
**A critical commentary and analysis of South African Tax legislation affecting the
different offshore investment structures that are available to residents**

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Abstract

The aim of this dissertation is to provide a detailed and critical commentary on and analysis of South African tax legislation affecting the different offshore business or investment structures available to residents of South Africa so as to establish which is the most tax efficient structure.

The different business structures analysed in this dissertation included the following:

- Sole proprietorships.
- Partnerships.
- Companies.
- Trusts.

The principle provisions of the Income Tax Act dealt with in this dissertation include the following:

- Section 9D.
- Section 9E.
- Section 9F.
- Section 25B(2A).
- Paragraph 80 of the Eighth Schedule.

The following three countries have been selected as countries of investment choice:

- The United Kingdom (a ‘designated country’).
- Kenya (not a ‘designated country’).
- The Isle of Man (a tax haven).

Declaration of originality

I hereby declare that this dissertation is entirely my own work.

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Table of contents

Chapter 1: Introduction.....	10
Chapter 2: Residence basis of taxation.....	13
Meaning of a ‘resident’.....	15
Natural persons ‘resident’ test.....	16
The ordinarily resident test.....	16
The physical presence test.....	16
Non-natural persons ‘resident’ test.....	17
Chapter 3: Controlled foreign companies.....	20
Section 9D of the Act.....	20
The definition of a ‘CFC’.....	21
A foreign company.....	22
The greater than 50% threshold requirement.....	22
Directly or indirectly.....	23
‘Participation rights’.....	25
South African residents affected by s 9D.....	28
The so-called 10% <i>de minimus</i> rule.....	28
Determination of the proportional amount of income to be imputed.....	29
Calculation of the ‘net income’ of a CFC.....	32
The anti-loss rule.....	33
Certain payments made to other CFCs.....	33
Capital gains tax on the disposal of a CFC.....	36
Translation of the CFC’s ‘net income’.....	37
Exemptions available.....	38
The ‘designated country’ exemption (s 9D(9)(a)).....	38
The ‘business establishment’ exemption (s 9D(9)(b)).....	39
The already or concurrently taxed exemption (s 9D(9)(e)).....	43
The related CFC and intra-group exemptions (s 9D(9)(f),(fA) and (fB)).....	43
The participation exemption (s 9D(9)(h)).....	44
Relief available.....	46
Self-assessment.....	47
Where to establish the foreign company?.....	48
Double tax agreements and s 9D.....	49
Chapter 4: Foreign dividends.....	51
The meaning of ‘foreign dividends’.....	51
Inclusion in ‘gross income’.....	52
10% or more of the equity share capital.....	52
Less than 10% of the equity share capital.....	53
Exemptions available.....	53
Additional relief available.....	54
Avoidance of s 9E.....	54
Chapter 5: Foreign branches.....	55
Commercial factors influencing the decision.....	55

Taxation of foreign branches.....	55
Section 9F.....	55
Relief from the instance of double taxation.....	56
Double tax agreements.....	56
Foreign losses.....	57
Choice of jurisdiction when establishing the foreign branch.....	57
A foreign branch or a foreign company.....	58
Chapter 6: Partnerships and natural persons.....	60
Foreign company versus a natural person.....	60
Chapter 7: Offshore trusts.....	62
The concept and elements of the word ‘trust’.....	62
A discretionary trust.....	62
A vesting trust.....	63
South African tax legislation and offshore trusts.....	64
Funding of the trust.....	66
Funding of a trust by means of a ‘donation’.....	66
Sale at market value.....	69
Distribution of the income and capital to the beneficiaries.....	71
Contingent right versus a vested right.....	72
Income of offshore trusts... ..	74
Capital gains tax and the offshore trust.....	75
Relief from the instance of double taxation.....	77
Where to establish the offshore trust?.....	78
Chapter 8: Conclusion.....	79

Table of cases

	<i>Page</i>
<i>Cohen v CIR</i> 1946 AD 174, 13 SATC 362.....	16
<i>CIR v Kuttel</i> 1992 (3) SA 242 (A), 54 SATC 298.....	16
<i>Cape Brandy Syndicate v Inland Revenue Commissioners</i> [1921] 1 KB 64.....	27
<i>Bricom Holdings Ltd v Inland Revenue Commissioners</i> [1996] STC (SCD) and [1997] STC 1179 (CA).....	49
ITC 1584 57 SATC 63.....	68
<i>CIR v Simpson</i> 1949 (4) SA 678 (A), 16 SATC 268.....	68
<i>CIR v Berold</i> 1962 (3) SA 748 (A), 24 SATC 729.....	69 - 70
ITC 76 (1927) 3 SATC 68.....	72
<i>Estate Dempers v SIR</i> 1977 (3) SA 410 (A), 39 SATC 95.....	72
<i>Armstrong v CIR</i> 1938 AD 343, 10 SATC 1.....	75
<i>SIR v Rosen</i> 1971 (1) SA 172 (A), 32 SATC 249.....	75

Table of statutes

	<i>Page</i>
The Income Tax Act 58 of 1962.....	11
s 1.....	13-15,26,51,54,62,67-68,81,83-85
s 6 <i>quat</i>	32,44-48,54,56,58,60,61,77-78
s 6 <i>quat</i> (1).....	46
s 7.....	65,67,69-70,77
s 7(2).....	68
s 7(5).....	72
s 7(8).....	14,67-68,70,77
s 7(10).....	70
s 9A.....	47
s 9D.....	11-12,14,19-25,27-29,34-41,43-44,46-51,53-54,58-61,79
s 9D(1).....	21,26-27,45
s 9D(2).....	28-29
s 9D(2A).....	32-34
s 9D(2A)(c).....	33,35-36
s 9D(2A)(i).....	35-36
s 9D(2B).....	24
s 9D(9).....	37,50,61
s 9D(9)(a).....	38,48
s 9D(9)(b).....	39,41
s 9D(9)(e).....	43
s 9D(9)(f).....	34,43

s 9D(9)(fA).....	34-36,43
s 9D(9)(fB).....	34,43
s 9D(9)(h).....	44
s 9D(11).....	47-48,71
s 9E.....	12,14,19-20,23,28-29,51,54,56,58-59,67,79
s 9E(7).....	54
s 9E(7)(d).....	48
s 9E(7)(e)(i).....	37
s 9E(8).....	38
s 9F.....	12,14,55-59,61,79
s 9F(2).....	55,56
s 10(1)(k).....	14
s 10(1)(kA).....	14,55-56,58,61
s 20(1).....	33,57
s 24H.....	60
s 24H(5).....	60
s 25B.....	65,71-72
s 25B(2A).....	11-12,14,69,71-79
s 31.....	34-36,41,44,65,69-71,79
s 31(2).....	70
s 54.....	66,69
s 56.....	66
s 64C(3)(a).....	51
s 64C(3)(b).....	51
s 64C(3)(c).....	51
s 64C(3)(d).....	51

s 64C(4)(a).....	52
s 64C(4)(b).....	52
s 64C(4)(c).....	52
s 64C(4)(d).....	52
s 64C(4)(e).....	52
s 64C(4)(f).....	52
s 64C(4)(i).....	52
s 64C(4)(j).....	52
s 72A.....	47-48
s 74C.....	80
Seventh Schedule.....	52
Eighth Schedule.....	14,29,45,54
Para 2.....	36
Para 20(1)(h)(iii).....	37
Para 80.....	11,65,79
Para 80(3).....	76-78
The Revenue Laws Amendment Act 74 of 2002.....	47

Chapter 1

Introduction

From a South African point of view it has always paid to invest offshore as result of the unstable rand, emanating from political unrest, unemployment, excessive crime and high inflation. New technology advances have increased the ability of business and commercial activities to be conducted offshore. Globalisation has resulted in most investors realising the need to diversify and to enter into cross-border activities if they intend to remain competitive and in business.

The relaxation of foreign exchange control regulations implemented during 1997 to 2000 has resulted in the increased ability of South African individuals and corporate entities to invest funds offshore. In 2000 South African individuals sent R80 billion out of the country, by putting their money into various offshore investments.¹

There are a number of reasons that make offshore investments attractive for South African investors. These generally include the following:

- Diversification and spreading of risks, currency exposures, protection of assets, increasing returns and decreasing risk.
- Protection against the unstable rand. There is a general lack of confidence in South Africa's long-term investment prospects that highlights offshore investments as the preferred choice.
- Investment in different hard currencies, particularly strong currencies.
- Investment in better-performing stock markets. It was reported that over the past twenty years, the Dow Jones fared six times better than the JSE Securities Exchange all-share index.²

¹ 'Nothing to Lose when Setting up a Trust', *Finance Week*, 20 April 2001 at 44.

² R van der Kooy 'It Still Pays to Invest Offshore', *Finance Week*, 26 April 2002 at 29.

- Increased investment choices and opportunities exist. There is a greater selection of equity investments and investment products world wide that are not always available in South Africa.
- Increasing the investor investment portfolio.

When the decision to invest offshore is made, the investor is faced with a number of choices. These include

- the choice of country;
- the choice of currency; and
- the choice of stock exchange.

Of particular importance is also, the choosing of an appropriate jurisdiction. Countries are governed by their own laws that will ultimately affect the type of investment that a South African decides to make. Different tax consequences are attributable to different types of investments.

It must, however, always be borne in mind that tax structuring should not be the sole factor in deciding whether to invest or operate a business establishment offshore.

The main theme and purpose of this dissertation is to perform a critical analysis and review of South African tax legislation affecting the different available offshore investments. It is anticipated that this will help identify useful tax-planning opportunities and to establish which of the investment structures is the most tax efficient for a South African resident. The commercial entities that will be examined include companies; trusts; branches; partnerships; and individuals. Specifically the aim of the dissertation will include a critical review of the following:

- Section 9D of the Income Tax Act (the Act) for ‘controlled foreign companies’.
- Section 25B(2A) and para 80 of the Eighth Schedule of the Act, for offshore trusts.

A limited review of the following provisions of the Act will be performed so as to provide a holistic view of the tax effects of offshore investments. These are as follows:

- Section 9E of the Act for foreign dividends.
- Section 9F of the Act for foreign branches.

Section 9D is a provision that governs a ‘controlled foreign company’.

A ‘controlled foreign company’ is a defined term and refers to an offshore company that meets certain established criteria, in terms of the provisions of s 9D. These are reviewed in Chapter 3. Specific to the review and analysis of s 9D are the shortcomings and anomalies contained in this provision. For example, the meaning of the word ‘direct’ versus ‘indirect’ and the meaning of the term ‘participation rights’.

The implication of ‘foreign dividends’ accruing to a South African resident are also examined in the instance that the foreign company does not meet the criteria of a ‘controlled foreign company’. Particular to this is the review of s 9E of the Act.

Section 25B(2A) is analysed to determine, for example, the meaning of a ‘contingent’ right versus a ‘vested’ right; and the meaning of the terms ‘real’ and ‘*spes*’.

Three countries as choices of investment jurisdictions have been selected to illustrate the resulting tax consequences arising in light of the current South African tax legislation. The countries include

- a country that is classified as a ‘designated country’;
- a country that is not classified as a ‘designated country’; and
- a country that is classified as a tax haven.

Section 9D, s 9E, s 9F and s 25B(2A) are a few of a number of anti-avoidance measures that have been introduced into the Act preventing either the avoidance or the deferring of South African taxation by remitting income to offshore entities. These anti-avoidance provisions have been necessitated as a result of the relaxation of foreign exchange control and increased cross-border activities. The introduction of the residence basis of taxation into the South African tax law has also necessitated these anti-avoidance provisions to be introduced or amended, as the situation may be. The concept of the residence basis of taxation is discussed in the following Chapter.

Chapter 2

The residence basis of taxation

Effective for all years of assessment commencing on or after 1 January 2001 South African residents are now taxed on the 'residence' basis of taxation. This is a fundamental change to the South African income tax system that was previously generally a sourced-based system. The effect of this is that South African residents now become taxable on their world-wide receipts and accruals.

The main objective behind the change of the income tax system, from a sourced-based system to a that of a residence-based system, was to bring the South African tax system in line with some of the first-world tax systems like those systems found in the United States of America, the United Kingdom and Australia. The residence basis of taxation was also introduced as a measure to protect the tax base in South Africa as a result of increased globalisation, relaxed foreign exchange control regulations and increased offshore activities that have resulted in taxes lost to the fiscus as a result of an abuse of offshore structures.

Gross income is defined in section 1 of the Act as follows:

'[I]n relation to any year or period of assessment [gross income], means–

- (i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or
- (ii) in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within or deemed to be within the Republic,

during such period of assessment, excluding receipts or accruals of a capital nature, but including, without in any way limiting the scope of this definition, such amounts (whether of a capital nature or not) so received or accrued as are described hereunder, namely –'

Therefore gross income for a resident means the world-wide receipts and accruals; or for a non-resident, the total receipts or accruals that have their source within or deemed to be within the Republic.

The issue of the residence basis of taxation has become an important one. It affects a number of provisions of the Act. Some of these include the following:

- The definition of ‘gross income’ in s 1 of the Act. As stated above South African residents are now taxed on their world-wide receipts and accruals.
- Section 7(8) of the Act.³ This provision deems income received by a non-resident as a result of a ‘donation’ by a resident, to be the income of that resident.
- Section 9D of the Act.⁴ This provision imputes the income of the ‘controlled foreign company’ to be taxed in the hands of the South African resident in certain circumstances.
- Section 9E of the Act.⁵ ‘Foreign’ dividends are included in the gross income of a South African resident. But if the shareholding in the foreign entity is 10% or more, a portion of the profit of that foreign company (as opposed to the dividend), relative to the percentage of shareholding, is included in the resident’s gross income.
- Section 10(1)(k) of the Act that exempts dividends from taxation, now applies only to local dividends. Most ‘foreign’ dividends are subject to taxation.
- Section 9F read together with s 10(1)(kA) exempts offshore branches from South African taxation if the branch is located in a country classified as a ‘designated country’.⁶
- Section 25B(2A) of the Act deems the accumulated profits of a non-resident trust to that of a South African resident, when the resident acquires a vested right to the capital of the trust, and the capital consists of accumulated profits of the trust that have not been taxed in South Africa.⁷
- The Eighth Schedule of the Act results in South African residents being subject to capital gains tax on their world-wide capital gains.

³ Refer to Chapter 7 for a detailed analysis of this provision.

⁴ Refer to Chapter 3 for a detailed analysis of this provision.

⁵ Refer to Chapter 4 for a detailed analysis of this provision.

⁶ Refer to Chapter 5 for a detailed analysis of this provision.

⁷ Refer to Chapter 7 for a detailed analysis of this provision.

