

**A CRITICAL LEGAL ANALYSIS OF THE REGIME FOR THE
TAXATION OF CONTROLLED FOREIGN COMPANIES IN
TERMS OF SECTION 9D OF THE INCOME TAX ACT NO. 58 OF
1962**

BY

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ABSTRACT

For eighty-six years up to the year 2000,¹ the South African income tax system was based primarily on the source principle. This meant that only income which was from a source in the Republic or deemed to be from a source in the Republic was taxable in the hands of residents. The election of a new Government in 1994, and the subsequent relaxation in exchange controls, necessitated a change from the source-based system of taxation to a residence-based system of taxation. The residence-based system of taxation in turn necessitated the introduction of new legislation to ensure that South African residents were taxed on their foreign source income, and appropriate anti-avoidance provisions were in place in order to prevent an erosion of the South African tax base.

The residence-based system of taxation was phased into South Africa by the introduction of section 9C to the Act. Section 9C was introduced in 1997 as an interim and partial provision which provided for the taxation of foreign passive income² on a residence-basis. A possible loophole that the revenue authorities needed to deal with at the time was the fact that residents could establish controlled foreign companies³ in low tax jurisdictions and divert⁴ and accumulate income in such foreign jurisdictions, thereby escaping the South African tax net by avoiding or at least deferring South African tax on such income.⁵

¹ The first Income Tax Act in South Africa was enacted in 1914.

² This term is not specifically defined in the Act but includes investment income such as interest, royalties, annuities and rentals; see Jooste (2001). The definition of 'investment income' in s 9C(1) (repealed in 2000) was 'any income in the form of any annuity interest, rental income, royalty or any income of a similar nature'.

³ The term 'controlled foreign company' was introduced by s 6(1)(d) of the Revenue Laws Amendment Act 74 of 2002 and replaced the term 'controlled foreign entity'. This amendment was effective from years of assessment commencing on or after 13 December 2002. The reason for the change was to clarify that only foreign entities that qualify as companies, as defined in section 1 of the Act, would be subject to section 9D. The purpose of the original definition ('controlled foreign entity') was to include trusts. The avoidance of tax through the use of offshore trusts is dealt with by ss 7(5), 7(8) and 25B of the Act. Prior to the amendment to section 9D by section 10 of the Revenue Laws Amendment Act 59 of 2000, a trust could have qualified as a controlled foreign entity. According to Jooste, this had very little effect since very few offshore trusts have beneficiaries with vested rights and discretionary trusts would not have constituted controlled foreign entities (Jooste 'The Imputation of Income of Controlled Foreign Entities' (2001) 118 *South African Law Journal* 474). The definition of 'controlled foreign company' is more consistent with the international description used by the OECD (SARS, 2002, *Explanatory Memorandum* on the Revenue Laws Amendment Act 74 of 2002 14).

⁴ The 'diversion' of income is only effective, as a tax-avoidance device, if the income is diverted before it has accrued to the taxpayer. Para (c) (ii) of the definition of 'gross income' in section 1 and section 7 (1) of the Act cover situations in which a taxpayer attempts to avoid tax by requesting that income due to him be paid to another party. Section 9D is intended to widen the tax net by including such income that is 'diverted' to a controlled foreign company.

⁵ This will improve the cash flow of the business by avoiding or deferring South African tax. Over the last five years South African corporate and individual tax rates have come down (refer to section 5 of the Act for the years 1997 through to 2002). As a result, deferring South African tax could result in lower taxes being paid when the income is remitted to South Africa.

Section 9D was introduced simultaneously with section 9C in 1997 as the specific anti-avoidance provision in this regard.⁶

With the introduction of a residence-based system of taxation effective from years of assessment commencing on or after 1 January 2001, section 9C was repealed.⁷ As a result section 9C and the concepts of ‘active’⁸ and ‘passive’ income are of historical significance, and the main focus in terms of a residence-based taxation system now remains a decision regarding whether or not a taxpayer is a ‘resident’ as defined in the Act.

This dissertation critically analyses the structure, application, exemptions and shortcomings of section 9D⁹ as an anti-avoidance provision consequential upon the introduction of a residence-based system of taxation, and states the law up to and including the Revenue Laws Amendment Act 74 of 2002, which took effect from the commencement of years of assessment ending on or after 1 January 2003.

⁶ Sections 9C and 9D were inserted by s 9(1) of Act 28 of 1997 with effect from 1 July 1997. Currently South Africa is the only Southern African Development Community (SADC) State and also the only African country to introduce CFC legislation (Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 160).

⁷ Section 9C was repealed in terms of section 9 of the Revenue Laws Amendment Act 59 of 2000 with effect from years of assessment commencing on or after 1 January 2001.

⁸ The Katz Commission’s *Fifth Interim Report* para 4.2 provides a non-exhaustive list of activities which would generate active income. Among these are the buying and selling of goods, manufacturing, processing or assembling goods/assets, construction and so on.

⁹ Section 9D was substituted by the Revenue Laws Amendment Act 74 of 2002, section 14, with effect from years of assessment ending on or after 13 December 2002. However, the change of name from ‘controlled foreign entity’ to ‘controlled foreign company’ (s 9D(1)) and the base cost adjustment in terms of s 9D(7) only came into effect from years of assessment commencing on or after 13 December 2002. Both these changes were proposed by s 14 of the Revenue Laws Amendment Act 74 of 2002.

DECLARATION

I hereby declare that the whole of this dissertation, save as specifically acknowledged in the text, is my own original and unaided work, and has neither been published elsewhere nor submitted to any other University.

-----Signed this-----day of ----- 2003

Manoj Kumar Seonath at Pietermaritzburg, Kwa-Zulu Natal.

KEY TERMS AND ABBREVIATIONS

The terms and abbreviations used in this dissertation refer to the following:

- Act** - Income Tax Act No. 58 of 1962¹ as amended. The reference to any section in this dissertation refers to sections of this Act.
- CFC** - controlled foreign company.
- SARS** - South African Revenue Service.
- South Africa** - the Republic of South Africa.
- Republic** - the Republic of South Africa
- OECD** - Organisation for Economic Co-operation and Development

¹ The South African Tax Act. The term 'controlled foreign entity' was replaced by the term 'controlled foreign company' by section 6(1)(d) of the Revenue Laws Amendment Act 74 of 2002, with effect from years of assessment commencing on or after 13 December 2002.

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CHAPTER 1

INTRODUCTION

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1.1 BACKGROUND TO THE SOUTH AFRICAN TAX RATES¹

Prior to the general elections of 1994 and throughout the last decade, South Africa has had high corporate and individual tax rates by comparison to major first world countries such as the United States and the United Kingdom.² A forty-eight percent basic corporate rate as recently as 1993 signified that the Republic was not viewed as an ideal tax haven, or for that matter a 'classical'³ tax haven, for foreign investors from countries where the source-

¹ The tax rates are important as they represent a key factor in determining whether South African residents will invest offshore to avoid high local taxes. It will also give some indication as to which countries resident investors will seek to divert income to, as it is not profitable to divert local income to a country that has a higher tax rate than the Republic, unless special taxation incentives are offered, for example the offering of excessive rebates or the exemption of specific types of earnings from tax, for which such abovementioned resident investors will qualify.

² It might be argued that it is unfair to compare South Africa to countries like the USA and UK because they have a completely different economic 'viewpoint' i.e. both are welfare states and do not have the huge economic disparities that South Africa has had to deal with. However, the intention of this comparison is to illustrate that South Africa has had high tax rates in comparison to countries such as the United States and the United Kingdom.

The relaxation of exchange controls in South Africa was a sign of growing confidence in the stability and growth of the South African economy, ultimately leading to a reduction in local tax rates. The reduction of local tax rates, in turn, is a direct response to the challenge of globalisation and is in line with the strategies for growth, equity and redistribution; see *The Taxpayer* 'Editorial: The Budget' (1999) 20–23.

Some of the more recent attempts to reduce local tax rates have been, firstly, the implementation of the Katz Commission's recommendation which resulted in the creation of the South African Revenue Service (SARS) with effect from 1 October 1997 as an administrative body amalgamating all previous tax administrations and secondly, a vigorous drive currently employed by SARS to widen the South African tax base by registering more individuals and companies who were not registered previously to ensure effective and timely tax administration.

³ A 'classical' tax haven is defined as a jurisdiction which makes an attempt to hold itself out as a tax haven for the avoidance of tax which would otherwise be paid in high tax jurisdictions (Sandler *Pushing the Boundaries: The Interaction between Tax Treaties and Controlled Foreign Company Legislation* (1994) 5).

based⁴ system of taxation was still the rule. The higher-earning individual was in as much of a predicament as industry, with the maximum individual marginal rate at forty-five percent of every rand of taxable income earned in excess of R100 000 per annum as recently as 1998.⁵

The situation has since brightened, with the corporate basic rate being thirty percent, and forty percent of every rand earned in excess of R255 000 for individuals, for the year of assessment ending 29 February 2004.⁶ The Revenue Laws Amendment Act 59 of 2000 was introduced by the Minister of Finance as part of the overall effort to reduce South African tax rates by widening the tax base.⁷

1.2 THE INTRODUCTION OF A RESIDENCE-BASED SYSTEM OF TAXATION

With the relaxing of exchange controls since 1994⁸, South African investors have had more freedom to invest in the rest of the world. With these opportunities being created for South African investors, and the fact that adventurous foreign investors were already knocking on South African doors, the South African business sector was in for a much-needed transformation.⁹

The above led to a phenomenal increase in the volume and complexity of international business in the Republic. Trade and investment flows across international borders have increased substantially. In addition, international businesses have become increasingly integrated with transnational alliances among firms which combine technology, production and marketing across borders. The dismantling of the capital barriers discussed above

⁴ Under the source-based principle of taxation only income earned or deemed to be earned in a particular jurisdiction will be taxed in that jurisdiction.

⁵ The Taxation Laws Amendment Act 28 of 1997.

⁶ Pierre du Toit, (tax partner with Arthur Anderson) in an interview with Gillian Counihan, remarked: '...[B]ut over the last three or four years some fifteen billion rands have been given back to individual taxpayers in the income tax system, including at the higher income levels. Corporate income tax has come down from the previous 48% (1993) to an internationally competitive 30% prior to dividend distribution' (*Enterprise*, June 2000).

⁷ National Treasury's *Detailed Explanation to s 9D of the Tax Act* (June 2002) 'Preface' p (iii).
<<http://www.finance.gov.za/tax/9d.pdf>>

⁸ These changes have been outlined in a *Statement on Exchange Control* issued by the Governor of the Reserve Bank, Tito Mboweni, on 23 February 2000, and in a media statement by Finance Minister, Trevor Manuel, on 25 June 1997.

⁹ Finance Minister, Trevor Manuel, addressing the National Assembly on 31 October 2000 (see footnote 11 below). Also see Tillinghast *Tax Aspects of International Transactions* 2nd ed (1996) 456 and *The Taxpayer* 'Source or Residence as the Basis for Taxation' (1999) 48.

makes it significantly easier for multinationals to design their operations in a manner which may be perceived as an abuse of their tax regimes.¹⁰

The above changes necessitated a move from the old source-based system of taxation to a new residence-based system in South Africa. Speaking in the National Assembly, Finance Minister Trevor Manuel commented that ‘the source-plus base of taxation is a relic of the colonial era. The change to a residence-minus system gives our sovereignty real meaning, and it secures our tax base.’¹¹ Manuel further stated that the source-based system had become increasingly inadequate as exchange controls were relaxed and South African businesses dealt more with companies abroad. He also made mention of the fact that most of South Africa’s trading partners at the time were already operating on a residence-based taxation system.

With the lightening of exchange controls it was necessary to revise the South African tax system to prevent an imbalance arising from the existing source-based system due to more capital flowing out of the country than that which was coming in. If income from foreign investment were tax free, there would be an incentive to move capital out of the country¹² creating such an imbalance as a result.¹³

The initial move to the ‘residence-basis’ of taxation was achieved by the enactment of section 9C with effect from 1 July 1997,¹⁴ which was an interim and partial provision taxing only foreign ‘passive’ income and not ‘active’ income. The Katz Commission¹⁵ only listed what constituted ‘active’ income,¹⁶ regarding all other income as passive.

¹⁰ Sandler *Pushing the Boundaries: The Interaction Between Tax Treaties and Controlled Foreign Company Legislation* (1994) 1. With the lightening of exchange controls it would be easier than it was previously for multinationals to set up controlled foreign companies in low tax jurisdictions and divert income to such low tax jurisdictions, thereby avoiding or deferring high local taxes. However, the *Ruding Committee Report of 1992* (OECD) confirmed that non-tax factors continue to play a primary role in the location of manufacturing facilities.

¹¹ Finance Minister, Trevor Manuel, addressing the National Assembly on 31 October 2000 regarding legislation that aimed to shift South Africa from a source-based to a residence-based system of taxation. According to Brincker, Honiball and Olivier (2003), jurisdiction goes hand in hand with sovereignty in the international arena. A State’s authority to tax extends only so far as its sovereignty. This effectively means that a State can only tax income if there exists a necessary connecting factor between the income and the State (Brincker, Honiball & Olivier *International Tax: A South African Perspective* (2003) 159).

¹² The concept of ‘capital flight’ refers to the situation where local residents actively seek to invest in offshore activities, and in so doing exceed the amount that foreign investors invest in South Africa.

¹³ National Treasury’s *Detailed Explanation to s 9D of the Tax Act* (June 2002) ‘Preface’ p (iii).

¹⁴ Section 9 of Act No. 28 of 1997.

¹⁵ *Fifth Interim Report* para 9.6.

¹⁶ The Katz Commission’s *Fifth Interim Report* para 4.2.

Passive income was, in the main, income in the form of dividends, interest and royalties, but extended to passive forms of rental income and even pensions.¹⁷

Other sections which comprise the foundation of the residence-based system of taxation relate to the definitions of 'resident' and 'gross income', section 9F (which deals with foreign branches), section 6quat (which deals with foreign tax credits) and section 9E (which deals with foreign dividends).

The purpose of section 9C was broadly, with certain exemptions, to deem investment income from sources outside South Africa which accrued to South African residents, to be from a source within South Africa and therefore taxable in the Republic. The initial move in 1997 was to tax only foreign passive income (such as interest, royalties, annuities and rentals, but excluding foreign dividends). In 2000 foreign dividends became taxable in the hands of South African residents as well.¹⁸ During his budget speech of 23 February 2000, the Minister of Finance announced that a residence-basis of taxation would replace the source-basis of taxation with effect from years of assessment commencing on or after 1 January 2001. As a result, on 1 January 2001, a residence-based tax system¹⁹ came into effect in South Africa which subjects South African residents to tax on their worldwide income irrespective of its source or nature.²⁰ This completed the circle of South African residents having all their foreign source income (active and passive), including foreign dividends, taxable. It also led to section 9C, which was in effect an interim provision, being repealed.²¹

The most important reasons for changing to the new residence-based system of taxation as outlined by the South African Revenue Service²² were:

¹⁷ The Katz Commission's *Fifth Interim Report* para 4.2.1.

¹⁸ Foreign dividends were included through the insertion of section 9E in the Act by the Revenue Laws Amendment Act 59 of 2000, which became operative in respect of any foreign dividend received or accrued to a resident on or after 23 February 2000.

¹⁹ The residence-based system of taxation applies to normal tax and capital gains tax.

²⁰ Jooste's (2001) 'The Imputation of Income of Controlled Foreign Entities' explains how, in 1997, a major move towards a residence-based tax system occurred, whereby only foreign passive income was subject to South African tax. This included investment income such as interest, annuities, rentals and royalties but excluded foreign dividends. A step closer to an entirely residence-based system was taken in 2000 when foreign dividends also became taxable in the hands of South African residents. In 2001 all income, including non-investment income i.e. 'active' income, became subject to a residence-based taxation system. (Jooste 'The Imputation of Income of Controlled Foreign Entities' (2001) 118 *South African Law Journal* 473-502).

²¹ Section 9C was repealed by s 9 of the Revenue Laws Amendment Act 59 of 2000 with effect from years of assessment commencing on or after 1 January 2001. This Act did not repeal section 9D.

²² See <<http://www.sars.gov.za/IT/Brochures/ResidenceBasisofTaxation.htm>> This SARS brochure highlights the reasons for a residence-based system of taxation, defines a 'resident' and discusses exemptions and foreign tax credits arising from a residence-based system of taxation.

- to place the income tax system on a sounder footing, thereby protecting the South African tax base from exploitation;²³
- to bring the South African tax system more in line with international principles;
- the relaxation of exchange control and the greater involvement of South African companies offshore; and
- to more effectively cater for the taxation of E-Commerce.

The residence-based legislation generally allows the country of residence of a taxpayer to tax what it perceives to be the share of 'worldwide'²⁴ profits attributable to its domestic taxpayers.²⁵

Further to the above, the most important difficulties presented by the 'source-based' taxation were in the definition and determination of 'source'. The legal principles applied in determining whether or not an amount was received from a source within the Republic have been stated in a number of decisions by the Court, the leading decisions being in the cases of *CIR v Lever Brothers and Unilever Ltd*,²⁶ *CIR v Epstein*²⁷ and *CIR v Black*.²⁸ These authorities point out that the legislature, probably aware of the difficulty of doing so, had not attempted to define the phrase 'source within the Republic' and had left it to the Courts to decide on the particular facts of each given case whether an amount was or was not received from such a source.

As stated by Watermeyer C J in the *Lever Bros* case:²⁹

'... the source of receipts, received as income, is not the quarter whence they come, but the originating cause of their being received as income, and this originating cause is the work which the taxpayer does to earn them, the *quid pro quo* which he gives in return for which he receives them. The work which he does may be a business which he carries on, or an enterprise which he undertakes, or an activity in which he engages, and it may take the form of personal exertion, mental or physical, or it may take the form of employment of capital, either by using it to earn income or letting its use to someone else. Often the work is some combination of these.'

²³ The 'source-based' system of taxation allowed South African investors to establish controlled foreign companies in low tax jurisdictions and divert income to such jurisdictions, thus escaping the South African tax net.

²⁴ 'Worldwide' in this context means income derived within and outside the Republic (SARS, 2002, *Income Tax Interpretation Note 6* 'Resident: Place of Effective Management' 1).

²⁵ Sandler *Pushing the Boundaries: The Interaction Between Tax Treaties and Controlled Foreign Company Legislation* (1994) 2.

²⁶ *CIR v Lever Bros and Unilever Ltd* (1946) AD 441.

²⁷ *CIR v Epstein* (1954) (3) SA 689 (A).

²⁸ *CIR v Black* (1957) (3) SA 536 (A).

²⁹ Refer to *CIR v Lever Bros and Unilever Ltd* (1946) AD 441 at 450. The principles of Watermeyer CJ in this case were upheld in *CIR v First National Bank of South Africa Ltd* (2000) 62 SATC 253 (T).

In a particular case there may be a number of causal factors relevant to the ascertainment of 'source'. In such a case it would seem appropriate to weight these factors in order to determine the dominant or main cause of the receipt.³⁰ In delivering judgement in the case of *Nathan v Federal Commissioner of Taxation*,³¹ Isaacs J remarked:³²

'The legislature in using the word "source" meant, not a legal concept, but something which a practical man would regard as a real source of income.... The ascertainment of the actual source of a given income, is a practical, hard matter of fact.'

1.2 THE ENACTMENT OF SECTION 9D

Due to the newly introduced residence-based system of taxation and the high tax rates in South Africa (as discussed earlier in this chapter), and the fact that the initial introduction of section 9C in 1997 only declared foreign passive income (excluding foreign dividends) taxable, South African investors who now had the opportunity of investing overseas could still establish controlled foreign companies³³ in low taxation jurisdictions, thus allowing the diversion of income to such low taxation jurisdictions. As a result lower taxes would be paid, leading to an increase in the retained income and cash flows of the company. This simultaneously led to the introduction of section 9D, the anti-avoidance section which prevented such diversions of income to low tax jurisdictions.³⁴

The purpose of section 9D was broadly, to apportion the income accruing to a controlled foreign company from any source to 'participants' resident in South Africa, and to include the apportioned amount in their total taxable income. The structure of section 9D is that the net³⁵ amount of income of a controlled foreign company is apportioned to the resident participants.

³⁰ In *Tuck v CIR* (1988) (3) SA 819 (A), 1998 *Taxpayer* 92, 49 SATC 28 the court found two originating causes for a payment and apportioned it accordingly.

³¹ *Nathan v Federal Commissioner of Taxation* (1918) 25 CLR 183 at 189-190 (High Court of Australia).

³² Also see *Rhodesia Metals Ltd (in liquidation) v COT* (1938) AD 282, 9 SATC 363 at 300 and 1940 AD 432 (PC) at 436 for a similar interpretation.

³³ A 'controlled foreign company' is any foreign company where more than 50 percent of the total participation rights are held by one or more residents, whether directly or indirectly.

³⁴ Para 8.1.1 of the Katz Commission's *Fifth Interim Report* states that the general anti-tax avoidance provisions of section 103(1) of the Act would not have been adequate and often not apply, for example where an offshore company, which was set up in order to avoid South African tax, also functions to avoid or reduce foreign taxes. As a result this necessitated the introduction of a new and specific anti-avoidance provision in the form of section 9D. Also see Macheli *A Critical Legal Analysis of the Regime for the Taxation of Controlled Foreign Entities in Terms of Section 9D of the Income Tax Act No. 58 of 1962* (Unpublished PhD dissertation, University of Natal, Pietermaritzburg) (2000) 352.

³⁵ The 'net' amount being the gross amount reduced by deductions and allowances provided by the Income Tax Act; in other words, the foreign taxable income in the hands of the South African resident participant should equal what would have been the taxable amount had the resident derived the income from a South African source (s 9D(2A)).

Introducing suitable anti-avoidance measures to counter avoidance resulting from a residence-based taxation system was not an easy affair. Such measures needed to strike a balance between being sufficiently detailed to be effective, but not so elaborate so as to be counter-productive and unduly inhibiting of international trade and investment into South Africa. In the words of the Katz Commission:³⁶

‘...[A]nti-avoidance measures must strike a balance between perfection and pragmatism. Measures that seek to address every possible eventuality become highly complex with two results: firstly, they inhibit legitimate trade, which is a sure sign of a bad international tax system; and secondly they more often than not lead to an ineffective anti-avoidance regime because their complexity prevents proper administrative implementation.’

The seriousness of the above inhibiting qualities of CFC legislation is clearly illustrated in the US Treasury Department’s report *The Deferral of Income Earned Through US Controlled Foreign Corporations: A policy Study* (December 2000). This investigation was specifically undertaken by the US Treasury Department in response to US multinationals often perceiving US CFC rules being strict and compromising their competitive advantage. The report concluded that CFC rules in the US at the time did not adversely affect the competitiveness of US-based multinationals.

Apart from the above inhibitive and complexity concerns, Brincker, Honiball and Olivier (2003) comment that compliance costs should also be considered. It is their view that the compliance costs of administering ‘over-complex’ legislation needs to be weighed up against the revenue derived from such legislation.³⁷

Section 9C taxed residents on their investment income as defined from foreign sources. Section 9D complemented section 9C by apportioning the investment income of controlled foreign companies (i.e. companies in respect of the profits to which South African residents had the majority participation or control).³⁸ However, sections 9C and 9D were not only confined to investment income arising only from the investment of funds that left the Republic, but also included the investment of funds from whatever country they were

³⁶ The Katz Commission’s *Fifth Interim Report* para 8.1.3. A similar view was expressed by Louw in ‘SA Regime and Foreign Investment’, Lexicon e-brief. (<<http://www.lex-icon.co.za>> - issue 50, 15 November 2001).

³⁷ Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 159.

³⁸ See chapter 3 for a discussion on the issue of ‘control’ with regard to a controlled foreign company.

obtained, as well as investments by non-residents prior to their becoming residents. According to *The Taxpayer*, ‘...the move to a residence-based system of taxation in 2001 has made the taxation of residents “all-embracing” without regard to the nature or source of income or the source of the funds producing the income.’³⁹

Sandler (1996)⁴⁰ states that the growing use of international intermediaries and the development of preferential tax regimes have prompted a number of countries to enact legislation to reduce the risk of losing domestic tax revenue from international investment. Such legislation is generally referred to as ‘controlled foreign company legislation’.

Carmody (1999)⁴¹ comments that in order for effective controlled foreign company legislation to be enacted, and thereafter the smooth administration thereof, a high quality tax administration in the international arena will require:

- an ongoing dialogue with the other tax administrations to clarify existing concepts, and properly address strategic issues – like the fair sharing of taxing rights and the profit allocation in the context of accelerating internationalisation of electronic commerce;
- good working relationships between the various countries’ tax administrations, both at executive and senior operative levels, and a readiness to enter into bilateral discussions on any difficulties that arise;
- co-operative approaches to the sharing of experience and training opportunities; and
- common approaches and speedier turnaround times on Mutual Agreement Procedures, Advance Pricing Arrangements and Exchanges of Information; and equitable and timely resolution on the basis of internationally accepted principles of any double taxation cases that might arise.

I submit that with the introduction of a residence-based system of taxation and the repealing of section 9C, section 9D might be rendered ineffective in that now all foreign income irrespective of nature or source is being taxed in the Republic. However, it is important to understand the objective of section 9D with regard to the non-distribution requirement:

- a) firstly, due to the fact that section 9C initially from 1997 to 1999 taxed only foreign passive income excluding foreign dividends, with foreign dividends only falling into this net in

³⁹ *The Taxpayer* ‘Editorial: The Revenue Laws Amendment Act’ (2000) 181. The term ‘all-embracing’ is misleading because there are still exemptions in terms of s 9D(9) which may be applicable. However, it appears that the intent of *The Taxpayer* in using this term is to point out that the application of s 9D is not dependent on the source of the funds producing the income, subject to the application of the exemptions in s 9D(9).

⁴⁰ Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 10.

⁴¹ Carmody ‘International Business Taxation-An Administrator’s Perspective “A Brave New World”’ in Vann *Taxing International Business: Emerging Trends in APEC and OECD Economies* (1997) (OECD) 9.

2000, meant that a resident could accumulate income in a controlled foreign company, and due to the resident being a controlling participant,⁴² he could thus allow the income to accumulate with minimal distributions. The fact that the income earned or any associated passive income which was due to the controlling resident was not distributed (keeping it active) would have made section 9C inapplicable to such income. This is where section 9D comes into play, in that section 9D is based on the net income of a controlled foreign company and is not dependent on distribution; and

- b) secondly, although the South African tax rates are currently more competitive than they were five years ago,⁴³ a resident could still set up a controlled foreign company in a tax haven, accumulate income in the CFC, and at a later stage take up residence in another country, possibly the tax haven, and thus escape South African tax. Section 9D prevents this as, once again, it is not dependent on distribution and the income would be taxed in the hands of the resident upon being earned by the CFC.⁴⁴

In view of the above, and the fact that not all income earned from a controlled foreign company is subject to the provisions of section 9D(2) (exemptions in terms of section 9D(9)), section 9D remains an integral part of South African tax legislation. There are certain exemptions or exclusions in terms of section 9D(9) which have their justification in the context of economic considerations affecting the operations of residents in countries outside South Africa, as well as administrative considerations involving the reduction of the rebates required in order to avoid double taxation. Apart from these exemptions and exclusions, South Africa has entered into double taxation agreements with a number of countries. These agreements will, in respect of various types of income, have an impact on their taxation in the hands of residents.⁴⁵ Analysts have subsequently debated, after the

⁴² A controlling resident participant would be a resident who holds greater than 50 percent of the participation rights of the CFC as defined in s 9D(1) sv 'controlled foreign company'. Resident participants holding less than 5 percent of the shares in a listed company, scheme or arrangement contemplated in paragraph (e)(ii) of the definition of 'company' in section 1 of the Act, are not considered in the equation for determining control 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 they are acting in concert with other resident participants and together with such resident participants holds more than 50 percent of the shareholding (s 9D(1) sv 'controlled foreign company').

⁴³ Counihan and du Toit 'Expert Throws Light on Taxing Issues: Finance for you' *Enterprise* (June 2000) 79.

⁴⁴ National Treasury's *Detailed Explanation to s 9D of the Tax Act* (June 2002), 1, comments that section 9D, like other internationally used regimes of this kind, taxes South African residents as if the income earned by CFCs were immediately repatriated to them, and is not dependent on distribution.

⁴⁵ Meyerowitz, Davis and Emslie in explaining the Revenue Laws Amendment Act 59 of 2000, state that under the previous regime of taxing on the basis of source, the existence of double taxation agreements were detrimental to the South African revenue. This is explained where South Africa, under the source-based regime, entered into a double taxation agreement with a foreign country having a residence-based regime. South Africa would be required to yield tax in favour of that foreign country because of the residence there of the taxpayer, even though the income had its source in South Africa. However, if a South African resident earned income in that foreign country, that foreign country would not need to yield any tax in favour of South Africa, as such income would not be taxed under the source-based regime; *The Taxpayer* 'The Revenue Laws Amendment Act 2000' (2000) 181.

necessary legislation introducing a residence-based system of taxation had been enacted, that the final form of the legislation differed quite markedly from what was announced in the Minister's budget speech, particularly in respect of the anti-avoidance provision (section 9D) which had been introduced.⁴⁶

As a result of the taxation of residents on their worldwide income, the general deduction provision (section 11) is no longer restricted to trade carried on inside the Republic. Consequently, assets used by residents to generate non-South African source income on which no allowances were granted in the past, might now qualify for sections 11(e), 11(o), 12B, 12C, 12D, 13, 13*bis* and 13*ter* capital allowances.⁴⁷

du Toit (2000) states that one of the immediate negative aspects of the newly enacted changes to the South African tax system was the fact that it came without warning. Business people, who formed (in terms of previous legislation) completely legitimate international business structures, suddenly discovered that their cash flow predictions were not valid.⁴⁸ Certain other countries allow taxpayers a window period during which to adjust their international structures in terms of new legislation. However, the South African taxpayer was allowed no such period. Even *The Taxpayer*, a specialist journal, did not foresee the change from the source-based system of taxation to the residence-based system of taxation commencing with effect from years of assessment beginning on or after 1 January 2001, when in 1999 it commented 'it is likely that, for the foreseeable future, residence as such, without linkage to source, will not become the basis of taxation in South Africa.'⁴⁹ According to du Toit, 'international businessmen share the common sentiment that they would far prefer a high tax rate, together with an undertaking from the Government that it will remain fixed for a number of years than to receive tax surprises all the time. The element of surprise should only be used to target specific abuse and care

⁴⁶ Eastaugh, R, *Deloitte & Touche Tax News*, 'Tax on Foreign Dividends' 3 (2000) 4.

⁴⁷ The Income Tax Act 58 of 1962 as amended.

⁴⁸ du Toit C, *Finance Week*, 'The High Price of Tax Uncertainty', May 5 (2000) 48. However, a contra argument to this is that it was the Katz Commission which recommended the partial move to a residence-based taxation system by taxing only passive income initially – refer to section 9C of the Act (repealed in 2000). The Katz Commission's *Fifth Interim Report* in para 9.1 stated the need to distinguish between active and passive income. In para 9.2 it suggested that active income should continue to be taxed on a source-basis, and in para 9.4 it suggested that passive income should be taxed on a worldwide basis. This in turn constituted a gradual 'phase in' of the residence-based system of taxation, as it was only four years later that foreign active income became taxable in the hands of residents. Brincker, Honiball and Olivier even go so far as to comment that 'it can be argued that CFC legislation had already been introduced in 1987 in the form of the now repealed s 9A, in terms of which investment income accrued to or received by a company in a neighbouring state was taxed in South Africa'; Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 160.

⁴⁹ *The Taxpayer* 'Source or Residence as the Basis for Taxation' (1999) 8.

should be taken not to penalise legitimate and long-standing commercial structures in the process.⁵⁰ Changing from a source to residence-basis of taxation eliminated the problem of defining 'source', however it introduced the problem of defining 'foreign'.⁵¹ In broad terms, the interpretation of the South African Revenue Service seems to be that a company will be deemed to be 'foreign' according to where its control is based.⁵²

1.4 THE ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT⁵³

Countries affiliated to the Organisation for Economic Co-operation and Development⁵⁴ (OECD) utilise a separate accounting basis for taxation, briefly termed AL/SA.⁵⁵ AL/SA recognises each corporation (and depending on the country, to different extents each permanent establishment) as a separate entity, with intra-firm transactions booked, for tax purposes, as if the two legal persons were unconnected and dealing at arm's length.

Without CFC legislation it would, as discussed earlier, be easy for a resident taxpayer in an OECD country to avoid domestic taxation on its foreign income simply by interposing a foreign corporation in a territory with a lower level of taxation to receive such income instead of remitting it to the home country (or equivalently to charge deductible arm's length fees to the domestic taxpayers in respect of services rendered).⁵⁶ For most countries, the adoption of CFC legislation basically fulfils an anti-avoidance objective to prevent the diversion of passive and certain 'base company'⁵⁷ income to CFCs.

⁵⁰ du Toit, *Finance Week*, 'The High Price of Tax Uncertainty', May 5 (2000) 48.

⁵¹ The SARS *Explanatory Memorandum* on the Revenue Laws Amendment Act 74 of 2002 mentions that the issue of 'source' is still an important one as it is only foreign source income that is eligible for a section 6quat rebate. Furthermore, non-residents remain subject to South African tax only to the extent that their income is from a South African source. (SARS, 2002, *Explanatory Memorandum* on the Revenue Laws Amendment Act 74 of 2002 11).

⁵² SARS, 2002, *Income Tax Interpretation Note 6* 'Resident: Place of Effective Management'. Also refer to chapter 3 of this dissertation for an in depth discussion on the issue of 'control' with regard to a controlled foreign company.

⁵³ Carmody states that the OECD is uniquely placed to promote and support a focus on strategic management of tax systems (Carmody 'International Business Taxation-An Administrator's Perspective "A Brave New World"' in Vann *Taxing International Business: Emerging Trends in APEC and OECD Countries* (1997) (OECD) 12).

⁵⁴ Countries affiliated with the OECD and which have enacted CFC legislation include the United States, Germany, Canada, Japan, France, the United Kingdom, New Zealand, Sweden, Australia, Norway, Finland, Spain, Portugal, Denmark, Italy, Mexico and Hungary (Sandler *Controlled Foreign Company Legislation* (1996) (OECD) and Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 160).

⁵⁵ Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 10.

⁵⁶ Ginsberg *International Tax Havens* (1990) 3.

⁵⁷ 'Base company income' is generally considered to be income derived from selling property or rendering services which are considered attributable to the domestic shareholders (Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 55).

In the late seventies and early eighties there were often misconceptions regarding international tax planning, and the rewards promised by international investments, both actively and passively, easily became inescapable liabilities through hasty decision-makings.⁵⁸ Currently the establishment of controlled foreign companies is still a major decision, and I am of the view that those criteria such as double taxation agreements and where the management and control of the company vests are vital to such decision-making.

It is evident from this chapter that there have been numerous changes in the last decade in countries all over the world, especially South Africa, regarding the taxation of income of controlled foreign companies. The topic of setting up controlled foreign companies or converting existing investments into controlled foreign companies remains much spoken about in the boardrooms of many South African companies regarding the pros and cons. More importantly, one must not forget how current and proposed legislation is going to impact on such decisions.

1.5 THE METHODOLOGY AND SCOPE OF THIS DISSERTATION

This dissertation centres on the structure of section 9D of the Act. Although the subject matter is fairly new in South Africa, I have relied predominantly on current South African legislation and publications, with particular focus on the Income Tax Act, the Revenue Laws Amendment Act 59 of 2000, the Taxation Laws Amendment Act 5 of 2001, the Revenue Laws Amendment Act 19 of 2001, the Second Revenue Laws Amendment Act 60 of 2001, National Treasury's *Detailed Explanation to section 9D of the Tax Act* (June 2002), and the Revenue Laws Amendment Act 74 of 2002. Foreign material, with particular reference to the United Kingdom, United States and Australia have been relied

⁵⁸ It is important to note that not all OECD countries have enacted CFC legislation. The decision depends, in part, on whether the country follows a doctrine of 'capital import neutrality' or 'capital export neutrality'. Those countries which follow the former tend to avoid double taxation of foreign income by exempting it from domestic taxation. Amongst the countries which have enacted CFC legislation, there is also a range of different philosophical and policy objectives for such legislation.

Capital import neutrality (sometimes referred to as foreign or competitive neutrality) 'is seen as ensuring that capital funds originating from various countries compete on equal terms in the capital market of any country'. Capital export neutrality (sometimes referred to as international tax neutrality) 'is seen as ensuring that the investor pays the same total income tax (domestic plus foreign), whether he receives given income from foreign or domestic sources' (Doernberg *International Taxation in a Nutshell* (1989) 5). Also see Katz Commission's *Fifth Interim Report* para 3.1.2.2.

upon, as these countries have had controlled foreign company legislation for many years now⁵⁹ and have seen extensive writing on the legislation.

Chapter two focuses on the concepts of ‘residence’, ‘place of effective management’ and ‘tax havens’ as they relate to the South African residence-based taxation system. These concepts are analysed with particular regard to the view adopted by the Courts in circumstances of uncertainty.

