

An international comparative study of South African controlled foreign company legislation

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Preface

Globalisation of trade and investment has led multinational enterprises to develop strategies to maximise profits by investing in countries with a favourable tax climate, resulting in loss of tax revenue to domestic economies. In South Africa, recent economic liberalisation and associated relaxation of exchange controls have created increasing exposure to global competition, risk of capital flight and potential threat to the tax base. Heeding OECD recommendations intended to counter negative tax implications for domestic economies and curb harmful tax practices, South Africa introduced controlled foreign company provisions initially in 1997, followed by comprehensive legislation in 2001.

Appropriateness of South Africa's CFC regulations as domestic anti-avoidance measures is assessed in this study for their relevance in the international fiscal arena, highlighting key divergences, shortcomings and anomalies in the South African regulations compared with OECD recommendations, and with regulatory measures in the United Kingdom (jurisdictional-entity approach) and the United States (transactional approach), these two exemplars offering paradigms of the most important CFC regulatory approaches currently in force.

The primary materials investigated in the study are the statutes which constitute the taxation laws, read in conjunction with auxiliary, quasi-statutory advisory and explanatory documentation issued by the respective regulatory authorities, along with test cases that established legal precedent on points of ambiguity in taxation law. A key finding in the literature review is the relative dearth of publications on current South African CFC regulations in an international comparative context.

A paradigm shift is noted in United Kingdom tax policy, as it migrates towards a territorially inclined tax system in CFC regulations – more compatible with European Union (EU) requirements and propelled in large measure by EU-pressure – with a similar trend in United States tax policy, intended to rekindle expansion and growth of the United States economy through repatriation of foreign funds earned by CFCs. The study finds that it would be unrealistic to seek an absolute paradigm for reform or evolution of South African CFC regulations in either the United Kingdom or the United States, although the South African and United Kingdom CFC measures show significant affinities in their entity-based mechanisms to grant full exemption. More significant constituents of CFC regulation in one or another of the two countries do, however, prove to be generally congenial to the South African situation and offer useful pointers for ongoing reform of the South African measures.

Other areas in the United Kingdom or United States CFC regulations are identified as less relevant to South African requirements, being linked to tax principles that would be excessively complicated in the South African circumstances, needlessly demanding for tax administrators and for South African

shareholders, contradictory to South African tax principles, anachronistic, or not suited for the underlying global-entity approach in the South African regulations. The research provides an updated assessment of the current state of the South African CFC regulatory measures, when seen in a broader international context, and indicates areas that could be the subject of fruitful ongoing investigation.

Keywords

anti-avoidance tax legislation; controlled foreign companies; foreign business establishment; Katz Commission; mobile foreign income; model tax treaty; place of effective management; residence-based tax assessment; resident / non-resident taxpayer; source-based tax assessment

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List of abbreviations

ABTA	Association of British Travel Agents
APA	Advanced transfer pricing agreements
ATR	Advanced tax rulings
BEPS	Base erosion and profit shifting
BRICS	Brazil, Russia, India, China, South Africa
CFC	Controlled foreign company
CFE	Controlled foreign entity
CGT	Capital gains tax
CMA	Common monetary area
CMC	Central management and control
CP	Cost plus
CTB	Check-the-box
CTSA	Corporation tax self-assessment
CUP	Comparable uncontrolled price
DISC	Domestic international sales corporations
DTA	Double-tax agreement
DTR	Double-taxation relief
ECI	Effectively connected income
ECJ	European Court of Justice
EEA	European Economic Area
EPE	Exempt period exemption
EU	European Union
FBC	Foreign base company
FBCI	Foreign base company income
FBCSaI	Foreign-base company sales income
FBCSvI	Foreign base company services income
FBE	Foreign business establishment
FDAP	Fixed or determinable annual or periodical
FDI	Foreign direct investment
FIF	Foreign investment fund
FPHC	Foreign personal holding companies
FPHCI	Foreign personal holding company income
FSC	Foreign sales corporation
FTC	Foreign tax credit
GAAP	Generally Accepted Accounting Practice
HMRC	Her Majesty's Revenue Commissioners
HQC	Headquarter company

IAS	International accounting standards
ICTA	Income and Corporation Taxes Act
IEI	Income equivalent to interest
IP	Intellectual property
IRC	Inland Revenue Commissioners
IRR	Interest, rents, and royalties
IRS	Inland Revenue Service
ISP	Internet service provider
JSE	Johannesburg Stock Exchange
LLC	Limited liability companies
LLP	Limited liability partnership
LPE	Low profits exemption
LPME	Low profit margin exemption
MAP	Mutual agreement procedure
MNE	multinational enterprises
MTC	Model Tax Convention
MTM	Mark-to-market
OECD	Organisation for Economic Co-operation and Development
PE	Permanent establishment
PFIC	Passive foreign investment company
PS	Profit-split
PTI	Previously taxed income
PWC	PriceWaterhouseCoopers
QEF	Qualified electing funds
QLR	Qualifying loan relationships
REMIC	Real estate mortgage investment conduit
RP	Resale price
RPII	Related person insurance income
SA	South African
SARS	South African Revenue Service
SCI	Same country insurance income
SME	Small or medium size enterprises
SSE	Substantial shareholdings exemption
STC	Secondary tax on companies
TAA	Taxation Administrative Act
TAG	Technical Advisory Group
TCGA	Taxation of Chargeable Gains Act
TEFRA	Tax Equity and Fiscal Responsibility Act

TIPRA	Tax Increase Prevention and Reconciliation Act
TNMM	Transactional net-margin method

Chapter 1

INTRODUCTION

1.1 Background to the study

Dating from 1914, with the enactment of the inaugurating Income Tax Act, No. 28 of that year (South Africa, 1914), until 2000, the South African income tax system was based primarily on the source principle, according to which only income from a source within or deemed to be within the Republic (previous to 1961, the Union) was taxable in South Africa. In the Income Tax Act, No 28 of 1914 “income” in relation to any person was defined as “any gains or profits ... from any source within the Union”. “Taxable income” was in turn defined as “an income exceeding one thousand pounds, which has been received by, or has accrued to or in favour of, any person wheresoever residing, from any source whatever in the Union.” The source principle was preserved in subsequent Union income tax legislation in Income Tax Acts, Nos. 41 of 1917, 40 of 1925 and 31 of 1941 (South Africa, 1917; 1925; 1941), up to and including the promulgation of the Income Tax Act, No. 58 of 1962 (South Africa, 1962) (referred to hereafter as “the Income Tax Act”) (Danziger, 1983:193-194). The Income Tax Act thereafter defined “gross income” in Section 1 as “the total amount in cash or otherwise received by or accrued ... during the year or period of assessment from a source within or deemed to be within the Republic, excluding receipts or accruals of a capital nature.”

With the relaxation of exchange controls since 1994 and a perceived threat that this could pose to the tax base, the South African taxing authority began contemplating changes to its tax legislation, and in 1997, with a major move towards a partially residence-based system of taxation, a new residence-based principle of taxation was introduced into the Income Tax Act in respect of “passive” income: investment income such as interest, annuities, rentals and royalties, but excluding dividends (Section 9C). In 2000, a further step was taken, in Section 9E of the Taxation Laws Amendment Act, No. 30 of 2000, towards an entirely residence-based system of taxation which made foreign dividends taxable in the hands of South African residents. Subsequently “the circle was completed in 2001 when all income, including non-investment income, i.e. ‘active’ income, became subject to a residence-based system” of taxation (Jooste, 2001:473).

Although the “residence basis of taxation” may ensure worldwide taxation of the income of a country’s residents, taxes could still be avoided if such income is earned by South African-owned foreign companies (principally, by South African-owned foreign subsidiaries). The reason is that the “foreign corporation ... is generally considered to be a separate taxable entity” and that the controlling

shareholders of the corporation “are not taxable until distributions from the corporation ... are received” (Arnold & McIntyre, 2002:87). Therefore, in order for income not to be taxed, “it is simple for South African residents to avoid tax by shifting their income to foreign entities in tax havens and preferential regimes”, in which case that income could only be subject to South African tax when it is repatriated as a dividend (Jooste, 2001:474). Consequently, an efficiently instituted residence-based system of taxation will counter the delay or deferral of taxation, as taxpayers may often delay repatriation for years, or may never repatriate funds at all – thus resulting in the loss of substantial revenue for any domestic economy.

As a counter measure to avoidance or deferral of taxation, certain countries have introduced Controlled foreign company (CFC) legislation in an “attempt to draw within their tax nets income accrued to or received by foreign corporations over which their residents have a certain degree of control” (Olivier & Honiball, 2008:428). However, non-sourced income received by or accrued to a non-resident company cannot be directly taxed in a country in which the controlling shareholders reside. The only alternative will be, through the enactment of CFC legislation, to tax the residents controlling the foreign entity, on the proportional amount of the income that is deemed to have been distributed to them by the controlled foreign company. The Organisation for Economic Co-operation and Development (OECD) has stated “that countries [which] do not have [CFC] rules [should] consider adopting them and that countries [which] have such rules [should] ensure that they apply in a fashion consistent with the desirability of curbing harmful tax practices” (OECD, 1998:40-41).

South Africa first introduced a limited form of CFC legislation in 1987, in the now-repealed Section 9A, in terms of which investment income accrued to or received by a company in a neighbouring state which was controlled by a South African resident or residents was taxed in South Africa. On the recommendations of the Katz Commission, Sections 9C and 9D were inserted into Income Tax Act in respect of the taxation of “investment income” accruing on or after 1 July 1997 (Katz Commission, 1997: paras 3.2.2-3.2.3). The purpose of Section 9C was to deem investment income accruing from sources outside South Africa to South African residents, as income from a South African source, and thus taxable in South Africa (The Taxpayer, 1998:81). The purpose of Section 9D was to apportion investment income accruing to a “controlled foreign entity”, from any source outside South Africa, to “participants” resident in South Africa, and to include these apportioned amounts as part of their income (The Taxpayer, 1998:83).

On 23 February 2000, the Minister of Finance announced that a fully-fledged residence basis of taxation would replace the source basis of taxation, with effect from years of assessment commencing on or after 1 January 2001. The most important reasons for changing to the new residence-based system of taxation, as outlined by the South African Revenue Service (South Africa, 2000d:1), were

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

This change to a fully-fledged residence basis of taxation was a fundamental shift in South African CFC legislation (Section 9D): All income, both passive and active, became fully subject to South African taxation, and with certain types of active income being granted exemptions in terms of Section 9D(9) (Danziger & Stack, 2001:78).

1.2 Motivation for the study

Historically, tax policies were formulated principally to deal with “domestic economic and social concerns” (OECD, 1998:13). While the domestic tax systems of essentially closed economies also had an “international dimension” – a limited form of the residence basis of taxation – in respect of the amount of tax that was to be levied on certain foreign-sourced income of domestic residents and including the taxation of locally-sourced income of non-residents, “the interaction of domestic tax systems [was] relatively [minimal], given the limited mobility of capital” (1998:13). But the situation changed in recent decades as a consequence of the accelerating globalisation of trade and investment, fundamentally altering the relationships among domestic tax systems. Globalisation is recognised as a propelling force in tax reforms, requiring countries to continually assess “their tax systems and public expenditures with a view to making adjustments where appropriate [so as] to improve the ‘fiscal climate’ for investment” (1998:13). Globalisation has increased the mobility of capital, “encourag[ing] countries to reduce tax barriers to capital flows and to modernise their tax systems to reflect these developments” (1998:13-14).

One consequence of globalisation is an increase of competition among businesses in the global marketplace. Faced with high tax rates in their countries of residence, individuals and multinational enterprises have developed global strategies to maximise profits by investing in countries with a favourable tax climate. Tax havens and jurisdictions with preferential tax regimes are seen by multinational enterprises (MNEs) as ideal places for the establishment of subsidiary companies (Ginsberg, 1997:10). To counter this situation of MNEs leaving their domestic economies to invest abroad, a number of countries have set in place measures (in the form of CFC regulations) designed to block the avoidance or deferral of domestic taxation; among these are the United States (1962), Germany (1972), France (1980) and the United Kingdom (1984) (Arnold & McIntyre, 2002:89).

The Government of National Unity that followed South Africa's first democratic elections in 1994 introduced economic policy reforms that favoured the liberalisation of the economy, and was accompanied by a relaxation of exchange controls that came into effect on 1 July 1997. The transition from a virtually closed and besieged economy to an open and free economy (and with fewer exchange controls), also meant new exposure to global competition, risk of capital flight and erosion of the tax base (Macheli, 2000:1-2). Propelled by the relaxation of exchange controls, there were increased outflows of funds from South Africa, which potentially threatened the country's tax base by the phenomenal increase of foreign direct investments made by South African companies as: R67 698 million (1993), R203 036 million (1999), R244 653 million (2000) (Greenleaf, 2003:580). In response (and heeding to the recommendations of the OECD and other leading economies that had enacted CFC legislation), South Africa incorporated new CFC regulations, formulated as Section 9D of the Income Tax Act, in its domestic tax legislation. Section 9D would therefore initially apply only to investment income, but in the year 2000 South Africa would change to a fully-fledged residence basis of taxation in which all CFC income became subject to taxation (South Africa, 2000a:1).

In the new trajectory since 1994 of gradually liberalising exchange control regulations (with a view to their ultimate elimination), a key initial issue was the abolition on 13 March 1995 of the dual currency system of the financial and commercial rands. Thereafter, any investment or repatriation of capital was done through the single medium of the Rand. Further developments in deregulating and liberalising of exchange control regulations have led to the introduction of the foreign capital allowance for private individuals resident in South Africa and the exchange control limits applicable to newly approved foreign direct investments by South African corporates (see below). (Darsoo & de Beer, 2011:71.)

The foreign capital allowance and discretionary investment allowance: (per calendar year outside South Africa) in respect of private individuals (natural persons) resident in South Africa who are taxpayers in good standing and above the age of 18 years has increased to R4 million (1997: R750 000) and the single discretionary allowance has increased to R1 million. (Haupt, 2013:1001.)

Foreign direct investments by domestic companies offshore: Exchange control approval is still required in instances where the total cost of foreign direct investment exceeds R500 million per company per calendar year, provided that at least 10 per cent of the foreign entity's voting rights must be obtained and that the proposed investment must be in the same line of business as that of the applicant company. Longer-term monetary benefits to the Republic must be demonstrated. (Darsoo & de Beer, 2011:72.)

These considerations have given impetus to the current study – prompting a closer examination of South Africa’s CFC legislation (in particular, as embodied in Section 9D of the Income Tax Act).

1.3 Literature review

The literature review is guided by the research problem statement and provides the basic trajectory for the current study. The primary material under investigation in the study are the statutes which constitute the taxation laws, read in conjunction with the auxiliary, quasi-statutory advisory and explanatory documentation published by the respective regulatory authorities, along with selected legal test cases that establish precedent on various points of ambiguity in taxation. A key finding in the literature review is the dearth of secondary researched material on current South African CFC regulations in an international comparative context.

To date no comprehensive publication has been issued by the OECD with regard to CFC regulations. In a 1996 publication entitled “OECD Controlled Foreign Company legislation”, the OECD gives an overview of the inauguration of CFC regulations in the various OECD member countries. In essence, these discussions were directed towards the configuration policies contained in the relevant countries’ CFC regulations, from which it emerged that these were primarily the responsibility of member countries themselves. However, in a recent action plan pertaining to Base Erosion and Profit Shifting (BEPS), presented to the G20 Finance Ministers meeting in Moscow on 19 July 2013, the OECD has pledged to strengthen OECD rules by developing recommendations for the design of domestic CFC rules. This is a new area for the OECD (having hitherto been a concern only of national governments), but it is a familiar concept in many OECD member countries. (Deloitte, 2013a; 2013b.)

A paradigmatic CFC regulatory measure: In 1962, the United States enacted CFC regulations and in 1984 the United Kingdom enacted CFC measures as part of their respective domestic tax legislations. These two countries represent the most important types of CFC regulatory approaches currently in force: the global transactional approach (United States) and the jurisdictional entity approach (United Kingdom). The transactional approach subjects specified types of transactions, namely passive income and foreign base company income, to taxation (Arnold & McIntyre, 2002:89). The entity approach subjects “all or none” of the income to taxation, although United Kingdom Finance Bill 2012 has introduced certain fundamental changes to this approach (United Kingdom, 2012d).

Countries are entirely responsible for their own design and promulgation of CFC regulations in line with their individual domestic requirements and therefore no single CFC regulatory paradigm exists. These country-by-country needs are determined by fiscal and macro-economic policies – whether a particular country is capital importing or capital exporting, the level of tax non-compliance by its residents and the extent of foreign investments in tax havens and preferential tax regimes. In practice,

CFC rules do manifest a notable degree of convergence – and in some cases there may even be direct transplantation of key provisions from one jurisdiction to another: residence, definition of CFC, control requirements, attribution requirements of shareholders, calculation of net profit, relief provisions. The pressure to converge arises partly from domestic apprehension in each case that tax competition will lead to the establishment of parent corporations in foreign jurisdictions to avoid CFC regulations (as was the case in the United States when public corporations set up new nominal parents in Bermuda, and also in the United Kingdom when a number of companies moved their operations to Ireland). (Avi-Yonah & Sartori, 2012:6.)

1.4 Contribution of this study to the research field

No detailed comparative study could be found of the current state of South African CFC legislation in relation to corresponding anti-avoidance legislations of other leading economies (in particular, the United States and the United Kingdom). Nor has there been any systematic comparison of the key elements in the South African CFC legislation with the foundational guidelines set out in the OECD and UN Model Tax Conventions. The current research is therefore intended to fill these lacunae.

