where the day-to-day operational management and commercial decisions taken by the senior managers are actually implemented'.\textsuperscript{54} In other words, that is the place where business operations are actually carried out. It should be acknowledged, however, that SARS’s interpretation of the concept may limit the possibility of multiple company residences, because the actual implementation of the day-to-day operational management and commercial decisions taken by the senior managers is less likely to occur in more than one location.\textsuperscript{55}

In this respect, it could be argued that this interpretation keeps pace with the discernible changes in management structures, reporting lines and responsibilities as a result of global multinational and electronic business environment.\textsuperscript{56} It is trite, though, that SARS Interpretation Notes are not law, and, in a number of cases,\textsuperscript{57} it has been argued that SARS is not bound by its own Practice Notes and Interpretation Notes. This implies that South Africa’s courts are not bound to follow SARS Interpretation Notes. The term ‘place of effective management’ is a treaty term; so in interpreting its meaning, courts are bound by s 231 of the Constitution\textsuperscript{58} to follow an interpretation that is in line with customary international law. This includes following the interpretation of the term as set out in the OECD Model Tax Convention.\textsuperscript{59} In \textit{Secretary for Inland Revenue v Downing},\textsuperscript{60} the Court held that South Africa is required to take cognisance of the guidelines for interpretation issued by the OECD in its commentaries on the concepts used in the OECD Model Tax Convention.

\subsection*{3.4.1 Challenges that E-Commerce Poses In Determining the ‘Place of Effective Management’}

The effectiveness of the OECD’s interpretation of the concept of ‘place of effective management’ faces challenges when trade is conducted electronically. In the past, the most senior managers of a company tended to operate from and meet in a single location such as the head office of an enterprise, and so the determination of the place where the key management and commercial decisions were made was not too difficult. The place where the top-level

\begin{footnotesize}
\textsuperscript{53} Doernberg & Hinnekens op cit note 7 at 198; Buys op cit note 40 at 17 defines ‘video conferencing’ as ‘a live connection of two or more people using a combination of video, audio and data to communicate’.
\textsuperscript{54} SARS Interpretation Note 6 op cit note 45 in par 3.3.
\textsuperscript{55} Ibid.
\textsuperscript{57} ITC 1675, 62 SATC 219, 2000 (6) JTLR 219.
\textsuperscript{58} The Constitution of the Republic of South Africa, 1996.
\textsuperscript{59} Olivier & Honiball op cit note 6 at 32–3.
\textsuperscript{60} 37 SATC 249; 1975 (4) SA 518 (A).
\end{footnotesize}
management activities occurred would normally coincide with the place where the company was incorporated and had its registered office, or where the business activities were conducted and where the directors or senior managers resided. 61 And, as par 21 of the Commentary on art 4 of the OECD Model Tax Convention provides, it was rare in practice for a company to be subject to tax as a resident in more than one state. However, global telecommunications and technological advancements are fundamentally changing the way in which people run their business, especially when trade is conducted electronically (by e-commerce).

With the increased global mobility of resources, functions can easily be decentralised. This change can significantly affect the taxation of dual resident companies, and the application of the concept of ‘place of effective management’ as a tie-breaker rule. 62 This is because global computer-based communications cut across territorial borders, creating a new realm of human activity and undermining the feasibility and legitimacy of laws based on geographic boundaries. ‘Place’ has little meaning in the networked world. 63 E-commerce makes it easy to manipulate the principle of ‘place of effective management’, since it is governed by national sovereignty, having been developed in the days of ‘bricks and mortar’ businesses where physical presence in a jurisdiction was necessary to enforce tax laws. 64 The Internet, on the other hand, provides the information and opportunities necessary to make residence a matter of deliberate choice rather than fate. 65 Buys and Cronjé 66 note that e-commerce potentially affects residence tests under domestic laws and under double tax treaties (such as the place of effective management) to the extent that reliance is placed on the location of management functions to determine a taxpayer’s residence. 67 The Confédération Fiscale Européenne 68 noted that

‘[t]he appropriate application of the present tie-breaker test in the Model is affected by two factors. Firstly, there has been a change in the modus operandi of the Boards of multinationals. Increasingly, the concept of a Board of Directors of a company, coming together to sit, generally in a particular place, but sometimes in different places, to make key decisions, is becoming less usual than in the past. The reasons for this . . . lie in the fact that modern telecommunications facilities have made such physical occasions much less essential. . . . Secondly, there has been a change in the modus operandi of the business of many

63 Johnson & Post op cit note 61 at 33-4.
64 York & Chia op cit note 7 at 255; Westin op cit note 7 at 2; The Green Paper on E-Commerce op cit note 27 at 22.
66 Buys & Cronjé op cit note 18 at 300.
67 Ibid; Hickey, Mathew & Rose op cit note 17 at 257; York & Chia op cit note 7 at 259.
multinationals. Increasingly companies are run with a focus on the divisions through which they operate rather than the legal entities in which the components of those divisions are found.

With global communications technology such as videoconferencing or electronic discussion group applications via the Internet, it is no longer necessary for a group of persons to meet physically in one place to hold discussions. If the senior managers adopt conferencing through the Internet as a key medium for making management and commercial decisions, and those managers are located in various countries, it may be difficult to determine a single place of effective management. This scenario may become more prevalent as more companies list on multiple stock exchanges.