Chapter three focuses on the structure of section 9D with particular reference to the wording in the Act with regard to the issue of ‘control’ as it relates to a controlled foreign company. Chapter three discusses reasons for the recent changes in controlled foreign company legislation in South Africa⁶⁰ as well as current uncertainties and proposed future changes to the legislation.

Chapter four comprises a theoretical discussion on the exemptions of section 9D(9), with a focus on the requirements that need to be satisfied in order to meet these exemptions. It also discusses situations which lend themselves to uncertainty regarding whether the exemptions are applicable or not, and concludes on such situations based on previous international and South African court decisions.

Chapter five focuses on relief provisions granted to taxpayers with regard to income earned from controlled foreign companies. Such relief is provided in South Africa through the granting of foreign tax credits in terms of section 6quat. This chapter focuses on when such relief is granted, to which taxes it applies and the issue of carrying forward unutilised foreign tax credits.

Chapter six discusses the South African reporting requirements in order to assist local tax authorities in facilitating and administering compliance with the provisions of section 9D.

The areas of particular focus are:

- who is affected;
- what disclosures need to be made;
- on what forms do such disclosures need to be made;

⁵⁹ CFC legislation was introduced in the United States in 1962 by Subpart F provisions of the Internal Revenue Code of 1954. In Australia, CFE legislation was introduced in 1990 (Part X of the Income Tax Assessment Act of 1936).

⁶⁰ Chapter three discusses changes implemented by the Revenue Laws Amendment Act 59 of 2000 and the Revenue Laws Amendment Act 74 of 2002.

- by when the disclosure must be made; and
- what the penalties for non-disclosure and false disclosure are.

Chapter seven concludes my analysis and discusses the effectiveness of section 9D since its enactment in 1997, and whether it has met its objectives in preventing residents from diverting income to controlled foreign companies set up in low tax jurisdictions and thereby avoiding South African tax. It also highlights the shortcomings experienced with section 9D as identified in the body of this dissertation, and looks at possible future changes to section 9D.

CHAPTER 2

KEY CONSIDERATIONS WITH REGARD TO A RESIDENCE-BASED SYSTEM OF TAXATION AND CONTROLLED FOREIGN COMPANY LEGISLATION IN SOUTH AFRICA

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2.1 INTRODUCTION

With the introduction of a residence-based system of taxation in South Africa and the enactment of controlled foreign company legislation, the concept of 'residence' has become more important than it was previously under the source-based system of taxation. One of the main focus areas with regard to the applicability of section 9D is in determining the residence of the taxpayer as well as the controlled foreign company in question. The South African Revenue Service (SARS) has issued guidelines in the form of Interpretation Notes 2, 3, 4 and 6 to assist with determining the residence of a taxpayer, whether a natural person or a legal entity. Brincker, Honiball and Olivier (2003)¹ comment that the term 'residence' is unique to tax law and should not be confused with terms such as 'nationality', 'citizenship' or 'domicile'.

2.2 THE CONCEPT OF RESIDENCE²

2.2.1 Natural persons

The definition of 'gross income' in section 1 of the Act has been amended to include a reference to the word 'resident', also defined in section 1 and referring to a natural person who is:³

- ordinarily resident in South Africa, or
- physically present in South Africa for a specified period.

There are therefore two tests applicable to determine whether or not a natural person is a resident of South Africa, namely the 'ordinarily resident test' and the 'physical presence test'.

¹ Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 14.

² The concept of 'residence' is directly linked to the taxation of income from controlled foreign companies as the definition of controlled foreign company in section 1 of the Act makes reference to the term 'resident'. It is worth noting that the move from a source-based system of taxation to a residence-based system of taxation is what drove the need for CFC legislation in South Africa.

³ This amendment to the definition of 'gross income' (para (i) and (ii)) in section 1 of the Act was introduced by s 2(c) of the Revenue Laws Amendment Act 59 of 2000 with effect from years of assessment commencing on or after 1 January 2001. The above definition of 'resident' was subsequently substituted by s 6(1)(p) of Act 74 of 2002 with effect from 1 March 2001. The reference to the word 'resident' discussed above remains unchanged in the definition of 'gross income'.

2.2.1.1 Ordinarily resident test

As the Act does not define ‘ordinarily resident’, the courts have interpreted the concept to mean ‘the country to which a person would naturally and as a matter of course return from his/her wanderings’. It might therefore be called a person’s usual or principal residence and would be described more appropriately, in comparison to other countries, as the person’s real home.⁴ The above approach was followed in the case *Cohen v CIR*⁵ and confirmed in the case *CIR v Kuttel*.⁶

In *Cohen’s*⁷ case Shreiner JA said:

‘It seems to me that the precise effect to be given to the word “ordinarily” is linked up with the question whether a man can be “ordinarily resident” for the purpose of the statute in question in more than one country. If, though a man may be “resident” in more than one country at a time he can only be ordinarily resident in one, it would be natural to interpret “ordinarily” by reference to the country of his most fixed or settled residence...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. If this suggested meaning were given to “ordinarily” it would not, I think, be logically permissible to hold that a person could be “ordinarily resident” in more than one country at the same time....’

In the case of *CIR v Kuttel*,⁸ the Appellate Division made the following comment:

‘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 principal residence and it would be described more aptly as his real home.’

The court in *Kuttel’s* case adopted the formulation of Shreiner JA and if a taxpayer’s real home is outside the Republic, regular periodic visits to the Republic will not result in him being a resident unless such visits brings him into the category of ‘resident’ as a result of the physical presence test.

⁴ SARS, 2002, *Income Tax Interpretation Note 3* ‘Resident: Definition in relation to a natural person—ordinarily resident’ 2.

⁵ *Cohen v CIR* (1946) AD 174 13 SATC 362.

⁶ *CIR v Kuttel* (1992) SA 242 (A) 54 SATC 298.

⁷ *Cohen v CIR* (1946) AD 174 13 SATC 362.

⁸ *CIR v Kuttel* (1992) SA 242 (A) 54 SATC 298.

In the United Kingdom case *Shah v Barnet London Borough Council and Other Appeals*⁹ it was held that to be ordinarily resident in a specific country ‘a person must be habitually and normally resident there, apart from temporary or occasional absences of long or short duration.’

In summary, in ascribing a meaning to the concept ‘ordinarily resident’, the courts have held that it refers to:¹⁰

- living in a place with some degree of continuity, apart from accidental or temporary absence. If it is part of a person’s ordinary regular course of life to live in a particular place with a degree of permanence, he/she must be regarded as ordinarily resident (*Levene v Inland Revenue Commissioner* (1928) All ER Rep. 746(HL));
- the place where his/her permanent place of abode was, where his/her belongings were stored, which he/she left for temporary absences and to which he/she regularly returned after such absences (*H v Cot* 24 SATC 738);
- the residence must be settled and certain and not temporary and casual (*Soldier v Cot* (1943) SR);
- the term ‘ordinarily resident’ being narrower than ‘resident’. A person is ordinarily resident where he/she normally resides, apart from temporary/occasional absences (*CIR v Kuttel* (Supra)).

There are no hard and fast rules when it comes to deciding whether a person is ordinarily resident in the Republic. A physical presence at all times is not a requisite to be ordinarily resident in the Republic. However, the following two requirements need to be present:¹¹

- an intention to become ordinarily resident in a country, and
- steps indicative of this intention having been or being carried out.

In my view, from interpreting the decision given by Shreiner JA in the *Cohen* case, and based on the Courts’ decisions in *Kuttel’s* case and *Shah v Barnet London Borough Council*, it appears that a natural person’s place of residence is his real home. Every person will know where his real home is. I believe the following two factors can also be considered in determining such ‘real home’:

⁹ *Shah v Barnet London Borough Council and Other Appeals* (1983) 1 All ER 226 (HL) 234b-c

¹⁰ SARS, 2002, *Income Tax Interpretation Note 3* ‘Resident: Definition in relation to a natural person—ordinarily resident’ 3.

¹¹ Ibid 4.

- the place of residence of his/her spouse and minor children, and
- whether the taxpayer owns land and a residential building which he and his family frequently use.¹²

According to Meyerowitz,¹³ the cessation of ordinarily resident is very much a factual issue, in that a set of facts conclusive in the case of one taxpayer may not be so in another. It should also be noted that a natural person may be a resident in South Africa even if that person was not physically present in South Africa during the relevant year of assessment.¹⁴

2.2.1.2 Physical presence test

If a natural person is not ordinarily resident in the Republic of South Africa, the physical presence test is applied to determine whether he/she is resident in the Republic for the purposes of the Act. The physical presence test, also known as the 'day test' or 'time rule', is based on the number of days during which a natural person is physically present in the Republic. The purpose of presence is irrelevant. A day is counted irrespective of the purpose or nature of the visit or presence in the Republic. The application of the physical presence test must be done annually and consists of three requirements. These are that the person must be physically present in the Republic for a period or periods exceeding:¹⁵

- 91 days in aggregate during the year of assessment under consideration;
- 91 days in aggregate during each of the three years of assessment preceding such year of assessment under consideration; and
- 549 days in aggregate during the three preceding years of assessment.

A natural person has to meet all three requirements before he/she becomes a resident. The *Income Tax Interpretation Note 4*¹⁶ states that a day includes part of a day and that a day begins at 00:00. Should a person arrive in the Republic at 23:55, he would be regarded as

¹² It can be argued that wealthy businessmen often own houses in many countries, however, it is not expected for his entire family to move with him from country to country. I am of the opinion that owning a residential building in a country in which your family lives presents a strong case for determining your 'real home'.

¹³ Meyerowitz Meyerowitz on *Income Tax* (2002–2003 ed) (2003) §§ 5.17–5.18, p 5-5.

¹⁴ SARS, 2002, *Income Tax Interpretation Note 3* 'Resident: Definition in relation to a natural person– ordinarily resident', 4, explains how a common feature of multinational corporations is that certain staff are virtually permanent wanderers. In such a case the burden would be on the taxpayer to discharge the onus that he/she is not ordinarily resident in the Republic. It is not possible to lay down any clearly defined rule or period to determine ordinarily residence.

¹⁵ Section 1 sv 'resident' para (a)(ii)(aa) and (bb) as substituted by s 6(1)(p) of the Revenue Laws Amendment Act 74 of 2002 with effect from 1 March 2001.

¹⁶ SARS, 2002, *Income Tax Interpretation Note 4* 'Resident: Definition in relation to a Natural Person-Physical Presence test' 4.

having been present in the Republic for a full day, even though he has been physically present in the Republic for only five minutes.¹⁷

In terms of the physical presence test, a person who is not ordinarily resident in the Republic can only become a resident in the Republic in the fourth year of assessment after having been physically present in the Republic for the first time. When these requirements are fulfilled, he is treated as a resident for the whole of the fourth year, even though his period of 91 days is completed only by the end that year. Brincker, Honiball and Olivier (2003)¹⁸ mention that there may be a need for caution with regard to the above, for example, where a businessman living in the United Kingdom who has or represents significant South African and United Kingdom business interests and who, for a period of four years or more, spends about half of his time in South Africa and half in the United Kingdom. Brincker, Honiball and Olivier (2003) also point out that in certain circumstances it may be very difficult to establish whether a person has been physically present in South Africa for the required number of days. This may be the case when persons in possession of dual passports use one passport to leave the country and the other to re-enter the country and unless the two passports are linked to each other, SARS is placed in a difficult position.¹⁹ It should be noted that a natural person who is ordinarily resident, who spends time outside the Republic and has the intention of returning to the Republic as his/her permanent home is regarded as a resident regardless of the period of time spent outside the Republic.²⁰

2.2.1.2.1 Continuous absence

A person who is a resident in terms of the physical presence test will be deemed not to be a resident if he is physically outside the Republic for a continuous period of at least 330 full days immediately after the day on which he ceases to be physically present in the Republic

¹⁷ The physical presence test can be subject to manipulation in that the taxpayer could structure his wanderings in such a way that he avoids being classified as a resident.

du Toit C in 'Who is a resident?' comments how the Rolling Stones once cancelled a concert in Britain because the performance would have caused Mick Jagger to exceed the number of days present in Britain (*Finance Week*, May 5 (2000) 48).

Section 6(1)(p) of the Revenue Laws Amendment Act 74 of 2002 clarified the situation that where a person is in transit through the Republic between two places outside the Republic, and that person does not enter the Republic formally through a port of entry, such 'in transit' time spent in the Republic will be excluded in computing the number of days spent in the Republic for purposes of the physical presence test.

¹⁸ Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 16.

¹⁹ Ibid.

²⁰ This arises from the concept of returning from your wanderings to your 'real home' which was the judgment given in the cases of *CIR v Cohen* and *CIR v Kuttel*.

for the first time.²¹ He will be deemed not to be a resident from the day on which he ceased to be physically present in the Republic (this concession does not apply to a person who is ordinarily resident in the Republic, for example, a person who is absent from his home in the Republic for study purposes for one year).

The period of 330 days must be continuous. Because this concession applies only to a person who has met the physical presence requirements, he must have been physically present in the Republic for more than ninety-one days in the current year of assessment, which means that the period of 330 days will cover two years of assessment:

- the first being the year of assessment in which the person was last considered to be a resident in terms of the physical presence test, and
- the second being the following year of assessment.²²

The concession applies from the commencement of the 330-day period, so that the qualifying person will be a resident for part of the first year of assessment and a non-resident for the remainder of the first year. It is only after the 330-day period has been fulfilled that the person will be deemed not to be a resident.

2.2.2 Persons other than natural persons (legal entities)

The Revenue Laws Amendment Act 59 of 2000 introduced a definition of a 'resident' in section 1 of the Act²³ which includes the term 'place of effective management'²⁴ as one of the tests to determine the residence of a person other than a natural person. As a result of this definition, a person, other than a natural person, (that is, an entity) which has its place of effective management in the Republic will be regarded as a 'resident' as defined in the Act. The effect of this is that such person will be subject to income tax on its worldwide income, i.e. income derived within and outside the Republic, under the residence-based taxation system. A person other than a natural person is also a resident if it is incorporated, established or formed in the Republic.

²¹ Section 1 sv 'resident' para (a)(ii)(B).

²² One of the requirements of the physical presence test is that the person must be present in the Republic for 91 days in aggregate during the year of assessment under consideration. If it is assumed that the person was physically present in the Republic for the first 91 days of the year of assessment under consideration, this leaves 274 days in that year, making the 330-day continuous absence rule impossible to achieve in a single year of assessment.

²³ Section 2(h)(b) of the Revenue Laws Amendment Act 59 of 2000. The definition of 'resident' was subsequently substituted by s 6(1)(p) of Act 74 of 2002 with effect from 1 March 2001. The reference to the term 'place of effective management' remains unchanged.

²⁴ Section 1 sv 'resident' para (b).

In summary, in terms of paragraph (b) of the definition of ‘resident’ in section one of the Act, the word ‘resident’ is defined as a person, other than a natural person, which is:

- incorporated, established or formed in the Republic; or
- which has its place of effective management in the Republic.²⁵

An international headquarter company is excluded from the above definition of ‘resident’.²⁶

2.3 PLACE OF EFFECTIVE MANAGEMENT

The term ‘place of effective management’ is not defined in the Act and the ordinary meaning of the words, taking into account international precedent and interpretation, will assist in ascribing a meaning to it. The term ‘effective management’ or ‘effectively managed’ is used by various countries throughout the world, as well as by the Organisation for Economic Co-operation and Development (OECD) in its publications and documentation. However, the concepts of ‘effective management’ or ‘effectively managed’ are not defined in the OECD Model or the OECD Model Commentary. The OECD Model Commentary²⁷ only refers to the place where key management and commercial decisions necessary for the conduct of the entity’s business are made. This will be the place where the most senior person or group of persons makes its decisions and is generally the place where actions to be taken by the entity as a whole are determined. The OECD Model Commentary points out that although the company may have more than one place of management, it can only have one place of effective management at any one time.²⁸

The concept of effective management is not the same as shareholder control or control by the board of directors. Management focuses on the company’s purpose and business, not on the shareholder-function.²⁹ In order to determine the meaning of ‘place of effective management’ one should keep in mind that it is possible to distinguish between:³⁰

²⁵ Also see *The Taxpayer* ‘Sections 9C and 9D revisited’ (1998) 82.

²⁶ Section 1 sv ‘resident’ para (b). Also refer to SARS, 2002, *Income Tax Interpretation Note 6* ‘Resident: Place of effective management’ 2.

²⁷ OECD Model Commentary para 24.

²⁸ Also see Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 311.

²⁹ SARS, 2002, *Income Tax Interpretation Note 6* ‘Resident: Place of Effective Management’ 2.

³⁰ Ibid 3.

- the place where central management and control is carried out by a board of directors;
- the place where executive directors or senior management execute and implement the policy and strategic decisions made by the board of directors and make and implement day-to-day/regular/operational management and business activities; and
- the place where the day-to-day business activities are carried out/co-ordinated.

2.3.1 General approach to determining ‘place of effective management’

The ‘place of effective management’ is the place where the company is managed on a regular or day-to-day basis by the directors or senior managers of the company, irrespective of where the overriding control³¹ is exercised, or where the board of directors meets.

In the United Kingdom case *Wensleydale’s Settlement Trustees v IRC*³², Special Commissioner D A Shirley sitting in private remarked that ‘effective’ implies ‘a realistic, positive management’. The place of effective management is where the ‘shots are called’.³³ Management by the directors or senior management refers to the execution and implementation of policy and strategy decisions made by the board of directors. It can also be referred to as the place of implementation of the entity’s overall group vision and objectives.³⁴

In analysing the *Wensleysdale* case, Brincker, Honiball and Olivier (2003)³⁵ comment that it seems that the meaning of effective management refers to a higher level of management as opposed to the day-to-day operations. Further to this, such higher level management should still be contrasted with normal management vested in the board of directors. In summary, the place of effective management should be determined with reference to, *inter alia*, the following circumstances:³⁶

- the place where the real board of directors actually make decisions on important business affairs of the company as opposed to the place where they are formally resolved (rubber-stamped), and
- the place where more important management decisions are taken and/or carried out as opposed to day-to-day administrative management.

³¹ Overriding control here means the location of the shareholders or board of directors, for example, an entity located in Stockholm with shareholders and the board of directors located in South Africa and management located in Stockholm. In this case, under the general approach, the place of effective management would be Stockholm.

³² *Wensleysdale Settlement Trustees v IRC* (1996) STC SCD.

³³ This is colloquial language which, roughly translated, means where ‘management decisions are made’.

³⁴ It is not possible to lay down any hard and fast rules as management structures, reporting lines and responsibilities vary from entity to entity, depending on the requirements of the entity.

³⁵ Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 312.

³⁶ *Ibid* 313.

If the management functions are executed at a single location, this location will be the place of effective management, which might or might not correspond with the place from where the day-to-day business operations are conducted. If the management functions are not executed at a single location, the view is held that the place of effective management would best be reflected where the day-to-day operational management and commercial decisions taken by the senior managers are actually implemented. If the nature of a person, other than a natural person, is such that the business operations/activities are conducted from various locations, one needs to determine the place with the strongest economic nexus.³⁷ According to *The Taxpayer*,³⁸ a different view is expressed with regards to 'place of effective management'. The view taken by *The Taxpayer* is that the place of effective management is not necessarily the place where a corporate body carries on business, but is rather where the board of directors meets on the company's business. Such place may differ from where the company's business is being carried on or is managed by staff or directors individually and not acting as a board. The place of effective management is where executive directors effectively manage the company but not necessarily by the board as a whole. Based on this argument, it is possible for a company to have more than one place of effective management.

United Kingdom legislation also determines the residence of a non-natural person by reference to the 'place of effective management'. In the Statement of Practice SP 1/90,³⁹ the Inland Revenue indicates that 'effective management may, in some cases, be found at a place different from the place of central management and control. This could happen, for example, where a company is run by executives based abroad, but the final directing power rests with non-executive directors who meet in the UK. In such circumstances the company's place of effective management might well be abroad but, depending on the

³⁷ SARS, 2002, *Income Tax Interpretation Note 6* 'Resident: Place of Effective Management' lists various criteria which need to be considered in order to determine place of effective management. Among these criteria are:

- where the centre of top level management is located,
- locations of and functions performed at the headquarters,
- where the business operations are conducted,
- where the controlling shareholders make key management and commercial decisions in relation to the company,
- legal factors such as the place of incorporation, formation or establishment, the location of the registered office and public officer, and so on.

Refer to SARS, 2002, *Income Tax Interpretation Note 6* (pages 4-5) for further criteria.

³⁸ *The Taxpayer* 'Sections 9C and 9D revisited' (1998) 84.

³⁹ Board of Inland Revenue Statement of Practice SP 1/90—see Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 103. Also see Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 313.

precise powers of the non-executive directors, it might be centrally managed and controlled (and therefore resident) in the UK.’

In short, the above refers to the place where management decisions are made and approved,⁴⁰ i.e. where the ‘shots are called.’

Sandler⁴¹ (1996) also comments that the term ‘place of effective management’ is used in Art. 4, para 3 of the OECD Model Convention. However, the OECD does not state what constitutes ‘place of effective management’ in any of its reports or publications.

It should also be noted that a company that has its place of effective management in the Republic is regarded as a ‘resident’ as defined in section 1 of the Act, and can therefore not be regarded as a controlled foreign company as defined in section 9D of the Act in relation to another resident.

2.4 FOREIGN EQUITY INSTRUMENTS OF CFCs

A new provision (section 9G)⁴² was introduced into the Act from 1 October 2001 to determine the tax payable in respect of a ‘foreign equity instrument’ held as trading stock. For the purposes of section 9D, the foreign currency gain or loss in relation to a foreign equity instrument is determined in rands, and that gain or loss must be translated into South African rands at the average exchange rate for the year of assessment during which that foreign equity instrument is disposed of. Section 9G further states that any expenditure incurred in any foreign currency relating to any foreign equity instrument which is deductible, or any other amount in a foreign currency which is taken into account in calculating the taxable income of any person in relation to any foreign equity instrument, shall be translated into the currency of the Republic—

⁴⁰ ‘Approved’ here does not necessarily mean where the decision is ‘rubber-stamped’, but the place where the decision was actually taken by the approving authority.

⁴¹ Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 103.

⁴² Section 9G was substituted by s 17(1) of Act 74 of 2002 applying in respect of the disposal of any foreign equity instrument during any year of assessment commencing on or after 13 December 2002.

- (i) in the case of a foreign equity instrument acquired before 1 October 2001, at the ruling exchange rate on 1 October 2001; or
- (ii) in any other case, at the average exchange rate for the year of assessment during which that expenditure was actually incurred by that person.

2.5 BASE COMPANY INCOME

Sandler (1996)⁴³ states that there are basically three types of income that fall within the provisions of CFC legislation, namely, 'passive income', 'active income'⁴⁴ and 'base company income'.

'Base company income' is generally used to refer to the income derived from selling property or rendering services which are considered attributable to domestic shareholders.⁴⁵ For example, a foreign sales corporation may be established for few or no economic or business reasons, but primarily to avoid domestic tax. A classic example would be a distribution centre located in a low tax jurisdiction, through which goods manufactured by a related corporation resident in a high tax country are sold either to the ultimate purchaser or to related distribution centres in the country in which the goods will ultimately be sold, so that the bulk of profits of the group are derived by the distribution centre. The circumstances in which base company income is attributed to the domestic shareholders of the CFC vary.

Factors considered relevant by various jurisdictions in deciding whether base company income should be attributed to domestic shareholders may include any or all of the following:⁴⁶

- where the income derived by the CFC is disproportionate to the amount of economic activity or independent decision-making is exercised by the CFC (i.e. does the CFC effectively manage its business in its country of residence, including employing sufficient staff to conduct the volume of business transacted therein?),
- whether the base company income is derived in the resident jurisdiction of the controlling shareholders, in the local market or in third countries, and
- whether the base company income is derived from related or unrelated persons.

⁴³ Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 55.

⁴⁴ The concepts of active and passive income have been dealt with earlier in this dissertation.

⁴⁵ Sandler op cit 55.

⁴⁶ Ibid.

A further issue arises as to whether CFC provisions should apply where a foreign company is used to avoid foreign tax, as opposed to domestic tax. However, in some cases, it may be difficult to determine whose tax is being avoided.

CFC legislation in various countries may take a number of approaches:⁴⁷

- i) it can exclude base company sales or services income and apply only to passive income,
- ii) it can be used to reinforce domestic transfer pricing rules, which are concerned only with an unsubstantiated diversion of domestic source income to related foreign persons (i.e. a diversion of income that is inconsistent with the fair market value of goods or services provided), or
- iii) it can be used to counteract the avoidance of foreign tax, incorporating elements of both capital export neutrality and capital import neutrality, so that deferral is only permitted so as to allow the CFC to compete in the jurisdiction in which it is resident.

The manner in which a country's CFC regime is applied to 'base company income' depends on the basis of the legislation itself. Where a country applies a 'transactional' approach,⁴⁸ the definition of attributed income will generally include specifically defined 'base company income'. Where a country applies a 'jurisdictional' approach, base company income is generally dealt with in defining the exemption for industrial or commercial profits (so that 'base company income' may render the exemption inapplicable).

Two primary considerations in the application of base company income provisions are the geographic location of the transaction and the relationship between the parties to the transaction.⁴⁹

2.6 INTERNATIONAL COMPETITIVENESS

The overall solution to solving the problem of taxing foreign source capital income has been, as discussed earlier, the introduction of CFC legislation.⁵⁰ However, the introduction of CFC legislation needs to strike a balance between controlling the potential evaporation

⁴⁷ Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 55.

⁴⁸ In a pure transactional-based regime, all passive investment income and tainted base company income (as defined) is attributed to domestic taxpayers subject to the application of the regime, while active business income is excluded. The jurisdiction in which the CFE operates is irrelevant.

⁴⁹ These concepts fall outside the scope of this dissertation. For further reading refer to Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 56–60.

⁵⁰ CFC legislation, in a nutshell, apportions a portion of the net income earned by a CFC to the controlling resident shareholders.

of the domestic tax base and not losing tax revenue, while at the same time not prejudicing the competitive position of domestic firms in foreign markets. International competitiveness dictates that foreign company income should be ignored so that South African multinationals can fully compete on an equal basis with their foreign local rivals. The following example, extracted from the National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002), illustrates such a scenario in which a South African multinational is disadvantaged as a result of the foreign company income tax rules:⁵¹

Facts: South African company owns all the shares of Foreign Subsidiary. Foreign Subsidiary generates R100 of income in Country X. Country X imposes a 10 percent tax on all income earned within its territory.

National Treasury's response: Under a pure anti-deferral regime, South Africa would fully tax the 20 percent differential (a 30 percent tax less a 10 percent tax credit rebate). However, a full taxation would mean that the income of Foreign Subsidiary would be subject to a cumulative 30 percent income tax rate while foreign local competitors would be subject to a rate of 10 percent. This higher rate would leave the foreign subsidiary with comparably less after-tax profits for re-investment, thereby making operations non-competitive.

National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002)⁵² goes on to comment that 'the principles of anti-deferral and international competitiveness are diametrically opposed. Anti-deferral warrants complete taxation whereas international competitiveness warrants complete exemption. In the end, section 9D follows a balanced approach.' Balancing these competing goals and constraints has led to different countries adopting specific CFC rules. Some of these rules are as follows:⁵³

- In some countries, the resident may be taxable only if the non-resident company is in a tax haven. Other regimes will examine the headline corporate tax rate.
- In some countries the resident may only be taxable where the non-resident company benefits from individual incentives – it earns income (or incurs expense) subject to a preferential treatment in its residence country, either because of the nature of the activity being undertaken or because of the type of entity undertaking it. Sometimes, offending regimes are identified by reference to a list (either of tax haven countries/offending regimes or of non-tax-haven countries/non-offending regimes) or by reference to general characteristics or both.
- In order to capture only serious causes of deferral offshore, some countries will exempt companies whose income is derived primarily from active businesses in the foreign country.

⁵¹ National Treasury' *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 2.

⁵² Ibid.

⁵³ Vann *Taxing International Business: Emerging Trends in APEC and OECD Economies* (1997) (OECD) 31.

Another way of eliminating small cases is to have a 'de minimis' threshold of foreign profits, below which the taxpayer need not pay tax on retained profits.

Section 9D achieves this balance through favoring international competitiveness by exempting income stemming from foreign active operations. Taxation in terms of section 9D applies where the income stems from passive investments or from transactions that meet objective criteria with a high tax avoidance risk. As a result, limited forms of net income of a controlled foreign company fall under the ambit of section 9D, which mainly involve objective forms of income that present a potential threat to the South African tax base while presenting few international competition concerns.

The substantial freedom of a country's residence to transfer capital abroad increases the ability to deter or avoid tax in the resident country. This result stems from a combination of two factors:

- firstly, corporations are generally treated as separate taxpayers from their shareholders by virtue of the definitions of a person subject to tax in a particular country.⁵⁴ If the shareholder's country of residence taxes on a territorial basis, dividends paid by the foreign corporation may be exempt from tax, in which case the profits of the foreign corporation completely avoid domestic tax, and
- the second factor being the existence of jurisdictions that tax certain entities or certain types of income at very low rates or not at all.⁵⁵

Despite the fact the CFC legislation is worded in a very complex way, not just in South Africa but in all countries that adopt CFC legislation, there have been very few reported cases in relation to the CFC provisions. The reason behind this is that taxpayers generally plan their affairs to avoid the application of the provisions of CFC legislation rather than risk a case questioning whether their particular activities fall within the scope of the provisions.⁵⁶ Due to a residence-based system of taxation only being introduced in South Africa with effect from 2001, there have been no cases in South Africa relating to the provisions of section 9D. I submit that should such cases present themselves, then our courts will need to consider the facts of each individual case, decisions by international courts on similar cases and the reasons provided for such decisions.⁵⁷

⁵⁴ Paragraph (b) of the definition of 'resident' in the Act. [Section 1 sv 'resident']

⁵⁵ These countries are commonly referred to as 'tax havens'.

⁵⁶ Sandler *Pushing the Boundaries: The Interaction between Tax Treaties and Controlled Foreign Company Legislation* (1994) 21.

⁵⁷ In considering international case law, South African courts need to give consideration to the type of CFC legislation in the relevant countries from where such decisions are sourced, as certain decisions may pertain to the CFC legislation adopted in that specific country and not another country.

2.7 TAX HAVENS

According to Brincker, Honiball and Olivier (2003) ‘a tax haven is generally a country or state which has a lower rate of taxation than elsewhere’.⁵⁸ According to the OECD⁵⁹ a tax haven can be described as ‘a country which is able to finance its public services with no or nominal income taxes and which actively makes itself available to non-residents for the avoidance of tax which would otherwise be paid at a relatively high tax rate’. This definition partly coincides with Sandler’s⁶⁰ definition of a ‘classical’ tax haven which he describes as ‘a jurisdiction which actively makes itself available as a tax haven for the avoidance of tax which would otherwise be paid in relatively high tax countries’. As a result resident taxpayers can shift income to a tax haven, thus avoiding the higher tax at their resident countries.⁶¹

The use of the term ‘tax haven’ has in recent times become increasingly unpopular in the relevant jurisdictions themselves, and may be taken to imply the ‘circumvention of that country’s tax laws’. Brincker, Honiball and Olivier (2003) comment that this is probably as a result of the global increase in anti-avoidance measures and initiatives directed towards tax havens.⁶² Reference is instead being made to ‘low tax jurisdictions’ or ‘offshore finance centres’ in an attempt to alleviate the above misconception.⁶³

2.7.1 Methods of determining whether a foreign country is a tax haven

According to Macheli⁶⁴ countries have adopted two approaches to determine whether a country is a tax haven: the ‘tax rate approach’ and the ‘list or designated jurisdiction approach’.⁶⁵ These two approaches are very often used in combination. The tax rate approach is further split into a nominal rate method, an effective rate method and an actual

⁵⁸ Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 88. The term ‘elsewhere’ appears sweeping. There are no global hard and fast rules in determining a tax haven, as ‘tax haven status’ can be achieved in a number of ways, and can vary from country to country.

⁵⁹ OECD *Harmful Tax Competition: An Emerging Global Issue* (1998) para 42.

⁶⁰ Sandler *Pushing the Boundaries: The Interaction between Tax Treaties and Controlled Foreign Company Legislation* (1994) 5.

⁶¹ This is only possible if the resident country taxes their residents on a source-basis.

⁶² Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 88.

⁶³ Ibid.

⁶⁴ Macheli *A Critical Legal Analysis of the Regime for the Taxation of Controlled Foreign Entities in Terms of Section 9D of the Income Tax Act No. 58 of 1962* (Unpublished PhD dissertation, University of Natal, Pietermaritzburg) (2000) 227.

⁶⁵ The tax rate approach is based on low or zero taxes on certain or all income of tax havens. The list or designated jurisdiction approach involves a country maintaining a list of foreign countries which it designates as tax havens. Accordingly, CFCs located in these foreign countries on the list are subject to CFC legislation.

tax paid method. The nominal rate method is defined on the basis of comparison of nominal rates.⁶⁶ According to Deak and Sandler⁶⁷ the nominal rate method does not take into account the use of fiscal incentives. For example, a company may have a high tax rate but offer incentives such as tax holidays for new businesses, accelerated depreciation, investment tax credits and other similar incentives, all of which reduce the CFC's effective tax rate to considerably below such statutory nominal rate.

The effective tax rate approach involves calculating the effective tax rate paid by the CFC in its country of residence and determining on this basis if the country is a tax haven.⁶⁸ The effective tax rate approach appears to eliminate the flaw caused by the nominal tax rate approach as discussed by Deak and Sandler above, however, as pointed out by the OECD⁶⁹, this method involves calculating the effective tax rate of each CFC in each foreign country on an annual basis and as such is compromised by its tediousness and complexity.

The actual tax paid method involves comparing the actual foreign tax paid by the CFC to what it would otherwise have paid had it been resident in the domestic country. According to the OECD,⁷⁰ this is the most effective method of the three methods discussed. However, like the effective tax rate method, an annual calculation has to be done to determine the tax payable in the domestic country. Macheli⁷¹ comments that because of the complexity of the calculations and the uncertainty for taxpayers and revenue authorities in determining whether a particular foreign country is a tax haven within the meaning of a country's definition, most countries have tended to adopt the list or designated jurisdiction approach independently or to supplement the tax rate approach.

2.7.2 Characteristics of tax havens

⁶⁶ The nominal rate is the rate of tax specified in a country's tax legislation that is applied to a company's taxable income to determine the tax payable.

⁶⁷ Deak and Sandler 'Hungary: CFC Legislation Introduced' (1997) 37 *European Taxation* 402.

⁶⁸ Arnold *The Taxation of Controlled Foreign Corporations: An International Comparison* (1986) 424–430.

⁶⁹ Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 42.

⁷⁰ Ibid.

⁷¹ Macheli *A Critical Legal Analysis of the Regime for the Taxation of Controlled Foreign Entities in Terms of Section 9D of the Income Tax Act No. 58 of 1962* (Unpublished PhD dissertation, University of Natal, Pietermaritzburg) (2000) 234.

The Gordon Report (Gordon 1981), prepared by the U.S. treasury on the use of tax havens, lists a number of characteristics of tax havens:⁷²

- low or no taxes on all or certain types of income and capital;
- bank and commercial secrecy;
- lack of exchange controls;
- relative importance of banking;
- excellent communication facilities;
- effective tax treaties; and
- political and economic stability.

The 1998 OECD report *Harmful Tax Competition: An Emerging Global Issue* (1998 OECD Report) lists the following factors to identify tax havens:

- no or nominal taxes on income;
- lack of effective exchange of information about taxpayers benefiting from the low tax regime;
- lack of transparency in the operation of legislation, legal or administrative provisions; and
- the absence of a requirement that a qualifying activity needs to be substantiated (1998 OECD Report *op cit* para 52).

As can be deduced from the above, there is common ground with regard to the characteristics of tax havens as viewed by different authors and authorities, especially with regard to secrecy, lack of information exchange and low or no taxes on income.

2.7.3 Motivation to use a tax haven

According to Ginsberg, the most common factors motivating the use of a tax haven are:⁷³

- high taxes in the country of residence, particularly where a progressive system of taxation applies;
- inheritance provisions in the country of residence;
- overseas employment contracts, particularly if overseas income is free of tax unless remitted to the country of domicile;
- anonymity and secrecy with regard to bank accounts, nominees and bearer shares;
- political considerations⁷⁴;
- re-routing of export sales⁷⁵;

⁷² An in-depth analysis of each of these characteristics falls outside the scope of this dissertation. For such an in-depth analysis of the characteristics refer to Sandler *Tax Treaties and Controlled Foreign Company Legislation* 2nd ed (1994) 5.

⁷³ Ginsberg *International Tax Havens* (1990) 7.

⁷⁴ This refers to political considerations such as those which inhibit wealthy individuals (or companies) from holding their fortune in the country of residence.

⁷⁵ For example in the case of an author or investor, or of overseas purchasing in the case of an individual entrepreneur.

- depositing surplus funds⁷⁶;
- accumulation of income prior to emigration or retirement;
- geographical expansion needed for multinational corporations; and
- couples intending to divorce, to protect their estates from greedy ex-spouses.