Meaning of a ‘resident’

Central to the application of the residence basis of taxation is the meaning of the word ‘resident’ and determining when a person is a resident. A ‘resident’ is defined in s 1 of the Act as

‘any—

(a) natural person who is—

(i) ordinarily resident in the Republic; or

(ii) not at any time during the year of assessment ordinarily resident in the Republic, if such person was physically present in the Republic—

(aa) for a period or periods exceeding 91 days in aggregate during the relevant year of assessment, as well as for a period or periods exceeding 91 days in aggregate during each of the three years of assessment preceding such year of assessment; and

(bb) for a period or periods exceeding 549 days in aggregate during such three preceding years of assessment:

‘Provided that—

(A) a day shall include a part of a day, but shall not include any day that a person is in transit through the Republic and that person does not formally enter the Republic through a “port of entry” as defined in the Immigration Act, 2002 (Act No. 13 of 2002); and

(B) where a person who is a resident in terms of this subparagraph is physically outside the Republic for a continuous period of at least 330 full days immediately after the day on which such person ceases to be physically present in the Republic, such person shall be deemed not to have been a resident from the day on which such person so ceased to be physically present in the Republic; or

(b) person (other than a natural person) who is incorporated, established or formed in the Republic or which has its place of effective management in the Republic (but excluding any international headquarter company).’

Natural persons 'resident' test

Consequently, as a result of the above definition, there are two distinct tests for determining when an individual will be a resident of South Africa. These tests are

- the ordinarily resident test; and
- the physical presence test.

The ordinarily resident test

There is no definition for the term 'ordinarily resident' and as a result the test is a subjective one. South African case law does provide guidance in this regard. In *Cohen v CIR*,⁸ the Appellate Division of the Supreme Court (now the Supreme Court of Appeal) was required to determine whether an individual was ordinarily resident in the Republic. Schreiner JA, in the course of an *obiter dictum*, gave a meaning to the term, 'ordinary residence'. It was said that⁹

'his ordinary residence would be the country to which he would naturally and as a matter of course return from his wanderings, as contrasted with other lands it might be called his usual or principal residence and it would be described more aptly than other countries as his real home'.

This meaning finds further support in *CIR v Kuttel*, where it was held that¹⁰

'a person is "ordinarily resident" where he has his usual or principal residence, [that is] what may be described as his real home'.

Consequently from the guidance given above and in broad terms, ordinary residence can be described as a person's most usual or habitual place of residence, the place where the person would naturally and as a matter of course return from his travels and wanderings.

The physical presence test

The physical presence test on the other hand is an objective test based on the number of days that a person, not ordinarily resident in South Africa, spends in South Africa. This objective test is briefly the following:

⁸ 1946 AD 174, 13 SATC 362.

⁹ At 371.

¹⁰ 1992 (3) SA 242 (A), 54 SATC 298 at 306.

- A person must be present in South Africa for a period or periods exceeding ninety-one days in aggregate during the current year of assessment.
- A person must be present in South Africa for a period or periods of ninety-one days in aggregate during each of the three preceding years of assessment.
- A person must be present in South Africa for a period or periods exceeding 549 days in aggregate during the three preceding years of assessment.

Non-natural persons ‘resident’ test

Non-natural persons include juristic persons, for example, companies, close corporations and trusts. The criteria for determining whether a person other than a natural person is a resident for taxation purposes is based on the following:

- Whether the juristic person has been incorporated, established or formed in South Africa;
or
- whether the juristic person has its place of effective management in South Africa.

Effective management has been described to mean the day-to-day running of the business activities.

For the purposes of South African taxation, once it can be said that a person is a resident of South Africa, he will be subject to taxation on both his South African receipts and accruals and on his foreign receipts and accruals.

Over the past two years the Act has not only undergone a fundamental change regarding a change in the basis of taxation, but various other anti-avoidance provisions have been introduced or amended. Prior to these amendments taxpayers could have taken assets offshore; brought their income back in the form of untaxed foreign dividends; or merely held the assets offshore in the form of a business interest. Increased international trade has brought with it international tax planning.

International tax planning is a measure aimed to minimise the tax burden of business operations. The aim of international tax planning is to meet any one of the following three objectives:

- To eliminate; or
- to reduce; or
- to defer the incidence of taxation.

To achieve this there are essentially three techniques that can be implemented. These are as follows:

- Ensuring that the profits are earned in countries that have low tax rates or preferential regimes. Frequently tax-planning techniques include the use of ‘tax havens’. A tax haven is a country that imposes no or low taxes.
- Maximising deductions against taxable income in countries that have the highest tax rates.
- Distribution of dividends to countries that levy the least amount of taxation.

The anti-avoidance provisions and measures implemented to stop the above include the following:

- The taxation of foreign dividends.
- Tightening up of tax provisions governing offshore trusts.
- A clearly-defined definition of a ‘resident’.
- Changes to legislation governing South African managed or owned offshore companies and offshore trusts by imputing their income, in certain circumstances, to be taxable in the hands of the South African resident.

The introduction of the residence basis of taxation has resulted in a South African resident being taxable on his

- foreign investment income, that is his passive income, including interest, royalties, rentals and annuities; and

- foreign business income, that is his active income, including trading profits, manufacturing profits, salaries, commissions, share and property dealings.

With these recent amendments to the Act, the legislature is making it extremely difficult for taxpayers to avoid South African tax and to hide income-earning assets in foreign-based companies or trusts. The above illustrates the importance when determining the status of a person's residence in light of current tax legislation. Without the anti-avoidance provisions South African taxpayers could easily avoid the impact of the residence basis of taxation by retaining profits in foreign corporations. As a result, the concept of a 'controlled foreign company' and in particular the provisions of s 9D and s 9E have been introduced.

Chapter 3

Controlled foreign companies

Prior to 1997 South African residents were not subject to taxation on their foreign-sourced income. From 1997, with the advent of the relaxation of foreign exchange control regulations, passive income¹¹ received or accrued to a resident from a foreign source was subject to South African taxation, in terms of the now-repealed s 9C of the Act. Foreign dividends remained exempt from taxation. The 2000 year of assessment saw the start of the taxation of foreign dividends received by or accrued to residents, as a result of the provisions of s 9E.¹² With the further relaxation of foreign exchange control and the realignment of the South African tax system with first-world countries, came the introduction of the residence basis of taxation, thus subjecting residents to taxation on all their offshore receipts and accruals.

Generally, in terms of international tax law, a taxpayer in one country is not subject to domestic tax on the profits of a foreign subsidiary. It is only when those profits are remitted as dividends, that taxation is incurred.

Without the provisions of s 9D, income earned from foreign companies would be subject to taxation only in terms of s 9E, once repatriated to residents in the form of foreign dividends. There would be no immediate taxation of income earned from foreign companies. This offered the opportunity for tax deferral and tax avoidance by establishing entities in low-tax jurisdictions and diverting income to them. Section 9D prevents this deferral and is a specific anti-avoidance measure to curb identified specific abuses and tax-avoidance schemes in the use of offshore investments in low-tax jurisdictions.

Section 9D of the Act

The main purpose of s 9D is to deem income of a foreign company to be that of a South African resident if it meets the definition of a 'controlled foreign company' (CFC), therefore preventing the avoidance or deferral of South African taxation. The income of a foreign company can be imputed to a South African resident only if the company is a CFC as defined.

¹¹ Passive income includes interest, rentals, royalties and other items of a similar nature.

¹² Effective from 23 February 2000.

This is, however, subject to a number of requirements and exemptions that are discussed in detail below.

An analysis of s 9D reveals that the following must be established before its provisions will apply:

- Does the foreign company meet the definition of a ‘CFC’?
- Which South African residents are subject to this provision?
- What foreign income or what portion of the foreign income must be imputed to the South African resident?
- Are any exemptions available?
- Is the CFC located in a target territory, for example, a tax haven?
- What relief is available?

The definition of a CFC

In terms of s 9D(1) of the Act, a CFC is defined as

‘any foreign company where more than 50% of the total participation rights in that foreign company are held by one or more residents whether directly or indirectly: Provided that a person who holds less than five percent of the participation rights of a foreign company which is either a listed company or a scheme or arrangement as contemplated in paragraph (e) (ii) of the definition of “company” in section 1, shall be deemed not to be a resident in determining whether residents directly or indirectly hold more than 50% of the participation rights in–

(a) that foreign company; or

(b) any other foreign company in which that person indirectly holds any participation rights as a result of the interest in that listed company or scheme or arrangement,

unless more than 50% of the participation rights of that foreign company or other foreign company are held by persons who are connected persons in relation to each other.’

Consequently, what the above definition states is that there will be a CFC if a South African resident, individually or in aggregate, either directly or indirectly, holds more than 50% of the ‘participation rights’ in a foreign company.

A foreign company

A ‘foreign company’ is any association, corporation, company, etcetera that is not a resident as defined.

As discussed above, a non-resident company will be any company that is incorporated, formed or established in a jurisdiction other than South Africa, and whose day-to-day business activities are conducted outside of the Republic.

A foreign company for the purpose of s 9D can also be a ‘resident’ company, that is, it is incorporated in the Republic or it has its place of effective management in the Republic but is deemed to be a non-resident, as a result of a double taxation agreement entered into by South Africa.

The greater than 50% threshold requirement

All that is required in determining the greater than 50% threshold requirement, is to count the aggregate percentages of ‘participation rights’ held by South African residents, no matter how independent they are in relation to the CFC, or to each other.

Recent amendments to the Act support this interpretation.¹³ Prior to the amendments the definition of a CFC (previously referred to as a ‘controlled foreign entity’) had reference to the ‘participation rights’ being held ‘individually or jointly’ and an alternative requirement of a CFC, was a greater than 50% of ‘voting rights’ held by South African residents. The removal of these terms has removed the ambiguities in determining the 50% threshold requirement.

¹³ The Revenue Laws Amendment Act 74 of 2002.

If it is established that the foreign company does not have South African residents who directly or indirectly, in aggregate hold more than 50% of its total participation rights, then the foreign company will not be a CFC as defined. The provisions of s 9D will not be applicable. This does not automatically result in profits or gains arising in the offshore company being free from South African taxation. The provisions of s 9E may be applicable when the offshore company distributes a dividend to its resident shareholders.

A further proviso in the definition of a ‘CFC’ must be borne in mind, when determining whether greater than 50% of the total ‘participation rights’ are held by South African residents. This proviso states that, where shareholders of either a foreign *listed* company or a foreign unit trust, hold less than 5% of its total participation rights, these shareholders are deemed to be foreign shareholders. They are then not included in determining the aggregate participation rights held by South African residents. This proviso assists in avoiding any ownership tracing problems that are necessary when establishing the 50% threshold requirement.

This proviso also states that where resident shareholders hold less than 5% of the participation rights but together with ‘connected persons’ hold greater than 50% of the participation rights, its provisions will be inapplicable.¹⁴ The shareholders will be residents when determining whether the 50% threshold requirement has been achieved. This ‘connected person’ rule prevents any tax-saving scheme that could be implemented by a group of companies who individually hold less than 5% of the participation rights as a means to avoiding the 50% threshold requirement.

Directly or indirectly

What is the meaning of the word ‘indirectly’ in the definition of a ‘CFC’? In an article written by Richard Jooste entitled ‘The Imputation of Income of Controlled Foreign Entities’ the following is stated:¹⁵

‘The reference in the definition of a [CFC] to the holding of participation rights “indirectly” covers holdings through a nominee or agent. It is arguable that options to take up shares in a company and similar interests are not covered on the basis that these instruments do not represent participation rights until converted into shares. Similarly, it could be contended that the holding of options to shares in a

¹⁴ See Glossary of Terms for the definition of a ‘connected person’.

¹⁵ *SALJ* Volume 118 at 476.

company does not represent an indirect entitlement to the exercise of the votes attaching to those shares. It appears, however, that votes in a foreign entity controlled by a South African resident through a voting agreement with the holders thereof would qualify as votes that the resident is “indirectly” entitled to exercise and, accordingly, would be counted in determining whether the foreign entity is a [CFC].’

Based on the above interpretation provided by Jooste, and with the recent amendment to the definition of a ‘CFC’ and the removal of the voting rights requirement, it could also be contended that ‘participation rights’ to either the capital or income in a foreign entity controlled by a South African resident through a participation agreement with the holders of options could qualify as participation rights that the resident is ‘indirectly’ entitled to exercise.

It is suggested by Jooste that the term ‘indirectly holds’ may cover¹⁶

‘holdings of participation rights through other entities. An example illustrating such an interpretation is as follows:

‘A foreign company (FORCO) has 400 shares in issue. Mr X (a South African resident), Company Y (a South African resident), Company Z (non-resident) and Mr F (non-resident) each own *100 shares* in FORCO. Mr P (a South African resident) owns 40% of the shares in Company Y and in Company Z. In these circumstances, FORCO qualifies as a [CFC] because South African residents hold more than 50% of the participation rights in FORCO. Mr X and Company Y collectively own 50% and Mr P holds an additional 10% (that is 40% of 25%) indirectly through Company Z. The shares of FORCO, indirectly owned by Mr P through Company Y, are ignored because those shares are directly owned by company Y (the same South African resident-owned shares cannot be counted twice).

‘A contrary view is that “indirectly hold” covers only agency or nominee holdings and “not a holding through an entity or an entity which itself holds legal title to the participation rights in question”. It is submitted that given the intention behind s 9D this interpretation is too narrow and is unlikely to be accepted by the courts.’

This interpretation is further supported by the provisions of s 9D. It is stated in s 9D(2B) that there will be no inclusion in the income of a South African resident that holds participation rights in a CFC

‘to the extent that the participation rights are held by residents indirectly through any company which is a resident’.

¹⁶ ‘The Imputation of Income of Controlled Foreign Entities’ *SALJ* Volume 118 at 476-477.

This proviso also removes obscure results when participation rights are held by a resident indirectly through resident companies. The following example illustrates this submission:¹⁷

‘Mr X, a South African resident, holds all the shares in Company Y, also a South African resident. Company Y holds 60% of the participation rights in a [CFC]. Who is the net income of the [CFC] to be imputed in terms of s 9D? Mr X or Company Y or both? Company Y directly holds 60% of the participation rights of the [CFC] and Mr X indirectly holds sixty percent. They both, therefore, appear to fall within the purview of s 9D. Can Revenue tax both? It is unlikely that Revenue would impose tax on both Mr X and Company Y because this would amount to a form of double taxation. Does Revenue have a choice? Due to the differences in the tax rates applicable, a choice could make a significant difference.’

