

# **An analysis of the South African controlled foreign company regime in light of amendments in the United Kingdom**

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*“But they that wait upon the Lord shall renew their strength; they shall mount up with wings as eagles; they shall run, and not be weary; they shall walk, and not faint”* (Isaiah 40:31). All the praises and glory is onto the Lord our God for granting me the grace and strength to complete this study.

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**Title: An analysis of the South African controlled foreign company regime in light of amendments in the United Kingdom**

**Titel: 'n Ontleding van die Suid-Afrikaans-beheerde buitelandse maatskappystelsel aan die hand van die veranderinge in die Verenigde Koninkryk**

**Keywords:** Controlled Foreign Company; Controlled Foreign Company Rules; CFC; United Kingdom; UK

**Sleutelwoorde:** Beheerde buitelandsemaatskappy; Beheerde buitelandsemaatskappybeleid; BBM; Verenigde Koninkryk

## ABSTRACT

With constant changes in the nature of businesses, the way businesses are managed and the manner in which corporate groups are structured, a valid risk exists that legislation, including controlled foreign company (CFC) legislation can become outdated. The implication is that a country's tax base will not be effectively protected. The aim of this mini-dissertation is to analyse section 9D of the South African Income Tax Act (58 of 1962) against the United Kingdom's CFC regime to identify aspects of the new CFC rules enacted in Great Britain that could enhance South African CFC rules. Since the United Kingdom and South Africa levy income tax on a residence basis, it was concluded that the CFC regimes of these countries would be comparable.

The research problem statement was determined to consider whether any aspects of the amended United Kingdom CFC legislation could be incorporated in the South African CFC rules to ensure that they are more accommodating to investors on the one hand and still protect the South African tax base efficiently on the other hand.

The problem statement was addressed through the research objectives. Their findings are summarized as follows:

*1 To determine what the factors and circumstances were that resulted in the revised CFC legislation in the United Kingdom.*

It was found that the Commissioner of Inland Revenue was applying the "motive test" very subjectively which resulted in resident-holding companies being taxed on legitimate trading profits of foreign subsidiaries. The "motive test" therefore lacked objectivity which resulted in the residents being taxed on the profits of their subsidiaries.

Since section 9D of the South African Income Tax Act (58 of 1962) also applies a subjective test to consider the investor's motives, it was concluded that the South African legislation is faced with a similar pitfall as the UK CFC legislation enacted in 1984.

*2 To critically compare the CFC rules per section 9D of the South African Income Tax Act to the CFC legislation effective 1 January 2013 in the United Kingdom.*

It was found that the South African rules address a wider range of activities, whereas the UK CFC regime focuses on specific income streams. A number of aspects were identified where the two sets of legislation agree, but areas were also identified where the legislation differs.

*3 To identify elements of the new CFC legislation in the United Kingdom that might improve the current South African CFC regime.*

The differences identified between the South African and United Kingdom CFC regimes were evaluated. It was concluded that there are elements of the South African legislation that should remain unchanged as it addresses specific risks. It was, however, also concluded that there are valid elements implemented in the UK CFC regime that could simplify the South African CFC legislation, enhancing its competitiveness while still retaining the integrity and effectiveness of the legislation.

It was concluded that even though the differences between section 9D and the UK CFC regime may enhance section 9D when enacted in South Africa, these enhancements should be considered very carefully as they might create loopholes providing false progress to section 9D.

## UITTREKSEL

Die volgehoue verandering in die manier waarop besighede bedryf en bestuur word, asook korporatiewe herstruktureringe veroorsaak dat daar 'n wesentlike risiko ontstaan dat wetgewing, insluitende beheerde buitelandse maatskappy ('BBM') wetgewing, binnekort verouderd sal wees en daarom nie meer die spesifieke land se belastingbasis sal kan beskerm nie. Die doel van die skripsie is dus om artikel 9D van die Suid-Afrikaanse Inkomstebelastingwet (Wet 58 van 1962) te analiseer aan die hand van nuwe BBM-beleid wat in die Verenigde Koninkryk gebruik word, en om dan elemente te identifiseer wat moontlik Suid-Afrikaanse wetgewing kan bevorder. Aangesien beide Suid-Afrika en die Verenigde Koninkryk belasting hef gebaseer op die belastingpligtige se inwonerskap van die spesifieke belastingjurisdiksie, het die navorser tot die gevolgtrekking gekom dat die wetgewings van hierdie twee lande vergelykbaar is.

Die navorsingsvraag is geformuleer om vas te stel of enige aspekte van Groot Brittanje se opgedateerde BBM-beleid gebruik kan word om die Suid-Afrikaanse wetgewing meer toeganklik vir buitelandse beleggers te maak, terwyl die belastingbasis steeds voldoende beskerm word.

Die navorsingsvraag is beantwoord deur die volgende navorsingsdoelwitte te ontleed:

*1 Identifiseer die faktore wat bygedra het tot die opgedateerde BBM-wetgewing in die Verenigde Koninkryk.*

Die navorser het gevind dat 'n subjektiewe "motieftoets" gebruik is om BBM's te belas, met die gevolg dat geldige handelsinkomstes verkeerdelik belas is. Die gevolgtrekking is dus dat objektiwiteit nie toegepas is nie.

Artikel 9D van die Inkomstebelastingwet (Wet 58 van 1962) gebruik ook subjektiewe toetse om beleggers se motiewe vas te stel. Die navorser het tot die gevolgtrekking gekom dat Suid-Afrika soortgelyke risiko's as Groot Brittanje in die gesig staar.

*2 Vergelyk Artikel 9D van die Suid-Afrikaanse Inkomstebelastingwet met BBM-wetgewing wat op 1 Januarie 2013 in Groot Brittanje in werking gestel is.*

Die spesifieke Suid-Afrikaanse wetgewing spreek 'n wyer basis aan, terwyl soortgelyke wetgewing in Groot Brittanje eerder spesifieke inkomstebronne aanspreek. Die bevinding is dat die wetgewings ooreenstem ten opsigte van sekere sake, maar duidelike verskille kan ook waargeneem word..

*3 Identifiseer aspekte van die hersiende wetgewing in die Verenigde Koninkryk wat Suid-Afrikaanse BBM-wetgewing kan bevorder.*

Die verskille tussen Artikel 9D en Groot Brittanje se BBM-stelsel is ondersoek. Die navorser het bevind dat sekere elemente van Artikel 9D spesifieke aspekte en risiko's aanspreek en dus onveranderd gelaat moet word. Daar is geldige aspekte van die die Verenigde Koninkryk se BBM beleid wat die Suid-Afrikaanse wetgewing tot voordeel mag wees.

Die algemene bevinding is dat selfs al sou sekere elemente van die Britse wetgewing Artikel 9D wel komplimenteer, die implimentering daarvan deeglik oorweeg moet word om moontlike slaggate en valse vooruitgang te vermy.

## Abbreviations

The following abbreviations and their explanations used in this document are provided below:

CFC	Controlled Foreign Company
GBP	Great British Pounds
HMRC	Her Majesty's Revenue and Customs
ICTA	Income and Corporations Taxes Act
SARS	South African Revenue Services
UK	United Kingdom
USA	United States of America



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## Chapter 1

### Introduction, background, research question and objectives, research methodology

#### 1. Introduction

A CFC regime is an attempt by a tax jurisdiction to prevent its corporate taxpayers from moving capital into mobile assets in offshore subsidiaries so that the income from those assets rolls up outside the specific tax jurisdiction (McGowan & Thomson, 2012:1). As is the case with any law, CFC legislation is subjected to a systematic discovery process (Younkins, 2000) which will result in the legislation evolving and being amended based on historic experiences.

#### 1.1 Background to the research area

England is considered to be the oldest industrial country in Europe. It made effective use of steam power as early as the dawn of the 19<sup>th</sup> century. England, being rich in coal and iron ore, was preferred above other European countries for setting up factories, causing the English residents to proudly proclaim their country as the “Workshop of the World” (Berman, De Graaff, *et al.*, 1979a:432).

England also influenced many parts of the world during different periods in history. In the 18<sup>th</sup> century the United Kingdom of Great Britain rose to become the world’s most dominant colonial power. These colonies included the thirteen colonies of North America which were formed as early as 1606 (Virginia) (Berman, De Graaff, *et al.*, 1979b:3078). However, after the Freedom War the English declared the Americas independent from British rule on 04 July 1776 (Berman, De Graaff, *et al.*, 1979b:3078). The United States of America was born.

Even with the largest economy of 2011 (Anon., 2013d: 12) being lost as a colony, the UK still had significant political and economic influence on the world. Some of the colonies ruled by Great Britain in the past form part of the 54 members to the Commonwealth today. Some members of the Commonwealth acknowledge her majesty, Queen Elizabeth II, as Sovereign, but the Commonwealth also includes kingdoms and republics (The official website of the British Monarchy, 2013). All 54 members of the Commonwealth joined voluntarily and enjoy the opportunity to

consult and co-operate with fellow members in certain areas such as strengthening democracy, promoting human rights and working for social and economic development of poorer countries (The official website of the British Monarchy, 2013). Of the 54 countries, sixteen of the members (including Australia, Canada, New Zealand and the United Kingdom) acknowledge Queen Elizabeth II as Sovereign, and all members recognise the Queen as Head of the Commonwealth. The Republic of South Africa has been a member of the Commonwealth since 1931, withdrew in 1961 and re-joined in 1994 (The official website of the British Monarchy, 2013).

The UK also led the way in significant changes in taxation made by other countries. Almost all the OECD countries followed the UK's example in 1984 by enacting tax regime reforms. At that time the reforms generally took the form of reducing the corporate and personal income tax rate and broaden the tax base (OECD, 2011:1).

The UK was reported to be the ninth largest economy in 2011 when growth in GDP was measured in terms of purchasing power parity (PPP). Using the same method of estimates, it was expected that the United Kingdom would retain this spot until 2030 and will only drop to the eleventh place by 2050 (Anon., 2013d: 12). The United States of America was ranked at first place as the largest economy in 2011 (Anon., 2013d: 12). It is expected that the USA will be the second largest economy by 2030 and will still retain that position by 2050.

It is a well-known fact that decisions made and policies implemented by the government of the United States influence the whole world. The Paris-based OECD, for example, acknowledged the possibility of a global recession, should the United States of America not avoid the \$607 billion in federal spending cuts and tax increases which were scheduled to take effect in 2013 (Klimasinska, 2012:1).

The USA does not only impact the global economy today, but it also pioneered the implementation of limits on tax deferral by enacting the "Accumulated Earnings Tax" rules in 1921 (Avi-Yonah & Sartori, 2012:3). In 1937 the "Foreign personal holdings" rule was enacted, which deemed the income of foreign personal companies to be distributed to their U.S. shareholders by way of dividend declaration. The implementation of these rules was still not sufficient to stop the deferral of tax, as

these rules only applied to individuals. In reaction to these failures, the USA was the first country to adopt CFC legislation (or Subpart F, as it is called) in 1962. The rules primarily indicated that a CFC will exist where a US resident has at least 50% control over this foreign company. Each shareholder in the specific company must have at least a 10% share. After taking the exclusions and other legislation into account, the amount of income calculated for the CFC will be taxed in the USA (Avi-Yonah & Sartori, 2012:4).

Since its adoption of the CFC rules in 1962, several countries have also adopted CFC rules including Canada (in 1975), Japan (in 1978), France (in 1980) and China (in 2008). These countries are typically net capital exporters (Bush, 2006:132). It is therefore safe to make the statement that the USA set the trend and led the way in the field of implementing rules of addressing the tax deferral phenomenon. The UK incorporated CFC legislation in their Finance Act in 1984 (Wellens, 2006:1). It was significantly reviewed from 2007 to 2012, with the new CFC rules enacted in 2013. Since the UK led the way for European tax reform in the 1980s, the next section will focus on the UK CFC rules.

## **1.2 Literature review of the research area**

As mentioned in the introduction paragraph, a CFC regime is an attempt by a tax jurisdiction to avoid its corporate taxpayers from moving capital into mobile assets in offshore subsidiaries so that the income from those assets rolls up outside the specific tax jurisdiction. After abolishing the exchange controls in 1979, the UK was faced with this risk in that its resident companies would divert and accumulate their profits in low tax jurisdictions, or tax havens (Wellens, 2006:1). In reaction to this, the Inland Revenue proposed CFC legislation in 1981 which was introduced in the Finance Act in 1984.

Similar to the CFC rules implemented by the USA, the UK introduced the CFC rules to tax the artificial diversion of business profits. Similar to the rules enacted by the USA, the UK's CFC rules were aimed at non-resident companies of the UK, but controlled by a UK resident. Control was defined as a 51% interest in this non-resident company (Wellens, 2006:1). A further test was introduced that if this possible "CFC company" were taxed at a rate of 50% or less of the corresponding

UK tax, CFC legislation would apply (Wellens, 2006:2). The rate was subsequently increased to 75%. A few exclusions were incorporated in CFC legislation.

The above-mentioned rules reigned true for a quarter of a century. Her Majesty's Revenue and Customs were challenged to review the CFC rules in 2006 after the *Vodafone 2* and *Cadbury Schweppes* cases. Without going into too much detail about the *Cadbury Schweppes* case (case number C-196/04) (United Kingdom, 2006), the background is as follows: Cadbury Schweppes plc, a UK tax resident, incorporated two new entities in Ireland with the purpose of raising and providing finance for the Cadbury Schweppes group (*Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue*, 2006). Since the companies benefited from a lower tax rate in this jurisdiction, the Inland Revenue concluded that the main motive of the establishment of the two companies was to avoid being taxed in the UK. It was therefore concluded that the companies failed the motive test in the UK CFC legislation.

It was, however, held in the case that *"the mere fact that a resident company establishes a secondary establishment, such as a subsidiary, in another Member State cannot set up a general presumption of tax evasion and justify a measure which compromises the exercise of a fundamental freedom guaranteed by the Treaty."* (*Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue*, 2006)

The European Court of Justice further held (*Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue*, 2006) that the profits earned in a lower tax member state should only be considered for inclusion in the UK tax base if the intention of the taxpayers was solely to escape the higher national tax normally payable.

O'Shea (2007:18) summarizes the judgment of the European Court of Justice and stated that the CFC legislation implemented by the UK needed a radical overhaul. The "all or nothing" principle of the current UK legislation was questioned.

Devereux and Loretz (2011:21) reported that of the GBP 356 million which was payable during the ten year period 1999 to 2008, GBP 308 million was payable by multinational companies, of which GBP 149 million was payable by multinational companies who are owned by UK tax residents. With the significant portion of taxes paid to Inland Revenue by multinationals and with the Cadbury Schweppes case in mind, The Commissioner of Her Majesty’s Revenue and Customs had to reassess the application of the CFC legislation implemented in the UK to be more accommodating to its multinational companies.

After a period for drafting the new legislation was allowed, the new CFC rules came into effect in the UK for accounting periods beginning on and after 1 January 2013. A high level overview of the new legislation indicates that it exempts certain entities and streams of income. Keeping the Cadbury Schweppes case in mind, the statement can be made that each situation will be assessed on a case-by-case-basis, ensuring that normal trading companies formed outside the UK are not unfairly disadvantaged. The comment was made by Wright (2012:12) that the “all or nothing” regime has been replaced by rules focusing on certain types of profits.

Blick Rothenberg LLP (2013) compared the main exemptions available under the old and the new CFC rules in the following table:

<b>Exemptions</b>	<b>Old rules</b>	<b>New rules</b>
Motive test	Yes, but used sparingly	Not applicable
Temp exempt period exemption	12 months – via motive test	12 months – with conditions
Excluded territories	Yes, 90% local source income required	Yes, similar but excludes Singapore and has an IP condition
Low / de minimus profits	<= GBP 200k	<= GBP and non-trading income <= GBP50k
Low profit margin exemption	Not applicable	Profits <= 10% operating spend
Lower level of tax	75% UK rate	75% UK rate



Exempt activities test	Gross receipt < 50% from UK/group	Not applicable
Business profits	Not applicable	Depends on UK SPFs and conditions
Trading profits exclusion	Not applicable	<= 20% from UK of income/mgt/export to and no IP transferred from UK for six years
Gateway test	Not applicable	Need SPFs to be non-UK
Finance company partial exemption	Not applicable	25% of profits apportioned to UK

Table 1: Blick Rothenberg LLP comparison of old and new UK CFC rules

When reviewing the above-mentioned changes, it is evident that significant effort was made to move the CFC rules to legislation, taking into account the globalized arena in which multinational companies operate. In doing so, the Commissioner of Her Majesty's Revenue and Customs may just succeed in creating a competitive tax system for companies owned by UK residents. In turn, these changes may just attract more multinational companies to incorporate their head-quarters or holding companies in the UK, and by doing so, boost the British economy.

Gorringer (2010:1) reports that the CFC updates implemented by the UK will enhance its competitiveness, while still protecting the tax base. This statement is echoed by Robert Lee (2011).

### 1.3 Motivation of topic actuality

Following the trends set by the USA and the UK, the Republic of South Africa legislated its controlled foreign companies' rules in 1997 (Van Heerden 2009:151). Similar to that explained above, the legislation contained in section 9D of the Income Tax Act (58 of 1962) was introduced to protect South Africa's tax base.

Section 9D of the South African Income Tax Act (58 of 1962) (hereafter referred to as "the Act") contains similar elements to the CFC rules of the UK in that where a

South African tax resident holds more than 50% of either the participation or voting rights in any foreign company, the taxable income of this foreign entity, as calculated under the Act, will be included in the taxable income of the South African holding company. The section does provide exemptions, including the “lower level of tax” exemption where the CFC pays at least 75% of the taxes it would have been liable for should the company have been a South African tax resident as defined in the Act. The similarities between the CFC rules of the USA, the “old” rules of the UK and that of South Africa are evident from these few examples. Some professionals are of the opinion that the current section 9D is too complex with multiple aspects to be understood by the taxpayer (Hoosen, 2013). Definitions and terms in the section are at times difficult to apply and questions arise with regards to the applicability of section 9D(9A)(iv) with regards to outsourced development of intellectual property.