1.5 Research problem statement

In the wake of a general international trend to relax exchange controls, many countries have experienced an exponential outflow of funds from within their domestic economies (especially the capital-exporting countries). In this context of accelerating globalisation of trade and investment, removal of tax and non-tax barriers to international trade, and increased mobility of capital precipitated by the relaxation of exchange controls internationally, the South African government introduced CFC regulations. Fearing an impending threat to its tax base instigated by non-disclosure of foreign-sourced income earned through CFCs, the government enacted CFC regulations in its domestic tax law as one of its fundamental measures to counter the avoidance and deferral of taxation. The present thesis therefore is principally concerned with an evaluation of the South African CFC legislation primarily to determine anomalies and shortcomings in the South African CFC legislation that emerge from international comparisons with (a) the OECD and UN Model Tax Conventions, and (b) the CFC regulations of the United Kingdom and the United States.

The primary research question is

To what extent, and with what significant practical implications, does South African Controlled foreign companies tax legislation (as embodied, in particular, in the provisions of Section 9D of the Income Tax Act, No. 58 of 1962), conform to, diverge from, or fall short of

international norms as reflected (a) in the directives and advisories of the OECD and UN, and (b) in the tax regimes of certain of the leading economies of the world?

1.6 Research objectives

Primary objective

To determine to what extent, and with what significant practical implications, South African CFCs tax legislation (as embodied, in particular, in the provisions of Section 9D of the Income Tax Act, No. 58 of 1962) conforms to, diverges from, or falls short of international norms as reflected (a) in the directives and advisories of the OECD and UN, and (b) in the tax regimes of two selected leading economies (the United Kingdom and the United States) that could be considered as pioneers and leading tax jurisdictions in the promulgation of CFC legislation.

Secondary objectives

- To give a historical account of South Africa's CFC regulations (Chapter 2)
- To analyse the operation, effects and consequences of South Africa's anti-avoidance provisions (as embodied in Section 9D) (Chapter 3)
- To compare the interpretations of key elements in the South African CFC legislation with corresponding interpretations of these in both the OECD and the UN Model Tax Conventions (Chapter 4)
- To compare South African CFC regulations with corresponding provisions in the tax legislations of the United States and United Kingdom (Chapters 5 and 6)
- To identify shortcomings in the South African CFC legislation to which recommendations could be made (Chapter 7)
- To identify areas in the field which future researchers could pursue (Chapter 7)

1.7 Research methodology

1.7.1 Philosophical dimensions of taxation research

The "three worlds" framework indicates the methodological differences between various research approaches in the social sciences research, and is outlined by Mouton (2005:137-139) as follows:

- World I: *pragmatic interest*, which refers to the lay knowledge used to cope with everyday tasks
- World II: *epistemic interest* in which World I phenomena are turned into objects of enquiry

- World III: *critical interest* where researchers reflect on the reasons and justifications for certain actions

This framework is a set of meta-principles and reflects the progressive nature of everyday enquiries, which initially begins as the mode of curiosity (World I) and going through higher levels of analytical review (World II) until it is transformed into a World III level research enquiry. The critical interest research approach (World III) is the approach which most closely applies to the stated research question and is discussed below.

1.7.2 Paradigmatic perspective of the research

A paradigm may be defined as a typical example or pattern of something: it is a pattern or model. Thomas Kuhn, the historian of science, gave it its contemporary meaning when he adopted the word to refer to the set of practices that defined a scientific discipline at any particular period of time (Dash, 2005:1). Although the current frameworks and assumptions in taxation lack clarity in respect of the underpinning philosophies, the field could be regarded as based on the positivist paradigm (and certain aspects of interpretivism). The following three frameworks of theoretical paradigms may be outlined briefly as follows:

Positivism: The positivist paradigm in exploring social reality is based on the philosophical ideas of the French philosopher Auguste Comte, who emphasised observation and reason as means of understanding human behaviour (Dash, 2005:1). According to Comte, true knowledge is based on experience of senses and can be obtained by observation and experiment. Positivistic thinkers adopt his scientific method as a means of knowledge generation. Hence, it has to be understood within the framework of the principles and assumptions of science. These assumptions, as listed by Conen *et al.* (cited by Edirisingha, 2012:1), are “determinism”, “empiricism”, “parsimony”, and “generality”. Determinism means that events are instigated by other circumstances, and, hence, understanding such causal links is necessary for prediction and control. Empiricism means collection of verifiable empirical evidences in support of theories or hypotheses. Parsimony refers to the explanation of the phenomena in the most economical way possible. Generality is the process of generalising the observation of the particular phenomenon to the world at large (Dash, 2005:1). The phenomena “tax non-compliance opportunities”, for example, are investigated in the context of their underlying causes, verifiable through the collection of empirical evidence that demonstrate their presence and nature.

Interpretivism: Unlike the positivists, interpretivists believe that reality is relative and multiple. According to this practice there can be more than one reality and more than a single structured way of accessing such realities (Edirisingha, 2012:1). Lincoln and Guba (as cited by Edirisingha, 2012:1)

explain that these multiple meanings are very difficult to interpret as they depend on other systems for meanings. The knowledge generated from this discipline is perceived through socially constructed and subjective interpretations. Since interpretivist research knowledge is expected to emerge from value-laden socially constructed interpretations, researchers follow more personal and flexible research structures than in the positivist paradigms. Their research approaches have to be more receptive to meanings in human interaction and capable of making sense of what is perceived as multiple realities. The interpretivist researcher enters the field with some sort of prior insight about the research topic but assumes that this is insufficient in developing a fixed research design due to the complex, multiple and unpredictable nature of what is perceived as reality. During the data collection stage the researcher and his informants are interdependent and mutually interact with each other and construct a collaborative account of perceived reality. The researcher remains accessible to new ideas throughout the study and lets it develop with the help of his informants. The use of such an emergent approach is also consistent with the interpretivist belief that humans have the ability to adapt and that no one can gain prior knowledge of time and context bound social realities (Hudson and Ozanne, 1988, as cited by Edirisinha, 2012:1-2). In seeking to identify the implications of actions by the parties within a complex regulatory tax environment interpretivism may be helpful as underpinning for a theoretical framework from which to approach the issues in question.

Critical theory: Critical theory is fundamentally a process of deconstruction of the world and is an alternative to positivism, traditional realism and relativism. The critical theory approach aims to encourage critical consciousness and to break down the structures and arrangements that re-produce oppressive ideologies and the social inequalities that are produced and maintained by these structures. Therefore, the critical framework holds that we will only be able to understand and change the social world if we identify the structures that generate the events and discourses of the social world. Researchers are no longer satisfied with predicting or even understanding the researched, but also want to address social issues. Therefore, critical thinking can occur whenever one judges, decides, or solves a problem, or when one must fathom out what to believe or what to do, and do so in a reasonable and reflective way (Dash, 2005:1). In designing tax regulations, a legislator has to understand the full range of interpretations that could be given to them, which necessarily demands full (or critical) deconstructive analysis of their inherent scope.

1.7.3 Research methodology and design

1.7.3.1 Introduction

Research is a process that involves obtaining scientific knowledge by means of various objective methods and procedures, where objectivity implies methods and procedures that do not rely on

personal feelings or opinions, and where specific methods are used in each stage of the research process (Welman et al., 2005:2). The research methodologies applicable to this taxation study embrace certain paradigmatic assumptions: ontological assumptions, in relation to the nature of the social (and in this case, the financially regulated) world which the study aims to understand, and epistemological assumptions in relation to the character of the knowledge being pursued by the researcher in the legislative and regulatory fields under investigation. These epistemological assumptions relates to the knowledge of the regulatory and statutory framework underpinning taxation law, supported by statutory and quasi-statutory auxiliary documentations which lends clarity to areas of ambiguity in the application of taxation law. (Edirisingha, 2012:1-5.)

1.7.3.2 The research approach and its design

The research method used in this study comprises reviews of regulatory documents in conjunction, where appropriate, with selected legal test cases. Primary literature study (review of statutory and auxiliary, quasi-statutory documentation) sets the foundation for understanding and appraisal of CFC regulations in the respective countries.

The prime focus in the current research is Section 9D as a key anti-avoidance measure in the South African Income Tax Act, in conjunction with other pertinent Sections of the Income Tax Act; all subsequent comparisons in this thesis are to be made against Section 9D of the Income Tax Act. The key tax issues listed below constitute the underlying framework for the analyses and comparisons undertaken in the chapters that follow:

- Approaches to CFC regulations
- Shareholder qualification
- Control requirements of a CFC
- Qualification criteria of a CFC
- Lower level of taxation test
- Residence
- Place of effective management
- Central management and control
- Permanent establishment/ foreign business establishment
- The definition and calculation of business profits
- Transfer pricing
- Passive income
- Active income
- Exemptions

- Tax relief measures

A critical examination is made of these key elements in the South African CFC regulations, leading in turn to an international comparative study of

- provisions in the OECD and UN Model Tax Conventions (MTCs), and
- selected national regulations relating to the same issues in two leading economies – the United States and the United Kingdom.

The statutory and quasi-statutory auxiliary documents are the primary point of investigation in the research. The secondary literature comprises scholarly or professional tax journals, textbooks and electronic media.

Since the current research endeavours to evaluate the current state of South Africa's CFC regulations in an international context, the theoretical framework within which this study is conducted is primarily critical and evaluative, which incorporates the positivist and the interpretivist paradigms. It assesses, as must the tax authorities, the nature and effectiveness of South Africa's CFC regulations in acting as anti-avoidance tax measures. The thesis adopts the strategy of evaluating the validity of South Africa's CFC regulations as an effective anti-avoidance tax measure through an international comparative study of similar anti-avoidance tax measures in leading economies of the world, taken as representative instances of the main approaches currently used in CFC regulations – namely, the jurisdictional-entity approach in the United Kingdom and the global transactional basis adhered to in the United States. This research accordingly pursues the matter in detail by comparing the South African CFC regulations in relation firstly to certain key constituents in the OECD and UN Model Tax Conventions, and secondly, to key issues in the United Kingdom and United States CFC legislation.

This research is primarily qualitative in nature and is set within the context of axiomatic principles underpinning the OECD and UN Model Tax Conventions and the United Kingdom and United States CFC regulations. As characterised by Welman *et al.* (2005:188), “qualitative research can, theoretically speaking, be described as an approach rather than a particular design or set of techniques”. According to Van Maanen (cited in Welman *et al.*, 2005), it is an “umbrella” phrase “covering an array of interpretative techniques which seek to describe, decode, translate, and otherwise come to terms with the meaning of naturally occurring phenomena in the social world”. The qualitative approach is also fundamentally a descriptive form of research in which “the aims ... are to establish the socially constructed nature of reality, to stress the relationship between the researcher and the object of study, as well as to emphasise the value-laden nature of the enquiry”. (Welman *et al.*, 2005:8.)

Following detailed examination of the relevant elements of the OECD and UN Model Tax Conventions and the regulatory measures of the United Kingdom and United States CFC regulations, comparison is made with the South African CFC regulations from the perspective of recommendations to the South African regulators on shortcomings and anomalies in the South African CFC regulations. The research also considers the evolutionary nature of CFC regulation, notably in the United Kingdom and to a lesser extent the United States, and its corresponding impact in South African CFC regulations.

A salient feature in the promulgation of CFC regulations internationally is the extent of convergence (and in certain cases total transplantation) between countries in their respective framing of CFC regulations. Where they diverge is normally a reflection of varying national macro-economic policies, the size of the national economy, whether it is a capital exporting or importing country, and so forth. These are factors that have guided investigation in this study, which has also taken into account limitations in underlying design features in regulatory drafting and also the particular challenges created by electronic commerce.

Outcomes that emerge include: an updated assessment of the current state of the South African CFC regulations, with indications, where pertinent, of anomalies, discrepancies, inconsistencies or lack of clarity in the South African regulations when seen in a broader international context; recommendations for possible regulatory amendments; and identification of areas that could be the subject of fruitful further investigation.

1.8 Limitation of scope

The study focused on the CFC regulatory measures of the United States (transactional approach), and the United Kingdom (jurisdictional entity approach). Because of the volume and complexity of these legislations, it was not possible to extend the research to include any further countries. The study pertaining to these two countries includes legislation up to the United Kingdom Finance Bill 2012 and United States Job Creation and Tax Reform Act, of 2012. The South African tax legislation covered includes the tax amendments up to Taxation Laws Amendment Act, No. 22 of 2012. From the perspective of the South African tax legislation, it was beyond the scope of this study to include any relevant matters contained in the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2013.

1.9 Outline of chapters

Chapter 2: Historical background: CFC legislation in South Africa

The chapter gives an overview of the historical evolution of CFC regulations in South Africa. As a starting point, the territoriality principle (source) is examined in a South African context, from its inception through various stages in its evolutionary process up to the promulgation of a fully-fledged residence-based system of taxation in 2001. The chapter also reflects on the meaningful contributions made by the various government appointed statutory commissions: the Steyn Committee (1951); the Franzsen Commission (1970); the Margo Commission (1987); and the Katz Commission (1997). Various proposals and recommendations were submitted by these commissions, especially significant being the contributions made by the Katz Commission – considered a landmark in South African taxing history. One of its key recommendations was to retain the source basis for active income and to introduce the residence basis for passive income. As a direct result of these recommendations, Sections 9C and 9D were promulgated and incorporated into the South African Tax Act. The chapter concludes with a discussion of the replacement of the source basis of taxation with the fully-fledged residence basis of taxation by the Revenue Laws Amendment Act, Act 59 of 2000.

Chapter 3: South Africa's CFC Tax Legislation

The chapter provides a detailed analysis of the structural components forming part of South Africa's CFC legislation, thus laying the foundation against which the international comparisons with the OECD and UN Model Tax Conventions and United Kingdom and United States CFC legislations will be made. Issues dealt with in the chapter include definition of a CFC, defining the country of residence, determining the place of effective management, shareholder qualification, shareholders subject to attribution of CFC income, calculation of net income of CFC, capital tax implications; exemptions in terms of Section 9D(9), relief tax measures and administrative requirements, and other salient issues relating to South Africa's CFC legislation. Key constituents in the South African CFC legislation are to be the subject of enquiry and comparison to both the OECD and the UN Model Tax Conventions (Chapter 4). This will follow with comparisons of the South African CFC legislation to both the United Kingdom (Chapter 5) and the United States (Chapter 6) CFC legislation.

Chapter 4: South African CFC legislation and the OECD and UN Model Tax Conventions

The chapter provides a detailed analysis of certain key constituents of South Africa's CFC legislation in terms of the interpretations postulated in both the OECD and the UN Model Tax Conventions. This is followed by a critique of the South African interpretations attached to these key constituents. The main constituents selected for scrutiny are resident, place of effective management, foreign business establishment, permanent establishment, business profits, and transfer pricing. Analysis of these key concepts in terms of both the OECD and the UN Model Tax Conventions forms the basis of the

comparison with the South African interpretations in regard to these key constituents. Variations in the South African interpretations arising from the comparison to the OECD and UN Model Tax Conventions are highlighted as shortcomings to the South African CFC legislation – regarding which various recommendations are made in the concluding chapter of the thesis.

Chapter 5: CFC Regulations: United Kingdom

The primary aim of United Kingdom CFC regulations is to prevent multinationals from avoiding United Kingdom tax by diverting profits to tax havens and preferential tax regimes. Serving as an anti-avoidance tax measure to counter diversions of profits, the United Kingdom CFC regulations set in place (prior to the promulgation of Finance Bill 2012) convoluted criteria for a foreign company to qualify as a CFC (including company residence, control, and the lower level of taxation). This was extended with a set of elaborate exemptions available to shareholders of the company (the exempt activities exemption, the *de minimis* exemption, the motive test, and the excluded countries exemption) combined with rigorous administrative requirements.

An important factor that has impacted strongly on the trajectory of United Kingdom CFC regulations is the recent spate of judgements delivered by the European Court of Justice (ECJ), relating to these United Kingdom regulations. This judicial scrutinising of United Kingdom CFC legislation has set in motion a new trajectory for United Kingdom CFC legislation, particularly, in relation to member countries of the European Union. In consequence, Finance Bill 2011 and Finance Bill 2012 instigated a historic overhaul of United Kingdom CFC regulations. Through Finance Bill 2011, interim improvements were effected to United Kingdom CFC legislation in regard to three key areas: three wholly new CFC statutory exemptions (over and above existing exemptions), a widening of *de minimis* exemption, and an extension of transitional reliefs for holding companies. Finance Bill 2012 has been envisaged as completing the reform process of United Kingdom CFC regulations in response, particularly, to European Union requirements.

Chapter 6: CFC Regulations: United States

The United States was the first country to enact CFC legislation, which it did in 1962. Unlike the other two countries under scrutiny (South Africa and the United Kingdom) which apply their CFC regulations on an entity basis – under the presumption of “the all-or-nothing approach” – the United States applies its CFC regulations on the transactional “tainted income” approach. Only certain types of income, subject to the various exceptions, are currently taxable to United States shareholders and include insurance income, foreign base company income, income from countries subject to international boycotts, illegal bribes, kickbacks and similar payments, and income from countries where the United States has severed diplomatic relations. One of the more important types of income is the foreign base company income and includes (Section 954) certain dividends, interest, rents,

royalties, gains and notional principal contract income, income from certain sales involving related parties, income from certain services performed outside the CFC's country of incorporation for or on behalf of related parties, and certain oil-related income.

A key issue in the United States regulations is that there are no blanket exceptions from Subpart F. The legislation does, however, have several exceptions related to particular classes or amounts of income. In addition to the substantive tax rules, the reporting and record keeping requirements under the CFC rules are extensive and enforced with substantial penalties for non-compliance. Further, the United States Job Creation and International Tax Reform Act of 2012 had introduced certain significant changes to United States CFC regulations: for example, the treatment of all gross income as low-taxed income unless the further requirements are fulfilled.

Chapter 7 – Conclusion

The chapter provides a summary of the main shortcomings that are highlighted in the South African CFC legislation arising from an independent evaluation and assessment of the state of South Africa's CFC regulation (Chapter 3), the international comparison with the OECD and UN Model Tax Conventions (Chapter 4), and the comparisons with United Kingdom and United States CFC legislation (Chapters 5 and 6). Central to the conclusion of the thesis are keystone recommendations (arising from the above) for the South African CFC legislation in areas where the legislation is found wanting. Asymmetrical concepts in South Africa's CFC regulations are discussed, with accompanying explanations and reasons for these.