The rapid telecommunications development may also increase the mobility of effective management. This situation could occur where the managing director of a company is constantly on the move. In extreme situations, that person may consistently be making company decisions while flying over the ocean or while visiting various sites in different jurisdictions where the company’s business is conducted. Similarly, a board of directors may arrange to meet in different places throughout the year. For example, the board of a multinational enterprise may agree to meet at the offices of the enterprise around the globe on a rotational basis. Because of such mobility, it may be difficult to determine a single place of the effective management of a company. Effective management based on where the directors meet becomes a matter of choice and manipulation as technology makes it difficult to pin effective management down to one constant location, and double or multiple residences or even non-residence may be the result.

The OECD has also recognised the limitations in its interpretation of the concept of ‘place of effective management’. In 2003, it developed two alternative proposals to change the meaning of the concept. The first one is the refinement of the concept by expanding the OECD’s Commentary explanations on it. This proposal centres on the place where key management and commercial decisions are taken by the entity as a whole. This proposal reiterates the current OECD interpretation of the concept. The second proposal puts forward an alternative definition of ‘place of effective management’ by using a hierarchy of tests. The proposal includes three

70 OECD 2001 Discussion Paper op cit note 61 in par 40.
71 Idem in pars 43-4.
72 Ibid.
75 Ibid in par 7.
76 Van der Merwe (2006) op cit note 56.
77 These are the place where economic relations are closer, the place where business activities are primarily carried on, or the place where senior executive decisions are primarily taken. If the above
different options for a possible second tie-breaker test. The Confédération Fiscale Européenne commented that the introduction of a hierarchy of tests along the lines already adopted for individual residence is preferred as a more complete answer to the issue. It is worth noting that, when I wrote this article, none of these proposals had been approved.

3.5 ‘Net Income’

In terms of s 9D(2) of the Act, when it has been established that a CFC exists, the net income of the CFC is attributed to the South African residents. ‘Net income’ is defined in s 9D(2) in relation to a CFC to mean an amount equal to the taxable income of the company determined in accordance with the provisions of the Act as if the company had been a South African resident taxpayer. The net income of the CFC is calculated at the end of the foreign tax year of the country in which the CFC is resident and it is included in the resident’s income at the end of the South African year of assessment. In calculating the net income of the CFC, the CFC is dealt with as if it is a South African resident (s 9D(2A)), subject to certain limitations.

3.5.1 Challenges that E-Commerce Poses In Determining the Net Income of a CFC

In calculating the net income of a CFC, companies have to keep two sets of books: one for the country in which the CFC is a resident and one for South African tax purposes. A full audit of each company is thus required, and a form will have to be completed and submitted to SARS for each CFC. Complying with these audit requirements is burdensome in traditional commerce, and quite a costly exercise from an administrative point of view. In traditional commerce, as I have explained, reliable paper audit trails can be consulted to determine a company’s net income. In e-commerce, by contrast, determining the net income of a company may be difficult, because there is usually no paper trail of e-commerce transactions. Electronic records can
easily be altered without trace, or may be encrypted in order not to reveal transaction information if the object is tax avoidance.

3.6 Exchange Rate

Section 9D(6) of the Act provides that the amount to be included in the income of a resident must be translated to the currency of the Republic. The net income of a CFC must be determined in the currency used by it for the purposes of its financial reporting, and must, for the purposes of determining the amount to be included in the income of any resident during any year of assessment under s 9D, be translated to the currency of the Republic by applying the average exchange rate for that year of assessment as contemplated in s 25D of the Act.

3.6.1 Challenges that E-Commerce Poses In Determining the Correct Exchange Rate

E-commerce makes it difficult to determine the amount that has to be translated to the currency of the Republic. This matter is complicated by the anonymous nature of electronic transactions and the electronic money or digital cash that is used to effect payment. A consumer can download electronic money from an online bank, and use those tokens to carry out various transactions leaving no paper or electronic trace as to the date and value of the transaction. The anonymous nature of electronic money may thus make it to difficult to apply the CFC exchange rate requirements.

3.7 The Exemptions to the CFC Provisions

In certain instances, the net income of a CFC is exempted from the ambit of s 9D of the Act and will not be attributed to the residents who hold voting rights or participation rights in the entity concerned. There are various exemptions to the CFC rules:

- The ‘foreign business establishment exemption’;
- The insurance policy exemption;

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83 Proviso (a) to s 25D states that any capital gain or loss of that CFC must, when applying the provisions of par 43(4) of the Eighth Schedule, be determined in the currency of the Republic and that that capital gain or loss must be translated to the currency used by it for the purposes of its financial reporting by applying the average exchange rate. Proviso (b) to this provision states that any amount to be taken into account in determining the net income of that CFC for the disposal of any foreign equity instrument must, when applying the provisions of s 9G, be determined in the currency of the Republic and that that amount must be translated to the currency so used by it by applying the average exchange rate. See Silke op cit note 1 in par 5.48 at 5-64.

84 Hardesty op cit note 27 in pars 10.01-10.4. Buys op cit note 40 at 301 notes that electronic money constitutes an electronic mechanism for the transfer of funds without the use of a deposit-taking institution (such as a bank) or a third party; the process is characterised by the transfer of value itself.