South Africa offers great opportunities to foreign investors. Not only does the country have an advantageous location, but the government is receptive to foreign investments (Big Media Publishers, 2013). The fact that it is the largest economy on the African continent and that its infrastructure is well-developed, South Africa is also foreign investors’ choice if they want to expand into Africa (Big Media Publishers, 2013). The statement can truly be made that South Africa is the gateway to Africa. In the 2012 - 2013 Global Competitiveness Report, South Africa was ranked as the 52<sup>nd</sup> most competitive country by the World Economic Forum (Schwab, 2012:13).

Amongst the factors considered by any foreign investor when investment opportunities in foreign countries are considered, are the political stability of the country, as well as the tax legislation and possible tax breaks available to foreign investors (Anon., 2013b). In the past South Africa could offer more political stability to potential investors who were looking to invest in Africa. However, with the rest of “dark Africa” becoming more peaceful and stable, investors might be tempted to overlook South Africa for investment purposes and rather invest in countries like Nigeria (Anon., 2012).

The question needs to be asked whether the CFC regime implemented in South Africa accommodates residents exploring investment opportunities on the African continent. This research is aimed at determining whether South Africa’s CFC

legislation is on par with that implemented in Europe, and more specifically in the UK. The question therefore is whether the South African CFC legislation is inviting to foreign investors who want to set up multinational holding companies in South Africa that fall outside the scope of “headquarter companies” in section 9I of the South African Income Tax Act (58 of 1962).

The question should also be raised whether the South African CFC legislation is empowering local companies to expand their horizons by allowing a favourable tax regime for investments abroad. Maswanganyi (2013:1) reports that R161 billion of the R814 billion tax collected for the 2012-13 financial year was from companies. With about 20% of revenue from taxes sourced from companies, it would be advisable to SARS to keep legislation relating to the taxation of companies relevant and up to date. The Minister of Finance, Pravin Gordhan, announced in his 2013/14 budget speech on 27 February 2013 that SARS will focus on multinational companies - with their operations based in South Africa - that are shifting their profits abroad (National Treasury, 2013). The question therefore should be whether updated CFC legislation, like that of the UK, might limit these occurrences yet still empower local companies and retain the South African tax base.

The UK moved from an “all or nothing” and almost “narrow” legislation to a CFC regime which considers various aspects of transactions and motives of taxpayers. This happened after the Cadbury Schweppes case where the UK was encouraged to move from a strict “motive” approach to the more multiple aspect legislation currently implemented. With this in mind, section 9D of the South African Income Tax Act (58 of 1962) will be analysed against the new UK CFC rules. It will be considered whether any of the factors that moved the UK to amend their CFC legislation holds true for the South African environment and which elements of the updated UK CFC regime may enhance South African legislation.

The USA levies income tax on a citizen basis (McKinnon, 2012:1), while the UK levies tax on a residence basis. Since the current practice in South Africa is to also levy income tax on a residence basis, legislation enforced in the UK will be more relevant to the South African legislation than that enacted in the USA. For this reason, together with the fact that the UK recently enacted significant amendments

to its CFC rules, the CFC legislation in section 9D of the South African Income Tax Act (58 of 1962) will be analysed in light of the recently enacted CFC legislation in the UK, rather than that of the USA.

## **2. Problem statement**

The research question posed in this study is:

Are there any aspects of the amended UK CFC legislation that could be incorporated in the South African CFC rules to be more accommodating to investors and still sufficiently protect the South African tax base?

## **3. Objectives**

In order to answer the research questions above, the following research objectives were formulated:

- 3.1 To determine what the factors and circumstances were that resulted in the revised CFC legislation in the UK (factors determined in Chapter 2).
- 3.2 To critically compare the CFC rules per section 9D of the South African Income Tax Act to the CFC legislation effective from 1 January 2013 in the UK (comparison performed in Chapter 3).
- 3.3 To identify elements of the new CFC legislation in the UK that might improve the current South African CFC regime (elements identified in Chapter 4).

## **4. Research method**

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

### ***4.1 Positivist or quantitative method***

This research method typically uses various forms of experiments and or surveys on a sample basis to obtain information relevant to the study. Variables are compared and the effect of the experiments is used to draw conclusions on a greater population (McKerchar, 2009). This research method might be subjected to statistical testing and the information gathered are most likely of a numerical nature (Hutchinson & Duncan, 2012),

Given the qualitative nature of the analysis of the provisions of the respective controlled foreign company regimes, it is concluded that this paradigm was not relevant or appropriate for the study.

#### ***4.2 Interpretive or qualitative method***

Unlike the quantitative research, qualitative research seeks to answer a question rather than prove or disprove a hypothesis (McKerchar, 2009). The researcher will perform his study by performing case studies, grounded theory research and analysis. As this is an interpretive research, the conclusion to the study will be highly influenced by the researcher's creativity and insights (McKerchar, 2009). It can be concluded that the qualitative method derives meaning in that researcher analyses the data to extract meaning and to develop a perception and an understanding (Hutchinson & Duncan, 2012).

The research will include the study of the UK CFC regime. The regime will be interpreted and that of South Africa analysed against these interpretations. As the interpretation will be influenced by the researcher's insights, the research will incorporate some elements of a qualitative or interpretive research. Since it was concluded that the quantitative research method would not be applicable due to the qualitative nature of the study, the specific qualitative research method applicable to this study will be considered next.

##### ***4.2.1 Legal research method***

Legal research can be divided in two broad traditions, i.e black-letter law and law in context (McConville & Chui, 2007:1). Black-letter law is also referred to as doctrinal research, while the other is referred to as non-doctrinal research. One method focuses on law itself, while the other focuses on the impact of legislation on social problems.

The objective of the research is to study the CFC regime of the UK, to compare that to the CFC rules enacted in South Africa and to identify areas where the South African CFC legislation can possibly be improved. The study will therefore focus on

the actual black-letter legislation of the UK and South Africa. It is therefore suggested that a doctrinal research method is followed.

Doctrinal research can further distinguish between hermeneutical research, which is interpretive research, and normative research that recommends how something ought to be done.

After analysing the UK CFC legislation and interpreting the changes, this will be set as the norm against which the South African legislation will be measured. The research conducted in the study was therefore normative doctrinal research.

## **5. Overview of the research**

The research conducted has been divided in the remainder of this document under the following chapters:

### **Chapter 2**

#### **The factors and circumstances that brought about the change in CFC legislation in the United Kingdom: an analysis**

The objective of this chapter is to gain an understanding of the factors that encouraged the revision of the CFC legislation in the UK. This analysis identifies factors that are discussed in Chapter 4 when considering whether similar changes should be enacted in the South African Income Tax Act.

### **Chapter 3**

#### **The CFC legislation enacted in the United Kingdom and section 9D of the South African Income Tax Act: a comparison**

The objective of this chapter is to compare the legislation enacted in the UK with effect 1 January 2013 to section 9D of the Income Tax Act of South Africa. This comparison identifies areas where the two pieces of legislation are significantly different as discussed in Chapter 4.

## **Chapter 4**

### **Elements in the United Kingdom CFC legislation that might enhance section 9D of the South African Income Tax Act: an evaluation**

The objective of this chapter is to evaluate the factors identified in Chapter 2, as well as the differences in legislation identified in Chapter 3 and then to come to the conclusion whether any of these might simplify or enhance the local South African CFC legislation.

## **Chapter 5**

### **Summary, conclusion and recommendations**

This chapter provides a summary of the findings of Chapters 2, 3 and 4 with regards to the differences and similarities in the CFC legislation of South Africa and the UK. A recommendation is provided about certain factors that should be considered to simplify South African CFC legislation.

## Chapter 2

### **An analysis of the factors and circumstances that brought about the change in CFC legislation in the United Kingdom**

#### **1. Introduction**

In 2007 Russia updated its derivative tax legislation (Kuznetsov & Sychev, 2008:28). The derivative legislation was initially updated in the early nineties. In the meantime the landscape relating to derivatives changed. New instruments were introduced in the market and the existing tax legislation did not provide clear guidance on the changing market. In February 2007 the legislation was amended to effectively tax derivatives and was described as a milestone in improving the derivative transaction environment. This is an example of tax becoming outdated if not amended, due to changes in the nature of businesses, the way businesses are managed and the manner in which corporate groups are structured. The risk will arise that unchanged and possible outdated CFC legislation will not effectively protect a country's tax base. It is therefore necessary to review relevant legislation regularly, and update where and when necessary.

CFC legislation was introduced in the UK in 1984. With the above example of the constant review of legislation in mind, this chapter will consider the factors contributing and convincing the UK government to update its CFC legislation. The three areas that will be explored will be the actions of multinationals in the UK, the influence of the European Union, as well as the *Cadbury-Schweppes* case. Before these areas will be considered, the CFC legislation effective before the 2013 updated legislation will be reviewed to obtain an understanding of the original CFC regime.

#### **2. Pre-2013 CFC regime in the United Kingdom**

In order to understand the changes enacted by the CFC legislation that came into effect on 1 January 2013, the previous CFC regime that governed companies in the UK needs to be considered. To obtain this understanding, the key elements relating to controlled foreign companies as embodied in the UK's Income and Corporations Taxes Act (1 of 1988) will be considered.



The Income and Corporations Taxes Act (hereafter referred to as “ICTA”) defined a “controlled foreign company” (referred to as a CFC) in section 747(1) to the ICTA as a company who is not a resident of the United Kingdom, is controlled by a resident in the UK and is subject to lower taxes in the tax jurisdiction where such a company is a resident. The three requirements of this definition will be considered next.

*a. The company is not a resident of the United Kingdom*

The ICTA did not define the term “resident” and therefore tax practices need to be considered. A company was considered to be a tax resident of the United Kingdom when the company was incorporated there (EIU, 2011). A company incorporated elsewhere could have been considered to be resident in the UK if the company’s place of central management and control were in the UK. The “place of central management and control” was considered to be there where the directors of a company exercise such management and control.

It is therefore concluded that if a company was incorporated or had its place of central management and control in the UK, it would be a tax resident of the UK. If these requirements were not met, the company would not be a resident and would have been referred to as a “foreign company”.

*b. The foreign company is controlled by a resident of the United Kingdom*

The ICTA did not require a single tax resident to control the foreign company. Control could have been exercised by multiple persons who had an interest in a company residing outside the UK (hereafter referred to as “foreign company”). Section 749(5) stipulated persons to have an interest in a foreign company if the person:

- Held share capital or voting rights in the foreign company or had the right to acquire such shares or voting rights.
- Had a right to participate in distributions made by such foreign company or had the right to acquire such rights.
- Was entitled to secure assets or income of the company directly or indirectly for his benefit.

- Who alone or together with others controlled the foreign company.

Section 416(2) of the ICTA defined the term “control” to mean any person holding the greater part of the share capital, issued shares or voting rights in the company. Since no definition was given for the term “greater part,” it is assumed that any company residing outside the UK will be a CFC as defined in the ICTA if 50% or more of such company’s voting rights or shares are held by tax residents of the UK.

The ICTA did not put any limitation on the number of resident companies to be considered when determining whether a foreign company was controlled in the UK. Therefore, if any number of companies resident in the UK in aggregate had more than a 50% interest in a foreign company, such a company would have been considered to be controlled in the UK.

*c. The foreign company is subject to lower taxes in its own jurisdiction*

Section 750(1) of the ICTA determined that a foreign company would have been considered to be subject to taxes lower than that of the UK when the taxes payable by the foreign company in its tax jurisdictions on its taxable income or profits was less than 50% of the taxes that would have been payable on the company’s taxable income or profits in the UK.

If the preceding three requirements were met and a foreign company was therefore deemed to be a controlled foreign company, all persons resident in the United Kingdom having an interest in such a company would have been taxed on its share of the foreign company’s chargeable or taxable profits for the specific accounting period. The amount to be included in the shareholder’s taxable income would have been its share of the foreign company’s chargeable profits less any tax creditable for the accounting period. Section 751(6) defined “creditable tax” to mean the aggregate of any amount of any non-refundable income and corporate taxes charged to the foreign company and any relief from corporate taxes provided by the ITCA. According to section 752(2) of the ICTA the chargeable profits would have been apportioned to the UK resident companies based on their percentage interest in the foreign company. The accounting period of the foreign company would commence on the date when UK residents obtain control of the foreign company and would end

when such control ceases to be exercised. The shareholder resident in the UK who had an interest of less than 10% in the foreign company was exempt from including its share of the CFC's chargeable profits in its own taxable income (section 747(5)).

Section 748 (1) of the ICTA stated that a foreign company would not have been considered to be a controlled foreign company when the chargeable profits of the company for a specific accounting period was less than £20,000 or the portion thereof for accounting periods less than a year. Section 748 (3) further exempted the chargeable profits of a controlled foreign company where the main reason for such a company's existence in the accounting period was not to divert profits to minimize tax obligations in the UK. Profit diversion was achieved when substantial profits earned by the controlled foreign company would have been attributable to a company resident in the UK if such a controlled foreign company did not exist. Three more exemptions existed and will be considered next.

*a. The foreign company has an acceptable dividend distribution policy*

Schedule 25 Part I of the ICTA held in paragraph 2 that a controlled foreign company would implement an acceptable dividend distribution policy when all the following requirements were met:

- Dividends declared from retained earnings were paid for the current accounting period.
- The dividends declared needed to be paid to the shareholder within eighteen months from the end of the accounting period to which such dividend related to.
- The dividend was paid when the foreign company was not a resident of the UK.
- The dividends declared should have represented at least 50% of the foreign company's available profits for the accounting period. If the controlled foreign company was not a trading company, 90% of the profits needed to be distributed.

*b. The foreign company is engaged in exempt activities*

Part II of Schedule 25 to the ICTA stated that a controlled foreign company would be engaged in exempt activities when all of the following requirements were met:

- The foreign company had a business establishment in the country where it was ordinarily a tax resident.
- The business affairs of such an establishment were effectively managed in the country where the foreign company was ordinarily a tax resident.
- Where:
  - The main business of the company was not that of investment or dealing in goods imported or exported from the UK or to and from a connected person, but that of wholesale or distribution less than 50% of its trading receipts was allowed to be from trading with connected persons; or
  - The company was a holding company who earned at least 90% of its gross income from companies resident in the same jurisdiction as the holding company and who were engaged in exempt activities themselves. Such a holding company was referred to in the Schedule as a “local holding company;” or
  - The company was a holding company who earned at least 90 per cent of its gross income from “local holding companies” or companies engaged in exempt activities.

All of the above requirements must have been met throughout the accounting period under consideration.

A “business establishment” referred to was defined in paragraph 7(1) of Schedule 25 of the ICTA to mean premises occupied and used with a reasonable degree of permanence from where the foreign company conducts its business in the country where it was tax resident. The “premises” mentioned included any office, shop, factory or building, a mine, an oil and gas well, a quarry or any building site where work or projects are carried out for a duration of at least twelve months. The premises needed to be staffed with a sufficient number of personnel employed by the foreign company in the country where it was a resident for tax purposes to

conduct its business. Services this foreign company rendered abroad may not have been performed by residents of the United Kingdom.

*c. The company fulfils the public quotation conditions.*

Paragraph 13(2) of Schedule 25 to the ICTA stated that the public quotation conditions would have been met when investors holding at least 35% of the voting rights in such foreign company had been allotted or acquired unconditionally and held beneficially by the public throughout the accounting period. Within twelve months from the end of such accounting period, these shares needed to be subject to dealings on a recognised stock exchange in the country where the foreign company was a tax resident during which time the shares needed to be quoted in the official list of such stock exchange.

The UK tax resident could therefore ignore its share of the controlled foreign company's chargeable income in any of the following circumstances:

- The foreign company declared at least 50% of its available profits to shareholders and paid these dividends within a period of eighteen months from the last date of the accounting period.
- The foreign company conducted its business through a business establishment controlled and managed in the country where the company was a resident for tax purposes. Certain restrictions applied to the business of this company which was discussed in detail.
- The shares of the foreign company were traded on a recognised stock exchange in the country of the company's tax residency. At least 35% of these shares were beneficially held by the public.
- The chargeable income of the foreign company was less than £20,000 or the relevant portion thereof for the accounting period.
- The controlled foreign company was not established with the main purpose to divert taxable profits away from the United Kingdom.

The rules discussed above remained substantially unchanged for almost twenty years (Deuchar & Steel, 2008:41). Some of the changes to CFC legislation included the "excluded countries" regulation in 1998. Controlled foreign companies resident in

specific territories as specified by UK tax authorities were exempt from being taxed in the UK when at least 90% of a controlled foreign company's commercial income was earned in the country where the company was resident for tax purposes (Davis, 2004). Another amendment to the original CFC legislation was the revision of the "lower tax level" in determining whether a company is a controlled foreign company. With reference to Table 1 reflecting the CFC exemptions prior to the implementation of the new regime in 2013, the rate was increased from 50% to 75% of the taxes that would have been payable on the company's taxable profits in the UK. The maximum chargeable profits of a controlled foreign company to be exempt from the CFC legislation were also revised. This ceiling was increased from £20,000 to £50,000 for any accounting period.

The original CFC legislation was considered in detail to obtain an understanding of the structure of the original legislation. With the background of the original CFC legislation enacted in the UK, criticism relating to this regime will be considered.

### **3. Multinationals in the United Kingdom**

According to the Prime Minister of the UK, Mr David Cameron, Britain has an open door policy which invites foreigners to invest there. An example of a foreign company investing in the UK is the Chinese Investment Corporation holding shares in Heathrow Airport and Thames Water Utilities Limited (Mehta, 2013).

The problem the UK experienced with their economy's doors being open to foreigners investing in Britain was that UK companies relocated from Britain to other tax jurisdictions as well. Several companies relocated from the UK due to their dissatisfaction with corporate taxes. These companies include Ineos, Shire, United Business Media, Charter, Henderson, Regus, Brit Insurance, Informa and WWP (Hammond & Gray, 2010). Two of the largest companies are Wolseley and Ineos who both relocated their tax residency to Switzerland (Shaheen, 2010:28). These two companies and some others are discussed below.