Chapter 2 considers the historical background of CFC legislation in South Africa.

Chapter 2

HISTORICAL BACKGROUND: CFC LEGISLATION IN SOUTH AFRICA

2.1 Introduction

2.1.1 History and background

This chapter gives an anecdotal account of the evolution of CFC regulations in South Africa, commencing from its initial promulgation in 1997, up until the promulgation of a fully-fledged residence basis of taxation by Revenue Laws Amendment Act, No. 59 of 2000. The secondary objective of this thesis, addressed in this chapter, is accordingly to give a historical account of South Africa's CFC regulations (see 1.6 above).

From 1914, with Income Tax Act, No. 28 of that year, until 2000, the South African income tax system was based primarily on income source. The effect of this was that only income from a source within or deemed to be within the Republic was taxable in South Africa. The relaxation of exchange controls from 1994 onwards that allowed South African investors to invest abroad, within the limits set by the Exchange Control Regulations of 1961 (as amended from time to time), made it necessary to revise the South African income tax system to prevent the existing source-based system from causing an imbalance should more capital flow out of the country than was coming in. This in turn, necessitated the introduction of a statutory regime to tax the foreign income of all South African residents, backed up by appropriate anti-avoidance provisions. (Katz Commission, 1997:8.)

The residence-based system of taxation was phased in by the introduction of Sections 9C and 9D to Income Tax Act, in respect of investment income accruing to South African residents on or after 1 July 1997. The broad aim of Section 9C, after taking the exceptions into consideration, was to deem investment income from sources outside South Africa which accrued to South African residents to be from a source within South Africa and therefore taxable here. The aim of Section 9D, with certain exceptions, was to apportion to "participants" in South Africa, certain investment income accruing from any source to a "controlled foreign entity", and to include the apportioned amount in their income. This initial move in 1997 was to tax only foreign passive income such as interest, royalties, annuities and rentals, and excluded foreign dividends. The reason given for the introduction of both Section 9C and Section 9D was to preserve our tax base in view of the contemplated relaxation of exchange controls and the potential of residents to invest offshore. (The Taxpayer, 1998:82.)

Section 9C taxed residents on their investment income accruing from foreign sources, as defined. Section 9D complemented Section 9C by apportioning the attributable investment income of CFCs to

South African resident shareholders – CFCs in respect of whose profits South African residents had the majority participation or control (The Taxpayer, 2000:1 81). Section 9C taxed foreign investment income that was received by or accrued directly to any South African resident, but it excluded foreign dividends (these only falling into the tax net in 2000), which meant that a resident could accumulate income in a CFC and, because the resident was a controlling participant, the income could accumulate with minimal or no distributions. The fact that income or any associated investment income which was due to the controlling resident was not distributed by the foreign company would have allowed such income to escape the South African tax net. It was not within the legislative jurisdiction of Section 9C to tax such income. A new legislative regime, in the form of Section 9D, had to be promulgated to counter this specific type of tax avoidance. The application of Section 9D did not depend on the actual distribution of the investment income by the CFC to its resident participants in South Africa; rather, the investment income was taxed in the hands of the participant resident upon being earned by the CFC. Therefore the actual distribution by the CFC of its investment income was irrelevant for the application of Section 9D.

According to Macheli (2000:18), taxation of income in a particular country is based either on source (the territoriality principle) or on residence (the domicile principle). The former only taxes income that is sourced within the territorial boundaries of a country. The latter taxes the worldwide income of a country's residents. In practice, no country adheres to one principle to the total exclusion of the other. Source-based countries tend to have provisions that deem income to be derived from within their territories which otherwise would be regarded as exempted foreign-sourced income. In a similar light, residence-based countries have source rules exempting certain types of income, but primarily the income of non-residents (Macheli, 2000:27). Therefore, in the world of complex international trade, neither principle can be applied in a pure form. Both systems of taxation have typically been modified in the direction of some common middle ground. Residence-based systems, as originally adopted by the United States and other industrialized nations, are associated with net capital-exporting countries and subject the residents of other countries to domestic taxation if they derive their income from within their domestic economies; this is viewed as the "importing" of an element of the source principle. (Katz Commission, 1997:5.)

Sourced-based systems, on the other hand, usually adopted by developing and net capital importing countries, have extended their tax nets by including certain types of foreign income (such as passive income) received by their residents to be from a domestic source and taxable, irrespective of the fact that the income is earned or generated in a foreign country (Katz Commission, 1997:5).

2.1.2 Source vs residence

In South Africa, Income Tax Act, No 28 of 1914 embraced the source principle when it defined “income” as “any gains or profits ... from any source within the Union”. “Taxable income” was in turn defined, “as income received by any person wheresoever residing, from any source whatever in the Union.” This definition was contained in all subsequent amendments to the Income Tax Act, culminating in Income Tax Act, No. 58 of 1962, as amended.

The Income Tax Act defined “gross income” in Section 1 as “the total amount in cash or otherwise received ... or accrued ... during the year or period of assessment from a source within or deemed to be within the Republic excluding receipts or accruals of a capital nature”.

The relaxation of exchange controls in South Africa since 1994, and the phenomenal increase in the volume and complexity of international transactions with South African residents, led the South African government to review our taxing system (Katz Commission, 1997:4). When a country’s citizens or residents transact business or invest abroad, or when non-residents trade or invest within a country’s domestic jurisdiction, the tax system as it affects these activities needs to balance carefully the domestic and international economic objectives. Globally, countries need to implement impartial tax regimes or systems that promote international trade, and there is a need for internationally accepted rules and practices that will regulate a country’s right to tax its own citizens or residents investing abroad, or non-residents of other countries investing domestically. The significant principles or bases which have developed for this kind of international taxation are the source and the residence bases. Residents are then afforded reprieve through a network of bilateral double tax agreements which seek to remove any remaining conflict and to eliminate the danger of taxing the same income twice. Since 1987, South Africa has dramatically increased its network of double-taxation treaties. (Katz Commission, 1997:8.)

It may be argued that a limited form of CFC legislation had already been introduced during 1987 in the form of the now-repealed Section 9A, in terms of which investment income accrued to or received by a company in a neighbouring state and controlled by South African residents was taxed in South Africa. “To counter the avoidance of this and other deemed source provisions, South Africa introduced its own so-called ‘Controlled Foreign Corporation’ (CFC) rules under Section 9A of the Income Tax Act” (Katz Commission, 1997: para 6.2.1.2). The same kind of avoidance was expected should South Africa lift controls over South African residents investing offshore, and the only proper solution to such tax avoidance was to expand the anti-avoidance provisions so that all forms of passive income were taxed on a worldwide basis (1997:para 6.2.1.2).

2.1.3 Commissions of tax inquiry in South Africa

Since 1951, various commissions have advised the government from time to time on whether South Africa should continue with the source basis of taxation or implement the alternative residence-based system of taxation. A discussion of these commissions and their findings now follows.

2.1.3.1 The Steyn Committee

As early as 1951, the government appointed the Steyn Committee to examine and advise on the retention of the source principle as a method of calculating tax liability for South African taxpayers (Steyn Committee, 1951:para 68). A preponderance of the submissions the Committee received favoured retaining the principle of taxing only income arising from Union sources. The Committee recommended the retention of the source principle primarily on two grounds. Firstly, adopting the residence-based taxation system would introduce considerable complexity into South Africa's tax law. Secondly, unless a considerable amount of foreign income was earned from abroad by South African residents and which had to be taxed at substantially lower rates than those in South Africa (neither of which was the case), there would be no material gain to the South African Treasury in abandoning the source principle (Katz Commission, 1997:para 2.1.1). The Committee did, however, note the tax-avoidance potential of the source principle as it enabled South African residents to derive income from abroad and contribute nothing to the fiscus, while at the same time enjoying the protection and facilities provided by the state.

2.1.3.2 The Franzsen Commission

In 1970 the Commission of Enquiry into Fiscal and Monetary Policy in South Africa (Franzsen Commission) recommended the adoption of the residence-based system of taxation. The Commission established that adherence to the source-based system of taxation could not be reconciled with the economic welfare of South Africa, especially in view of the increase in international trade with South African foreign trade partners (Franzsen Commission, 1970:para 20). The Commission recommended the retention of the source principle only for non-residents and to include income for residents from all sources, both domestic and foreign. The reason for the contemplated change to a residence-based system of taxation was, firstly, that the amount of income received from foreign sources by South African residents had increased significantly since the Steyn Committee's Report in 1951. Secondly, South Africa's major trading partners applied a worldwide basis of taxation and the South African Income Tax Act had already deviated from a pure source basis through the introduction of various deeming provisions. Thirdly, the residence-based system of taxation was in accord with the principle of ability to pay. The government in a subsequent white paper accepted these recommendations, subject to further study on various aspects. The intention of a change to a worldwide tax system was not pursued any further. (Katz Commission, 1997:para 2.1.2.)

2.1.3.3 The Margo Commission

The 1987 Commission of Inquiry into the Tax Structure of the Republic of South Africa reaffirmed the policy of the Steyn Committee insofar as it recommended retention of the sourced-based system of taxation for South Africa (Margo Commission, 1987:para 26.3) but adopted a more compromising position on the matter, with retention of the sourced-based system of taxation to be made subject to the possibility of extending some of the then existing deeming source provisions. In addition, the Commission highlighted the following factors that influenced its decision to recommend retention of the sourced-based system of taxation:

- A worldwide basis of taxation would require a more complex form of administration than the source-based system of taxation.
- There would be no significant impact on revenue after providing relief for foreign taxes, and the fiscal benefits would be reduced as and when South African tax rates were reduced.
- The disruption in terms of time and cost entailed in the implementation of a worldwide basis of taxation would not be justified by the potential benefits. (Katz Commission, 1997: paras 2.1.4 and 2.1.5.)

However, not all was discouraging for the implementation of a worldwide basis of taxation, as the Margo Commission did give some consideration to it, despite recommending that the source basis should be retained. The Commission highlighted the following considerations in favour of the residence or worldwide basis of taxation. (Katz Commission, 1997: paras 2.1.3.)

- If exchange controls that were then in place were lifted, the adoption of a residence or worldwide basis of taxation might be instrumental in curbing consequential tax-avoidance schemes.
- The “independent national states” that then existed (and to some extent the existence of other countries in the Rand monetary area) exposed the Republic to tax-avoidance schemes that seriously undermined the country’s tax base and was further exacerbated by tax rate differentials that prevailed in Southern Africa. A worldwide system would help to counter this tax avoidance.

2.1.3.4 The Katz Commission

The source vs residence issue was investigated by the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa, chaired by Professor Michael Katz, and known as the Katz Commission. It examined the source and residence basis of taxation very extensively and, in fact, more comprehensively than any of the previous tax commissions that had been appointed by the government of the day. The Katz Commission task was mainly to report on both the residence principle and source principle as the basis of taxation, in the light of the relaxation of exchange controls. Unlike the recommendations made by the previous commissions, which did not impact

significantly on South African tax legislation, the Katz Commission's key recommendations were implemented within months after the release of the report (in Section 9C and Section 9D).

Recommendations: Since the democratic elections in 1994, South Africa had become part of the global economy. This development now required a careful analysis of the international or cross-border transactions on its tax system in general and, more specifically, of whether South Africa's tax system should be based on the so-called "residence" or *source principle*. The Commission felt there was a critical need for the protection of the South African capital base. In a post-exchange control era, and in a world of mobile capital, a relatively higher South African tax rate posed the potential threat that it could prompt an exodus of financial capital and human skills through relocation of holding companies (Katz Commission, 1997: para 3.1.3.1). The Commission concluded on the basis of submissions received "from a broad range of South African businesses, both individually and through organized business structures" (1997: para 3.1.3.1) that such an exodus of resources would be caused by a change to a residence basis of taxation for as long as our tax rates exceeded those in other jurisdictions. This would carry a real danger of encouraging the export of South African financial and human capital, deleteriously for the South African multinational sector. (1997: para 3.1.3.2.)

Taxation of active income: Retaining a source-based system of taxation for South Africa would make it an ideal location, from a tax perspective, for the establishment of headquarter companies, finance companies and even management companies. Thus, South Africa would become a key player for investments into Africa. The Commission stressed the need for South African business to become reintegrated with the world economy. Direct outward investments by South African-based multinationals would not only result in the longer term inward flow of both technology and the income from those investments, but it also often forms the base through which the multinational operations located in this country would find access to international trade and technology. The Katz Commission was of the view that the objective of the new system was to both encourage and enhance the prevailing competitive tax neutrality of South African direct foreign investments. This was seen by the Commission as an important argument for the retention of a source-based system (Katz Commission, 1997: para 3.1.2.7). The Commission therefore recognised the objectives of tax neutrality in so far as it relates to both outbound and inbound direct foreign investments, as set against domestic business investment. The Commission concluded that the jurisdictional tax basis of the Republic should emphasise both capital import neutrality and capital export neutrality. (1997: para 3.1.2.11.)

The Commission noted the administrative complexity of changing the system from a source basis to residence basis for active income, negating the advantage of the worldwide basis of taxation, and presenting a further reason for retention of the source principle in respect of active income. The Katz

Commission, like its predecessors the Steyn Committee and the Margo Commission, also contended that it would not be cost effective to switch to the residence principle in respect of active business income. (Katz Commission, 1997: para 3.1.6.1.)

Taxation of passive income: The Katz Commission was established in the light of a new political and economic dispensation that emerged after the democratic elections in 1994 and South Africa's having re-joined the global economy. This had brought about a new challenge in respect of the taxation of passive income and, more particularly, highlighted the question of whether the taxing system should be based on the residence or the source principle. With the mobility of capital in the modern world, it had become evident that once relevant exchange controls were lifted, South African residents, including the institutions, will make considerable passive investments offshore, which could undermine South Africa's capital base. The Commission therefore recommended, purely from a revenue viewpoint, that a worldwide system will be more effective in securing the tax revenue on income arising from such passive investments (Katz Commission, 1997: para 3.1.1.1). The Commission noted that the residence-based taxing system was not a new approach in respect of passive income. The taxation of passive income was viewed by the Commission as an extension to the current deeming provisions to source, so as to include all forms of passive income. The Commission made reference to Section 9A of the Income Tax Act, which deemed certain investment income of foreign investment companies based in neighbouring countries to be from a source within the Republic and therefore taxable in the hands of controlling shareholders who were ordinarily resident in the Republic or were domestic companies. It now amounted to South African residents, corporate or individual, paying South African tax on their passive income, irrespective of the source of such income (1997:para 6.2.1.2). It was further recommended that protecting the South African tax base without relying on exchange controls would help to unlock the tax and exchange control systems, so that vital decisions on exchange controls could be made without taking into account their effects on the tax base (1997:para 3.1.7.1).

The Commission established that South Africa already applied a fair measure of residence-based taxation of passive income, as well as noting the existence of commensurate double tax treaties and the application of anti-avoidance measures with some administrative and legal infrastructure already in place. Therefore, the taxation of passive income on the residence basis would not have added excessive complexity to the tax law and its administration. The Commission recommended that South Africa will have to continue to allow relief against its own taxes for taxes paid on passive income in the country of source, so as to avoid double taxation. It was further established that passive income is mainly exempt from taxation in the source country and that as a result of this exemption the tax relief to be granted in South Africa in respect of passive income would be substantially lower than in the

case of active income. The Commission concluded that the gain or increase in revenue to the South African fiscus would justify the taxation of passive income. (Katz Commission, 1997:6.)

2.2 Taxation of investment income from foreign sources

2.2.1 Introduction

Both Sections 9C and 9D were promulgated as a direct result of the recommendations made by the Katz Commission. The Commission recommended that “active income” should be continued to be taxed on the source basis while “passive income” should effectively be taxed on a worldwide basis (Katz Commission, 1997: paras 3.2.1–3.2.3). The initial move to a “residence basis” of taxation was achieved by the promulgation, with effect from 1 July 1997, of both Sections 9C and 9D, which was an interim and partial provision and subjected foreign “passive” income to South African taxation (Jooste, 2001:473). The Katz Commission (Katz Commission, 1997:para 4.2.1) only listed what comprised “active” income, regarding all other income as “passive” income. The purpose of Section 9C was broadly, with certain exceptions, to categorise investment income from sources outside South Africa which accrued to South African residents as being from a source within South Africa and therefore taxable in South Africa (The Taxpayer, 1998:81). The initial aim in 1997 was to tax only foreign passive income comprising interest, royalties, annuities and rentals, but excluding foreign dividends. In the year 2000, foreign dividends too became taxable in the hands of South African residents.

There existed a variation between the two provisions in that Section 9C dealt with investment income that accrued directly to the resident and therefore the matter was dealt with as one that related to source, whereas in the case of Section 9D, the investment income accrued to a foreign entity, other than the taxpayer or resident, and therefore Section 9D had the purpose of including a portion of such receipt or accrual in the hands of a South African resident who had participation rights in the income of the foreign entity (The Taxpayer, 1998:83). While the content may differ in respect of passive investment income with regard to each country’s tax system, reflecting its domestic terminology and concepts, passive income generally refers to investment income from portfolio investments (OECD, 1996:49), as opposed to income generated from a business or trade. Countries have adopted two different approaches to the definition of passive income. Passive income may be defined directly, by listing the common types of investment income (as is the case of Australia, Canada, Denmark, Norway, Spain and the United States) or indirectly, in the negative as income other than a corporation’s defined active business income (as is done in Germany) (OECD, 1996:49). The Katz Commission preferred the latter approach, as in Germany, and recommended that passive income

should not be separately defined in South Africa, but should include all income which was not active income (Katz Commission, 1997: para 4.2.1).