85 Buys op cit note 40 at 300 notes that electronic coins are in the form of digitally signed numbers that are used in exchange for money from the user’s bank account.

86 Idem at 247, 297.

87 In terms of s 9D(9)(c), the CFC provision will not apply to income which is attributed in respect of any policy issued by a company licensed to issue any long-term policy as defined in the Long-term Insurance Act 52 of 1998.
• The exemption of South African taxable income;\textsuperscript{88}
• The exemption of foreign dividends;\textsuperscript{89}
• The exemption of income from interest, ‘royalties’, rentals and similar amounts;\textsuperscript{90}
• The capital gains exemption.\textsuperscript{91}

Of these exemptions, the one that faces the most challenges in the e-commerce era is the first: ‘foreign business establishment’. The operation of this exemption and the way in which it is affected by e-commerce are discussed below.

3.7.1 The ‘Foreign Business Establishment’ Exemption

The CFC rules do not apply when the net income of a CFC is attributable to a ‘foreign business establishment’ (including the disposal of any assets forming part of that business establishment) of a company in a country other than the Republic.\textsuperscript{92} This exemption is intended to accommodate income derived from legitimate business activities, in contrast with income that is derived from illusory business undertakings.\textsuperscript{93} In terms of s 9D(1) of the Act, a ‘foreign business establishment’ in relation to a controlled foreign company, refers (among other things) to:

- A place of business with an office, shop, factory, warehouse or other structure which is used or will continue to be used by that controlled foreign company for a period of not less than one year, whereby the business of such company is carried on, and where that place of business
- (i) is suitably staffed with on-site managerial and operational employees of that controlled foreign company and which management and employees are required to render services

\textsuperscript{88} In terms of s 9D(9)(e) of the Act, CFC rules do not apply to the net income of a CFC to the extent that it is included in the taxable income of a company in the Republic and has not or will not be exempt or taxed at a reduced rate in the Republic as a result of the application of any double taxation agreements. This provision is intended to prevent double taxation. See Silke op cit note 1 in par 5.47 at 5-60; Huxham & Haupt op cit note 50 at 311; Olivier & Honiball op cit note 6 at 460.

\textsuperscript{89} In terms of s 9D(9)(f), CFC rules do not apply to the extent that the net income of a CFC is attributed to any foreign dividend declared or deemed to have been declared to it by any other company from an amount which relates to an amount of income that has been or will be included in the income of a resident in terms of s 9D. The rationale for exempting dividends declared by a company to a CFC is that the profits out of which the dividend is declared were already attributed to the South African resident or qualify for exemption under s 9D(9). The aim of this exemption is to avoid double taxation. See Silke op cit note 1 in par 5.47 at 5-61; Huxham & Haupt op cit note 50 at 311; Olivier & Honiball op cit note 6 at 461.

\textsuperscript{90} In terms of s 9D(9)(fA) of the Act, CFC rules do not apply in relation to the net income of a CFC to the extent that it is attributed to interest, royalties, rental or income of a similar nature that is paid or payable or deemed to be paid or payable to it by another foreign company. The reason for this exemption is that such amounts are not allowed as a deduction in terms of s 9D(2A)(c), and will not be attributed to the South African resident, provided that both CFCs belong to the same group of companies. See Silke op cit note 1 in par 5.47 at 5-62; Huxham & Haupt op cit note 50 at 311; Olivier & Honiball op cit note 6 at 461.

\textsuperscript{91} In terms of s 9D(9)(fB), the provisions of s 9D do not apply to the net income of a CFC that is attributable to any capital gain of the CFC that is determined for the disposal of any asset as defined in the Eighth Schedule (other than any financial instrument or intangible asset as defined in par 16 of the Eighth Schedule), when the asset was attributable to a foreign business establishment of it or any other foreign company that forms part of the same group of companies. See Silke op cit note 5 in par 5.47 at 5-63.

\textsuperscript{92} Section 9D(9)(b) of the Act. Previously, s 9D referred to a ‘business establishment’, but this term was deleted from the Act and replaced by the term ‘foreign business establishment’ by the Revenue Laws Amendment Act 20 of 2006.

\textsuperscript{93} Olivier & Honiball op cit note 6 at 447.
on a full time basis for the purposes of conducting the primary operations of that
business;
(ii) is suitably equipped and has proper facilities for such purposes; and
(iii) is located in any country other than the Republic and is used for bona fide business
purposes (other than the avoidance, postponement or reduction of any liability for
payment of any tax, duty or levy imposed by this Act or by any other Act administered by
the Commissioner).

It appears from s 9D(1) that, for a place of business to qualify as a ‘foreign
business establishment’, there must be an ‘economic substance’ and ‘a
business purpose’. For there to be an ‘economic substance’, the foreign
business must exist not merely on paper but in substance. There must be a
presence of persons who make the day-to-day management decisions of the
foreign business. The requirement of a ‘business purpose’ ensures that there
must be permanence and economic substance. So the exemption will not be
granted if the business activities are not conducted for bona fide business
purposes, but to obtain a tax benefit.

There are certain exclusions to the ‘foreign business establishment’
exemption. Before these are dealt with, the challenges that e-commerce poses
to the meaning of the term ‘foreign business establishment’ are discussed
below.