Wolseley is the world's largest supplier of plumbing and heating products and a leading supplier of building materials (Wolseley, 2013). The company announced in September 2010 that it would be relocating its tax residency from the UK to

Switzerland. The move was driven by the unfavourable CFC regime implemented in the UK. Wolseley, a company earning 81% of its revenues abroad was liable for tax in the UK on these earnings (Ruddick, 2010). If the company failed to prove that the motive for the existence of these foreign companies controlled by Wolseley was not purely to divert income from the UK to lower tax jurisdictions, Wolseley would have been liable for tax in the UK on its share of the profits of these controlled foreign companies. The decision to move was purely driven by management's dissatisfaction with the high tax rates applicable to the company (Ruddick, 2010). With the company relocating to Switzerland, Wolseley would not be taxed in the UK on the earnings of the company's foreign investments, but only on the income of its trading company incorporated in the UK as the group would not be resident in Great Britain any longer. Since Wolseley relocated from the UK due to what was considered unfavourable tax and CFC regimes, it is concluded that the CFC legislation did not succeed in its purpose of protecting the UK tax base.

The UK chemical production company, Ineos, confirmed in April 2010 that the company was to move its headquarters and tax residency from the UK to Lausanne, Switzerland. The company employs 15,500 people across 64 plants in 14 countries and generates 70% of its revenue outside the UK (Ineos, 2010). Similar to Wolseley described above, Ineos would be liable to UK tax on the revenue earned from its foreign investment companies due to the UK CFC legislation. Management expected that the company's improved financial performance and UK tax legislation would burden the company with significant levels of additional tax being payable (Shaheen, 2010:28). Switzerland was the preferred residence of the company due to more favourable tax legislation than that of the UK and also to compete with leading Swiss chemical companies (Mathiason, 2010). Yet again, the UK CFC legislation did not safeguard the UK tax base.

United Business Media (hereafter referred to as "UBM") was incorporated in 1918 and is a global events, marketing and communications services business (UBM, 2013). The company's operations span into Asia and it earns 85% of its revenue from outside the UK. It was announced that the company's relocation from the United Kingdom was to escape what they considered the complexities of the UK controlled foreign company tax regime (Edgecliffe-Johnson, 2008). Since the UK

imposes tax on all companies in a worldwide group, UBM experienced difficulty in managing the interactions between the UK and other countries where the company operated from (Edgecliffe-Johnson, 2008).

Charter Engineering Group and Henderson Global Investors moved their tax domiciles to Ireland. The relatively high UK corporate tax rate and the regime of the UK taxing companies on foreign subsidiary profits without their profits being submitted to the UK were submitted as the factors encouraging the companies to leave the country (Kollewe, 2008). These companies could therefore not claim an exemption in terms of the “acceptable dividend distribution” exemption and was taxed on the income earned by the foreign companies they controlled.

From the discussion it appears that taxpayers who relocated their tax domicile from the United Kingdom from 2008 to 2010 was driven to do so due to the following issues experienced by the taxpayers:

1. The complexity of the CFC legislation implemented by the UK.
2. The regime of taxing foreign companies in the UK due to their shareholders being resident there.
3. A relatively high corporate tax rate when compared to that of other European companies.

South Africa is no stranger to the relocation of its tax residents. In the case of Tradehold Limited (Commissioner for the South African Revenue Services v Tradehold Limited, 2012), the company changed its tax domicile to Luxembourg. Like Great Britain it will therefore be worthwhile for National Treasury to reassess the current income tax policy to make sure that it is accommodating to taxpayers but still protect the tax base.

It was, however, not only the actions of the UK corporate taxpayers that influenced its decision to overhaul the CFC regime. As a member of the European Union, Great Britain has to adhere to the requirements and objectives of this body. The European Union itself disapproved of the CFC regime of the UK, which will be considered next.



#### **4. European Union require United Kingdom to update CFC legislation**

The European Union (hereafter referred to as the “EU”) is an economic and political partnership created between 28 European countries after the Second World War (European Union, 2013b). The countries trade with one another in an effort to avoid conflict and building political and economic bonds amongst themselves. The UK joined the EU in 1973 (European Union, 2013a).

In a press release on 23 May 2001 the EU announced their objective to make the EU the most competitive economy in the world by 2010 (European Union, 2001). It was predicted that increased tax co-ordination would assist the members of the EU to achieve this objective. The EU, however, was of the opinion that the UK was not fulfilling EU Treaty obligations (Lee, 2011). With not all the member states complying with the treaty obligations, the EU was at risk of not achieving the objectives set.

With its CFC regime, as it was at that time, the UK would tax the profits of foreign subsidiaries of companies resident in Great Britain. These subsidiaries were resident in both the countries who are members of the European Union and elsewhere. This action was, however, condemned by the European Union as under the EU law the profits received by a parent company (who was resident in the EU) from a subsidiary (resident in another EU state and subject to tax there) might not be taxed in the country of the parent’s residency as well (Lee, 2001). The only instance where such taxation would have been allowed was when such a foreign subsidiary existed to shift profits from one state to another. The risk identified was that the UK might, however, tax the profits of subsidiaries resident in the EU member states whose existence could be justified as not aiming to shift profits.

The biggest critique that the EU had against the CFC regime as implemented by the UK was that the motive test incorporated in the CFC legislation was failing in its purpose. In applying this motive test, the United Kingdom tax authorities considered the activities of the foreign companies as a whole when determining whether the CFC rules apply (Deuchar & Steel, 2008:41). This approach is referred to as the “entity-based approach.” The application of the motive test was considered to be subject to uncertainties which could only be clarified with the implementation of

clearer and more objective criteria to identify those instances where foreign subsidiaries had been established with the sole purpose of diverting profits away from the UK (Paszczka, 2011:76).

The European Union's disapproval of the UK CFC regime and specifically the so-called "motive test" was most clearly demonstrated in the *Cadbury Schweppes* case which will be discussed next.

## **5. The Cadbury Schweppes case**

The *Cadbury Schweppes* case (case number C-196/04) is considered to be the landmark case that encouraged the UK to update its CFC legislation (Lee, 2001). The facts and ruling of the European Court of Justice will be considered next (*Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue*, 2006).

Cadbury Schweppes plc is a tax resident in the UK and the holding company of the Cadbury Schweppes group of companies. The subsidiaries in which Cadbury Schweppes plc holds interests are established in the UK, other members of the European Union as well as elsewhere. The group terminated its treasury company situated in Jersey and established Cadbury Schweppes Treasury Services and Cadbury Schweppes Treasury International in Dublin, the capital city of the Republic of Ireland. Cadbury Schweppes Overseas Ltd, which is also a tax resident in the UK and a subsidiary of Cadbury Schweppes plc, was the intermediary holding company of these two new companies. Ireland is a member of the European Union and joined in 1973 (European Union, 2013a). These companies were created to replace the Jersey company in order to accommodate Canadian tax resident shareholders, to enter into international loan transactions without the consent of the UK tax authorities and to reduce withholding tax payable on dividends declared within the Cadbury Schweppes group.

Cadbury Schweppes Treasury Services and Cadbury Schweppes Treasury International were established as the Cadbury Schweppes group's treasury companies that raised finance to be provided to the companies in the Cadbury Schweppes group. As companies established in Ireland and therefore tax residents

there, these companies were subject to a corporate tax rate of 10% in Ireland when compared to the corporate tax rates experienced by companies in the UK during the 1990s of well over 30% (HMRC, 2013h). As these companies were controlled indirectly by Cadbury Schweppes plc, it was concluded that these companies were controlled foreign companies of a UK tax resident. With the companies' sole purpose to provide finance to its fellow subsidiaries, the "exempt activity" exemption could not be applied, since more than 50% of its income was earned from transactions with connected parties. It was, however, the "motive test" that was put forward by the Commissioner of Inland Revenue to motivate the taxing of Cadbury Schweppes Overseas Ltd on the chargeable profits of Cadbury Schweppes Treasury Services and Cadbury Schweppes Treasury International.

As stated earlier, Cadbury Schweppes Treasury Services and Cadbury Schweppes Treasury International were subjected to a tax rate of 10% in Ireland. This rate was therefore less than 75% of the tax rate these companies would have been subject to had they been residents of the UK. The Commissioner of Inland Revenue therefore concluded that Cadbury Schweppes group established these two companies in this "low tax jurisdiction" with the sole purpose to avoid paying tax in the UK. The Commissioner therefore taxed Cadbury Schweppes Overseas Ltd under the CFC legislation on the chargeable profits of Cadbury Schweppes Treasury Services for its financial year ending 28 December 1996. Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd appealed against the notice of taxation to the Special Commissioner of Income Tax in London. The companies maintained that being taxed in such a manner is contradictory to the European Community's articles which allow residents of members of the European Union to establish their businesses freely within the European Union. The Special Commissioner of Income Tax referred this matter to the European Court of Justice.

The European Court of Justice (Grand Chamber) held that it was the prerogative of a company to exercise the freedom of establishment under the European Community's articles and establish its business in any of the member states of the European Union. If such a state had a lower tax rate than that of the holding company, it would not necessarily imply that the company had the motive to divert profits from the country of residence of the holding company. The court condemned the "entity

approach” applied by the Commissioner of Inland Revenue to conclude that Cadbury Schweppes had the motive to divert profits from the UK to a lower tax jurisdiction. The court further held that as the companies were trading in Ireland and not dormant offices where profits earned in the UK were transferred to pay tax at a lower rate, Cadbury Schweppes complied with the “freedom of establishment” requirements in that subsidiaries were established in other member states to the European Union which would advantage the economic and social interactions within the EU. The court described the imposing of UK tax in these circumstances as disadvantaging the taxpayer in that the UK resident holding company was taxed on the legitimate trading profits of a subsidiary established abroad. The court finally held that the Commissioner of Inland Revenue should not only have considered the subjective elements to draw the conclusion that Cadbury Schweppes were diverting profits from the UK, but should also have considered objective circumstances supporting the objective or motive of the company. On the grounds of those findings the court criticized the motive test included in the UK CFC legislation in that the test did not include objective factors which could easily be considered by third parties to assess the true motive of the taxpayer.

## **5. Summary and conclusion**

In this chapter the original CFC legislation implemented in the UK was considered, as well as the reaction from taxpayers, the European Union and European Court of Justice on this legislation. It was evident that multinational holding companies resident in the UK relocated elsewhere between 2008 and 2010, mainly due to them being taxed on the profits of controlled subsidiaries established abroad. In the light of the *Cadbury Schweppes* case, the Commissioner of Inland Revenue applied the “motive test” very subjectively which would have resulted in resident holding companies being taxed on legitimate trading profits of foreign subsidiaries. The “motive test” therefore lacked objectivity, which caused residents to be taxed on the profits of their subsidiaries.

Section 9D of the South African Income Tax Act (58 of 1962) exempts the income earned by a CFC’s foreign business establishment from the net income charge. In determining whether such foreign business establishment exists, it needs to be proven that its place of business is not outside the Republic to avoid South African

tax obligations. The motive of the foreign business establishment's existence in such foreign country therefore needs to be considered. As the section does not provide any guidance on how to determine this motive, it can be concluded that it is a subjective test that may result in valid trading profits being taxed. As the South African legislation is faced with a similar pitfall as the UK CFC legislation enacted in 1984, a consideration and analysis of the CFC legislation enacted on 1 January 2013 is justified. This consideration of the new UK CFC legislation and analysis of the South African CFC regime against this legislation will be considered next.

## **Chapter 3**

### **A comparison of the CFC legislation enacted in the United Kingdom and section 9D of the South African Income Tax Act**

#### **1. Introduction**

It was identified in the previous chapter that the CFC regime in the United Kingdom was not achieving the set purpose of the legislation in protecting the UK tax base, but was rather incorrectly taxing valid trading income in some areas. As such, the UK government was determined to overhaul the legislation to arrive at a more dynamic, effective and relevant legislation.

With corporate tax avoidance being high on the priority list worldwide, the Organisation for Economic Co-operation and Development (OECD) was charged with the task of developing policies to address these tax loopholes, especially arrangements where profits are shifted to lower tax jurisdictions (Heller & Bergin, 2013). The need for these policies originates from international technology companies, such as Amazon, Apple and Google that used tax loopholes to divert significant profits to tax havens and in some instances to avoid creating residency in a specific tax jurisdiction (Reuters, 2013). On request of the G20 the OECD produced an action plan to prevent double non-taxation to be rolled out over the next two years (OECD, 2013). The fifteen action points seek to address the tax challenges of the digital economy, strengthen CFC rules, prevent treaty abuse and establish policies to collect and analyse data to identify profit shifting issues and to address these promptly (OECD, 2013). Even though the OECD proposed changes will not be considered specifically in this study, the fact that changes were proposed reiterate the importance of reviewing and updating legislation regularly – in this instance the CFC legislation of a tax jurisdiction.

Keeping the pitfalls identified in the previous chapter in mind, the new CFC legislation effective in the UK from 1 January 2013 will be considered, followed by an analysis of section 9D of the South African Income Tax Act (58 of 1962) against the updated UK CFC rules.

## **2. United Kingdom CFC legislation effective from 1 January 2013**

After a period of consulting, drafting and redrafting of almost six years, the updated CFC legislation was enacted in the Finance Act (14 of 2012) with effect from 1 January 2013. Schedule 20 of the Finance Act 2012 (14 of 2012), which contains the revised controlled foreign company regime, is discussed in this section.

The “simplistic” but proven subjective motive test was removed as the main determining factor of taxable CFC profit and replaced with the so-called “CFC gateway”. According to section 371AA (3) of schedule 20 of the Finance Act (14 of 2012), a CFC is still defined as a “non-UK resident company which is controlled by a UK resident person or persons.”

Chapter 18 of schedule 20 of the Finance Act 2012 (14 of 2012) establishes that a person will control a foreign company when such a person will be able to ensure that the affairs of such a foreign company will be conducted as per the investor’s wishes. The section goes further to state that it will be reasonable to suppose that a resident controls a foreign company when such investor will be entitled to over 50% of the company’s distribution. This is legal control. The section also states that a foreign company will also be deemed to be controlled when a parent/subsidiary relationship exists between the UK holding company and the foreign subsidiary. This relationship will exist when the UK resident company is entitled to at least 50% of the CFC’s chargeable profits. If the CFC only has two shareholders, one a UK resident and the other not, the CFC will be considered to be controlled by the UK resident if the resident holds at least 40% of the shares in the CFC, with the non-UK resident holding between 40 and 55% (section 371RC(3) and 371RC(4)).

The controlled foreign company’s taxable income will be determined from the profits that pass through the CFC gateway. The method in determining the taxable income of the CFC can be demonstrated in diagram 1, based on a diagram prepared by KPMG (2013), with additional information included:

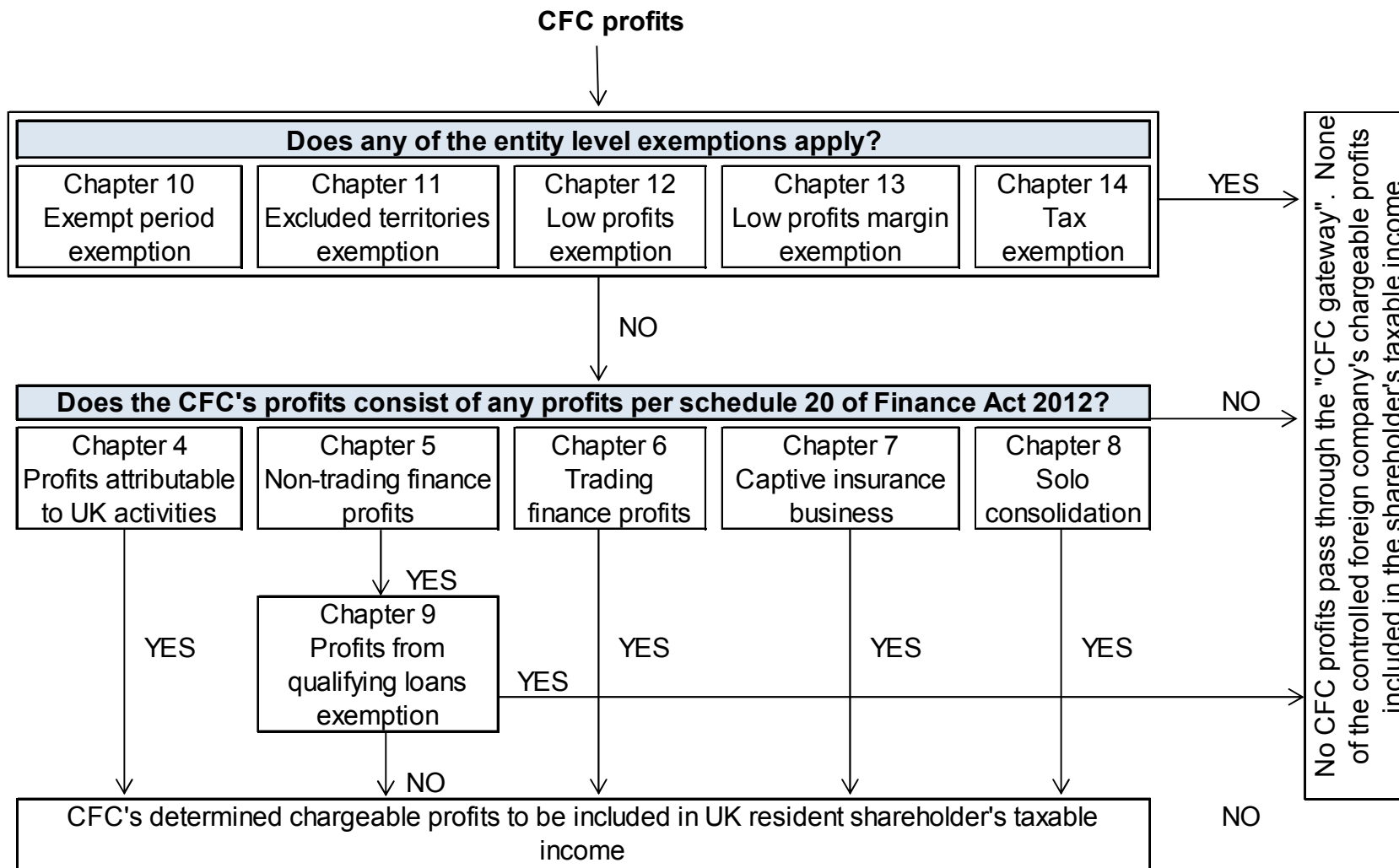


Diagram 1: UK CFC rules enacted on 1 January 2013



The above CFC gateway was designed with the goal to target those profits of foreign subsidiaries diverted from the UK to lower tax jurisdictions (Baker Tilly UK Audit LLP, 2013). The gateway test is however considered to be complex and still involves applying some subjective tests (KPMG LLP, 2013).