Therefore in determining whether a foreign company falls within the definition of a CFC, that is whether the 50% participation threshold is met, indirect holdings through other entities are taken into consideration. But if the indirect holding is through a South African resident company, there is no imputation of income to the South African resident with the indirect interest. Without this proviso double taxation on the same amount of income would arise.

In conclusion therefore, the word ‘indirectly’ in the definition of a ‘CFC’ can be interpreted to cover the following:

- The holding of participation rights through a nominee or agent.
- The holding of options, where the holders are entitled to participation rights through participation agreements.
- The holding of participation rights through an entity that itself holds legal rights directly to the foreign entity.

Participation rights

A review of CFC legislation in selected jurisdictions, namely, Germany, the United States of America and the United Kingdom reveals that generally, the ability to control the distribution of dividends is considered an appropriate basis for the application of CFC rules. Most foreign legislations establish a threshold of control that must be satisfied to characterise the foreign entity as a ‘CFC’. For example,

¹⁷ National Treasury’s Detailed Explanation to Section 9D of the Income Tax Act (June 2002) at 5.

- in Germany, the United States of America and the United Kingdom, CFC rules apply when more than 50% of the shares or voting rights of a non-resident corporation, are held by resident taxpayers, and
- in France and Portugal, the CFC rules are based on substantial interests rather than control.

Participation rights are defined in terms of s 9D(1) as

‘in relation to a foreign company . . . the right to participate directly or indirectly in the share capital, share premium, current or accumulated profits or reserves of that foreign company, whether or not of a capital nature’.

This definition is ambiguous.

- First, does it mean the rights to participate in the share capital *or* share premium *or* current or accumulated profits or reserves, whether of a capital nature or not?
- Alternatively, does it mean the rights to participate in the share capital *and* share premium *and* current or accumulated profits or reserves, whether of a capital nature or not?

The following has been stated:¹⁸

‘Consistent with the anti-avoidance nature of the [CFC] rules, the term “participation rights” is defined broadly in order to ensure that South African taxpayers cannot enter into convoluted share arrangements as a means of controlling foreign entities while avoiding tax under section 9D.’

The above quotation makes reference to the now amended definition of ‘participation rights’.

The definition prior to the amendment in terms of s 1 of the Act was

‘the right to participate directly *or* indirectly in the capital *or* profits of, or dividends declared by, *or* any other distribution or allocation made by, any entity’.

The above definition in contrast to the amended definition, clearly states that ‘participation rights’ includes the right to participate in the capital *or* the profits of an entity and that no

¹⁸ See National Treasury’s Detailed Explanation to Section 9D of the Income Tax Act (June 2002) at 3.

attention must be given to the particular type of right. Clearly there was no ambiguity in the definition, in contrast to the now-amended definition, and that when determining the total participation rights held by a South African resident, the *entire* participation rights were aggregated to determine whether the 50% requirement had been met. This interpretation finds further support in an article written by David Clegg ‘Getting it Right, Avoiding s 9D’.¹⁹ In this article it was suggested that²⁰

‘it is the entire bundle of participation rights in relation to any one entity which must be evaluated, to determine whether South African residents hold more than 50%. If they do, then irrespective of the particular type of right the resident holds, income is attributable on some relative basis.’

And that²¹

‘for s 9D to have meaning the resident must hold more than 50% of the *bundle* of rights’.

(Emphasis added.)

Finding support in the above article and in National Treasury’s guide, the amended definition of ‘participation rights’ can be interpreted to mean the right to participate directly or indirectly in the share capital *or* share premium *or* current or accumulated profits or reserves, whether of a capital nature or not.²² It makes no difference whether the South African resident has the right to participate only in the capital of the foreign company and no right in the income. Even though this interpretation may appear unfair, in that why should income be imputed to a South African resident in terms of s 9D when in reality the resident has no right to the income of the foreign company, it must be borne in mind that there is ‘no equity about a tax’.²³ The aggregate of *all* the participation rights is determined irrespective of the type of right held.

The definition of a ‘CFC’ in terms of s 9D(1) also uses to the word ‘total’ participation rights when determining whether the 50% threshold has been exceeded. If the word ‘the’ had been used, that is, where more than 50% of ‘the’ participation rights are held by South African residents, it may be interpreted as meaning participation rights to a specific type of right, for example, participation rights to the income only.

¹⁹ (2000) 14 *Tax Planning* 42.

²⁰ At 42.

²¹ At 43.

²² National Treasury’s Detailed Explanation to Section 9D of the Income Tax Act (June 2002) at 3.

²³ *Cape Brandy Syndicate v Inland Revenue Commissioners* [1921] 1 K B 64 at 71.

This wide interpretation supports the overall anti-avoidance measures that s 9D achieves. There seems to be no South African case law to support this interpretation of ‘participation rights’ and in providing guidance in the structuring of offshore companies it is probably best to avoid entities with multiple rights attached to the shares.

South African residents affected by s 9D

On establishment that a foreign company is a CFC, it remains to be determined which resident shareholders are required to impute a portion of the CFC’s net income into their South African taxable income. The fact that the foreign company is a CFC and earns undistributed foreign income does not necessarily mean that all the South African resident shareholders will have foreign income imputed to them.

The CFC rules will apply to a resident who holds 10% or more of the participation rights of a CFC. In terms of the proviso to 9D(2) there is no imputation of income, and hence the provisions of s 9D are inapplicable, to

- residents (together with a ‘connected person’ in relation to that resident) who hold less than 10% of the participation rights in a CFC, this being determined at the last day of the CFC’s reporting financial year end or on the last day that the foreign company ceased to be a CFC; or
- residents who hold their participation rights indirectly through a resident company.

The so-called 10% *de minimus* rule

The so-called 10% *de minimus* rule applies to both direct and indirect holdings. It has been designed to eliminate tax on shareholders who have no say to the control or operations of a CFC. These shareholders will, however, be liable to taxation in terms of the provisions of s 9E, when the profits are remitted to them in the form of a foreign dividend.

At a first glance of this provision, it appears that there is the possibility of implementing a tax scheme that will result in the avoidance of the provisions of s 9D.

For example, the scheme may entail the creation of a foreign company where the shareholders of the company consist of a number of South African resident trusts that are

entitled, in terms of the rights attached to their shareholdings, to less than 10% of the participation rights of the offshore company. The beneficiaries of the trusts cannot be the same persons, as the trusts will then be ‘connected persons’ as defined and the proviso will be inapplicable (greater than 10% of the participation rights will be held by residents).

In this example, although the foreign company has met the definition of a ‘CFC’ (greater than 50% of its total participation rights being held by South African residents) there is no application of the provision as a result of the s 9D(2) proviso. The scheme would appear attractive if the foreign company was set up in a tax haven. All profits and gains accruing to the foreign company would be free of foreign taxation and there would be no imputation of the CFC’s net income into the resident trusts’ taxable income.

This scheme results in the avoidance of s 9D but the Act contains a further number of anti-avoidance provisions when dealing with offshore structures. In particular when the CFC, in the above example, distributes the profits to its shareholders by way of a dividend, the provisions of s 9E will apply. Simply, the South African resident trust will be liable to South African taxation on the foreign dividend that has accrued to it. Alternatively it may be decided by the shareholders that the reserves of the foreign company are to be capitalised. The only return of the investment by the South African resident shareholders will be in the form of the appreciation of the value of their shareholding. No liability for South African taxation will arise but this amounts to a mere deferral of taxation. Should the shareholders, at a later stage, decide to dispose of their shareholding, the Commissioner may deem the proceeds to be a foreign dividend and again, the provisions of s 9E may be applicable. Capital gains tax in terms of the Eighth Schedule may also arise.

Foreign dividends and the provisions of s 9E are analysed in Chapter 4.

Determination of the proportional amount of income to be imputed

As has been identified above, when a foreign company is defined as a CFC, a proportional amount of its ‘net income’ is imputed to its South African resident shareholders, unless they hold less than 10% of its ‘participation rights’. The portion of the net income to be included in

a resident shareholder's taxable income, will be the proportion that his participation rights bear to the total participation rights in that foreign company.²⁴

As a general rule, based on the CFC rules of foreign jurisdictions, the undistributed CFC income apportioned to the South African resident shareholders should have the same tax treatment as it would have under domestic legislation. This means that South African income tax law is applied to the accounting profit of the foreign entity in determining the 'gross income', 'income', deductions and allowances when calculating the 'net income' of the CFC. The resulting tax liability on the 'net income' of the CFC arises in the year of assessment of the South African resident shareholder, when the net income of the CFC is earned and not when the profits are remitted to South Africa. As is analysed in detail, with the use of an example, the imputation of 'net income' can create absurd results for resident shareholders.

It therefore becomes essential for the CFC to maintain two separate tax books: one for the country of jurisdiction and one for South Africa. Without this it will be almost impossible for the CFC to determine its 'net income' in terms of South African tax legislation. This necessity is further exacerbated in the instance that the foreign company is not a CFC for the whole of the foreign year of assessment. For example, the foreign company become a CFC during the foreign tax period or the foreign company ceases to be a CFC during the foreign tax period. In these instances the South African resident shareholder that is subject to the imputation of 'net income', has the option to elect either

- to apportion the proportional amount with the ratio of the number of days that the foreign company was a CFC to the total number of days in the foreign tax year; or
- to determine the proportional amount of the 'net income' of the CFC for the period that the foreign company was a CFC. In this instance the CFC would need to keep accurate records for the period affected.

Interestingly, in an article written by Maeve Kolitz entitled 'Tax on Foreign Income – II'²⁵ it was observed that the tax payable by South African resident shareholders of CFCs and the amounts included in their 'taxable income', bears little relationship to their shareholdings.

²⁴ Refer to s 9D(2) of the Act.

²⁵ (2001) 15 *Tax Planning* 112.

An abridged and amended example from the article referred to that illustrates this absurdity follows:

Shareholder A (a South African resident) holds 7,5% of the participation rights of Company X (a non-resident). Shareholder B (a South African resident) holds 15% of the participation rights of Company X. Shareholder C (a South African resident) holds 30% of the participation rights of Company X.

In total 52,5% of the participation rights of Company X are held by South African residents. Company X is therefore a CFC as defined.

The income attribution rules in terms of s 9D(2) of the Act apply to shareholder B and C. The provision does not apply to shareholder A as it holds less than 10% of the participation rights in Company X. Shareholder A is subject to South African taxation when a foreign dividend accrues from Company X.

The 'net income' of Company X, as determined in terms of the provisions of the South African tax legislation, is R130 000. Dividends of R50 000 have been declared that are subject to a withholdings tax of 10%. The foreign tax payable by the CFC is R20 000. Assume a South African statutory tax rate of 30%.

The effect of the South African tax consequences on the three shareholders are summarised in the table that appears on the next page.

Shareholder	A	B	C
Participation rights	7,5%	15%	30%
Net dividend received (after withholding tax)	3 375	6 750	13 500
Inclusion in income (before withholding tax and South African tax)	3 750	19 500	39 000
South African tax payable (after set off of foreign tax credits ²⁶)	750	2 100	4 200
After-tax return on the investment	2 625	4 650	9 300
South African tax as a percentage of the net dividend	22%	31%	62%

When analysing the above results it is important to note that the ‘actual’ amount received by the South African resident shareholder is the foreign dividend that has been remitted to South Africa. That is the return from the investment in Company X and not the proportional income amount that is imputed into shareholder B’s and C’s taxable income.

The taxation payable by shareholder B and C as compared to that of shareholder A, bears no relationship to the ratio of the participation rights held. There is an inequitable result. Shareholder B and shareholder C are taxed on their proportional share of the total ‘net income’ of the CFC that is imputed and not on their proportional share of the net income of the CFC that is declared as a dividend.

Calculation of the ‘net income’ of a CFC

The ‘net income’ of a CFC is calculated in terms of the provisions of s 9D(2A) of the Act. The ‘net income’ is calculated in the same manner that the taxable income of a South African resident is determined, with two exceptions to this rule. These include the anti-loss rule and certain payments made to other related CFCs.

²⁶ See s 6quat rebate of the Act.

The anti-loss rule

Expenses are deducted and allowances are made against the income of a CFC but these are limited to the income of the CFC. No tax loss can be created by the CFC. This anti-loss rule ensures that as a result of the move towards a residence basis of taxation, the current South African tax base is not eroded by foreign tax losses. The rule is also consistent with the provisions of s 20(1) of the Act, where it states that:

‘For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be set off against the income so derived by such person–

(a) any balance of assessed loss incurred by the taxpayer . . .

Provided that there shall not be set off against any amount–

(a) . . .

(b) derived by any person from carrying on within the Republic of any trade, any–

(i) assessed loss incurred by such person during such year; or

(ii) any balance of assessed loss incurred in any previous year of assessment,

in carrying on any trade outside the Republic.’

The above provision relates to foreign branches and provides that losses incurred by foreign branches cannot be set off against South African source income.

Section 9D(2A), however, provides that the foreign tax loss is not ignored and simply lost. It can be carried forward to the next foreign year of assessment and be set off against the ‘net income’ of the CFC but no further tax loss can be created.

Certain payments made to other CFCs

A further qualification to the calculation of the ‘net income’ of a CFC is that no deduction is allowed for certain amounts paid or payable by the CFC to other related or intra-group CFCs. This is in terms of s 9D(2A)(c) of the Act. These amounts include the following:

- Interest, rental, royalties or other income of a similar nature.

- Any similar amounts adjusted in terms of s 31 of the Act.²⁷
- Any exchange items arising between CFCs that are part of the same ‘group of companies’.

At first glance it appears that there is no fairness or equity to this provision as a greater ‘net income’ of the CFC is calculated. It must, however, be noted that there is a corresponding exemption provision in terms of s 9D(9)(fA) of the Act. This exemption states that the items as listed above, received or receivable by a CFC from other related CFCs or intra-group CFCs are excluded from the ‘net income’ and s 9D is inapplicable to those income items.

This provision prevents CFCs from making artificial payments to other related CFCs, so as to reduce their ‘net income’ for the purposes of s 9D. For example, a CFC could shift its profit by paying interest, rental or royalties to an intra-group CFC that is situated in a tax haven.

Throughout s 9D of the Act, there are provisions that allow related CFCs to undertake intra-group transactions and to shift income among one another without resulting in a South African tax liability.²⁸ It has been reported that the reason for these rules include the following:²⁹

‘These rules [s 9D(9)(f), (fA) and (fB)] recognise that multinational structures frequently contain multiple foreign subsidiaries that act as a single economic unit. The multilevel nature of these structures (often involving holding companies) have legitimate non-tax reasons, such as isolating risk to particular countries in which economic activities arise. Moreover, even though tax reasons may exist for multilevel structures, taxpayer efforts at tax reduction in this regard are aimed solely at reducing foreign tax as opposed to South Africa tax. Structures of this kind allow South African multinationals to compete in an environment where their foreign multinational competitors utilise similar foreign tax reducing structures.’