3.7.1.1 Challenges that E-Commerce Poses In Determining the
Existence of a ‘Foreign Business Establishment’

It is worth noting that the definition of the term ‘foreign business
establishment’ is in line with the definition of the term ‘permanent
establishment’ in art 5 of the OECD Model. The requirement of ‘a place of
business’ that is fixed faces challenges when trade is conducted electronically.
With e-commerce, it is possible to conduct substantial business in a country
without having a fixed place of business in that country. The OECD has
recognised this shortcoming and composed a document clarifying its position
on the application of the definition of ‘permanent establishment’ to
e-commerce. The gist of the clarifications is set out below.

One of the reasons that e-commerce poses challenges to this exemption is
that the rules for establishing the existence of a foreign business establishment
are based on geographical location, whereas e-commerce takes place in

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94 Ibid.
95 Article 5 of the OECD Model Tax Convention defines a ‘permanent establishment’ as a fixed place
of business through which the business of an enterprise is wholly or partly carried on. It includes a place
of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry, or any
other place for the extraction of natural resources, but excludes the use of facilities for activities of a
preparatory or auxiliary character such as storage, display or delivery. A fixed place of business will
exist where any premise, facility, installation or space is used regularly by the enterprise for business
purposes. A permanent establishment will also be deemed to exist where a non-resident person
habitually transacts business in South Africa through an authorised dependent agent, in respect of any
income attributable to the dependent agent’s activities.
96 OECD Committee on Fiscal Affairs ‘Clarification on the Application of the Permanent
Establishment Definition in E-commerce: Changes to the Commentary on the Model Tax Convention on
accessed 6 June 2008).
cyberspace.\textsuperscript{97} Take the following example: a CFC sells software through a website hosted on a server located in a tax-haven jurisdiction. The parent company that created the CFC is resident in South Africa. Customers can purchase the software by accessing the CFC’s website and downloading the software on their own computers. Setting up a server in a tax-haven jurisdiction where customers can download the parent company’s software may be much easier than incorporating a more traditional business establishment in the tax haven.\textsuperscript{98} The question that arises is whether the website or the server located in the tax-haven jurisdiction qualifies as a ‘foreign business establishment’\textsuperscript{99} for it to be exempted from the CFC rules.

An Internet website comprises the software and electronic data that are stored on a server. The website is what appears on computer screens and allows an enterprise to interact with its customers. However, a website is not like a ‘bricks and mortar office’, and so it has been referred to as a ‘virtual office’.\textsuperscript{100} Through the website, an enterprise can have direct access to any customer who has access to the Internet. By logging onto the website, customers can select products for purchase from an online catalogue and buy them by filling out a form and charging the purchase on their personal credit cards.\textsuperscript{101} Since a website is a virtual office, it is intangible property. It is not physical and therefore it cannot be deemed to be a ‘foreign business establishment’ for the purposes of the CFC rules.\textsuperscript{102}

On the other hand, a server is a piece of automated equipment on which an Internet website is stored and through which the website can be accessed. Since a server is a piece of equipment, it can have a physical location.\textsuperscript{103} Often the website through which the enterprise carries on its business may be hosted on the server of an Internet Service Provider (ISP).\textsuperscript{104} This hosting arrangement usually takes the form of the provision of an amount of disk space for the website for the storage of its software and data.\textsuperscript{105} The issue then is whether the server creates a business establishment for an enterprise by

\textsuperscript{97} Schulze op cit note 28 at 33. See also Johnson & Post op cit note 16 at 1367, 1370-1; Cox op cit note 16 at 244-5.
\textsuperscript{99} Buys & Cronjé op cit note 18 at 313; York & Chia op cit note 7 at 262.
\textsuperscript{101} Arnold & McIntyre op cit note 3 at 153.
\textsuperscript{102} See OECD Committee on Fiscal Affairs ‘Clarification on the Application of the Permanent Establishment Definition in E-commerce: Changes to the Commentary on the Model Tax Convention on Article 5’ op cit note 96; Simmons & Simmons Communication Practice E-commerce Law: Doing Business Online (2001) at 165; Clive Gringras The Laws of the Internet 2 ed (2003) at 406; Plotkin, Wells & Wimmer op cit note 14 in par 15.06.
\textsuperscript{103} Oguttu & Van der Merwe op cit note 69 at 318.
\textsuperscript{104} OECD 2000 Report on the Application of the Permanent Establishment Definition in E-commerce op cit note 96 at 5. Schulze op cit note 28 at 31 notes that each Internet user must access the Internet by way of an Internet Service Provider (ISP), which itself is a network. The ISP connects to larger regional networks, which, in turn, connect to high capacity networks called ‘backbones’. This network of networks links computers and users worldwide. See also Chen op cit note 10 at 426-7; Plotkin, Wells & Wimmer op cit note 14 in par 15.06.
\textsuperscript{105} Oguttu & Van der Merwe op cit note 69 at 318; York & Chia op cit note 7 at 262.
virtue of the hosting arrangement. In other words, can the server be considered to be at the disposal of the enterprise?