2.2.2 Passive investment income

“Investment income” meant any income in the form of any annuity, interest, rental income or royalty or any income of a similar nature, and included any foreign dividend as defined in Section 9E. The Katz Commission (1997:para 4.3.1) recommended that passive income should not be separately defined, but should include all income which was not active income. Despite this recommendation, the legislature took a different approach (as also adopted in many other countries) and defined investment income (as per the Income Tax Act) as income in the form of an annuity, interest, rental income, royalty or any income of a similar nature, and foreign dividends were included, as defined in terms of Section 9E, which came into effect on 23 February 2000, by the insertion of Section 19(1)(a) of Act No 30 of 2000 which stipulated that foreign dividends may now be subjected to taxation. Excluded from the CFE regime in terms of Section 9C(9)(b) was investment income arising from and effectively connected to the business activities of a substantive business enterprise of any controlled foreign entity conducted through a permanent establishment in any foreign country other than the Republic where such permanent establishment was suitably equipped for conducting the principal business of such substantive business enterprise.

2.2.2.1 Annuities

The term “annuity” is not defined in the Income Tax Act, 58 of 1962. According to the Explanatory Memorandum that accompanied Income Tax Act, No 28 of 1997, which introduced both Sections 9C and 9D in South Africa, “annuity” was intended to follow its ordinary meaning. South African case law ITC 761(South Africa, 1952), had defined an annuity as a recurring annual payment (even if payable in monthly instalments) to someone who has a right to receive at least more than one annual payment. A similar definition is found in tax treaties that the Republic had concluded with other countries where under relevant Articles, “annuity” was defined as a stated or fixed sum payable periodically at stated times, either during the annuitant’s life or for a specified or ascertainable period, under an obligation to make the payment in return for adequate and full consideration in money or money’s worth. This requirement is similar to that of Section 10A of the Income Tax Act. In terms of Sections 9C and 9D, “annuity” was defined as any annuity, but excluding pensions in consideration of past employment or payments made under the social security system of any other country.

2.2.2.2 Interest

The Katz Commission recommended that for purposes of any provisions relating to cross-border interest, whether inflow or outflow, the concept “interest” should carry the meaning ascribed to it in

Section 24 J of the Income Tax Act, since different meanings could result in random discrimination between local and cross-border funding situations(Katz Commission, 1997:para 6.2.1.5). The legislators enacted this recommendation and defined “interest” as interest and amounts as contemplated in Section 24J (dealing with incurral and accrual of interest, in general) and 24K (dealing with incurral and accrual of interest in respect of interest rate agreements), and also included any other income which, by the laws of the Republic administered by the Commissioner, was subjected to the same treatment as income from money lent, such as dividends on affected instruments as was contemplated in Section 8E of the Income Tax Act. The overall effect was that, as in other countries, “interest” under the South African CFE legislation was defined quite broadly to encompass the widest range of forms in which interest could arise. The major concern with regard to interest relates to the fact that it can be either active income or passive income, with different tax consequences. The problem related mainly to circumstances involving banks and other financial institutions where interest was the major source of business income, and other inter-group financing where a controlled foreign entity was used to finance activities of related parties in a multinational corporate group conducting legitimate activities (OECD, 1996:49).

Banks and other financial institutes: Banks and other financial institutions are primarily involved in the business of lending money at interest, hence their income is generally considered to be active income. The tax legislators have accepted that interest income of these institutions should be exempted from CFE legislation. However, an unqualified exemption of interest earned by banks and other financial institutions may lead to the manipulation of the legislation, through the use of banking and insurance subsidiaries established in tax havens (Macheli, 2000:269-270). In many tax haven countries including the Bahamas, Cayman Islands, Grenada and St Vincent, it is easy to establish a bank without stringent capital reserve or other restrictive requirements (2000:270-271). The Cayman Islands, for example, is one of the most popular bases for offshore banks: it was noted that at the end of 1996, 46 of the world’s largest 50 banks had a presence in the Islands; in 1995, the number of banks and trust companies licensed in the Islands increased to 564, representing more than 62 countries, including 87 banks with local operations (Ginsberg, 1997:219, 223).

With such potential for manipulation, interest income of banks and other financial institutions is subject to attribution in some countries’ CFE legislation. A classic example was Denmark, whose legislation exclusively targeted all income arising mainly from financial activities (including interest, dividends, royalties, financial leasing and capital gains from disposal of shares and other securities), regardless of whether it was passive or active income (Sandler & Chartered Institute of Taxation, 1998:230-231). South Africa’s tax provision granted exemption if investment income was effectively connected to the business activities of a controlled foreign entity’s permanent establishment (Section 9D(9)(b)).

Inter-group financing: A crucial question was how to treat interest income earned by a controlled foreign entity established in a tax haven whose principal activity was to lend funds to related parties in a multinational group of entities. According to Arnold (1986:42), if the funds were used in an active business of the borrower entity, the interest received by the lender entity should be characterised as active income and accordingly be exempted from CFE legislation. Conversely, if the funds were used to earn passive income by the borrower entity, interest received should be classified as passive income and subjected to attribution. On the basis of determining active income or passive income, the South African CFE legislation did not provide any special rules regarding interest from inter-group financing (Arnold, 1986:42). Interest income from inter-group loans, like any investment income, was exempted from CFE legislation if it arose from and was effectively connected to the business activities of a substantive business enterprise of a controlled foreign entity conducted through a permanent establishment in any foreign country (Section 9D(9)(b)).

2.2.2.3 Rental income and royalties

Like many other countries, South Africa subjected foreign-source rental income and royalties to attribution under CFE legislations as investment income. Rental income was defined in Section 9C (1) “as any amounts received by or accrued to any person as consideration for the use of, or the right to use, any moveable or immovable property”. “Royalty” in terms of Section 9C (1) “meant any amount received by or accrued to any person as consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work (including cinematograph films and films, tapes or discs for radio or television broadcasting), any patent, trade mark, design or model, plan, secret formula or process, or any other property or right of a similar nature, or for information concerning industrial, commercial or scientific experience.” Rental income arose from leases of tangible property such as ships, aircraft, cargo containers, machinery, land and plant, while royalty income arose from grants of use of intangible (or intellectual) property. Similar to interest, the exemption of rental income and royalties depended on whether they arose from or were effectively connected to the business activities of a substantive enterprise of a controlled foreign entity conducted through a permanent establishment. (Section 9D(9)(b).)

2.2.2.4 Dividends

Section 9(1) of Act, No. 28 of 1997 (South Africa, 1997) introduced Section 9C into the Income Tax Act. Its purpose was to deem the source of foreign investment income accruing to a South African resident to be from a South African source. While in most countries dividends were classified as tainted passive income, this was not the case in South Africa when the CFE rules were first introduced in 1997. “Investment income” was defined to include only income in the form of an annuity, interest, rental income or royalty or any income of a similar nature. The reason for the exclusion of foreign

dividends was not known, but perhaps it was an attempt to maintain an impartiality of tax treatment between domestic source dividends and foreign source dividends and not discourage offshore investments by South African residents. Unlike annuities, interest, rental income and royalties, dividends were, with only a few exceptions, exempt from tax in South Africa, even if derived from a domestic or a deemed domestic source. The legislation on the taxation of dividends was to deem all dividends (even if derived from foreign sources) to be from a source in the Republic of South Africa and included in a taxpayer's gross income in terms of para (k) of the definition of gross income, and then exempted or excluded most of them from tax in terms of Section 10(1)(k).

The Minister of Finance in his Budget Review of 2000 announced that foreign dividends became taxable with effect from 23 February 2000. The new provisions were contained in Section 1, 6*quat*, 9D, 9E, 64B, 64C and 70 of the Income Tax Act, and were enacted by the Taxation Laws Amendment Act, No. 30 of 2000 (The Taxpayer, 2000:166). A foreign dividend was, in broad terms, defined as a dividend received by or which accrued to any person from any company, to the extent that the dividend was declared from profits

- a) derived from a source outside the Republic and which were not deemed to be from a source within the Republic, or
- b) deemed to be from a source within the Republic and which have not been taxed in the Republic. (Section 9E(1).)

At the hearings on the Taxation Laws Amendment Bill 2000, it was brought to the attention of representatives that the reasons for introducing income tax on foreign dividends were

- to broaden the tax base
- to phase in a residence basis of taxation
- to limit tax-avoidance schemes effected by interposing entities in tax haven countries
- to introduce internationally accepted tax principles for taxing foreign dividends
- to do this in a manner that does not result in double taxation in respect of operating profits from foreign direct investment.

The new legislative amendment included dividends derived from foreign sources to be within the ambit of paragraph (k) of gross income (as amended) via the legislative regime of the new Section 9E, with effect from 23 February 2000. It was important to note that Section 9C was not specifically amended to include foreign dividends because that Section related directly to South African residents, and Section 1(k) had therefore been amended to include foreign dividends. Section 1(k) on gross income included any amount received or accrued by way of dividends including any amount which was deemed to be a dividend declared as contemplated in the definition of "foreign dividend" in Section 9E. Consequently, "foreign dividends" were included in the attributable "investment income"

of a controlled foreign entity under the CFE regime of Section 9D. “Investment income” comprised investment income as defined in Section 9C (1) and included any foreign dividend as defined in Section 9E. These measures were intended to bring South Africa closer towards the application of internationally accepted tax principles for the taxation of foreign dividends, and to reduce the effect of certain tax-avoidance schemes used to exploit the South African tax base. In essence, the new approach to dividends retained the corporate tax exemption system in respect of dividends from domestically-based companies and in respect of dividends from foreign based companies in countries that had a tax system on par with South Africa and any other dividends from foreign based companies that were subject to South African taxation, with a Section 6quat rebate granted for foreign taxes paid. (The Taxpayer, 2000:166.)

In terms of Section 9E (1) “foreign dividends”, meant “any dividend received by or which accrued to any person from any company, to the extent that the dividend was declared from profits derived by such company from a source outside the Republic and which were not deemed to be from a source in the Republic, or from profits which were deemed to be from a source within the Republic and which have not been subjected to tax in the Republic.” Included are

- the amounts which were deemed to be dividends declared by a company as contemplated in Section 64C(3)(a)-(d), subject to a proviso excluding capital liquidation dividends but including as dividends any amounts derived by the company from the disposal of any share in any other company if such amounts represent undistributed profits in such other company which were available for distribution to such company, and which would not have been excluded from the provisions of paragraph (b) had that paragraph applied, and
- the amounts that were derived by any shareholder from the disposal of any share or interest in the fixed capital in a company if such amounts represented undistributed profits which were derived from a source outside the Republic and which were not deemed to be from a source within the Republic or from profits deemed to be from a source within the Republic and which have not been subjected to tax in the Republic and which were available for distribution to such shareholder, subject to wide-ranging exclusions.

From the perspective of the CFE provisions, the definition of foreign dividends in this regard applied to dividends declared by foreign companies (including CFCs) to the Republic’s resident shareholders. However, such dividends were not ordinarily the target of CFE rules because, once declared, they were taxed on an accrual basis in the Republic without any deferral benefits but subject to a rebate in terms of Section 6quat.

CFE rules were more concerned about foreign dividends received by a CFC from other foreign companies. As a consequence of this, “investment income” in Section 9D had been extended to include the amount of any investment income received by or accrued to a controlled foreign entity by way of foreign dividends, determined in accordance with the provisions of Section 9E as if such company had been a resident of the Republic of South Africa. In other words, the provisions of Section 9D had been extended so that foreign dividends received by a CFC could have been imputed to South African residents with participation interests in such an entity. The South African CFE legislation provided for the impartiality of treatment both for dividends received by a controlled foreign entity from foreign companies and for those received by a resident directly from foreign companies. This principle was embodied in the provision that foreign dividends received by or accrued to a controlled foreign entity should have been determined in terms of Section 9E, as if such entity had been a resident. If foreign dividends were taxable or exempted when received by or accrued to a resident, they should also have been taxed or exempted when received by or accrued to a controlled foreign entity.

The taxation of dividends in terms of Section 9E are discussed in the following subsections:

Percentage shareholding: The percentage shareholding of a resident to whom a foreign dividend accrued was decisive in determining the amount to be included in his gross income. The amount of the foreign dividend that was to be included in gross income was determined in terms of the provisions of Section 9E(3) and (4).

Section 9E(3) distinguished between a foreign dividend received by or accrued to

- a resident who held less than 10 per cent of the equity share capital of the company that declared the dividend (often referred to as a “portfolio shareholder”), and
- a resident who held at least 10 per cent of the equity share capital of the company that declared the dividend.

The shareholding was either by the resident for his own benefit or, in the situation of a shareholder that was a company, it was held by the company, together with any other company in a group of companies of which the company forms a part, for their own benefit.

In the situation of a portfolio shareholder who held less than 10 per cent of the equity share capital of the company that declared the dividend, the amount to be included in his gross income was the amount of the dividend declared, before the deduction of the amount of any withholding tax paid in respect of the dividend (Section 9E(3)(b)).

In the situation of a resident who held at least 10 per cent of the equity share capital of the company that declared the dividend, the amount to be included in his gross income was the proportionate share of the profit from which the dividend was distributed, before the deduction of

- any foreign tax imposed in respect of the profit, and
- any withholding tax paid in respect of the dividend. (Section 9E(3)(a).)

A shareholder who held at least 10 per cent of the equity share capital therefore had to look through the company declaring the dividend and include in his gross income his proportionate share of the profit of that company, out of which the dividend was distributed.

There were no definitions of the word “profit” and the term “foreign tax on income” in Section 9E. According to the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2000, the term “income” in the expression “foreign tax on income” included profits, income and gains. Foreign taxes on income included taxes imposed by national and certain lower tiers of government in the foreign country, and also capital gains taxes (Kolitz, 2001:93-94).

Election: A resident could have elected that only the net amount of a foreign dividend or profits received, or after the deduction of foreign taxes paid, was to be included in his gross income (Section 9E(6)). This election had to be made on an annual basis and was binding on all foreign income received by or accrued to the resident during the year of assessment in respect of which the election was made.

If a portfolio shareholder, being a shareholder who held less than 10 per cent of the equity share capital of the company that declared the dividend, made the election, the amount that was to be included in his gross income was the amount of the dividend after the deduction of any withholding tax paid in respect of the dividend (Section 9E(6)(b)).

If the shareholder who held at least 10 per cent of the equity share capital of the company that declared the dividend made the election, the amount that was to be included in his gross income was the amount of the profits from which the dividend was declared, after the deduction of any foreign tax on income and any withholding tax paid in respect of the dividend (Section 9E (6)(a)).

If the election was made, a deduction was effectively granted for the foreign taxes paid on the foreign dividend received and the claimed portion could therefore not be taken into account in calculating the amount of the foreign tax credit relief (Section 6quat (1B)(e)) (Kolitz, 2001:95).

Qualifying interest: Section 9E(4) provided that where a resident shareholder held at least 10 per cent of the equity share capital of a company declaring a foreign dividend as required by Section 9E(3)(a), determination of the proportionate amount of the profit to be included in the income of the resident

shareholder must take into account any profits derived by any other company in which the dividend-distributing company had an interest if those profits had themselves been distributed to that company in the form of dividends and if the resident shareholder had a qualifying interest in the other company.

A qualifying interest of any person was defined in Section 9E(1) as

- any direct interest of at least 10 per cent held by such person in the equity share capital of any company; and
- any direct interest of at least 10 per cent held by any such company in the equity share capital of any other company. The other company was then deemed to also be a company in which the person held a direct interest of at least 10 per cent.

Effectively then, where a shareholder held at least 10 per cent of the equity share capital of a company that declared a dividend out of its profits that had been derived by way of a dividend received from any other company in which the shareholder also held a qualifying interest, the shareholder must have “drilled down” to the profits of the other company in order to quantify the amount of the foreign dividend that was to be included in his gross income (Kolitz, 2001:96).

Exemption: In a similar light, foreign dividends distributed to a controlled foreign entity which directly or indirectly held for its own benefit at least 10 per cent of the equity share capital in the distributing foreign company were exempt from attribution, to the extent that the profits from which the dividend were declared

- a) were generated in a designated country
- b) were subject to tax at a rate of at least 27 per cent without any right of recovery by any person (other than a right of recovery in terms of an entitlement to carry back losses arising during any year of assessment to any year of assessment prior to such year of assessment), and
- c) complied with any other requirement which the Minister may have prescribed by regulation. (Section 9E(7)(d).)

Section 9E(7)(d) provided an exemption from tax of any foreign dividend declared by any company which had distributed directly or indirectly to a resident who held a qualifying interest in such company, to the extent that the profits from which the dividend were declared

- were generated in a designated country, and
- were subject to tax at a rate of at least 27 per cent without any right of recovery by any person (other than a right of recovery in terms of an entitlement to carry back losses arising during any year of assessment to any year of assessment prior to such year of assessment).

Section 9E (8) authorized the Minister of Finance to designate the countries by notice in the *Gazette*. He had done so in Notice No 866 *Government Gazette* 21526 issued by SARS on 1 September 2000: The following countries were listed by the Minister in terms of Section 9E (8): Algeria, Australia, Austria, Belgium, Canada, Croatia, Czech Republic, Denmark, Egypt, Finland, France, Germany, Israel, Italy, Japan, Republic of Korea, Lesotho, Malawi, Namibia, Netherlands, Norway, Poland, Romania, Slovakia, Swaziland, Sweden, Thailand, Tunisia, United Kingdom, United States of America, Zambia and Zimbabwe. (The Taxpayer, 2000:169.)

The basic exemption of interest income earned by natural persons had been extended to include the aggregate of interest and taxable dividend income. This exemption was deemed first to apply to foreign dividends and thereafter to interest income. The maximum exemption for the 2001 year of assessment was R3000 for persons under 65 years and R4000 for persons who are 65 years and older (The Taxpayer, 2000:166). These exemptions or exempted amounts have been amended or changed in each subsequent tax year thereafter.