The following provisions of s 9D(2A) must be considered when determining the ‘net income’ of a CFC:

- The ‘net income’ includes capital gains or losses realised by the CFC. If the resident shareholder is a natural person, a special trust or an insurer the inclusion rate for the

²⁷ The transfer pricing and thin capitalisation provisions.

²⁸ Refer to s 9D(9)(f), (fA) and (fB) of the Act.

²⁹ National Treasury’s Detailed Explanation to Section 9D of the Income Tax Act (June 2002) at 21.

CFC's net capital gain is 25% as opposed to the inclusion rate of 50%, if the resident shareholder is a non-natural person.

- For the purposes of the anti-avoidance provisions relating to thin capitalisation,³⁰ where there is a transaction, operation or scheme entered between a CFC and a 'connected person' in relation to that CFC, that CFC is deemed to be a resident and the transaction, operation or scheme is deemed to be an 'international agreement' as defined.³¹ As a result when financial assistance granted to a CFC from a non-resident 'connected person', the interest or finance charges incurred by the CFC will be disallowed, when the financial assistance is considered to be excessive in relation to the equity of the CFC. The disallowed interest or finance charges will be deemed to be dividend and the secondary tax on companies, at a current rate of 12,5% will be levied and payable by the CFC.

Recent amendments to the Income Tax Act³² have resulted in the provisions of s 9D(2A)(c) and s 9D(9)(fA) being applicable to amounts adjusted in terms of s 31. Section 9D(2A)(c) states that

'no deduction shall be allowed in respect of any interest . . . paid or payable or deemed to be paid or payable by that company to any other controlled foreign company in relation to the resident (*including any similar amount adjusted in terms of section 31*) or . . . to which that controlled foreign company and other foreign company are parties, as contemplated in subsection (9)(fA)'.

(Emphasis added.)

Section 9D(9)(fA) states the following:

'[The provisions of s 9D will not apply to any net income of a CFC as] is attributable to any interest . . . paid or payable or deemed to be paid or payable to that company by any other foreign company (*including any similar amount adjusted in terms of section 31*), or . . . to which that controlled foreign company and that other foreign company are parties, where that controlled foreign company and that other foreign company form part of the same group of companies.'

(Emphasis added.)

³⁰ Refer to s 31 of the Act.

³¹ Refer to s 9D(2A)(i) of the Act.

³² The Revenue Laws Amendment Act 74 of 2002.

At first glance it appears that s 9D(2A)(c) and s 9D(9)(fA) nullify the provisions of s 9D(2A)(i) because any adjustment arising as a result of the provisions of s 31 is ignored. There is no imputation of income or alternatively no deduction will be allowed, to a CFC that is party to an 'international agreement' as defined. It appears however, that there will still be a deemed dividend with the secondary tax on companies being incurred. But this is only when the transactions are between related or intra-group CFCs. The CFC's 'net income' would in terms of the provisions of s 9D be imputed to the South African resident shareholders 'taxable income' and there would be no tax loss to the fiscus. This interpretation makes logical sense because on consolidation of the group of foreign companies, the s 31 adjustments would be neutral.

The ability to thinly capitalise a local company, where interest is tax deductible, results in a reduction in its 'taxable income' and a reduction to the South African tax base.

The above interpretation supports the opinion of many tax practitioners who do not accept the validity of transfer pricing adjustments between CFCs. It was stated that³³

'the intention of s 31 was never to bring within its scope transactions wholly between non-residents. Applying these transfer-pricing provisions in these circumstances is admittedly somewhat bizarre and appears to run contrary to the purpose for which s 31 has been enacted.'

It can then be interpreted that the only purpose for the provision of s 9D(2A)(i) is to apply the provisions of thin capitalisation to transactions, operations or schemes entered into between a CFC and a connected person of that CFC, not forming part of the same 'group of companies'.³⁴ This means that the CFC and the connected person must not have 75% or more of their equity share capital held by the same holding company. For example, the provisions of s 9D(2A)(i) will come into operation when there is loan transaction between the CFC and a non-resident shareholder (natural person) of the CFC. The non-resident shareholder is a 'connected person' as defined but does not form part of the same 'group of companies'.

Capital gains tax on the disposal of a CFC

Capital gains tax needs to be calculated when a resident shareholder disposes of the whole or a portion of his 'participation rights' in a CFC. This is in terms of para 2 of the Eighth

³³ Dewald Joubert, 'International Financing Problems', (2002) 16 *Tax Planning* 30.

³⁴ Refer to Glossary of Terms for the definition of a 'group of companies'.

Schedule. It states that a resident is subject to tax on the capital gain arising on disposal of any asset, wherever the asset is situated in the world.

There are ‘base cost’³⁵ adjustments to shares held in CFCs when there are ‘net income’ inclusions and ‘foreign dividends’ are received. The determination of the ‘base cost’ of the CFC shares held by a South African resident is necessary for calculating any capital gain that may arise on the disposal of any portion of the ‘participation rights’ held. These adjustments are determined in terms of para 20(1)(h)(iii) of the Eighth Schedule. Adjustments are made to either increase or decrease the base cost of the CFC held.

In brief, an upward adjustment is made to the base cost for any proportional amount of a CFCs ‘net income’ that has been included in the net income of a South African resident shareholder in terms of s 9D. This, however, excludes any portion that relates to any taxable gain. A further upward adjustment is made from the proportional amount of the net capital gains of the CFC before applying the inclusion rate, that is, 100% of the capital gain is upwardly adjusted for.

Downward adjustments are made to the base cost of a CFC when a tax-free dividend is received from a CFC that was exempt from tax in terms of s 9E(7)(e)(i). For example, dividends already included in income and taxed in terms of s 9D will not be subject to taxation again in terms of s 9E(7)(e)(i). Amounts not taxed in terms of s 9D have no effect on the base cost.

This provision also applies to determining the capital gain or loss of a CFC from the disposal of an interest in any *other* foreign company.

Translation of the CFC’s ‘net income’

To impute the CFCs ‘net income’ into the taxable income of a qualifying South African resident shareholder, it is necessary to translate the ‘net income’ of the CFC, denominated in the foreign currency, into South African rands. This is calculated by using the average exchange rate for the year of assessment of the resident shareholder.

³⁵ Refer to Part V of the Eighth Schedule of the Act.

Exemptions available

Certain receipts and accruals of a CFC are exempt and hence the provisions of s 9D are inapplicable to those items. This is in terms of s 9D(9) of the Act.

There are five main categories that these exemptions fall into. They are as follows:

- The 'designated country' exemption.
- The 'business establishment' exemption.
- The already or concurrently taxed exemption.
- The related CFC and intra-group exemption.
- The share participation exemption.

The 'designated country' exemption (s 9D(9)(a))

A 'designated country' is defined in s 9E(8) of the Act. Section 9E(8) states that

'the Minister may, by notice in the *Gazette* –

(a) designate countries which –

- (i) have a tax on income that is determined on a basis which is substantially the same as that of the Republic;
- (ii) have a qualifying statutory rate of tax on companies; and
- (iii) comply with any other requirement which the Minister may prescribe by regulation;

(b) exclude specific forms of income which are derived from those countries contemplated in paragraph (a)'.

The 'designated country' exemption is a straight forward exemption test. It basically exempts income from taxation, earned by a CFC that is similarly taxed and comparable in amount to that imposed in South Africa. This exemption assists in easing the administration burden of the Commissioner.

What the exemption means is that if foreign-sourced income of a CFC is taxed in a designated country at a statutory tax rate of at least 27%, or for capital gains tax at a statutory rate of 13,5%, the income is exempt from the provisions of s 9D. It is important to note that there are two requirements that need to be satisfied:

- First, the statutory rates of tax must be met, and
- secondly, the foreign country must be a ‘designated country’ as published in the *Gazette*.

The situation may arise where no foreign taxation is payable by the CFC. This may occur where the CFC has a tax loss or an ‘assessed loss’ from a prior foreign year of assessment. But this situation does not render the ‘designated country’ exemption inapplicable.

The ‘business establishment’ exemption (s 9D(9)(b))

Income of a CFC is exempt if it is derived from a ‘business establishment’. This is complex exemption and operates to³⁶

‘promote international competitiveness by allowing South African – owned foreign entities to compete with their foreign-owned competitors in equal terms from a tax point of view. On the other hand, there is the wish to achieve equity between South African residents earning income at home and those earning income abroad.’

A ‘business establishment’ is a business that has the following three characteristics:

- Element of permanence.
- Economic substance.
- *Bona fide* business reasons for operating offshore.

Element of permanence

The element of permanence characteristic ensures that the CFC operates through a fixed location with a degree of permanence. This requirement therefore excludes ‘letter box’ companies and CFC arrangements that consist of mere websites and mailing addresses.

³⁶ Richard Jooste ‘The Imputation of Income of Controlled Foreign Entities’, *SALJ* Volume 118 at 486.

Economic substance

The economic substance characteristic must demonstrate that the CFC has a place of business that is fully operational, suitably equipped with on-site operational managers, staff, etcetera, to conduct its primary business operations. The essential of this characteristic is that the *primary* operations must be conducted by the establishment. The use of an independent agent to conduct the primary operations would fall foul of this requirement.

Bona fide business reasons for operating offshore

The *bona fide* business reasons for operating offshore is a subjective enquiry and it is uncertain whether it suffices that the main reason and not the *sole* reason for operating offshore is for non-tax reasons. As the word 'solely' is not used in the legislation, it is interpreted that a *main* reason would suffice. There must be real business reasons, for example, developed infrastructure in the offshore jurisdiction that provides a low cost of production.

It is interesting to note that even a CFC located in a tax haven may be exempt from the provisions of s 9D if it meets the requirements of a 'business establishment'. For example, a CFC that is located in a tax haven and that has the characteristics of locational permanence and substance. Even though there are tax advantages of setting up a business in the tax haven, its location was selected because of its significant production cost advantages over South Africa. This CFC would then be exempt from the provisions of s 9D.

The complexity of this provision resides in the number of provisos to it. These ignore the 'business establishment' criterion, if the 'business establishment' is used for transactions with connected residents or for the derivation of passive income. This type of income includes what has been termed the following:

- Mobile business income.³⁷
- Diversionary business income.³⁸

³⁷ Income that is derived from a business that lacks economic substance.

³⁸ Income earned by a CFC derived out of transactions involving transfer pricing.

- Mobile passive income.³⁹

Mobile business income

Mobile business income is derived from a CFC that fails to meet the definition of a ‘business establishment’.

Diversionsary business income

The proviso to s 9D(9)(b) that refers to diversionsary business income is to prevent the diversion of South African taxable income offshore by means of transfer pricing. Even if the CFC meets the definition of a ‘business establishment’, if the income generated is through a transfer-pricing transaction, the exemption from s 9D will be unavailable.

Diversionsary business income transactions can result in both the provisions of s 9D and s 31 being applied by the Commissioner. So as not to defeat the promotion of international competitiveness and trade, transactions will not be excluded from the ‘business establishment’ exemption if these transactions contain no intention of transfer pricing and the country of residence of the CFC was not chosen as a result of tax advantages. The direct or indirect transactions undertaken by the CFC and a connected South African resident need to be examined to determine whether they are of a ‘higher business activity standard’. This, for example, includes substantial business and economic reasons for establishing an entity offshore, other than for tax advantages. The ‘higher business activity standard’ is achieved when⁴⁰

‘the [CFC’s] conduct meets a higher business activity standard than that required where the transactions are with parties other than connected South African residents’.

Diversionsary business income can be derived from the following transactions:

- The sale of goods or services by or to a CFC with any resident ‘connected person’, where the consideration received for the goods or services is not considered to be arm’s length.

³⁹ Passive income that can easily be shifted around. Examples include interest, dividends and rentals.

⁴⁰ Richard Jooste ‘The Imputation of Income of Controlled Foreign Entities’, *SALJ* Volume 118 at 491.

- The sale of goods by the CFC to a connected South African resident unless
 - the goods were acquired by the CFC from its country of residence; or
 - the goods manufactured by the CFC involve significant and substantial production processes and not mere minor processes. This may be due to the country of residence of the CFC having substantial infrastructure; or
 - a significant volume of the same goods are sold to external persons at comparable prices to those that the goods are sold to connected South African residents.

- The sale of goods to external and unconnected persons, where the goods were acquired by the CFC from a resident connected person unless
 - the goods acquired have been used as inputs of a final finished product and the inputs are an insignificant portion of the total make-up of the goods;
 - the goods manufactured by the CFC involve significant and substantial production processes and not mere minor processes; or
 - the goods are sold to external parties for delivery in the country of the CFC's residence. These transactions are indicative of economic and business reasons for the offshore establishment, due to market demand.

- The CFC performs services to the connected South African resident and the fees generated generally consist of management fees; inter-group fees; internal accounting fees; etcetera. These type of fees generate transfer-pricing abuses and will only meet the 'higher business activity standard' and fall within the 'business establishment' exemption, if
 - the service is conducted outside the Republic and the goods are not situated in South Africa; or
 - services performed by the CFC are for goods delivered to external persons who are residents in the country of jurisdiction of the CFC.

Mobile passive income

Mobile passive income consists of interest, dividends, rental, royalties and other items of a similar nature including any capital gains arising on the disposal of any asset from where the passive income was derived, for example, a capital gain on the disposal of shares from which dividends were previously earned.

It is easy to see why these forms of income will result in the inapplicability of the 'business establishment' exemption. Passive income items can easily be diverted offshore in a scheme to avoid South African taxation.

There are, however, two exceptions to this proviso:

- The passive income of a CFC will qualify for the 'business establishment' exemption if the passive income does not exceed 5% of the CFC's total receipts and accruals. The main reason for this proviso is an administration convenience.
- In the instance where the CFC's main or principal trading activity results in passive income being derived. For example, the CFC's main form of trading may be that of banking. The passive income must, however, not be derived from a connected South African resident and must not be part of a taxing-saving scheme.

The already or concurrently taxed exemption (s 9D(9)(e))

The already or concurrently taxed exemption includes amounts derived by a CFC that have already been included in the South African resident shareholder's 'taxable income', for example, income that has its source in South Africa. The exemption is, however, subject to the proviso that the income will not be exempt from South African taxation or taxed at a reduced rate. This exemption prevents the incidence of double taxation.

The related CFC and intra-group exemptions (s 9D(9)(f),(fA) and (fB))

Dividends received by a CFC from a foreign company that is another CFC in relation to the South African resident shareholder, will not be imputed and subject to South African taxation in terms of s 9D. This exemption again prevents double taxation arising as the earnings underlying the dividend would already have been subject to direct taxation by the declaring CFC.