Arnold and McIntyre in *International Tax Primer* (2002)⁷⁷ ascribe the increase in the use of tax havens over the last two decades to the following additional factors:

- the elimination of exchange controls in high-tax countries;
- improved communications and financial services;
- flexible commercial regimes and strict confidentiality requirements; and
- aggressive marketing by tax havens.

As pointed out above, there is also common ground of agreement with regard to the reasons for using tax havens, especially that of flexible commercial regimes and confidentiality requirements.

During the last 10 years, there have been specific anti-tax haven initiatives taken by the OECD. The 1998 OECD Report⁷⁸ suggests a number of measures that countries may take to counter the abuse of tax havens and harmful tax practices. These include enacting unilateral legislative provisions like CFC legislation to more effective exchange of information provisions in double taxation agreements.

2.7.4 South African legislative provisions regarding tax havens

To date South Africa has not enacted any specific legislation regarding tax havens. As a result there is no identification or 'blacklisting' of countries as tax havens by the South African revenue authorities. According to Brincker, Honiball and Olivier (2003)⁷⁹ the only country-specific anti-tax avoidance legislation is the 2002 amendment to s 9E (8)⁸⁰, in terms of which the Minister of Finance may exclude specific forms of income derived by designated countries by notice in the Gazette. Section 9E can be regarded as an example of domestic legislation which attempts to curb harmful tax practice in another country.

⁷⁶ This could be, for example, in a family trust.

⁷⁷ Arnold and McIntyre *International Tax Primer* (2002) 137.

⁷⁸ OECD Report *Harmful Tax Competition: An Emerging Global Issue* (1998)

⁷⁹ Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 102.

⁸⁰ Section 15 of the Revenue Laws Amendment Act 74 of 2002 with effect from 13 December 2002.

Apart from section 9E(8) above, the general anti-avoidance provision of section 103(1) is wide enough to apply to the abuse of tax havens. Section 103(1) applies both to residents and non-residents and provides that:

‘...where the Commissioner is satisfied that any transaction, operation or scheme has been entered into or carried out which has the effect of avoiding or postponing liability for the payment of any tax, has created rights or obligations which would not normally be created between persons dealing at arm’s length, was entered into in a manner which would not normally be employed for bona fide business purposes or in any abnormal manner, and was entered into or carried out solely or mainly for obtaining a tax benefit, the Commissioner may determine the tax liability as if the transaction had not been carried out.’⁸¹

As a result, section 103(1) can serve as general anti-tax haven legislation, as the Commissioner may use the power bestowed upon him in this section to curb the abuse of tax havens by residents.

⁸¹ Section 103(1) of the Income Tax Act 58 of 1962.

CHAPTER 3

AN ANALYSIS OF THE RECENT CONTROLLED FOREIGN COMPANY LEGISLATION IN SOUTH AFRICA WITH EMPHASIS ON CURRENT UNCERTAINTIES

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3.1 INTRODUCTION

The fundamental purpose of controlled foreign company legislation is to bring the avoidance or deferral of domestic tax through the use of a foreign company in a low tax jurisdiction back within the tax net. According to Macheli¹ ‘the focus of the legislation is therefore on the foreign source income of residents, specifically how the taxation of such

¹ See Macheli *A Critical Legal Analysis of the Regime for the Taxation of Controlled Foreign Entities in Terms of Section 9D of the Income Tax Act No.58 of 1962* (Unpublished PhD dissertation, University of Natal, Pietermaritzburg) (2000) 351.

income may be structured to prevent the avoidance of domestic tax on foreign as well as domestic source income.’

3.2 THE STRUCTURE OF SECTION 9D

In broad outline, section 9D is structured as follows:²

- it determines how a foreign company, which is to be subject to section 9D, is to be identified. Such a foreign entity is referred to in section 9D as a ‘controlled foreign company’ (CFC),
- the section then determines to which South African resident shareholders the income of the identified CFC will be imputed,
- it determines how the income of the CFC which is to be imputed to its above South African resident shareholders is to be calculated,³ and
- finally, the section provides for a number of exemptions from the operation of its provisions. The exemptions make up the bulk of section 9D and are themselves subject to exceptions.⁴

In terms of section 9D, it is the ‘net’ amount of income accruing to the controlled foreign company that is to be apportioned to the South African resident shareholders. The ‘net’ amount is defined as the gross amount reduced by deductions and allowances provided for by the South African Income Tax Act. Thus the taxable amount in the hands of the South African resident should equal what would have been the taxable amount had the resident derived the income from a direct South African source.⁵

With the relaxing of foreign exchange controls and the increasing globalisation of South African businesses, more South African individuals and companies are setting up businesses overseas. As a result, the potential of local residents controlling foreign companies is greater than it was previously. With this potential comes the ability to expand South African based multinationals as well as the ability to avoid South African taxes by shifting income to low tax jurisdictions and paying the taxes in such low tax

² Jooste ‘The Imputation of Income of Controlled Foreign Entities’ (2001) 118 *South African Law Journal* 478.

³ Discussed under chapter 6 of this dissertation.

⁴ The exemptions in terms of section 9D(9) are discussed in chapter 4 of this dissertation.

⁵ Section 9D(2A) of the Act. Deak and Sandler ‘Hungary: CFC Legislation Introduced’ (1997) 37 *European Taxation* 402, in considering the nominal rate method of determining a tax haven, point out that tax havens very often offer fiscal incentives such as tax holidays for new businesses, accelerated depreciation, investment tax credits and other similar incentives. If this is the case, one can see the advantages of basing the net income on the South African Tax Act, as tax havens may charge minimal tax in their jurisdiction and a direct conversion of this tax paid in the tax haven jurisdiction (which is calculated in terms of the legislation of the tax haven) may result in an anti-avoidance of South African tax, and to an extent defeat the purpose of CFC legislation in South Africa.

jurisdictions. CFC legislation aims to prevent such tax avoidance without hampering the growth of genuine businesses into the international markets.

It should be noted that the income of a foreign company can only be imputed to a South African resident in terms of section 9D if it is a controlled foreign company as defined.⁶

3.3 THE TERM 'FOREIGN COMPANY'

One of the major issues surrounding controlled foreign company legislation is the determining of companies to which such legislation is applicable. This reverts to the definition of 'controlled foreign company' with particular emphasis on the words 'foreign' and 'controlled'. A 'foreign company' has been clearly defined in s 9D(1) of the Act as:

'...any association, corporation, company, arrangement or scheme contemplated in paragraph (a), (b) or (e) of the definition of company in section 1, which is not a resident, or which is a resident but where that association, corporation, company arrangement or scheme is as a result of the application of the provisions of any agreement entered into by the Republic for the avoidance of double taxation treated as not being a resident.'⁷

The above definition clearly states under which circumstances a company can be considered a foreign company. However, the issue of 'control' is far more complex than that of 'foreign'. CFC legislation primarily targets foreign companies due to the fact that such legislation is generally restricted to separate taxable entities. Foreign companies meet the definition of being separately taxable by the definition of 'company' in section 1 of the Act.

The basis of determining what constitutes a 'company', whether in terms of foreign or domestic law, is much narrower than that which constitutes an 'entity'. The characterisation of entities in the international arena is fraught with ambiguity and uncertainty due to a variety of business forms in different legal systems. There are generally two approaches regarding the characterisation of a foreign entity as a separate taxable entity:

- a) where the characterisation of a foreign entity as a separate taxable entity is

⁶ A 'controlled foreign company' is a foreign company in which more than 50 percent of the participation rights are owned by South African residents.

⁷ Section 9D(1) *sv* 'foreign company'.

determined according to the law of the country in which it is resident (separate judicial entity approach),⁸ and

- b) where the characterisation of a foreign entity as a separate taxable entity is determined according to domestic law (separate economic interests' approach).⁹

Up until 2002 South Africa utilised its domestic laws to determine whether a country qualified as a controlled foreign entity. I believe that a possible reason for this was that it provided security for the term 'controlled foreign entity' at the time. The term 'controlled foreign entity' may seem to present the opportunity for tax havens to structure their domestic tax laws in such a way that an entity, which might otherwise be considered as a controlled foreign entity for the purposes of domestic law and subject to CFC legislation, might not qualify in terms of the law of the tax haven.¹⁰ This is generally counteracted by the adoption of the 'separate economic interests' approach i.e. where the characterisation of the foreign entity for CFC legislation purposes is determined in terms of domestic law.

Some countries restrict the term 'foreign entity' to apply only to a juristic person, i.e. a company. Other countries adopt a broader approach in which a foreign entity is not restricted to companies only, but specifically include such entities as a trust and a partnership. The United States defines the term as any corporation incorporated outside the United States.¹¹ New Zealand adopts a similar approach to that of the United States.¹²

The United States Internal Revenue Code also makes mention of other characterising attributes under this approach, which include:¹³

⁸ Under this approach the formal characteristics of a foreign entity under foreign law would be determinative of the character of that entity for domestic tax law purposes (Stitt 'Characterisation of Foreign Business Entities for Tax Purposes: The Chaos Continues' (1986) 8 *Houston Journal of International Law* 204).

⁹ Under this approach the character of a foreign entity for domestic tax purposes is determined by looking at the underlying economic relationships between the parties forming the entity, instead of the formal characteristics of the entity under the foreign law. Stitt (1986), however, points to the chaotic state of affairs in the United States, erratically vacillating between the two approaches (Stitt 'Characterisation of Foreign Business Entities for Tax Purposes: The Chaos Continues' (1986) 8 *Houston Journal of International Law* 209. Also see Macheli *A Critical Legal Analysis for the Regime of Taxation of Controlled Foreign Companies in Terms of Section 9D of the Income Tax Act No. 58 of 1962* (Unpublished PhD dissertation, University of Natal, Pietermaritzburg) (2000) 192).

¹⁰ Some countries go to the extent of publishing lists of exactly what type of foreign entities are to be considered the equivalent of taxable entities under domestic law in an attempt to reduce uncertainty. Such countries include, for example, Canada, New Zealand and the United States of America. Classification of foreign entities in this manner is itself elusive and sometimes unhelpful. In a list of 200 foreign business entities published by the United States Internal Revenue Service 1976, some entities were listed as 'corporation or partnership' or as 'quasi -corporation' or as 'special status,' thus adding more uncertainty (see Stitt 'Characterisation of Foreign Business Entities for Tax Purposes: The Chaos Continues' (1986) 8 *Houston Journal of International Law* 202-203).

¹¹ Section 770 (1) (a) (3)– (5) of the Internal Revenue Code.

¹² Section 16(2) of the Income Tax Amendment Act No. 5 of 1988 in New Zealand defines the term in relation to a 'company' which is defined as including any body corporate or other entity which has a legal personality or existence distinct from those of its members, whether that body corporate is incorporated in New Zealand or elsewhere.

¹³ See Reg. Section 301. 7701– 2 (a).

- continuity of life;
- centralised management;
- limited liability; and
- unrestricted transferability of ownership or participation interest.

Other countries adopting a broader approach generally provide for the term ‘foreign entity’ to include entities such as trusts and partnerships. This broader approach is said to provide more certainty for taxpayers and revenue authorities regarding which foreign entities may fall within the ambit of CFC legislation.

The Revenue Laws Amendment Act 74 of 2002 introduced the term ‘controlled foreign company’ to replace the term ‘controlled foreign entity’.¹⁴ This clarified that the entity in question, for South African controlled foreign company legislation purposes, needed to be a foreign company. From para (b) of the definition of ‘company’ in section 1 of the Act, it is clear that a foreign company is one that is incorporated under the law of that foreign country and not the law of the Republic. Brincker, Honiball and Olivier (2003)¹⁵ confirm this by stating the following:

- in order to determine the legal status of the foreign entity, the foreign law needs to be applied and not South African law, and
- treaty law needs to be considered in determining whether the company in question is a South African resident or not. A company could be incorporated in South Africa and as a result regarded as a South African resident in terms of domestic law. However, in terms of treaty law the company might be regarded as a non-South African resident and as such qualifies as a CFC.

One of the immediate issues that comes to mind is that if CFC legislation strictly applies to controlled foreign companies only, as defined above, is it not possible to circumvent CFC legislation by the establishment of a close corporation instead of a company? It should be noted that although a close corporation is regarded as a company for South African income tax purposes, it is not included in the definition of ‘foreign company’ for the purposes of section 9D. This is because the term ‘close corporation’ is unique to South African law.¹⁶

According to Arnold,¹⁷ the approach adopted by most countries is to leave the rights and obligations of the parties participating in foreign entities to be determined under the foreign

¹⁴ Section 6(1)(d) of the Revenue Laws Amendment Act 74 of 2002 with effect from years of assessment commencing on or after 13 December 2002.

¹⁵ Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 162.

¹⁶ Ibid 161.

¹⁷ Arnold *The Taxation of Controlled Foreign Corporations: An International Comparison* (1986) 412.

law and then apply domestic law to determine whether, on the basis of those rights and obligations, the entity would be a separate taxable entity for domestic purposes.

A key feature of all CFC regimes is that the legislation only applies to foreign companies over which domestic taxpayers have 'substantial influence'. In most countries 'substantial influence' means control (generally of a majority of the shares of a corporation.)¹⁸ However, this is not a hard and fast rule as there are a number of exceptions and variations.

3.4 THE ISSUE OF 'CONTROL' WITH REGARD TO A CFC

A significantly more complex issue regarding the definition of a controlled foreign company is that of 'control'. What exactly constitutes control is often a challenging question as uncertainties arise due to issues such as the following:

- does holding exactly 50 percent or more than 50 percent of the equity share capital or participation rights in a company give rise to control?;
- what happens if a resident owns less than 50 percent of the participation rights of a foreign company but is able to elect the majority of the board of directors?; or
- does control exist when a resident company does not hold more than 50 percent of the equity share capital of the foreign company, and is not able to elect the majority board members of the foreign company but is able to control the foreign company by making all strategic decisions due to its foreign status and the possession of certain required expertise?

As discussed earlier, countries which have adopted CFC legislation apply such legislation to foreign companies over which resident taxpayers have some form of 'substantial influence'. In most countries substantial influence means control, both direct and indirect, of the foreign entity. In the English case of *BW Noble Ltd v CIR*,¹⁹ Rowlatt J concluded that 'control will only be constituted by ownership of more than 50 percent of the shares of a corporation.' However, this is not the case in all countries, as in certain countries CFC legislation applies where at least 50 percent of the shares, or voting or participation rights of the foreign entity are held by resident taxpayers.²⁰

¹⁸ Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 32.

¹⁹ *BW Noble Ltd v CIR* (1926) 12 TC 911. Ownership of exactly 50 percent of the voting or participation rights was held as not constituting control.

²⁰ These include Australia, Finland, Indonesia, Norway, Spain and Sweden. (Sandler *Controlled Foreign Company Legislation* (1996) (OECD)).

It was as recently as 2002 that the entire wording of section 9D was substituted by the Revenue Laws Amendment Act 74 of 2002.²¹ One of the key changes of Act 74, as noted earlier, was the replacement of the term ‘controlled foreign entity’ with ‘controlled foreign company’.²² A ‘controlled foreign company’ is defined as:²³

‘...any foreign company where more than 50 percent 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 5 percent of the participation rights of a foreign company which is either a listed company or a scheme or arrangement 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 percent 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 percent 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.’

3.4.1 The need for control

Questions that arise from controlled foreign company legislation are ‘why does there need to be control for the legislation to apply? Why not just impute the income earned by all domestic residents from foreign companies to such residents?’ The reason for the control requirement in the majority of the countries which have adopted CFC legislation is ‘fairness’.²⁴ It would be unfair to tax residents on the income of a foreign company if they did not have the power to require the company to distribute the income.²⁵

In this respect, the application of a *de facto*²⁶ control test appears reasonable, although there may be difficulties in administering such a test (especially a ‘subjective *de facto* control’ test). Additional anti-avoidance rules are required in order to prevent avoidance of the control rules. Indirect and constructive ownership rules are found in most CFC regimes.

²¹ Section 14(1) of the Revenue Laws Amendment Act 74 of 2002 applying in respect of years of assessment ending on or after 13 December 2002.

²² It should be noted that this change was only effective from years of assessment commencing on or after 13 December 2002 (s 6(1)(d) of the Revenue Laws Amendment Act 74 of 2002).

²³ Section 9D(1) sv ‘controlled foreign company’.

²⁴ Arnold *The Taxation of Controlled Foreign Companies: An International Comparison* (1986) 415.

²⁵ Macheli *A Critical Legal Analysis of the Regime for the Taxation of Controlled Foreign Entities in Terms of Section 9D of the Income Tax Act No. 58 of 1962* (Unpublished PhD dissertation, University of Natal, Pietermaritzburg) (2000) 200.

²⁶ Common law relationship.

If the ability to control the distribution of the CFC's income is generally considered the appropriate basis for the application of the attribution rules, then concerns arise regarding situations in which control by domestic shareholders is not in the hands of a single shareholder or group of related shareholders.²⁷

Considering the situation from an administrative perspective, it would be difficult to comply with a CFC regime without access to the foreign company's records and documentation (often a prerogative of those who control the company) in order to determine tax liability. This would lead to excessive compliance and administration costs by taxpayers and revenue authorities alike due to the fact that the interest held by each local taxpayer in any foreign company would need to be determined and the related tax liability calculated accordingly.

The reasons for not requiring control were considered in New Zealand in 1988 in a consultative document.²⁸ These can be summarised as follows:

- without the requirement of control, all residents would be subject to tax on their worldwide income in the year that it was earned;
- it would be unnecessary to determine whether a non-resident company was controlled by the domestic residents, often a complex process involving the tracing of ownership rights through a network of connected entities;
- this would significantly limit opportunities for tax avoidance, in which taxpayers would try to manipulate the threshold ownership percentages.

Despite the above advantages proposed by the consultative document, the proposal was extensively criticised and subsequently abandoned.²⁹ It appears that shortcomings of the above argument would include the added burden on revenue authorities in determining ownership of all shareholders in foreign companies, no matter how small their

²⁷ In Spain the test of control is limited to a single resident shareholder and all non-arm's length shareholders (whether resident in Spain or not) are taken into account. In a number of other countries (Australia, Canada, New Zealand and the United States) in order for a foreign company to be subject to CFC legislation, it must be controlled by five or fewer residents.

The French and Portuguese regimes utilise a test based on substantial interest rather than control for the purpose of applying their rules. Under these regimes, a minority shareholder with the requisite shareholding (10 percent in the case of France, and 25 percent in Portugal) will be subject to tax on undistributed profits of the CFC, even though it may not have any legal power to compel payment of such profits. The remaining shares of the CFC may be owned by unrelated persons, even unrelated foreigners (Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 33).

²⁸ The Minister of Finance 'A Full Imputation' *Consultative Document* (1987) NZGP: Wellington.

²⁹ New Zealand, as noted earlier, now requires greater than 50 percent holding of the foreign company in order for the CFC legislation to apply.

shareholding. This would in turn defeat the objective of fairness in that most of these small shareholders would not constitute sufficient influence to require the company to distribute its income. Such a type of CFC legislation, not requiring control, will also prevent local residents investing in foreign activities and thus inhibit international trade and investment.

3.4.2 The issue of ‘acting in concert’

Previously a ‘controlled foreign entity’ was defined as follows:

‘...any foreign entity in which any resident or residents of the Republic, whether individually or jointly, and whether directly or indirectly, hold more than fifty percent of the participation rights, or are entitled to exercise more than fifty percent of the votes or control of such entity.’³⁰

The wording used in the definition of a controlled foreign entity above raised some uncertainties. Jooste³¹ (2001) in ‘The Imputation of Income of Controlled Foreign Entities’ described a few of these uncertainties. Firstly, the meaning of the words ‘held jointly’ was not precise. For example, if resident A owned forty-five percent of a foreign entity and resident B owned six percent, did they jointly own more than fifty percent of the foreign entity, irrespective of their relationships with each other or whether they were ‘acting in concert’, i.e. with a common purpose? It would have been difficult for a resident participant to have known the extent of his participation in the controlled foreign entity when he had no knowledge of other investors or the quantum of their investment. It is worth noting that if ‘jointly’ meant ‘with common purpose’, then it was theoretically possible that all the participation rights and all the votes in a foreign entity could have been held by South African residents and yet, because they were all held independently of each other (no common purpose), the foreign entity would not have qualified as a controlled foreign entity and, accordingly, none of its income would have been imputed to the residents.

As can be deduced from the above example and confirmed by Brincker, Honiball and Olivier (2003)³², Jooste is of the view that the aim of section 9D is to prevent South African residents from keeping their foreign sourced income outside the South African tax net. Further, a common purpose is not required for the application of section 9D. Brincker,

³⁰ Section 9D(1) sv ‘controlled foreign entity’ – prior to the Revenue Laws Amendment Act 74 of 2002.

³¹ Jooste ‘The Imputation of Income of Controlled Foreign Entities’ (2001) 118 *South African Law Journal* 475–483.

³² Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 163.

Honiball and Olivier (2003)³³ are of the view that section 9D was introduced as a specific anti-avoidance measure and not to bring all foreign income into the tax net (i.e. to bring into the South African tax net foreign income over which control exists) and as such a deliberate attempt to avoid foreign income from being taxed in South Africa is required. According to *The Taxpayer*,³⁴ it has been suggested that:

‘...it would be more understandable and therefore equitable if the requirement of voting and control were not confined to all South African residents who have votes, but only to those who are associated and act, whether expressly by agreement or tacitly, “in concert”.’

I believe that the view expressed by Jooste has merit in that it is not susceptible to manipulation. However, it has the disadvantage of being burdensome to the tax authorities who have to determine such ownerships without readily available information. The view expressed by Brincker, Honiball and Olivier (2003) and *The Taxpayer* is in line with the objectives of the legislation to prevent ownership tracking and cost-associated problems of minority shareholders while at the same time not being restrictive on international investment. However, the determining of whether residents are acting in concert can be viewed as a subjective issue, and as such lends itself to manipulation.

The requisite of shareholders acting in concert could impose immense difficulty to the revenue authorities. How is it possible to determine whether or not a certain group of shareholders are ‘acting in concert’?³⁵ It should also be noted that such residents would naturally seek to avoid or defer domestic tax on foreign source income, especially where such income would be subject to a significantly lower foreign tax rate than the domestic one.³⁶ As a result, the issue of determining whether domestic shareholders are acting in concert is a contentious one and consideration should be given to whether the administrative burden of having to prove that the relevant shareholders are in fact acting in

³³ Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 163.

³⁴ *The Taxpayer* ‘Editorial: Sections 9C and 9D revisited’ (1998) 83.

³⁵ Unless confirmed by the resident shareholders themselves, it would be up to the revenue authorities to prove that such shareholders are, in fact, acting in concert.

³⁶ Macheli *A Critical Legal Analysis of the Regime for the Taxation of Controlled Foreign Entities in Terms of Section 9D of the Income Tax Act No. 58 of 1962* (Unpublished PhD dissertation, University of Natal, Pietermaritzburg) (2000) 205.

concert actually outweighs the cost and time factor incurred in making this determination.³⁷

3.4.3 The 5 percent rule (a minimum ownership requirement)

The above uncertainty was partly solved by the amendment to the definition of a controlled foreign entity.³⁸ The amendment stated that, in determining whether residents jointly held more than 50 percent of the participation rights of any foreign entity which was listed on a recognised stock exchange, or which was a collective investment portfolio scheme (as contemplated in the definition of a 'company' in section 1), any person who held less than five percent of the participation rights was deemed not to be a resident, except where connected³⁹ persons held more than 50 percent of the participation rights of that foreign entity. This, in essence, constituted a minimum ownership requirement for determining control.

A minimum ownership requirement essentially requires each domestic shareholder to hold a required minimum interest in the foreign company for the purposes of determining whether the foreign company is controlled by domestic shareholders. It is important to note that even though most countries do not employ a minimum ownership requirement to determine control, these countries apply a minimum shareholding for the purposes of determining which domestic shareholders are taxable on the undistributed income of the CFC.⁴⁰

For the years of assessment ending on or after 13 December 2002 the 'individually or jointly' requirement has been removed, giving the impression that collusion between South African residents is no longer a requirement. The current definition of 'controlled foreign company' also restricts the 5 percent rule above to a foreign company which is either a listed company or a scheme or arrangement contemplated in paragraph (e)(ii) of the definition of company in section 1.⁴¹ Once again, the above 5 percent rule is not applicable

³⁷ It would prove difficult for local authorities to decide on whether certain shareholders are acting in concert, as it would be necessary to examine foreign documents, share certificates and books of account of the foreign entity. Furthermore regard needs to be had as to 'word of mouth' of the actual taxpayers as this is what it may very well come down to.

³⁸ Amendment to section 9D(1) by section 2 of the Revenue Laws Amendment Act 59 of 2000 with effect from 1 January 2001.

³⁹ Persons acting in concert i.e. with a common purpose.

⁴⁰ Sandler *Controlled Foreign Company Legislation* (1996) 37. In South Africa, such minimum threshold is 10 percent (s 9D(2)(A)).

⁴¹ Section 9D(1) sv 'controlled foreign company'.

to connected persons holding more than 50 percent of the participation rights. The following example quoted in the National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002) is used to illustrate the above:⁴²

Example Facts: Foreign Company X has issued 100 ordinary shares which are owned by 100 different South African residents. None of these South African residents are connected to one another nor do any of these shareholders have any formal or informal arrangement to vote as one or more blocks.

According to the National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002), 'Foreign Company X qualifies as a CFC. Foreign Company X is more than 50 percent owned by South African residents. It makes no difference whether shareholders act individually or jointly.'

From the above response two issues are deducible:

- a) Foreign Company X is not a listed company or a scheme or arrangement as contemplated in the definition of 'company' in section 1 of the Act, and
- b) due to (a) above, the 5 percent rule is not applicable and thus Foreign Company X is a controlled foreign company even though each resident only holds one percent of the participation rights.

It is clear from the above discussions and example that collusion is definitely no longer a requirement for determining control in a controlled foreign company. I submit that a particular risky scenario could therefore be one in which South African resident participants, who are independent of each other, collectively hold, for example, 45 percent of the participation rights of a foreign company. Any investment by another South African resident in excess of 5 percent will render section 9D applicable to all such resident participants. This will have serious consequences for those residents holding greater than 10 percent of the participation rights, as they will be unable to seek shelter in terms of the 10 percent minimum threshold rule under s 9D(2)(A), and will hence be liable for tax in terms of section 9D.

The effect of the above 5 percent rule is that small portfolio holders will, therefore, be taken out of the equation in determining whether a large scale foreign company constitutes a CFC, unless connected persons hold more than 50 percent of the participation rights. This

⁴² National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 3.

avoids ownership tracking problems associated with such shareholders.⁴³ It should be noted that it is not a requirement that the connected persons who together hold more than 50 percent of the stake be connected in relation to the person who holds less than 5 percent of the participation rights.

3.4.4 Direct control

Direct control generally stems from the holding of more than 50 percent of voting shares or rights in an entity. However, I believe it is not ethical and for that matter correct to restrict 'control' to the holding of more than 50 percent of voting rights due to the fact that effective control may still be retained while holding less than 50 percent of the voting shares. This may be attained through the appointment of the majority of the directors giving such shareholders indirect control over the management of the CFC's business and possibly control over the declaration of dividends.⁴⁴ Control can also be maintained through joint venture companies in which residents hold 49 percent of the voting shares, with locals in the country of residence of the CFC holding 51 percent. In most cases, the locals will lack the technical know-how to make any significant impact on the management decisions of the company.

The same result may also be achieved through the use of artificial technical devices such as options, rights to acquire shares or to control the voting rights and other similar arrangements which, overall, may entitle the residents to more than 50 percent of the value of the CFC even though they hold less than half of its voting shares.⁴⁵

Different countries adopt different methods of determining control. As discussed earlier, relying solely on the number of voting shares held can be misleading, and as a result such an approach has only been adopted by a few countries.⁴⁶

⁴³ National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 5. Brincker, Honiball and Olivier in *International Tax: A South African Perspective* (2003), 164, comment that it is difficult to obtain information required in terms of s 72A in respect of a shareholding of less than 5 percent in large-scale foreign entities.

⁴⁴ Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 34.

⁴⁵ Arnold *The Taxation of Controlled Foreign Companies: An International Comparison* (1986) 414 – 418. Also see Macheli *A Critical Legal Analysis of the Regime for the Taxation of Controlled Foreign Entities in Terms of Section 9D of the Income Tax Act No.58 of 1962* (Unpublished PhD dissertation, University of Natal, Pietermaritzburg) (2000) 200–207.

⁴⁶ Examples of countries adopting such an approach include Canada and Indonesia (see Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 227 and 241).

Most other major OECD countries use the above test but strengthen this by looking at various other supplementary criteria such as:

- value of assets in liquidation (e.g. Australia, New Zealand, Spain and the United Kingdom);
- share of distributable income (e.g. Australia, Finland, Spain and the United Kingdom);
- value of the shares held (e.g. Germany, Japan, Norway, Spain, Sweden, and the United States);
- *de facto* control tests (e.g. Australia, New Zealand, the United Kingdom and the United States); and
- *de minimis* value thresholds (e.g. France).⁴⁷

In South Africa, control is said to exist where resident taxpayers own more than 50 percent of the participating rights of the foreign company.⁴⁸ In certain countries CFC legislation is applicable even if the foreign company in question is not controlled by the domestic residents. Such countries include France, Hungary, Portugal and the United Kingdom. In these countries the legislation applies where domestic residents own at least 10 percent of the shares of the foreign company in the case of France, 25 percent in the case of Hungary and Portugal, and 40 percent in the case of the United Kingdom.⁴⁹

A notable point with regard to the above is that although the threshold for the applicability of CFC legislation in the above countries is far less than 50 percent, the determination of such ownership threshold is made in respect of a single resident shareholder (except in the United Kingdom where the 40 percent control can be constituted by more than a single resident shareholder). In most other countries the determination of whether control exists or not is dependant on the aggregate shareholding of all resident shareholders. As discussed earlier, this also appears to be the situation in South Africa.⁵⁰

In Australia, Finland, Norway, Spain and Sweden (and previously New Zealand), the CFC regime applies where 50 percent of the shares are owned by resident taxpayers. In the

⁴⁷ In France, if a shareholder has a capital investment of at least Ffr 150 million in the foreign company, the CFC legislation applies even if the percentage shareholding is less than 10 percent.

⁴⁸ Section 9D (1) sv 'controlled foreign company'. *The Katz Commission Fifth Interim Report* paragraph 8.3.1.4 recommended that CFC legislation should apply where South African residents control 50 percent or more of the shareholding / voting right / participation right of the CFC. Note: the holding of such rights may be constituted directly as well as indirectly in terms of s 9D(1).

⁴⁹ Macheli *A Critical Legal Analysis of the Regime for the Taxation of Controlled Foreign Entities in Terms of Section 9D of the Income Tax Act No.58 of 1962* (Unpublished PhD dissertation, University of Natal, Pietermaritzburg) (2000) 198.

⁵⁰ In terms of section 9D (1) sv 'controlled foreign company', local shareholders who hold less than 5 percent of the participation rights in a foreign company which is either a listed company or scheme or arrangement as contemplated in paragraph (e)(ii) of the definition of 'company' in section 1 of the Act, shall not be regarded as residents for the purposes of determining control of that foreign listed company, or scheme or arrangement.

remaining countries, more than 50 percent of the shares must be owned by resident shareholders (or, in the case of Spain, a single resident shareholder). It should also be noted that Australia and New Zealand have *de facto* control provisions, although there is some variation. In both countries, *de facto* control exists where one person holds 40 percent or more of the shares of the CFC, as long as no other person holds at least as many shares (objective *de facto* control). Both also employ a subjective *de facto* control test, applicable where five or fewer residents, while not holding 50 percent or more (in New Zealand, more than 50 percent) of the CFC, effectively control it (i.e. effectively control the exercise of shareholder decision-making rights).⁵¹

The extended definitions of control appear reasonable and justified. Where domestic shareholders are entitled to more than 50 percent of distributable income (or assets on liquidation), they would benefit from the deferral of domestic tax. As Arnold notes⁵², it is likely that where shareholders own more than 50 percent of the value of the corporation based on these supplementary tests, it is reasonable to assume that legal control has been given up in an attempt to avoid the CFC measures, and that the domestic taxpayers have retained effective control of the corporation.

The above supplementary tests reduce the risk of domestic taxpayers structuring their shareholdings in such a way so as to not hold more than 50 percent of the voting shares of a foreign company, but nevertheless maintain control by some other means as discussed earlier.

In South Africa, the above uncertainty arose with regard to the last part of the definition of 'controlled foreign entity' which stated 'or are entitled to exercise more than fifty percent of the votes or control of such entity.' The question that arose was, did the phrase 'more than fifty percent of' qualify the word control? Once again, what would happen in a situation in which the shareholders were widely dispersed and the ability to exercise well below fifty percent of the votes was sufficient to control the company?

It is clear that the current definition of 'controlled foreign company' does not eliminate the above problem. The current definition leaves out the words 'or are entitled to exercise 50

⁵¹ Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 33.

⁵² Arnold *Taxation of Domestic Shareholders on Undistributed Income of Foreign Corporate Affiliates: Objectives, Techniques and Consequences* (1987) 315-320.

percent of the votes or control of such entity' and restricts control to the holding of more than 50 percent of the participation rights whether directly or indirectly. From the wording of the definition of 'participation right' in the Act, this is in turn restricted to the ability to participate in the share capital, share premium and current and accumulated profits of the company, whether of a capital nature or not. As a result, the ability to control the foreign company by holding less than 50 percent of the participation rights but being able to significantly influence strategic decisions or having ability to control the board remains unresolved.

I would think that more than fifty percent does qualify the word control. Should a South African resident or residents individually or jointly hold more than fifty percent of the participation rights of a foreign company, the company is automatically construed as being under the control of those South African residents and as such regarded as a CFC. In the case of a foreign company within which a South African resident holds less than fifty percent of the participation rights, but is still able to exercise control over the foreign company,⁵³ that company will not be deemed to be a CFC. In my view this represents a flaw in the legislation and controlling, for argument's sake, 49 percent of the participation rights but still being able to control the foreign company by any other means may be an attractive opportunity for residents aiming to avoid South African tax by setting up controlled foreign companies in low tax jurisdictions. The following two examples have been extracted from the National Treasury's *Detailed Explanation to Section 9D of the Tax Act*⁵⁴ (June 2002) and are used to explain the uncertainties above:

Example (1) Facts: South African Individual owns 60 percent of the shares of Foreign Company X which owns 60 percent of the shares in Foreign Company Y. Both Foreign Companies X and Y each have only one class of ordinary shares outstanding.

National Treasury's Response: Both Foreign Company X and Foreign Company Y qualify as CFEs. Foreign Company X is more than 50 percent directly owned by South African Individual. Even though South African Individual has only an indirect 36 percent stake in the participation rights of Foreign Company Y (60 percent x 60 percent), South African Individual indirectly has more than 50

⁵³ In terms of Accounting Statement AC 132 'Consolidated Financial Statements and Accounting for Investments in Subsidiaries', para 10, control also exists even when the parent owns one half or less of the voting power of an enterprise when there is:

- (a) power over more than one half of the voting rights by virtue of an agreement with other investors,
- (b) power to govern the financial and operating policies of the enterprise under a statute or an agreement,
- (c) power to appoint or remove the majority of the members of the board of directors or equivalent governing body, or
- (d) power to cast the majority of votes at meetings of the board of directors or equivalent governing body.

⁵⁴ National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 4.

percent of the votes. South African Individual has the majority voting stake in Foreign Company X which in turn has the majority voting stake in Foreign Company Y.

The above response might no longer hold true under the definition of 'controlled foreign company'. The definition of controlled foreign company does not take voting rights into consideration but restricts control to the holding of participation rights (as discussed earlier). As can be seen above, South African Individual only holds 36 percent of the participation rights in Company Y and therefore does not control Company Y in terms of holding more than 50 percent of the participation rights. This example illustrates one of the flaws of restricting control to the holding of participation rights only and not taking voting rights into consideration.⁵⁵

Example (2) facts: Foreign Company X has issued 100 ordinary shares, of which South African Individual owns 50 and Foreign Individual owns 50. South African Individual and Foreign Individual have a voting agreement in terms of which South African Individual decides all tie votes.

National Treasury's Response: Foreign Company X qualifies as a CFC. The power to decide all tie-votes provides South African Individual with control over Foreign Company X.

It is clearly evident that in order for control to be established, more than 50 percent of the voting power needs to be held. Even though the definition of controlled foreign company does not consider voting rights, it does mention that more than 50 percent of the participation rights need to be held by residents. Thus, the holding of exactly 50 percent of the participation rights is not sufficient to establish control.

It should be noted that the above responses from National Treasury are not necessarily those of the South African Revenue Services. To date the South African Revenue Services has not issued an interpretation note regarding section 9D and it remains to be seen whether, if and when such interpretation note is issued, it concurs with the interpretation of that of the National Treasury.

⁵⁵ It is not clear from the legislation whether the term 'participation rights' encompasses voting rights. From the interpretation of the wording in the Act, it does not appear to include voting rights. Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003), 162, comment that up until 2002 the test to determine whether a foreign entity was a controlled foreign entity examined not only participation rights but voting rights were also taken into account. It is clear that they are of the view that, based on the new definition of controlled foreign company and participation rights, voting rights are no longer considered.