2.3 Structure and components of Section 9D implemented 1 July 1997

2.3.1 Introduction

Section 9D referred to “investment income of controlled foreign entities and investment income arising from donations, settlements or other dispositions”. The key requirements of South Africa’s CFE legislation were the definitions of both “foreign entity” and “controlled foreign entity”. These definitions were essential for both the identification of the foreign entity and its connection with South African resident taxpayers. An essential characteristic of the 1997 CFE legislation was that it applied to certain foreign entities controlled by South African residents. The legislation was generally aimed at curbing or preventing avoidance and deferral of domestic tax by South African residents, whose aims were the diversion and accumulation of income in a foreign entity, and the avoidance or deferral of domestic tax on such income. The legislation referred to foreign taxable entities. Companies and trusts were regarded, for the purposes of Section 9D, as those entities that fulfilled the attribution requirements of Section 9D. To be effective, the South African CFE legislation had to be wide enough to bring within its ambit foreign conduit entities, whose use would have allowed the avoidance and deferral of domestic tax. Therefore, in this respect, Section 9D specifically included a trust. In South Africa, except for the purpose of the Income Tax Act, a trust is not a legal entity and may also not be considered a legal entity in other jurisdictions. “The fact that in the [Income Tax] Act the definition of person includes a trust would not in itself bring a trust within the definition of foreign entity, but we consider that it can be inferred from the provisions of Section 9D(4) – that irrespective of the legal

status of a trust established in a foreign country, it is to be regarded as a person for the purpose of Section 9D”. (The Taxpayer, 1998:84.)

The inclusion of a trust in the definition of the term “person” was introduced as an anti- avoidance tax measure, following the decision in Trustees of the Philip Frame Will Trust v CIR (South Africa, 1991), upheld on appeal in CIR v Friedman and Others NNO (South Africa, 1993). It was held that, because a trust was not a person at common law or under the Income Tax Act, the trustees could not be taxed in their representative capacity with regard to the undistributed income of a trust as a trust was not a “person”, capable of being represented. The term “person” was subsequently amended to include a trust, simultaneously with the enactment of Section 25B which contains the rules for the taxation of trusts and trust beneficiaries in South Africa. With regard to our CFE legislation, the provisions of Section 9D clearly included a trust as falling within the ambit of a “foreign entity”. The Explanatory Memorandum to the 1997 Income Tax Bill which introduced both Sections 9C and 9D made specific reference to a trust in terms of Section 9D.

2.3.2 Defining a controlled foreign entity

2.3.2.1 Applicable law

In South Africa the term “foreign entity” was defined in Section 9D(1), “as any person, other than a natural person, which has its place of effective management in a country other than the Republic”. Clearly adopting a wide approach, the South African definition embraced not only a company, but also a trust. In view of the definition of a foreign entity, the legislature had defined a foreign entity in relation to its foreign place of effective management, making it easier to identify and classify foreign entities under the South African CFE legislation. “Controlled foreign entity” meant, “any foreign entity in which any resident or residents of the Republic, whether individually or jointly, and whether directly or indirectly, hold more than 50 per cent of the participation rights, or are entitled to exercise more than 50 per cent of the votes or control of such entity” (Section 9D(1)).

2.3.2.2 Foreign status of an entity

South Africa had chosen the “place of effective management” test with regard to the determination of the foreign status of entities under the CFE legislation. The interpretation of place of effective management was, however, not free from controversy. According to an editorial article in *The Taxpayer* (1998:84), “the place of effective management is not necessarily the place where a corporate body carries on business but where the board of directors meet on the company’s business which may differ from the place where the company’s business is carried on or is managed by staff or directors individually and not acting as a board, but where the company has executive directors and the facts reveal that the company is effectively managed by such directors and not by the board as a

whole, the place of effective management would be where such directors conduct the company's business". With regard to trusts, the determination of their foreign status is closely linked with the question of whether they are recognised as a separate legal person. In South Africa, as in some other countries, a trust is regarded as a distinct legal persona under the Income Tax Act . (Section 9D(1).)

The term "place of effective management" was not defined in the Income Tax Act, and the ordinary meaning of the words, taking into consideration international precedent and interpretation, was taken to apply. The terms "effective management" or "effectively managed" were used by various countries throughout the world, as well as by the OECD in its publications and documentation. However, the terms did not have a universal meaning linked to them, and the various countries and the members of the OECD have attached different meanings to it. (The Taxpayer, 2002:67-69.)

In South Africa, the test for residence of a trust was its "place of effective management" which was clearly stated in the definition of a "foreign entity" in Section 9D(1). According to The Taxpayer (1998:84), in the case of a trust, "the place of effective management will normally be the place where the trustees meet to deal with the affairs of the trust". It was submitted that under the "place of effective management" test a trust could have been resident in a country where its affairs were administered on a regular basis by its trustees or any particular trustee, regardless of where the meetings of trustees were held. This meant the place which had the closest nexus with the business or investment activities of the trust (Macheli, 2000:197).

2.3.3 Control of a foreign entity

All countries that have implemented CFC legislation apply it to foreign entities over which their resident taxpayers have some form of substantial influence or control. In most countries, substantial influence means control, directly and indirectly, of the foreign entity. In Australia, Finland, Norway, Spain and Sweden, the CFC legislation applied where 50 per cent of the shares of the foreign entity were held by resident taxpayers (OECD, 1996:32). In South Africa, as per Section 9D(1), the CFC legislation applied if "any resident or residents of the Republic, *whether individually or jointly* ... held more than 50 per cent of the participation rights, or were entitled to exercise more than 50 per cent of the votes or control of such entity." The Katz Commission (Katz Commission, 1997: para 8.3.1.3) stated that, "the definition of 'control' should be wide to avoid manipulation, particularly through the use of 'straw persons' as directors as well as the use of offshore discretionary trusts as holding entities".

2.3.3.1 Direct control

A key feature of all CFC legislations is the requirement of control of a foreign entity by a country's residents, usually determined on the basis of ownership of a sufficient number of voting shares or

rights in the entity. More than 50 per cent of the voting shares of a company gave shareholders the power to influence most decisions of the company, and grant shareholders the power to appoint at least a majority of directors, which, arguably, gave such shareholders indirect control over the management of the CFC's operations and possibly control over the declaration of dividends. (OECD, 1996:34.)

In South Africa, there were three tests applied to determine the control of a foreign entity under the CFE legislation:

- Control was defined in terms of the ownership of more than 50 per cent of “participation rights” in a foreign entity. “Participation rights”, in terms of Section 9D(1), was defined as “the right to participate directly or indirectly in the capital or profits of, dividends declared by, or any other distribution or allocation made by, any entity”. With regard to trusts, “participation rights” would clearly have meant control by virtue of any right to any form of distribution or allocation made out of the trust income or assets. A “right” in this connection would have referred to a vested right to the income or capital of the foreign entity, and not merely a contingent right or a *spes* – an expectation which might not have been realised (Macheli, 2000:202).
- Control was defined as an entitlement or right to exercise more than 50 per cent of the votes of a foreign entity. Usually, this assumption meant that domestic shareholders should have held more than 50 per cent of the voting shares of a CFC (Section 9D(1)). With respect to trusts, the assumption would be fulfilled where, for example, South African residents who were trustees of a foreign trust (i.e. a trust whose place of effective management was outside the Republic) were empowered to exercise more than 50 per cent of the trust's voting power (Macheli, 2000:203).
- Control was determined with regard to the holding of more than 50 per cent control of the foreign entity. Residents were not required to have participation rights or similar interests in the foreign entity. It would have been sufficient if they exercised control of the entity through strategic control of the composition of the board of directors of a company, ability to make or influence decisions of the company, control through options and other similar arrangements, or power to veto key decisions of the company (Macheli, 2000:203).

In respect of trusts, control may relate to the power retained by a creator or donor to revoke a right in favour of any person under the trust deed and confer it on someone else. This construction would be consistent with Section 7(6) of the Income Tax Act, with a specific type of stipulation in which the right to receive income conferred by any deed of donation, settlement or other disposition may, under powers retained by the person conferring the right, be revoked or conferred upon another. The income which is received by or accrued to or in favour of the person on whom the right is conferred, by

reason of the donation, settlement or other disposition, will be deemed to be the income of the person conferring the right, for as long as he retains this right of revocation. (Macheli, 2000:204.)

With regard to the determination of control of a foreign entity, two important factors were taken into consideration. The first was that all South African resident participators (companies, trusts and individuals) were taken into account to determine whether a foreign entity was controlled by South African residents. The CFC regime applied only if the aggregate individual interests of the South African participators exceeded 50 per cent of the shareholding of the foreign entity. The second was absence of any requirement in South Africa that each resident participator should hold or own a certain minimum percentage of shares or rights in the foreign entity for purposes of determining control of the foreign company (a minimum ownership requirement). It was also not required that control be based in a small group or a related group of South African residents (a consolidated/concentrated ownership requirement). (Macheli, 2000:204-205.)

2.3.3.2 Indirect control

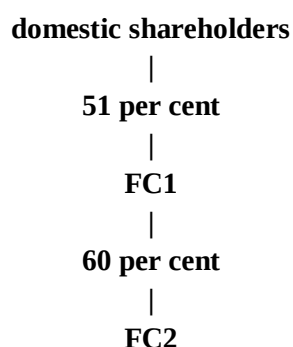
The definition of control under the South African CFC legislation included both direct and indirect control of a foreign entity. The legislation was, however, silent on how indirect control was determined. All of the jurisdictions that had adopted CFC legislation contained indirect ownership rules, so that control was inclusive of indirect control. Two basic issues emanate with respect to indirect control: (i) Where the indirect interest is a minority interest, should it be treated in the same way as a direct interest? (ii) Where domestic shareholders control a first-tier subsidiary, should they be considered to control a second-tier subsidiary which is controlled by the first-tier entity, or only the percentage determined by multiplying the respective ownership interests. (OECD, 1996:35).

With regard to the first issue, there are two possible approaches. If the emphasis for determining indirect control is on the ownership of shares as a means of control, the minority interest is disregarded. Thus, for example, where a domestic taxpayer owns 30 per cent shares of a foreign company (FC1) and 40 per cent of the shares of another foreign company (FC2) and FC1 in turn owns 60 per cent of the remaining shares of FC2, the taxpayer is considered to have a 58 per cent ($40 \text{ per cent} + (30 \text{ per cent} \times 60 \text{ per cent})$) control of FC2. But if the remaining 70 per cent of the shares of FC1 is owned by unrelated persons, the minority interest in FC1 is disregarded, as it cannot be used to compel FC2 to distribute its profits. The computation done in respect of the above is to multiply the domestic taxpayer's direct percentage of shareholding in a foreign entity to that entity's direct percentage of shareholding in any other foreign entity. The calculation is made for as many tiers as necessary, with both direct and indirect interests being counted once through all tiers. This, in turn, will give the effective or actual shareholding in a particular tier. (OECD, 1996:35.)

On the other hand, if the emphasis is on the ownership of shares as a measure of the equity or value of the foreign entity, the minority interest is taken into account. In the example above, the indirect minority interest of 18 per cent (30 per cent x 60 per cent) that domestic taxpayers have in FC2 through FC1 is taken into account, regardless of whether the majority interest in FC1 is held by unrelated persons. The rationale is that, although the taxpayers do not have more than 50 per cent voting power, their aggregate direct and indirect equity holding is 58 per cent in FC2, and thus they would benefit more from deferral of the domestic tax in respect of FC2's income. The extension of the supplementary value test to indirect interest would be harsh on domestic taxpayers, especially where the balance of the majority of interest is held by unrelated persons. (OECD, 1996:35.)

With regard to the second issue, it may once again be resolved on the basis of whether the focus of determining indirect control is on the ownership of the equity of a foreign entity or on the value of the equity owned. If the focus is on the former, then all of the shares of any foreign company owned by a controlled foreign entity are taken into account in determining whether the domestic participators have control in any such company as well.

Consider the following example (from Arnold, 1986: 420) (OECD, 1996:36-37.)



Based strictly on control, since the domestic shareholders have voting control of FC1, which in turn has voting control of FC2, it is fair to conclude that the domestic shareholders control FC2. However, based on the value of FC2, the domestic shareholders effectively own 30.6 per cent (51 per cent x 60 per cent) of FC2. Where the test of control is based on voting control, then all the shares of FC2 held by FC1 should be taken into account where domestic shareholders control FC1 (as is the case, for example, in Norway and the United Kingdom). The first approach would seem to be better than the second, in that the latter, in the above example, would result in the participators being held not to be in control of FC2.

It should be noted that the tests for determining control were not necessarily the same as those for determining the amount of undistributed income of the CFC attributed to the domestic shareholders. Domestic shareholders should only be taxed on their percentage interest in the CFC (based on value,

since that is the maximum amount of undistributed income to which they are entitled) (OECD, 1996:36). A similar approach was followed in South Africa when Section 9D(2) read, “there shall be included in the income of any resident contemplated in the definition of ‘controlled foreign entity’ in subsection (1), a proportional amount of any investment income received by or accrued to such entity, which bears to the total investment income received by or accrued to such entity, the same ratio as the percentage of the participation rights of such resident in relation to such entity bears to the total participation rights in relation to such entity”.

This approach restricted the test for the determination of attributable income to the percentage shareholding of a domestic resident in a foreign company, whereas the test for control of the foreign company was applied much more widely, and included not just the participation rights of shareholders but also the votes or control which the residents exercised in the company.

2.3.3.3 Constructive ownership

A substantial number of countries that adopted CFC legislation used constructive ownership rules to determine whether a foreign entity was controlled by their residents. The purpose of such rules was to ensure that CFC legislation was not avoided by fragmentation of shares in the foreign entity among a number of associated or related persons or entities (resident as well as non-resident). The effect of the rules was to attribute to a domestic shareholder or resident the ownership of the participation rights in a foreign entity which were owned by related persons or entities. (OECD, 1996:37.)

There were no constructive ownership rules under the South African CFC legislation when it first came into effect on 1 July 1997. The Katz Commission alluded to constructive ownership rules under the German CFC rules and recommended that such rules should be considered for enactment in South Africa. The Katz Commission (Katz Commission, 1997: para 8.3.1.3) stated that the German definition of “control” “includes any form of indirect control through a person holding shares or voting participation rights where such a person has to follow the instructions of a local resident in such a way that he/she does not have real freedom to make his or her own decision”. The German definition of “control” was not embraced or enacted by Parliament in promulgating the relevant provisions of the Income Tax Act. As a result the South African legislators did not see the need for the constructive ownership provisions and did not incorporate the minimum ownership and consolidated ownership requirements into Section 9D of the Income Tax Act.

2.3.3.4 Timing of control

The South African CFC legislation was silent as to the date from which residents should have acquired control of a controlled foreign entity for attribution to apply. There was also no direct reference to this issue in the Katz Commission’s report that recommended the enactment of this

legislation. In certain countries (e.g., Denmark, New Zealand, the United Kingdom and the United States) the CFC regime applied if resident participators acquired control at any time during the CFC's financial year; in other countries, control was determined at the end of the CFC's financial year (OECD, 1996:39). A great advantage of this approach was the simplicity of administration and compliance although it could be manipulated. However, many countries have general anti-avoidance tax provisions as part of their tax laws which would attempt to prevent any scheme or arrangement to divest control before the last date of the financial year and re-acquire it after the year end (OECD, 1996:39). In South Africa, the legislation on the control of a foreign entity was determined on the closing date of the company's tax year.

2.4 Resident taxpayers subject to CFE legislation

2.4.1 Introduction

The next issue that arises is identification of those resident taxpayers who were subject to attribution in respect of South Africa's CFE legislation. Not all residents considered for the determination of control were subject to attribution under the CFE legislation.

Consideration is given to the following issues which are regarded as crucial for the determination of resident participation, and can be categorised thus:

- resident shareholders vs voting or controlling rights only
- incorporated or juristic persons vs natural persons
- minimum participation requirement
- shareholders' residence
- accountability for attribution

2.4.2 Resident shareholders vs voting or controlling rights only

In South Africa, CFE measures applied to any South African resident who had a participation right (defined in terms of Section 9D(1), broadly to include a right to participate directly or indirectly in the capital, profits, dividends or any distribution or allocation) in a controlled foreign entity. There had been some obscurity in the application of this provision and it was not clear whether the Income Tax Act would have applied only to shareholders and beneficiaries or whether it included other persons such as loan creditors.

What created a degree of obscurity in the interpretation and application of this Section was the latter part of the definition of a controlled foreign entity, which read, "or are entitled to exercise more than 50 per cent of the votes or control of such entity" (Section 9D(1)). It was generally accepted that in a

thinly capitalised CFE major loan creditors could have substantial control or votes of more than 50 per cent. The loan creditor, resident in South Africa, could qualify as a resident participator since the foreign debtor now qualified as a controlled foreign entity. The question this then raised was whether the CFE loan creditor qualified for attribution in terms of Section 9D. (Macheli, 2000:217-218.)

In determining whether a foreign entity was controlled by South African residents, loan creditors could have been taken into consideration, but it did not necessarily follow that they should also have been subject to attribution, since these were two distinct and separate questions. It was possible to include loan creditors for control requirement purposes but to have them excluded for attribution purposes. The other reason for the exclusion of loan creditors from CFE legislation, for attribution purposes, was that it could have been used by them as a tax saving strategy. For example, in South Africa, subsection 31(2) read concurrently with Section 31(1) of the Income Tax Act, would deter a domestic loan creditor from granting a loan to a foreign entity at a low or zero interest rate in order to avoid domestic tax liability. The Commissioner has the right to adjust the interest rates in respect of the transaction to reflect an arm's length price or interest rate for the relevant transaction. (Macheli, 2000:215-217.)

2.4.3 Incorporated or juristic persons vs natural persons

The term "resident" as employed in Section 9C(1) and incorporated into Section 9D(1) referred to all forms of residents, both natural and incorporated or juristic persons. The CFE legislation therefore applied to all types of residents. There was no strong justification for excluding domestic individuals or subjecting individuals to a different set of legislation, since CFCs can be used by both individuals and corporations to avoid domestic taxation. If the CFC legislation excluded individuals, they would have been able to use entities in tax havens to avoid domestic tax (normally at higher marginal rates), unless there were alternative anti-avoidance rules. A separate set of rules applicable to individuals adds unnecessary complexity to domestic legislation, especially where the tax-avoidance concern is the same for both. (OECD, 1996:62.)