This exemption takes into account only foreign dividends whose underlying profits will be included in the South African resident shareholder's income. The exemption does not provide for the situation when foreign dividends received by the CFC are from minority-held investments or joint ventures and the provisions of s 9D are not applicable. In these situations the foreign dividend may be directly imputed into the South African resident shareholder's 'taxable income'. In this regard, the participation exemption provides relief under certain circumstances.

There is no inclusion in the 'taxable income' of a South African resident shareholder for the following amounts received or receivable by a CFC from a foreign company that form part of the same 'group of companies':⁴¹

- Interest, rental, royalties or other income of a similar nature.
- Any similar amounts adjusted in terms of s 31.
- Any exchange items arising between the CFC and the foreign company.

As stated above, this exemption from income correlates directly to the prohibition of the deduction from 'net income' of the CFC paying these amounts.

There is also no inclusion in the 'taxable income' of the South African resident shareholder for a 'capital gain' made by a CFC. This refers to assets that were attributable to a 'business establishment' of that CFC or any other foreign company, where the CFC and the foreign company form part of the same 'group of companies'. The exemption does not apply to the disposal of financial instruments and intangible assets.

The participation exemption (s 9D(9)(h))

The participation exemption caters for the situation where dividends and capital gains are derived by a CFC from a foreign company that is not a related CFC, for example, a joint venture.

The CFC is to disregard any amount derived

⁴¹ Refer to Glossary of Terms for the definition of a 'group of companies'.

- from the disposal of an interest in the equity share capital of a foreign company (ordinary shares and or certain participating preference shares), for example, a capital gain arising on the disposal of the shares as calculated in terms of the Eighth Schedule of the Act. This exemption will not be available if the foreign company is a ‘foreign financial instrument holding company’⁴² immediately prior to disposal; or
- by way of a dividend declared to that CFC from a foreign company.

This is subject to the following provisos:

- The CFC held more than a 25% interest in the equity share capital of the foreign company immediately prior to disposal of the share capital or the declaration of the dividend; and
- for the disposal of shares, the greater than 25% interest was held for a period of at least eighteen months. Where the CFC acquired the interest from another foreign company, forming part of the same ‘group of companies’, this requirement is satisfied if both companies in aggregate held the interest for at least eighteen months.

What appears to have been a relief mechanism to gains and dividends derived from non-CFCs, where a lower or no tax relief was provided (the related CFC and intra-group CFC exemptions being inapplicable) has aggravated matters. In many circumstances the situation may result in an increased tax liability that could otherwise have been avoided if this exemption had not been legislated.

Consider the following example:

A South African company owns all the shares in non-resident Company Y, which in turn owns all the shares in non-resident Company Z. Company Z has a 50% interest in a joint venture. Company Z disposes of the shares in the joint venture. A capital gain is derived by Company Z. On the assumption that

- the values of Company Z and the joint venture do not consist mainly of financial instruments;

⁴² A ‘foreign financial instrument holding company’ is a company whose value consists mainly in financial instruments, for example, shares and bonds. Refer to s 9D(1) of the Act for the definition.

- more than 25% of the equity share capital in the joint venture was held by Company Z for a period greater than eighteen months; and
- the companies form part of the same 'group of companies',

any capital gain arising will not be imputed to the South African company and not subject to taxation at the effective rate of 15% (that is the 50% capital gain inclusion at the 30% corporate tax rate). In fact, the gain will be capitalised in Company Y and distributed to the South African company as a foreign dividend, subject to a corporate tax charge of 30%.

In conclusion, the application of the participation exemption has resulted in an increased tax charge of 30% as compared to a tax charge of 15% had the exemption not been available.

Caution is therefore necessary where investment disposals by multinational companies in jointly-owned foreign assets are to be undertaken that will result in significant capital gains being earned. Tax-planning opportunities consist of ensuring that the requirements of the participation exemption are not met. For example, in the example illustrated above, by increasing the financial instrument value of Company Z or by disposing of the interest in the joint venture at a higher group level, for example, at Company Y.

The benefit of the participation exemption is the exemption of the non-CFC dividend but there is a disadvantage of being taxed at a higher rate of tax on capitalised capital gains.

Relief available

The following are provisions contained in the Act that provide relief to the South African resident shareholder, when the provisions of s 9D are applicable.

The s 6quat rebate

Relief from economic double taxation is provided by the foreign tax rebate.⁴³ Section 6quat(1) specifically includes within its ambit any proportional amount contemplated in s 9D that has been included in the taxable income of a South African resident. The amount

⁴³ Refer to Glossary of Terms for the definition of double taxation.

of the tax rebate that can be off-set against South African taxation arising on the proportional amount imputed in terms of s 9D, is the sum of the foreign taxes proved to be payable by the CFC concerned, to its country of jurisdiction, without any right of recovery. The rebate is, however, limited to the proportion of South African taxation payable that bears to the ratio of the proportional amount of 'net income' in terms of s 9D, to that of the total 'taxable income'.

Section 9A

Section 9A is a new provision that was brought into the legislation by the Revenue Laws Amendment Act 74 of 2002. This provision refers to 'blocked foreign funds'. It applies to the proportional amount of imputed income determined in terms of s 9D that may not be remitted to the Republic during a year of assessment as a result of currency or other restrictions or limitations imposed by the law of the country where the CFC is a resident.

Section 9A allows that portion of the imputed 'net income' that cannot be remitted to be deemed not to have been received or accrued to the South African resident shareholder. The amount will not be subject to the provisions of s 9D until the time that the funds may be remitted to the Republic.

This provision cannot be used as a tax-planning tool by the South African resident shareholder, for example, to smooth the taxable income over a period of years. The provision is not elected at the option of the taxpayer.

Self-assessment

Section 9D(11) of the Act states that if a resident fails to comply with the provisions of s 72A, that is the completion of a tax return (an IT 10) required for participation rights in a CFC, all exemption provisions that may be available for usage by the CFC, will not apply, except for the 'designated country' exemption.

Section 9D(11) emphasises that unless adequate disclosure is made by the resident taxpayer, the Commissioner may never know of the offshore investment and as a result of the foreign-sourced income derived by the taxpayer. The provisions of s 72A have, however, harsh penalties should the disclosure not be made to the Commissioner and may result in double taxation being incurred.

Where to establish the foreign company?

As will be identified with offshore branches⁴⁴ the choice of country in where to establish the foreign company has varying tax implications. Consider establishing the foreign company in one of the following three countries, one of which is a ‘designated country’, one that is not a ‘designated country’ and one that is recognised as a tax haven.

The United Kingdom

The United Kingdom is a ‘designated country’ as defined. In terms of the United Kingdom tax legislation, a company established in the United Kingdom is a taxable person liable for corporations tax at the current rate of 30%. As a result a foreign company that meets the definition of a ‘CFC’ that is incorporated in the United Kingdom will be exempt in terms of the provisions of s 9D(9)(a) and not subject to taxation in the Republic.

Interestingly, identified in Chapter 5 relating to ‘foreign dividends’, any amounts distributed to the South African shareholders, who have an interest of 10% or more in the equity share capital of the CFC situated in a ‘designated country’, for example, the United Kingdom will also be exempt from taxation on the foreign dividend in terms of s 9E(7)(d).

Kenya

Kenya is not a ‘designated country’ as defined and the ‘designated country’ exemption is therefore not available. If the foreign company is a CFC the provisions of s 9D may be applicable provided that none of the other exemptions are available. For example, if the company established in Kenya has no fixed place of business and all the management and control of the company is conducted outside South Africa, the provisions of s 9D will be applicable and no exemptions will be available.

The foreign company will be incorporated in Kenya and subject to foreign taxes. Relief from double taxation can be obtained by applying the provisions of the s *6quat* rebate.

Isle of Man

The Isle of Man is not a ‘designated country’ as defined. It is recognised as a tax haven.

⁴⁴ Refer to Chapter 5.

The tax consequences and the tax relief as a result of establishing a foreign company in a country recognised as a tax haven will be the same as that for Kenya, as illustrated above.

The OECD Model Convention's concept of a tax haven is a tax jurisdiction that offers itself as a place that non-residents can use to escape tax obligations in their countries of residence. There are no tax savings by establishing a foreign company in a tax haven as South African residents are taxed on their world-wide receipts and accruals – provided full disclosure is made by these residents to the Commissioner.

Double tax agreements and s 9D

Double tax agreements (DTAs) provide taxing rights to countries and provide relief from the instance of double taxation. DTAs have the effect of law and override the domestic law, for example, South African tax legislation. In certain circumstances DTAs provide that business profits of an enterprise may be taxed only in its country of residence. Can a DTA therefore protect a resident from the provisions of s 9D? In this regard, in the European tax case of *Bricom Holdings Ltd v Inland Revenue Commissioners*,⁴⁵ it was held that the United Kingdom could not levy tax on the actual interest earned by a foreign subsidiary but was entitled to levy tax on any notional income deemed to have been received.

The proportional amount of 'net income' imputed to the resident, in terms of s 9D, in many instances bears little relationship to the actual earnings received or accrued. The taxation paid by the resident is based on a notional amount and not on the actual receipts or accruals.

Based on the courts findings in *Bricom Holdings Ltd*, it appears that the provisions of a DTA would not prevent the provisions of s 9D being applicable to South African residents. South African taxation would be levied on the notional income deemed to be earned. To date there seem to be no South African tax cases providing legal precedent on s 9D and CFCs.

It remains therefore to be determined what, if any, are the tax implications where the profits of the CFC are distributed to the resident shareholders as a dividend and

- the net income of a CFC is not imputed to the South African resident shareholder due to either of the following two reasons:

⁴⁵ [1996] STC (SCD) and [1997] STC 1179 (CA).

- first, one of the exemptions of s 9D(9) applies, for example, the CFC is situated in a 'designated country', or the CFC has a legitimate 'business establishment' offshore; or
- secondly, the resident shareholder does not, together with any connected person, have a qualifying interest in the CFC, that is, he has participation rights of less than 10%; or
- the foreign company does not meet the definition of a 'CFC' and is not subject to the provisions of s 9D.

Chapter 4

Foreign dividends

The scope of this dissertation is not to perform a critical analysis of ‘foreign dividends’ and the provisions of s 9E but to provide a holistic view on all tax implications affecting South African residents who invest offshore. The provisions of s 9E are therefore addressed so as to determine the tax consequences for South African residents when dividends or distributions are made to them.

The meaning of ‘foreign dividends’

‘Foreign dividends’ as well as ‘deemed foreign dividends’ are subject to taxation in terms of the provisions of s 9E and are included in the gross income of a South African resident in terms of para (k) of the definition of ‘gross income’. A ‘foreign dividend’ in terms of s 9E means

- any dividend received by or accrued to a resident from any company that is not a South African resident, that is, a ‘foreign company’ as defined in s 9D;
- any dividend received by or accrued to a resident from a company that is resident in South Africa but the dividend distributed is from profits derived by it before becoming a resident. This will include dividends that comprise of earnings attributable to offshore operations; and
- any amount deemed to have been distributed to a resident by a related CFC that consists of⁴⁶
 - any cash or asset distributed by the CFC for the benefit of the resident shareholder;
 - a debt owed by the resident shareholder to the CFC and the shareholder is released from the obligation;
 - a third-party debt owed by the resident shareholder, that is settled by the CFC; or

⁴⁶ Refer to s 64C(3)(a), (b), (c) and (d).

- any amount used or applied by the CFC in a manner for the benefit of the resident shareholder.

In the following circumstances, there will be no deemed dividend:⁴⁷

- An amount granted to the resident shareholder that is ‘remuneration’ as defined.
- A loan granted to a resident shareholder as permitted in terms of the Seventh Schedule of the Act, at an interest rate not less than the ‘official rate of interest’.
- A loan granted to the resident shareholder that is repaid within the end of the next year of assessment and the loan arrangement is not repeated.
- A loan that is granted in terms of an employees’ trust incentive scheme.
- A loan that is granted to a resident shareholder that is a company.

Inclusion in gross income

The manner that the ‘foreign dividend’ is included in a resident shareholder’s gross income is dependent on the quantum of the interest in the ‘equity share capital’ that the shareholder has.⁴⁸

10% or more of the equity share capital

If a resident, being a natural person or a non-natural person, together with a connected person, holds an interest of 10% or more of the equity share capital of the company declaring the dividend, there is a ‘qualifying interest’. When there is a ‘qualifying interest’, a proportionate amount of the profit from that which the dividend is declared, is included in the gross income of the resident shareholder.⁴⁹ The proportionate amount is before any foreign taxes payable and before any withholding taxes on the dividend declared.

⁴⁷ Refer to s 64C(4)(a), (b), (c), (d), (e), (f), (i) and (j).

⁴⁸ Equity share capital is the issued share capital excluding the right to participate beyond a specified amount in a distribution.

⁴⁹ The proportionate amount is the ratio of the shareholder’s shareholding to the total shareholding.

A ‘look through’ approach must be adopted when including the proportionate amount of pre-tax profit. So as to minimise any taxation, it may be discovered that a portion of the foreign profit may be exempt from taxation because of the nature and source of the profit. For example, if the ‘foreign dividend’ includes forms of income that have already been included in the gross income of the resident. These would include income imputed in terms of s 9D or income that is a ‘foreign dividend’ that has already been included in the resident’s gross income.

Less than 10% of the equity share capital

If a resident shareholder holds less than 10% of the equity share capital, the resident will include only the pre-tax dividend received or accrued in his gross income. The pre-tax dividend is the dividend before any withholding taxes.

Exemptions available

The following exemptions result in the ‘foreign dividend’ being free of taxation in South Africa:

- ‘Foreign dividends’ declared by a company listed on the JSE Securities Exchange to a resident who, together with any connected person, holds less than 10% of the equity share capital in the declaring company, provided that more than 10% of the shares were at the time of the dividend declaration, held collectively by residents;
- ‘foreign dividends’ declared to a resident, holding 10% or more of the equity share capital of the declaring company, where the profits from which the dividend was declared have been subject to tax in a ‘designated country’ at the qualifying statutory rates;⁵⁰
- ‘foreign dividends’ or ‘deemed foreign dividends’ declared from profits that includes income imputed to the resident’s taxable income in terms of s 9D; or
- ‘foreign dividends’ declared from profits that will be subject to taxation in South Africa.

The last two exemptions avoid double taxation arising.

⁵⁰ Being 13,5% for capital gains and 27% for amounts other than capital gains.