When an enterprise conducts its business through a website hosted on a server, these hosting arrangements do not necessarily result in the server and its location being at the disposal of the enterprise. This is because the enterprise does not have a physical presence at the location of the server, since the website through which it operates is not tangible.\(^{106}\) However, if the enterprise carrying on business through a website does have the server at its own disposal – for instance, if it owns (or leases) and operates the server on which the website is stored and used – then the place where that server is located could constitute a permanent establishment of the enterprise. This possibility is, however, subject to three conditions. First, in order to constitute a permanent establishment, the server must be ‘fixed’ at some location for a sufficient period.\(^{107}\) Second, the meaning of the expression ‘permanent establishment’ still requires that the business of the enterprise should be carried on wholly or partly through the place where the server is located.\(^{108}\) Third, a server will be considered to be a permanent establishment of the enterprise only if the specific exclusions stated in art 5(4) of the OECD Model Tax Convention do not apply. In terms of this article, no permanent establishment may be considered to exist where the e-commerce activities carried on through a server in a given location are restricted to preparatory or auxiliary activities.\(^{109}\) However, where such functions in themselves are the core functions of the enterprise or they are an essential and significant part of its business activities, these functions would go beyond being preparatory or auxiliary activities, and so a permanent establishment would be deemed to exist. For example, some Internet Service Providers are in the business of operating their own servers for the purpose of hosting website or other applications for other enterprises.\(^{110}\)

From the above discussion, it can be concluded that a physical permanent establishment will be deemed to exist only when the enterprise carries on business through a website that has a server at its own disposal, in a fixed

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\(^{106}\) See par 42.2 of the 2005 Commentary on art 5 of the OECD Model Tax Convention. See also Buys & Cronjé op cit note 18 at 303; York & Chia op cit note 7 at 262; Oguttu & Van der Merwe op cit note 69 at 318; Plotkin, Wells & Wimmer op cit note 14 in par 15.06.

\(^{107}\) The fact that equipment might be moved around within a general location such as an office is not relevant, nor is it relevant that the equipment moved to some other location unless it is actually moved. See par 42.4 of the Commentary on art 5 of the OECD Model Tax Convention; Arnold & McIntyre op cit note 3 at 153.

\(^{108}\) However, the fact that the enterprise does not require personnel at the location for the operation of the equipment does not in itself mean there is no permanent establishment. See par 42.6 of the Commentary on art 5 of the OECD Model Tax Convention; Buys & Cronjé op cit note 18 at 303.

\(^{109}\) Such activities would include the providing of a communication link between supplier and customer, the advertising of goods or services (such as the display of a catalogue of certain products), the relaying of information through a mirror server for security and efficiency purposes, and the gathering of market dates for the enterprise and supplying such information. See OECD 2000 Report on the Application of the Permanent Establishment Definition in E-commerce op cit note 96 at 5; see also Arnold & McIntyre op cit note 3 at 155; Simmons & Simmons Communication Practice op cit note 102 at 165; York & Chia op cit note 7 at 263.

\(^{110}\) See pars 42.8-42.9 of the Commentary on art 5 of the OECD Model Tax Convention; see also Buys & Cronjé op cit note 18 at 303; Gringras op cit note 102 at 406.
location, and the business of the enterprise is not of a preparatory or auxiliary nature. Where that is the case, an e-commerce business could claim that it has a foreign business establishment, and if the exceptions to the ‘foreign business establishment’ exemption do not apply to that particular situation, that business could be exempted from the CFC provisions.

It is, however, worth noting that in terms of the ‘foreign business establishment’ exemption to the CFC rules, such an establishment must be run for bona fide business purposes. Where a server is maintained in a tax-haven jurisdiction, from which customers can download software or interactive customer service programmes, it may be difficult to determine whether these online activities are sufficient to meet the test of a bona fide ‘foreign business establishment’ and are not a mere tax-avoidance scheme designed to escape CFC rules.\textsuperscript{111}

3.7.2 The Exclusions to the ‘Foreign Business Establishment’ Exemption

As an anti-avoidance measure, this exemption does not apply to certain diversionary transactions between a CFC and a connected person.\textsuperscript{112}

3.7.2.1 The Diversionary Activities

In terms of s 9D(9)(b)(i), the ‘foreign business establishment’ exemption is not granted where the net income of a ‘foreign business establishment’ of a CFC is derived from transactions with its connected person (who is a resident) for the supply of goods or services by or to the CFC, which do not reflect an arm’s length price and transfer pricing is involved.\textsuperscript{113} Where this is the case, severe penalties may arise, and the Commissioner may adjust the price of goods in terms of transfer-pricing provisions under s 31 of the Income Tax Act to reflect an arm’s length price. An arm’s length price is a price set in the marketplace for transfer of goods and services between unrelated persons.


\textsuperscript{112} According to s 1 of the Act, the definition of ‘connected person’ in relation to a company (as amended by the Revenue Laws Amendment Act 20 of 2006) includes its holding company as defined in s 1 of the Companies Act 61 of 1973 and any other company that would be part of the same group of companies as that company.