The chapters from the UK CFC rules mentioned above will be considered next.

## **2.1 Entity level exemptions**

### **2.1.1 Exempt period exemption (Chapter 10)**

Where a company is subject to CFC charge, the exempt period exemption can be claimed when all the following conditions are met:

- The CFC must be carrying on a business and be a CFC at the time when the exempt period commences.
- The CFC must remain a CFC for at least one accounting period after the exempt period exemption was claimed.

This exemption is aimed to allow the new CFC time to organise and restructure its activities in such a manner to avoid a CFC charge from arising (HMRC, 2013f:1). This is therefore a conscious effort by the UK government to afford residents the opportunity to arrange their affairs in such a manner not to be subjected to tax in a jurisdiction where no income is derived from.

The exempt period will be valid for a period of twelve months and the claim is subject to the anti-avoidance rules stipulated in section 371JF. This section states that the exempt period exemption will not be allowed should the CFC earn non-trading or trading finance profits or income from intellectual property from an arrangement that provides a tax advantage to any person and the arrangement was entered into with the goal to obtain the exempt period exemption for the current or another period. Similarly, where an arrangement entered into results in the accounting period of the CFC being less than twelve months with the main purpose of such an arrangement being to benefit from the exempt period exemption, such an exemption will not be allowed.

### **2.1.2 Excluded territories exemption (Chapter 11)**

Where the CFC is liable for tax in a country or jurisdiction outside the UK, the following sources of income will be exempt so far as it is not more than the lesser of 10% of the CFC's accounting profits or £50,000:

- Income included in the CFC's gross income which is exempt or subject to a lower tax rate in its country of residence by virtue of the provisions of the laws of that territory with the goal to encourage investment in the CFC's resident country.
- Any notional interests or debt charges calculated on the CFC's debt or equity which is exempt from taxation in the CFC's tax jurisdiction.
- Amounts accruing to a trust of which the CFC is a settlor or a beneficiary or its share of income earned from a partnership.
- Income earned by the CFC from an arrangement with a connected party which is reduced for tax purposes in the CFC's tax jurisdiction.

The list includes countries that have a tax rate of at least 75% of the UK rate (Buzzacott, 2013).

If the income is earned from intellectual property derived in the United Kingdom, such property may not have been transferred to the CFC that would have resulted in the value of the transferor decreasing and the profits of the CFC to increase. This exercise would cause the profits taxable in the UK to be shifted abroad and will therefore not be exempted.

If the CFC is at any time during the accounting period involved in activities or arrangement with the main purpose of obtaining a tax advantage, none of the income streams mentioned above will qualify for the exempt territory exemption. A tax advantage is defined in section 1139 of the Corporation Tax Act (4 of 2010) as any relief from tax, any repayment of tax, the avoidance of a tax charge or the avoidance of the possible assessment of tax. Since there are no specific guidelines provided on how to determine when the main purpose of an agreement is to obtain a tax advantage, it will still be a subjective test to determine such goal.

### **2.1.3 Low profit exemption (Chapter 12)**

The low profit exemption is designed to exclude CFCs that pose a low risk to the UK tax base (Joscelyne & Wentworth-May, 2012). The exemption will apply in the following two instances:

- Where the accounting or taxable profits of the CFC are less than or equal to £50,000.
- Where the accounting or taxable profits of the CFC are not more than £500,000 of which no more than £50,000 is made up of non-trading income.

This exemption will, however, not be allowed if the CFC entered into an arrangement with the main purpose to obtain the low profit exemption in the current or another accounting period. The exemption will also not apply if a resident of the UK personally renders services on behalf of the CFC as part of an agreement between the client and the CFC.

### **2.1.4 Low profit margin exemption (Chapter 13)**

The profits earned by the CFC will be exempt if these profits are less than 10% of the CFC's operating expenses. The purpose of this exemption is to exclude those CFCs that perform low value added functions outside Great Britain (HMRC, 2013g:1), such as back-office functions. These expenses need to be incurred by the CFC in carrying on its business and excludes expenses incurred with regards to generating income for connected persons, or generating income outside the CFC's country of residence.

Similar to the "low profit exemption," this exemption will not apply if the CFC entered into an arrangement with the main purpose of obtaining the low profit margin exemption in the current or another accounting period.

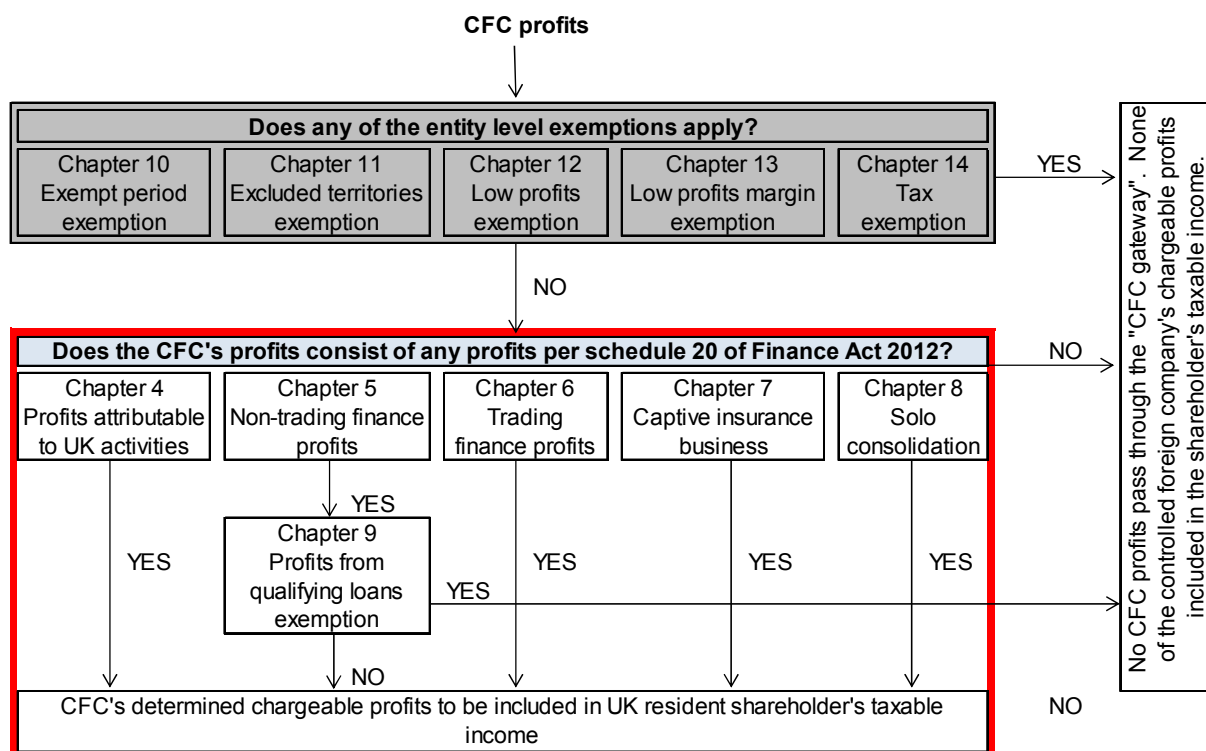
### **2.1.5 Tax exemption (Chapter 14)**

The final exemption allowed by schedule 20 and retained from the original CFC regime is the tax exemption, or "high tax exemption" as it was known. If the tax payable in the CFC's tax jurisdiction is 75% or more of the tax that would have been payable to Her Majesty's Revenue and Customs had the company been a resident

of the United Kingdom, the taxable profits of the CFC will be exempt from tax in the United Kingdom.

## 2.2 Possible profit shifting activities

If the company cannot make use of any of the above-mentioned entity level exemptions, the income streams of the entity have to be measured against the different gateway tests to determine whether any of the income might be shifting profits from the UK, and hence pass through the gateway to be subject to the CFC rules. With reference to the diagram under section 2, the entity level exemptions have been discussed. The next part of this chapter will focus on the possible profits shifting rules subjecting the CFC's income to tax in the UK as identified in the diagram below.



### 2.2.1 Profits attributable to United Kingdom activities (Chapter 4)

The profits attributable to the controlled foreign company under this section of the new legislation will be limited to those profits excluding non-trading finance and property business profits. It will only be considered that any of the CFC's trading profits can be attributed to activities in the UK when any of the following conditions are met (section 371CA):

- If the CFC holds assets or bears risks under an arrangement, one of the main objectives of this arrangement should be to reduce any tax liability of any person as imposed by UK tax legislation and as a consequence results in the CFC being more profitable due to the tax saving.
- If an arrangement as mentioned above reduces any person's tax liability in another jurisdiction and the arrangement exists solely for that purpose. The identification of the above-mentioned arrangements will assist in identifying those arrangements established purely to obtain a tax benefit (HMRC, 2013i:4). If these arrangements are concluded between connected persons, the terms and structure of such arrangements should be at arm's length.
- If the CFC has assets or risks managed by a UK tax resident. If the CFC has assets or risks managed by a UK tax resident, the CFC must have the ability to commercially manage the business effectively at any time when such a UK tax resident ceases to manage those assets and risks

The above-mentioned conditions were put in place to bring profits that are likely to be diverted from the UK into the scope of the CFC charge (HMRC, 2013i:2). With transfer pricing legislation being the primary defence against inappropriate diversion of profits within a group of companies ensuring that the transactions are correctly priced, the conditions above focus on identifying activities that would lead to inappropriate allocation of profits away from the UK (HMRC, 2013i:2).

The profit governed by Chapter 4 of schedule 20 is determined for the CFC group. A CFC group is defined in the chapter to mean "the CFC taken together with the companies with which it is connected." To the extent that the profits of the controlled foreign company is attributable to assets and risks managed in the UK, the profits will be taxable in the UK to the extent that these profits are not attributable to a permanent establishment of the CFC in the UK. This exclusion is therefore allowed if the UK activities of the CFC are a minor part of its total activities. If the net economic value of the CFC group exceeds the value had the assets and risks been held solely by a UK connected company, the profit determined under Chapter 4 can be disregarded for UK tax purposes. Section 371DD(3) states that the net economic value "does not include any value which derives (directly or indirectly) from the

reduction or elimination of any liability of any person to tax or duty imposed under the law of any territory outside the United Kingdom.” In its commentary on Chapter 4, Her Majesty’s Revenue and Customs (2013i:11) states that the net economic value of an asset will include the income earned from this asset and the increase in its market value reduced by expenditure incurred to generate such value excluding value derived from tax imposed outside of the United Kingdom. What this implies is that the value of the company should be considered excluding any reduced tax liabilities in foreign jurisdictions, therefore making the value determined more comparable to the value had the company been a tax resident in the UK.

The trading profits of a CFC can further be excluded from being taxed in the UK if the following conditions are met:

- The CFC was permanently trading in its own non-UK tax jurisdiction for the entire accounting period at a shop, office, building, factory, mine, quarry, gas well, building site or other premises, as defined in section 371DG(3), from where its activities are mainly carried on.
- Not more than 20% of the CFC’s trading profits are derived from UK residents or UK permanent establishments of foreign companies. The intention here is to make the exclusion available only to those CFCs earning a small portion of their income from Great Britain (HMRC, 2013j:16). Larger UK income portions are indicative of significant levels of operation in the UK which might necessitate raising taxes on the income sourced in Great Britain. If the CFC’s main business is banking business as defined in its local tax jurisdiction, the allowable trading income rate will be reduced to 10%.
- No more than 20% of the management employment or hiring expenses of the CFC may be attributable to members of management performing their duties in the UK. In its commentary to Chapter 4, Her Majesty’s Revenue and Customs does not mention that these members of management need to be residents in the UK, but merely that their management activities need to be undertaken in Great Britain (HMRC, 2013j:14).
- If the trading profits of the CFC includes income from intellectual property (hereafter referred to as “IP”), these profits will only be disregarded to the extent that the IP was not transferred by a UK tax resident to the CFC, with

the result that the value of and the tax payable by the UK tax resident is significantly reduced. This provision is aimed at those instances where IP has been transferred to a CFC outside the UK, but is still effectively managed from Great Britain (Buzzacott, 2012).

- No more than 20% of the CFC's trading income may be attributable to exports from the UK. The intent of this condition is to limit the extent to which the CFC can generate income by exporting goods from the UK. The logic applied in developing the legislation was that when a significant portion of the CFC's income is derived from goods exported from the UK, it is likely that these income streams are supported by significant business activities situated in the UK (HMRC, 2013j:16). Such significant activities will therefore still be subject to taxation in the UK. All goods exported from the UK to the jurisdiction where the CFC is a resident should be disregarded in determining the ratio.

Chapter 4 of schedule 20 of the Finance Act (14 of 2012) therefore provides sufficient allowance to exclude valid trading activities from the UK tax net.

### ***2.2.2 Non-trading finance profits (Chapter 5)***

Trading finance profits arise from the investment of funds held by the CFC for the purposes of the CFC's trade. The income can also be derived from funds invested by the CFC in UK property businesses or overseas property businesses carried on by the controlled foreign company. Section 297(1) of the Corporation Tax Act (4 of 2009) states that Part 5 of the same act relates to the trading profits from loan relationships of the taxpayer for purposes of trade carried on. Sections 297(2) and 297(3) of the Corporation Tax Act (4 of 2009) determine the trading finance profit as the receipts from this trade less expenses deducted. Section 301(1) of the same act continues to define non-trading finance profits as those profits not falling into the scope of sections 297(2) and 297(3), therefore being profits not from the companies' trade. It can therefore be concluded that non-trading finance profits are derived from passive investments held for financing capital expansion, dividend distributions and other contingencies. These profits will be subject to taxation in the UK in the following instances:

- The non-trading finance profits will be taxed in the UK to the extent that they were derived from activities carried out in the UK.
- If the non-trading finance profits arise from an arrangement between the CFC and a UK resident or UK permanent establishment and the arrangement was made as an alternative to the CFC distributing dividends with the main purpose to divert tax liability, these profits will be taxed in the UK. This criterion was included to identify those instances where the foreign subsidiary would grant a loan to its UK resident shareholder instead of distributing a dividend to avoid possible withholding tax on the dividend (HMRC, 2013a:11).
- If the non-trading finance profits arise from a lease between the CFC and a UK resident or UK permanent establishment as an alternative to the company purchasing such assets with the main purpose of the lease being to divert tax liabilities, these non-trading profits will be subject to taxation in the UK.

The non-trading finance profits of the CFC, as referred to above, can be disregarded when the non-trading finance profits of the CFC are no more than 5% of its total trading profits and one or both of the following conditions are met:

- If a significant portion of the CFC's business is the holding of shares or securities in companies, it must hold at least 51% of the shares in each of those companies.
- The CFC holding company must earn trading profits or property business profits. Section 205 of the Corporation Tax Act (4 of 2009) describes a property business to consist of every business carried on by a company to generate income from land.

The exclusions mentioned above therefore exclude the incidental non-trading finance profits from the CFC charge subject to the CFC also being engaged in trading activities.

From the above it is evident that this chapter only intends to include artificial arrangements and non-trading finance profits earned in the UK in the UK tax base.



### **2.2.3 Trading finance profits (Chapter 6)**

Chapter 6 will be applicable to the extent that the CFC earns trading finance profits and holds funds or other assets derived from UK connected capital contributions. Section 371VA of the Finance Act (14 of 2012) defines UK connected capital contributions as “any capital contribution to the CFC made (directly or indirectly) by a UK resident company connected with the CFC (whether in relation to the issue of shares in the CFC or otherwise).” These trading finance profits will be treated as non-trading finance profits to the extent that the CFC performs a group treasury function and elects for the profits to be treated as such by informing an officer at Her Majesty’s Revenue and Customs. By electing its finance profits to be treated as non-trading finance profits, the group treasury company may qualify for the qualifying loan exemption discussed in Chapter 9 of schedule 20 (Blick Rothenberg LLP, 2013) and later in this chapter.

The excess funding available to the CFC due to being a 51% subsidiary needs to be determined. This will be achieved by determining the funding that would have been available to the CFC had it not been such a subsidiary of any company and deduct the result from the company’s actual capital funding available. By using this test Her Majesty’s Revenue and Customs determines the extent to which a CFC retains its free capital due to being controlled by another company rather than for commercial reasons (HMRC, 2013b:3). The trading finance income attributable to this excess funding will be determined and will be subject to tax as discussed in Chapter 6 of the Finance Act (14 of 2012). As per sections 371FD and 371FE, Her Majesty’s Revenue and Customs may issue regulations which will exempt the trading profits of banking and insurance businesses.

### **2.2.4 Captive insurance business (Chapter 7)**

If the main business of the CFC is that of insurance and such insurance contracts are entered into between the CFC and connected UK resident persons or permanent establishments in the UK of persons connected to the CFC, or is entered into with a non-connected UK resident but linked to services rendered by the mentioned connected persons of the CFC, such income will pass through the CFC gateway.