In South Africa, the CFE provisions applied to all classes of resident shareholders in a CFE. In terms of Section 9D(2) of the Income Tax Act, CFE investment income was attributable to any South African resident (defined to mean any natural person who is ordinarily resident in the Republic and any person other than a natural person which has its place of effective management in the Republic). Resident taxpayers under the CFE legislation would therefore have included individuals, companies, close corporation, trusts and any other type of corporate entity. This broad inclusivity was in line with Government's policy to protect the South African tax base simultaneously with an exchange control-free environment. Therefore, the tax system should be able to protect itself against erosion of its base

without reliance or dependence on an exchange control system (Katz Commission, 1997: para 3.1.7.1.)

2.4.4 Minimum participation threshold

South Africa, as noted, did not have any minimum ownership and concentrated ownership requirements with respect to the determination of whether a foreign entity was controlled by South African residents. Neither did it have a minimum participation requirement as a threshold for attribution of CFE income when the original Section 9D first came into operation on 1 July 1997. Countries adopted different approaches to the issue of a minimum participation threshold for attribution. In most other countries, the threshold is 10 per cent (OECD, 1996:63). Two main reasons were generally given for limiting the attribution of CFE income to larger domestic participators or resident shareholders. The first was that smaller participators (shareholders and beneficiaries) have little influence over the CFE to make decisions, although this ignored the fact that control of the foreign entity would in any case have been established by aggregating participation interests of all those small shareholders, and therefore it was within their means to influence the entity to make decisions. The second reason was that it would have been difficult for small shareholders to obtain the necessary information to determine their share of the undistributed CFE income or even to establish whether the corporation was a CFC at all. (Arnold, 1986:426.)

For a minimum threshold limit to be effective, it must be supported by indirect and constructive ownership rules to prevent avoidance through the splitting of ownership interests among related persons. Most countries with minimum thresholds included these rules. As stated with the issue of determining control, these rules added considerable complexity to the CFE legislation. These complexities were not welcome when South Africa first implemented CFE legislation in 1997 because South Africa lacked the experience and expertise in the implementation of CFE legislation. The Katz Commission did not refer to the concept of a minimum participation threshold and this could have influenced the legislators to keep the legislation simple to administer in its initial adoption. The South African system may have been influenced by those of Germany and Norway which had neither the minimum participation threshold nor the constructive ownership rules to determine attribution of CFE income to domestic shareholders (OECD, 1996:63).

2.4.5 Residence of shareholders

An essential characteristic of the CFE legislation was that the attribution of CFE income was limited to a country's residents. The question of the residence of a shareholder was fundamental to the application of this legislation, as a means by which a country could obtain taxing rights over the CFEs foreign-sourced income which otherwise would have eluded that country's taxing jurisdiction to tax

such income. Countries normally used the term “resident” in relation to domestic persons who were subject to the CFE legislation. In South Africa, the term “resident” was used in relation both to natural persons and to persons other than natural persons which were incorporated, or had their place of effective management, in the Republic (Section 9C(1)).

2.4.5.1 Natural persons

In respect of a natural person, Section 9C(1) defined the term “resident” as a person who was ordinarily resident in the Republic. Neither “resident” nor “ordinarily resident” was defined in the Income Tax Act when Section 9C was promulgated. Few publications gave any consideration to these terms, as the concept of residence had historically been insignificant under the South African tax system which was based primarily on the source principle. Broadly, there is a distinction between “resident” and “ordinarily resident”. Because the Income Tax Act did not furnish definitions in respect of “resident” and “ordinarily resident”, reliance was placed on leading court cases that were used as a guideline in making a distinction in respect of the above two terms.

In *Soldier v COT* (United Kingdom, 1943) Tredgold J., after referring to the English case of *Levene v IRC* (United Kingdom, 1928), stated that the term “resident” is a much broader concept than the term “ordinarily resident” which is a narrower concept and which emphasised that the residence must be settled and certain and not temporary and casual. In *Levene v IRC*, a British subject who spent about eight months abroad each year, and who lived in hotels and with no fixed place of abode of his own whenever he returned to the United Kingdom, was still held to be ordinarily resident in Britain.

From the preceding two English cases, it has been established that to determine whether a person is “resident” or “ordinarily resident” in a particular country is a question of fact, and not of law. The following factors must be taken into consideration in order to determine the above: frequency, regularity and duration of visits, nationality, most fixed and settled place of residence, habitual abode (present habits and modes of life), location of personal belongings, family and social relations (schools, church, etc.), period abroad, purpose and nature of visits.

The term “ordinarily resident” is not defined in the Income Tax Act. The Court held in *Cohen v CIR* (South Africa, 1946b) that “ordinarily resident” refers to, “the country to which he would naturally and as a matter of course return from his wanderings, as contrasted with other lands it might be called his usual or principal residence and would be described more aptly than other countries as his real home”. This approach was confirmed in *CIR v Kuttel* (South Africa, 1992).

2.4.5.2 Persons other than natural persons

The term “resident” in terms of Section 9(c)(1) also includes, “any person, other than a natural person, which is incorporated, or has its place of effective management, in the Republic”. The persons included under this definition comprise companies, close corporations, estates, trusts, and any other corporate entities. Incorporation relates to the formal registration of a juristic or legal person. We have already alluded to the term “place of effective management”; also used in respect of a domestic company was the term “managed and controlled”. A domestic company was defined as a, “South African company or a company which was managed and controlled in the Republic” (Section (1)). However, “managed and controlled” was less definitive than the term “its place of effective management” as used to define a resident other than a natural person.

2.4.6 Timing of residents’ interest subject to attribution

With respect to the determination of control of a controlled foreign entity, the South African CFE legislation was silent on the date on which resident shareholders should have been held accountable for the purpose of attribution of the entity’s investment income. In some countries, the date is specifically stipulated. In most countries, the undistributed income is attributable to resident shareholders who have participation rights in the controlled foreign entity at the end of the accounting year. (OECD, 1996:64.)

It was generally accepted that the correct approach for South Africa would have been to attribute CFE income only to residents who owned participation rights at the end of the tax year. The ownership of participation rights for only part of the year should have been disregarded for attribution purposes provided that the resident in question had not contravened the general anti-avoidance tax provision of Section 103 of the Income Tax Act. The advantage of this approach was its simplicity of enforcement which had kept both administration and compliance costs within an acceptable range. (Arnold, 1986:426.)

2.5 Exemption and relief

2.5.1 Introduction

In this chapter section consideration is given to the various exemptions and forms of relief which were contained in the CFE legislation of South Africa that came into effect on 1 July 1997. Exemptions related to circumstances in which income of a CFC or foreign entity were not attributed to domestic shareholders of the foreign company or foreign entity. Relief related to the avoidance of double

taxation by allowing a credit against the South African tax liability for the tax paid to a foreign government. The relief was limited to residents, as was defined in Section 9C (1) of the Income Tax Act, and only applied in respect of income actually derived from a source that was outside the Republic and which was not deemed to be derived from a source within the Republic (Section 6quat).

Exemptions provided in a country's CFE legislation reflect the country's stance towards the competing policy objectives of capital export neutrality and capital import neutrality. For most countries, CFE legislation is based on some balance between capital export neutrality and capital import neutrality and provided exemptions which may have varied in extent and nature. Availability of such exemptions indicates a willingness to tolerate deferral at least in certain circumstances and hinges on whether the legislation was entity-based or jurisdiction-based (OECD, 1996:68). According to the OECD (1996:67), countries that applied an entity approach usually provided for five types of exemptions for certain CFCs:

- an active income exemption for CFEs engaged in genuine business activities
- a distribution exemption for CFEs that distributed a certain percentage of their income in a given year
- a motive exemption for CFEs which were not established for the purpose of avoiding domestic taxes
- an exemption for CFEs whose shares were listed on a recognised stock exchange
- a *de minimis* exemption where the total income or tainted income of the CFE, or a domestic shareholder's *pro rata* share of such income, did not exceed a certain minimum amount

2.5.2 Exemptions

The following subsections examine these five types of exemptions and consider their relevance to the South African CFE legislation per Section 9D of the Income Tax Act.

2.5.2.1 Active income exemption

Active income exemption indicates a fundamental policy choice of balancing the demands of capital export neutrality against those of capital import neutrality so that the legislature does not interfere with the ability of domestic investors to compete internationally and invest in genuine business activities. In the recommendations of the Katz Commission due consideration was to be given to both active and passive income, with active income to be defined by reference to a non-exhaustive list of activities which would constitute such income (Katz Commission, 1997:para 9.7), while passive income should not be separately defined but should include all income which was not active income

(1997:para 9.8). Despite the Commission's recommendations, the South African legislator went ahead and defined passive income or investment income in Section 9C(1).

Under the South African legislation, the exemption was granted by defining the attributed investment income, under Section 9C (1), and thereafter expressly exempting investment income "where the investment income arises from and is effectively connected to the business activities of a substantive business enterprise of any controlled foreign entity conducted through a permanent establishment" (Section 9D(9)(b)). For countries which used the entity approach, the exemption was usually given by exempting all income of a controlled foreign entity where the active business income fulfilled certain threshold requirements (generally, it was primarily active business income). Three criteria were examined for determining whether the exemption was available, and included such factors as (i) the nature and extent of the entity's presence in a foreign country, (ii) the type of business activity carried on by the CFC and (iii) the nature of the income earned or derived by the CFC (OECD, 1996: 70). Section 9D(9)(b) of the Income Tax Act exempted active investment income of a controlled foreign entity if the entity conducted its principal business (i.e., a "substantive business enterprise") through a "suitably equipped" "permanent establishment" in a foreign country. These terms are discussed below.

Permanent establishment: The term "permanent establishment" was referred to in Section 9C(1) as a "permanent establishment as defined from time to time in Article 5 of the Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development". The OECD (The Taxpayer, 1997:103-104), described a "permanent establishment" in great detail and referred to a fixed place of business through which the business of an enterprise is wholly or partly carried on. It specifically included a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry or any other place of extraction of natural resources. The Article specifically excluded, *inter alia*, the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise. No specific time period was laid down for which the place of business must exist before it was considered to be permanent except for a building site or construction or installation project which would have constituted a permanent establishment only if it lasted for more than 12 months.

The issue of a permanent establishment had arisen in a South African context in *Transvaal Associated Hide and Skin Merchants v Collector of Income Tax Botswana* (South Africa, 1967). In this case the taxpayer was a company incorporated in South Africa. The management and control of the taxpayer was also in South Africa. The taxpayer bought and sold hides and skins and other by-products of livestock. These articles were purchased at abattoirs where the animals were slaughtered, these abattoirs being in Botswana. The sales were effected from the offices of the taxpayer in Johannesburg

and Pretoria and all payments were required to be made in Johannesburg. The taxpayer took delivery of the hides at the abattoir in Botswana. Before they could be transported to South Africa they had to be prepared for removal by a process of curing, which prevented damage to the hides. For this purpose the company maintained a staff of between twenty and thirty employees in Botswana, who carried out the work in a “shed” which was an extension of the abattoir buildings.

The question which arose was whether the taxpayer could be taxed in Botswana in respect of the activities concerned. This could only have been the case if a permanent establishment existed in Botswana. It was stated that the activities of the taxpayer went beyond the mere purchase of goods or the storing of goods in a warehouse for the convenience of delivery. It was indicated that the word “permanent” is used in contra-distinction to a merely temporary or occasional use of premises for purposes of trade or business. In the light of the fact that the taxpayer occupied the shed for six or more years, it was determined that his occupation of the premises was not temporary or occasional, but permanent. The word “permanent” was actually interpreted as meaning “indefinitely continuing”. On that basis it was held that the operations carried on by the taxpayer in Botswana constituted a permanent establishment.

Substantive business enterprise and suitably equipped: The terms “substantive business enterprise” and “suitably equipped” used in relation to a permanent establishment were not defined, but from their application in Section 9D(9)(b), it was apparent that in order for a permanent establishment to be acceptable, so that it could have enjoyed the exemption afforded by the above Section, it also had to satisfy the other requirements of being suitably equipped and being a substantive business enterprise. “Suitably equipped” should have fulfilled an economic substance test. In operational terms, it meant that the business must have been suitably equipped with on-site operational managers and employees, equipment and other facilities to have conducted the primary operations of the substantive business enterprise. It was also important to note that the infrastructural requirements could have differed for different types of business.

South Africa accepted a controlled foreign entity which operated its permanent establishment in any country other than the Republic and it was also not a requirement that the foreign entity and the permanent establishment be based in the same country. The South African legislators acceded to the Katz Commission’s recommendation (Katz Commission, 1997:para 8.3.1.9) that “the restriction under the United Kingdom rules that a CFE must carry on an active business in the country of its incorporation is not recommended”. The Commission expressed the view that any offshore presence qualifying as a permanent establishment (as defined) should suffice to classify attributable income arising therefrom as exempt active income.

Source of income: In South Africa, the source of income was immaterial for purposes of determining the active income exemption with regard to CFE legislation. The important factor was that a controlled foreign entity was not allowed to conduct its business through a permanent establishment operating in South Africa. The permanent establishment could have been established in any foreign country and it was not necessary that the active income derived was to be in the same country as the country in which the CFE was resident. There were no prescriptions in Section 9D as to related-party transactions. Therefore, a CFE satisfying all the requirements of Section 9D(9)(b) of the Income Tax Act could transact with a related party, either a resident in South Africa or in a foreign country, without any additional tax implications or tax liability. Usually the objective in the denial of the CFE income exemption, especially where a CFE dealt with related parties was to prevent the diversion of income from the domestic jurisdiction to foreign low-tax jurisdictions or to tax havens and thus averting or avoiding domestic taxes (OECD, 1996:73).

The Katz Commission (Katz Commission, 1997:para 8.3.1.10) advocated that the restriction applicable under both the United Kingdom and the German rules, whereby a CFC may not derive income from related parties, were not to be introduced in South Africa since transfer-pricing rules as contained in Section 31 were adequate to counter any related-party abuse.

2.5.2.2 Distribution exemption

Under the distribution exemption, none of the income of a CFC was subject to attribution provided that the company implemented an acceptable distribution policy (i.e., if a certain percentage of the company's income was distributed to domestic shareholders by way of dividends within a prescribed period of time). The United Kingdom was the only country or jurisdiction which utilised a distribution exemption policy. The United States previously used one, but it was repealed in 1975. The United Kingdom exemption applied where the CFC distributed a certain percentage of its income within the year or shortly thereafter (within 18 months). Under the United Kingdom rule, it was *a sine qua non* that the CFC must have distributed at least 50 per cent of its profits (determined under foreign accounting principles) if it was a trading company, and at least 90 per cent of its taxable income (determined under United Kingdom domestic tax law) in the event it was a non-trading company. The distribution exemption could have been justified on the basis that it encouraged repatriation of foreign-earned profits to domestic shareholders so that such profits were currently taxed in the hands of resident shareholders, as domestic-earned profits would have been subject to domestic taxation. The exemption thus effectively encouraged deferral in respect of the undistributed income of the CFC, provided that the company had distributed the minimum legislated percentage of income. (OECD, 1996:68.)

The Katz Commission (Katz Commission, 1997:para 8.3.1.8) opposed the implementation of the distribution exemption on the premise that dividends were (at the time the Commission reviewed the matter) exempt from tax in South Africa. Since 23 February 2000, foreign dividends were taxable under Section 9E of the Income Tax Act. One of the main reasons for the distribution exemption not being implemented in South Africa was that Section 9D was not entity-determined. On the contrary, South Africa's legislation was fundamentally transaction based and only "passive investment income" of a controlled foreign entity was targeted for attribution (Section 9D(2)). Therefore the exemption of all income, provided the CFE fulfilled the minimum percentage distribution as required, would have permitted the CFE to shelter a portion of its undistributed investment income. This sheltered portion would have escaped the taxation net. (1997:para 8.3.1.8.)

2.5.2.3 Motive exemption

The aim of the motive exemption was to exclude from CFE legislation all those controlled foreign entities which were not established for the purpose of avoiding domestic tax. At the time when South Africa first implemented the CFE legislation in 1997, the United Kingdom was the only country that had adopted the motive exemption (OECD, 1996:74). In order for the United Kingdom exemption to have applied, the CFE had to satisfy two of the subsequent requirements: firstly, none of the main reasons for the existence of the CFC was to divert profits from the United Kingdom, and secondly none of the CFE's activities in a particular accounting period was for the purpose of avoiding or reducing United Kingdom income tax (OECD, 1996:75).

In South Africa, the Katz Commission (Katz Commission, 1997: para 8.3.1.11) referred to the motive exemption as per the United Kingdom guidelines and opposed its adoption, "as it would make it very easy to avoid the application of the rules". The Commission recommended that the rules should have applied in all cases where passive income was re-routed through an offshore controlled foreign entity, irrespective of the motive. The South African legislators heeded the Katz Commission's recommendations and did not include the motive exemption in Section 9D when the CFE legislation first came into effect. There was general consensus that the South African legislation should not embrace the motive exemption, especially in respect of the discretion that needed to be applied in the implementation of the motive exemption (Katz Commission, 1997:para 8.3.1.11). The shortcomings in implementation of the motive exemption are well illustrated in the OECD's observation that

While a motive exemption appears consistent with the policy of anti-avoidance legislation, the practicalities of such an exemption give rise to considerable difficulties both to taxpayers (since the application of the exemption may be highly discretionary) and to tax authorities (due to the test's subjectivity). (OECD, 1996:75.)

2.5.2.4 Publicly traded shares exemption

In South Africa, the publicly traded shares exemption was introduced into the Income Tax Act with the taxation of foreign dividends in terms of Section 9E of the Income Tax Act. Section 9E(7)(c) exempted from income tax any foreign dividends received by a resident shareholder who, together with any connected persons in relation to such shareholder, held less than 10 per cent of the equity share capital of such company listed on a stock exchange as defined in Section 1 of the Stock Exchange Control Act, No. 1 of 1985, if more than 10 per cent of the equity share capital in such company was held collectively by South African residents. Similarly, Section 9D(9)(g) exempted from attribution a proportional amount of any investment income of any company listed on a stock exchange as defined in Section 1 of the Stock Exchange Control Act, No. 1 of 1985, or any subsidiary of such company, which was attributable to any resident and which resident, together with any connected person in relation to such resident, directly or indirectly held less than 10 per cent of the equity share capital in such company or subsidiary.