\textsuperscript{113} The term ‘transfer pricing’ describes the process by which related entities set prices at which they transfer goods or services between each other (see the South African Revenue Service (‘SARS’) \textit{Practice Note No 7 Determination of Taxable Income of Certain Persons from International Taxation: Transfer Pricing (s 31 of the Income Tax Act No. 58 of 1962) (6 August 1999)} in par 2.1. Transfer pricing is also described as the systematic manipulation of prices in order to reduce profits or increase profits artificially or cause losses and avoid taxes in a specific country. A transfer price is a price set by a taxpayer when selling to, buying from, or sharing resources with a related or connected person. It is usually contrasted with a market price, which is the price set in the marketplace for transfer of goods and services between unrelated persons where each party strives to get the utmost possible benefit from the transaction. Transfer prices are usually not negotiated in a free, open market and so they may deviate from prices agreed upon by non-related trading partners in comparable transactions under the same circumstances. See Arnold & McIntyre op cit note 3 at 53; Victor H Miesel, Harlow H Higinbotham & Chun W Yi \textit{International Transfer Pricing: Practical Solutions for Intercompany Pricing – Part II} (2003) 29 \textit{International Tax Journal} 1; Ware & Roper op cit note 27 at 178; see also art 9 of the OECD Model Tax Convention.
where each party strives to get the utmost possible benefit from the transaction.114

3.7.2.1.1 Challenges that E-Commerce Poses In Determining An Arm’s Length Price

Apart from the challenges of determining whether the parties are connected persons as discussed above, e-commerce also makes it difficult to determine whether the price charged between the connected parties is an arm’s length price.115 Finding the prices set between connected parties that deal with each other is not as problematic in traditional commerce, because the parties concerned often keep paper records of the transactions in which they are involved. In e-commerce, by contrast, transactions are often anonymous, thus making it difficult to maintain complete and useful records of transactions.116 This makes it difficult to determine whether the prices charged in a given transaction are at arm’s length.117 Finding the price of goods or services is further complicated by electronic money,118 which can be used to make purchases without leaving a trace as to the date and value of the transaction.119 The anonymous nature of electronic money also makes it easy for CFCs and residents to engage instantaneously and secretly in diversionary activities that cannot be caught by the CFC provisions.120

The OECD has noted that in the era of e-commerce, it may be difficult for tax administrators to arrive at an arm’s length price without having a detailed examination of e-commerce at such an early stage of its development.121 Despite the challenges posed by e-commerce, the OECD member countries consider that the arm’s length principle is sound in theory, since it provides the closest approximation to the operations of the open market in cases where goods and services are transferred between associated enterprises.122 Even if it may not be straightforward to apply in practice, this principle generally

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114 See SARS Practice Note No 7 op cit note 113 in par 7.1. See also Diane Hay, Frances Horner, Jeffrey Owens ‘Past and Present Work in the OECD on Transfer Pricing and Selected Issues’ (1994) 10 InterTax 423; Miesel, Higinbotham & Yi op cit note 113; OECD Report on Transfer Pricing Guidelines op cit note 33 in par 12.

115 A non-arm’s length price is a price set by a taxpayer when selling to, buying from, or sharing resources with a related or connected person. It is usually contrasted with a market price, which is the price set in the marketplace for transfer of goods and services between unrelated persons where each party strives to get the utmost possible benefit from the transaction. See SARS Practice Note No 7 op cit note 113 in par 7.1; art 9 of the OECD Model Tax Convention.

116 Doernberg, Hellerstein & Li op cit note 7 at 390; Buys op cit note 40 at 248; Melvin op cit note 9 at 53.

117 Buys & Cronjé op cit note 18 at 306; Oguttu op cit note 14 at 154.

118 Hardesty op cit note 27 in pars 10.01-10.4; Hickey, Mathew & Rose op cit note 17 at 257. Buys op cit note 40 at 301 notes that electronic money constitutes an electronic mechanism for the transfer of funds without the use of a deposit-taking institution (such as a bank) or a third party, the process being characterised by the transfer of value as such.

119 Buys op cit note 40 at 300 notes that electronic coins are in the form of digitally signed numbers that are used in exchange for money from the user’s bank account.

120 Idem at 247 and 297; Oguttu op cit note 14 at 154.

121 Schwarz op cit note 14 at 287.

122 OECD ‘Transfer Pricing Guidelines’ op cit note 33 in pars 30-1. See also Hay, Horner & Owens op cit note 114 at 428.
produces appropriate results acceptable to tax administrators. A move away from this principle would destabilise international consensus and substantially increase the risk of double taxation. Many countries that apply this principle have now gathered experience that has produced a level of understanding among the business community and tax administrators. This shared understanding is of great practical value in achieving the objectives of securing the appropriate tax base in each jurisdiction.\textsuperscript{123} This experience should be drawn on to elaborate the arm’s length principle further, to refine its operations, and to improve it to cater for e-commerce transactions. The view of the OECD is that at this stage it is better to sit back and see what develops. Unfortunately, though, taxpayers cannot afford to do the same, since they are required to address these issues at a practical level in order to set appropriate terms for intra-group transactions so that they produce the appropriate documentation that stands up to the scrutiny of tax authorities.\textsuperscript{124}

3.7.2.2 The Reversionary Rules

Apart from the fact that the ‘foreign business exemption’ does not apply to diversionary transactions that do not reflect an arm’s length price, this exemption also covers the so-called reversionary rules with respect to certain transactions. These are transactions that are not subject to s 31 of the Act, but that are subject to the possibility of price manipulation. The ‘foreign business establishment’ exemption will be granted only if a higher business activity is present.\textsuperscript{125} This exemption is intended to ensure that income is exempt from the CFC rules only if the transaction has a non-tax economic nexus within the country in which the CFC is a resident.\textsuperscript{126} These transactions are covered by s 9D(9)(b)(ii)) of the Act.