### **2.2.5 Solo consolidation (Chapter 8)**

The profits of the CFC will be taxable in the UK to the extent that the CFC is a subsidiary of a UK resident company and subject to a solo consolidation waiver in terms of the Financial Services Authority handbook. According to section BIPRU 2.1.3 of the FCA Handbook (FCA, 2007), a banking firm is not allowed to incorporate the assets and liabilities of any subsidiaries in calculating the firm's own capital and requirements. Should the firm wish to include any of its subsidiaries in such calculations, it needs to apply for a solo consolidation waiver which will allow the UK resident bank to treat the CFC as a division of the bank. The UK resident bank will have a strong incentive to invest capital in CFCs resident in lower tax jurisdictions where these CFCs will undertake banking activities without any borrowing costs and report significant profits (HMRC, 2013j:1). The resident bank will most likely incur all borrowing cost for itself as well as the CFC and would wish to perform a solo consolidation to only report the UK resident's reduced profits. By specifically including this provision, the UK government is once again focusing on those instances where UK residents will be diverting UK profits to lower tax jurisdictions. If the CFC is controlled by a UK resident bank and one of the main reasons of the bank holding the mentioned shares is to obtain a tax advantage, such profits will also pass through the CFC gateway.

### **2.2.6 Qualifying loan relationships (Chapter 9)**

If a CFC earns non-trading finance profits as discussed earlier, these profits may be exempt to the extent that a qualifying loan relationship exists. A "qualifying loan relationship" will exist where the ultimate debtor to the relationship is connected to the CFC and controlled by the CFC's shareholders or any other resident of the UK. Section 32(1) of the Corporation Tax Act (4 of 2009) does not allow the deduction of finance costs incurred by a permanent establishment to another non-UK resident company when determining its chargeable profits. The Income and Corporation Taxes Act (1 of 1988) states in schedule 24 that a controlled foreign company will be deemed to be a resident of the UK when determining its chargeable income. As finance expenses incurred for business purposes will be deductible when a UK resident determines its taxable income, it is concluded that the CFC will be able to deduct interest expenses incurred when determining its chargeable profits. Where one CFC (for illustration referred to as "FinCo") advances a loan to another CFC (for

illustration referred to as “Debtor”), FinCo will be able to apply the Chapter 9 exemption on interest from Debtor while Debtor will still be allowed the interest paid to FinCo as a deduction when determining its own chargeable profits. Debtor’s financing expense will only be disallowed under section 32(1), should Debtor be a permanent establishment in the United Kingdom.

The qualifying loan relationship will however not exist if the ultimate debtor is not a resident of the UK, but whose profits are still taken into account due to the debtor being a foreign company’s permanent establishment in the UK, or where the debtor is a UK property business. These loans ought to be funded by the CFC’s profits from its moneylending business to members of the CFC group or from assets received from the shares it holds in the members to the CFC group. This is referred to in section 371IB(6) as loans from “qualifying resources.” If a loan is therefore funded from qualifying resources, it will be funded from the CFC’s own assets without demanding group resources outside the CFC’s tax jurisdiction (HMRC, 2013e:15). Again this excludes the loans being funded from resources in the UK avoiding those instances where funds are diverted abroad. The exemption will therefore only apply when a qualifying loan relationship exists and the loan is granted from qualifying resources.

Should the company claiming this exemption not specify a percentage of the profits to be exempt, section 371ID will exempt only 75% of the profits from the qualifying loan relationship. If a portion of the profits could not be claimed under section 371IB (qualifying resources) or section 371 ID (75% exemption), the profits of a qualifying loan relationship will still be exempt to the extent that the income and expenses relating to those profits do not arise from UK banking or insurance businesses.

Blick Rothenberg LLP (2013) stated that the qualifying loan relationship profit exemption provides an opportunity for UK group companies to form finance companies to finance overseas operations and to grow the group internationally.

### **2.3 Summary**

The income amounts determined under Chapters 4 to 8 of schedule 20 of the Finance Act 2012 (14 of 2012), less the exemptions allowed in Chapters 9 to 14 of the same act, will be apportioned to all investors and included in their taxable income based on their percentage shareholding in the controlled foreign company. This income will only be included in the profits of the investor if such a person is a resident in the UK and more than 25% of the CFC's profits are attributable to the specific shareholder.

From the discussion in the chapter this far, it is apparent that the CFC legislation enacted in the UK with effect from 1 January 2013 focuses on income earned by a CFC from a source in Great Britain. Valid trading and financing activities are exempt, but artificial arrangements to benefit from such arrangements targeted. According to Wright (2012:12) the all-or-nothing regime has been replaced with HMRC focusing more on profits artificially diverted from the UK. As mentioned in 2.1.5 above, the "high tax exemption" was retained along with the low profit exemptions. Blick Rothenberg (2013) mentioned that one of the changes to the CFC regime was the exclusion of the motive test. It appears, however, that even though the motive test might have been excluded, the new legislation exercises more objective tests in determining the nature of the CFC's profits. Referring to 2.1.2 in this chapter, when considering whether the excluded territories exemption applies, there are no specific guidelines available that could be used to determine whether an arrangement was entered into with the main goal to obtain a tax advantage. Some subjectivity will therefore come into play when determining this. The judgment laid down by the European Court of Justice in the *Cadbury Schweppes* case may therefore still be relevant, at least to some extent, in the updated legislation. Overall, professionals in the UK experience the new CFC legislation as being more accommodating to businesses (Baker Tilly UK Audit LLP, 2013).

Blick Rothenberg (2013) summarises the instances when business profits of a controlled foreign company will be taxable in the UK as follows:

- If the main purpose of an arrangement is to obtain a reduced UK tax liability which in turn will result in the CFC recording higher profits.

- If the management and control of the CFC is exercised from the UK to a significant extent.
- If the CFC's assets and risks are managed from the UK due to the company not being able to perform these duties themselves elsewhere.

It remains to be seen whether the new CFC legislation is in line with the changes recommended by the OECD to avoid profit shifting arrangements. It is proposed that a further study be performed to analyse the CFC legislation in the UK and South Africa against the action plans to be implemented by the OECD to avoid profit shifting arrangements.

### **3. Controlled foreign company legislation in South Africa – Section 9D**

The Republic of South Africa enacted its CFC legislation in 1997 (Van Heerden 2009:151) with the aim of protecting the South African tax base from profits being shifted to lower tax jurisdictions.

The flow of section 9D of the South African Income Tax Act No 58 of 1962 is illustrated in the diagram 2 (own compilation):

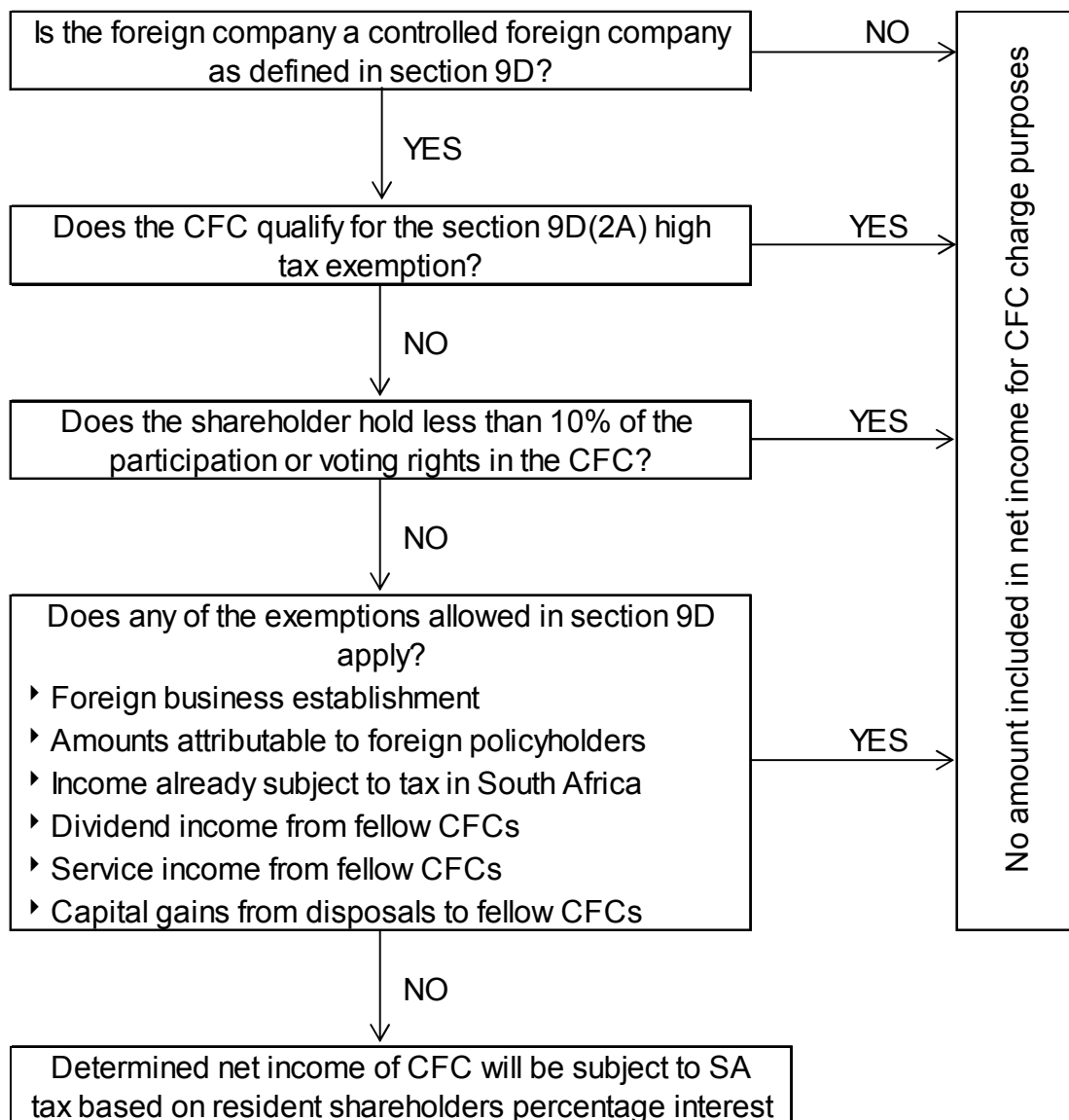


Diagram 2: Section 9D of South African Income Tax Act (58 of 1962)

The elements of section 9D will be discussed next in order to draw a comparison between the controlled foreign company regime imposed in South Africa in terms of this section and the revised regime of the UK, as discussed above.

### 3.1 Relevant definitions

Section 1 of the South African Income Tax Act (58 of 1962) defines the term “resident” to mean any natural person ordinarily resident in South Africa, or in the case of a non-natural person, any such person established, formed or incorporated in South Africa or who has its place of effective management in the Republic. The term “effective management” is not defined, but SARS issued Interpretation Note 6

to give guidance on the approach regarding this term. Interpretation Note 6 states that the place of effective management will be where the company is managed on a regular daily basis by members of senior management (SARS, 2002:3). A “foreign company” as defined in section 9D will therefore be any non-natural person not incorporated, formed or managed on a daily basis from South Africa.

“Participation rights” as defined in section 9D will be determined based on each shareholder’s percentage voting rights in the company or shareholding. If a person, whether a natural or another person is a resident in South Africa and holds more than 50% of these participation rights in a foreign company (as described above), this foreign company will be controlled by a South African resident. Such foreign company will therefore be a “controlled foreign company,” as defined in section 9D.

### ***3.2 How the amount taxable in South Africa is determined***

According to section 9D(2A) the net income of the CFC will be determined as if that CFC was subject to tax in South Africa. Since South African tax residents are taxed on their worldwide income as per the definition of gross income in section 1 of the South African Income Tax Act (58 of 1962), all income earned by the CFC will be included in the net income, irrespective of its source. Such net income will be included in the South African resident shareholders’ taxable income based on their percentage shareholding, or participation rights from the first day when the foreign company is considered to be a controlled foreign company (section 9D(2)(a)). If the resident shareholder holds less than 10% of the shares in the CFC, it can disregard its share of the net income when determining its taxable income for the specific tax year. Section 9D(2A)(c) specifically disallows any deductions of the following amounts:

- Any interest, royalties, rental income or other income of similar nature paid by the CFC to a fellow controlled foreign company.
- Any exchange differences relating to an exchange item to which the CFC and a fellow controlled foreign company are parties.
- The reduction or discharge by the controlled foreign company of any debt owed to it by another CFC for no consideration or consideration of less than the face value of debt.

The above disallowances are subject to controlled foreign companies being part of the same group of companies. A “group of companies” is defined in section 1 of the Income Tax Act (58 of 1962) to mean “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 70 percent of the equity shares in 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 at least 70 per cent of the equity shares in at least one controlled group company”.

In its Explanatory Memorandum on the Draft Taxation Laws Amendments Bill, 2011 (2011:85) National Treasury expressed the goal of CFC rules to be to impose tax on tax residents of the Republic on their share of so-called tainted income of a controlled foreign company. The memorandum also states that tainted income will include all passive and diversionary income earned by the CFC. Passive income includes income from interest, dividends, royalties, rentals, annuities, exchange differences, insurance premiums and other capital gains. Diversionary income in turn is that type of income earned by a CFC from transactions between a CFC and a South African tax resident that will likely lead to transfer pricing issues. The memorandum states that this type of diversionary income poses a high risk to the South African tax base.

A resident shareholder in a CFC can ignore its share of the net income in the following instances:

- If the tax payable by the CFC in jurisdictions outside South Africa is at least 75% of the tax that would have been payable had the company been a resident in South Africa (section 9D(2A)). This exemption is therefore an entity level exemption, as it excludes the income of the entire entity if more than a specific tax rate is paid in its own tax jurisdiction.
- The profits attributable to a foreign business establishment of the CFC outside the Republic will not be included in the net income (section 9D(9)(b)). The



income from certain services rendered by this fixed business establishment to connected persons resident in South Africa will, however, not enjoy this exemption in the light of the National Treasury's considerations above. These exceptions are discussed in points (i) to (iv) below. This is an example of exempting a specific income stream as only the income from the CFC's foreign business establishments will be exempt from the net income of the CFC.

- The amount is attributable to a policyholder of a long-term policy defined in the Long-term Insurance Act, 1998 (53 of 1998). This policyholder should neither be a resident in South Africa, nor a controlled foreign company of a resident of the Republic (section 9D(9)(c)). Since only the income from holding the policy will be exempt, this is an income stream exemption.
- Any income already included in the controlled foreign company's taxable income subject to South African tax will be excluded from the company's net income (section 9D(9)(e)). This exemption is aimed at those income items earned by the foreign company from sources within the Republic which will be subject to South African tax in the CFC's hands (National Treasury, 2002:21). This exemption therefore excludes a specific income stream from the CFC's net income.
- The net income is attributable to foreign dividends declared to a controlled foreign company by a fellow CFC of the same South African resident shareholder (section 9D(9)(f)). This exclusion will however only be allowed to the extent of the declaring company's net income being included in the South African resident's taxable income. Since dividends are declared from retained income and the income of the declaring CFC already being taxed in the Republic, this exclusion will prevent the income from being taxed twice: once as part of the declaring CFC's income and another time as part of the shareholder's income. Specific income items are therefore exempted by this stipulation which results in this being an income stream exemption.
- Section 9D(9)(fA) excludes the net income of a controlled foreign company to the extent that the income was earned in interest, royalties, rental or other similar income from any other fellow controlled foreign company. The section also excludes the exchange differences on the mentioned transactions.

These exclusions are only available to the extent that these companies are part of the same group of companies. This is counter to section 9D(2A)(c) which disallows a deduction of interest, royalties, rental or other similar expenses payable to any other fellow controlled foreign company when determining the CFC's net income. The section mentions specific income streams to be excluded from the CFC's net income which suggests that this is an income stream exemption.

- The income attributable to the disposal of assets as defined in the Eighth Schedule to the Income Tax Act (58 of 1962) will be excluded from the CFC's net income to the extent that such disposal was made to a fellow CFC in the same group of companies (section 9D(9)(fB)). Since the exclusion relates to income from disposals of fixed assets specifically, this is another exemption of a specific income stream.

Even though section 9D(9)(b) excludes the income earned from a foreign business establishment from the CFC's net income, section 9D(9A)(a) disallows this exclusion when any of the following exemptions apply: (These exclusions were included in the legislation to avoid the income earned by a CFC from transactions between the CFC and a South African resident that will likely lead to transfer pricing issues (diversionary income as discussed earlier) enjoying tax exemptions).

***(i) Goods sold to connected persons***

The income will be included in the net income when it is earned from goods sold by the controlled foreign company to a connected person who is tax resident in South Africa. Income from such sales will, however, still be exempt when the CFC making the sale is subject to tax other than that payable in South Africa of at least 50% of the tax, it would have paid had the company been a resident of the Republic. The income will also be exempt when the income was attributable to a permanent establishment of the CFC. The term "permanent establishment" is defined in section 1 of the Income Tax Act (58 of 1962) to mean a permanent establishment as defined by the OECD Model Tax Convention on Income and on Capital. The OECD Model Tax Convention (2010, 24) defines the term permanent establishment as "a fixed place of business through which the business of an enterprise is wholly or partly carried on". The income from the sale of goods to connected persons will still be

exempt should the CFC not be resident in a low tax jurisdiction, or when it is operating from a permanent place outside the Republic.

***(ii) Services performed to connected persons***

The income from services provided to connected persons resident in South Africa will be included in the controlled foreign company's net income. This type of income will, however, still be exempt from the CFC charge when the services are performed outside South Africa and any of the following applies:

- The service relates to the creation, production, assembly or repair of goods utilised outside South Africa.
- The CFC provides marketing services to connected persons resident in South Africa for goods to be sold to unconnected persons resident in the same jurisdiction as the controlled foreign company.
- The services are provided by the CFC in its own country of residence to customers resident there.
- The income will be exempt to the extent of which the amounts paid by the connected person to the CFC for services rendered are disallowed for deductions.

***(iii) Income from financial instruments***

The income earned by the controlled foreign company from financial instruments will be included in its net income, unless such income is from the company's principal trading activities as a bank, insurer or financial services provider. If the amount is attributable to exchange differences or to the activities of a treasury operation or captive insurer, the income will be included in the CFC's net income. The income from financial instruments will also be excluded from net income to the extent that this income is no more than 5% of the permanent establishment's total income excluding foreign dividends, interest, royalties or rental income received from fellow CFCs.