Additional relief available

The s 6quat rebate is available to the resident shareholder in the instance that the ‘foreign dividend’ falls into gross income in terms of para (k) of the definition of ‘gross income’. This provides relief from the incidence of double taxation. The resident shareholder has the option to elect to include into ‘gross income’ the *net amount*⁵¹ of the dividend received or accrued and not to include the pre-tax dividend or pre-tax profit, as the situation may be. But, if this election is made no s 6quat rebate is available.

Further relief is available to a resident that is a natural person. The first R1 000 of the ‘foreign dividend’ received or accrued, is exempt from South African taxation during the year of assessment.

Avoidance of s 9E

With reference to the example of a scheme that a taxpayer may implement so as to avoid the provisions of s 9D being applicable, the provisions of s 9E can also be avoided.⁵² This can be achieved by the foreign company not declaring a dividend. In this instance the profits of the foreign company will be capitalised and enjoyed by the shareholder only on disposal of his shareholding in the company. Unfortunately, however, the above scheme has simply deferred the tax liability. On disposal of these shares, normal tax or capital gains tax in terms of the Eighth Schedule of the Act will arise.

Again, the choice of jurisdiction as to where to invest funds has an impact on the tax consequences of ‘foreign dividends’. Investments yielding ‘foreign dividends’ that are situated in countries classified as ‘designated countries’, for example the United Kingdom, will be exempt from South African taxation. Investments yielding ‘foreign dividends’ that are situated in countries that are not ‘designated countries’ may be subject to South African tax if none of the other exemptions in terms of s 9E(7) apply.

⁵¹ Dividend after withholding tax.

⁵² Refer to Chapter 3.

Chapter 5

Foreign branches

The establishment of a foreign company is just one of the many ways to conduct cross-border activities and to invest offshore. An alternative to the creation of an offshore subsidiary or foreign company is to structure the offshore operation as a branch.

Commercial factors influencing the decision

The following are some of the commercial factors that may affect the decision as to the type of entity to establish:

- It is sometimes easier to establish a branch than an offshore subsidiary.
- There are usually no minimum capital requirements for a branch.
- The branch is not a separate legal entity and hence there is no separate limited liability protection.
- There may be no alternative but to form a branch, for example, where a licence is necessary to operate a resident institution.

Taxation of foreign branches

A branch is not a separate legal entity and a foreign branch of a resident company would then too be a resident for the purposes of South African taxation. The profits and gains of a foreign branch of a South African company are subject to taxation at the statutory tax rate of 30%. Exemption from South African taxation may be available in terms of the provisions of s 9F.

Section 9F

Section 9F(2) states the following:

‘The amount of any income which shall be exempt from tax in terms of the provisions of section 10(1)(kA), shall be so much of any amount received by or accrued during the relevant year of assessment by or to any company which is a resident from a source outside the Republic, which is not

deemed to be from a source in the Republic, which has been or will be subject to tax in any designated country at a qualifying statutory rate as defined in section 9E.’

Section 10(1)(kA) states that

‘so much of any amount received by or accrued to any company which is a resident from a source outside the Republic as determined in accordance with the provisions of section 9F(2)’.

This provision provides relief for branches established in ‘designated countries’ that are subject to normal taxation at a rate of at least 27% and capital gains tax at a rate of at least 13,5%. This exemption from South African taxation assists in improving and maintaining international competitiveness for resident taxpayers.

There is, however, a shortcoming of this provision. Section 9F is available only to companies that are resident in South Africa. As a result, if a natural person or a partnership established a branch offshore in a ‘designated country’ to conduct foreign trading, the provisions of s 9F would not apply and South African taxation would be incurred. The s 6quat rebate would need to be claimed to avoid double taxation.

Relief from the instance of double taxation

The s 6quat rebate is available to a resident that has income included in its ‘taxable income’ that has been derived from a source outside South Africa. The rebate will be available to a foreign branch and assist in the prevention of double taxation.

Double tax agreements

Double tax agreements (DTAs) may provide further relief where the provisions of s 9F are unavailable. In terms of art 7 of the OECD Model Taxation Convention on Income and Capital, the business profits of a contracting state may be subject to taxation in another contracting state if the enterprise carries on business through a ‘permanent establishment’⁵⁵ situated in it.

A ‘permanent establishment’ specifically includes a branch.

⁵⁵ Refer to art 5 of the OECD Model Taxation Convention on Income and Capital.

To understand what art 7 effectively means, consider the following:

A South African resident company establishes a branch. It is not situated in a ‘designated country’. A branch is a ‘permanent establishment’ for the purposes of DTAs. The provisions of s 9F will not be available and the branch’s profit will be subject to taxation in South Africa. Assuming that there is a signed DTA between South Africa and this country complying with the terms of the OECD Model, the business profits will be subject to taxation only in the foreign country. South Africa will have no taxing right to the foreign income. The DTA assists in preventing the instance of double taxation.

Foreign losses

In terms of the proviso to s 20(1), foreign losses incurred by a resident company in carrying on a trade outside the Republic cannot be used and set-off against its local ‘taxable income’. This proviso therefore limits the use of foreign losses. The foreign losses can be carried forward only to future years of assessments, to be set-off against other foreign income. The reasoning behind this proviso is to prevent any erosion of the South African tax base as a result of introducing the residence basis of taxation.

Choice of jurisdiction when establishing the foreign branch

As identified with foreign companies and ‘foreign dividends’ the choice of country where to establish the foreign branch has varying tax implications. The implications for establishing a foreign branch in either a ‘designated country’, or a non-designated country, or a tax haven are identified below.

The United Kingdom

The United Kingdom is a ‘designated country’ as defined. In terms of the United Kingdom tax legislation, a branch of a non-resident company is subject to corporation tax in the United Kingdom at the current rate of 30%, if the branch is carrying on a trade in the United Kingdom. As a result foreign taxation is payable on the branch’s income. There is no withholding tax on any payments made to the South African resident company that are attributable to the trade carried on in the United Kingdom.

As the United Kingdom is a ‘designated country’ and if this branch is a branch of a resident company, the provisions of s 9F, read with s 10(1)(kA), are applicable and the branch’s profit is not subject to South African taxation.

Kenya

Kenya is not a ‘designated country’ as defined. In terms of Kenya tax legislation, a branch of a non-resident company is subject to tax in Kenya at the current rate of 37,5%. As a result foreign taxation is payable on the branch’s income.

As Kenya is not a ‘designated country’ the provisions of s 9F, read together with s 10(1)(kA), are not available and there will be a South African tax liability on the branch’s income.

There is no DTA in place between South Africa and Kenya and it cannot be determined which country will have taxing rights. The provisions of s 6quat, however, will provide relief from double taxation.

Isle of Man

The Isle of Man is not a ‘designated country’ as defined. It is recognised as a tax haven. The provisions of s 9F, read together with s 10(1)(kA), are not available.

The tax consequences as a result of establishing the foreign branch in a country recognised as a tax haven will be the same as that for Kenya, as illustrated above.

Provided the resident makes full disclosure to the Commissioner, there are no tax savings by establishing a branch in a tax haven as South African residents are taxed on their world-wide receipts and accruals.

A foreign branch or a foreign company

A foreign branch as opposed to a foreign company is a further choice that an offshore investor may need to consider. As identified above s 9F is applicable to company profits earned by a foreign branch established in a ‘designated country’ and s 9D and s 9E are applicable to foreign companies.

When investing in a country that is not a ‘designated country’ as defined, for tax purposes it makes no difference whether to create a company or a branch from which to conduct a foreign trade. Section 9F will not exempt the branch’s profit from South African income tax and the profit earned by the foreign company will be subject either to South African income tax

- in terms of s 9D, if the foreign company meets the definition of a ‘CFC’, or
- in a later year of assessment in terms of s 9E, when its profits are distributed as a dividend.

Again, when investing in a country that is a ‘designated country’ as defined, no South African taxation will be payable, either by the foreign branch or by the foreign company.

In conclusion, operating through a foreign branch or a foreign company makes no difference for South African tax purposes.

But these are not the only types of operating entities that a South African resident can conduct offshore trading operations through. It remains to be considered what the tax implications are for conducting offshore operations through a partnership, or as an individual, or as a trust.

Chapter 6

Partnerships and natural persons

As a result of a partnership lacking legal personality, the provisions of s 9D cannot be applied. No imputing of income to the partner from a foreign partnership will be made in terms of s 9D. The partner of a foreign partnership, who is a resident cannot however, escape taxation from the offshore profit earned. South African residents are taxed on their world-wide receipts and accruals in terms of the residence basis of taxation.

In terms of South African tax legislation a partnership is not recognised as a taxpaying entity. Each partner includes his share of the partnership profit or loss in determining his own taxable income. Persons carrying on a trade or business through a partnership are subject to income tax in terms of the provisions of s 24H of the Act.

Section 24H(5) of the Act states that a partner is deemed to have received or accrued his share of the partnership profits when the profits are received or accrued to the partnership. As a result there is no deferral of income. The profits of the foreign partnership are included in the 'taxable income' of a partner as and when they are earned.

The basis of taxation of a foreign partnership is that of a natural person, who is taxed on his world-wide receipts and accruals if he is a resident of South Africa.

As a result of the provisions of s 9D not being applicable to partnerships and natural persons, the term 'designated country' has no influence on the taxation of the foreign profit earned. The choice of tax jurisdiction when carrying on a trade will also have no differing tax implications.

In the event of double taxation arising, the provisions of the s *6quat* rebate may be used. A DTA may also provide relief.

Foreign company versus a natural person

Again, it may be in the interest of a foreign investor, to consider whether it would be more tax beneficial to carry on his offshore trading through a foreign company or in his own name, as a

natural person. The tax payable by the two different taxpayers differs materially if the foreign business is established in a 'designated country' as defined.

The profit of the foreign company, assuming it is a CFC, will be exempt from the provisions of s 9D if it is established in a 'designated country'. No South African tax will be payable. Note that this will also apply to a foreign branch that is situated in a 'designated country', due to the provisions of s 9F, read together with s 10(1)(kA).

For the natural person, who is a resident, the net foreign profit, after deductions and allowances, will be subject to taxation in South Africa as a result of the residence basis of taxation. Relief from double taxation can be obtained through the s 6quat rebate or in terms of a DTA, if in place. The DTA may provide that one of the countries has a taxing right to the income earned.

The 'net income' of a CFC, provided that none of the exemptions in terms of s 9D(9) are available, is subject to South African taxation at a statutory tax rate of 30% whereas individuals are subject to tax at their marginal tax rates that may in some instances be 40%. As a result the taxation payable in South Africa on the same amount of income earned by two different types of taxpayers could differ substantially.

Chapter 7

Offshore trusts

The concept and elements of a ‘trust’

The concept of the trust is derived from English jurisprudence. It was introduced into South Africa in 1815. The word ‘trust’ suggests a fiduciary relationship. A trust can be described as an arrangement for the holding and administration of property, under which the property or legal rights are vested by the owner (the settlor) in persons (the trustees), that hold them or exercise them for or on behalf of others (the beneficiaries), for the accomplishment of certain purposes. The concept of a trust is in essence⁵⁴

‘the separation of the legal and beneficial ownership [of property], the property being legally vested in one or more trustees but in equity held for and belonging to others [the beneficiaries]’.

A trust is included in the definition of a ‘person’ in s 1 of the Act. In terms of South African legislation, a trust is a separate legal entity and subject to taxation. The word ‘trust’ is defined in s 1 as

‘any trust fund consisting of cash or other assets which are administered and controlled by a person acting in a fiduciary capacity, where such person is appointed under a deed of trust or by agreement or under the will of a deceased person’.

Trusts therefore fall into two categories;

- those that arise on death of a person, known as testamentary trusts, and
- those that are formed during a person’s lifetime, known as *inter vivos* trusts.

These trusts can be further classified into either discretionary trusts or vesting (non-discretionary) trusts.

A discretionary trust

A discretionary trust is a trust where the ownership, control, income and capital of the trust fund vest in the trustees, in their representative capacities for the benefit of the beneficiaries.

⁵⁴ Barry Spitz, *Offshore Trust Planning* at 1.

The beneficiaries have no legal entitlement to any of the benefits or assets of the trust, until the trustees exercise their discretion and award the benefits or assets to them. In law, the trustees are required to exercise independent judgement in making distributions of trust income and capital to beneficiaries.

A vesting trust

Non-discretionary or vesting trusts are trusts where the ownership, control, income and capital of the trust fund vest in the beneficiaries. The beneficiaries have legal entitlement to the benefits and assets of the trust. The trustees have no discretion.

Trusts are viewed by many investors and business advisers as the most appropriate structure for holding offshore investments. Investors want a simple investment structure, that is inexpensive to set up and to administer, that is tax efficient, offers protection against creditors and that offers anonymity while the investor retains control over the assets.

Trusts have been said to provide many of the solutions to this.

A trust is governed by its trust deed. This assists the trustees in carrying out their obligations and exercising their duties. In South Africa, for a valid trust to exist the following characteristics must be present:

- The founder of the trust must relinquish control over the trust property. The founder must not attempt to retain control, either directly or indirectly, of any of the trust property. The trust property must be treated as belonging to the trust.
- Parties involved in the establishment of the trust must intend to form and give effect to the trust. In this regard the substance over form principle must be applied and the true intention of the parties involved will be determined so to ensure that in 'substance' a trust has been formed.
- The trust deed should not contain provisions that allow the founder to be in ultimate control over the trust property and hence control the trustees.
- The trustees too, must always independently exercise their duties in terms of the trust deed and always in the best interests of the beneficiaries. Trustees should also not be under the control of the beneficiaries.

There is no universal trust law and this becomes problematic in jurisdictions that do not recognise trusts. The *Hague Convention on the Law Applicable to Trusts and on Their Recognition* (1985), is a convention that attempts to standardise and determine how the trust concept should be governed. The *Hague Convention* is a document that has assisted in increasing the awareness of trusts internationally. Article II of the *Convention* also describes a valid trust in terms of the characteristics as described above. Article II states the following:⁵⁵

‘For the purposes of this Convention, the term “trust” refers to the legal relationship created – *inter vivos* or on death – by a person, the settlor, when assets have been placed under the control of a trustee for the benefit of a beneficiary or for a specified purpose.

‘A trust has the following characteristics–

- (a) The assets constitute a separate fund and are not a part of the trustee’s own estate;
- (b) title to the trust assets stands in the name of the trustee or in the name of another person on behalf of the trustee;
- (c) the trustee has the power and the duty, in respect of which he is accountable, to manage, employ or dispose of the assets in accordance with the terms of the trust and the special duties imposed upon him by law.

‘The reservation by the settlor of certain rights and powers, and the fact that the trustee may himself have rights as a beneficiary are not necessarily inconsistent with the existence of a trust.’