In South Africa, for example, a company which was not listed on a stock exchange on the date of declaration of the foreign dividends was required to obtain the approval of the Commissioner to obtain the above exemption. The Commissioner were to give due cognizance to the following factors (Section 9E(7)(c)):

- whether the company's profits were generated in a designated country, and
- whether the tax rate at which the profits from which the dividend was declared was or will be taxed at rate of at least 27 per cent.

Prior to such approval, the Commissioner would have had to satisfy himself that the applicant company had fulfilled the requirements of Section 9D(9)(d) as to the profits that were generated in a designated country and in terms of Section 9E(7)(d), and that a tax rate of at least 27 per cent was in operation without any right of recovery. The Minister of Finance was empowered to designate those countries which qualified by giving notice in the Government Gazette, in terms of Section 9E(8).

2.5.2.5 *De minimis* exemption

In South Africa, a percentage *de minimis* exemption was introduced with effect from 23 February 2000 and was contained in Section 9E(7)(a) which exempted from tax any foreign dividend which was declared or deemed to have been declared by a resident South African company that “during the entire period of [its] existence ... or each of the three years of assessment preceding the year of assessment during which [the] dividend [was] declared or deemed to have been declared”, whichever was the shorter period, “derived 75 per cent or more of its total receipts or accruals from a source within ... or deemed to be ... within the Republic and which was subject to tax in the Republic.”

In other words, where foreign-source income of a resident South African company (excluding income or deemed income from a source within the Republic and which was subject to South African tax) did not exceed 25 per cent of the total income of that company, the portion of the dividend that related to foreign profits was not to be regarded as a foreign dividend and was therefore, not taxable.

It was important to note that the exemption related directly to foreign income earned by a South African resident company. However, this exemption had some relevance to the CFE legislation of Section 9D. To the extent that dividend was declared or deemed to have been declared by a South African resident company out of foreign profits, the dividend declared would have qualified as “foreign dividend” and would, if received or accrued by a foreign entity that was controlled by South African residents, have been attributed to such residents under Section 9D. However, the exemption would have operated and excluded such foreign dividend from attribution. The South African justification for the exemption, according to the *Explanatory Memorandum* on the Taxation Laws Amendment Bill (South Africa, 2000a:3), was to avoid the necessity of calculating and taxing a small percentage of dividends as foreign dividend and to thereby reduce the administrative and compliance burden in administering the taxation of foreign dividends. However, there were two major grievances that were directed towards the *de minimis* exemption. Firstly, it was not entirely correct that the exemption reduced the administrative and compliance burden, as it was still required to compute the necessary calculations so as to have determined whether the exemption applied or not. Secondly, the calculations would have been more complex in the case of South Africa where the exemption was only granted in respect of foreign dividends, as it did not include the other items of tainted investment income. In addition, the exemption came within the jurisdiction of the South African CFE rules in such a convoluted way that complicated dividend tracing rules had to be applied to keep track of dividends that were declared in South Africa to foreign entities and thereafter attributed back to South African domestic shareholders. According to the Katz Commission (Katz Commission, 1997:para 8.3.1.14), “the *de minimis* exception under United Kingdom rules should also be introduced” into South Africa’s CFC legislation.

The aim of the implementation of a *de minimis* exemption was to avoid the unnecessary administrative and compliance difficulties that could have ensued in the absence of such legislated exemption, while at the same time the legislator had to recognise the potential for manipulation and exploitation and its adverse impact on the South African tax base.

2.5.3 Relief provisions

The underlying principle for the justification of the statutory provisions that are embodied in various forms of relief under CFE legislation was that domestic residents of controlled foreign entities were,

by the principle of attribution, treated as if they had earned the income of such foreign entities directly or as if the entities had actually distributed their profits to such resident shareholders (Arnold, 1996:497). Most countries with CFE legislation provide relief against double taxation in respect of foreign taxes paid by a controlled foreign entity in the year when income was attributed or earned (Section 6quat(1)(b)). Other forms of relief that were provided by CFE legislation included losses incurred by the entity; dividends distributed subsequent to attribution and relief in respect of blocked currency.

2.5.3.1 Foreign taxes

By its very nature, South Africa's CFE legislation resulted in double taxation because the same income was taxed twice when it was originally earned, initially in the hands of the controlled foreign entity in a foreign country of residence and, thereafter, domestically in the hands of resident shareholders (participators and beneficiaries, depending on whether the entity was a company or a trust) of such entity. In South Africa, relief for foreign taxes paid was provided as a rebate under Section 6quat of the Income Tax Act. A rebate was made available to any resident of the Republic or any person contemplated in Section 9C(2)(b) or any shareholder who was a resident as defined in Section 9E and in whose taxable income there was included any proportional amount of investment income as was contemplated in Section 9D, or any foreign dividend as was contemplated in Section 9E. In the calculation of the rebate, the following aspects were addressed under Section 6quat.

Taxes covered by relief provisions: A rebate was granted in respect of the "sum of any taxes on income" which was proved to be payable to the government of any foreign country, without any right of recovery by any person (other than a right of recovery in terms of any entitlement to carry back losses arising during any year of assessment to any year of assessment prior to such year of assessment). According to the *Explanatory Memorandum* on the Taxation Laws Amendment Bill, (South Africa, 2000a:6), taxes on income included taxes on profits, income or gains as well as capital gains tax. Furthermore, taxes on income imposed by national and certain lower tiers of government in a foreign country and capital gains taxes qualified as a rebate against South African tax liability. It was with foresight that the *Memorandum* included capital gains taxes, as capital gain (both domestic and foreign) were exempted from tax in South Africa. There were, however, plans to introduce capital gains tax in South Africa with effect from 1 April 2001. It was accepted that, for purposes of the CFE legislation of Section 9D, only taxes incurred by a controlled foreign entity on investment income which was attributed to domestic participators would have qualified for a rebate in terms of Section 6quat (1A).

Foreign taxes paid by CFEs and other foreign entities: The taxation of dividends in terms of Section 9E (3) and 9E (4) and the corresponding tax relief in terms of Section 6quat (1A) were not limited to

the foreign taxes paid by the company that declared the dividend. This was according to the Explanatory Memorandum on the Taxation Laws Amendment Bill, (South Africa, 2000a:6), which advocated that a look-through approach be adopted in determining the tax on the underlying profits. For this, a “qualifying interest” was defined as the indirect interest held by a resident shareholder through a chain of companies where each company in the chain of companies held a direct interest of at least 10 per cent in the company in the next tier. In other words, taxes on underlying profits from a second-tier foreign company will be rebated if the first-tier foreign company, directly controlled by South African residents, directly held at least 10 per cent interest in that company.

Excess tax credit: An excess amount was attributable where the sum of any taxes payable to the government of any such other country exceeded the rebate as determined in terms of Section 6quat(1B)(a) (foreign taxes payable exceeded the normal South African tax on the grossed-up amount of investment income attributed under Section 9D(2)). There were two ways in which the excess credit could have been dealt with. First, if the taxpayer concerned was a company, the excess could have been set off against any secondary tax on companies (STC) payable by such company, provided the set-off did not exceed the amount determined by applying the rate of STC (12.5 per cent) on the profits that were attributable by the inclusion of any amount of investment income in the company’s taxable income (Section 6quat(1B)(b)(i)(ii)). Second, if the excess amount was not all written off against STC, any remaining excess could have been carried forward to the immediately succeeding year of assessment and be set off against the amount of any normal tax payable by such company during such year of assessment in respect of any amount derived from such country which was included in the taxable income of such shareholder during such year (Section 6quat(1B)(A)(AA)(BB)). The excess amount was not allowed to be carried forward for more than three years from the year of assessment when such excess amount was for the first time carried forward. (Section 6quat(1B)(B).)

2.5.3.2 Foreign losses

In terms of Section 9D(8), deductions and allowances under Section 11 of the Income Tax Act were also allowable *mutatis mutandis* in respect of investment income earned by a controlled foreign entity in the course of the carrying on of any trade outside South Africa. The deductions and allowances were apportioned among resident shareholders by applying the same ratio as determined in terms of Section 9D(2) or 9D(4) as the case may be, and each shareholder was entitled to deduct his proportionate share of the applicable deductions and allowances. The same principle was applied to assessed losses of a controlled foreign entity where deductions and allowances exceeded investment income in any given year of assessment. However, there were additional conditions and limitations which had to be satisfied in respect of foreign incurred losses by controlled foreign entities.

Firstly, the deductions and losses were limited to the amount of investment income apportioned to the resident in terms of Section 9D(2) or 9D(4) for any particular year of assessment. In reality, the deductions and allowances were ring fenced to the amount of the investment income attributed to the resident shareholder, apportioned according to each resident's proportionate share as determined in terms of Section 9D(Section 9D(8)(a)). Secondly, where the deductions and allowances of a controlled foreign entity exceeded the amount of investment income attributed to a South African resident, the excess (i.e. the assessed loss) should have been carried forward and deducted by such resident in the immediately succeeding year of assessment if such controlled foreign entity carried on such trade during such succeeding year of assessment (Section 9D(8)(b)). The carry forward of the assessed loss was allowed indefinitely and the balance of the assessed loss could have been set off in each of the immediately succeeding years of assessment after it was incurred until it was completely depleted. To have qualified for the deduction in each succeeding year, the same controlled foreign entity which had incurred the loss had to be carrying on trade during the subsequent years of assessment. The latter requirement ensured that a foreign assessed loss remains in the controlled foreign entity that incurred the loss and that the loss could not be utilised by any other connected party.

This was also in compliance with Section 20(2A)(b) of the Income Tax Act which only allowed an assessed loss to be carried forward if the South African company continued trading in the subsequent year and therefore any unutilised balance of an assessed loss will be cancelled if the company cease trading in any subsequent year. However, an editorial piece in *The Taxpayer* (1998:47) expressed some reservations over the wording of Section 9D(8)(b), observing that "a reader could find difficulty in construing the amendment as allowing the excess of a deduction in year 1 to be carried forward into year 3 and so on, if not fully set off against investment income apportioned to the taxpayer in year 2."

2.5.3.3 Subsequent dividend declaration

The objective of this relief was to avoid or prevent double taxation on the same income that was received under two different circumstances. Firstly, in terms of Section 9D(2), there was to be included in the income of any resident a proportional amount of any investment received by or accrued to such controlled foreign entity, and secondly in terms of Section 9E(2), when the same income was subsequently received by domestic residents as dividend. Countries therefore employed various techniques to provide relief in the above-mentioned circumstances. According to the OECD (1996:79) these reliefs that were incorporated into a country's legislation could be

- a deduction of such dividends when the domestic shareholder's tax liability was computed – as in Canada, France, and Japan (subject to certain requirements)

- an exemption of the dividends to the extent of previously attributed income – as in Australia, Denmark, Finland (if paid within the next 5 years), Norway, Spain, Sweden and the United States
- dividends that were included in income, but the tax levied on undistributed profits previously attributed is refunded – as in Germany (if paid in the next four years)
- dividends that were included in income, but a credit given for the tax previously paid on the attributed income – as in New Zealand, and the United Kingdom
- dividends reduce income of CFC subject to attribution in the year the dividend is paid, up to the amount of previously attributed income (Portugal).

South Africa, like member countries of the OECD, provided relief by way of an exemption. Section 9E(7)(e) excluded foreign dividends from tax to the extent that the profits from which the dividends were distributed related to any amount of investment income which were already subject to South African income tax in the hands of the South African resident shareholder in terms of Section 9D(2). In addition, Section 9D(9)(f) excluded the application of the CFE rules in relation to the proportional amount of any investment income that was attributable to any resident only to the extent that it related to any foreign dividend that was declared to a controlled foreign entity by any other foreign entity which was also a controlled entity in relation to the resident shareholder. Therefore this amount is excluded from the income of the resident, as this amount has already been included in the income of the resident via Section 9D(2) or 9D(4) when attribution of the proportional amount of investment income was made on the other controlled foreign entity.

2.5.3.4 Blocked currency

Some countries provided relief in respect to blocked currency or other restrictions or limitations imposed in terms of the laws of the country where the investment income was received or accrued. In South Africa, Section 9D(4A) provided that where it was established to the satisfaction of the Commissioner that all or any portion of the attributable investment income received or accrued (in terms of Section 9D(2)) by a controlled foreign entity during any year of assessment could not be remitted to the Republic as a result of currency or other restrictions or limitations imposed by the laws of the country where the investment income was received or accrued, the inclusion of such investment income in the income of such resident may be postponed until such investment income may be remitted to the Republic.

2.6 Residence basis of taxation (Act 59 of 2000)

2.6.1 Introduction

During his budget speech of 23 February 2000, the Minister of Finance announced that a residence basis of taxation would replace the source basis of taxation with effect from years of assessment commencing on or after 1 January 2001 (South Africa, 2000c). As a result, on 1 January 2001, a residence-based tax system came into effect in South Africa, which subjects South African residents to tax on their worldwide income irrespective of its source or nature. According to Jooste (2001:473), “The circle was completed in 2001, when all income, including non-investment income, i.e. ‘active’ income, became subject to a residence-based system”. It also led to Section 9C, which was in effect an interim provision, being repealed.

Any person who is considered to be a South African resident will be taxed on their worldwide income, although certain categories of income and activities undertaken outside South Africa were exempt from South African tax. Foreign taxes paid by these residents will, however, be allowed as a credit against their South African tax liability (Section 6quat). Non-residents will still be taxed on their South African sourced income. With regard to legal entities, any company incorporated in South Africa or entity established, formed or which has its place of effective management in South Africa will also be classified as a resident, but excluding any “international headquarter company” as defined (Section (1)). A non-resident will continue to be taxed in accordance with the source-based principles in terms of Section (1) of the gross income definition. The most important reasons for changing to the new residence-based system of taxation as outlined by the South African Revenue Service were (South Africa, 2000e)

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

It had been established that the difficulties created by the source-based system of taxation were in the definition and determination of “source”. The application of the legal principles in determining whether or not an amount was received from a source within the Republic has been stated in a number of decisions by the Court, with the leading decisions being in the cases of CIR v Lever Brothers and Unilever Ltd (South Africa, 1946a); CIR v Epstein (South Africa, 1957b) and CIR v Black (South Africa, 1957a). These authorities point out that the legislature, probably aware of the difficulty of doing so, had not attempted to define the phrase “source within the Republic” and had left it to the

courts to decide, on the particular facts of each given case, whether an amount was received from a source within the Republic or not.

2.6.1.1 Tax base for residence basis of taxation

The South African Income Tax system had undergone a fundamental change. This move was attributed to the relaxation of exchange control regulations and the globalisation of the South African market (Accountancy SA, 2001:3). Act No. 59 of 2000, introduced the new basis for the South African income tax system, which shifted from the source of income as the determining factor to the residency of the taxpayer. The “gross income” definition had been amended to incorporate a resident’s worldwide income and to retain the right to tax non-residents on their South African sourced income. Thus gross income in terms of Section (1) means: (a) “in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or (b) in the case of any person other than a resident, the total amount in cash or otherwise, received by or accrued to or in favour of such person from a source within or deemed to be within the Republic”. Thus, residents will now be taxable on their worldwide income, while non-residents will be taxable only on income whose source is within, or deemed to be within South Africa. Section 9C of the Income Tax Act, like most of the deemed source provisions of the Income Tax Act, had been repealed, and as provided by Act No. 59 of 2000, residents will now be taxable, not only on their worldwide passive investment income, but also on their worldwide active income.

2.6.1.2 Definition of “resident”: residence basis

After the adoption of a residence basis of taxation, a general definition of “resident” had been inserted into Section (1) of Act No. 58 of 1962, and is now defined as

- a) any natural person who is ordinarily resident in the Republic;
- b) any natural person who is not at any time during the relevant year of assessment ordinarily resident in the Republic, but who
 - a. is physically present in the Republic for more than an aggregate of 91 days during the relevant year of assessment, as well as during each of the three years preceding such year of assessment; and
 - b. was physically present in the Republic for more than an aggregate of 549 days during such three preceding years of assessment, provided that in respect of the above two requirements, a day shall include a part of a day; and
 - c. where such a person is outside the Republic for a continuous period of 330 full days immediately after the day on which such person ceases to be physically present in the Republic, then such person shall be deemed not to have been a resident from the day such person ceased to be physically present in the Republic;

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

2.6.2 Amendments to CFE legislation by Act 59 of 2000

2.6.2.1 General

The definition of “foreign entity” had been amended to mean a legal person (other than a natural person or trust) which is not a resident as defined, or where it is a resident, it is to be treated as a non-resident in terms of an applicable double-taxation agreement. The definitions of “domestic”, “South African” and “external companies” had been deleted. Section 9A (which was viewed as one of the first pieces of legislation imposed on CFCs operating in neighbouring countries and their profits derived wholly or mainly in the form of investment income) had been deleted. Essentially, the provisions contained in Section 9D(4) in relation to individuals have been moved to Section 7. The new subsection 7(8) provides that where any donation, settlement or other disposition had been made by a resident, income that is received by or that is accrued to any non-resident person (excluding a CFE) will be included in the income of the resident. Only that amount which is attributable to the donation, settlement or disposition will be included in the resident’s taxable income. Under the provision contained in Section 9D(5), where any asset had been disposed of for less than the market value of the asset, the amount by which the market value exceeded the consideration was deemed to be a donation. This subsection has been deleted from Section 9D and it has moved to the new Section 7(9).

In addition, the former Section 9D(7) had been incorporated into Section 7(10) which requires any resident who makes any such donation, settlement or other disposition to disclose such information in his tax return. The provision contained in Section 9D(3), whereby a resident was taxed in the situation where the resident acquired a vested right to participate in any amount representing the capital of the CFE, had been deleted with effect from 1 March 2001 and incorporated into Section 25B(2A). A new Section 25D had also been inserted into the Income Tax Act, and this Section deals with the determination of a resident’s taxable income in the currency of the country from where the income was derived and provides that in determining the value of the resident’s taxable income such income will be converted to South African Rands at the rate applying on the last day of the resident’s year of assessment or any other rate that the Commissioner may approve (Accountancy SA, 2001:5). Section 25D is reinforced by Section 9D(6) or vice versa, as both these Sections emphasise similar principles for the conversion of foreign income that is to be included in a resident’s taxable income.