***(iv) Other exclusions***

The following amounts of income will be included in the net income of the CFC's foreign business establishment:

- Income arising from rental from immovable property, unless where the property is leased by the CFC in terms of an operating lease or a lease constituting a financial instrument (section 9D(9A)(a)(iv)).
- The income is earned from the right to use intellectual property as defined in section 23I. If the income is earned from the CFC creating and developing its own intellectual property and this property not being tainted intellectual property as defined in section 23I, the income will be exempt from the CFC's net income. Section 23I defines the term "intellectual property" as any patent, design, trade mark or copyright as defined in the relevant legislation. The section also defines "tainted intellectual property" as property of the end user or property developed, devised or created by the end user. If the CFC therefore derives income from intellectual property which was initially developed by a connected end user and transferred to the CFC subsequently, the income will be included in its net income.
- Income from the disposal of such intellectual property will be included in the net income, unless the CFC regularly creates and develops intellectual properties.
- Where the CFC receives income in the form of insurance premiums, this will be included in the company's net income unless its business is that of an insurer, but not a captive insurer.

If the transactions take place between the CFC and a connected person resident in the Republic, the nature of these transactions will be considered in the light of section 31 of the Act. If such a transaction was entered into between the CFC and a connected person resident in the Republic at rates not at arm's length or with the main purpose to obtain a tax benefit, that transaction will be considered to not have occurred at market-related terms.

#### **4. Comparison, summary and conclusion**

At first glance the CFC legislation enacted by the UK appears to be more complex and detailed than that of South Africa. In Table 2 section 9D of the South African Income Tax Act (58 of 1962) is analysed against the provisions of the UK CFC legislation as discussed in section 2 of Chapter 3 above.

<b>UK CFC legislation (Schedule 20)</b>	<b>SA CFC legislation (Section 9D)</b>	<b>Commentary</b>
Chapter 18 establishes control to be where a shareholder is entitled to at least 50% to the CFC's distributions (refer to 2). This is as a result of a parent/subsidiary relationship existing between the UK resident and its foreign investment company.	A foreign company will be controlled where more than 50% of its participation rights or voting rights are held by South African residents (refer to 3.1).	The UK legislation focuses on rights to distributions, while the South African legislation considers participation rights and voting rights. This difference will be considered in Chapter 4.
UK CFC legislation applies entity-level exemptions and then applies the CFC rules to include specific income for purposes of imputation (refer to diagram 1).	The net income of a South African CFC is calculated and afterwards the specific exemptions considered. Refer to diagram 2.	The UK CFC rules therefore focus on taxing specific income, while the SA rules include all income and exempt certain income streams.
<b>Entity level exemptions</b>		
The exempt period exemption discussed in 2.1.1 exempts a newly acquired CFC from the UK CFC rules if such CFC will also be exempt in the next period.	No such exemption in South African legislation.	As no similar rules are present in section 9D, the possible impact of Chapter 10 of the UK Finance Act (4 of 2012) will be considered in Chapter 4.
The income earned from CFC in	No such exemption in South African	As no similar rules are present in

determined exempt territories will be exempt from a CFC charge (refer to 2.1.2).	legislation.	section 9D, the possible impact of Chapter 10 of the UK Finance Act (4 of 2012) will be considered in Chapter 4.
The low profit exemption exempts lower risk income from the CFC charge (refer to 2.1.3).	No such exemption in South African legislation.	As no similar rules are present in section 9D, the possible impact of Chapter 10 of the UK Finance Act (4 of 2012) will be considered in Chapter 4.
Low value adding businesses are exempt from the CFC charge by Chapter 13 (refer to 2.1.4).	No such exemption in South African legislation.	As no similar rules are present in section 9D, the possible impact of Chapter 10 of the UK Finance Act (4 of 2012) will be considered in Chapter 4.
Chapter 14 provides for an exemption from the CFC charge where the tax payable by the CFC is at least 75% of the tax it would have been liable for had the company been a resident of the United Kingdom (refer to 2.1.5).	The income of a CFC is exempt from being included in its net income to the extent that the tax payable by the CFC is at least 75% of the amount of tax it would have paid had the company been a resident in South Africa (refer to 3.2)	The two pieces of legislation appear similar in nature. The high tax exemption will however still be considered in Chapter 4 as the determination of the tax amount may prove to be different.
<b>Income streams taxed under CFC regime</b>		
Income earned from activities within	Income from foreign business	The term “business premises” and

<p>the UK will be subject to the UK CFC charge (refer to 2.2.1). This income is exempt to the extent that it was earned by the CFC's permanent business premises in its own tax jurisdiction, or to the extent that no more than 20% is from connected parties.</p>	<p>establishments as discussed in 3.2 is exempt. Any income earned from connected parties could however still be included in the CFC's net income where the requirements of section 9D (9A) are met.</p>	<p>“foreign business establishment” may have different meanings. Also, section 9D does not have any connected party income threshold that will not be subject to the CFC rules. These differences will be considered in Chapter 4.</p>
<p>Chapter 5 discussed in 2.2.2 includes the income earned by a CFC from non-trading finance profits from activities carried out in the UK, unless that income is from a qualifying loan relationship with a fellow CFC (refer to 2.2.6).</p>	<p>Section 9D (9A)(a)(iii) states that all income earned by the CFC from financial instruments will be included in the CFC's net income (refer to 3.2(iii)).</p>	<p>The UK taxes income earned from treasury operations carried out in Great Britain, while South Africa calculates tax on all revenue from such operations. The difference will be considered in Chapter 4.</p>
<p>CFC trading finance income earned from UK resident capital contributions will be treated as non-trading finance profits discussed in 2.2.2 and be subject to the CFC charge (refer to 2.2.3).</p>	<p>Section 9D (9A)(a)(iii) states that all income earned by the CFC from financial instruments will be included in the CFC's net income (refer to 3.2(iii)).</p>	<p>Since Chapter 6 of schedule 20 determines that trading finance income from contributions by UK residents will be treated under Chapter 5, the difference between Chapter 5 and section 9D(9A)(a)(iii) will be considered</p>

		in Chapter 4.
Captive insurance income discussed in 2.2.4 earned by the CFC from transactions with UK residents will be subject to the CFC charge.	All income earned by the CFC from financial instruments will be included in the CFC's net income if the activities of the CFC constitute that of captive insurer (refer to 3.2(iii)).	The difference will be considered in Chapter 4.
With reference to 2.2.5 discussing solo consolidations, resident banks invested in CFCs with the sole purpose to obtain a tax advantage will be taxed in the UK.	No specific legislation included dealing with banks.	Even though no specific legislation is included in section 9D, all banks resident in South Africa investing in CFC will have to comply with section 9D. Section 9D (9A)(iii)(aa) will tax the income from the CFC where financial instruments are traded but not as part of the principal trading activities. As sufficient provisions exist this will not be considered further.
Where no more than 25% of the CFC's profits are attributable to the UK shareholder, the CFC rules will not apply (refer to 2.3).	Where the resident shareholder holds less than 10% shares of the CFC, section 9D will not be applicable (refer to 3.2).	The difference in legislations will be considered in Chapter 4.

Table 2: Analyses of the South African CFC rules against UK CFC rules (own compilation)



All chapter references relating to the UK CFC legislation in Table 2 relates to the chapters included in schedule 20 of the UK Finance Act 2012 (14 of 2012), while references to Chapter 4 under the commentary section relates to the fourth chapter of this research document.

The differences identified in Table 2 will be considered and discussed in Chapter 4. The policies of determining the chargeable income imply a further difference in the legislation. The UK CFC regime focuses to tax only specific income streams where the revenue was generated from Great Britain. The South African legislation, on the other hand, includes all income from the CFC and only excludes those items that qualify for exemption per section 9D of the Income Tax Act (58 of 1962). This causes the extent of the South African rules to be broader than that of the UK.

It was identified in Chapter 2 that certain aspects of the factors motivating the change in the UK CFC regime also reigned true to South Africa. The updated UK CFC rules could therefore act as a good guideline to assess the competitiveness and effectiveness of the South African CFC legislation. Bearing this in mind, the differences in the South African and UK CFC rules identified in Chapter 3 and summarized in Table 2 should be considered to evolve the South African CFC rules into a set of rules that is more competitive, yet still effective. The possible impact of these differences on the South African CFC legislation, as well as recommendations on amending current legislation and adopting additional legislation will also be considered in Chapter 4.

## Chapter 4

### An evaluation of elements in the United Kingdom CFC legislation that may enhance section 9D of the South African Income Tax Act

#### 1. Introduction

Legislation is enacted to assist in achieving a set goal or outcome. The Oxford Dictionaries website (2013) defines the term “law” as any set of rules or system recognised by a country or community to regulate their actions and which will be enforced by penalties. The goal that the CFC legislation has set to achieve is to protect a jurisdiction’s tax base of companies shifting profits to offshore investment companies by including profits of such CFCs in the taxable income of the resident parent company (Lang *et al.*, 2004:5). From the Oxford Dictionary definition and considering the purpose of CFC legislation as per Lang *et al.*, it can be concluded that the CFC regime of a country regulates the actions of the resident shareholders to invest in legitimate offshore companies, or else penalise these investors by including such foreign companies’ income in the taxable income of the resident shareholder.

As mentioned before, South Africa introduced its controlled foreign company legislation in 1997 (Van Heerden, 2009:151). The legislation was originally aimed to only allocate passive income earned abroad to the South African shareholder (Snyckers, 2006). The legislation has, however changed in recent years with the “net income” amount targeting trading income introduced in 2001. Definitions have been revised and other pieces of legislation adjusted.

When one considers the global economy changing and the manner in which business is conducted being amended and at times revolutionized, legislation does tend to become outdated and ineffective. This was evident from the *Cadbury Schweppes* case which resulted in the UK redrafting their CFC legislation. Since there were specific matters that urged the UK to update their CFC legislation, this chapter will focus on matters identified in Chapter 3 as differences between the two sets of legislation. The implications of the UK CFC rules as well as that of section 9D will be evaluated and a recommendation made about aspects that should be considered to improve the South African CFC regime.

## 2. Differences identified between United Kingdom CFC and section 9D

The differences identified between the UK CFC rules and that included in section 9D are summarized in Table 3 (own compilation).

Ref.	Schedule 20 of UK Finance Act	Section 9D of SA Income Tax Act
2.1	Control is established in accordance to Chapter 18 based on the shareholder's percentage right of distributions.	In the definition of "controlled foreign company" in section 9D, a foreign company will be controlled if <u>more than</u> 50% of the participation rights are held by a South African resident.
2.2	UK CFC legislation applies entity-level exemptions and then applies the CFC rules to specific income (refer to 2).	The net income of a South African CFC is calculated and the specific exemptions considered afterwards.
2.3	Chapter 4 excludes any income earned from a business premises in the CFC's tax jurisdiction which is occupied with a reasonable degree of permanence from the CFC charge.	Income earned by a CFC from a foreign business establishment will be exempt in terms of section 9D(9)(b). The foreign business establishment definition incorporates elements of staffing a premises and occupying such premises.
2.4	Chapter 4 exempts those trading profits earned from connected resident companies to the extent that this income is no more than 20% of the total income of the CFC.	Section 9D (9A) includes income from connected persons, except where that income is earned in a high tax jurisdiction.
2.5	Chapter 5 includes non-trading financial income in the CFC charge to the extent that this income is earned from activities carried out in the UK.	All income earned by the CFC from financial instruments will be included in the CFC's net income (section 9D (9A)(a)(iii)).
2.6	Chapter 7 only includes income from captive insurance business to	All income earned by the CFC from financial instruments will be included in

	the extent that this income was earned from UK connected persons.	the CFC's net income if the activities of the CFC constitute that of captive insurer (section 9D (9A)(a)(iii)).
2.7	Chapter 10 allows an exemption for the first period during which the foreign company is a CFC subject to the company being a CFC in the next period and not subject to a CFC charge then.	The net income of a CFC will be included in the taxable income of its resident shareholders from the first day the company is considered to be a CFC (section 9D(2)(a)(ii)).
2.8	Chapter 11 exempts the income from CFC residents in government approved states from the CFC charge.	No such exemptions are identified in section 9D.
2.9	Chapters 12 and 13 provide the low profit and low profit margin exemptions which exempt the income from lower risk CFCs from the CFC charge.	No such exemptions are identified in section 9D.
2.10	Chapter 14 provides for an exemption from the CFC charge where the tax payable by the CFC is at least 75% of the tax it would have been liable for had the company been a resident of the UK.	Section 9D(2A) exempts the income from a CFC from being included in its net income to the extent that the tax payable by the CFC is at least 75% of the amount of tax it would have paid had the company been a resident in South Africa.
2.11	All CFC charges are only relevant for foreign companies in which the UK resident holds more than 25% of the shares of the controlled foreign company.	Section 9D (2) only requires those residents holding more than 10% in the CFC to include its share of the net income in the resident's taxable income.

Table 3: Differences between UK CFC rules and section 9D

Some professionals are of the opinion that the current section 9D is overly complex with multiple aspects to be understood and at times misunderstood by the taxpayer (Hoosen, 2013). The South African Revenue Services acknowledged in the Tax Proposals document for Budget 2011 (2011:8) that some provisions of section 9D was not accommodating to normal business practices. The differences in the legislation will be considered next to assess whether the UK rules might assist in erasing some of the complexities and obstacles experienced in South Africa as a result of the CFC regime in section 9D.

### ***2.1 Basis of establishing control***

Chapter 18 to schedule 20 of the Finance Act 2012 (14 of 2012) establishes that a person will control a foreign company when such a person will be able to ensure that the affairs of such a foreign company will be conducted as per the investor's wishes. The section continues by stating that it will be reasonable to suppose that a resident controls a foreign company when such an investor will be entitled to over 50% of the company's distribution. The accounting test establishes control when a UK resident is entitled to at least 50% of the CFC's chargeable income. A resident will therefore control a foreign company when it has the authority and power to direct the company's affairs as the resident investor pleases, or when the CFC is a subsidiary for accounting purposes which will be consolidated in the resident's group results.

The definition of a controlled foreign company in section 9D of the South African Income Tax Act (58 of 1962) mentions that control will be exercised when more than 50% of the total participation rights are held by South African residents. The section proceeds to define "participation rights" as "the right to participate in all or part of the benefits of the rights (other than voting rights) attaching to a share, or any interest of a similar nature, in that company or in the case where no person has any right in that foreign company as contemplated in paragraph (a) or no such rights can be determined for any person, the right to exercise any voting rights in that company." The term "participation rights" was given a broad meaning to address those circumstances during which a South African resident might attempt to arrange its shareholding in a foreign company in such a manner to avoid being taxed under section 9D (National Treasury, 2002:3). National Treasury is of the opinion that a foreign company will be controlled by a South African resident when more than 50%

of the voting shares or shares entitled to more than 50% of the undistributed profits are held by such resident (National Treasury, 2002:3). Therefore, a foreign company will be considered to be controlled by a South African resident or residents when such resident is entitled to more than 50% of the company's profits, or when the resident can exercise more than 50% of the voting rights of the foreign company and therefore ensure that the affairs of the company are conducted in accordance with the resident's wishes.

The voting rights provision relating to the establishment of control is similar in both Chapter 20 of the Finance Act (14 of 2012) as in section 9D of the Income Tax Act (58 of 1962). The UK CFC rules, however, refer to control based on profit share as having to hold at least 50% of the rights to the foreign company's income, while the South African CFC rules require the resident to be entitled to more than 50% of the undistributed income. Under the UK CFC rules a company will be considered to be controlled when 50% of the profit participating shares are held. Considering the shareholders' ability to direct the activities of the investment company, it is unlikely that a shareholder holding 50% of the rights to profits in a company will be able to direct the company's activities in the way the shareholder pleases. To achieve this, the 50%-shareholder needs another shareholder to share its views and vote in a similar manner as the 50%-shareholder. IFRS 11 (IASB, 2011b) defines the term "joint control" as "the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control." Based on this definition it would appear that the "accounting test" may very well allow those foreign companies which are jointly controlled by a UK resident to be taxed in the United Kingdom. This is, however, in contradiction to the test determining the ability of the shareholder to direct the activities of the company as a more than 50% shareholding is required for this.

The South African rules state that a shareholder entitled to more than 50% of the undistributed profits will be considered to control the foreign company. This implies that the resident shareholder must hold at least 50% of the shares plus one share. This is in line with the test of determining the shareholder's ability to influence the activities of the foreign investment company. It is therefore submitted that the test to

establish control in section 9D echoes the true essence of control better than that of the UK rules.

## ***2.2 Order of determining the CFC's chargeable or net income***

The UK CFC legislation allows a number of entity-level exemptions in Chapters 10 to 14 to schedule 20 of the United Kingdom Finance Act (4 of 2012). If any of these exemptions applies, Chapters 4 to 8 do not need to be considered in determining the CFC's chargeable income. It therefore appears that the UK CFC rules only target specific sources of income earned by non-exempt entities.

Unlike the UK rules, section 9D of the South African Income Tax Act (58 of 1962) first requires the South African investor to determine the CFC's net income before allowing certain specific exemptions against this net income. Referring to the high tax exemption consideration in 2.10 below, the determination of the net income is necessary when assessing whether the high tax exemption is applicable. It is therefore not an entire waste of time to apply this order as one of the two entity level exemptions allowed by the South African CFC rules is reliant on the net income calculation.

The UK CFC rules were changed to focus on certain types of income diverting profits away from Great Britain (Wright, 2012:12), while the South African rules include all income of the CFC and thereafter exempt certain amounts. The UK CFC rules therefore appear to only focus on taxing those income streams sourced in Great Britain and therefore passing the gateway test. The South African legislation on the other hand initially taxes the CFC on its worldwide income as if all income earned by this foreign company were repatriated to the Republic (National Treasury, 2002:1) and only after this inclusion exempts certain income amounts. With the UK moving from its 1984 CFC rules which appeared to be of a similar structure as that of South Africa's (refer to chapter 2) to its new CFC rules, it was reported that the new rules implemented by the UK were more competitive in nature (Gorringer, 2010:1). Comparing this aspect of the South African CFC regime to the new UK CFC rules, it appears that South Africa is at risk of promoting uncompetitive CFC rules which may prove to be unfavourable towards South African CFCs. It should be considered that a similar approach be implemented whereby section 9D only targets those profits

diverted from the Republic to be taxed in the hands of the South African resident investor.