3.4.5 Indirect Control

The issue of indirect control is a more complex one than that of direct control. The South African CFC legislation includes both direct and indirect control, but is silent on what exactly constitutes indirect control.

The Katz Commission⁵⁶ suggested that the definition of 'control' should be wide enough to avoid manipulation, particularly through the use of 'straw persons' as directors as well as the use of offshore discretionary trusts as holding entities. The German CFC rules were considered as a guideline in this regard. The Commission said that 'under the German regime, the definition of "control" includes any form of indirect control through a person holding shares or voting rights/participation where such a person has to follow the instructions of a local resident in such a way that he/she does not have the real freedom to make his/her own decision'. This method was not adopted by Parliament who felt that, at the time, there would be no need for constructive ownership provisions by not including the minimum ownership and consolidated ownership requirements. This was, in effect, an easy way out in that it avoided the complexity that would result in defining a variety of relationships and the proximity of their connection.⁵⁷

According to Sandler,⁵⁸ there are two basic issues with regard to determining indirect control:

- a) whether the indirect interest is the minority interest and whether it should be treated the same way as a direct interest; and
- b) where the first-tier entity is itself a CFC, whether domestic participators should be considered to control the second-tier entity or only the percentage determined by multiplying the respective ownership interests.

According to Macheli,⁵⁹ there are two possible approaches with regard to the first issue. If the emphasis for determining indirect control is on the ownership of shares as a means of

⁵⁶ *Fifth Interim Report* para 8.3.1.3.

⁵⁷ See Macheli *A Critical Legal Analysis of the Regime for the Taxation of Controlled Foreign Entities in Terms of Section 9D of the Income Tax Act No.58 of 1962* (Unpublished PhD dissertation, University of Natal, Pietermaritzburg) (2000) 311.

⁵⁸ Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 35.

⁵⁹ Macheli *A Critical Legal Analysis of the Regime for the Taxation of Controlled Foreign Entities in Terms of Section 9D of the Income Tax Act No. 58 of 1962* (Unpublished PhD dissertation, University of Natal, Pietermaritzburg) (2000) 35.

control, the minority interest is disregarded. An example illustrating the above is as follows:⁶⁰

'...where a domestic taxpayer owns 40 percent of the shares of a foreign company (FC1) and 30 percent of the shares of another foreign company (FC2), which in turn owns 60 percent of the remaining shares of FC1, the taxpayer is considered to have 58 percent $\{40\% + (30\% \times 60\%)\}$ shares of FC1. But if the remaining 60 percent of the shares of FC1 are owned by unrelated persons, the minority interest in FC1 is disregarded, as it cannot be used to compel FC2 to distribute its profits.'⁶¹

If the emphasis is on the ownership of shares as a measure of the equity or value of the foreign company, the minority interest is taken into account. Thus in the example above, the indirect minority interest of 18 percent (30 percent x 60 percent) that domestic taxpayers have in FC2 through FC1 is taken into account, regardless of whether the majority interest in FC1 is held by unrelated persons. Even though the residents themselves do not hold more than 50 percent of the voting shares directly, their aggregate direct and indirect holding is 58 percent in FC2, and thus they would benefit more from deferral of the domestic tax in respect of FC2's income.

The rationale for extending the supplementary value test to indirect minority interests is more difficult to justify than a direct ownership test based on value, as it may not be fair to assume in the former case that the absence of legal control was effected solely to avoid the tests, and it is less plausible to assume in such cases that effective control has been retained by minority shareholders.⁶² Once again, with regard to the second issue, the basis of determining control depends on whether the focus is on the ownership of the equity of a foreign company or on the value of the equity owned.⁶³ If it is the ownership of the equity, then all the shares of any foreign company owned by a controlled foreign company are taken into account in deciding whether such foreign company is controlled by domestic

⁶⁰ Example sourced from Arnold *The Taxation of Controlled Foreign Corporations: An International Comparison* (1986) 419.

⁶¹ The computational method under this approach multiplies the domestic taxpayer's direct percentage of share ownership in a foreign company by that company's direct percentage of share ownership in any other foreign company, and such calculation is made for as many tiers as necessary, with both direct and indirect interests being considered. It should be noted that 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' (Davis, Olivier and Urquhart *Juta's Income Tax* 9D-4). However, it is submitted that, given the intention behind section 9D, this interpretation is too narrow and is unlikely to be accepted by the courts (Jooste 'The Imputation of Income of Controlled Foreign Entities' (2001) 118 *South African Law Journal* 477).

⁶² Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 35.

⁶³ Arnold *The Taxation of Controlled Foreign Corporations: An International Comparison* (1986) 420. Also see Macheli *A Critical Legal Analysis of the Regime for the Taxation of Controlled Foreign Entities in terms of Section 9D of the Income Tax Act No. 58 of 1962* (Unpublished PhD dissertation, University of Natal, Pietermaritzburg) (2000) 208.

residents. Thus, for example, where a domestic participator owns 51 percent of the shares of FC1, which in turn owns 60 percent of the shares in FC2, the participator will be deemed to control 60 percent of the shares of FC2. On the other hand, if the emphasis is on the value of equity held in a foreign company, domestic participators are only considered to control such proportion of the shares of FC2 as results from the multiplication of the participators' direct share ownership percentage in FC1 with the direct share ownership that FC1 has in FC2, that is 30,6 percent (51 percent x 60 percent).

It is worth noting that the first approach seems to be better than the second. The second approach as illustrated in the example above, would result in the participator being held not to be in control of FC2, while they have both its *de jure* and *de facto* control.⁶⁴ It is also interesting that the criteria used to determine the amount of undistributed income attributable to a local resident are less stringent than the criteria used to establish whether control exists. In determining the amount of undistributed income attributable to a resident shareholder, he is only attributed with so much income as equals his percentage interest in the foreign company. This test is usually value-based representing the maximum amount of undistributed income to which the resident is entitled.⁶⁵

Another point of note is that economic double taxation could also result in circumstances where a subsidiary corporation (though not the ultimate CFC whose undistributed income is subject to the CFC regime) is resident in a country which also has a CFC regime. In the previous example, if FC1 were resident in another country with a CFC regime, it is feasible that the undistributed income of FC2 is attributed and taxed twice, first to FC1 in its country of residence and second to the domestic shareholders in their country of residence. Not many countries employing CFC regimes have provisions concerning the interaction of their regime with another country's regime. It is also not certain whether a tax treaty between the two countries with competing CFC regimes would necessarily avoid such double taxation.⁶⁶

In South Africa, in terms of section 9D(2), the amount of income attributable to a local resident is determined based on the percentage of the participation rights held by him that

⁶⁴ Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 36.

⁶⁵ Ibid.

⁶⁶ Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 37.

bears to the total participation rights of the company. The tests of control are thus, as pointed out earlier, restricted to the holding of participation rights.

I submit that it appears that the definition of 'participation rights' in section 9D(1) of the Act which refers to the phrase 'directly or indirectly' clarifies the situation where the resident has a contingent (conditional and uncertain) right to the income from a CFC, as opposed to a vested (unconditional and certain) right. Both of the above should fall within the ambit of section 9D based on the use of the phrase 'directly or indirectly'.⁶⁷ However, this might not have been the intention of the legislation. National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002)⁶⁸ explains that participation rights include shares representing equity share capital as well as other forms of shares, such as non-participating preference shares. The term 'participation right' needs to be broadly defined to be consistent with the anti-avoidance nature of CFC rules and in order to ensure that South African taxpayers cannot enter into convoluted share arrangements as a means of controlling foreign companies while avoiding tax under section 9D.

However, convertible debentures, options and similar interests do not qualify as participation rights because these instruments do not represent a participation interest until converted into shares. Thus it appears that the intention of the legislation in using the term 'indirectly' is to refer solely to the holding of shares through another company and not to conditional holdings. The wording of the term 'indirectly' in the legislation remains to be clarified in order to reflect this.

With regard to controlling fifty percent of participation rights directly or indirectly, a conundrum existed which is explained as follows:⁶⁹

A, a natural person resident in South Africa, is the sole shareholder in Company X which is incorporated in South Africa and a resident as defined. Company X is a shareholder to the extent of more than fifty percent of participation rights in Company Y which is incorporated offshore and has its effective management in a country other than the Republic. Therefore Company Y is a CFC.

⁶⁷ Professor Lynette Olivier comments that 'taken to its extreme it means that even a South African creditor who has a secured claim against the foreign entity may fall within the definition of participation rights'. (Olivier L 'Controlled Foreign Entities' *Accountancy SA* (May 2001) 12-13). In her book (Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003), 164, Professor Olivier once again raises the question of whether a creditor who holds debentures or a mortgage over the CFC's property would fall under section 9D. It may be argued that until the security is called up, such a creditor has no direct right to participate in the profits or reserves of the company, however he or she indirectly has the right to do so. In the UK the Taxes Act was amended expressly to exclude loan creditors (s 749B(2) of the Taxes Act 1988, amended by the Finance Act 1998).

⁶⁸ National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 3.

⁶⁹ *The Taxpayer* 'Controlled Foreign Entity: Participation Rights' (1999) 199.

Company Y has income as defined in section 9D. Who is subject to South African tax? Company X because it is a resident, or A because A, a resident, individually through Company X participates in more than fifty percent of the profits of Company Y, or both A and Company X, because they both fall within the ambit of section 9D(2).

National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002) did not comment on the above conundrum. However, the insertion of section 9D(2)(B)⁷⁰ clarified this situation and the income of Company Y above will be imputed to Company X and not Mr A. This in effect also clarified another situation. Consider the following example:

Assume South African Company A (incorporated and resident in the Republic) holds 100 percent of the participation rights of Foreign Company B, a CFC. However, only some of the shareholders of South African Company A are residents.

In the above example, it is now clear that the income earned from Foreign Company B will be imputed to South African Company A, as South African Company A is a resident.

Section 9D(2)(B) also provides clarity on the following situation:

Assume Mr A, a South African resident, holds 51 percent of company B (a foreign company). Mr A also owns 20 percent of company C (a South African company) which in turn holds 30 percent of company B as well. Now, Mr A effectively holds 57 percent of company B (51 percent directly plus $(20\% \times 30\% = 6\%)$ through company C (indirectly)). Company C holds 30 percent directly.

In the above example, is the revenue authority (SARS) to tax Mr A on 57 percent and company C on 24 percent, or is Mr A to be taxed on 51 percent and company C on 30 percent?⁷¹ Section 9D(2)(B) makes it clear that income earned from a CFC through indirect holdings of another resident company is to be attributed to that resident company, and therefore Mr A will be taxed on 51 percent of the income of company B and company A on 30 percent of the income of company B.

3.4.6 The timing of control

Internationally there are two approaches that various countries adopt as regards the timing of control:

⁷⁰ Section 14(1) of the Revenue Laws Amendment Act 74 of 2002 with effect from years of assessment commencing on or after 13 December 2002.

⁷¹ Jooste 'The Imputation of Income of Controlled Foreign Entities' (2001) 118 *South African Law Journal* 480.

- a) where participants acquire control at any time during the CFC's accounting year;⁷² and
- b) where control is only determined with regard to the participation shareholding at the end of the CFC's financial year.⁷³

The problem with the former approach is that it poses a heavy administrative burden on the revenue authorities attempting to enforce such legislation. The primary reason for this is that local authorities do not have constant access to the books and records of the foreign company and cognisance needs to be taken of the willingness of such foreign company to disclose such information at various times during the year.

With regards to the latter approach, this is far simpler to implement and less of an administrative burden on the revenue authorities. However, this approach seems open to manipulation, as this could lead to resident participators disposing of part of their interest shortly before the CFC's year-end and then re-acquiring it shortly after year-end in order to shed control for that period of time. It can also result in an element of unfairness, especially in a scenario in which a shareholder acquires control shortly before the CFC's year-end. Many countries adopting the latter approach have general anti-tax avoidance provisions in their tax laws which would prevent such schemes of arrangement.⁷⁴

Up until 2002, this was also the case in terms of section 9D for the holding of participation rights in order to determine control of the company. The Revenue Laws Amendment Act 74 of 2002 rectified this shortcoming, in that rules were laid down where:

- a) the foreign entity becomes a CFC during the foreign tax year (s 9D(2)(a)(ii)); and
- b) the CFC ceases to be a CFC at any time during the foreign tax year (s 9D(2)(b)).

⁷² Denmark, New Zealand, the United Kingdom and the United States adopt this approach. New Zealand calculates control interests only on the last dates of each calendar quarter, and if control is established on any one of such dates, the foreign company is considered a controlled foreign company for the entire year, ss CG3 and CG4 of the Income Tax Act of 1994.

⁷³ Examples of countries that have adopted this approach include Australia (s 340 read with s 319 of the Income Tax Assessment Act of 1936), France (see van Waardenburg 'France: Taxation of Profits Derived Through Subsidiaries in Low Tax Areas' (1983) 23 *European Taxation* 181), and Spain (Raventos 'Spain: CFC Provisions Introduced' (1995) 35 *European Taxation* 165).

⁷⁴ Macheli *A Critical Legal Analysis of the Regime for the Taxation of Controlled Foreign Entities in terms of Section 9D of the Income Tax Act No. 58 of 1962* (Unpublished PhD dissertation, University of Natal, Pietermaritzburg) (2000) 212.

Where the CFC becomes a CFC during the foreign tax year, the South African resident has the option of including in his local taxable income his proportion of:

- a) the income that accrued to or was received by the CFC during the days of the foreign tax year when the company was a CFC (s 9D(2)(a)(ii)(aa)); or
- b) an amount in proportion to the number of days the company was a CFC (s 9D(2)(a)(ii)(bb)).

It is clear that option (a) above can only be achieved if detailed accurate records of income and expenditure are kept by the controlled foreign company and available to the resident. This makes option (b) attractive for its ease of computation and the fact that no detailed record keeping is required. However, option (b) could have serious consequences in a business where sales are seasonally driven. This is illustrated by the following example:⁷⁵

Example Facts: Mr A, a South African resident acquires a 60 percent shareholding in Foreign Company X, an ice cream manufacturing company, based in Country Y, on the 1 October 2002. Foreign Company Y's year-end is 31 March. Due to country Y being in the Northern Hemisphere, the period October to March represent the Autumn and Winter months in which generally one-third sales are conducted. The company earns net income of R15m for the entire foreign year under assessment, of which R5m is earned in the period 1 October 2002 to 31 March 2003.

Result (assuming option (a) above): Mr A will be liable for R1.5 m (R5m x 30 percent) tax.

Result (assuming option (b) above): Mr A will be liable for R2.25 m (R15m x 6/12 months x 30 percent) tax.

As a result it is imperative that the purchaser be aware of the above situation. A possible solution to the above problem, especially where no detailed records are kept, might be to build any additional, or for that matter reduced taxes, into the purchase price. Once again, due to the fact that no accurate records were kept, historic figures might have to be relied upon in estimating current year sales figures and agreed by the seller and purchaser.

Where the foreign company ceased to be a foreign company at any stage during the foreign tax year, the South African resident has a similar option to the above (s 9D(2)(b)).

3.4.7 Control by a concentrated group

⁷⁵ Example not previously reported.

According to Sandler⁷⁶, apart from France (which requires control to be vested in a single resident shareholder) and Portugal (under its 25 percent ownership test for CFCs), the remaining major OECD countries may be divided into four groups:

- Spain, which requires control to be held by a single Spanish resident (although there are constructive ownership provisions, so that effectively all related Spanish shareholders will be subject to the CFC regime);
- Denmark, which requires control to be held by a single Danish company (and there are no constructive ownership provisions);
- Australia, Canada, New Zealand and the United States, which requires control to be concentrated in a relatively small number of domestic taxpayers. In these jurisdictions, a foreign corporation which is widely held by unrelated residents is not a CFC; and
- Finland, Germany, Japan, Norway, Portugal (under its alternative definition of a CFC), Sweden and the United Kingdom, where all domestic shareholders are taken into account.

Spain and Denmark adopt the view that if the ultimate justification of the CFC regimes is that the domestic shareholders controlling the CFC could compel it to pay out its income as dividends (thus eliminating deferral), then the CFC regime should be limited to those circumstances. Where control is concentrated in a small group, the group can be presumed to be acting in concert.⁷⁷ Where ownership of the foreign company is widely held, it may be difficult for any one domestic shareholder to determine if a foreign corporation in which it owns shares is a CFC.

Concentrated ownership requirements add complexity to the rules, and make constructive ownership and other anti-avoidance rules that much more important, as it would otherwise be too easy to avoid the application of the provisions simply by spreading the shares amongst related persons. On the other hand, as reported by the OECD⁷⁸, the number of situations in which a foreign company is widely held by residents are likely to be very few. Such situations do, nevertheless, present immense difficulties for domestic taxpayers to comply with the regime, as well as revenue authorities to enforce such CFC regimes where control is not concentrated.

⁷⁶ Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 38.

⁷⁷ Ibid.

⁷⁸ Ibid 39.

In terms of South African controlled foreign company legislation, control does not need to be vested in a concentrated group. A logical reason for this is avoidance of the complexity associated with this rule. Although this rule is closely linked to the ‘acting in concert’ theory, it does not necessarily mean that if control is vested in a concentrated group of residents that these residents are acting with a common purpose.⁷⁹ As discussed earlier, a general presumption does exist that where control is held in a small group, the group will be acting in concert.⁸⁰

3.5 THE 10 PERCENT RULE

Section 9D(2)(a)(i) provides that there shall be included in the income for the year of assessment of any resident who holds any participation rights in a controlled foreign company:

‘...where that foreign company was a controlled foreign company for the entire foreign tax year, the proportional amount of the net income of that controlled foreign company determined for that foreign tax year, which bears to the total net income of that company during that foreign tax year, the same ratio as the percentage of the participation rights of that resident in relation to that company bears to the total participation rights in relation to that company on that last day...’

However, a resident referred to in section 9D(2) will be excluded from its operation in terms of section 9D (2)(A):⁸¹

‘where such resident (together with any connected person in relation to such resident)

- (i) at the end of the last day of the foreign tax year of the controlled foreign company; or
- (ii) in the case where that foreign company ceased to be a controlled foreign company during the relevant foreign tax year, immediately before that foreign company so ceased to be a controlled foreign company,

in aggregate holds less than 10 percent of the participation rights in that controlled foreign company’.

According to National Treasury’s *Detailed Explanation to Section 9D of the Tax Act* (June 2002)⁸² the 10 percent threshold prevents section 9D from applying to minority owners who have no practical say over the company’s affairs.⁸³

⁷⁹ As discussed earlier, this is not a requirement in terms of South African CFC legislation.

⁸⁰ Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 38.

⁸¹ Section 9D(2A) proviso.

⁸² National Treasury’s *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 5.

⁸³ The 10 percent rule is in essence a minimum ownership requirement for the imputation of income in terms of section 9D.

The above 10 percent rule is illustrated in the following example:

South African Company A (incorporated in the Republic) holds 48 percent of the shares in a Foreign Company B. Mr C, a South African resident owns a further 7 percent of the shares. Foreign Company B will meet the definition of a CFC, as it is being controlled by South African residents to the extent of holding more than 50 percent of the participation rights (being South African Company A and Mr C). However, income earned from the CFC can be imputed to company A in terms of section 9D, but not to Mr C because he holds less than 10 percent of the participation rights.⁸⁴

It appears from the wording in the legislation regarding the 10 percent rule that it is possible for a foreign company to satisfy the requirements of being a controlled foreign company but at the same time not have any of its income imputed to South African residents. Consider the following example of the National Treasury:⁸⁵

Example Facts: Foreign Company X has issued 100 shares, each of which is owned by a separate South African resident, none of whom are connected to one another.

Result: Even though Foreign Company X qualifies as a CFC and is controlled by South African residents, none of these shareholders satisfy the 10 percent threshold.

I submit that the above 10 percent threshold can be manipulated in an instance in which, for example, six South African residents who are connected persons each hold 9 percent of a foreign company. This will result in the foreign company being a CFC but no income imputed to the residents. The fact that they are connected persons is irrelevant in terms of section 9D. Macheli⁸⁶ is of the same view and comments that in order for a minimum threshold limit to be effective, it must be supported by indirect and constructive ownership rules to prevent anti-avoidance through the splitting of ownership interests among related persons. As discussed earlier, there are no constructive ownership rules in South Africa and it appears that the legislation in the use of the term 'indirect' refers only to holdings through another company. Thus, the 10 percent minimum threshold rule as it stands is vulnerable for the reasons discussed above.

⁸⁴ Jooste 'The Imputation of Income of Controlled Foreign Entities (2001) 118 *South African Law Journal* 478. It should also be noted that if Foreign Company B is a listed company or scheme or arrangement as contemplated in paragraph (e)(ii) of the definition of 'company' in section 1 of the Act and Mr C holds less than 5 percent of the participation rights (for example, 3 percent), then Mr C together with Company A hold more than 50 percent of the participation rights, but Mr C will not be deemed to be a resident in terms of s 9D(1) *sv* 'controlled foreign company' and hence the foreign company will not be deemed to be a controlled foreign company. Also see National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002), 9, for a similar example.

⁸⁵ National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 5.

⁸⁶ Macheli *A Critical Legal Analysis of the Regime for the Taxation of Controlled Foreign Entities in terms of Section 9D of the Income Tax Act No. 58 of 1962* (Unpublished PhD dissertation, University of Natal, Pietermaritzburg) (2000) 220.

In determining whether the above 10 percent rule is applicable to a particular resident, it should be borne in mind that only direct holdings of participation rights by the resident and connected persons in relation to such resident are to be taken into account.

Another important aspect with regard to the 10 percent rule is that it applies to the shareholding on the last day of the financial year.⁸⁷ Once again, this opens this proviso to manipulation, as it appears to lend itself to investors entering into agreements to dispose of part of their interest shortly before the CFC's year-end and re-acquiring it shortly after the year-end in order to avoid the application of s 9D. It remains to be seen if this aspect of the legislation regarding the 10 percent threshold will be changed to include provisions similar to those of s 9D(2)(a)(ii) and s 9D(2)(b).

As new CFC legislation was enacted into South Africa, businessmen and entrepreneurs who had already set up structures earlier now began to look closely at the legislation. Some of the possible methods of avoiding section 9D included:

- not to control the foreign company as defined by this section;⁸⁸
- structuring your foreign operations so as to legally meet one of the exemption criteria in terms of section 9D(9); or
- not holding greater than 10 percent of the participation rights if you are aware that South African residents collectively hold greater than 50 percent of the participation rights in that foreign company and thus control it.

The above appear to be three simple escape methods in order to avoid the application of section 9D. However, they are much more difficult to achieve than they initially appear especially when it comes down to the loss of control of the foreign company, restructuring of operations and so on. Furthermore, the requirements that need to be satisfied in order for the exemptions to be met are onerous. These exemptions are dealt with in detail in the next chapter.

⁸⁷ Section 9D (2A) (i) and (ii).

⁸⁸ This will normally apply where there are a few shareholders from different countries holding large portions of the participation rights in a foreign company. However, the option of controlling the company, in more cases than not, will outweigh the application of section 9D.

CHAPTER 4

EXEMPTIONS IN TERMS OF SECTION 9D(9)

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4.1 INTRODUCTION

It is important for investors seeking to invest capital abroad by establishing controlled foreign companies and for those who, prior to controlled foreign company legislation in the Republic had already set up CFCs abroad, to understand the objective of the legislation and exactly what types of income fall within the ambit of section 9D.

A sound knowledge of the exemptions in terms of section 9D(9) and the requirements necessary to qualify for such exemptions form the core basis of the above understanding. Section 9D(9) provides for numerous exemptions in terms of section 9D. The income contemplated in this subsection, even though earned from a controlled foreign company, would escape the tax implications of section 9D. It is worth noting that some of these exemptions are subjective in nature and impose difficulties on taxpayers and revenue authorities alike.

Similar to the establishment of anti-avoidance provisions is the decision and ruling of what constitutes 'exempt income'. Care has to be taken in striking a balance between not allowing too much to escape the CFC tax net, but at the same time not hindering local businesses trying to internationalise themselves. Fairness towards the resident taxpayer should also be considered.

Section 9D(9) forms a major portion of the entire structure of section 9D and the nature of exemptions makes them material and important to any taxpayer as well as the tax authorities. A thorough discussion of these exemptions is imperative and forms a major component of this analysis.

These exemptions may be summarised as follows:

- the business establishment exemption (s 9D(9)(b)),
- the previously taxed exemption (s 9D(9)(e)),
- the designated countries exemption (s 9D(9)(a)),
- the related and intra-group exemptions (s 9D(9)(f) and (fA)),
- the capital gain on capital assets exemption (s 9D(9)(fB)), and
- Co-CFC disposal and dividends (s 9D(9)(h)).

It should be noted that section 9D(9) does not mention the 10 percent minimum threshold rule in terms of section 9D(2), which in itself is an exemption of income to be attributed in terms of section 9D.¹

The exemptions offered in terms of section 9D(9) are closely linked to those offered by most other countries adopting CFC legislation. Sandler (1996), in comparing such legislation of the various OECD member countries, summarises the exemptions offered by these member countries as follows:²

1. an exemption for CFCs that distribute a certain percentage of their income in a year (the percentage distribution exemption);
2. an exemption for CFCs engaged primarily in genuine business activities (the business establishment exemption);
3. a motive exemption for CFCs which are not established for the purpose of avoiding tax;
4. an exemption for CFCs whose shares are listed on a recognised stock exchange (the publicly traded shares exemption); and
5. a *de minimis* exemption where the total income or tainted income of the CFC, or a shareholder's pro-rata share of such income, does not exceed a certain amount ('*de minimis*' exemption).

Only the United Kingdom utilises all five exemptions. Australia and Canada utilise exemptions number 2 and 5. For Canada, the use of exemption 2 is limited to certain 'base company income'.³ The United States utilises 3 and 5, except that its motive exemption is applied on a purely objective basis based on the effective rate of foreign tax on an item of CFC income. France utilises 2 and 3. Finland, Japan and Portugal utilise exemption 2 only and Germany utilises exemption 5 only.⁴ Currently South Africa appears only to utilise exemption 2 from Sandler's list. It may be argued that the 10 percent rule discussed

¹ The 10 percent minimum threshold rule has been discussed in chapter 3 of this dissertation.

² Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 67.

³ 'Base company income' has been defined as income derived from selling property or rendering services which are considered attributable to domestic shareholders (Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 55).

⁴ Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 67.

earlier is a form of a *de minimis* exemption based on percentage interest in the company and not value.

When one of the exemptions listed above is applicable with respect to a CFC, none of the income of the CFC is subject to attribution as the exemption applies to the CFC itself rather than to its income. The availability of such exemptions indicates a willingness on the part of the imposing country to tolerate deferral in certain circumstances.⁵ This chapter analyses the current exemptions in terms of section 9D(9) and focuses on the requirements that need to be satisfied in order to qualify for these exemptions.

I submit that the numerous exemptions and relief provisions of section 9D(9) complicate legislation and open it to numerous objections. Subjective exemptions often become targets in an attempt to avoid tax. The ‘motive’⁶ exemption adopted in the United Kingdom and previously in the United States, is a typical example of such a subjective provision. In such a case the onus would lie on the resident taxpayer to prove that the establishment of a CFC was for a ‘bona fide’ business motive and not to avoid local taxes. Even in such situations discussed above, it would be difficult for the Courts to establish the validity and correctness of the taxpayer’s argument. Consideration would need to be given to the set of facts that presents itself for each individual case and the previous decisions of the Court in similar situations.

4.2 THE BUSINESS ESTABLISHMENT EXEMPTION

The business establishment exemption excludes income earned from a controlled foreign company that is attributable to any ‘business establishment’ from the ambit of section 9D. At its core, this exemption aims to simultaneously balance the demands of allowing local companies to compete internationally on an equal footing to foreign competition with the achievement of ‘fairness’ between local residents earning local income and local residents earning foreign income.

⁵ Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 68.

⁶ Macheli *A Critical Legal Analysis of the Regime for the Taxation of Controlled Foreign Entities in Terms of Section 9D of the Income Tax Act No. 58 of 1962* (Unpublished PhD dissertation, University of Natal, Pietermaritzburg) (2000) 304. The ‘business establishment’ exemption is available if it can be established that the main purpose of the CFC is not the avoidance of local taxes by channelling local profits to foreign countries.

Macheli⁷ (2000) in his analysis of CFE income states:

‘[T]he exemption signifies a fundamental policy choice of balancing the demands of capital export neutrality against those of capital import neutrality, so that the legislation does not interfere with the ability of domestic enterprises to compete internationally in regard to genuine business activities.’

In his analysis, Jooste⁸ (2001) states that the business establishment exemption seeks to achieve a balance between the above two objectives by permitting South African CFCs to operate without imputation of their income to their South African owners in terms of section 9D if a motive exists for operating abroad and the foreign operations present no threat to the South African tax base. This was confirmed by the National Treasury in their *Detailed Explanation to Section 9D of the Tax Act* (June 2002) where they comment that, as a policy matter, this exemption promotes international competitiveness so long as the income poses no threat to the South African tax base.⁹ Brincker, Honiball and Olivier (2003)¹⁰ further comment that the business establishment exemption is one of the most complicated provisions to understand and it is clear from the wording in section 9D(9)(b) that the legislature in granting the exemption ‘attempted to strike a balance between granting an exemption to income derived from legitimate business activities and that derived from illusory business undertakings’.¹¹

The way in which the business establishment exemption seeks to achieve the balancing of the two objectives is to effectively exempt from the operations of section 9D all foreign income of a CFC except for income that may be termed¹²:

- mobile foreign business income,
- diversionary foreign business income, and
- mobile foreign passive income.

4.2.1 Mobile foreign business income

⁷ Macheli *A Critical Legal Analysis of the Regime for the Taxation of Controlled Foreign Entities in Terms of Section 9D of the Income Tax Act No. 58 of 1962* (Unpublished PhD dissertation, University of Natal, Pietermaritzburg) (2000) 304.

⁸ Jooste ‘The Imputation of Income of Controlled Foreign Entities’ (2001) 118 *South African Law Journal* 486–488.

⁹ National Treasury’s *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 8.

¹⁰ Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 174.

¹¹ *Ibid* 175.

¹² Section 9D(9)(b)(i-iii). Also see National Treasury’s *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 8.

The Act does not define ‘mobile business income’. Rather, ‘mobile business income’¹³ is identified by virtue of its failure to qualify as income attributable to a business establishment.¹⁴ National Treasury is of the view that mobile foreign business income involves income from paper shell businesses without economic substance that attract taxable income. In other words, the business is no more than a paper shell whose only real economic activity is the maintenance of a post office box or postal address, or an electronic website. These businesses usually involve employing staff who do not take day-to-day management decisions. As was pointed out in the case of *SIR v Downing*,¹⁵ the employment of independent agents to carry out such day-to-day management functions also does not qualify for the requirements of a business establishment. This minor activity is located abroad for tax reasons and could quite easily be carried on at home. The absence of any real business means that international competitiveness is not undermined.¹⁶ To qualify as a business establishment, a business must satisfy three criteria, namely:¹⁷

- permanence and independence,¹⁸
- suitably equipped, and
- utilised outside the Republic for a bona-fide business purpose.

4.2.1.1 Permanence and independence

Silke¹⁹ states that this criterion might refer to an enterprise with the qualities of a sound and stand alone or independent existence which is not subordinate to another business. National Treasury states that ‘a business establishment essentially involves a business that has some permanence, some economic substance, and a non-tax business reason for operating abroad rather than at home.’²⁰

A ‘business establishment’ in relation to a controlled foreign company is defined in section 9D(1) as:²¹

- a) a place of business with an office, shop, factory, warehouse, farm or other structure which is used and will continue to be used by the foreign entity for a period of not less than one year, whereby the business of such company is carried on, and where:

¹³ Jooste ‘The Imputation of Income of Controlled Foreign Entities’ 118 *South African Law Journal* 487.

¹⁴ See section 9D(1) of the Act for the definition of a ‘business establishment’.

¹⁵ *SIR v Downing* SATC 249.

¹⁶ Jooste ‘The Imputation of Income of Controlled Foreign Entities’ (2001) 118 *South African Law Journal* 487.

¹⁷ Sections 9D(1)(a), 9D(1)(a)(ii) and 9D(1)(a)(iii).

¹⁸ These terms are not used in the Act but describe the fixed locations mentioned in s 9D(1)(ii) of the Act.

¹⁹ Silke *South African Income Tax* (2002) I §§ 5.40.

²⁰ National Treasury’s *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 9.

²¹ Sections 9D(1)(a), 9D(1)(b) and 9D(1)(c).

- (i) that place of business is suitably equipped with on-site operational management, employees, equipment and other facilities for the purposes of conducting the primary operations of that business; and
 - (ii) the place of business is maintained in a country outside South Africa for *bona fide* business purposes (other than tax avoidance, postponement or reduction);
- b) a mine, oil or gas well, a quarry or any other place of extraction of natural resources where the CFC has a right to directly explore those natural resources, or any area where that CFC has the right to carry on prospecting operations preliminary to the establishment of a mine, oil or gas well, quarry or other place of extraction or prospecting operations;
- c) a site for the construction or installation of buildings, bridges, roads, pipelines, heavy machinery or other projects of comparable magnitude which lasts for a period of not less than 6 months, where that CFC carries on those exploration, extraction or prospecting operations;
- d) agricultural land used for *bona fide* farming activities directly carried on by that CFC; or
- e) a vessel or an aircraft solely engaged in transportation within a single country, or a fishing vessel used for prospecting, exploration or extraction, where that vessel or aircraft is operated directly by that CFC.

Brincker, Honiball and Olivier (2003) comment that the above definition of 'business establishment' broadly resembles the definition of 'permanent establishment' in the OECD and UN Model Tax Convention.²² It is evident from the above examples given in the Act that if the business is an office, shop, factory, warehouse, farm or other structure, then the one-year criteria must be satisfied. This, I believe, can be done historically (i.e. business already in existence for more than one year), or it can be proved that the business will continue to be used by the CFC for a period of not less than one year (in the case of a newly established business). In the case of a construction site or installation of buildings, bridges, roads, pipelines, heavy machinery or other projects of comparable magnitude, the six-month criteria will need to be satisfied.²³ According to National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002), the six-month requirement is designed simply to ensure that the CFC is providing an activity that amounts to more than a momentary service.²⁴

²² Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 175.

²³ Jooste, in his analysis of 'The Imputation of Income of Controlled Foreign Entities', states that due to these periods not being of a substantial length of time, and the fact that in most cases an enquiry will be done long after the date of receipt or accrual, it will therefore be easy for the courts to decide whether the one year or six month period as described here has been satisfied. (Jooste 'The Imputation of Income of Controlled Foreign Entities' (2001) 118 *South African Law Journal* 488).

²⁴ National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 9.

Mines, construction sites, farms and fishing operations are all deemed to be business establishments without having to satisfy the additional economic substance and business purpose test. This is because of the extreme difficulty associated with trying to fabricate operations of these kinds which have a fixed nature. There are also no time limits applicable for mining and fishing operations due to the fact that a one-year period will more than likely always be satisfied with respect to these kinds of operations.²⁵ Brincker, Honiball and Olivier (2003)²⁶ also comment that although a company that operates a vessel or aircraft solely for transport purposes need not have a place of business in the foreign country, it has to operate within a single country. This emphasis on operation within a single country is due to the tax planning opportunities that exist with regard to international transportation.

4.2.1.2 Suitably equipped

The second requirement for the definition of 'business establishment' to be satisfied is that such a place of business must be suitably equipped with on-site operational management, employees, equipment and other facilities for the purposes of conducting the primary operations of such business.²⁷

The term 'suitably equipped' is not defined in the Act. From its usage in section 9D(9)(b), it seems to qualify 'permanent establishment' and require it to have such physical, human and financial support bases as are sufficiently necessary for conducting the controlled foreign company's principal business.²⁸ In other words, the business must possess the funding, business premises, facilities and suitably qualified and skilled employees as is appropriate for the type of business concerned.²⁹

The 'suitably equipped' criterion attempts to ensure that a business does not qualify as a business establishment purely on the basis of the form that is presented. Businesses involving purely paper-based transactions or a business that is conducting passive income-generating activities which may be disguised as something more substantial are therefore

²⁵ Also see Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 176.

²⁶ Ibid.

²⁷ Section 9D(9)(a) (i) of the Act.

²⁸ Macheli *A Critical Legal Analysis of the Regime for the Taxation of Controlled Foreign Entities in Terms of Section 9D of the Income Tax Act No. 58 of 1962* (Unpublished PhD dissertation, University of Natal, Pietermaritzburg) (2000) 294.

²⁹ Silke *South African Income Tax* Vol 1 SS 5:40.

excluded.³⁰ There is no objective standard of proving whether a business constitutes a permanent establishment. Once again, the courts will need to rely on the facts of each given case.

An example of a business that satisfies both the permanence and independence and suitably equipped criteria would be the following:³¹

SA Co (a company resident in South Africa) owns all the shares in CFC (X), a company that manufactures a drug in a factory in country Y to sell to other CFCs of SA Co. The factory is leased by CFC (X) in terms of a three-year lease. The manufacturing equipment in the factory is owned by CFC (X) and it employs twenty employees to run the factory and to keep the books. All security, cleaning and other incidental functions are contracted out. In these circumstances, because there is a place of business (the factory) which is to be used by CFC (X) for a period of not less than a year, the 'permanence and independence' criterion is satisfied. The suitably equipped criterion is also satisfied because the business is suitably equipped with on-site operational management, employees and equipment to conduct the primary operations of the business. The functions contracted out are incidental.