It is interesting to note that although the *Hague Convention* describes a valid trust with characteristics similar to that of a South African trust, South Africa has to date not yet ratified the *Convention*. The applicability of the *Convention* is important, however, when deciding in which country to establish an offshore trust. It is important to choose a jurisdiction that recognises the concept of a trust. The country chosen may or may not have implemented the *Convention* and as a result may not recognise or enforce the trust.

South African tax legislation and offshore trusts

From the definition of a ‘resident’, an offshore trust is any trust that is not established or formed in the Republic and that has its place of effective management outside of the

⁵⁵ The Hague Convention on the Law Applicable to Trusts and on Their Recognition (1985).

Republic. As a result the offshore trust that is not a resident as defined, will itself not be subject to South African tax on its foreign-sourced income.

Offshore trusts have in the past been favoured vehicles for offshore investments. It has been estimated that one quarter of the money in the world is held in offshore trusts and more than half of the world's money is offshore.⁵⁶ Offshore trusts have grown in popularity in South Africa with the relaxation of foreign exchange control regulations. With the introduction of the residence basis of taxation, South Africans are, however, liable for income tax on offshore trust income and capital distributions. For this reason as well as a variety of other reasons, there are more efficient ways of holding investments than in an offshore trust. The high cost of administering an offshore trust, more enforced foreign exchange regulatory requirements, together with the current South African tax legislation, no longer renders an offshore trust as attractive as it was in the past.

In the past residents could have avoided or postponed paying tax on any foreign-sourced income by creating foreign entities, for example, offshore trusts, where this income could be placed. But as the legislature is always quick to respond to tax-saving schemes, various anti-avoidance provisions have been put in place to counter these arrangements. The anti-avoidance provisions that specifically relate to trusts include s 7, s 25B, s 31 and para 80 of the Eighth Schedule of the Act. The current tax legislation renders offshore trusts as unattractive as possible.

When a person thinks of a trust, three questions arise:

- First, how will the trust be funded?
- Secondly, how will the income and capital be distributed to the beneficiaries?
- Thirdly, who will be liable for taxation?

Unsurprisingly, all three of the above have resulting tax implications that are described in detail below.

⁵⁶ KPMG, *History and Current Status of Offshore Jurisdictions*, at 1.

Funding of the trust

Assets are usually settled in an offshore trust by the settlor, either

- in terms of a sale at market value, or
- by means of a donation.

Both methods can have tax implications.

Funding of a trust by means of a ‘donation’

If the settlor is a ‘resident’ as defined in terms of s 1, assets settled in an offshore trust by means of a ‘donation’ attract donations tax in terms of s 54 of the Act. For the purposes of donations tax, a ‘donation’ is defined and includes any gratuitous disposal of property including any gratuitous waiver or renunciation of a right.⁵⁷ For the purposes of donations tax, the term ‘property’ is also defined and includes any right in or to property movable or immovable, corporeal or incorporeal, wheresoever situated.⁵⁸ There is, however, an exemption that may in certain circumstance be applicable resulting in no donations tax being incurred. The exemption is in terms of s 56 of the Act and refers to property situated outside the Republic that was acquired by the donor

- before he became a South African resident for the first time; or
- by inheritance or donation from a person who was not ordinarily resident at the time of death or donation; or
- out of funds derived from the disposal of the property referred to above, or from revenue derived from any of the above properties; or
- out of funds derived by him from any trade carried on by him outside the Republic; or
- for immovable property, not less than ten years before the date the donation takes effect.

⁵⁷ In terms of s 54 of the Act.

⁵⁸ In terms of s 54 of the Act.

Therefore in the instance that the above exemption is not applicable, when the settlor donates any property or rights in or to property, irrespective of whether the South African resident holds the assets locally or abroad, donations tax will be incurred.

The provisions of s 7 are also applicable to assets donated to an offshore trust. In particular the provision of s 7(8) will apply. Section 7(8) of the Act is a deeming income provision and states the following:

‘Where by reason of or in consequence of any donation, settlement or other disposition (other than a donation, settlement or other disposition to an entity which is not a resident and which is similar to a public benefit organisation contemplated in section 30) made by any resident, income is received by or accrued to any person who is not a resident (other than a controlled foreign company in relation to such resident), there shall be included in the income of that resident so much of the amount of any income as is attributable to such donation, settlement or other disposition: Provided that any amount of income received by or accrued to such person by way of foreign dividends, shall for the purposes of this section be determined in accordance with the provisions of section 9E, as if such person had been a shareholder who is a resident.’

There are two issues that remain to be determined and understood before the provisions of s 7(8) can be comprehensively understood and applied. These are

- the meaning of the word ‘income’ as it appears in s 7(8), and
- the deferral of income tax.

Meaning of the word ‘income’

The provision of s 7(8) makes reference to the word ‘income’ accruing to a non-resident. This ‘income’ is deemed to be the ‘income’ of the person making the donation, settlement or other disposition. Income is defined in s 1 as

‘the amount remaining of the gross income of any person for any year or period of assessment after deducting therefrom any amounts exempt from normal tax under Part I of Chapter II’.

‘Gross income’ of a non-resident is also defined in s 1 as follows:

‘[I]n relation to any year or period of assessment, [it] means . . . in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within or deemed to be within the Republic.’

On a strict interpretation of s 7(8), it can be interpreted that 'income' received by or accrued to non-residents can only include income from a South African source or income that is deemed to be from a source within the Republic.

Section 1 of the Act is the interpretation or definition provision. This provision is introduced with the following words:

'In this Act, unless the context otherwise indicates.'

The effect of these introductory words is that the definition of a term or a word in s 1 of the Act is conclusive unless the context in which it appears suggests another interpretation or meaning. The Bill of Rights has also resulted in the so-called new approach in relation to the interpretation of fiscal legislation. The 'new approach' is a more flexible approach to fiscal interpretation and gives effect to the intention of the legislature rather than a strict and literal interpretation of the legislation. In an article on the new approach it was identified that Seligson AJ in ITC 1584⁵⁹

'invoked the well-established rule of statutory construction that where the usual everyday meaning of the words of an enactment is in conflict with the clear intention of the legislature as gleaned from the statute as a whole and other relevant circumstances, it is permissible to depart from this meaning to give effect to the real intention. But at the same time, he cautioned about departing from the literal meaning of a statutory provision by supplementing it and noted that a court should only do so "where the contrary legislative intent is clear and dutiable".'

Consequently, it is doubtful whether this literal interpretation of s 7(8) will give effect to the true intention of the legislature. There is a good chance that the meaning of 'income' in s 7(8) will be interpreted as something other than its definition in s 1 of the Act. The word 'income' could be construed as meaning, *all* the gains and profits being received by or accruing to a non-resident by virtue of the donation, settlement or other disposition. This is further supported by the decision in *CIR v Simpson*,⁶⁰ where it was held that the word 'income' in the equivalent of s 7(2) meant profits or gains, and not that part of gross income remaining after the deduction of exempt income.

⁵⁹ Jonathon Silke 'The New Approach' (1995) 9 *Tax Planning* 138. See further ITC 1584 (1997) 57 SATC 63 at 71.

⁶⁰ 1949 (4) SA 678 (A), 16 SATC 268.

The deferral of income tax

As will be evident later, s 25B(2A), a taxing provision relating to a resident beneficiary of an offshore trust, does not prevent the deferral or postponement of income tax when dealing with an offshore trust. It is only when the accumulated income vests in a beneficiary that the provisions of s 25B(2A) will apply with the resulting accumulated income being subject to South African taxation, in the hands of the resident beneficiary.

When income is received by or accrued to an offshore trust that has only discretionary beneficiaries, the income accruing in the offshore trust will not be subject to South African taxation. If the income being received by or accrued to the offshore trust 'is by reason of or in consequence of' a 'donation, settlement or other disposition', the income will be deemed to be that of the donor and taxable in the hands of that donor. This prevents any deferral or postponement of the tax liability.

Sale at market value

Assets sold to an offshore trust can be funded by an interest-free loan. The reason is often as a result of the trust being newly established with little or no equity.

It is a 'grey area' whether or not the interest-free loan will attract donations tax. *Silke* states the following:⁶¹

'It is doubtful whether the making of an interest-free loan constitutes a "gratuitous disposal of property", and it is not the general practice of Inland Revenue to levy donations tax on interest-free loans. It has been held in relation to s 7(3) (see §10.63) that the granting of an interest-free loan to a company is a continuous donation to that company by the grantor of that loan [*CIR v Berold* 1962 (3) SA 748 (A), 24 SATC 729], but it must be borne in mind that the term "donation" is not defined in s 7(3) as it is for the purpose of donations tax.'

It can therefore be assumed that the sale of assets at their market value, settled by means of an interest-free loan, will not be subject to donations tax in terms of s 54 of the Act, but the provisions of s 7⁶² and s 31⁶³ may be applicable.

⁶¹ *Silke on South African Income Tax* in §23.3.

⁶² Deeming income provisions of the Act.

⁶³ The transfer pricing and thin capitalisation provisions of the Act.

Section 31

Section 31 of the Act is the provision that determines the taxable income of certain persons for international transactions. An interest-free loan granted by the settlor for the sale of assets to an offshore trust will attract the provisions of s 31(2).

Section 31 of the Act and the provisions relating to transfer pricing are beyond the scope of this dissertation, so in the main, if a South African resident who is a ‘connected person’ in relation to the trust, enters into a transaction with the trustees of an offshore trust and the transaction concluded is not at arm’s length, then the transfer pricing provisions will apply and the South African resident may be subject to taxation on a deemed basis.⁶⁴ The granting of an interest-free loan is not considered to be an arm’s length transaction in terms of s 31(2) and the settlor may, as a result, be subject to tax on deemed interest determined at a market-related rate of interest.

Section 7(8)

With reference to *Silke*,⁶⁵ as stated above, and in *CIR v Berold*,⁶⁶ it has been held that an interest-free loan is a continuing donation for the purpose of the provisions of s 7 of the Act. As a result, when a settlor sells assets to the offshore trust at a market-related price but which is settled by means of an interest-free loan, there is a ‘donation’ and the provisions of s 7(8) may become applicable.

The effect of this is that any income accruing to the offshore trust as a result of the interest-free loan, from a resident settlor, will be deemed to accrue to the settlor and the income will be subject to tax in the resident settlor’s hands.

Section 7(10) of the Act states the following:

‘Any resident who, at any time during any year of assessment makes any donation, settlement or other disposition as contemplated in this section, shall disclose such fact to the Commissioner in writing when submitting his return of income for such year and at the same time furnish information as may be required by the Commissioner for the purposes of this section.’

⁶⁴ Refer to Glossary of Terms for the definition of a ‘connected person’.

⁶⁵ In §23.3.

⁶⁶ 1962 (3) SA 748 (A), 18 SATC 354.

The above provision clearly states that the onus rests on the taxpayer making the donation, settlement or other disposition, to disclose the fact to the Commissioner. A self-assessment is invoked, similar to that found in s 9D(11) for CFCs.

Distribution of the income and capital to the beneficiaries

The tax provisions applicable to trusts and the distributions to the beneficiaries are determined in terms of s 25B. This provision deals with the income of both domestic and offshore trusts and their beneficiaries. Offshore trusts, are effectively governed by the provisions of s 25B(2A).

Section 25B(2A) provides that

- if any resident acquires a vested right to any amount representing the capital of a trust, the trust being a non-resident trust, and
- the capital arose from income received by or accrued to the trust, or
- the capital arose from receipts and accruals of the trust that would have constituted income if the trust was a resident,
- in any previous year of assessment during where the resident had only a contingent right to the receipts and accruals, and
- the income or receipts and accruals have not been subject to tax in the Republic,
- then the amount must be included in the income of the resident in that year of assessment.

South African residents who now set up offshore discretionary trusts run the risk of resident beneficiaries with vested rights becoming liable to income tax on any capitalised income that is available in the offshore trust. Where foreign-sourced income accrues to the trust and is not vested in any resident beneficiary, the accumulated income (the capital) of the trust will become subject to income tax only in the year that the resident beneficiary acquires a vested right to the capitalised income.

Income of discretionary offshore trusts are subject to South African taxation only when a vesting or a distribution to the resident beneficiaries takes place. There is no imputation of the

foreign income as and when it is earned, as the rules relating CFCs do not apply to an offshore trust.

The main aim of the provisions of s 25B(2A) is to bring within the tax net distributions of accumulated income (the capital) earned by trusts from income received in prior years. Without the provisions of s 25B(2A) the distributions of capital would not form part of the gross income of a taxpayer and would bypass any resulting South African taxation.

At first examination of this provision, it is clear that there is one certain requirement that needs to be met before the provision can be successfully applied. This is that the beneficiary must have had only a contingent right to the income, in the year that the income was received by or accrued to the trust, and that the beneficiary's contingent right has become a vested right in a later year of assessment. Following this then, it is necessary to compare a vested right with a contingent right.

Contingent right versus a vested right

When examining the provisions of s 25B of the Act, the issue of a contingent right versus a vested right has been the subject of debate in a number of tax cases over the years. It has been said when drawing a distinction between a vested and a contingent right that⁶⁷

‘[v]esting implied the transfer of dominium, and the children had clearly not in the year under review acquired dominium of the trust income or any portion thereof. A vested right was something substantial; something which could be measured in money; something which had a present value and could be attached. Contingent interest was merely a spes – an expectation which might never be realized. From its very nature it could not have a definite present value. In the income tax sense, therefore, a vested right was an accrued right.’

This distinction finds further support in *Estate Dempers v SIR*,⁶⁸ where the court was called to determine the applicability of the equivalent of s 7(5). Corbett JA when analysing the requirements of the provision stated that⁶⁹

‘[a] “contingent event” (Afrikaans text: “ongewisse gebeurtenis”) is an event which may or may not happen. A “fixed event” (Afrikaans: “gewisse gebeurtenis”) is the converse: it is an event which will

⁶⁷ Per G J Maritz, President of the Special Court for Hearing Income Tax Appeals, in ITC 76 (1927) 3 SATC 68 at 70.

⁶⁸ 1977 (3) SA 410 (A), 39 SATC 95.

⁶⁹ At SATC 112.

certainly and inevitably happen. The word “contingent” is also used to describe a right which is conditional and uncertain, as opposed to a vested right which is certain, unconditional and immediately acquired, even though in some instance enjoyment of the right may be postponed (*Jewish Colonial Trust v Estate Nathan* 1940 AD 163, 175-6; *Durban City Council v Association of Building Societies* 1942 AD 27, 33-4).’