### **2.3 Income from foreign business establishments**

Section 371DG of schedule 20 of the Finance Act 2012 (14 of 2012) exempts the trading profits of a controlled foreign company when the “business premises condition” is met. This condition will be met when the controlled foreign company at all times has premises in its own tax jurisdiction that it occupies with a reasonable degree of permanence from where the company’s activities are mainly performed from. The section proceeds to define “premises” as “an office, shop, factory or other building or part of a building, a mine, an oil or gas well, a quarry or other place of extraction of natural resources or a building site or the site of a construction or installation project, but only if the building work or project has a duration of at least 12 months.” Therefore, if the controlled foreign company occupies any building or sight in its country of tax residence and mainly carries on its income earning activities from there, the income will be exempt from the CFC charge.

Section 9D of the South African Income Tax Act (58 of 1962) has a similar exemption in that the income earned from a foreign business establishment of the controlled foreign company will be excluded from the company’s net income for CFC purposes. The section defines a “foreign business establishment” as having the following meaning:

*“a fixed place of business located in a country other than the Republic that is used or will be used for the carrying on of the business of that controlled foreign company for a period of not less than one year, where –*

- (i) that business is conducted through one or more offices, shops, factories, warehouses or other structures;*
- (ii) that fixed place of business is suitably staffed with on-site managerial and operational employees of that controlled foreign company who conduct the primary operations of that business;*
- (iii) that fixed place of business is suitably equipped for conducting the primary operations of that business;*



- (iv) that fixed place of business has suitable facilities for conducting the primary operations of that business; and*
- (v) that fixed place of business is located outside the Republic solely or mainly for a purpose other than the postponement or reduction of any tax imposed by any sphere of government in the Republic.”*

The definition also includes places outside the Republic where prospecting operations are performed, construction sites and agricultural land. Therefore, different to the UK CFC rules, the foreign business establishment of the CFC does not only have to be a premises outside the Republic from where its business is conducted, the site must be suitably staffed with operational and managerial personnel and suitably equipped to perform the activities of the business. Finally, the main purposes of this foreign business establishment may not be only to obtain a tax reduction in South Africa. The objective with the foreign business establishment exemption is to promote international competitiveness, but to still protect the South African tax base from those transactions that lack economic substance (National Treasury, 2002:8).

When comparing the UK CFC rules to that of South Africa, section 371DG of the Finance Act 2012 (14 of 2012) only requires the CFC to have a place of business outside the UK tax jurisdiction from where the CFC's activities are performed. Section 9D of the Income Tax Act (58 of 1962) is structured in a way to confirm that the business abroad has economic substance and has sufficient employees and dedicated management members to make the day-to-day decisions (Olivier & Honiball, 2011:582). It therefore appears that section 9D of the South African Income Tax Act (58 of 1962) tests the validity of the foreign business establishment in light of the motive of the CFC having its place of business abroad, the permanence of it conducting its business from a premises abroad and the management, staff and facilities available at the premises abroad.

The main difference between these two pieces of legislation is that the South African legislation specifically mentions that the premises need to be sufficiently staffed with managerial staff members. This echoes the requirement of the foreign company to determine with certainty that it is not effectively managed from the Republic and

therefore qualifies as a controlled foreign company (Hoosen, 2013). Since Interpretation Note 6 (SARS, 2002:3) states that the place of effective management will be where the company is managed on a regular daily basis by members of senior management, it can be assumed that per the South African legislation the foreign business establishment not only needs to be operated abroad, but should also have its place of effective management at the same premises. The requirements of the foreign business establishment exemption therefore reduce the risk of the operations being conducted from abroad while the company is actually managed from within the South African tax jurisdiction. As mentioned in the previous paragraph, dedicated management members should reside at the premises. If this was indeed the case that the CFC was managed from South Africa, it would have been considered to be a resident as defined in section 1 of the Income Tax Act (58 of 1962). The requirements of section 9D therefore appear to be more comprehensive while still achieving the goal of creating international competitiveness and protecting the tax base.

#### ***2.4 Trading profits from transactions with connected parties***

The income earned by the CFC will be exempt to the extent that no more than 20% of such income is earned from companies resident in the United Kingdom. This is per section 371DH of the United Kingdom Finance Act 2012 (14 of 2012). The incidental income earned from sources within the UK will therefore be exempt from the CFC charge (HMRC, 2013j:14). No mention is made in the legislation that these transactions are limited to connected parties.

Sections 9D(9A)(a)(i) and (ii) include the income earned by a CFC from certain transactions with a connected party resident in the Republic in the net income. The goal of this exemption is to prevent shifting South African income offshore through the use of a controlled foreign company (National Treasury, 2011:86).

Even though the two pieces of legislation are comparable, they address different matters. The section 371DH excludes incidental or insignificant income earned from all UK sources from the CFC charge, while section 9D(9A)(a)(i) and (ii) are aimed at taxing the income artificially diverted from the Republic earned from transactions with connected residents. The aim of section 9D(9A), including sections 9D(9A)(a)(i) and

(ii), is to make sure that the CFC considers the arm's length transfer pricing principle on each income stream to prove that the transactions form part of a legitimate trade and not merely a profit shifting arrangement (Pretorius, 2013). Section 9D(9A)(a)(i) and (ii) therefore provide objective criteria to consider whether the income from intercompany transactions should be included in the CFC's net income. The inclusion of such rules as set out in section 9D(9A)(a)(i) and (ii) are crucial as it prevents the shifting of profits to connected persons in lower tax jurisdictions while still applying objective tests to exempt valid intercompany business transactions from being included in the net income which makes it more favourable for inclusion in the South African CFC rules.

## **2.5 Financial income**

The income earned by a controlled foreign company whose trade is that of a bank, investment company or moneylender will be considered to be trading income and will be exempt in terms of Chapter 5 of the Finance Act (14 of 2012). Where it is not the primary business of the company to lend money, the income from such activities or passive investment activities will be considered to be non-trading income which will be included in the controlled foreign company's chargeable income. Where this type of income is purely incidental and less than 5% of the company's total income, such non-trading income will be exempt. The chapter therefore focuses on including artificial arrangements and non-trading finance profits earned in the UK in the UK tax base.

Section 9D(9A)(a)(iii) of the Income Tax Act (58 of 1962) includes in the net income of a CFC's foreign business establishment the income earned from financial instruments. Section 1 of the Income Tax Act (58 of 1962) states that the term "financial instrument" is to include amongst others "a loan, advance, debt, bond, debenture, bill, share, promissory note, banker's assistance, negotiable certificate of deposit, deposit with a financial institution, a participatory interest in a portfolio of a collective investment scheme, or a similar instrument." The income from a financial instrument will therefore include any income based on a debt instrument. Section 9D(9A)(a)(iii), however, excludes from the net income any financial income earned by a CFC from its principal trading activities that constitute that of a bank, financial services provider or an insurer, but include activities of a treasury operation or

captive insurer. The National Treasury stated that such income earned by a CFC from its principal trading activities will not be considered to be tainted income, which includes passive income (National Treasury, 2011:88).

The Financial Advisory and Intermediary Services Act (37 of 2002) defines the term “financial services provider” as “any person, other than a representative, who as a regular feature of the business of such person furnishes advice or furnishes advise and renders any intermediary service or renders an intermediary service.” Intermediary services are defined as services that include managing and administering financial products purchased by a client. These types of services are therefore similar to those rendered by a bank or insurer. Companies normally set up captive insurers and treasury companies to render similar financial services to the group and not to third parties (Dachs & Du Plessis, 2012). By including the net income of captive insurers and treasury companies in the resident shareholder’s net income, section 9D(9A)(a)(iii) of the Income Tax Act (58 of 1962) therefore attempts to exempt the valid trading income of a CFC carrying on the business of a financial services provider, but tax the income earned by CFC rendering services solely to the group bearing the risk of artificial profit shifting.

Section 9D proceeds in section 9D(9A)(b)(iv) to state that the financial income earned by a CFC from its principal trading activities will still be considered to be income from the activities of a captive insurer and hence taxable when any of the following conditions are met:

- Less of the controlled foreign company’s principal trading activities are conducted in the country where the foreign business establishment is located than in any other single country.
- The CFC’s principal trading activities do not include regular and similar transactions with unconnected parties.
- More than 50% of the income from its principal trading activities is earned from connected persons.

It would appear that the exceptions target income earned from connected parties, as well as income earned from outside the CFC’s country of residence. If the CFC earns a significant portion of its income from outside its country of residence, the risk

is that the company was set up outside South Africa to avoid being taxed in the Republic. The taxation of these profits therefore prevents possible tax mismatches. These exclusions also contribute to the goal of the section 9D to target the income earned by a CFC from transactions and structures designed to avoid South African tax (Pretorius, 2012).

The rules implemented by the UK in Chapter 5 of schedule 20 of the Finance Act (14 of 2012) therefore focuses on taxing the income earned by a CFC from its activities in the UK, while section 9D of the Income Tax Act (58 of 1962) seeks to tax those profits diverted from South Africa and focuses on transactions with connected persons. As discussed earlier, as treasury companies are set up with the primary business to provide funding to the group (Dachs & Du Plessis, 2012), section 9D will tax the income earned by such CFC as this service could have been rendered from the Republic irrespective of the source of the income. This is in contradiction with the UK regime which only targets income from a source within Great Britain. While the current legislation might identify and tax the income earned from South Africa if it is more than the income earned in the jurisdiction where the foreign business establishment is located, the CFC can still structure its activities in such a manner to earn significant income from the Republic which is less than the income earned in its own jurisdictions. To further address the possible loopholes in the current CFC regime, National Treasury might need to consider amending the current legislation to include specific criteria relating to income earned from sources within South Africa. The current legislation has been simplified to be less complex to understand and implement but still protect the fiscus (Pretorius, 2012). It should also be considered to include a similar de minimis clause that will exempt insignificant portions of income earned from the Republic, as these would most probably be incidental while larger portions might be indicative of attempts to shift profits to lower tax jurisdictions.

Section 9D(9A)(a)(iii) includes the worldwide income earned by a CFC being captive insurer or conducting treasury activities in the company's net income. As a topic for further research it should be investigated whether the requirements of section 9D (9A)(b)(iv) should be considered when applying this section to only include the income earned by the treasury company or captive insurer from the sources within the Republic.

## **2.6 Income earned from captive insurance**

A captive insurance company is described as being “an insurance subsidiary that is set up by the parent company, to underwrite the insurance needs of the other subsidiaries” (Adkisson, 2013). It was reported that this type of company could be a useful risk management tool when used correctly.

According to Chapter 7 of schedule 20 of the Finance Act (14 of 2012), the UK CFC rules include in the chargeable income of a CFC the income earned by the CFC from captive insurance transactions with connected UK resident persons or permanent establishments in the UK of persons connected to the CFC. The UK government identified the risk that UK resident multinationals would likely set up these captive insurance companies in low tax jurisdictions. The risk would then be that the UK resident connected to the CFC will claim the expenses incurred toward the connected captive insurance company for tax purposes, while the captive insurance company will be subject to zero or a lower tax charge in the jurisdiction where it is resident (HMRC, 2013c:1). The taxation of these profits therefore prevents possible tax mismatches. Similar to section 9D(9A)(a)(iii) discussed in 2.5 above, this section along with section 9D(9A)(a)(vii) attempts to still tax those transactions with connected parties where income is diverted to lower tax jurisdictions.

Sections 9D(9A)(a)(iii) and (vii) of the South African Income Tax Act (58 of 1962) specifically include the income earned by a foreign business establishment of a CFC from captive insurer activities in the net income of the CFC. In their Explanatory Memorandum on the Draft Taxation Laws Amendment Bill 2011 (National Treasury, 2011:89) the National Treasury states that in determining whether a company is a captive insurance company will be considered based on each case’s facts and circumstances. It was, however, stated that the CFC will be considered a captive insurance company when any of the requirements of section 9D(9A)(b)(iv) as discussed in 2.5 above is met. From the South African legislation it is evident that the income earned by a CFC trading as a captive insurer will be included in its net income, whether the income is from transactions with connected parties or not.

The concern the South African Revenue Services have is that foreign companies conducting the business of a captive insurer might be over-funded by their resident shareholders, as well as the growing existence of these companies abroad (Byrnes, 2011). The risk also exists that even though the foreign captive insurer does not deal with connected parties resident in the Republic, the activities of the captive insurer could have been performed from South Africa and hence the income earned in the Republic. Since companies normally set up captive insurance companies to only serve the companies within the group, the risk arises that these companies are set up in low tax jurisdictions where the premiums received will be subject to lower tax than in the Republic while a deduction is still allowed to the resident paying these premiums (PwC, 1999).

It is evident from the discussion above that sections 9D(9A)(a)(iii), (iv) and 9D(9A)(b)(iv) attempt to tax the income earned by the captive insurance company which has been diverted from the Republic. The South African CFC rules therefore focus on the wider income earning activities of the CFC and not purely on transactions with connected parties. As discussed in the previous paragraph, this is an attempt to avoid a tax mismatch where the income is not taxed in the lower tax jurisdiction while the South African Revenue Services will allow the payment of the premium as a deduction. Even though section 9D appears to have the more comprehensive rule, the risk still exists that a CFC might be taxed on legitimate trading income. Where this is the case, it is recommended that the motive of the CFC's existence be proven to the South African Revenue Services and a ruling obtained to avoid the possible taxation of valid income.

### ***2.7 Initial exempt period exemption***

Chapter 10 of Finance Act (14 of 2012) allows a holding company a period of twelve months before applying the CFC legislation on any newly bought subsidiaries. This exemption is aimed at allowing the new CFC time to organise and restructure its activities in such a manner as to avoid a CFC charge from arising (HMRC, 2013f:1). This is therefore a conscious effort by the UK government to allow residents the opportunity to arrange their affairs in such a manner not to be subjected to tax in a jurisdiction where no income is derived from. The assumption made by Her Majesty's Revenue and Customs is that the foreign subsidiaries acquired will not be engaged

in artificially diverting profits from the UK and only needs to make minor commercial changes to enjoy CFC exemptions (HMRC, 2013f:1). This exemption is, however, subject to the subsidiary not being liable to CFC rules after the period of twelve months.

With no similar exemption currently included in section 9D this might be an amendment worth considering. Section 9D(2)(a)(ii) states that the net income of a CFC will be included in the income of its resident shareholder from the day such subsidiary becomes a CFC. The section does not provide any period exemption. Referring to the motive the UK had in implementing such an exemption, the South African shareholder and CFC therefore need to have the activities of the CFC formalized prior to the company becoming a CFC if it is preferred that the company is not subject to section 9D of the Income Tax Act (58 of 1962).

Without sufficient planning, South African investors pursuing investment and expansion opportunities abroad might be faced with the possible compliance with section 9D (Hoosen, 2013). An exemption in section 9D similar to Chapter 10 of the Finance Act (14 of 2012) will allow resident investors pursuing valid investment opportunities the time to make minor adjustments to their activities to avoid being taxed in the Republic on valid trading income earned by the CFC. Even in the absence of such provision, the shareholder can still claim all the exemptions offered by section 9D on its newly acquired controlled foreign company.

## ***2.8 Exempt territory exemption***

On 9 September 1999 the African Union was formed with the quest of unity amongst the African countries and to promote economic and social development on the continent (African Union, 2013). With the political turmoil in Africa settling down to some extent, the continent is more attractive to foreign investors. The Institute for International Finance, a financial body of more than 450 of the world's biggest banks and financial institutions, reported in 2012 that their members showed higher levels of interest in the African continent (Allison, 2012) due to the economic growth. It was expected that the gross domestic product of the African continent will amount to 4.8% in 2013 and 5.3% in 2014 (Anon., 2013c).



South Africa, however, disappoints by being seen as part of the ten slowest growing economies on the African continent in 2013, with an expected gross domestic product of only 2.8% (Anon., 2013c). When one considers the prediction that Africa will have six or seven of the fastest growing economies in the world over the next five years (Anon., 2013a), the opportunity might just have presented itself to international investors to expand their regions into Africa. In order to reap the benefits of this growth opportunity, the investor resident in South Africa should consider expanding its horizons by investing into the different African economies.

As member of the African Union, this type of investment into Africa will achieve the objective of promoting economic development in the continent and also improve the local economic growth rate. This may also assist South Africa to retain its reputation as the gateway into Africa. To promote such investment, the National Treasury should consider implementing a territory exemption as part of section 9D similar to that included in Chapter 11 of the Finance Act (14 of 2012) implemented in the UK. The net income of controlled foreign subsidiaries resident in African countries approved by government and published in the Government Gazette will be exempt from the CFC charge according to section 9D of the Income Tax Act. This exemption can be subject to the entity existing for valid trading purposes and not purely to divert profits from South Africa to other and possible lower tax jurisdictions.

### ***2.9 Low profit exemption***

Schedule 20 to the Finance Act (14 of 2012) also provides for a low profit exemption in Chapter 13. If the profits earned by a CFC are no more than 10% of the operating expenditure, no CFC charges will arise. The purpose of this exemption is to exclude those CFCs that perform low value added functions outside the UK (HMRC, 2013g:1) such as back-office functions.

Section 9D does not provide any relief specifically for foreign subsidiaries' performing a back-office function to the group of companies. If there is such a "low profit subsidiary" within the group, it will still be privileged to exemptions offered by section 9D. It was reported that in 2006 about 15% of the Fortune 500 companies would have moved their back-office function outside the borders of the USA (Chabrow, 2006). The Fortune 500 is a list compiled annually by the Fortune

magazine of the 500 largest companies in the USA (CNNMoney, 2013). This migration might be motivated by saving costs (Chabrow, 2006) by moving the office to those jurisdictions where labour and other relevant services and resources are cheaper.