An example illustrating the absence of the suitably equipped criterion but satisfying the permanence and independence criterion is the following:³²

SA Co (a company resident in South Africa) holds all the shares in CFC (X) located in country Y. CFC (X) owns a block of flats in country Y. All the day-to-day administration, maintenance and related operations involved in the leasing of the flats are conducted by an independent contractor. CFC (X) has an office in country Y, which is under a five-year lease. This office is occasionally occupied by an employee of CFC (X) and is where the accounting and bookwork is performed. In these circumstances the 'permanence and independence' criterion is satisfied, but not the 'suitably equipped' criterion. CFC (X) does not have a place of business that is suitably equipped to conduct the primary operations of the business. The primary operations are performed by an independent contractor.

The following example has been extracted from National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002) and illustrates further the absence of a business establishment:³³

³⁰ Jooste 'The Imputation of Income of Controlled Foreign Entities' (2001) 118 *South African Law Journal* 488. Also see National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 13.

³¹ Jooste op cit 488 (adapted).

³² Jooste op cit 489.

³³ National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 10.

Example Facts: South African Company owns all the shares of CFC, a company located in a tax haven. CFC owns a 100-unit apartment building located in Country X. CFC hires an independent contractor to run all the daily operations of the apartment building, paying the independent contractor a flat annual fee. CFC has two office employees located in a Country X office. The Country X office has been leased for many years; the two office employees occasionally visit the apartment buildings; and all the apartment accounting functions are handled at the Country X office.

National Treasury's response: The CFC does not have a business establishment. The CFC lacks economic substance in running the primary daily operations of the business, all of which are conducted by the independent contractor.

It should also be noted that in order for the business establishment exemption to be granted, there should be a direct relationship between income and a controlled foreign company's permanent establishment.³⁴ This effectively means that the volume of financial resources, facilities and employees of the establishment must correspond to the volume of business being conducted. Although to qualify for the business establishment exemption, the establishment needs to satisfy the 'permanence and independence', 'suitably equipped' and utilised outside the Republic for a 'bona fide business purpose' criteria³⁵, the Act does not place any restrictions on the type of business being conducted. For example, it is also possible for the principal business activity to be money lending, in which case the facilities should be adequate for the type and volume of business being conducted.³⁶

4.2.1.3 Outside the Republic for a '*bona fide*' business purpose

According to Brincker, Honiball and Olivier (2003),³⁷ in deciding whether the place of business is conducted outside the Republic for a '*bona fide*' business purpose, the Commissioner will need to have regard for the general anti-avoidance section (section 103(1)). This is in accordance with the view expressed by National Treasury who states that similar to the tax avoidance rule of section 103(1), a *bona fide* business reason exists only when that reason bears some significance other than the tax advantage of operating abroad.³⁸

³⁴ *The Taxpayer* 'Sections 9C and 9D revisited' (1998) 82. Also see *The Taxpayer* 'Editorial: The 1997 Income Tax Act' (1997) 103 and Meyerowitz *Meyerowitz on Income Tax* (1999-2000 ed) 7.31A.

³⁵ Sections 9D(a), 9D(a)(i) and 9D(a)(ii).

³⁶ *The Taxpayer* 'Sections 9C and 9D revisited' (1998) 82.

³⁷ Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 176.

³⁸ National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 10.

4.2.2 Diversionary business income

Even to the extent that a CFC satisfies the business establishment requirements, the exemption will not apply if the income stems from diversionary sales and services. These diversionary sales and services generally relate to transactions conducted with a connected South African resident. The purpose of this rule is to ensure that CFC activities are not being employed to shift taxable income offshore through artificial transfer pricing. Broadly speaking the rules dealing with diversionary business income distinguish between, on the one hand, transactions subject to the transfer pricing provisions contained in section 31 (s 9D(9)(b)(i)) and on the other hand, those that are not subject to transfer pricing provisions, but where the possibility for price manipulation still exists (s 9D(9)(b)(ii)).³⁹ National Treasury comments that although transfer-pricing rules exist under section 31, transfer pricing requires intensive case-by-case enforcement.⁴⁰ The anti-diversionary rule essentially acts as a backstop.⁴¹

There are two ways in which the anti-diversionary rule prevents tax avoidance through the use of diversionary transactions. These are:

- an increased penalty (s 9D(9)(b)(i)), and
- the imposition of a higher business activity standard (s 9D(9)(b)(ii)).

4.2.2.1 Increased penalty

Under the increased penalty rule, if a CFC engages in sales or services transactions with a connected South African resident, where the consideration for the transaction is not at arm's length in accordance with section 31, such non-arm's length transactions create 'deemed income' under section 9D. This deemed income under section 9D exists for all the net income of the CFC derived from the transactions with connected South African persons, not just the disparity in price.⁴² The Commissioner has the power, in terms of section 31, to adjust the price back to arm's length. In practice, the Commissioner may first adjust the price for both the South African resident and the CFC under section 31, followed by the section 9D inclusion. Where the Commissioner deems fit, and in the case

³⁹ Birncker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 176.

⁴⁰ National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 11.

⁴¹ Ibid.

⁴² Ibid

of aggressive tax avoidance where profits of a CFC are inflated as a result of transactions entered into with a connected South African resident, the Commissioner may apply the provisions of section 31 solely in respect of the South African resident and not in respect of the CFC, and fully include the profits of the CFC from these transactions in the income of the resident in terms of section 9D. This in effect means that the adjusted price will be taken into account in the hands of the South African resident (in terms of s 9D), but will not be taken into account in the hands of the CFC, resulting in an increased amount being attributed to the South African resident.⁴³ The following example illustrates this point:

Example Facts:⁴⁴ South African Company (resident in South Africa) owns all the shares of a CFC, a company located in Country X which imposes income tax at a rate of 20 percent. South African Company assembles televisions for R600 each and sells those televisions to CFC for R700 each. CFC has a business establishment that modifies these televisions for thousands of customers within Country X at a cost of R80 each, and then CFC resells the televisions for R1 000 each. Under market principles, the arm's length price between South African Company and CFC under section 31 amounts to R900 rather than R600.

Result: The Commissioner has the power to re-adjust the sales price between South African Company and CFC to R900. In exercising this power, the Commissioner may first re-adjust the price for both parties so that R300 of gain (R900 deemed sales price – R600 cost) is solely attributed to South African Company, thereby treating the full R300 as South African source gain and not subject to section 6quat rebates. The Commissioner may then reduce the gain for CFC to R20 (R1000 customer price – the R900 deemed purchase price – R80 customising cost), all of which will be taxed as foreign source income under section 9D.

In analysing the above example from National Treasury, it is evident that if the CFC was situated in a tax haven, the R300 gain shifted from South Africa to the tax haven will once again revert to South Africa, where it will be taxed.⁴⁵ It is also noteworthy that it is at the discretion of the Commissioner whether or not to apply the provisions of s 31 to the CFC or to the South African Company only, in which case the CFC will also not be allowed to deduct the extra R300 (the CFC will only be allowed to deduct R600 as opposed to R900).

⁴³ It is imperative to note that once an adjustment to the consideration as contemplated in section 31 has been made, such adjustment does not have any secondary tax on companies (STC) implications, as STC is only payable by residents and a CFC, by definition, is generally a non-resident. Although s 9D(2A) provides that the net amount must be calculated as if the CFC is a taxpayer, this is only for purposes of the calculation of taxable income, which does not include STC. Consequently, STC will not be payable on any adjusted consideration in respect of the net income of a CFC (Brinker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 218).

⁴⁴ Adapted from National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 11.

⁴⁵ The R300 gain will be imputed to the South African resident by adjusting the transfer price from R600 to R900 as discussed in the example above.

This will result in a higher net income of the CFC which will be attributed to the South African Company.

4.2.2.2 The higher business activity standard

The higher business activity standard creates deemed income under section 9D without regard to section 31⁴⁶ if the CFC engages in certain sales or service activities with a connected South African resident. This rule targets structures that most likely contain artificial transfer pricing without undertaking the transfer-pricing exercise.⁴⁷ This target is achieved by subjecting all the sale and service transactions between the CFC and a connected South African resident to section 9D unless the CFC's conduct falls within a higher business activity standard than the standard prescribed by the business establishment rule.⁴⁸

The higher business activity standard rule is also aimed at another concern which involves certain sales and service transactions with connected South African residents which are so closely linked with South Africa that these transactions call into question the reason for the offshore presence. It is interesting to note that National Treasury⁴⁹ comments that the business establishment rule does take the above closely linked transactions into account, but that the business establishment rule is fairly light. The higher business activity threshold ensures that the offshore business is of substantial influence. On that note, Brincker, Honiball and Olivier (2003)⁵⁰ comment that 'it is almost as if the legislator's view is that where transactions take place between a CFC and a connected South African resident, the business establishment test in s 9D(9)(a) is not sufficient.'

The higher business activity standard caters for 3 types of income:⁵¹

- CFC inbound sales;
- CFC outbound sales; and
- CFC South African connected services (s 9D(9)(b)(ii)).

⁴⁶ This rule does not take into account whether the transaction in question was conducted at an arm's length price. Instead an objective standard is applied.

⁴⁷ National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 12.

⁴⁸ Ibid.

⁴⁹ Ibid.

⁵⁰ Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 178.

⁵¹ National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 12.

Net income falling within one of these subcategories will be exempt from attribution if:

- the transaction has a non-tax economic nexus within which the CFC is a resident; or
- the transaction most likely does not contain elements of transfer pricing.

4.2.2.2.1 CFC Inbound Sales

A CFC inbound sale occurs when a CFC sells goods to a connected South African resident (s 9D(9)(b)(ii)(aa)). The income derived from these sale transactions does not qualify for the higher business activity standard exemption unless the sale falls into one of three categories:

- purchases in the country where the CFC is resident from an unconnected person (local purchases) (s 9D(b)(ii)(aa)(A));
- production of goods that involve more than a minor assembly or adjustment, packaging, repackaging and labelling (local production) (s 9D(b)(ii)(aa)(B)); and
- sale of comparable goods to a connected South African resident that are of the same or similar nature to goods sold to unconnected persons at comparable prices after taking into account whether the sales are wholesale or retail, volume discounts, and other geographical differences such as location costs of delivery (comparable sales) (s 9D(9)(b)(ii)(aa)(C)).

The following three examples illustrate the sales categories explained above:

Example (1) facts: ⁵² South African resident company (Company A) owns all the shares of a CFC resident in Country Y. CFC purchases all its computers and telecommunications equipment from an unconnected third party that has its entire physical location in Country Y. CFC resells all the computers to Company A at a profit.

Result: The CFC sales to Company A satisfy the higher business activity standard. All the resales stem from local Country Y purchases.

Example (2) facts: ⁵³ South African resident company (Company A) owns all the shares of CFC, a Country X resident. CFC does not engage in any production activities but maintains a purchasing office and a warehouse within Country X that qualifies as a business establishment. CFC purchases desks from an unrelated Distributor, a company with its full physical location in Country Y. CFC resells 30 000 of these desks to various retailers located within Country Z at R4 500 each and resells 20 000 desks to Company A in South Africa at R5 000 each (the difference in price reflects a difference in geographic proximity).

⁵² Adapted from National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 13.
⁵³ Ibid.

Result: The CFC sales to Company A satisfy the higher business activity standard. Admittedly, CFC does not engage in any local purchases (since none of the goods purchased were ever located within Country X) nor any production activities. However, CFC is selling the desks to a significant number of unconnected persons at comparable prices after taking into account differences in geography.

Example (3) facts: South African resident company (Company A) owns all the shares of CFC, a Country X resident. CFC assembles machinery in a 100-person factory located within Country X which CFC then resells to Company A. CFC purchases the machinery parts from various distributors located outside Country X at a cost of R730 a unit. Each machine has 250 parts to assemble. The physical factory overhead, equipment, and labour costs to produce the machinery amount to R200 per machine. The management, accounting and administrative fees amount to R70 per machine. CFC sells each machine to Company A for R1 600.

Result: The machinery sold satisfies the higher business activity standard. The factory conducts more than minor assembly or adjustment. The 250-part assembly is significant and so are the physical production costs that amount to 20 percent of the total (R200/R1 000).

The rationale behind granting an exemption to local purchases and the production of goods is that if the local country is in a position to produce the goods, it is likely to have a sufficiently good infrastructure. National Treasury comments that countries having such an infrastructure usually do not tax their local sales at artificially low tax haven rates.⁵⁴ It is believed that the conclusion reached by the legislator is that the CFC is situated in the foreign country not for tax reasons, but for non-tax business reasons.⁵⁵

Furthermore, it is evident that where comparable sales are involved, the issue of transfer-pricing is not a matter of concern as outside pricing to third parties is available. Sales to unconnected persons by the CFC demonstrate viable business operations outside South Africa.

4.2.2.2.2 CFC outbound sales

A CFC outbound sale exists when a CFC sells goods to foreign residents or unconnected South African residents and when those goods were initially purchased from connected South African residents (or goods representing resultant products from materials, parts, or

⁵⁴ National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 13.

⁵⁵ Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 179.

ingredients were purchased from connected South African residents (s 9D(9)(b)(ii)(bb)). In the case of these sale transactions, the CFC does not satisfy the higher business activity standard unless the sale falls into one of the following three categories:

- only insignificant amounts of tangible goods are purchased from connected South African residents (insignificant South African purchases) (s 9D(9)(b)(ii)(bb)(A));
- production of goods that involves more than minor assembly or adjustment, packaging, repackaging, and labelling (local production) (s 9D(9)(b)(ii)(bb)(B)); or
- delivery of goods within the country of residence of the CFC (s 9D(9)(b)(ii)(bb)(C)).

The following examples illustrate the above CFC outbound sale transactions⁵⁶:

Example (1) facts: South African Company (resident in South Africa) owns all the shares of CFC 1 and CFC 2. CFC 1 is resident in Country X and CFC 2 is resident in Country Y. CFC 1 assembles radios from its 20-person workshop located in Country X which CFC 1 sells and delivers to CFC 2 in Country Y at a R250 per unit price. CFC 1 purchases the internal mechanics from South African Company for R120 per unit and the coverings from unrelated parties at a cost of R30 per unit. In the hands of CFC 1, each radio requires a 6-part assembly process for completion that requires little skill. The factory overhead, equipment, and labour cost incurred by CFC 1 to produce each radio costs R10 per machine.

Result: CFC 1 sales fail to satisfy the higher business activity standard. CFC 1 is purchasing a significant amount of the parts from a connected South African resident (R120 out of R150), and no delivery occurs within the Country X market. CFC 1 is engaging a minor assembly that requires little skills and amounts to only 6.67 percent of the total materials cost (R10/R150). (Note: CFC 2 falls wholly outside of the section 9D(9)(b) business establishment exclusion because CFC 2 is not engaging in any transaction with a connected South African resident).

Example (2) facts: The facts are the same as example (1), except that CFC 1 sells and delivers radios to unconnected Foreign Company in Country X. Foreign Company solely sells to Country X customers at the retail level.

Result: CFC 1 satisfies the higher business activity standard despite the low level of value-added production. CFC 1 is selling to a person (other than a connected South African resident) for delivery within its country of residence (Country X).

⁵⁶ National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 15. Also see Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 180.

Once again, the rationale behind granting an exemption to local purchases and the production of goods is that if the local country is in a position to produce the goods, it probably has a sufficiently good infrastructure to be a country that does not usually tax its local sales at artificially low tax haven rates. Hence, the presence of the CFC in such countries is viewed by the legislation as being for genuine business reasons rather than tax-avoidance reasons.⁵⁷ Furthermore, the purchase of insignificant amounts of tangible goods from South African residents suggest that independent value is added by the CFC and thus the CFC is in all likelihood structured for non-tax purposes.⁵⁸

4.2.2.2.3 CFC connected services

CFC connected services exist where the CFC performs services for a connected South African resident (s 9D(9)(b)(ii)(cc)). These connected services generally fail to satisfy the higher business activity standard, unless those services fall directly into one of the following two categories:

- the services relate directly to the creation, extraction, production, assembly, repair or improvement of goods and the goods are utilised outside South Africa (production related services) (s 9D(9)(b)(ii)(cc)(A)); or
- the services relate directly to the sale or marketing of goods made by a South African connected person and the goods are sold to persons who are connected for delivery outside the country in which the CFC is resident (selling related services) (s 9D(9)(b)(ii)(cc)(B)).

The following example illustrates the application of the above CFC connected services exemption:

Example facts:⁵⁹ South African Company (a South African resident) owns all the shares of a CFC resident in Country X. South African Company sells refrigerators to various customers located in Country X. CFC provides services for the refrigerator installation as well as a 90-day warranty. CFC also markets and sells the refrigerators within Country X on South African Company's behalf. South African Company pays R1-million to CFC for the installation and repairs, as well as R5-million for sales commissions and marketing fees.

Result: CFC satisfies the higher business activity standard for:

- (i) the R1-million of installation and repair fees because all these fees relate to refrigerators utilised outside South Africa, and

⁵⁷ National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 14-15. Also see Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 180.

⁵⁸ Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 180.

⁵⁹ National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 17.

- (ii) the R5-million of sales commissions and marketing fees because these fees relate to refrigerators sold by South African company to unconnected customers within Country X, CFC's country of residence.

National Treasury further comments that CFC services of a more general nature, such as management fees, internal accounting fees and fees to guarantee loans never satisfy the higher business activity standard. These more general fees typically bear the mark of transfer pricing (due to their mobile nature) and no business reason, other than tax, exists for these services to be rendered by a company outside South Africa.⁶⁰

There are also certain ministerial discretions provided in section 9D in terms of which the Minister of Finance may waive the higher business activity standard (s 9D(10)). The following are the discretions provided for to the Minister of Finance:⁶¹

- a) to treat one or more foreign country or countries as a single economic market, provided that the treatment does not lead to an unacceptable erosion of the tax base; or
- b) in consultation with the Commissioner, to waive the application of the subsection to the extent that its application will unreasonably prejudice national economic policies or South African international trade, provided that the waiver does not lead to unacceptable erosion of the tax base.

The Minister may use the discretionary powers bestowed upon him in this section to, for example, treat the countries within the European Union as one country to the extent that these countries impose a rate of income tax comparable to one another. Such treatment would mean that the CFC residing in the European Union could satisfy the higher business activity standard when acting as a sales distributor on behalf of connected South African goods for customers located within multiple European Union countries.⁶²

4.2.3 Mobile foreign passive income

CFC receipts and accruals attributable to a business establishment will not qualify for exemption if those receipts and accruals are of a passive nature. For the purposes of s 9D(9)(b)(iii) passive income includes:⁶³

⁶⁰ National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 15. Also see Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 181.

⁶¹ National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 17.

⁶² Ibid.

⁶³ National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 17.

- dividends;
- interest;
- royalties;
- rental;
- annuities;
- insurance premiums;
- income of a similar nature;
- capital gains derived from the disposal of an asset from which dividends, interest, royalties, rental, annuities, insurance premiums and income of a similar nature was or could be earned; and
- foreign currency gains determined under s 24I.

According to National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002),⁶⁴ passive income and gains are fully subject to tax because they present no direct competitiveness concerns since no active income is involved. The mobile nature of assets producing such passive income makes it easy to shift such assets abroad without economic consequences. The general rule above will not be applicable where:

- a) the passive income does not exceed five percent of the CFC's total receipts and accruals, including capital gains, foreign currency gains derived in respect of foreign equity instruments, and foreign currency gains determined under s 24I (*de minimis* exception) (s 9D(9)(b)(iii)(aa)); and
- b) the passive income is derived from the principal trading activities of a bank, financial services, insurance or rental business, except if the amount is derived:
 - (i) by a company that is a foreign financial instrument holding company at the time the amounts are so derived;
 - (ii) from a South African resident connected person; or
 - (iii) from the resident to the extent that it is part of a scheme for the avoidance of taxes, duties or levies (s 9D(9)(b)(i)-(iii)).

Brincker, Honiball and Olivier (2003)⁶⁵ comment that the aim of the *de minimis* exception ('a' above) is to alleviate the administrative burden involved in complying with the CFC rules. National Treasury⁶⁶ further comments that the five percent rule is an 'all-or-nothing' rule i.e. where the five percent threshold is exceeded, all passive income falls within the tax net and not only the portion that exceeds the threshold. Passive gains, as discussed above, are also part of the *de minimis* exception. Such gains are measured in terms of gains (not

⁶⁴ National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 17.

⁶⁵ Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 182.

⁶⁶ National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 18.

total proceeds) with capital losses ignored. The following example illustrates the operation of the *de minimis* exception:

Example facts:⁶⁷ A, a South African resident owns all the shares in X, a company resident in C. X derived R4-million from its trading activities during the tax year. In addition it made a capital gain of R400 000 on the sale of rights in respect of which it received royalties and a capital loss of R600 000 on the sale of the shares.

Result: The R400 000 capital gain does not qualify for exemption from attribution as it amounts to 9 percent of its total taxable income (R400 000/ R4 400 000). The loss of R600 000 on the sale of the shares is ignored.

It is noted from the above example that the capital gains are measured for purposes of the numerator and the denominator.

The following example illustrates the above exemption:

Example facts:⁶⁸ A holds all the shares in various foreign companies, including X, a finance company resident in a tax haven. X acts as a banker for the group of companies and derived R8-million from its financing activities.

Result: Although the R8-million arose from X's principal trading activities, it will be exempt as it arose out of dealings with connected persons. The interest portion of the income may be exempt under s 9D(9)(fA).

Brincker, Honiball and Olivier (2003)⁶⁹ comment that the terms 'banking business' and 'insurance business' are not defined in the Act and this omission is a shortcoming which could result in litigation. The purpose of the principal trading activity requirement is to ensure that a CFC is not merely a finance or a treasury operation utilising a title designed to avoid section 9D. The purpose of the three exclusions under sections 9D(9)(b)(i)-(iii) are to ensure that these entities can compete competitively internationally. It is also worth noting that there are additional safeguards built into the legislation to avoid abuse in that a CFC that deals with banking, financial services, insurance or rental business as a subsidiary business will not qualify for the exemption. Furthermore, not all the income of the CFC is exempt but only income arising from the principal trading activities. The following example illustrates this concept:

⁶⁷ Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 182. Also see National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 18.

⁶⁸ Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 182.

⁶⁹ Ibid 183.

Example facts: A owns all the shares in X, a company resident in Country C. The principal business of X is to rent an apartment building. It received R4-million rental income, which it deposited with a financial institution in Country C. X received R400 000 interest on this deposit.

Result: Only the R4-million rental income is exempt from attribution and not the R400 000, as the latter does not arise from X's principal trading activities.⁷⁰

4.3 PREVIOUSLY TAXED EXEMPTION

The net income of a controlled foreign company will not be taxed in the hands of resident shareholders if the actual income of the CFC is subject to South African tax, i.e. the CFC itself as a corporate body is taxed in South Africa.⁷¹ This exemption is aimed at South African actual and deemed source income and is an essential exemption to avoid double taxation in that it is imposed on the South African sourced income of a non-resident as well as being attributed to the South African resident.⁷² This is explained by the fact that should a CFC be subject to South African tax on its net income, after which resident participants are taxed on their share of the net income of the CFC, the result would be an unacceptable double counting. The resident participants would effectively be paying tax twice on the same income - once through the CFC (whose income is in effect partly the taxpayer's), and again in his own personal capacity in terms of section 9D. In the words of the National Treasury:⁷³ 'no reason exists to tax this income under section 9D because this income is already accounted for by the South African tax system.'

The mere fact that the net income is in principle subject to South African tax is not a sufficient qualification for this exemption. In addition, the net income must not be exempt or taxed at a reduced rate as a result of the application of a double tax agreement.⁷⁴ If as a result of a double tax agreement the South African income of a CFC is not taxed in South Africa, the exemption does not apply because it is not included in the taxable income of the resident entity and is therefore not subject to South African tax.⁷⁵

⁷⁰ The R400 000 arises from interest earned and not from income derived from apartment building rental.

⁷¹ See s 9D(9)(e).

⁷² Jooste 'The Imputation of Income of Controlled Foreign Entities' (2001) 118 *South African Law Journal* 498. Also see Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 184.

⁷³ National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 21.

⁷⁴ Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 184.

⁷⁵ Refer to s 9D(9)(e).

It follows that South African residents cannot avoid tax on South African income by operating through CFCs located within the South African tax treaty network. This is fair because the income would have been taxed if earned directly by the South African residents. I submit that this exemption prevents the same income actually being taxed twice, and the underlying objective of CFC legislation is to see to it that the income of a CFC which is not subject to any of the exemptions in terms of section 9D(9) is taxed once and does not in its entirety escape the South African tax net.⁷⁶

The following example is used to explain the application of the previously taxed exemption:⁷⁷

Example facts: A CFC, which is resident in country Y, earns royalty income from a South African source.

Response: The royalty income will not be attributed to the South African resident as the CFC will in any event be liable for tax in South Africa as it is South African sourced income received by or accrued to a non-resident. However, should the DTA between South Africa and Country Y provide that South Africa cannot tax the income or that the income may be taxed but only at a lower rate than the rate that would have applied had the CFC been liable for tax directly, the exemption will not apply.

4.4 THE DESIGNATED COUNTRY EXEMPTION⁷⁸

The designated country exemption excludes controlled foreign companies from taxation in South Africa if those companies have already been subject to foreign income taxes which are comparable to South Africa.⁷⁹ This exemption specifically excludes receipts and accruals of a controlled foreign company if they have been, or will be, subject to income tax in a designated country at a statutory rate of at least thirteen percent in the case of

⁷⁶ Jooste 'The Imputation of Income of Controlled Foreign Entities' (2001) 118 *South African Law Journal* 498.

⁷⁷ Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 184.

⁷⁸ Macheli in *A Critical Legal Analysis of the Regime for the Taxation of Controlled Foreign Entities in Terms of Section 9D of the Income Tax Act No. 58 of 1962* (Unpublished PhD dissertation, University of Natal, Pietermaritzburg) (2000), 288, refers to the designated country exemption as the 'black/white list' approach. Designated countries will either be designated by inclusion in a white list or exclusion from a black list.

⁷⁹ Section 9D(9)(a).

capital gains and twenty-seven percent⁸⁰ for all other amounts (after taking into account the application of any double tax agreement).⁸¹

A designated country is one designated by the Minister of Finance in the Gazette.⁸² These countries may have an income tax system which is similar to that of South Africa and which has the statutory twenty-seven percent rate referred to by the Minister in compliance with any other requirement he may prescribe by regulation.⁸³ It is worth noting that in order to qualify for designation the foreign country does not necessarily have to have a double tax agreement with South Africa.⁸⁴ For the exemption to apply, two requirements must be satisfied:

- a) the foreign country must have a statutory rate of at least twenty-seven percent, and
- b) the foreign country must be a designated country.

It is obvious that for the Minister to designate a country, the minimum statutory rate of that country needs to be twenty-seven percent. However, both of the above need to be satisfied in order to cover a situation in which, the foreign country's tax rate drops to below the required twenty-seven percent after designation. In such a case the country will no longer be considered a designated country.

A proviso⁸⁵ to this exemption was included in relation to jurisdictions that have progressive scales of statutory tax rates. In this regard, the highest rate on the scale will be

⁸⁰ Section 9D(9)(a).

⁸¹ The legislation does not deal with situations where the foreign jurisdiction may have different tax rates for different types of income (e.g. Mozambique) (Casey *Deloitte and Touche Tax News* 'Residence-Based System of Taxation' 5 (2000) 5).

The legislation refers to a 'statutory' rate because an effective tax rate takes into account special losses and deductions or incentives available in the calculation of the actual tax liability of a company (Mitchell and Mitchell, ABSA Presentation (2001)).

No exemption arises, however, if any person has any right of recovery of the foreign tax other than the right of recovery in terms of an entitlement to carry back losses arising during any year of assessment to any year of assessment prior to such year of assessment (s 9D(9)(a)) (Casey *Deloitte and Touche Tax News* 'Residence-Based System of Taxation' 5 (2000) 5).

For example, in year one a CFC is subject to foreign tax on its receipts and accruals in a designated country. In a subsequent year the CFC incurs a loss which, in terms of the designated country's tax system, can be carried back to year one, resulting in a re-opening of year one's assessment and in less tax being paid in year one. This will not affect the application of the exemption in year one. (Jooste 'The Imputation of Income of Controlled Foreign Entities' (2001) 118 *South African Law Journal* 485).

⁸² *The Taxpayer* 'Editorial: The Revenue Laws Amendment Act 59 of 2000' (2000) 186.

⁸³ Ibid.

⁸⁴ This was previously a requirement for designation, but was eliminated by the removal of s 9E(8)(a) of the Act by section 11(1)(a) of the Revenue Laws Amendment Act 59 of 2000 with effect from years of assessment commencing on or after 1 January 2001.

⁸⁵ Proviso to section 9E(h)(ii) introduced by section 11 of the Revenue Laws Amendment Act 59 of 2000 with effect from years of assessment commencing on or after 1 January 2001.

the statutory rate for the purpose of this section, i.e. the highest tax rate should be at least twenty-seven percent.⁸⁶

The operation of the designated country exemption is illustrated by Jooste⁸⁷ using the following example:

Country X imposes tax on income at a statutory rate of thirty percent on country X source income and is a designated country. Country Y imposes tax on income at a statutory rate of ten percent on income carried by its residents. Mr Z owns all the shares in a foreign company FORCO, which is a CFC resident in country Y. FORCO generates one million rand of receipts and accruals from a source located in country X. In these circumstances, because the one million rand is subject to tax in a designated country (country X) and meets the twenty-seven percent statutory tax rate requirement, the one million rand will not be imputed to Mr Z. The designated country exemption applies. If, however, there was a double tax agreement between country X and country Y, in terms of which the one million rand was not taxed in country X, then the designated country exemption does not apply.

The following example is extracted from the *Explanatory Memorandum* on the Revenue Laws Amendment Act 59 of 2000 and is used to illustrate the operation of the twenty-seven percent rule:⁸⁸

A South African resident owns a United States company which earns rental income from letting an office block. The United States is a designated country. The profits of the company are subject to a tax rate of 35% in the US. The profits of the company will not be imputed to the SA resident on a current basis, due to the fact that it complies with a legitimate business establishment test.

Similarly, any foreign dividend declared by the CFC from profits which were not previously imputed to the resident will also be exempt as the underlying profits would have been subject to tax in a designated country (on a similar basis to that of South Africa) at a rate of at least 27 percent.

Jooste⁸⁹ states that the rationale for the designated country exemption relates to the international law requirements regarding foreign tax credits. The residence-based system of taxation permits South Africa to tax its residents on their worldwide income, including foreign source income earned indirectly through CFCs. Whenever South Africa taxes its residents on their foreign source income, international law requires that the South African tax imposed be reduced by the foreign taxes imposed on that same income.⁹⁰ International

⁸⁶ Casey *Deloitte and Touche Tax News* 'Residence-Based System of Taxation' 5 (2000) 5.

⁸⁷ Jooste 'The Imputation of Income of Controlled Foreign Entities' (2001) 118 *South African Law Journal* 485.

⁸⁸ SARS, 2000, *Explanatory Memorandum* on the Revenue Laws Amendment Bill 59 of 2000, 8.

⁸⁹ Jooste 'The Imputation of Income of Controlled Foreign Entities' (2001) 118 *South African Law Journal* 485.

⁹⁰ If this is not the case an unacceptable double counting will arise.

law demands that the country that taxes on a residence-basis must yield its tax to the country imposing tax on a source-basis.⁹¹ In South Africa this is done by way of a foreign tax rebate.⁹² The net effect of the foreign tax rebate system is that South Africa can only tax foreign source income to the extent that the South African tax rate exceeds the rate imposed by the foreign country in which the foreign income is sourced.⁹³

To date the following designated countries have been listed:

*Algeria, Australia, Austria, Belgium, Botswana, Canada, Croatia, Cyprus, Czech Republic, Denmark, Egypt, Finland, France, Germany, Granada, Hungary, India, Indonesia, Iran, Ireland, Israel, Italy, Japan, Korea, Lesotho, Luxembourg, Malawi, Malta, Mauritius, Namibia, Netherlands, Norway, Pakistan, People's Republic of China, Republic of China (Taiwan), Poland, Romania, Russian Federation, Sierra Leone, Singapore, Slovak Republic, Swaziland, Sweden, Switzerland, Thailand, Tunisia, Uganda, United Kingdom, United States of America, Zambia, Zimbabwe.*⁹⁴

Brincker, Honiball and Olivier (2003)⁹⁵ comment that uncertainty exists as to the meaning of 'subject to tax' in another country. They focus particularly on two questions that arise:

- whether amounts that are exempt from tax still subject to tax; and
- whether amounts against which a deduction may be claimed are still subject to tax.

On comparing the meaning of the term 'subject to tax' in the legislation of the United States, the United Kingdom and Australia, Brincker, Honiball and Olivier (2003)⁹⁶ conclude that for the purposes of South African CFC legislation, income 'subject to tax' means income that falls within a particular country's tax base. This means that for the purposes of section 9D(9)(a) the amount must have been included in the tax base of the foreign country. It is further observed that income exempt under a DTA is regarded as being exempt under the Income Tax Act of South Africa.⁹⁷

⁹¹ Jooste 'The Imputation of Income of Controlled Foreign Entities' (2001) 118 *South African Law Journal* 485.

⁹² Section 6quat.

⁹³ Jooste op cit 486. This means that if the foreign tax rate is higher than the South African tax rate, no South African tax will result and if it is very much the same, little South African tax will result. The designated country exemption accordingly excludes such similarly taxed income from the operation of s 9D in order to reduce the administration on Revenue.

⁹⁴ Stack, Cronje and Hammel *The Taxation of Individuals and Companies* (2000) 411. Also see Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 171. It was announced in the 2003/2004 budget that the designated country list will be repealed.

⁹⁵ Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 174.

⁹⁶ Ibid.

⁹⁷ Ibid.

4.4.1 The concept of ‘cross-crediting’

A further aspect of the reasoning behind the designated country exemption relates to the prevention of what is known as ‘cross-crediting’.⁹⁸ The exemption prevents a taxpayer who has both high-taxed foreign source income and low-taxed foreign source income from manipulating the foreign tax credit system by balancing the one against the other. Such ‘cross-crediting’ is not possible if the high-taxed foreign income is excluded from the system as a result of the application of the twenty-seven percent rule.

4.5 THE RELATED AND INTRA-GROUP EXEMPTIONS

In order to promote competence in the international arena, section 9D contains certain provisions which allow CFCs to shift income among one another without triggering tax.⁹⁹ Multinational structures often contain multiple foreign subsidiaries that function as a single economic unit. According to National Treasury’s *Detailed Explanation to Section 9D of Tax Act* (June 2002), it is imperative to recognise that such multinational structures are designed not necessarily for the avoidance of tax, but for the isolation of risk to particular countries. Furthermore, if tax avoidance is one of the objectives of such structures, it is generally aimed at the reduction of foreign taxes as opposed to South African taxes. It is important that South African tax legislation allow such manoeuvrability of income in order for South African multinationals to compete on an equal footing in an environment in which their foreign multinational competitors utilise similar tax structures.¹⁰⁰ In this regard the following types of exemptions are offered in terms of section 9D:

- an exemption for related CFC dividends,
- an exemption for related CFC interest, rent and royalties, and
- an exemption for the disposal of leased CFC intra-group assets.

4.5.1 The related CFC dividend exemption

The income of a CFC shall not be included in the income of resident participants to the extent that such income earned by the CFC actually constitutes dividends received from

⁹⁸ National Treasury’s *Detailed Explanation to Section 9D* submitted to Parliament’s Portfolio committee on Finance in October 2000 (draft).

⁹⁹ National Treasury’s *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 21.

¹⁰⁰ Ibid.

another CFC in relation to the same resident participant.¹⁰¹ National Treasury comments that in order for the payor and payee CFCs to be related for this purpose, both CFCs must qualify as a CFC in relation to the same South African resident.¹⁰²

Jooste¹⁰³ states that this exemption effectively caters for the redeployment of offshore operating income (that is, other than passive income) without imputation in terms of section 9D by allowing a South African multinational group to re-invest such income offshore without it falling into the South African tax net. The exemption allows such groups to preserve the value of offshore tax concessions on operating income, at least as long as the funds are actively invested offshore by allowing a CFC (an intermediate foreign holding company) to receive dividends from another connected CFC without imputation in terms of section 9D. The rationale for the exemption is that the earnings underlying the dividends are generally earnings generated by a business establishment or are already taxed directly.

One of the advantages of the above exemption is that it does not impose tax as a result of higher tier subsidiaries receiving dividends from lower tier subsidiaries. The following example has been extracted from National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002)¹⁰⁴ and illustrates the operation of the related CFC dividend exemption:

Example Facts: South African Company owns all the shares of CFC 1, a Country X company. CFC 1 is a shell holding company that owns all the shares of CFC 2, a Country Y company. CFC 2 generates R2 million of receipts and accruals from a business establishment. CFC 2 distributes a dividend of R2 million to CFC 1 from these receipts and accruals.