Three situations need to be distinguished.

In terms of s 9D(9)(b)(ii)(aa), income that arises when a CFC sells goods to a connected South African resident (‘CFC in-bound sales’) does not qualify for the ‘foreign business establishment’ exemption unless the sale falls into one of the following four categories:

- local purchases from an unconnected person in the country where the CFC has its place of effective management;
- local production of goods that involve more than minor assembly or adjustment, packaging, repackaging, and labelling;
- sales of significant quantities of comparable goods to unconnected

\textsuperscript{123} OECD ‘Transfer Pricing Guidelines’ op cit note 33 in pars 30-1 at 325.
\textsuperscript{124} Schwartz op cit note 14 at 287.
\textsuperscript{125} Olivier & Honiball op cit note 6 at 450.
\textsuperscript{126} In terms of s 9D(10)(a) and (b), the Minister of Finance has a discretion to waive the higher business standard. By notice in the Gazette, the Minister may also exercise his discretion to treat a number of foreign countries as one, if the foreign countries comprise a single economic market, provided that this treatment will not lead to an unacceptable erosion of the tax base. He may also, in consultation with the Commissioner, grant exemption to any person from the application of this provision to the extent that this does not unreasonably prejudice national economic policies or South African international trade, and the exemption does not lead to an unacceptable erosion of the tax base.
persons, ie, where the goods sold to a connected South African resident are of the same, or similar nature, to goods sold to unconnected persons at comparable prices after taking into account whether the sales are wholesale or retail, volume discounts, and other geographical differences such as costs of delivery to different locations;

- the same or similar goods are purchased by the CFC mainly within the state in which the CFC has its place of effective management from persons who are not connected persons in relation to the CFC.\(^{127}\)

Second, in terms of s 9D(9)(b)(ii)(bb), income that arises when a CFC sells goods to foreign residents or unconnected South African residents, in circumstances where those goods were initially purchased from connected South African residents (‘CFC out-bound sale of goods’), does not qualify for the ‘foreign business establishment’ exemption unless the sale falls into one of the following four categories:

- the goods or tangible intermediary inputs purchased from its connected persons who are residents amount to an insignificant portion of the total tangible intermediary inputs of the goods (ie, insignificant South African purchases);
- the creation, extraction, production, assembly, repair or improvement of goods undertaken by the CFC amount to more than minor assembly or adjustment, packaging, re-packing and re-labelling (ie, local production) or;
- the products are sold by the CFC to persons who are not its connected persons for delivery within its country of residence (ie, local sales); or
- the products of the same or similar nature are sold by the CFC mainly to persons who are not its connected persons for delivery within its country of residence (ie, the CFC is selling its products mainly to local customers).\(^{128}\)

Third, in terms of s 9D(9)(b)(ii)(cc), income that arises when the CFC performs services for a connected South African resident (‘CFC connected services’) does not qualify for the ‘foreign business establishment’ exemption unless the service falls into the following two categories:

- the service relates to the creation, extraction, production, assembly, repair or improvement of goods used in countries outside the Republic; or
- the services relate directly to the sale or marketing of goods belonging to

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\(^{127}\) In general, it appears that the qualifying business activities are not artificial. The reason for granting an exemption to local purchases and the production of goods is that if the local country is in a position to produce goods, it probably has sufficiently good infrastructure. It is assumed that the CFC is situated in the foreign country not for tax reasons, but for non-tax business reasons. In situations where comparable sales are involved, it is assumed that transfer pricing does not occur because outside pricing is fully available. In addition, sales to unconnected persons by the CFC demonstrate viable business operations outside South Africa. See Olivier & Honiball op cit note 6 at 454.

\(^{128}\) As with the ‘CFC in-bound sales’ mentioned above, the reason for this exemption is that the business activities that give rise to the income are in all likelihood not artificial. Where insignificant amounts of intangible goods are purchased from connected South African residents, independent value is added. As a result, it is assumed that the business was established for non-tax purposes. See Olivier & Honiball op cit note 6 at 454.
its connected person who is a resident, and the goods are sold to persons
who are not its connected person in the country of residence of the
CFC.\textsuperscript{129}

\subsection*{3.7.2.3 Mobile Passive Income}

In terms of s 9D(9)(b)(iii), the ‘foreign business establishment’ exemption
will not apply to net income that is attributed to any amounts derived from
the mobile passive income of an enterprise. Mobile passive income includes
income such as dividends, interest, royalties, rental, annuities, insurance
premiums, capital gains and foreign currency gains under s 24I of the Act.
This income does not qualify for the exemption because no active business
activities are performed and no direct competitiveness concerns are at
stake.\textsuperscript{130} The provision will, however, not apply where the income and the
capital gain attributed to those amounts does not exceed 10 per cent of the
income and capital gain of the CFC attributed to that foreign business
establishment (other than income or capital gains to which any of the
provisions of s 9D(9)(e) to (fB) apply). This reason for this exception is that it
is most likely intended to alleviate the administrative burden of complying
with the CFC rules.\textsuperscript{131} This provision will also not apply when the amounts
arising from the principal trading activities of the CFC are banking or
financial services, insurance or rental businesses. The reason for this
exclusion is to ensure that these entities can compete competitively
internationally.\textsuperscript{132}