Even though the back offices of South African resident companies may still qualify for the other exemptions allowed by section 9D, a specific exemption for these back-office companies might motivate South African resident companies to implement this group structure more regularly. However, in a country that reported an unemployment rate of 25.6% in the second quarter of 2013 (Taborda, 2013), this might have adverse implications on the South African economy by reducing employment opportunities even further.

### ***2.10 High tax exemption***

The UK CFC rules will exclude the chargeable income of a CFC from tax in the UK if the tax payable by the CFC in its own tax jurisdiction is at least 75% of the tax it would have been liable for had the company been a resident in the UK. According to section 371NE of schedule 20 of the Finance Act (14 of 2012) the UK taxable amount will be determined by applying the corporate tax rate to the taxable profit of the CFC as per section 4 of the Corporation Tax Act (4 of 2010), ignoring any double taxation relief that would be allowed between the UK and the CFC's tax jurisdiction. It will still reduce the taxable profit with any payments made to and income tax charges raised by Her Majesty's Revenue and Customs. The taxable profit is determined in accordance with section 4 of the Corporation Tax Act (4 of 2010) as total profit of the company reduced with allowable deductions and exclusions for tax purposes.

Section 9D(2A) of the Income Tax Act (58 of 1962) excludes the net income of a CFC from South African tax when the tax payable to all spheres of government, excluding the government of South Africa, in the CFC's own tax jurisdiction is at least 75% of the tax the company would have paid had it been a resident of the Republic. Referring to subsection (ii) of the high tax exemption in section 9D(2A), the amount of taxes payable to all spheres of government needs to be determined after taking into account any double tax agreements, credits, rebates or other tax recoveries

granted by these foreign governments, but disregards any previous year's losses. Since the tax payable in South Africa will be determined on the company's net income, the net income needs to be determined according to section 9D(2A) as if the company were a resident in the Republic (Anon., 2011). The determination of the net income therefore requires the controlled foreign company to maintain two sets of records for tax purposes: one to comply with its local tax legislation and another determining its taxable income in accordance with South African legislation (National Treasury, 2002:6). As the net income of the foreign company will be calculated in accordance with the Income Tax Act (58 of 1962) and the tax payable by the CFC considered after taking the available rebates into account (Anon., 2011), the relief provided by section 6quat also needs to be taken into consideration when calculating the amount taxable in South Africa.

Both sets of legislation exclude the taxes paid or payable to the governments of the UK and South Africa respectively from the calculation of the taxes that would have been payable had the foreign company been a resident in the local tax jurisdiction. Both pieces of legislation also determine the income subject to the local corporate tax rate using the local legislation as if the company were a resident in that jurisdiction. It initially seemed that the high-tax exemption in section 9D (2A) of the Income Tax Act (58 of 1962) and in Chapter 14 of schedule 20 of the Finance Act (14 of 2012) differed in some instances. It is, however, concluded that the principles of the two sections are similar in that the tax paid in the CFC country of residence, excluding taxes payable to South Africa or the UK, should be at least 75% of the tax the CFC would have been liable to pay had its taxable income been calculated in terms of the South African or UK tax legislation and had the relevant corporate tax rates been applied.

The question however still remains whether the section 6quat rebate of the Income Tax Act (58 of 1962) should be taken into account when determining the CFC tax charge had it been a resident in South Africa. Section 6quat is a rebate that provides relief to those South African residents who is liable for tax in South Africa due to their residency on income which was already taxed abroad (Morphet, 2008). Some professionals are of the opinion that the section 6quat rebate should be excluded from calculation of the CFC taxable income had it been a South Africa resident as

the rebate is given after the normal taxable amount is determined. Section 6quat is however still a section to the Income Tax Act (58 of 1962) and it can also be argued that this section should be considered when determining tax payable by the CFC as the section will be considered for any other resident. The purpose the high tax exemption is to disregard those income streams with little or no South African tax implications after the relevant rebates are taken into consideration (Pinch, 2010). From this it appears that the section 6quat rebate should be taken into account when considering the high tax exemption as it is a valid rebate per the explanation. This might be an area for future study to clarify what the most accurate method would be when calculating the CFC's tax payable had it been a resident of South Africa.

### ***2.11 Minority shareholding exclusion***

Section 371BD of schedule 20 to the Finance Act (14 of 2012) exempts United Kingdom resident shareholders from considering the CFC rules where such resident is entitled to less than 25 per cent of controlled foreign company's chargeable income.

Per section 9D(2)(A) of the Income Tax Act (58 of 1962) the net income of a controlled foreign company will be exempt from being taxed in South Africa when at the last day of the foreign tax year the resident's share of the participation or voting rights in such CFC is less than 10 per cent. The 10 per cent is considered sufficient and practical to prevent minority shareholders of such CFCs who do not have any significant influence over the CFC's affairs the burden of considering and complying with the CFC rules (National Treasury, 2002:5). The exemption therefore attempts to exempt insignificant resident shareholders from the burden of complying with section 9D.

When considering whether to equity account an investment for accounting purposes under IAS 28, only those investments in which the investor has significant influence will be considered for equity accounting. Per IAS 28 paragraph 28 the investor will be considered to have significant influence when the investor has "the power to participate in the financial and operations policy decisions of the investee" (IASB, 2011a). It is considered that the investor will have significant influence when the investor holds at least 20 per cent of the voting powers in the investee, but does not

control the investee (PwC, 2013). Even though an accounting definition is being used when considering a term in the field of taxation, it would appear that South Africa is applying a conservative approach when determining the significance of its residents' investments while the United Kingdom might be slightly generous.

From the above should it be decided to increase the exemption percentage from 10 per cent to 25 per cent like that in the United Kingdom, South Africa may risk exempting the income of investors who significantly influences the activities of its investment companies through joint control as discussed in IFRS 11 and 2.1 of this chapter. On the other hand should it be decided to leave the rate at the current 10 per cent and not increase it to 20 per cent as per the IAS 28 definition of significant influence, insignificant shareholders might be burdened with complying with additional South African income tax requirements. It is therefore recommended that the current 10 per cent minority rate proposed by section 9D(2)(A) of the Income Tax Act (58 of 1962) should not be increased to a rate of 25 per cent similar to that of the United Kingdom. It might however be worth National Treasury's while to assess whether the 10 per cent does not lay an unnecessary burden on minority shareholders which may be relieved when doubling this rate to 20 per cent.

### **3. Summary and conclusion**

In this chapter the differences between the UK and South African CFC rules as identified in Chapter 3 were considered and section 9D of the South African Income Tax Act (58 of 1962) evaluated against schedule 20 of the United Kingdom Finance Act (14 of 2012). In this evaluation it was identified that the South African legislation does in some instances address local matters more appropriately than the UK legislation. It appears that section 9D addresses a wider range of activities whereas the UK CFC regime focuses on specific streams of income. However, there are also instances where it seems that the implication of the UK CFC rules might improve South African legislation. The following matters have been identified as areas of the UK CFC regime that National Treasury may investigate to consider whether implementing them in the South African CFC legislation could be beneficial:

- With reference to 2.2 above, the move the UK Kingdom undertook to incorporate the gateway approach in their CFC regime, only targeting certain income streams, improved the country's competitiveness of the CFC rules.

To improve the competitiveness of its own CFC regime, South Africa should consider changing its policy from including all the CFCs' income and only exclude certain exempt items to also target specific income items. This might promote global investments in and from South Africa.

- Section 9D(9A)(b)(iv) only taxes insurance income attributable to a CFC where more of its income is earned outside than from its own tax jurisdiction. The risk exists that significant income streams from the Republic will not be addressed by this exemption. The other matter identified is that valid captive insurers and treasury companies are taxed on income earned from sources outside the Republic. Similar to Chapter 5 of schedule 20 of the UK's Finance Act (14 of 2012), it should be considered to only tax insurance income earned by a CFC from sources within South Africa. Refer to 2.5 for a detailed discussion on this matter.
- Referring to 2.7 above, the income of a CFC will be included in its net income from the first day of becoming a CFC (section 9D(2)(a)(ii)). Chapter 10 of schedule 20 of the Finance Act (14 of 2012) allows a CFC to be exempt from the CFC rules for a period of twelve months from becoming a CFC, subject to the foreign company that would be exempt from the CFC rules after the twelve-month period. Even though South African CFCs will still qualify for the other CFC exemptions, a provision such as this might assist companies expanding their business and investments whose objective is not to divert profits away from South Africa the opportunity to finalize their commercial agreements.
- Chapter 11 of the Finance Act (14 of 2012) exempts CFC residents in jurisdictions specified by the government from the CFC charge. When one considers the fact that South Africa's economy does not exhibit signs of real growth while the economy of the African continent is expected to grow in the next seven years, government should consider exempting the income earned from CFC located in specific African countries to motivate resident multinationals to invest in the continent, thereby enhancing the economic growth of South Africa and the African continent. Refer to discussion in 2.8 above.

- With reference to 2.9 above, Chapter 13 of schedule 20 of the Finance Act (14 of 2012) exempts from the CFC charge any CFC whose profit as a percentage of its operating expenses is less than 10%. This low profit exemption excludes from the CFC charge those back office companies that perform low value-added services outside the UK. Even though such a South African CFC back office company will be entitled to the relief provided by section 9D a specific low profit margin exemption, it might encourage local investors to expand their companies abroad to jurisdictions where employment cost is less expensive. However, with an economy that is below expectation and an unemployment rate of over 25%, a specific exclusion like this might motivate investors to scale their South African activities down and relocate these activities abroad which will have an adverse effect on the already cumbersome economic growth and employment statistics.

It was also identified that there are different trains of thought when considering whether section 6quat should be taken into consideration when determining the CFC's South African tax liability had it been a resident of the Republic for the section 9D(2A) high tax exemption. This is due to the section being considered a rebate on the already determined normal tax liability. It can, however, also be argued that section 6quat is a section of the Income Tax Act (58 of 1962) which is available to a resident and should be considered when determining the CFC's tax liability as if it were a resident of the Republic. Though no guidance was obtained from the UK CFC rules to address this matter, it is recommended that a further study be undertaken to address this matter.

Finally, section 9D of the South African Income Tax Act (58 of 1962) exempts resident investors from the CFC charge when these investors hold less than 10% of the voting rights in the foreign company. It is considered that shareholding of less than 10% is too insignificant to have any impact on the foreign company's activities and hence no control will be exercised. The UK CFC legislation has a similar exclusion, with the rate being set at 25%. Comparing this to IAS 28 which states that significant influence will exist when the shareholder holds more than 20% of the rights in an investment, it is considered that the percentage stipulated by the UK might be overly generous, while the 10% requirement by South African law might be

too conservative. The applicable rate could therefore still be reassessed by National Treasury using guidelines other than the UK CFC legislation.

When considering the impact of implementing the above-mentioned findings, National Treasury might just achieve the goal of protecting the South African tax base while empowering South African investors to invest abroad.

After evaluating the differences between the South African and UK CFC regimes as identified in Chapter 3, it is concluded that there are elements of the South African legislation that should remain unchanged as they address specific risks. It is, however, also concluded that there are valid elements implemented in the UK CFC regime that could simplify the South African CFC legislation by enhancing its competitiveness while still retaining the integrity and effectiveness of the legislation.

The summarized findings and conclusion above will be considered in Chapter 5 to assess whether the research question formulated in Chapter 1 has been sufficiently addressed.



## Chapter 5

### Summary, conclusion and recommendations

#### 1. Introduction

In the introduction to Chapter 1 it was stated that a CFC regime is an attempt by a tax jurisdiction to prevent its corporate taxpayers moving capital into mobile assets in offshore subsidiaries so that the income from those assets rolls up outside the specific tax jurisdiction. Since 1962 when CFC rules were implemented by the USA, several countries adopted similar legislation, including the UK in 1984 as well as the Republic of South Africa in 1997. The UK in its own right also influences global legislation. This is evident from the fact that almost all the OECD countries followed the lead provided by the UK in 1984 by enacting tax regime reforms (OECD, 2011:1).

As business and the world economy changes, so does the need to update relevant legislation. This was evident from the updates by Russia in their derivative tax legislation during 2007 (Kuznetsov & Sychev, 2008:28), as well as the significant overhaul the UK implemented in their CFC legislation with effect 1 January 2013. As with any updated legislation, praise as well as critique was expressed. Professionals reported the updated CFC legislation in the UK to be more effective in providing UK resident companies with a competitive edge (Lee, 2011), but still appears to be a complicated piece of legislation (Marsh Ltd, 2013). Even with this being the case, the updated legislation as well as the motivation about the changes should be seen as a valuable learning school for tax jurisdictions globally.

South Africa is a country offering great investment opportunities to foreign investors (Big Media Publishers, 2013). When taking into consideration the African continent's expected economic growth of 4.8% in 2013 and 5.3% in 2014 (Anon., 2013c), South Africa can utilize this opportunity to facilitate investments in Africa and also invest in the continent itself. However, with the local CFC regime perceived as too complex to understand (Hoosen, 2013), the risk does exist that local companies will not seize the opportunity to invest in Africa and enjoy the benefits of the continent's growth. South Africa is at risk of losing its status as the gateway to Africa. After the UK government has received so much acclamation about its new CFC legislation and

since South Africa and the UK levy tax on a residence basis, it was decided to analyse section 9D of the South African Income Tax Act (58 of 1962) and compare it with the updated CFC rules of the UK found in schedule 20 of their Finance Act (4 of 2012).

The motive of this analysis was to identify those elements implemented by the UK that could improve the effectiveness and competitiveness of the South African CFC regime. The problem statement formulated in Chapter 1 was to identify the aspects of the amended UK CFC legislation that could be incorporated into the South African CFC rules which would make them more accommodating to investors, but still protect the South African tax base sufficiently.

To answer the research question formulated in Chapter 1 and mentioned above, the objectives mentioned below were set.

## **2. Findings throughout research**

The objectives mentioned above were considered throughout the research process as well as in this document with the conclusions and findings presented below.

### *1.1 To determine what the factors and circumstances were that resulted in the revised CFC legislation in the United Kingdom.*

It was found in Chapter 2 that the most significant contributor to the change in the 1984 CFC regime implemented in the UK was because of the *Cadbury Schweppes* case. The Commissioner of Inland Revenue was found applying the “motive test” very subjectively, which would have resulted in resident holding companies being taxed on legitimate trading profits of foreign subsidiaries. The “motive test” therefore lacked objectivity which resulted in the residents being taxed on the profits of their subsidiaries.

Since section 9D of the South African Income Tax Act (58 of 1962) also considers the investors’ motive in some instances when applying the CFC rules, the risk was identified that applying a subjective test when considering this motive may result in

valid trading profits being taxed. It was concluded that the South African legislation is faced with a similar pitfall as the UK CFC legislation enacted in 1984.

*1.2 To critically compare the CFC rules per section 9D of the South African Income Tax Act to the CFC legislation effective 1 January 2013 in the United Kingdom.*

The first impression of the new CFC rules implemented by the UK with effect 1 January 2013 was that they appeared more complex than those of South Africa. It was found in Chapter 3, however, that the South African rules address a wider range of activities whereas the UK CFC regime focuses on specific streams of income.

In Table 2 included in Chapter 3 it was found that there are a number of aspects where the two sets of legislation agree, but areas were also identified where the legislation differs. These differences were considered in Chapter 4 and discussed in 1.3 below with the objective of identifying those aspects that will improve the South African CFC legislation.

*1.3 To identify elements of the new CFC legislation in the United Kingdom that might improve the current South African CFC regime.*

The differences between the South African and UK CFC regimes identified in Chapter 3 were evaluated in Chapter 4 to identify those elements that might improve section 9D of the South African Income Tax Act (58 of 1962). Even though section 9D was found to address a wider range of activities as compared to the UK's specific income stream approach, some matters were identified that National Treasury might consider implementing to improve the South African CFC legislation. The possible improvements identified in Chapter 4 can be summarized as follows:

- Amend policy to target specific income streams instead of taxing the CFCs' worldwide income after allowing certain deductions.
- Include South African sourced insurance income in the CFCs' net income to avoid the diversion of profits from the Republic.
- Exempt CFCs' formed with a valid business purpose from section 9D for a period to assist companies expanding their business and investments (whose

objective is not to divert profits away from South Africa) the opportunity to finalize their commercial agreements.

- Exempting the income earned from CFC incorporated on the African continent may motivate resident multinationals to invest in the continent and thereby enhance the economic growth of South Africa and the African continent.
- The minority shareholding exemption might be set too low. It should be considered to increase the shareholding from 10% to between 20% (IAS 28) and 25% (UK CFC regime).

### **3. Conclusion**

As mentioned earlier the world of business changes regularly which necessitates the revision of tax legislation. The UK reviewed its CFC legislation over a period of six years before implementing the updated CFC legislation on 1 January 2013. Another country revising its CFC legislation is Taiwan. Currently the income from foreign subsidiaries will only be taxed once a dividend has been received by the Taiwanese resident, resulting in business “parking” income from the CFC in tax havens and therefore deferring their tax liability in Taiwan (Deloitte, 2013). It is however, now recommended that going forward the Taiwan shareholder will include its share of the income of a foreign subsidiary of which it owns more than 50% of its current taxable income.

Leonardo da Vinci said that “Iron rusts from disuse; water loses its purity from stagnation... even so does inaction sap the vigour of the mind,” while Sydney J. Harris, an American journalist, said that “the greatest enemy of progress is not stagnation, but false progress” (Brainy Quote, 2013).

With the above in mind and seeing that legislation needs to be reconsidered and reworked to remain relevant, the elements identified in the UK legislation and mentioned in Chapter 4’s summary and conclusion need to be considered to enhance section 9D of the Income Tax Act (58 of 1962), as well as to prevent this legislation from becoming outdated or stagnant. These “enhancements” should, however, be considered very carefully as they might create loopholes that provide false progress to section 9D.

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