National Treasury's response: The R2 million dividend is exempt from tax under section 9D by virtue of the related CFC dividend exemption. Both CFC 1 and CFC 2 qualify as CFCs in relation to South African Company (i.e. both are more than 50 percent directly or indirectly owned by South African Company).

From the above example, it is also clear that apart from promoting international competitiveness of South African multinationals, another objective of this exemption

¹⁰¹ Section 9D(9)(f).

¹⁰² National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 21.

¹⁰³ Jooste 'The Imputation of Income of Controlled Foreign Entities' (2001) 118 *South African Law Journal* 499.

¹⁰⁴ National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 21.

would be the avoidance of double taxation, as discussed by Jooste.¹⁰⁵ The R2-million dividend received by CFC 1 above would have otherwise been taxed in terms of section 9D in the hands of CFC 2 had CFC 2 not qualified for the business establishment exemption.

4.5.2 Related CFC interest, rent and royalties exemption

Similar to the related CFC dividend exemption, this refers to the payment of interest, rent or royalties from one CFC to another CFC which are related to each other.¹⁰⁶ Should any of the above-mentioned income be distributed from one of the CFCs to the other, the income of the receiving CFC will not be imputed to the controlling resident shareholder.¹⁰⁷ In these circumstances the interest, royalties or rentals of the CFC making the payment will not be allowed as a deduction in computing the net income of that CFC.¹⁰⁸ According to National Treasury, 'these deductions are denied as a matter of symmetry in order to prevent artificial mismatches of deductible payments and non-included receipts within the same economic group'.¹⁰⁹ This rule also applies to income of a similar nature and to section 24I currency gains on intra-group exchange items.

It is imperative to understand that the income which is being distributed from the one CFC to the other, as contemplated above, would have already been taxed as part of the net income of the CFC distributing the income, or would be part of business establishment earnings, in which case it would be exempt. According to National Treasury, this rule effectively allows South African multinationals to utilise finance or treasury foreign subsidiaries as a tax-free means of channelling collective group loans, licences and leases. National Treasury also comments that structures of this nature typically allow a group to borrow within a single administrative structure, thereby creating opportunities for reduced group rates.¹¹⁰

¹⁰⁵ Jooste 'The Imputation of Income of Controlled Foreign Entities' (2001) 118 *South African Law Journal* 499.

¹⁰⁶ In order for the CFCs to be related for this purpose, both CFCs must qualify as a CFC in relation to the same South African resident

¹⁰⁷ Section 9D(9)(f A).

¹⁰⁸ Sections 9D(2A)(c) and 9D(9)(fA).

¹⁰⁹ National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 22.

¹¹⁰ The term 'group of companies' is defined in section 1 of the Act as:

'...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 percent 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 percent of more of the equity shares in at least one controlled group company.'

The operation of the related CFC interest, royalties and rental exemption is illustrated by way of the following example:¹¹¹

Mr A, a South African resident, owns one hundred percent of the shares in both CFC (X) and CFC (Y). In the year of assessment in question CFC (X) has receipts and accruals totalling R1 000 000. It paid interest, royalties and rentals to CFC (Y) totalling R250 000 and had other expenses deductible in terms of the Act of R100 000. CFC (Y) had net income of R400 000 excluding the R250 000 of interest, royalties and rentals received from CFC (X). The net income of CFC (X) imputable to Mr A is R900 000 (R1 000 000 - R100 000). The net income of CFC (Y) imputable to Mr A is R400 000.

It appears that due to the fact that the interest, rent or royalties received by one CFC is not taxable and the related payment of the other is not deductible, the operation of this exemption has a nil impact on the resident shareholder. I submit that this is not always true. Consider the following situation:¹¹²

Assuming in the example above, CFC (Y) has income of R100 000 before receiving interest, royalties or rentals of R250 000 from CFC (X) and deductible expenditure of R400 000. Now, transferring income from CFC (X) to CFC (Y) will reduce the net income of CFC (X) to be imputed to Mr A (assuming that the interest, rent and royalties were deductible). CFC (Y) will, as a result, be able to absorb up to R300 000 (R400 000 – R100 000) of such interest, royalties or rentals from CFC (X) whilst still remaining in a loss situation. Due to the fact that losses of a CFC cannot be set-off against SA source income or other foreign income¹¹³ (e.g. from another CFC), the overall effect will be a lower income of CFC (X) being imputed to Mr A and as a result less tax payable in terms of section 9D. The fact that CFC (Y) will still be in a loss situation will mean that no tax will be payable in terms of section 9D for CFC (Y).

The above situation appears to have merit in assisting the resident taxpayer to defer South African tax, and therefore the operation of the exemption as it stands prevents the above deferral of tax.

4.5.3 The disposal of leased CFC intra-group assets exemption

Under the exemption for the disposal of leased CFC intra-group assets, section 9D additionally exempts capital gains on the sale of tangible CFC assets (other than financial

¹¹¹ Adapted from Jooste 'The Imputation of Income of Controlled Foreign Entities' (2001) 118 *South African Law Journal* 481. Also refer to National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002), 22, and Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003), 185, for similar examples.

¹¹² Not reported previously.

¹¹³ Section 9D(2A)(b).

instruments¹¹⁴) if those assets are used in a business establishment conducted by another CFC within the same group. According to National Treasury, this exemption essentially allows attribution of group assets to CFC business establishments as long as both the CFC owning the asset and the CFC utilising the asset are within the same group of companies. It is clear from the wording in the Act that intangible assets are excluded from this exemption. Such intangible assets include:¹¹⁵

- goodwill;
- a patent as defined in the Patents Act 57 of 1978;
- a design (as defined in the Designs Act 195 of 1993) or a trade mark (as defined in the Trade Marks Act 194 of 1993), a copyright (as defined in the Copyright Act 98 of 1978), a right recognised under the Plant Breeders' Rights Act 15 of 1996, a model, pattern, plan, formula or process or any other property or right of a similar nature;
- an intellectual property right or property or right of a similar nature; or
- any other intangible property except a financial instrument (para 16 of the Eighth Schedule).

Brincker, Honiball and Olivier (2003) comment that as the exemption is only available if the capital asset in respect of which the gain arose was attributed to a business establishment, it therefore follows that one of the CFCs in the group must satisfy the business establishment test. Furthermore, as section 9D(9)(fB) makes no reference to the existence of a lease agreement between the two CFCs, it appears that the use of the asset by the acquiring CFC is irrelevant. Brincker, Honiball and Olivier (2003) comment that the exemption will most likely arise when a CFC leases capital assets to another CFC within the same group of companies. This appears to be the intention of the legislation as it was also the view taken by National Treasury, who further commented that such cases frequently involve sale and leaseback transactions.¹¹⁶

The following two examples illustrate the operation of the disposal of leased intra-group assets exemption:

¹¹⁴ Financial Instruments, as per section 1 of the Act, include:

- a) a loan, advance, debt, stock, bond, debenture, bill, share, promissory note, banker's acceptance, negotiable certificate of deposit, deposit with a financial institution, a participatory interest in a portfolio of a collective investment scheme, or a similar instrument;
- b) any repurchase or resale agreement, forward purchase arrangement, forward sale arrangement, futures contract, option contract or swap contract;
- c) any other contractual right or obligation which derives its value from the value of a debt security, equity, commodity, rate index or a specified index;
- d) any interest-bearing arrangement; and
- e) any financial arrangement based on or determined with reference to the time value of money or cash flow of the exchange or transfer of an asset.

¹¹⁵ Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 186.

¹¹⁶ National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 23.

Example (1) Facts:¹¹⁷ South African Company owns all the shares of CFC 1 which in turn owns all the shares of CFC 2. CFC 1 and CFC 2 are incorporated in different countries. CFC 1 conducts a textile manufacturing business, and CFC 2 is a pure holding company. CFC 1 owns a textile factory that CFC 1 uses in its manufacturing activities. CFC 1 then sells the factory to CFC 2 with CFC 2 leasing the factory back to CFC 1 for use by CFC 1 in its textile business. After a number of years, CFC 2 sells the factory on to an unconnected person.

National Treasury's Response: Section 9D does not apply to the leasing income received by CFC 1 pursuant to the exception contained in section 9D(9)(fA). In addition, the initial sale by CFC 1 is not subject to tax by virtue of section 9D(9)(b) because it is attributable to CFC 1's business establishment, and CFC 2's subsequent sale of the factory is not subject to tax by virtue of section 9D(9)(fB) because it is attributable to the business establishment of CFC 1 (both of which are within the same group of companies).

Example (2) facts:¹¹⁸ A, a South African resident, holds all the shares in a foreign company X, which in turn holds all the shares in another foreign company, Y. Both X and Y are residents in a low tax jurisdiction. X rents machinery to Y, which Y uses for its business activities. Y pays X rent of R50 000 per annum. In addition X receives R100 000 income from its trading activities. X then disposes of the machinery for a capital gain of R1-million.

Response: The R50 000 rental income is exempt from tax (s 9D(9)(fA)) and, on the assumption that X has a business establishment, also the R100 000 income (s 9D(9)(b)). The R1-million capital gain made will also be exempt from attribution as long as the asset can be attributed to the business establishment of Y.

4.6 CO-CFC DISPOSALS AND DIVIDENDS EXEMPTION¹¹⁹

Excluded from the ambit of section 9D is any amount received or accrued to a CFC:

- from the disposal of any interest in the equity share capital of another controlled foreign company, or
- by way of a dividend declared to that CFC by any other foreign company,

if that CFC on the date of that disposal or dividend declaration holds more than 25 percent of the equity share capital in that other foreign company.

¹¹⁷ National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 23.

¹¹⁸ Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 186.

¹¹⁹ Section 9D(9)(h).

Example facts:¹²⁰ South African Company owns all the shares of CFC 1. CFC 1 owns all the shares of CFC 2 which consists of 100 ordinary shares. On 15 January 2003, CFC 1 sells 90 shares of CFC 2 (retaining the remaining 10 shares as collateral for bank debt).

National Treasury's response: the participation exemption exempts CFC 1 from the application of section 9D upon the disposal of the CFC 2 shares because CFC 1 has the requisite level of ownership at the time of disposal. This exemption applies even though CFC 1 did not dispose of all the shares in the transaction. This exemption applies regardless of whether a gain or loss results from the disposal.

In the case of the disposal of an interest in the equity share capital of the other foreign company, the CFC must have held more than a 25 percent shareholding in that foreign company for a period of at least 18 months prior to the disposal, unless that interest was acquired by the CFC from any other foreign company which forms part of the same group of companies as that CFC, and both companies in aggregate held that interest of more than 25 percent for more than 18 months.¹²¹

Example Facts:¹²² South African Company owns all the shares of CFC 1, CFC 1 owns all the shares of CFC 2 and CFC 2 owns all the shares of CFC 3. CFC 3 operates a furniture factory within Country X. On 1 January 2002, CFC 2 distributes all the shares of CFC 3 to CFC 1 as a dividend after having owned CFC 3 since 1 September 2000. CFC 1 then sells CFC 3 to an unconnected party on 15 March 2002.

National Treasury's Response: CFC 2 does not receive the benefit of the participation exemption with respect to the gain on the disposal by virtue of the distribution because CFC 2 held the shares for only 16 months prior to that distribution. CFC 1 remains exempt from any tax upon receipt of the dividend because the participation exemption applies to the receipt of a dividend regardless of the time in which the shares were held (CFC 1 is also exempt from tax on the receipt of the dividend by virtue of the related CFC dividend exemption of section 9D(9)(f)). CFC 1 receives the benefit of the participation exemption upon the subsequent sale because CFC 1 and CFC 2 (both of which are part of the same group of companies) held the shares of CFC 3 for a combined period of at least 18 months.

¹²⁰ National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 23.

¹²¹ It is considered that a holding period of 18 months may be too restrictive, given the pace at which international business occurs, but SARS have indicated that they are satisfied with this period, which, after all, provides a concession for taxpayers. SARS have further indicated that they will not be considering reducing the 25 percent shareholding (to, say, 10 percent which would be in line with European jurisdictions), given that they consider 25 percent to be a meaningful stake in the foreign company.

¹²² National Treasury's *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 24.

Brincker, Honiball and Olivier (2003)¹²³ comment that the use of the term ‘participation exemption’ is incorrect as in the international context ‘a participation exemption refers to a tax regime under which dividends received from a foreign corporation by a resident corporation are exempt from residence country tax if the resident corporation owns at least some minimum percentage of the shares of the foreign corporation’. In terms of this theory, it appears that the transaction needs to be between the resident corporation and the foreign corporation and not between two related CFCs. National Treasury, however, in its *Detailed Explanation to Section 9D of the Tax Act* (June 2002) refers to this exemption of section 9D as the ‘participation exemption’.

However, this exclusion from section 9D will not apply where more than 50 percent of either the market value or the actual cost of all the assets of that other foreign company and any controlled company, as defined in section 41, on the date of that disposal or dividend distribution, consists of financial instruments (other than shares in a controlled company).¹²⁴ The rationale for this is to prevent abuse of the exemption in the form of trafficking in shares between foreign companies.¹²⁵

4.7 COMMON INTERNATIONAL EXEMPTIONS NOT UTILISED BY SOUTH AFRICAN LEGISLATION

4.7.1 The distribution exemption

The United Kingdom is the only country to have adopted the distribution exemption.¹²⁶

Under the distribution exemption, all income of a controlled foreign company is exempt

¹²³ Brincker, Honiball and Olivier *International Tax: A South African Comparison* (2003) 187.

¹²⁴ This amendment was effective from 1 October 2001 and applies to the disposal of any interest or dividend received or accrued on or after that date.

¹²⁵ National Treasury’s *Detailed Explanation to Section 9D of the Tax Act* (June 2002) 24. Also see Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 187.

¹²⁶ Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 68. The United States did have a distribution exemption until 1975 when it was repealed due to its complexity and susceptibility to manipulation (see Arnold *The Taxation of Controlled Foreign Corporations: An International Comparison* (1986) 484). Indonesia provides a similar exemption in that it requires no attribution where a CFC has distributed its after-tax profits in the form of dividends to domestic shareholders within four months after the end of its tax year, where the company is obligated to file a tax return, or within seven months after the end of its tax year, where the company is not obligated to file a tax return. (Sandler *Tax Treaties and Controlled Foreign Company Legislation* 2nd ed (1998) 241). It may be argued that the above does not in essence constitute a distribution exemption, but is actually a relief for double taxation that would otherwise result.

from attribution provided that the company pursues an acceptable distribution policy.¹²⁷ The theory underlying the distribution exemption is that it encourages repatriation of foreign-earned profits to domestic shareholders, as domestic-earned profits would be. A company is able to shelter a certain percentage of its profits, rather than having all foreign earned profits attributable. In the case of the United Kingdom, 10 percent deferral is allowed, merely by the fact that 90 percent of profits must be distributed within 18 months.¹²⁸

The exemption also ensures that CFC rules do not apply where domestic tax is not being avoided through the use of tax haven companies.¹²⁹ The Katz Commission¹³⁰ recommended against the adoption of the distribution exemption in South Africa on the grounds that dividends were (at the time the commission considered the matter) exempt from tax in South Africa anyway. Since 23 February 2000 foreign dividends are taxable in terms of section 9E of the Income Tax Act.¹³¹

There were two major reasons why the distribution exemption was not adopted in South Africa:

- a) firstly, the exemption is more compatible with entity-based countries where the requisite distribution percentage is determined by taking into account the dividends of a CFC, whether declared out of active income or passive income. On the contrary, South Africa's CFC legislation (at the time considered by the Katz Commission) was essentially transaction-based and only targeted passive income of a CFE for attribution.¹³² Therefore, the exemption of all income on the basis of distribution of a certain minimum percentage of that income would permit the entity to shelter a portion of its attributable investment income,¹³³ and

¹²⁷ A certain percentage of the company's income must be distributed to domestic shareholders by way of dividends within a prescribed period of time. Under the United Kingdom's legislation, the CFE rules do not apply if a controlled foreign company distributes at least 90 percent of its taxable profits (determined according to UK tax rules) as dividends within 18 months after the end of its tax year. (Section 748(1)(a) read with Part I, Schedule 25, of the Income and Corporations Taxes Act 1988 (UK)).

¹²⁸ Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 68. Also see Macheli *A Critical Legal Analysis of the Regime for the Taxation of Controlled Foreign Entities in Terms of Section 9D of the Income Tax Act No. 58 of 1962* (Unpublished PhD dissertation, University of Natal, Pietermaritzburg) (2000) 302.

¹²⁹ Hustler *Tax Haven Use and Control: A Study of Tax Haven Use by Australian Public Companies And The Development of Controlled Foreign Company Legislation in Australia* (1994) 286.

¹³⁰ *Fifth Interim Report* para 8.3.1.8.

¹³¹ Section 9E as amended by section 20 of the Taxation Laws Amendment Act 30 of 2000 with effect from 23 February 2000.

¹³² Even though both active and passive income is currently targeted in South Africa, the second reason (b) provided above, of the exemption being open to manipulation, outweighs the first reason (a), and hence this exemption will still not be considered for adoption in South Africa.

¹³³ Arnold *The Taxation of Controlled Foreign Corporations: An International Comparison* (1986) 484-488.

- b) secondly, the exemption is open to manipulation. It requires complex legislation and anti-avoidance rules to make it effective.¹³⁴ This provides for additional administrative burden on the South African Revenue Services (SARS), and accordingly was rejected by the Katz Commission.

4.7.2 *de minimis* exemption

A *de minimis* exemption is an exemption which exempts income earned from a CFC being taxed in the resident country, provided that such income does not exceed certain limitations.¹³⁵ There are two approaches to the *de minimis* exemption, and a country can adopt either one.¹³⁶ The two approaches are:

- a 'cap'¹³⁷ by way of a stipulated minimum amount designated in the local currency; and
- a 'percentage *de minimis*' approach being percentage foreign sourced income earned from a CFC in relation to total income of the resident shareholder.¹³⁸

In South Africa, a percentage *de minimis* exemption was introduced with effect from 23 February 2000 in terms of section 9E(7)(a) which exempted foreign dividends from tax:

- which was declared or deemed to have been declared by a resident South African company
- that derived 75 percent or more of its total receipts or accruals
- during the shorter of the entire period of its existence or each of the three years of assessment preceding the year of assessment during which the dividend is declared or deemed to have been declared from a source within or deemed to be within the Republic, and
- where these receipts and accruals were taxed in the Republic.

The above exemption was deleted by Act 59 of 2000.¹³⁹ The rationale for the deletion of this exemption was, at the time this legislation was enacted, that the definition of 'foreign

¹³⁴ Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 68 and Macheli *A Critical Legal Analysis of the Regime for the Taxation of Controlled Foreign Entities in Terms of Section 9D of the Income Tax Act No. 58 of 1962* (Unpublished PhD dissertation, University of Natal, Pietermaritzburg) (2000) 304. This exemption was abolished in the United States of America in 1975 (Martin and Wilson 'Comparative Analysis of Systems of Domestic Taxation of Controlled Foreign Corporations' (1981) 14 *Vanderbilt Journal of Transnational Law* 131), largely on account of its complexity and susceptibility to manipulation. Accordingly, none of the countries considered in this dissertation has followed the UK example and adopted the exemption.

¹³⁵ Sandler *Tax Treaties and Controlled Foreign Company Legislation* 2nd ed (1998) 75.

¹³⁶ Ibid.

¹³⁷ A 'cap' or 'ceiling' in this case which income earned from a CFC is not allowed to exceed in order for this exemption to apply.

¹³⁸ Australia, Germany and the United States use a percentage '*de minimis*' exemption. (Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 75).

¹³⁹ Deleted by s 11(1)(g) of Act No. 59 of 2000 with effect from years of assessment commencing on or after 1 January 2001.

dividend' included any dividend which was distributed by a company from a source outside the Republic which was not deemed to be from a source within the Republic, or which was deemed to be from a source within the Republic, which had not been subject to tax in the Republic. This effectively meant that it was possible for a South African company to declare a foreign dividend.¹⁴⁰ Subsequently¹⁴¹ the definition of foreign dividend was amended to only include dividends declared by non-resident companies, as dividends declared from profits which were already taxed in the Republic will be exempt.¹⁴² The amended definition of foreign dividend, however, includes a dividend distributed by a resident company from profits derived by such company before it became a resident.¹⁴³

The exemptions that were contained in section 9E(7)(a) were therefore no longer necessary, as it was now not possible for resident companies to declare foreign dividends. According to Sandler,¹⁴⁴ the only justification for a *de minimis* exemption is one of administrative convenience and simplicity, although it does sanction the avoidance of domestic tax to the extent of the exempt amount.

¹⁴⁰ Refer to the *Explanatory Memorandum* on the Revenue Laws Amendment Bill of 2000 17.

¹⁴¹ Section 11(1) of the Revenue Laws Amendment Act 59 of 2000 with effect from years of assessment commencing on or after 1 January 2001.

¹⁴² Section 9E(1)(a).

¹⁴³ Section 9E(1)(a).

¹⁴⁴ Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 76.

CHAPTER 5

RELIEF PROVISIONS OF INCOME TO BE ATTRIBUTED TO A RESIDENT TAXPAYER IN TERMS OF SECTION 9D

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5.1 INTRODUCTION

Controlled foreign company legislation potentially gives rise to a number of circumstances in which double taxation may result due to the fact that the income of the controlled foreign company may itself be subject to foreign tax. This is referred to as ‘economic

double taxation'.¹ Many countries provide relief against such double taxation through the granting of foreign tax credits, as failure to do so would make a country uncompetitive in the global economy.² Failure to provide relief in South Africa will push local taxpayers to operate through branches offshore rather than separate subsidiaries, as this will have income tax and STC benefits,³ which will, in turn, hamper South African businesses trying to internationalise themselves. It will also make the Republic an unattractive jurisdiction to house international holding companies. Technical questions which arise with regard to the calculation and availability of the foreign tax credit are:⁴

- Which taxes are creditable?
- Are taxes paid to other countries creditable?
- Should there be a limit on the amount of the credit?
- Does such limit apply on a source, country, basket of income or overall basis?
- Should excess credits be entitled to carry-over?

Relief against double tax is mainly provided for in the following areas:⁵

- i) foreign taxes already paid by a controlled foreign company in the year the income is attributed;
- ii) losses incurred by the company;
- iii) dividends distributed subsequent to attribution; and
- iv) capital gains arising on a disposition of shares of a controlled foreign company.

Some countries even provide relief in respect of blocked currency or currency restrictions in a country of a controlled foreign company limiting the distribution of income outside that country.⁶

¹ Sandler *The Interaction between Tax Treaties and Controlled Foreign Company Legislation* (1994) 12. The concept of 'economic double taxation' is used to describe the situation in which the same economic transaction, item or income is taxed in two or more countries during the same period but in the hands of different taxpayers.

This differs from the concept of 'juridical double taxation' which is generally defined as the imposition of comparable taxes in two (or more) countries on the same taxpayer in respect of the same subject matter and for identical periods.

² Counihan and Du Toit 'Expert Throws Light on Taxing Issues' *Enterprise* June (2000) 79.

³ 'Deloitte & Touche budget review 2000' *Deloitte & Touche Tax News* 1 (2000) 8.

⁴ Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 76.

⁵ Macheli *A Critical Legal Analysis of the Regime for the Taxation of Controlled Foreign Entities in terms of Section 9D of the Income Tax Act No. 58 of 1962* (Unpublished PhD dissertation, University of Natal, Pietermaritzburg) (2000) 313.

⁶ Ibid.

5.2 FOREIGN TAXES PAID

The establishment of controlled foreign companies could very likely give rise to situations in which taxes are paid by the CFC in the foreign country as well as in the hands of the resident shareholders in their domestic country in terms of CFC legislation. Relief against such double taxation is provided for by means of the granting of a credit.⁷

In South Africa relief for such foreign taxes is provided in terms of section 6quat of the Income Tax Act. A rebate is available to a resident of the Republic whose taxable income includes any proportional amount of income contemplated in section 9D.⁸ Brincker, Honiball and Olivier (2003)⁹ comment that ‘although section 6quat clearly allows for the fact that residents are entitled to claim a rebate in respect of foreign taxes paid, it still to a large extent begs the question as to the extent of proof which should be submitted in order to convince the revenue authorities that the credit should in fact be available.’

A basic structure of section 6quat is as follows:¹⁰

- Section 6quat(1) identifies the receipts and accruals which give rise to the rebate.
- Section 6quat(1A) determines the amount of the rebate.
- Section 6quat(1B) places a limit on the amount that may be set-off in the current year of assessment and allows an excess to be carried forward to the next year of assessment.
- Section 6quat(2) ensures that double relief does not result through relief under a double tax agreement and section 6quat.
- Section 6quat(3) provides the definitions of ‘controlled company’, ‘controlling company’, ‘group of companies’, and ‘qualifying interest’.
- Section 6quat(4) provides the method to be used in the conversion of the foreign taxes paid into the currency of the Republic.
- Section 6quat(5) allows for the reassessment of the rebate in certain circumstances.

A rebate is granted on any taxes on income paid to the foreign country¹¹ without any right of recovery by any person.¹² ‘Taxes on income’ include taxes on profits, income or gains as

⁷ Most major countries provide for such credit against double taxation. Some countries including Australia, Germany, Japan and the United States combine a tax credit with a deduction, each applying in certain specific circumstances (Sandler *Controlled Foreign Company Legislation* (1996) (OECD)).

⁸ Section 6quat (1)(b).

⁹ Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 37.

¹⁰ Mitchell and Mitchell ‘Residence-Basis of Taxation’ *Integritax – Special Issue* March (2001) 31.

¹¹ This fact needs to be proved by the taxpayer in question.

¹² This excludes a right of recovery in terms of any entitlement to carry back losses arising during any year of assessment prior to such year of assessment.

well as capital gains tax.¹³ In determining which taxes are creditable in terms of the relief provisions, a 'look-through' approach has been adopted by the *Explanatory Memorandum*¹⁴ in South Africa. This approach conceivably extends the section 6quat rebate to taxes paid in foreign countries other than the country of the controlled foreign company, provided a resident shareholder subject to section 9D holds a qualifying interest¹⁵ through a chain of companies. Section 6quat(1) specifically provides that the rebate is deductible from the normal tax payable by a 'resident' in whose taxable income any proportional amount of income of a controlled foreign company that is deemed to be income of the resident is included in terms of section 9D.¹⁶ It is also important to note that this right to claim a rebate is limited to the actual taxes payable by the controlled foreign company and not by any other entity as such.

Example 1:¹⁷ If A owns all the shares in a company doing business in the Isle of Man (a tax haven country), A has to account for the income of the company in terms of s 9D. Assuming this amount is R100, any taxes paid by the company will be taken into account. In South Africa (assuming a tax rate of 30%), the net liability would be R30.¹⁸ If the company paid R5 in taxes in the Isle of Man, the South African liability would be R25 (R30 – R5).

Example 2:¹⁹ If B holds 100% of X, a company incorporated in the Isle of Man, B would have to account for taxes in South Africa in respect of the underlying profits made by such company. Should one assume that profits of R100 have been made in the Isle of Man, the R100 will be included in the income of B for South African tax purposes. Assuming a tax rate of 30%, the tax payable would be R30 (30% of R100). If the company suffered taxes of R10 in the Isle of Man, the ultimate liability in South Africa would be reduced to R20 (R30 – R10).

Macheli²⁰ offers an explanation as to where each company in the chain of companies needs to hold a direct interest of at least 10 percent in the company in the next tier. Failure to satisfy this qualifying interest requirement at any tier in the chain of companies renders the exemption inapplicable and as a result no rebates will be granted.²¹

¹³ SARS *Explanatory Memorandum* on the Taxation Laws Amendment Bill 2000, 6.

¹⁴ Ibid.

¹⁵ As defined in section 9E(1).

¹⁶ Section 6quat(1)(b).

¹⁷ Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 38.

¹⁸ It appears that Brincker, Honiball and Olivier incorrectly have this net liability as R70 in their book.

¹⁹ Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 42.

²⁰ Macheli *A Critical Legal Analysis of the Regime for the Taxation of Controlled Foreign Entities in terms of Section 9D of the Income Tax Act No. 58 of 1962* (Unpublished PhD dissertation, University of Natal, Pietermaritzburg) (2000) 315.

²¹ Section 9E(1B)(d).

5.3 CALCULATIONS OF AND LIMITATIONS ON THE REBATE GRANTED

Since 23 February 2000, South Africa has adopted the per-country limitation method which requires that foreign taxes be limited to an amount bearing to the total normal South African tax payable in the same ratio as the taxable income attributable to the income included bears to the total taxable income of a resident.²² In terms of Practice Note 9,²³ the amount of normal tax attributable to the inclusion of a particular amount in income may be calculated either according to the 'top slice' method, in which the amount to be determined represents the difference between the normal tax calculated on the total taxable income and the normal tax calculated on the taxable income before the inclusion of the relevant amount, or according to the *pro-rata* method, in which the amount of attributable tax is determined by apportioning the total normal tax payable in the ratio which the relevant amount of income bears to the total taxable income. Inland Revenue has, in certain cases in the past, used the 'top slice' method.²⁴ However, SARS, 2003, *Income Tax Interpretation Note 18*: 'Section 6quat', issued on 31 March 2003, confines the above calculation to the *pro-rata* method. This appears due to the fact that *Income Tax Interpretation Note 18*: 'Section 6quat' actually replaces Practice Note 9 (rendering Practice Note 9 no longer applicable), and means that the 'top slice' method is no longer an option and that only the *pro-rata* method must be used.

In the case of *CIR v Estate Late Bulman*,²⁵ the Appellate Division, in considering a calculation required to be made for purposes of the proviso to the First Schedule to the Estate Duty Act, held that the *pro-rata* method was to be used. It was considered that the reasoning adopted by the Court in that case was also applicable to the income tax calculations in terms of section 6quat, which will accordingly be done on a *pro-rata* basis.

The rebate must be proved to be payable²⁶ to the government of the country in which the income connected to the rebate was earned. In other words, if a rebate is claimed on income earned from country A then it must be proved that the foreign tax is owed to the

²² Section 6quat(1B).

²³ Practice Note 9 issued by the Commissioner on 26 June 1989 and replaced by SARS, 2003, *Income Tax Interpretation Note 18* 'Section 6quat' issued on 31 March 2003.

²⁴ Macheli A *Critical Legal Analysis of the Regime for the Taxation of Controlled Foreign Entities in terms of Section 9D of the Income Tax Act No. 58 of 1962* (Unpublished PhD dissertation, University of Natal, Pietermaritzburg) (2000) 315.

²⁵ *CIR v Estate Late Bulman* 1987 (1) SA 659 (A) 49 SATC 1.

²⁶ The rebate is not only granted for foreign taxes actually paid, but also for taxes in respect of which a legal obligation to pay exists (SARS, 2003, *Income Tax Interpretation Note 18* 'Section 6quat' 2).

government of country A and not any other country.²⁷ All foreign taxes paid on qualifying amounts are taken into account. If more than one foreign tax has been paid, the total taxes are taken into account.²⁸ It is interesting to note that the legislation now clarifies the fact that rebates are available for income taxes paid at any level of government, including those that are imposed on a provincial or local level. This was previously not the case. The legislation, however, still excludes so-called city and other taxes.²⁹

Overall, foreign taxes paid or payable must not exceed the amount of normal South African tax payable on the respective foreign profits underlying the foreign dividend attributed under section 9D(2).

5.4 CARRY-FORWARD OF EXCESS FOREIGN TAXES PAID

Where the foreign tax actually paid exceeds the rebate granted in terms of section 6quat(1B)(a),³⁰ then the excess can be treated as follows:

- it may be carried forward to the immediately succeeding year of assessment and shall be deemed to be a tax on income paid to the government of the other country in that year of assessment,³¹ and
- it may be set-off against the amount of any normal tax payable by such resident during such year of assessment in respect of any amount derived from the other country which is included in the taxable income of such resident during such year after the tax payable on which the rebates of section 6quat(1) and (1A) have been deducted.³²

It should also be noted that this excess amount shall not be allowed to be carried forward for more than seven years from the year of assessment when such excess amount was for the first time carried forward.³³

²⁷ Section 6quat(1B)(a).

²⁸ Mitchell and Mitchell 'Residence-Basis of Taxation' *Integritax- Special Issue* March (2001) 32. This concept is known as the 'onshore mixing of foreign tax credits'.

²⁹ See Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 41.

³⁰ Section 6quat (1B)(b).

³¹ Section 6quat (1B)(a)(i)(aa).

³² Section 6quat (1B)(a)(i)(bb).

In the next year of assessment the amount is deducted from the normal tax payable by the resident only after the deduction of the current rebate attributable to the foreign tax in that next year of assessment. This essentially refers to a possible shortfall, i.e. where the rebate granted is less than the normal South African tax payable in the year immediately subsequent to the year in which the excess was created (a deficit). This deficit can be covered by the brought forward excess of the previous year.

³³ Section 6quat (1B)(a)(iii).

5.5 NET LOSS OF A CONTROLLED FOREIGN COMPANY

With regard to the second ‘carry-forward of excess’ rule discussed earlier, special rules apply if a controlled foreign company has a net loss. Foreign losses of a controlled foreign company are apportioned amongst resident participants by applying the same ratio as determined in terms of section 9D(2). There are two additional conditions and limitations which have to be satisfied in respect of foreign losses of controlled foreign companies:

- a) the deductions and losses are limited to the amount of income apportioned to the resident in terms of section 9D(2) for any particular year of assessment,³⁴ and
- b) where the deductions and allowances exceed the income, the excess may be carried forward to the immediately succeeding foreign tax year and be deemed to be a balance of assessed loss which may be set-off against the income of such company in such succeeding year for the purposes of section 20.³⁵

Although the net income of a CFC is imputed to a South African resident, South African residents cannot deduct net losses of a CFC.³⁶ Deductions and allowances are ring-fenced, being limited to the amount of the CFC’s income. The apparent justification for this anti-loss rule is that it ensures that the ‘move’ to a world-wide system of taxation does not result in an erosion of the current South African tax base, as there is no information available relating to the extent of foreign losses.³⁷ The rule is consistent with the *loss rule* applicable to foreign branches, which similarly provides that foreign branch losses cannot be set-off against South African source income.³⁸ The net loss can, however, be carried forward and set-off against net income of that CFC in the future.³⁹

The net loss of a CFC also cannot be set-off against the net income of another CFC.⁴⁰ According to Jooste,⁴¹ this is described as a harsh rule and could in fact result in South African tax being payable on offshore ‘profits’ by a group, even though the group’s foreign

³⁴ Section 9D(2A)(a).

³⁵ Section 9D(2A)(b).

³⁶ Section 9D(2A).

³⁷ Jooste ‘The Imputation of Income of Controlled Foreign Entities’ (2001) 118 *South African Law Journal* 480.

³⁸ Subsection 6 of the proviso to section 20(1) which provides that a person cannot set-off against income from carrying on a trade in South Africa any loss incurred by such person in carrying on a trade outside South Africa.

³⁹ Sections 9D(2A)(a) and (b).

⁴⁰ Section 9D(2A)(b).

⁴¹ Jooste ‘The Imputation of Income of Controlled Foreign Entities’ (2001) 118 *South African Law Journal* 481. It may be possible to move the loss-making enterprise to another CFC with sufficient income to absorb the loss.

operations are in an aggregate loss position. Such a result is consistent with the South African tax system which does not recognise group taxation.

The *Explanatory Memorandum*⁴² states that this limitation has been enforced in order to protect the existing tax base as there is no information available relating to the magnitude of foreign losses and to what extent this may erode the current South African tax base. Such a measure will also limit the possibility of a person starting a foreign operation in a branch in order to utilise the losses against the South African income and then converting the branch to a separate subsidiary when it becomes profitable. The effect of this could be that the income would be exempt once the branch showed a profit, while the losses previously allowed would not be recouped.⁴³

An example illustrating the operation of the above loss rule is as follows:⁴⁴

A South African company (SA Co) owns all the shares in CFC (1) and CFC (2). In a particular year of assessment SA Co earns R500 000 of South African source income. CFC (1) has receipts and accruals of R100 000⁴⁵ and R140 000 of expenses deductible in the determination of CFC (1)'s income. CFC (2) has receipts and accruals of R200 000 and R90 000 of expenses deductible in the determination of CFC (2)'s net income. The result is that CFC (1) has a net loss of R40 000 and CFC (2) a net income of R110 000. CFC (1)'s net loss cannot be offset against SA Co's R500 000 of South African source income. Nor can SA Co set-off the net loss of R40 000 from CFC (1) against the R110 000 net income of CFC (2). The net loss of R40 000 of CFC (1) can only be carried forward for set-off against future net income of CFC (1).

The carry-forward of the assessed loss is permitted indefinitely provided that the balance of the loss is offset in each of the immediately succeeding years of assessment after it was incurred until it has been completely offset.⁴⁶ This compares to legislation in Australia, New Zealand, Portugal, Sweden, the United Kingdom and the United States, which also allow an indefinite period for the carry-forward of the loss.⁴⁷ Other countries permit a five-year carry-forward.⁴⁸

⁴² SARS *Explanatory Memorandum* on the Revenue Laws Amendment Bill 2000, 7.

⁴³ *The Taxpayer* 'The Revenue Laws Amendment Act 2000' (2000) 190.