However, in terms of s 9D(9)(b)(iii), the passive receipts and accruals of a
CFC that conducts banking or financial services and any insurance or rental
business in a ‘foreign business establishment’ will be subject to s 9D if these
receipts and accruals are derived by a company that is a ‘foreign financial
instrument holding company’ (’FFIHC’) at the time that they were so derived.
In terms of s 41 of the Act, a FFIHC means any foreign company where more
than the prescribed proportion of all the assets of that company, together with
the assets of all influenced companies in relation to that company, consists of
financial instruments. This proviso acts as an anti-avoidance provision in that
the exclusion from the ‘foreign business establishment’ exemption of a

\textsuperscript{129} In terms of this exemption, it can be deduced that income derived from services of a general
nature, such as management fees, internal accounting fees, and fees to guarantee loans, never qualifies
for this exemption, because the possibility of manipulating prices is high and such services rendered by
a company outside South Africa will most likely have no business reason for their existence other than
to reduce tax liability. Where the services are not connected to South Africa, the possibility of price
manipulation is diminished. Although the goods are delivered within South Africa, the income will be
exempt, because shipping the products offshore for foreign servicing and then repatriating them to South
Africa does not make commercial sense. The income derived from the sale of related services is exempt
on the basis that the country in which the CFC is resident has an economic connection to the consumer’s
market. See Olivier & Honiball op cit 6 at 455.

\textsuperscript{130} Idem at 456-7.

\textsuperscript{131} Ibid.

\textsuperscript{132} Ibid.
FFIHC would cover foreign financial holding companies that are located in tax havens.\footnote{Idem at 457.}

3.7.2.3.1 The Challenges that E-Commerce Poses To the Character of Income as Set Out In the Exclusions to the ‘Foreign Business Establishment’ Exemption

In jurisdictions where CFC legislation is applied only to specific types of income (eg, only to passive income, as in the United States of America), e-commerce may make it possible to manipulate the character of the income so that it falls outside the ambit of the CFC legislation.\footnote{Doernberg, Hellerstein & Li op cit note 7 at 331.} In South Africa, for instance, CFC rules previously applied in respect to passive income but not to active income.\footnote{In terms of the previous s 9C of the Income Tax Act 28 of 1997, which was repealed by s 9 of the Revenue Laws Amendment Act 59 of 2000, the CFC provisions covered only investment income, which included any income in the form of any annuity, interest, rental income, royalty income or other income of a similar nature.} Through e-commerce, a CFC may modify its electronic products so that the character of income that arises from the transaction is viewed as active income, not passive income that is caught by the CFC rules.\footnote{Buys & Cronjé op cit note 18 at 313.}

Although South Africa’s CFC rules were amended to cover not only passive income but all income, some of the exceptions to the ‘foreign business establishment exemption’ may create situations that encourage the manipulation of the character of the income concerned so that the particular exception is rendered inapplicable.\footnote{Buys & Cronjé op cit note 18 at 313.} For example, s 9D(9)(b)(iii) of the Act provides that the ‘foreign business establishment’ exemption will not apply to net income that is attributed to any amounts derived from mobile passive income of an enterprise. This includes income such as dividends, interest, royalties, rental, annuities, insurance premiums, capital gains and foreign currency gains under s 24I. For example, if a CFC resident in a tax-haven jurisdiction licences software (created by its parent company in South Africa) to customers in other countries in exchange for a royalty, the transfer of the software could be characterised as a sale of goods or the licensing of an intangible. If the latter view were adopted, income received from the transaction would be royalty income that does not qualify for the ‘foreign business establishment’ exemption to the CFC rules. However, e-commerce may allow the CFC to modify the software before licensing it so that the royalties constitute active business income that could possibly qualify for the ‘foreign business establishment’ exemption to the CFC rules.\footnote{Buys & Cronjé op cit note 18 at 313.}

Similarly, a CFC could maintain an investment information database and charge fees to customers in other countries for accessing the database. For example, the employees providing the information found on the database

\footnote{Doernberg, Hellerstein & Li op cit note 7 at 331.}
could be located in South Africa where the parent company is located. Since the CFC is rendering services for the parent company, what has to be determined is whether the income received is for the right to access the information on the database (ie, for services rendered), or for the information contained on the database (ie, for a licence).\textsuperscript{139} If the income is considered to be royalty income, the ‘foreign business establishment’ exemption to the CFC rules may not be granted. But if the income is considered to be income from services rendered, it may be possible to claim the foreign business exemption to the CFC rule, because in terms of s 9D(9)(b)(ii)(cc), even though the foreign business establishment exemption cannot be claimed if services are performed by the CFC to its connected person who is a resident, there is an exception in that the exemption can be claimed if the services rendered relate to the creation, extraction, production, assembly, repair or improvement of goods used in countries outside the Republic, or services that relate directly to the sale or marketing of goods of its connected person who is a resident and the goods are sold to persons who are not its connected person in the country of residence of the CFC.

(To be continued.)

\textsuperscript{139} Doernberg, Hellerstein & Li op cit note 7 at 336.