From the above cited cases, it is evident that a vested right is distinguishable from a contingent right:

- A vested right is a real right, an accrued right. A right is said to vest in a beneficiary when he acquires it immediately, although its beneficial use or enjoyment may be postponed. The right acquired is certain and unconditional. On death or insolvency, the vested rights of a beneficiary become part of the assets of the beneficiary’s estate.
- A contingent right is only a hope, an uncertain right. The beneficiary’s rights are conditional upon the occurrence of an event or the passage of a particular period of time.

A contingent right can become a vested right in one of the following two ways:

- In the first instance a beneficiary’s right may be contingent upon the happening of an event. For example, the attainment of a certain age, marriage or even death. Once the event has occurred the contingent right will become a vested one.
- Alternatively, the exercise of a trustees’ discretion will change a contingent right into a vested right, that is, the right may be contingent on the exercise of the discretion of the trustees.

Therefore as long as the beneficiary has a contingent right to the income in the year that it was received or accrued to the trust, then the provisions of s 25B(2A) can apply in the year that the right becomes a vested right. Note that it is not a requirement of the provisions of s 25B(2A) that the trust be a discretionary trust.

The following example illustrates how a ‘contingent’ right becomes a ‘vested’ right in light of the current provisions of s 25B(2A).

An offshore trust has non-resident beneficiaries X and Y. The trust deed stipulates that all receipts and accruals accruing to and received by the trust, including all capitalised income, must become payable to X and Y on their attaining the age of twenty-one years. Prior to the

attainment of the stipulated age the trustees have the discretion to distribute income to X and Y, as they see fit. X becomes a resident of South Africa one day before his twenty-first birthday.

On X's twenty-first birthday all the capitalised income becomes taxable in X's hands. The attainment of twenty-one years has resulted in X's contingent right becoming a vested right. If X had become a resident only after his twenty-first birthday, no South African tax liability would be incurred, the provisions of s 25B(2A) would not be applicable.

From the above it is clear that it is immaterial whether the beneficiary was always a resident or if the beneficiary became resident only in the year that the vested right was acquired. A beneficiary, however, will not be liable to tax on a distributed amount if the vested right is obtained when the beneficiary is not a resident, even if he had a contingent right to the income, when he was a resident.

It is important to remember that in determining whether a beneficiary has a contingent or a vested right to the income and capital of a trust, the trust deed must be examined.

Income of offshore trusts

Section 25B(2A) of the Act clearly states that *all income* of the trust will become liable to taxation in the hands of a beneficiary whose contingent right to the income has become a vested right. Tax is an annual event and the holding of contingent rights for only a partial period of a year of assessment, does not render the provisions of s 25B(2A) ineffective. It must, however, also be noted that s 25B(2A) will be applicable only if the amount was received by or accrued to the offshore trust while the beneficiary had a contingent right to the income. It may therefore be necessary for an offshore trust to analyse its capital account and determine which capital amount was received as income when the beneficiaries had contingent rights. The provision clearly refers to any receipts or accruals that would have constituted income if the trust had been a resident. There is therefore no ability of excluding certain receipts or accruals from being subject to taxation in the hands of a beneficiary because the amounts did not constitute 'income' as defined in the Act.

Interesting to note, is that South African resident beneficiaries are subject to tax on capital distributions in terms of the income tax system and not in terms of the capital gains tax

system, that is, in terms of the Eighth Schedule. The beneficiaries are taxed on 100% of the accrual. If the beneficiary is a natural person 100% of the distribution may be taxed up to a marginal tax rate of 40%. If the distribution was taxed in terms of the Eighth Schedule, only 25% of the capital distribution would be included in the taxable income of the resident beneficiary. This is unfair to the beneficiary as s 25B(2A) taxes a capital distribution at the beneficiary's marginal tax rate for normal tax purposes as opposed to an amount that would normally be taxed at an effective lower tax rate in terms of the Eighth Schedule.

It remains to be established what other tax implications there are for resident beneficiaries with vested rights to the capital of an offshore trust. The provisions of s 25B(2A) will not be applicable to a beneficiary with unrestricted rights to the capital and no rights to the income of an offshore trust – the beneficiary that has no contingent rights to the income, renders the provisions inapplicable. Income tax will automatically accrue to a beneficiary with a vested right to the income and to any capitalised income of the offshore trust, and it will become evident later, that capital gains tax will apply to any vested capital amount.

An important principle that is to be considered when dealing with the taxation of trusts is the 'conduit principle'. The conduit principle was discussed in both *Armstrong v CIR*⁷⁰ and *SIR v Rosen*.⁷¹ This principle established that a trust is merely a conduit through which income flows and that income retains its identity until it reaches the parties in whose hands it is taxable. A 'qualification' to this principle was made in the *Rosen* judgment in that if income is retained by a trust it may lose its identity.

To date no indication has been given by the legislature as to the identity of capitalised income distributed to beneficiaries in light of the provisions of s 25B(2A). This may become critical to a taxpayer when there are provisions available that allow certain receipts and accruals to be exempt from tax, for example, 'foreign dividends' and foreign-sourced interest income are currently tax free to the extent of R1 000.

Capital gains tax and the offshore trust

Capital distributions made to South African beneficiaries out of capital received by or accrued to the trust will be subject to capital gains tax in terms of the Eighth Schedule of the Act.

⁷⁰ 1938 AD 343, 10 SATC 1.

⁷¹ 1971 (1) SA 172, 32 SATC 249.

Paragraph 80(3) of Eighth Schedule applies to an offshore trust. It states the following:

‘Where during any year of assessment any resident acquires a vested right to any amount representing capital of any trust which is not a resident, and–

(a) the capital arose from–

- (i) a capital gain of that trust determined in any previous year of assessment during which that resident had a contingent right to that capital; or
- (ii) any amount which would have constituted a capital gain of that trust had that trust been a resident; and

(b) that capital gain has not been subject to tax in the Republic in terms of the provisions of this Act,

that amount must be taken into account for the purposes of calculating the aggregate capital gain or aggregate capital loss of that resident in that year of assessment.’

When a beneficiary acquires a vested right in a trust he may have the rights to

- the income;
- the trust assets; and or
- the resulting gains on the trust assets.

The trust deed would need to be examined to determine this.

In the instance that the resident beneficiary has vested capital rights, capital gains that arise in an offshore trust will vest in the resident beneficiary and will be subject to capital gains tax in the beneficiary’s hands. This is a result of the vesting of the capital gain in the resident beneficiary. The capital gain is disregarded in the offshore trust.

This anti-avoidance provision further diminishes the tax advantages that can be obtained from the creation of an offshore trust. Both s 25B(2A) and para 80(3) of the Eighth Schedule of the Act ensure that any gains, both revenue and capital in nature, that vest in a resident beneficiary will be subject to South African taxation. The resident beneficiary with a vested right will become liable to taxation as and when the income or the capital gains are received by or accrued to the trust, even if actual payment or delivery is postponed. The applicable provisions of the Act apply and no deferral of taxation can be achieved.

If any foreign tax has been paid by the resident, relief is available. The resident will be able to claim a rebate against the resulting South African tax in terms of s 6quat of the Act.

Relief from the instance of double taxation

Section 6quat rebate for foreign taxes

For foreign taxes on income applicable to resident beneficiaries of offshore trusts, a s 6quat rebate may be available. Section 6quat is aimed at providing relief where double taxation arises. For the purposes of offshore trusts, this relief provision allows a rebate to be deducted from the normal tax payable by any resident in whose taxable income there is included

- any amount received by or accrued to any other person that is deemed to be received by or accrued to him in terms of s 7 of the Act, for example, when the provisions of s 7(8) are applicable to a resident donor of an offshore trust as a result of a donation;
- any amount that represents the capital of an offshore trust as contemplated in s 25B(2A);
or
- any amount that represents a capital gain taken into account in determining the aggregate capital gain or aggregate capital loss of that resident in terms of para 80(3) of the Eighth Schedule.

The rebate that is calculated in terms of this provision cannot exceed the foreign tax payable. Any rebate in excess of the foreign tax payable may be carried forward for a maximum period of seven years.

Relief from double taxation may also be obtained if there is a DTA between South Africa and the jurisdiction of the offshore trust. The s 6quat rebate cannot, however, be used in addition to any tax relief provided under a DTA, but it can be used in substitution of a DTA. This may occur where the s 6quat rebate provides a greater tax relief than a DTA.

Where to establish the offshore trust?

There are no significant tax effects for establishing an offshore trust in either a 'designated country', or a non-designated country, or a tax haven. The special rules applicable to companies and branches, when established in 'designated countries', do not apply to offshore trusts. It therefore makes no difference whether or not to establish an offshore trust in a 'designated country'. Once a resident beneficiary acquires a vested right to the income or the capital of the offshore trust, South African taxation is incurred.

The United Kingdom

Establishing an offshore trust in the United Kingdom will result in the provisions of s 25B(2A) and para 80(3) of the Eighth schedule being applicable to resident beneficiaries, subject to the relevant requirements being met.

In the instance of double taxation occurring relief can be obtained from either the DTA that is in place or by using the s 6quat rebate.

Kenya

The same tax effect will be achieved if an offshore trust is established in Kenya, as that in the United Kingdom. Relief from double taxation can however be obtained only by the provisions of the s 6quat rebate. There is no DTA in place between Kenya and South Africa.

Isle of Man

The same tax effect will be achieved if an offshore trust is established in the Isle of Man, as that in the United Kingdom or Kenya. Relief from double taxation can however be obtained only by the provisions of the s 6quat rebate. There is no DTA in place between the Isle of Man and South Africa.

In conclusion, offshore trusts cause tax to be imposed on a resident settlor or a resident beneficiary. Both normal taxation and capital gains tax are imposed. The choice of jurisdiction may be affected by the different tax rates in the above jurisdictions and any other commercial reasons but there are no South African tax benefits to be gained.

Chapter 8

Conclusion

The extensive anti-avoidance rules from the provisions of s 9D, s 9E, s 9F, s 31, s 25B(2A) and para 80 of the Eighth Schedule are the consequences that South African residents have to bear as a result of the full integration with the global economy and with the introduction of the residence basis of taxation.

The purpose of these anti-avoidance provisions is to stop South African residents from avoiding tax in South Africa by diverting income to foreign companies, trusts, branches or other establishments based in tax havens or in countries with lower-tax rates. Generally, the anti-avoidance rules work by requiring South African residents to pay an amount of tax equal to the tax that would otherwise be avoided. There are exemptions and reliefs that may be available in certain circumstances, but these are often difficult to establish. There is always the risk that taxation may be levied in South Africa.

The anti-avoidance rules require resident taxpayers to disclose their offshore assets and trusts and to make tax payments on the foreign income and capital earned. This disclosure is made in the annual tax returns. Non-disclosure by residents of their offshore assets and trusts has always been evident in South Africa mainly as a result of contraventions of Exchange Control Regulations. Non-disclosure can result in penalties up to twice as much taxation becoming payable and interest accruing, not forgetting imprisonment.

The resistance to the new tax laws are prevented to an extent by DTAs that South Africa has with other countries. These DTAs contain an article that provides for the exchange of information between parties of contracting states. Article 26(1) entitled 'Exchange of Information' states the following:⁷²

'The competent authorities of the Contracting State shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention insofar as the taxation thereunder is not contrary to the Convention. The exchange of information is not restricted by Article 1. Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and

⁷² OECD Model Taxation Convention on Income and on Capital.

administrative bodies) involved in the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Convention. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.’

The capability and increase in experienced staff employed by the Commissioner and the provisions of s 74C of the Act, being a provision that allows the Commissioner to conduct interrogations and inquiries, assists in preventing taxpayers using non-disclosure of foreign investments and earnings, as a way to prevent the levying of taxation.

The introduction of the above anti-avoidance provisions, have removed most tax-planning opportunities. The taxation of foreign income may be deferred but will eventually be subject to South African taxation.

Glossary of terms

Double taxation

Double taxation arises when more than one jurisdiction, in terms of domestic tax laws, seeks to impose tax on the same amount of income. There are two types of double taxation, namely,

- juridical double taxation - this is when the same amount of income is taxed more than once in the hands of the same taxpayer; and
- economic double taxation - this is where the same amount of income is taxed more than once but in the hands of different taxpayers.

Connected person

In terms of s 1 of the Act a 'connected person' means-

(a) in relation to a natural person –

- (i) any relative; and
- (ii) any trust of which such natural person or such relative is a beneficiary;

(b) in relation to a trust –

- (i) any beneficiary of such trust; and
- (ii) any connected person in relation to such beneficiary;

(bA) in relation to a connected person in relation to a trust (other than a collective investment scheme in property shares managed or carried on by any company registered as a manager under section 42 of the Collective Investments Schemes Control Act, 2002, for purpose of Part V of that Act), includes any person which is a connected person in relation to such trust;

(c) in relation to a member of a partnership –

- (i) any other member; and
- (ii) any connected person in relation to any member of such partnership;

(d) in relation to a company –

- (i) its holding company as defined in section 1 of the Companies Act, 1973 (Act No. 61 of 1973)
- (ii) its subsidiary as so defined;
- (iii) any other company where both such companies are subsidiaries (as so defined) of the same holding company;
- (iv) any person, other than a company as defined in section 1 of the Companies Act, 1973 (Act No. 61 of 1973), who individually or jointly with any connected person in relation to himself, holds, directly or indirectly, at least 20 percent of the company's equity share capital or voting rights;
- (v) any other company if at least 20 percent of the equity share capital of such company is held by such other company, and no shareholder holds the majority voting rights of such company;
- (vA) any other company if such other company is managed or controlled by-
 - (aa) any person who or which is a connected person in relation to such company; or
 - (bb) any person who or which is a connected person in relation to a person contemplated in item (aa); and
- (vi) where such company is a close corporation-
 - (aa) any member;
 - (bb) any relative of such member or any trust which is a connected person in relation to such member; and
 - (cc) any other close corporation or company which is a connected person in relation to-
 - (i) any member contemplated in item (aa); or
 - (ii) the relative or trust contemplated in item (bb); and

(e) in relation to any person who is a connected person in relation to any other person in terms of the foregoing provisions of this definition, such other person,

and in this definition the expression 'beneficiary' means any person who has been named in the will or deed of trust concerned –

- (i) as a beneficiary; or

(ii) as a person upon whom the trustee of the trust has the power to confer a benefit from such trust.’

Group of companies

In terms of s 1 of the Act a ‘group of companies’ means

‘two or more companies in which one company (hereinafter referred to as the “controlling group company”) directly or indirectly holds shares in at least one other company (hereinafter referred to as the “controlled group company”), to the extent that –

- (a) at least 75% of the equity shares of each controlled group company are directly held by the controlling group company, one or more other controlled group companies or any combination thereof; and
- (b) the controlling group company directly holds 75% or more of the equity shares in at least one controlled group company.’

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