⁴⁴ Jooste 'The Imputation of Income of Controlled Foreign Entities' (2001) 118 *South African Law Journal* 481.

⁴⁵ After conversion at the appropriate ruling rates in terms of section 9D(6).

⁴⁶ Macheli *A Critical Legal Analysis of the Regime for the Taxation of Controlled Foreign Entities in terms of Section 9D of the Income Tax Act No. 58 of 1962* (Unpublished PhD dissertation, University of Natal, Pietermaritzburg) (2000) 320.

⁴⁷ Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 78.

⁴⁸ These include, amongst others, Canada, Denmark, Finland, France, Germany, Japan and Spain. (Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 78).

5.6 DIVIDENDS DECLARED BY A CONTROLLED FOREIGN COMPANY

With regard to dividends declared by a controlled foreign company, section 9E(7)(e) excludes foreign dividends from tax to the extent that the profits from which the dividends are distributed have already been attributed and taxed in the hands of South African residents in terms of section 9D. This prevents double taxation in the hands of the resident participants.⁴⁹

It is suggested by the OECD⁵⁰ that where domestic shareholders have been subject to tax on undistributed profits of a controlled foreign company, they should not be subject to tax again when the profits are actually distributed. A number of techniques are employed by the various countries to prevent such double taxation:⁵¹

- deduction of dividends (Canada, France and Japan, if paid within five years in the case of corporate shareholders, or three years in the case of individuals);
- exemption of dividends [Australia, Denmark, Finland (if paid in the following five years), Norway, Spain, Sweden and the United States];
- dividends included in income, but the tax levied on undistributed profits previously attributed is refunded (Germany, if paid in the following four years);
- dividends included in income, but a credit is given for the tax previously paid on the attributed income (New Zealand and the United Kingdom); or
- dividends reduce income of a controlled foreign company subject to attribution in the year the dividend is paid, up to the amount of previously attributed income (Portugal).

Despite the differences in technique, all countries have a common purpose: to prevent double taxation on undistributed income of a controlled foreign company. The mechanics of determining the relief may prove complicated, especially in countries where the relief is only available for a certain period of time. Ordering rules are necessary to determine whether the dividends are paid out of previously taxed income or other amounts. Generally, previously taxed income is considered distributed first.⁵²

In South Africa, a separate rebate is claimable in respect of taxes payable by any company in respect of the proportional amount of any profits from which any dividend is declared or

⁴⁹ Double taxation arising from the situation where the undistributed income of a controlled foreign company has been attributed and taxed in the hands of resident participants, and taxed again when the income is subsequently distributed as dividends to the same resident participants.

⁵⁰ Sandler *The Interaction between Tax Treaties and Controlled Foreign Company Legislation* (1994) 79.

⁵¹ Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 79.

⁵² Ibid.

deemed to have been declared to a controlled foreign company, and which dividend relates to any proportional amount equal to the amount which was included in the income of the resident for purposes of the controlled foreign company legislation (section 6quat(1A)(d)). Brincker, Honiball and Olivier (2003)⁵³ comment that it is unfortunate that this wording is limited to dividends that are declared or deemed to have been declared to a controlled foreign company. This allows the resident, which has to account for the net income of the controlled foreign company, also to claim a rebate in respect of the underlying profits that have been subjected to tax to the extent that a third party company declared the dividend to the controlled foreign company. However, a strict interpretation of the wording does not allow the claiming of a rebate in respect of the grossing-up of dividends for the purposes of s 9E.

Example 1:⁵⁴ Should company 1 make a profit of R100 (pay taxes of R30) and declare R70 to company 2, which in turn declares a dividend of R50 to the resident (after paying taxes of R20), the resident has to gross up the dividend with reference to the taxes suffered by both company 1 and company 2. However, no rebate is claimable in terms of the strict wording of s 6quat as the rebate would be claimable only to the extent that a dividend is declared to a controlled foreign company. However, the grossing-up rules refer to a qualifying interest (implying a 10% interest) and not only where dividends are received from a controlled foreign company.

5.7 COMPREHENSIVE CALCULATION EXAMPLES

The following examples illustrate the calculation of the section 6quat rebates and were extracted from the *Explanatory Memorandum*.⁵⁵ These examples were also used for illustrative purposes by Stack, Cronje and Hamel (2000)⁵⁶ and Brincker, Honiball and Olivier (2003).⁵⁷

Example 1

A South African resident company owns all the shares in its foreign holding company in Switzerland. The Swiss company has interests in five other companies as follows:

- Company A, a wholly owned subsidiary in Namibia;

⁵³ Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 44.

⁵⁴ Ibid.

⁵⁵ *Explanatory Memorandum* on the Taxation Laws Amendment Bill, 2000 [W.P.I – '00] (Act 30 2000).

⁵⁶ Stack, Cronje and Hamel *The Taxation of Individuals and Companies* (2000) 420.

⁵⁷ Brincker, Honiball and Olivier op cit 54.

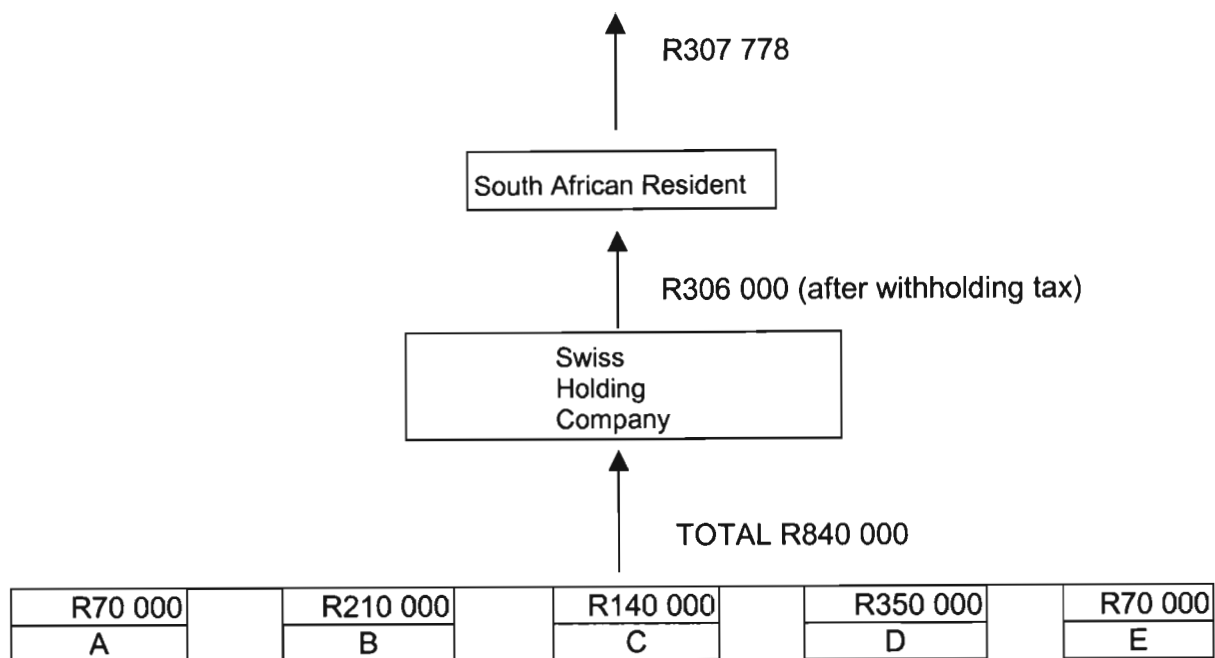
- Company B, a wholly owned subsidiary in Switzerland;
- A 50% shareholding in company C, located in Australia;
- A 50% shareholding in company D, located in the Bahamas; and
- A 5% interest in company E, located in Israel.

The profit of the Swiss company in respect of its financial year ending 31 December 2001 consists of dividends received in prior years. The relevant information from the perspective of the Swiss holding company is as follows: (C, D and E's figures reflect amounts attributable to the Swiss holding company's *pro-rata* interest in these companies.)

COMPANY	A	B	C	D	E	SWISS HOLD CO
	R' 000	R' 000	R' 000	R' 000	R' 000	R' 000
Income	105	250	200	350	150	840
Tax on Income	35	40	40	0	50	60
Profit after Tax	70	210	160	350	100	780
Dividend (50% of Profit)	70	210	160	350	100	390
Withholding Tax	0	0	20	0	30	30
Net dividend	70	210	140	350	70	360

None of the companies received income which was imputed to the South African resident company in terms of the provision of section 9D. The Swiss company declares a dividend of R390 000 (50% of its profits available for distribution) on 15 March 2002, and the South African resident company distributes all its profits by way of a dividend declaration.

This is illustrated diagrammatically as follows:



The taxable portion of the foreign dividend is determined as follows:

- the dividend declared by the Swiss company is deemed to be distributed *pro-rata* from all sources of profit;
- the profit distributed by the Swiss company and taxable in the hands of the South African company is as follows (only 50% as only 50% of the profits were distributed):

COMPANY A

50% x R70 000 = R35 000 - exempt because:

- Namibia is a designated country;
- the Swiss company owns more than 10% of the shares of the Namibian company; and
- the tax rate applying to the income of the Namibian company is at least 27%.

(The Namibian tax rate in 2002 was 35%)

R
Nil

COMPANY B

50% x R250 000 (grossed up by the tax paid)
Switzerland was not a designated country in 2002.

125 000

COMPANY C

50% x R140 000 = R70 000 - exempt because:

- Australia is a designated country;
- the Swiss company owns more than 10% of the shares; and
- the tax rate applying to the income of the Australian company is at least 27%.

(The Australian tax rate in 2002 was 36%)

Nil

COMPANY D

50% x R350 000 = R175 000

The Bahamas is not a designated country.

175 000

COMPANY E

50% x R100 000

50 000

Israel is not a designated country.

Because the shareholding is less than 10%, the net dividend is grossed up by the withholding tax only.

Total

350 000

The following credits are available to the South African company for set-off in terms of section 6quat:

Company B: 50% x R40 000

20 000

Company E: 50% x R30 000

15 000

Swiss Company = tax on income

50% of $[(R840\ 000 - R70\ 000 - R140\ 000) / R840\ 000]$

$\times R60\ 000] = 50\% \times 75\% \times R60\ 000$

Withholding tax: $75\% \times R30\ 000$

Taxable dividend income

Normal tax payable: $30\% \times R350\ 000$

Less: *6quat* rebate

Foreign tax credits available for set-off

Excess amount

STC LIABILITY

Dividend

R360 000

Less: Exempt dividend in terms of sections 9E
and 64(B)(3)

R 90 000

Less: Excess amount calculated earlier

Amount subject to STC

As only the net amount of the dividend income received by the South African company can be declared by way of a dividend (after the payment of all taxes), STC will be payable as follows:

$12,5\%/112,5\% \times R245\ 000 = R27\ 222$

Net dividend to be distributed

$R360\ 000 - R25\ 000$ (normal tax) - $R27\ 222$ (STC)

22 500
22 500
80 000
350 000
105 000
80 000
25 000
R
270 000
25 000
245 000
307 778

NOTE:

This example has been taken from Example 1 of the *Explanatory Memorandum* on the Taxation Laws Amendment Bill 2000. According to Stack, Cronje and Hamel,⁵⁸ the solution given above as per the *Explanatory Memorandum* does not appear to be correct. The Swiss company is a 'controlled foreign company' in relation to the South African company, although it is described as the 'holding company' of the South African company. If it is a controlled foreign company, those profits not distributed (that is 50% of total dividend income) will be deemed to have been distributed to the South African company in terms of section 9D.

This is in compliance with section 9D (2) which reads that the amount to be imputed to the South African resident is his *pro-rata* share of the net income earned by the controlled foreign company. Nowhere in section 9D is it mentioned that 'distribution' is a requirement for the imputation of such income, and as a result imputation is based purely on the earnings of the controlled foreign company and not on whether such earnings are distributed or not. Although Brincker, Honiball and Olivier (2003) use the exact example for illustrative purposes, they do not comment on the above apparent error in the *Explanatory Memorandum*.

Example 2⁵⁹

A South African resident company has wholly owned subsidiaries in Ireland and in Mauritius. The Mauritius company owns 10% of the shares in a company operating a holiday resort in Mexico and conducts no other activities. The Irish company conducts manufacturing operations.

The profits of the companies for two consecutive financial years are as follows:

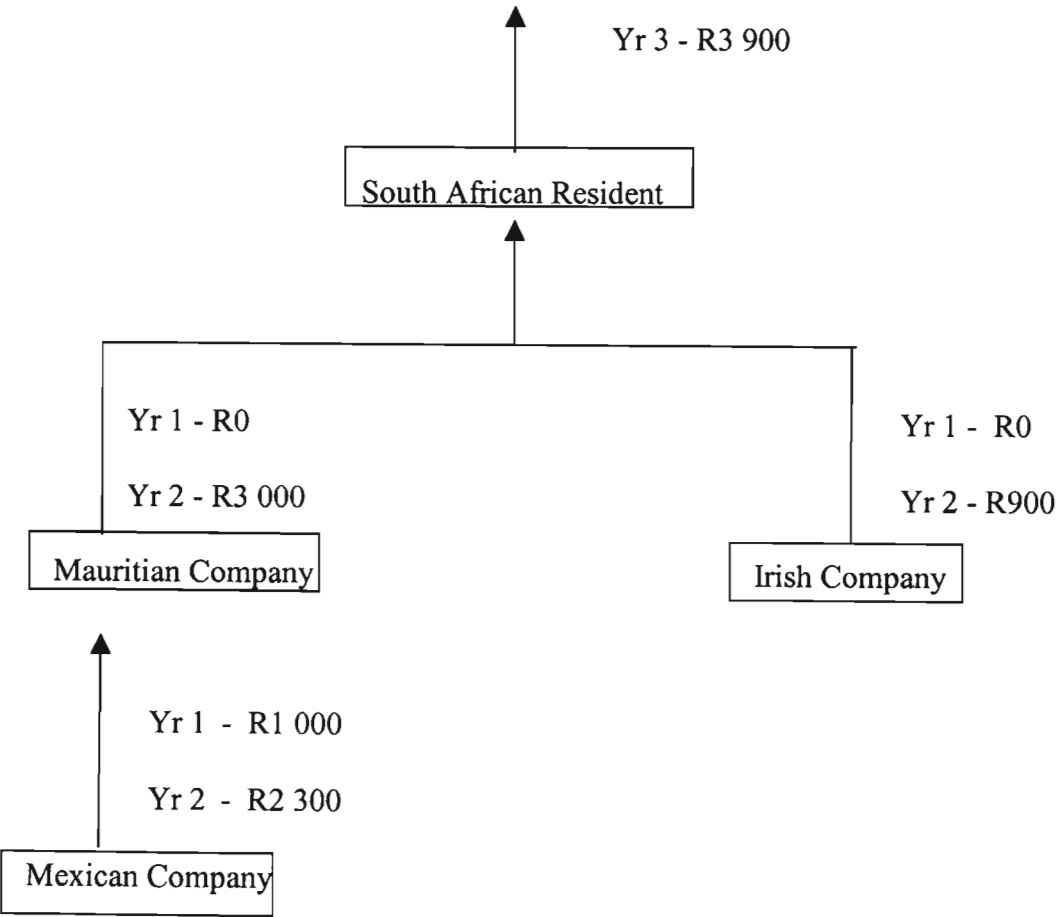
⁵⁸ Stack, Cronje and Hamel *The Taxation of Individuals and Companies* (2000) 422.

⁵⁹ This example is included as Example 2 of the *Explanatory Memorandum* on the Taxation Laws Amendments Bill of 2000.

COMPANY	IRISH CO YR 1	IRISH CO YR 2	MEXICAN CO YR 1	MEXICAN CO YR 2	MAURITIUS CO YR 1	MAURITIUS CO YR 2
	R	R	R	R	R	R
INCOME	500	1 500	2 000	3 000	1 000	2 300
TAX	50	150	680	1 020	0	0
PROFIT (AFTER TAX)	450	1 350	1 320	1 980	1 000	2 300
DIVIDEND	0	900	1 000	2 300	0	3 000

None of the countries in which the group operates imposes a withholding tax on dividends paid. The South African company on-distributes all dividends received by it in year three. The tax liability in respect of the on-distribution of dividends is covered by funds generated from other activities of the resident company.

The dividend distributions of the various companies in above example has been diagrammatically represented as follows:



The South African tax position of the group is as follows:

Ireland, Mauritius and Mexico are not on the list of countries designated by the Minister of Finance and dividends from those countries will not qualify for an exemption.⁶⁰

YEAR 1

The Irish company is a controlled foreign company (CFC), but has earned no income and has declared no dividend. Therefore no tax liability arises.

The Mauritian company is a CFC, and the foreign dividend of R1 000 from the Mexican company constituted investment income⁶¹ and is imputed to the South African resident in terms of section 9D(2). The amount to be included in gross income is the grossed up amount of the dividend, i.e. the pre-taxed profits from which it is distributed - R1 515 $[R1\ 000 + (R1\ 000/R1\ 320 \times R680)]$.

Normal tax of R455 ($30\% \times R1\ 515$) is imposed on the South African company, but in terms of section 6quat a credit is available for foreign tax of R515 $(R1\ 000/R1\ 320 \times R680)$ paid in Mexico in respect of the profits distributed by way of a dividend to the Mauritian CFC, R455 of the R515 tax paid in Mexico is credited against the South African normal tax liability. No South African tax is payable in respect of this year, but a foreign tax credit of R60 is available for set-off against a future tax liability in respect of the Mexican profits within the following seven years.

YEAR 2

The minutes of a directors' meeting of the Irish company indicates that the dividend was distributed out of profits of year 2. The amount of the foreign dividend from the Irish company to be included in gross income is the grossed up amount of the dividend, i.e. the pre-taxed profits from which it is distributed - R1 000 $[R900 + (R900 / R1\ 350 \times R150)]$.

⁶⁰ These countries were not designated at the time of the *Explanatory Memorandum* on the Taxation Laws Amendments Bill of 2000.

⁶¹ It should be noted that with the introduction of a residence-based system of taxation with effect from 1 January 2001, all income (passive and active) now falls within the ambit of section 9D, not just passive investment income.

Normal tax of R300 is imposed on the South African company on the Irish dividend ($30\% \times R900$), but in terms of section 6quat a credit is available for foreign tax of R100 ($R900/R1\ 350 \times R150$) paid in Ireland in respect of the profits distributed by way of a dividend to the South African company. After crediting the R100 foreign tax the normal tax liability is R200.

The Mauritian company is a controlled foreign company and the foreign dividend of R2 300 from the Mexican company is imputed to the South African resident in terms of section 9D(2). The amount of the foreign dividend to be included in gross income is the grossed up amount of the dividend, i.e. the pre-taxed profits from which it is distributed - R3 485 [$R2\ 300 + R1\ 020$ tax in year 2 + $(R2\ 300 - R1\ 980$ balance of dividend)/ $R1\ 380 \times R680$ tax in year 1].

Normal tax of R1 045 ($30\% \times R3\ 485$) is imposed on the South African company, but in terms of section 6quat a credit is available for foreign tax of R1 185 paid in Mexico in respect of the profits distributed by way of a dividend to the Mauritian CFC. R1 045 of the R1 185 tax paid in Mexico [$R1\ 020 + (R320/R1\ 320 \times R680) = R1\ 185$] is credited against the South African normal tax liability and the R140 excess is available for set-off against any future liability during the following seven years when the Mexican dividend forms part of the South African company's profits available for distribution and which have been declared as a dividend by the South African company. However, this amount would be limited to R288 [12,5% of $(R3\ 485 - (\text{greater of } R1\ 185 \text{ or } R1\ 045))$] had it been greater than R288.

The amount of the foreign dividend from the Mauritian company to the resident is exempt due to the fact that the dividend from the Mexican company has already been imputed to the South African resident in terms of the provision of section 9D(2).

The total normal tax payable is R200 in respect of the Irish dividends and a foreign tax credit of R200 ($R60 + R140$) is available for set-off against a future normal tax liability in respect of Mexican profits, subject to the seven year carry-forward rule.

5.8 CALCULATION PROBLEMS AS A RESULT OF THE INTERPRETATION OF 'PARTICIPATION RIGHTS'

A 'participation right' in relation to a foreign company means 'the right to participate directly or indirectly in the share capital, share premium, current or accumulated profits or reserves of that foreign company'.⁶²

This definition gives rise to difficulties with regard to the imputation of income in terms of section 9D(2). One such situation is where ordinary as well as preference shareholders exist. If preference shareholders exist, then the amount imputed will have to be reduced.⁶³

It has been previously reported that:⁶⁴

'logically this should be in the ratio that the total dividends to be distributed in respect of the preference shares bears to the total profits of the company available for distribution by way of dividend, but when it is borne in mind that the preference dividends are payable out of the net profits of the company after taxation, their ratio will give a false result.'

There would in fact be less, or maybe no, income to which the ordinary shareholder would be entitled by reason of his participation rights.⁶⁵

A further problem regarding participation rights and the imputation of income of a controlled foreign company, as pointed out by Jooste⁶⁶, is how the various types of rights referred to in the definition of a 'participation right' are to be taken into account in making the section 9D(2) apportionment.

An example which illustrates the problem is as follows:⁶⁷

The share capital of a company consists of 75% preference shares held by A and 25% ordinary shares held by B. Assume that:

- (i) the controlled foreign company has a share capital of R1 000;
- (ii) A, a resident, holds 750 R1 shares carrying a preference dividend of 10%;
- (iii) B, a resident, holds 250 ordinary R1 shares;

⁶² Section 9D (1) sv 'participation rights'.

⁶³ The preference shares have participation rights and as a result the preference dividend will need to be taken into account in calculating the amount to be imputed in terms of section 9D.

⁶⁴ *The Taxpayer* 'Editorial: Sections 9C and 9D Revisited' (1998) 84-85.

⁶⁵ Jooste 'The Imputation of Income of Controlled Foreign Entities' (2001) *South African Law Journal* 482.

⁶⁶ Jooste op cit 482.

⁶⁷ *The Taxpayer* 'Editorial: Sections 9C and 9D Revisited' (1998) 84-86.

- (iv) The gross income of the company is R500, all of which after tax is distributed.

In this scenario, A's legal right is to an annual dividend of R75. Yet applying the formula required by section 9D(2), the ratio in which the company's profits of R500 have to be apportioned, taking into account the shareholders rights to capital alone, would be -

$$A \quad R375 \quad (750/1000 \times 500)$$

and

$$B \quad R125 \quad (250/1000 \times 500)$$

In this example, the rights to participate in the profits or dividends, or any other distribution or allocation, were excluded simply because of the uncertainty of how it would affect the above formula. As the definition of participation rights reads, it appears that the various rights are cumulative in the sense that the same person may have more than one of the rights. In the above example, A has the right to capital and the right to a preference dividend, and B a right to capital and a right to dividends.⁶⁸ If it was correct to regard the rights as cumulative in this sense then A would be apportioned:

$$R275 \quad [\text{i.e. } ((750^{69} + 75^{70})/1500^{71}) \times 500]$$

and B

$$R225 \quad [\text{i.e. } ((250 + 425^{72})/1500) \times 500]$$

5.9 SUBSEQUENT CAPITAL GAINS ON THE SALE OF SHARES OF A CONTROLLED FOREIGN COMPANY

When the shares of a controlled foreign company are disposed of by a domestic taxpayer and the taxpayer had previously been taxed on the undistributed income of the controlled foreign company, a possible double taxation scenario might arise due to the fact that the gain on the sale of the shares may reflect that previously taxed income.⁷³ It follows that relief should be allowed for such possible double taxation. Many countries⁷⁴ with

⁶⁸ Section 9D(1) sv 'participation rights'.

⁶⁹ This is the right of capital.

⁷⁰ This is the right of 10% preference dividend (750 x R1 preference shares held).

⁷¹ This is made up of capital of R1 000 plus income of R500 = R1 500 to be apportioned.

⁷² The remaining profit of R425 (R500 - R75), which is fully distributable to ordinary shareholders.

⁷³ Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 79.

⁷⁴ These include Finland, France, Japan, Portugal and Sweden (Sandler op cit 79).

controlled foreign company regimes, including South Africa, do not provide any relief. Other countries do provide relief in the following manner:⁷⁵

- the cost base of the shares may be adjusted (Canada, Norway, Spain and the United States);
- the consideration received for the shares may be adjusted (Australia);
- the capital gain may be reduced by previously attributed profits, as reduced by already exempted dividends or capital gains (Denmark);
- the capital gain may be reduced by tax paid on previously attributed income to the extent not relieved by previous dividends (the United Kingdom); or
- the entire capital gain may be included in income, but tax on income previously attributed may be refunded (Germany, where the shares are sold in the following four years).

5.10 DOUBLE TAX AGREEMENTS

Section 6quat(2) provides that the rebate will not be granted in addition to any relief to which the resident is entitled under a double taxation agreement with the country concerned. It may, however, be granted as a substitution for the relief to which the resident would be entitled under an agreement. There has been a focus on increasing the number of comprehensive double tax treaties between South Africa and other states, so that an extensive network of treaties is created.⁷⁶ No indication is given as to who decides which form of relief will be given, but presumably it is the taxpayer who may elect which concession he/she would prefer.⁷⁷

5.11 CONVERSION OF FOREIGN TAX INTO REPUBLIC CURRENCY

The provision applicable to the conversion of foreign tax payable into the currency of the Republic is section 6quat(4). In terms of section 6quat(4) the amount of foreign tax proved to be paid to a foreign country on an amount included in a resident's taxable income during any year of assessment must be converted to the currency of the Republic on the last day of that year of assessment by applying the average exchange rate for that year of assessment.⁷⁸

5.12 REVISED ASSESSMENTS

⁷⁵ Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 80.

⁷⁶ Beneke and Klein 'Budget 2000' *Deloitte & Touche Tax News* 6 (1999) 4.

⁷⁷ Mitchell and Mitchell 'Residence-Basis of Taxation' *Integritax-Special Issue* March (2001) 34.

⁷⁸ Section 6quat(4). SARS, 2003, *Income Tax Interpretation Note 18*: 'Section 6quat' further explains that a resident has the option of translating the taxable income to Rand either on the time-based average rate or the weighted average of spot rates (SARS, 2003, *Income Tax Interpretation Note 18*: 'Section 6quat' 7).

Section 6quat(5) provides for the situation in which a rebate against the normal tax payable by a resident was given in a previous year of assessment and which subsequently proves to be incorrect. An adjustment is then allowed if:

- it can be proved by the resident that the amount of the tax actually payable to the foreign Government exceeds the amount that was allowed as a rebate, or
- the Commissioner is satisfied that the amount of the tax actually payable to the foreign Government is less than the amount allowed as a rebate.

A revised assessment will then be issued by the Commissioner. Such an amended or additional assessment cannot be issued more than six years from the date of the original assessment unless the Commissioner is satisfied that the amount of tax proved to be payable to the foreign government was incorrectly reflected due to fraud or misrepresentation or non-disclosure of material facts.⁷⁹

Problems which exist with the issuing of revised assessments include:⁸⁰

- Firstly, the assessments can only be issued if a rebate was allowed initially. If a taxpayer for some reason or another did not claim any rebate and discovers the ability to claim a rebate only in a subsequent year, he would not be entitled to do so.
- On the one hand, the revised assessment is issued if the resident can prove (presumably objectively) that an additional rebate should be allowed. On the other hand, the Commissioner can increase the tax liability of the taxpayer or reduce a rebate previously allowed only if he is satisfied that the taxes actually payable to the foreign government are less than the amount which was originally allowed. This implies that one would only be able to review the decision of the Commissioner (both in terms of common law and in terms of the Constitution of the Republic of South Africa, Act 108 of 1996) and it is not a question of whether or not it is objectively proved that the amount actually payable is less than the amount originally allowed. This clearly places the taxpayer in an invidious position.
- The ability to issue revised assessments within a six-year period goes against the principle that assessments can only be revised within a period of three years.⁸¹
- It is always an argument whether a taxpayer disclosed all material facts concerned for the Commissioner to make a decision. This arises from the fact that a return only requests specific information and it remains at the taxpayer's discretion whether it should volunteer all information at its disposal even if not requested. This is a controversial issue and the

⁷⁹ Section 6quat(5).

⁸⁰ Brincker, Honiball and Olivier *International Tax: A South African Perspective* (2003) 53.

⁸¹ In this case the general prescription periods provided for in sections 79 and 81(5) would not apply.

Courts favour an approach where a taxpayer should disclose sufficient information which would entitle the Commissioner to make a decision in the circumstances, notwithstanding the fact that the information may not specifically have been requested in terms of a return.

CHAPTER 6
CFC REPORTING REQUIREMENTS AND THE COLLECTION OF
INFORMATION

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6.1 INTRODUCTION

In order for the correct application of section 9D to take place, it is imperative that the resident shareholders firstly, possess and secondly, make available all the necessary information required for its enforcement. Section 72A¹ deals with the reporting requirements regarding tax returns as to participation rights in a controlled foreign company. Section 72A aims at facilitating the gathering of the necessary information for

¹ The wording contained in section 72A was substituted by s 42(1) of Act 74 of 2002 applying in respect of years of assessment ending on or after 13 December 2002. There is nothing in section 9D which deals with reporting requirements with regard to the holding of participation rights in a controlled foreign company.

the successful enforcement of section 9D and places a huge administrative burden on certain residents.²

6.2 THE PROVISIONS OF SECTION 72A

Section 72A(1) provides:

that every resident who at any time during the relevant year of assessment:

- a) directly or indirectly³ holds not less than 10 percent of the participation rights in any controlled foreign company as contemplated in section 9D; and
 - b) together with any connected person⁴ in relation to such resident in aggregate holds more than 50 percent of the total participation rights in such controlled foreign company,
- is required to submit a return disclosing detailed information.⁵

The provisions of the above subsection of the Act (section 72A(1)) shall not apply to any resident where any person who is a resident and who is a connected person in relation to such first-mentioned resident, holds a greater percentage of the participation rights than such first-mentioned resident.⁶

For example,⁷

Mr X, a South African resident, holds 10 percent of the participation rights in a CFC. Together with connected persons, Mr X holds more than 50 percent of the total participation rights in the CFC. Mr Y, a South African resident, and one of these connected persons, holds 11 percent of the participation rights in the CFC. In these circumstances Mr X has no reporting obligation in terms of section 9D. Mr Y has the obligation if he, in turn, together with connected persons, holds more than 50 percent of the total participation rights in the CFC, and none of the connected persons is a South African resident holding more than 10 percent of the total participation rights.

The return contemplated in subsection (1) shall show fully:

² Jooste 'The Imputation of Income of Controlled Foreign Entities' (2001) 118 *South African Law Journal* 500.

³ It is worth noting that the word 'indirectly' is used here but not in section 9D(2).

⁴ Such connected person does not have to be a South African resident (Jooste 'The Imputation of Income of Controlled Foreign Entities' (2001) 118 *South African Law Journal* 500).

⁵ Section 72A(1). The information must be submitted in such form and within such time as is prescribed by the Commissioner. The current form used in South Africa is referred to as the IT10 form.

⁶ See the proviso to section 72A(1). It is worth noting that although the previous definition of controlled foreign entity referred to participation and voting rights, this proviso has always only referred to participation rights. Jooste comments that the reason for this is not apparent (Jooste 'The Imputation of Income of Controlled Foreign Entities' (2001) 118 *South African Law Journal* 500).

⁷ Example sourced from Jooste 'The Imputation of Income of Controlled Foreign Entities' (2001) 118 *South African Law Journal* 500.

- a) the name, address and country of residence of such controlled foreign company;⁸
- b) the description of the various classes of participation rights in such controlled foreign company;⁹
- c) the percentage and class of participation rights held by such resident whether directly, indirectly, or together with connected persons;¹⁰
- d) the percentage and class of participation rights held by any other South African resident (who is a connected person in relation to such resident) who directly or indirectly holds not less than 10 percent of the participation rights in such controlled foreign company;¹¹
- e) a description of the receipts and accruals of such controlled foreign company which are:¹²
 - i) included in the income of such resident in terms of the section 9D;
 - ii) not included in the income of such resident in terms of the provisions of section 9D(9); and
- f) a description of any amount of tax proved to be payable by such controlled foreign company to the government of any other country in respect of any income contemplated in paragraph (e)(i) above, including particulars relating to the country in which such tax was payable and the underlying profits to which such foreign tax relates.¹³

The above requirements are similar to those of other international CFC regimes. Australia and New Zealand have similar requirements.¹⁴ The United Kingdom does not have specific statutory provisions relating to reporting and record-keeping requirements, but the Controlled Foreign Companies Supplementary Page (Form CT600B) to a Company Tax Return (Form CT600) requires similar information to that required in section 72A(2) above.

It should also be noted that every resident who is required to submit a return contemplated in subsection (1) shall:

- a) submit the relevant information referred to in subsection (2)(a), (b), (d) and (f) relating to any other resident contemplated in subsection (2)(d) to such other resident; and¹⁵
- b) have available for submission to the Commissioner, when so requested, an income statement and balance sheet of such controlled foreign company prepared in accordance

⁸ Section 72A(2)(a).

⁹ Section 72A(2)(b).

¹⁰ Section 72A(2)(c).

¹¹ Section 72A(2)(d).

¹² Section 72A(2)(e).

¹³ Section 72A(2)(f).

¹⁴ *Hustler Tax Haven Use and Control: A Study of Tax Haven Use by Australian Public Companies and the Development of Controlled Foreign Company Legislation in Australia* (1994) 320-323.

¹⁵ Section 72A(3)(a). It is also worthy noting as pointed out by Klein and Kruger 'Administrative Amendments' *Deloitte & Touche Tax News* 5 (2000) 16, that the resident referred to here must:

- a) be a connected person; and
- b) hold not less than 10 percent of the participation rights of the CFC.

with the laws of the country of which such controlled foreign company is a resident, or in terms of internationally accepted accounting practice.¹⁶

Section 72A(3)(a) facilitates the imputation of income in terms of section 9D to such other resident who, in turn, is required to submit such information to the Commissioner.¹⁷ He may otherwise have difficulty in obtaining such information on his own.¹⁸ Unless a South African resident is effectively in control of the controlled foreign company in which he is a participant and its records in relation to its income are available to him, he would not be able to make an accurate return or furnish the Commissioner with any relevant information. He may not even know whether the company is a controlled foreign company as defined in the Act. Even where he is entitled to and does receive the annual financial statements of the controlled foreign company, these may not disclose all the information required to furnish the Commissioner in terms of section 72A. Moreover, it can happen that such accounts reach the resident after the close of its year of assessment and possibly after he has been assessed for the year. If this happens, his assessment would have to be re-opened.¹⁹

The following comment was made by Meyerowitz and is applicable in the context of the interpretation of section 9D(2) under discussion:²⁰

‘Unless the controlled foreign company can and is prepared to disclose to the resident what income has accrued to it at the relevant times, it would be factually impossible for either the resident or the Revenue Department to determine what is taxable in the hands of the resident. It could therefore well be that where the resident’s participation is not constant throughout the resident’s tax year or where the controlled foreign company does not remain such throughout the resident’s tax year, section 9D(2) would be a ‘brutum fulmen’, something to which no effect can be given.’

¹⁶ Section 72A(3)(b).

¹⁷ Section 72A(4).

¹⁸ This view has been expressed by many authors, including:

- Macheli *A Critical Legal Analysis of the Regime for the Taxation of Controlled Foreign Entities in Terms of Section 9D of the Income Tax Act No. 58 of 1962* (Unpublished PhD dissertation, University of Natal, Pietermaritzburg) (2000) 326;
- Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 85;
- Jooste ‘The Imputation of Income of Controlled Foreign Companies’ (2001) 118 *South African Law Journal* 501; and
- *The Taxpayer* ‘Editorial: Sections 9C and 9D revisited’ (1998) 86.

¹⁹ *The Taxpayer* ‘Editorial: Sections 9C and 9D revisited’ (1998) 86. One might argue that section 72A places the onus on the resident taxpayer to obtain all the necessary information and provide these to the Revenue authorities, and that receiving and furnishing the authorities with such information timeously would be one of the disclosure objectives.

²⁰ *The Taxpayer* ‘Editorial: Sections 9C and 9D Revisited’ (1998) 84.

Surtees, in 'Transfer Pricing: The Next SARS Target', speaks about disclosure requirements relating to subsidiaries in tax havens. Surtees explains that the requirements now extend to the employees of subsidiaries in tax havens with the object of establishing whether they genuinely live there or whether they are South African residents who work in the subsidiaries for short periods to give the impression that the subsidiaries are genuine operating companies. This information is submitted via the use of a questionnaire which also requires names, whether the employment is full time or not, how much time the employees spend in South Africa each year, and the degree of autonomy they have. Details are required as to the physical addresses, descriptions of premises and copies of rental agreements. Even such matters as floor plans, staffing and floor space are included in the details required, as well as detailed financial information relating to gross margin and sales for such subsidiaries for the past five years.²¹

There are no penalties provided in section 72A itself for non-compliance with its provision. I believe that the legislation is lacking in this regard and foresee specific penalties being defined in the legislation in the future. A deterrent is, however, provided by section 9D(11) which states that in the event of default in complying with the provisions of section 72A, the 'business establishment' exemption,²² the 'related CFC dividend' exemption²³ and the 'related CFC interest, rents and royalties' exemption²⁴ are not available to the recalcitrant resident.

The obvious difficulty with respect to CFC legislation, and in particular section 72A, is that information is required about the net income of a company resident in a foreign jurisdiction. Generally, under principles of customary international law, one country may not generally enforce its tax laws, even through peaceful means (such as information-gathering), in the jurisdiction of another country without the latter country's consent.²⁵ In

²¹ Surtees 'Transfer Pricing: The Next SARS Target' *Deneys Reitz News Desk* (July 2002) 2.

²² Section 9D (9)(b).

²³ Section 9D (9)(f).

²⁴ Section 9D(9)(fA).

²⁵ See *Government of India v Taylor* (1955) AC 491 (House of Lords). In the House of Lords decision on *Re-State of Norway's Applications* (1990) 1 AC 723, the court did grant a Norwegian court's request to interview witnesses in the United Kingdom in respect of a claim for unpaid taxes in Norway following a tax insolvency. The Lords, while recognising the principle in the *Government of India* case, considered that the principle of non-enforceability did not affect the jurisdiction of the courts to examine witnesses at the request of foreign courts. This decision may suggest a liberalisation of the general principle, possibly limiting the non-enforceability to a suit for unpaid taxes, or an application for the enforcement of a foreign court order in respect of unpaid taxes but allowing one country at least with approval of the courts in the other country, to use 'peaceful' enforcement mechanisms. It is, however, questionable what impact *Norway's Applications* will have on the general principle of customary international law. (Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 115).

South Africa, section 72A places the onus on the taxpayer to report its share of the CFC's undistributed income and pay the tax owing in respect of that income. This is similar to most countries adopting CFC legislation, whereby the legislation sets out the preconditions which, if met, subject domestic taxpayers to liability.²⁶ It has also been said that the above disclosure may well precipitate the transfer pricing disclosure requirements of Practice Note 7.²⁷

6.3 UNILATERAL APPROACHES TO THE GATHERING OF THE REQUIRED INFORMATION

With regard to the enforcement of legislation, two types of information are necessary:

- a) the identity of the domestic shareholders subject to the regime; and
- b) financial information in respect of the CFC in order to compute tainted income.²⁸

The first type of information referred to above is generally provided by taxpayers in answering specific questions on a tax or information return.

The table that follows has been constructed from OECD findings and highlights the basic reporting requirements of major OECD countries.²⁹

²⁶ By contrast, under the previous United Kingdom legislation, a corporate taxpayer was only subject to United Kingdom tax if the Board of Inland Revenue made a direction in respect of a particular CFC. Accordingly, even if all the statutory requirements were met, the Inland Revenue could have decided not to make the necessary direction. Evidently, the purpose of requiring a Board direction was 'to avoid unacceptable staff costs (and additional compliance costs in the private sector)' (Board of Inland Revenue *Taxation of International Business* (1982) 26). This aspect of the United Kingdom legislation received considerable support from the business sector. While administrative discretion may reduce compliance and administrative costs, certainty and predictability suffer (Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 85). In particular, administrative discretion may result in an uneven enforcement of the law. It is probably on these grounds that the Board's discretion to direct application has since been removed, in line with the newly introduced corporate self assessment system, and as part of an effort to promote certainty and predictability in that the legislation now applies to any United Kingdom's resident corporate taxpayer once the legislation's criteria have been met (Section 747(1), as amended by section 113, Sch 17(1) of the Finance Act of 1998).

²⁷ Stanley 'Transfer Pricing –The Winds of Change' *Deloitte & Touche Tax News* 3 (2001) 4.

²⁸ Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 86.

²⁹ 1) Macheli *A Critical Legal Analysis of the Regime for Controlled Foreign Entities in Terms of Section 9D of the Income Tax Act No. 58 of 1962* (Unpublished PhD dissertation, University of Natal, Pietermaritzburg) (2000) 325-346,
 2) Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 85-91,
 3) Sandler *Tax Treaties and Controlled Foreign Company Legislation—Pushing the Boundaries* 2nd ed (1998) 23-36, 223-266,
 4) Vann R *OECD Proceeding –Taxing International Business* (1997) 13, 67, 95, and
 5) Sandler *The Interaction between Tax Treaties and Controlled Foreign Company Legislation—Pushing the Boundaries* (1994) 18-26.

<u>COUNTRY</u>	<u>REQUIREMENTS</u>
Australia	Operates a self-assessment system. No special information return requirements in the case of controllers of CFCs.
Canada	Domestic corporations must disclose on the corporate tax return all foreign affiliates. Resident individuals need to disclose their equity percentage interests in foreign affiliates and name the affiliates. ³⁰
Denmark	The parent corporation of the CFC must produce accounts of the CFC prepared in accordance with Danish tax legislation.
Finland	Specific provisions requiring taxpayers to report their direct and indirect shareholdings in CFCs.
France	Domestic corporations must produce a comprehensive statement listing the names and addresses of all foreign companies resident in a target territory in which the reporting company owns at least ten percent of the shares, financial statements for such companies, detailed calculations of taxable income and reconciliation with the financial statements, and so on.
Germany	Taxpayers must report investments in foreign corporations of 10 percent or more of the shares if held directly, or 25 percent or more if held indirectly. The taxpayer must also report in his annual tax return the ownership of shares in any foreign corporation subject to the provisions of the AStG due to the fact that all domestic shareholders are included in determining whether a foreign corporation is a CFC (i.e. no minimum ownership requirement is applicable).

³⁰ The taxpayer must not only identify foreign accrual property income (FAPI) but also other income of the CFC which is considered to be active business income.

Japan	Taxpayers having an interest in a CFC must file an information schedule with their annual tax return regardless of whether any income of the CFC is attributable to them or not.
New Zealand	Taxpayers are required to disclose ownership interests in CFCs.
Norway	Taxpayers must report their holdings in foreign companies and provide the financial accounts of such companies if they own at least ten percent of the shares directly, or 50 percent indirectly. Because Norway takes into account all domestic shareholders in determining whether a foreign corporation is a CFC, all Norwegian taxpayers who own or control, directly or indirectly, shares or capital of a foreign corporation resident in a low tax country must report their holdings.
Portugal	Taxpayers with CFC income must provide with their tax returns the financial statements of the CFC.
Spain	Taxpayers with CFC income must provide information with their annual general income or corporation tax form, setting out the name and fiscal residence of each CFC, accounts and profit statements, calculations of attributable income and proof of foreign taxes paid.
Sweden	Domestic corporations must disclose on the corporate tax return all foreign affiliates, while individuals are not asked to disclose their interests (or even whether they have interests) in foreign corporations in the annual tax return unless they are reporting income from such corporations.
United Kingdom	Previously there were no obligations on corporate taxpayers to provide information identifying interests in CFCs unless a direction was made by the Board of Inland Revenue (although the Board did have broad information gathering powers). The Board's discretion to

direct application has since been removed³¹ and taxpayers owning interests in CFCs are required to disclose such information on the CT600B form accompanying their tax return.

United States	Substantial and detailed reporting requirements. Any resident in or a citizen of the United States and any resident corporation who controls a foreign corporation must disclose the name and address of the corporation, financial statements prepared in accordance with generally accepted accounting principles and translated into English, details of certain non-arm's length transactions entered into by the foreign corporation as well as details of any other US person holding at least five percent of any class of shares of such foreign corporation. An information return must be completed and submitted to tax authorities by any US person acquiring more than five percent of any class of shares in a foreign corporation. ³²
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Information gathering can be difficult in the case of more widely owned CFCs. In countries where the minimum percentage interest held is not applicable (i.e. jurisdictions which include all domestic shareholders for the purposes of determining whether a foreign corporation is a CFC, as in the case of Germany and Norway, all residents must report their participation in foreign corporations by way of a special information return. The returns are all filed with the federal tax administration, which is then in a position to determine whether German/Norwegian taxpayers own in aggregate more than 50 percent of the shares in the CFC.

In the absence of voluntary compliance by taxpayers, tax authorities have to rely on public information³³ and on their information gathering powers.³⁴

6.4 BILATERAL AND MULTILATERAL APPROACHES

³¹ Section 747(1), as amended by section 113, Sch 17(1) of the Finance Act of 1998.

³² Any US person who is an officer or director of such a foreign corporation must also report the above acquisition by any US person. This will help identify instances of failure to report the acquisition by the acquirer.

³³ Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 88. These constitute annual financial statements of listed companies.

³⁴ These include two audits and two investigations, including issuing requirements to produce documents, answer written questionnaires, produce individuals for questioning, obtaining information from third parties, and finally, entering premises for the search and seizure of documents (Sandler op cit 88).

The concept of bilateral or even multilateral approaches means entering into ‘exchange-of-information’ agreements with certain target territories. The United States has had considerable success in concluding exchange-of-information agreements with certain target territories, primarily Caribbean basin countries, through the negotiations of certain concessions, such as duty-free shopping and allowing the deductibility of expenses in respect of conventions held there.³⁵

Other examples of agreements regarding the exchange-of-information include:

- a) The Mutual Assistance Directive of 19 December 1977,³⁶ and
- b) The Convention on Mutual Administrative Assistance in Tax Matters.³⁷

There are also joint audit programmes between a number of countries, whereby simultaneous examinations by two countries’ tax authorities are undertaken, usually in respect of members of an international corporate group.³⁸ The authorities share the information obtained in the investigation through competent authorities under the exchange-of-information provisions.³⁹

There are currently no double tax agreements between South Africa and any tax-haven jurisdictions regarding the exchange of information between the Revenue authorities of the contracting states to ensure that taxpayers make proper disclosure of their tax affairs.⁴⁰

6.5 THE KEEPING OF RECORDS

³⁵ Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 90.

³⁶ Article 1 of this directive requires that the competent authorities of the Member States ‘shall exchange any information that may enable them to effect a correct assessment of taxes on income and on capital.’ Article 4, in particular, sets out five circumstances where a Member State shall, without prior request, forward information of which it has knowledge of the competent authority of any other Member State concerned, including circumstances where:

- business dealings between a person liable to tax in a Member State and a person liable to tax in another Member State are conducted through one or more countries in such a way that a saving of tax might result in one or the other Member State or in both; and
- the competent authority of a Member State has grounds for supposing that a saving of tax might result from artificial transfers of profits within groups of enterprises.

³⁷ This was entered into and came into force on 1 April 1995 for Denmark, Finland, Norway, Sweden and the United States. Belgium and the Netherlands have also subsequently signed. This convention was drafted by the OECD and the Council of Europe and establishes, on a comprehensive and multilateral basis, the legal provisions for information exchange and mutual assistance in assessment and collection of taxes. According to the OECD, if a large number of countries eventually participate in the Convention, it could be an effective mechanism for collecting information on CFCs.

³⁸ Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 91.

³⁹ To encourage the use of such techniques, the OECD has established a standard format for simultaneous examinations.

⁴⁰ Jooste ‘The Imputation of Income of Controlled Foreign Entities’ (2001) 118 *South African Law Journal* 502.

Some countries have specific provisions relating to the keeping of records for purposes of assessing taxpayers under CFC legislation. The Australian regime provides for a taxpayer whose assessable income includes any income attributable from a controlled foreign company to statutorily keep records⁴¹ containing particulars of acts, transactions, and other circumstances showing, inter-alia, how the taxpayer came to be an attributable taxpayer; the basis of calculation of the direct and indirect attributable interest held by the taxpayer; the basis of calculation of the attributable percentage of the taxpayer in relation to the controlled foreign company; and the basis of the calculation of the amount included in the assessable income of the taxpayer in relation to the company's attributable income.⁴² The United States has substantially more detailed and specific record-keeping requirements.⁴³

There are no other such detailed record-keeping requirements of any other country considered in this dissertation. Schedule 18 of the Finance Act of 1988 of the United Kingdom requires companies submitting tax returns to preserve their records for a period of six years thereafter.⁴⁴

In South Africa section 73A(1)⁴⁵ provides for a taxpayer who has submitted a tax return, whether required to do so or not, to retain all records for a period of five years from the date upon which the return relevant to the last entry in those records was received by the Commissioner.⁴⁶ Section 73A goes on to mention that the taxpayer needs to maintain such records relating to any trade carried on by that person in which are recorded the details from which that person's returns for the assessment of taxes under the Act were prepared. It appears that section 73A does not confine the trade carried out to the Republic. Hence, it can be construed that the above section also applies to trade carried out in foreign jurisdictions, under which the income earned from a controlled foreign company will fall.

With regard to income earned from a controlled foreign company, the above provision will generally apply to the resident taxpayer who holds the largest percentage and who, together

⁴¹ Sections 462, 462A and 464A of the Income Tax Assessment Act of 1936.

⁴² Sections 462 (a-f) of the Income Tax Assessment Act of 1936. Also see Macheli *A Critical Legal Analysis of the Regime for the Taxation of Controlled Foreign Entities in Terms of Section 9D of the Income Tax Act No. 58 of 1962* (Unpublished PhD dissertation, University of Natal, Pietermaritzburg) (2000) 332.

⁴³ See 964(c) of the Internal Revenue Code; and Reg. 1.964-(c), providing detailed rules and linking these CFC regime-specific rules with even more onerous general ones under section 6001 of the Code and accompanying regulations there-under.

⁴⁴ Paragraph 21 of Schedule 18 of the Finance Act of 1988.

⁴⁵ Section 73A as substituted by section 43 of Act 74 of 2002 with effect from years of assessment ending on or after 13 December 2002. Also see *The Taxpayer* 'Foreign Dividends Media Release No. 20 of 2000' (2000) 167.

⁴⁶ Refer to sections 73A(2)(a) and (b) for a list of what constitutes 'records' to be maintained.

with other connected persons, holds more than 50 percent of the participation rights of the foreign company.⁴⁷

In addition to financial records, SARS may require a taxpayer to furnish any other information or document considered necessary for an enquiry into a return. Such additional information or document may comprise any document, book, deed, plan, instrument, trade list, stock list, affidavit, certificate, photograph, map, drawing and any computer print-out,⁴⁸ or any information such as any data stored by means of a 'computer' as defined in section 1 of the Computer Evidence Act 57 of 1983.⁴⁹

It should be noted that if any of the above documents are in a language other than any of the official languages of South Africa, the Commissioner may require the taxpayer to produce a translation into one of the official languages (as determined by the Commissioner) certified by a sworn translator or any other person approved by the Commissioner.⁵⁰ According to Macheli,⁵¹ it is not clear as to whose expense the translation should be made, but it is presumably at the taxpayer's.⁵²

6.6 EXEMPTIONS FROM THE DISCLOSURE REQUIREMENT

Due to the fact that the information requested might sometimes be difficult to obtain and the requirements difficult to enforce, such situations have resulted in certain countries providing some limited exceptions to the requirements.

Exceptions to the disclosure requirements relate generally to two given situations:⁵³

- a) where a resident participant in a controlled foreign company does not have sufficient influence over it to obtain the necessary information;⁵⁴ and

⁴⁷ It is generally this taxpayer who is required to furnish information to the Commissioner in terms of section 72A. It should also be noted that there is provision in section 72A for any other related taxpayer who possesses any other information as required by the Commissioner to either furnish the above taxpayer who will in turn furnish the Commissioner with such details or directly furnish the Commissioner with such details himself.

⁴⁸ Section 74(1) sv 'documents'.

⁴⁹ Section 74(1) sv 'information'.

⁵⁰ Sections 74(2) and 74(3).

⁵¹ Macheli *A Critical Legal Analysis of the Regime for the Taxation of Controlled Foreign Entities in Terms of Section 9D of the Income Tax Act No. 58 of 1962* (Unpublished PhD dissertation, University of Natal, Pietermaritzburg) (2000) 334.

⁵² Previously section 74 expressly provided that translation expenses were to be borne by the taxpayer and a reasonable amount thereof was allowed as a deduction. Section 74 was subsequently substituted by section 14 of Act No. 46 of 1996 and this provision was removed.

⁵³ These are not exceptions in terms of the Income Tax Act No. 58 of 1962 but exceptions which surface in various countries adopting CFC legislation and as a result recognised internationally.

⁵⁴ Macheli op cit 338.

- b) where the disclosure of information would involve a breach of foreign laws.⁵⁵

6.6.1 Insufficient influence

Macheli comments that, in terms of section 72(A)(3)(b), the disclosure requirements of section 72A shall not apply to a resident (even to a resident with the greatest percentage of the participation rights) where the Commissioner, at his discretion, does not find it necessary.⁵⁶ The above is not clearly apparent from the Act, as the wording in the Act refers to the information to be submitted in the form and within such time prescribed by the Commissioner. Whether this allows for the Commissioner to actually deem the disclosure requirements non-applicable to a taxpayer remains to be clarified.

The fact that section 72A(1)⁵⁷ of the Income Tax Act stipulates that only connected persons will ever qualify to control a foreign company, with each person holding a prescribed minimum 10 percent of the participation rights in the company, the disclosure requirements will only apply to such a connected person who holds the greatest percentage of the participation rights in the controlled foreign company. It is interesting to note that section 72A(1)(b) refers to connected persons holding more than 50 percent of the participation rights. However, as discussed earlier in this dissertation, it appears that ‘acting in concert’ is not a requirement for determining control. The definition of ‘controlled foreign company’ in section 9D(1) only refers to connected persons when applying the five percent minimum threshold requirement relating to a listed company or scheme or arrangement as contemplated in paragraph (e)(ii) of the definition of ‘company’ in section 1 of the Act. It therefore appears that a foreign company in which South African residents hold greater than 50 percent of the participation rights will be deemed a controlled foreign company, but because none of them are connected to each other, or to another shareholder and with whom they collectively hold more than 50 percent of the participation rights, they will not be liable for disclosure in terms of section 72A even though certain of these residents may hold greater than 10 percent of the participation rights in the controlled foreign company.

⁵⁵ Arnold *The Taxation of Controlled Foreign Corporations: An International Comparison* (1986) 511.

⁵⁶ Macheli *A Critical Legal Analysis of the Regime for the Taxation of Controlled Foreign Entities in Terms of Section 9D of the Income Tax Act No. 58 of 1962* (Unpublished PhD dissertation, University of Natal, Pietermaritzburg) (2000) 339.

⁵⁷ Introduced by section 46 of the Revenue Laws Amendment Act 59 of 2000 with effect from years of assessment commencing on or after 1 January 2001.

This alleviates the situation in which a concerned resident does not have sufficient influence to obtain the information. This would be, as discussed above, the case where the resident is only one amongst many unrelated residents to other domestic residents with whom he controls a foreign company. In the above scenario, it may very often become difficult for the shareholder with the greatest percentage to acquire all the relevant information as required by the Commissioner.

It is not very often that residents will not have sufficient influence and not be able to obtain all the necessary information for a controlled foreign company. In this regard Prebble⁵⁸ comments:

‘The typical controlled foreign company is a wholly owned subsidiary of its parent. This is particularly true of foreign companies that are established for the avoidance purposes. In practice, the control and minimum threshold rules are not very often called into operation. The reason is that even with modern communications, controlling a foreign company is difficult enough in any circumstances. Most companies that establish foreign operations prefer to own them outright, or, at least, severely to limit the number of people who participate in control.’

6.6.2 Breach of foreign laws

Countries adopting CFC legislation may adopt secrecy laws in order to protect persons operating in the country. Macheli⁵⁹ comments that it would ‘defeat the very purpose of CFC legislation if a taxpayer was allowed to escape liability under the legislation on the basis that the controlled foreign company’s income or financial records cannot be disclosed.’⁶⁰ South African legislation does not provide for this exemption. The situation presents a dilemma in that the secrecy laws make it difficult to verify the accuracy of any information supplied and tax authorities may have to assess tax on some estimated basis. In South Africa, section 78 empowers the Commissioner to make an estimate of the tax, either in whole or in part, in a case where the Commissioner is not satisfied with the return or information furnished by any person, or where that person defaults in furnishing any return or information as required by the Act.

⁵⁸ Prebble *Costs of Compliance with the New Zealand Controlled Foreign Company Regime* (1994) 3-4.

⁵⁹ Macheli *A Critical Legal Analysis of the Regime for the Taxation of Controlled Foreign Entities in Terms of Section 9D of the Income Tax Act No. 58 of 1962* (Unpublished PhD dissertation, University of Natal, Pietermaritzburg) (2000) 340.

⁶⁰ The above issue was addressed by the United States who introduced the Tax Equity and Fiscal Responsibility Act of 1982 (at present section 982 of the Internal Revenue Code) which specifically precludes any exemption from an Internal Revenue Service demand to produce information on the grounds of breach of foreign secrecy laws.

6.7 PENALTIES

Non-compliance with the provisions of section 72A may result in the taxpayer being penalised in terms of section 75 or section 104 of the Act. However, section 75 and section 104 are not sections which specifically target non-compliance of section 9D or section 72A. These are general punitive sections of the Act which basically state that it is an offence for a taxpayer not to comply with certain provisions relating to the facilitation of tax administration, such as non-disclosure of information, failure to submit any returns or other documents as requested, submission of false information, or hindering any officer in the discharge of his duties.

In addition to the criminal penalties of section 75 and section 104, section 76 of the Act imposes on a taxpayer additional tax in the event of default or omission with regard to the submission of tax returns and the furnishing of any other information or document as requested by tax authorities.

Fines and penalties imposed with regard to non-compliance with sections 9D and 72A need to be sufficient to encourage compliance with the provisions of these sections. The South African legislation provides for an imprisonment term as well as the payment of fines.⁶¹ This functions as an additional deterrent for tax evasion. It should also be noted that in South Africa section 75A also allows the Commissioner the right to publish the names of offenders relating to where such person has been convicted of such offence in terms of:

- a) section 75 or 104, paragraph 11A(7) or 30 of the Fourth Schedule or paragraph 19 of the Seventh Schedule; and
- b) the common law, where the criminal conduct corresponds materially with an offence referred to in paragraph (a),
after any appeal and renew proceedings in relation thereto have been completed or not been instituted within the period allowed therefor.

⁶¹ These cannot be imposed together as the Act reads either a fine or a period of imprisonment (section 75(1)).

Every publication may specify:⁶²

- a) the name and address of the offender;
- b) such particulars of the offence as the Commissioner may think fit;
- c) the year of assessment or tax period during which the offence occurred;
- d) the amount or estimated amount of the tax or additional tax involved;
- e) the particulars of the fine or sentence imposed.

As it can be seen, although there are no penalty clauses contained in section 9D or 72A, there are other punitive sections of the Act which may be applicable should a taxpayer fail to comply with the requirements of section 9D or 72A. In effect, there is sufficient power bestowed upon the Commissioner and the Revenue authorities in terms of the Act to adequately punish an offender. The extent of punishment is not apparent and will presumably depend on the seriousness of the offence as viewed by the Commissioner or Revenue authorities.

⁶² Section 75(A)(2).

CHAPTER 7

CONCLUSION

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7.1 GENERAL

The focus of this dissertation has been to critically examine the anti-avoidance provisions of section 9D with regard to its application and effectiveness as a provision aimed at preventing the avoidance of paying South African taxes through the setting up of controlled foreign companies in low tax jurisdictions and thus shifting profits to such jurisdictions.

Section 9D was initially introduced in 1997¹ when an initial and partial move to a residence-based system of taxation applying only to passive income of a controlled foreign entity was introduced. With the introduction of a residence-based system of taxation effective from 1 January 2001, section 9D was amended so that it could be applied to active as well as passive income.

7.2 THE NEED FOR CONTROLLED FOREIGN COMPANY LEGISLATION IN SOUTH AFRICA

The past decade has seen the relaxing of South African exchange controls, which, in turn, has contributed to the easier flow of capital into and out of the country. This has presented

¹ Section 9C was enacted by s 9(1) of Act 28 of 1997 with effect from 1 July 1997.

a better opportunity for venture capitalists to set up controlled foreign companies in low tax jurisdictions in order to divert profits and save local Republic tax. As reported by the OECD,² 'with the increasing mobility of capital comes the increasing ability of residents of a country to avoid its taxing provisions'. This, together with the move from a source-based to a residence-based system of taxation and the fact that South Africa had high individual and corporate basic tax rates, prompted the need for controlled foreign company legislation in the Republic. Furthermore, in the absence of international co-operation, countries have to preserve the integrity of their tax systems through unilateral action.

A positive issue has been that controlled foreign company legislation was enacted into South Africa long after it was already present in most of the major countries such as the United States, United Kingdom and Australia.³ It is, however, striking that the legislation takes such diverse forms across countries, not simply in detail, but even in broad structure, such as the 'transactional'⁴ vs jurisdictional⁵ approach in defining target territories and the 'transactional'⁶ vs entity⁷ approach in determining what income is subject to tax. As a result it was possible for South Africa to learn from the mistakes that these countries had made and the difficulties they had faced regarding the implementation and effective administering of controlled foreign company legislation. A lot could also be learnt from looking at the various laws in place in the different countries and identifying successful⁸ legislation.

7.3 THE COMPLEXITY OF SECTION 9D

Section 9D was initially a complex section with numerous exemptions, resulting partly from the fact that when it was introduced in 1997, only passive income was attributable in

² Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 97.

³ In the United States CFC legislation was introduced in 1962, in the United Kingdom in 1984 and in Australia in 1990 (Sandler op cit 21–25).

⁴ In a purely transactional-based approach, CFC legislation applies to a CFC wherever resident and as a result there is no definition of a target territory.

⁵ In a jurisdictional approach, the applicability of CFC legislation is dependent on where the CFC is resident and carries on business as well as the type of income it derives.

⁶ In a purely transactional-based regime, all passive investment income and tainted base company income is attributed to the resident taxpayers, while active business income is excluded.

⁷ In an entity approach, also referred to as an 'all or nothing' approach, all of a CFC's income is attributed to resident taxpayers, unless the CFC is exempt due to its jurisdiction of residence, or due to the amount of foreign tax paid on its income, or due to certain exemptions dependent on the nature of the CFC's predominant activities.

⁸ What constitutes successful legislation is a subjective issue, but issues such as the number of cases relating to CFC legislation and whether the Courts were able to successfully defend the legislation in these cases, are factors that could assist in determining the success of the legislation.

terms of section 9C⁹ and not active income. With the introduction of a residence-based system of taxation effective from 1 January 2001, all income, passive and active, is now attributable to a resident. This has led to sections 9D (3), (4), (4A), (5), (7) and (8) being deleted by section 10 of Act No. 59 of 2000¹⁰. This left only the sections necessary in order to administer effective controlled foreign company legislation in order to support such a residence-based taxation system.

However, section 9D still remains complex for numerous reasons. The enactment of CFC legislation in any country automatically poses two immediate problems: firstly, the issue of what constitutes a ‘foreign company’ and secondly, what defines the term ‘control’. The latter issue results in severe complexities especially due to indirect holdings through multi-tier structured groups or holding just below the required minimum voting shares to effect control but nevertheless still maintaining control by such other means as, for example, a veto power against the majority vote, or being able to control the board of directors. This in turn poses a huge administrative burden on both taxpayers and administrative authorities in order to determine if such ‘control’ really exists. Many major OECD¹¹ countries have stringent and unnecessary complexities attached to their CFC legislation, summarised as follows:

- a) having a minimum ownership requirement (i.e. only residents who hold greater than a certain percentage will be considered in determining control);¹²
- b) concentrating control in a limited number of individuals; and
- c) control can only be vested in a group of related individuals who are ‘acting in concert’.

South Africa did not initially adopt any of the above requirements. However, the determination of what constitutes a ‘controlled foreign company’ for the purposes of section 9D has been a point of debate since the introduction of the provision into the Act, particularly given that the wording as it stands appears to create a CFC in circumstances where South African residents jointly hold more than 50 percent of the participation rights, but are not acting in concert (for example, mere portfolio holders in foreign listed companies in which the shares happened to be more than 50 percent South African held).

⁹ Section 9C was deleted by section 9 of the Act No. 59 of 2000 with effect from 1 January 2001.

¹⁰ Section 10 of the Revenue Laws Amendment Act 59 of 2000 with effect from 1 January 2001.

¹¹ These include Australia, United Kingdom and Sweden.

¹² South Africa does have a 5 percent minimum ownership requirement in order to determine control, but this is only applicable to a listed company or a scheme or arrangement contemplated in paragraph (e)(ii) of the definition of ‘company’ in section 1. Furthermore, a resident taxpayer needs to hold a minimum of 10 percent interest in a CFC in order for his portion of its income to be imputed to him in terms of section 9D (s 9D(2)(A)).

The first two requirements (a and b) are open to manipulation, in that these can be fairly easily avoided by concentrating ownership so as to not meet these requirements, but just narrowly avoid them.¹³

However, the third requirement (c) can be extremely difficult to enforce. It would be almost impossible for the revenue authorities to determine if a group of individuals are 'acting in concert'. As a result, and as discussed in detail in chapter 3 of this dissertation, the 'acting in concert' requirement appears not to be a requirement in terms of South African CFC legislation in order to determine control.

Section 9D as it stands in the Act is not free from uncertainties and ambiguity. As pointed out in this dissertation, there are areas which are fraught with uncertainty and ambiguity. This is evident in the fact that the current definition of 'participation rights' in section 9D(1) no longer makes reference to the inclusion of 'voting rights'. It is therefore questionable whether 'participation rights' encompass all direct and indirect holdings in any form, thus preventing the system from being manipulated by holding fewer than the required number of shares or voting rights for control, but nevertheless maintaining control via some other indirect means, such as being able to control the majority of the board of directors. It also appears from the definition of 'participation rights' that the legislation, in using the term 'indirectly' in section 9D(2), refers solely to the holding of shares through another company and not conditional holdings.

The other complexity with regard to section 9D and its requirements is the calculations involved in determining the amount to be imputed to a South African resident. The calculations raise concern when multi-tiered groups are involved and indirect holdings are brought into play. Other complexities include the holding of preference shares as opposed to ordinary shares and how this affects the amount of income to be distributed and the percentage proportion that this income needs to be distributed to the various residents.

¹³ For example, if the minimum ownership requirement is 10 percent, then control can be concentrated in individuals who individually hold a maximum of 9 percent thus avoiding this requirement. Similarly, if control must be concentrated in a maximum of five individuals, then control can in turn be concentrated in six individuals, once again avoiding such a requirement.

The legislation also appears to be open to manipulation as regards imputation in terms of the 10 percent minimum threshold rule.¹⁴ Imputation can thus be avoided by never holding more than 10 percent of the participation rights of a foreign company. More importantly, this 10 percent shareholding is determined at the end of the foreign company's tax year and is independent of any other holdings during the year. As a result this encourages disposals and re-acquisitions in the controlled foreign company around its year-end.

Another issue that surfaces with regard to calculations with respect to section 9D is that it is now no longer possible to dispose of any interest prior to the controlled foreign company's year-end and avoid tax in terms of section 9D. In this case imputation will still need to take place based either on the number of days that the CFC was a CFC for the year of assessment under consideration or the proportion of the income earned during that period that the CFC was a CFC to total income earned for the year of assessment under consideration.

This approach imposes tremendous difficulty on revenue authorities as well as taxpayers due to the fact that they do not have access to the books and records of the foreign company and the fact that the foreign company might not always be willing to disclose such information at various times during the year. This might prove especially true if the resident taxpayer wishes to calculate his tax liability in terms of section 9D based on the net income earned during the period the foreign company was a CFC and if monthly management accounts of the foreign company are not readily available to the resident or the Republic revenue authorities.

Such calculations in terms of section 9D are also fraught with the various exemptions in terms of section 9D(9) and relief provisions in terms of section 6quat.

7.4 THE EFFECTIVENESS OF SECTION 9D

The aim of the enactment of controlled foreign company legislation in South Africa was to protect the South African tax base from exploitation. The fact that the South African tax system was changed from a source-based system to a residence-based system with effect

¹⁴ Section 9D(2)(A).

from 1 January 2001, at which time section 9D was drastically revised by section 10 of Act No. 59 of 2000, has not resulted in any problems surfacing in which the facts lend themselves directly to the questioning of CFC legislation. To date there have been no cases in South Africa where the facts at hand directly question the interpretation of section 9D. As a result the courts have no local decisions to fall back on and will therefore have to rely on international case law decisions. But in so doing utmost care needs to be taken, as the laws in the different countries are very diverse, and a decision made in a particular country may pertain to the laws of that specific country but not to the laws of another country. As a result it is still too early to make any judgments regarding the success and effectiveness of section 9D.

It is expected that a certain amount of fine-tuning of legislation will occur over its life as shortcomings come to light. The experience of the various countries analysed by the OECD suggests that when a country introduces its controlled foreign company legislation, features are drawn from other jurisdictions, although each country which has adopted such legislation has tended to add its own unique features. According to the OECD¹⁵, the legislation a country adopts must be consistent with its domestic tax policy, legislation and practice.

Due to the differing policies and the lack of harmonisation in domestic tax legislation, this has inevitably resulted in quite significant differences in the technical features of the CFC regimes of the various countries. There is also a significant difference in the over-all structure that the legislation takes.

Macheli¹⁶ (2000) states that, broadly speaking, there are two types of CFC regimes: one that is complex and comprehensive, covering almost every conceivable situation,¹⁷ and the other which is cast in simple and broad terms, with more discretion left to the tax authorities.¹⁸ In my view, and as shown in this dissertation, the current South African CFC regime is certainly not comprehensive so as to cover all conceivable situations. It is, however, complicated to an extent, but not as complicated as the regime of the United

¹⁵ Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 97.

¹⁶ Macheli *A Critical Legal Analysis of the Regime for the Taxation of Controlled Foreign Entities in Terms of Section 9D of the Income Tax Act No. 58 of 1962* (Unpublished PhD dissertation, University of Natal, Pietermaritzburg) (2000) 189.

¹⁷ These include, for example, the regimes in the United States and Australia.

¹⁸ These include, for example, the regimes in France, Germany and the United Kingdom.

States and Australia. As a result, the South African regime is somewhere in the spectrum between these extremes.

In deciding on any decision regarding CFC legislation, consideration needs to be given to the underlying intention of the legislation, which is 'fairness'. But at the same time the objective of apportioning income to the concerned resident must also be achieved. With South Africa's recent acceptance into the global economy and it striving for economic growth, further care has to be taken so that legislation is not too stringent so as to deter trade from South Africa, and more importantly hinder the growth of South African businesses internationally. It appears that, as it stands, current South African legislation contains adequate provisions in the form of, among others, the business establishment exemption, the already taxed exemption, the designated country exemption and the section 6quat rebates, so as to not hinder or affect growth of South African businesses in any way.

It is essential that both taxpayers and tax authorities be able to administer the CFC regime with efficiency and cost-effectiveness. There is little doubt that CFC regimes do give rise to additional compliance costs both for taxpayers and tax authorities. To date no studies have been undertaken to determine whether a particular regime may be more cost-effective than any other.¹⁹

It has previously been confirmed that the use of entities in target territories is still on the increase.²⁰ This may not necessarily be indicative of the fact that there are flaws in the technical detail of the legislation itself, but rather points to the inability of tax authorities to gather information and enforce the legislation. In this regard a greater multilateral co-operation may be of significant benefit.²¹ I believe that because the South African legislation places the onus on the taxpayer to report his holdings and other pertinent information, the cost effectiveness of the legislation is enhanced as the taxpayer is in a better position to obtain the necessary information and at a less costly means than the tax

¹⁹ Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 102.

²⁰ The Gordon Report of 1981 and the OECD Report of 1987.

²¹ For example, if a large number of countries eventually participate in the Convention on Mutual Administrative Assistance in Tax Matters, and apply it in a liberal manner (particularly the spontaneous exchange requirements), it may provide an effective tool for the more effective application of CFC regimes (Sandler *Controlled Foreign Company Legislation* (1996) (OECD) 102).

authorities. However, it may be argued that such disclosure requirements may pose serious hardships on taxpayers.²²

The issue of obtaining information from controlled foreign companies has been made easier by the OECD. Exchange of information agreements have been established between countries affiliated to the OECD among themselves and with other countries. The OECD has even gone to the extent of standardising a format for the exchange of such information. Such exchange of information questionnaires facilitate the attainment of the required information which may otherwise prove difficult to obtain.

Based on hindsight, be it merely for a 3-year period²³, section 9D cannot be criticised from the point of any deterioration of the South African tax base as there has been no case law questioning the application of section 9D in the Republic since its inception. Criticism and shortcomings shown by this dissertation are merely from questioning the wording in the Act or situations which appear not to be covered by the Act. Nevertheless, these shortcomings or 'uncovered' situations are real and certain changes to the legislation, as discussed throughout this dissertation, are anticipated. Despite these flaws in the current CFC legislation, other tax measures such as the transfer pricing rules of section 31 and the general anti-avoidance provisions of section 103 were not sufficient to afford the necessary protection with the introduction of a residence-based system of taxation in South Africa, thus making specific CFC legislation necessary.

²² Macheli *A Critical Legal Analysis of the Regime for the Taxation of Controlled Foreign Entities in Terms of Section 9D of the Income Tax Act No. 58 of 1962* (Unpublished PhD dissertation, University of Natal, Pietermaritzburg) (2000) 356.

²³ The period from 1 January 2001 (when a residence-based system came into effect in South Africa) to September 2003. Although section 9D was enacted in 1997, only passive investment income was subject to a residence-based system of taxation from 1997 to 2000. From 1 January 2001, both active and passive income now fall within the ambit of section 9D.

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