2.6.2.2 Income subject to CFE legislation

Section 9D, before its amendment by Revenue Laws Amendment Act, No. 59 of 2000, applied only to investment income: i.e. annuities, interest, rents, royalties, or any income of a similar nature and foreign dividends as defined in Section 9E. The most fundamental change being brought about by Act 59 of 2000 is that all income, both passive and active, is subject to attribution, and with certain types of income being granted exemptions in terms of Section 9D(9). The term “investment income”, previously defined in Section 9C “as any income in the form of any annuity, interest, rental income or royalty or any income of a similar nature”, had been repealed. The company must be a “controlled foreign entity”, which means, “any foreign entity in which any resident or residents of the Republic, whether individually or jointly, and whether directly or indirectly, hold more than 50 per cent of the participation rights, or are entitled to exercise more than 50 per cent of the votes or control of such entity” (Section 9D(1)).

As already noted, South Africa’s CFE legislation did not require or prescribe any minimum percentage shareholding for attribution purposes, except in Section 9D(9)(g) in respect of the proportionate amount of any investment income of any listed company or any subsidiary of such company which was attributable to any resident, which resident, together with any connected person in relation to such resident, directly or indirectly held 10 per cent or more of the equity share capital in such company or subsidiary to qualify for attribution. With the exception of the above, if a company qualified as a CFE and a resident had participating rights in the CFE, the resident was subject to attribution. This had changed by the amendment brought about by Section 10(1)(f) of Act No. 59 of 2000: the resident would not qualify for attribution if such resident (together with any connected person in relation to such resident) in aggregate at all times during the foreign tax year held less than 10 per cent of the participation rights and was entitled to exercise less than 10 per cent of the voting rights in such controlled foreign entity (Section 9D(2)).

Section 9D(2) had been amended so that the amount to be attributed to a resident will be an amount equal to the proportional amount of the “net income” of the CFE, determined at the same ratio as such resident’s participation rights to total participation rights in the CFE. The “net income” of a CFE is defined in the new Section 9D(2A) as “an amount equal to the taxable income of the CFE determined as if such CFE had been a resident”. Thus, the net income of the CFE now includes all its receipts and accruals (excluding those of a capital nature) as would be taxable in South Africa, minus such deductions and allowances as would be allowed in South Africa. However, in terms of Section 9D(2A)(a)(b), to protect the South African tax base, the deductions and allowances will be limited to the income of the CFE; any excess shall be carried forward to the immediately succeeding year of assessment and be deemed to be a balance of assessed loss which may be set off against the income of

such entity in such succeeding year for the purposes of Section 20. Furthermore, in terms of Section 9D(2A)(c) there will be no deduction allowed in respect of interest, royalties or rental paid by a CFE to another CFE where both entities are controlled by the same resident, as such interest, royalties or rental would have been exempt from attribution in the hands of the resident in terms of the new Section 9D(9)(fA), introduced by Act 59 of 2000.

2.6.2.3 Exemptions in respect of Section 9D(9)

Designated countries: Act 59 of 2000 seeks to establish a clearer and less restrictive requirement for designated countries to fulfil the exemption requirement. After the amendments introduced by the Revenue Laws Amendment Act 59 of 2000, the legislation pertaining to designated countries and exemptions is contained in Section 9D(9)(a) and 9E(7)(d) and 9E(8). These amended Sections had provided that the income of a CFE which qualified as a company was to be exempted from the CFE legislation of Section 9D (and be exempt from South African tax, in case of foreign dividends under the new Section 9E) if it had been or will be subject to tax in a designated country on a similar basis to that of the Republic at a statutory rate of at least 27 per cent. A designated country after the amendment, was defined in Section 9E(8) as any country which (a) has tax on income that is determined on a basis which is substantially the same as that of the Republic, (b) has a statutory rate of tax on companies of at least 27 per cent, and (c) complies with any other requirements as may be prescribed by the Minister by regulation.

In terms of Act 59 of 2000, the restriction of designated countries, as stipulated in Section 9E(8)(a), to countries which had a tax treaty with the Republic had been removed, so that the Minister may designate any country (a) which determines its income tax on a basis substantially the same as that of the Republic, (b) whose statutory tax rate on companies is at least 27 per cent, and (c) which complies with any other requirement as may be prescribed by the Minister by regulation. The intention was to extend the list of designated countries and to further limit the administrative burden created by the legislation. Specific reference was made to the fact that where a CFE has an assessed loss and as such is not liable to tax in the foreign jurisdiction, the resident is still entitled to the exemption. This confirmed that the statutory rate of 27 per cent did not refer to an effective tax rate. A proviso to this exemption was included in relation to jurisdictions which had progressive scales of statutory tax rates. In this regard, the highest rate on the scale was regarded as the statutory rate for this purpose. However, the legislation did not deal with situations where jurisdictions have different tax rates for different types of income (e.g. Mozambique). (South Africa, 2000a:7.)

Business establishment requirements: Under the amendments introduced by Act 59 of 2000, active income was now subject to attribution. This did not, however, mean that South Africa had abandoned its policy of promoting international competitiveness for its multinationals. The CFE provisions do

not apply to genuine international business activities carried out by business establishments through CFCs. The tax exemption extended to foreign business establishments was keeping abreast with international practice and the OECD Model Tax Convention on Income and on Capital (Articles 5 & 7).

To this effect, Section 9D(9)(b) provides that CFE provisions will not apply where the net income of a CFE which is a company is attributable to any foreign business establishment of such CFE. The term “business establishment” is now redefined as a place of business in terms of Section 9D(1) and comprises

- a) an office, shop, factory, warehouse, farm or other structure which is used or will continue to be used by the controlled foreign entity for a period of not less than one year;
- b) a mine, oil or gas well, a quarry or any other place of extraction of natural resources; or
- c) a site for the construction or installation of buildings, bridges, roads, pipelines, heavy machinery or other projects of comparable magnitude which lasts for a period of not less than six months, whereby the business of such entity is carried on, and where
 - i) such place of business is suitably equipped with on-site operational management, employees, equipment and other facilities for the purposes of conducting the primary operations of such business; and
 - ii) such place of business is utilised outside the Republic for a *bona fide* business purpose (other than the avoidance, postponement or reduction of liability for payment of any tax, duty or levy imposed by this Act or by any other law administered by the Commissioner).

It must be noted that the term “business establishment” is used exclusively in relation to a CFE and is defined narrowly; concentrating on the existence of a “place” where business is conducted or activities take place. “Business establishment” is a new term not defined in Article 5 of the OECD Model Tax Convention on Income and on Capital, which replaced the term “permanent establishment” used in the now-repealed Section 9C. The restrictive definition of “business establishment” is clearly intended to limit the application of the industrial, construction or commercial activity exemption to genuine business activities conducted through a physical presence of some permanence.

It is not a requirement, in order to qualify as a business establishment, that both the company and the business establishment be located in the same country of the CFE, as long as the CFE and its operations are outside South Africa. The restrictive definition of “business establishment” is also to prevent shell businesses without economic substance and with no real non-tax business reasons for their offshore existence to qualify or pass as a business establishment. It would also have been unwise

if the legislators had required that both the CFE and business establishment had to be located in the same country in order to qualify for the exemption. Macheli is of the view that “this would unduly constrain the ability of South Africa’s multinationals to use tax havens where South Africa’s tax base would not be threatened.” (Macheli, 2000:368.)

Business establishment: diversionary transactions: Circumstances may arise where, even though the CFE has a proper business establishment, certain categories of tainted income of the CFE will be subject to attribution. This will be so in the case of transactions which are generally referred to as diversionary transactions and which are aimed at exploiting the South African tax base. According to the Explanatory Memorandum on the Taxation Laws Amendment Bill (South Africa, 2000a:6), these transactions comprise both goods and services where the income, which should otherwise have been taxable in the Republic, is reduced or otherwise diverted to a low-tax jurisdiction or a tax haven country.

In terms of Act 59 of 2000, diversionary transactions are subjected to CFE provisions in that this is income which is specifically excluded from the exemption of such “net income” (essentially, genuine active business income) as is attributable to a “business establishment”. The exemption will not apply to any receipts and accruals of a CFE if derived from any transactions between the CFE and its related or connected South African residents relating to the supply of goods or services by or to such CFE, unless the consideration in respect of such transaction reflects an arm’s length price that is consistent with the provisions of Section 31 of the Income Tax Act. In the case of any transaction involving the sale of goods by the CFE to its connected South African resident, income will be subject to attribution, unless (Section 9D(9b)(ii)(aa))

- a) such CFE purchased such goods in its country of residence from unrelated persons, or
- b) the creation, extraction, production, assembly, repair or improvement of goods undertaken by such CFE amount to more than minor assembly or adjustment, packaging, repackaging or labelling, or
- c) such CFE sells a significant quantity of goods of the same or similar nature to unrelated parties, at comparable prices.

In addition, if the sale of goods by a CFE is to unrelated South African residents where such CFE had initially purchased such goods or any tangible intermediary inputs thereof from related South African residents, income will be subject to attribution, unless (Section 9D(9b)(ii)(bb))

- a) such goods or tangible intermediary inputs [were] purchased from connected South African residents and constitute an insignificant portion of the total tangible intermediary inputs of such goods; or

- b) the creation, extraction, production, assembly, repair or improvement of goods undertaken by such CFE amount to more than minor assembly or adjustment, packaging, repackaging or labelling; or
- c) the products are sold by such CFE to unconnected persons for delivery within the country of residence of such CFE.

As in the case of the sale of goods between the CFE and its related South African residents, any income arising from services performed by a CFE to a related South African resident will, as a general rule, be subject to attribution unless such service is performed outside South Africa and (Section 9D(9b)(ii)(cc))

- a) relates directly to the creation, extraction, production, assembly, repair or improvement of goods utilised within one or more countries outside South Africa; or
- b) relates directly to the sale or marketing of goods of a connected South African resident which are sold to unconnected persons for delivery within the country of residence of such CFE

In promulgating the above anti-tax avoidance measures in respect of transactions between a CFE and related South African residents, South Africa had followed the transactional approach with regard to foreign base company income earned by CFEs operating through a business establishment. According to the OECD (1996:42), “the transactional approach is more effective in preventing the use of foreign subsidiaries to avoid domestic tax on specific types of income”. The aim of the new base company income tax provisions are to identify companies, especially established in foreign tax jurisdictions, with the aim of transferring income from high-taxed jurisdictions to low-taxed jurisdictions. Therefore, South African tax authorities have used the CFE legislation (in the manifestation of Section 9D) as a reinforcement to the transfer-pricing rules of Section 31, so as to prevent abuse of the domestic tax jurisdiction, especially with regard to CFEs operating through a permanent establishment.

Passive income: Passive income consisted of annuities, dividends, interest, rental, royalties or any income of a similar nature, and was previously known as “investment income” in terms of the now-repealed Section 9C. Act 59 of 2000 included insurance premiums as passive income. Any such income earned by a CFE will be attributed to South African residents, unless

- a) it does not in total exceed 5 per cent of the sum of the receipts and accruals (other than receipts and accruals of a capital nature) and the amount of all capital gains and foreign currency gains of such controlled foreign entity; or
- b) the CFE’s receipts and accruals in respect of such income arise from the principal trading activities of any banking or financial services, insurance or rental business, excluding any such receipts and accruals from any

- i) related or connected South African resident, or
- ii) South African resident to the extent that such receipts and accruals are produced as part of a scheme for tax avoidance,

provided that the receipts and accruals of such banking or financial services, insurance or rental business are derived substantially from persons who are unconnected persons in relation to the controlled foreign entity (Section 9D(9b)(iii)(aa)(bb)).

2.6.2.4 Foreign dividends

Section 9E dealt with the taxation of foreign dividends in the hands of resident shareholders (i.e. that portion of a dividend that was attributed to sources of income outside South Africa). As the Revenue Laws Amendment Act, No of 59 of 2000 had amended the Income Tax Act in order that residents be taxed on their worldwide income, it had become imperative that some of the provisions that related to Section 9E be changed. Two of the more important changes that were introduced into Section 9E will be discussed here.

It was necessary to amend the definition of foreign dividends as South Africa was now taxing its residents on the worldwide basis. Because resident companies became liable to tax on their foreign income, it was proposed that the foreign dividend definition only include dividends declared by non-resident companies, as dividends declared from profits which were already taxed in the Republic will in any event be exempt. Dividends were, however, to include dividends distributed by a resident company from profits derived by such company before it became a resident. The definition of foreign dividend in terms of Section 9E (1) was amended to mean dividends received by or accrued to any person from either a foreign company (i.e. a company which is not a South African resident or is treated as a non-resident by virtue of an applicable double-taxation agreement), or a resident company to the extent that the dividend is declared from profits derived by such company before such company became a resident. (The Taxpayer, 2000:188.)

The general deduction formula in the Income Tax Act makes provision for the deduction of expenses actually incurred in the production of income. It may often happen that interest expenditure may not produce dividend income in the same year that the expenditure occurs. It was therefore proposed that the deduction of any interest expenses incurred in respect of foreign dividends was to be allowed to the extent of foreign dividend income that was included in taxable income (Section 11 of the Tax Act) (The Taxpayer, 2000:18). In relation to foreign dividends taxable in the hands of a resident, the Revenue Laws Amendment Act, No. 59 of 2000 added to Section 9E subsection (5A)(a) with effect from 23 February 2000, giving the allowable deduction of interest actually incurred by the resident in respect of foreign dividends but limited to the amount of foreign dividends included in the taxpayer's gross income for the year. Where the expenditure on interest exceeded the taxable portion of the

dividend, the excess was to be reduced by the amount of the exempt foreign dividends that accrued to the resident taxpayer and which was excluded from the taxpayer's taxable income, and if there was still an excess balance, it was to be carried forward to the immediately succeeding year of assessment and deemed to be an amount of interest actually incurred in that year in the production of foreign dividends.

2.6.2.5 Double taxation and foreign tax credit (Section 6 *quat*)

To avoid double taxation where a resident's foreign income is taxed by a foreign country, the foreign tax paid will be allowed as a credit against the South African tax liability. Section 6*quat* of Act 58 of 1962 had undergone some significant changes after the introduction of the residence basis of taxation. Tax credits are now granted in respect of total income which comprises both passive and active income. Foreign tax credits will no longer be limited per country, but may be pooled to offset foreign taxes incurred in different countries. As the resident will now be taxed on his total income earned, a rebate will be granted against the South African tax liability in respect of foreign taxes paid on income included in the resident's taxable income as per 6*quat*, (1)(a).

Foreign losses may not be used to shelter South African tax but may be used to shelter foreign taxable income. A concession had been granted by SARS in that "mixing" of foreign tax credits had been provided for and should under appropriate circumstances reduce tax payable in South Africa. This meant that foreign tax could be set off against South African tax arising on all foreign income. This applied to years of assessment commencing on or after 1 January 2001. In another positive move, Section 6*quat* (1B)(a)(ii) provided that excess foreign tax credits which could not be used against South African tax liability in a particular year can now be carried forward for use in later years, for up to seven years from the year in which they arose. However, the concession previously granted in relation to the set-off of foreign taxes against any STC liability had been removed. Foreign tax paid was to be converted into South African currency at the ruling exchange rate on the day on which the foreign tax was paid (Section 6 *quat* 4(a)). If the foreign tax had not been paid by end of the tax year, the ruling exchange rate on the last day of the tax year in question must be used (Section 6*quat* 4(b)). A further amendment permitted the issue of revised or additional assessments, to correct the amount of a rebate granted in respect of foreign taxes paid. Such an amended or additional assessment could not be issued more than six years from the date of the original assessment, unless the credit granted was incorrect due to fraud, misrepresentation or non-disclosure of material facts (Section 6*quat* (5)). Prior to the implementation of a residence basis of taxation, this period was limited to three years from the year in which they arose. (Accountancy SA, 2001:5.)

2.7 Chapter conclusion

The chapter gives an overview of the historical development of CFC regulations in South Africa, from the embryonic regulations of 1997 to the comprehensive anti-avoidance tax regulations, postulated on a fully-fledged residence basis of taxation, which came into effect on 1 January 2001. A limited form of CFC legislation had already been introduced in 1987 in Section 9A, which subjected South African controlling resident shareholders to taxation in respect of investment income accrued to or received by a company in a neighbouring State. According to the Katz Commission, “to counter the avoidance of this and other deemed source provisions, South Africa introduced its own so-called ‘Controlled Foreign Corporation’ (CFC) rules under Section 9A of the [Income Tax] Act” (para 6.2.1.2). The same kind of avoidance was expected should South Africa lift its exchange controls for South African residents investing offshore. The Commission recommended, however, that “active income” should be continued to be taxed on the source basis while “passive income” should effectively be taxed on a worldwide (residence) basis of taxation. (Katz Commission, 1997: paras 3.2.2–3.2.3.)

A turning point in the trajectory of South Africa’s tax regulations occurred when it made a paradigm shift from a source basis to a fully-fledged residence basis of taxation, supported by the Franzsen Commission, which made the following assertions; firstly, that adherence to the source-based system of taxation could not be reconciled with the economic welfare of South Africa, especially in view of the increase in international trade (Franzsen Commission, 1970:para 20). Secondly, South Africa’s major trading partners applied a worldwide basis of taxation and that the South African Income Tax system had already deviated from a purely source basis of taxation through the promulgation of various deeming provisions. Thirdly, the residence-based system of taxation was in accord with the principle of ability to pay. (Katz Commission, 1997:para 2.1.2.)

It was a significant moment in South African taxing history when the Minister of Finance announced on 23 February 2000 that a residence basis of taxation would replace the source basis of taxation, with effect from years of assessment commencing on or after 1 January 2001 (South Africa, 2000e). The primary reasons for the change to a residence-based system of taxation were outlined by the South African Revenue Services (see 2.6.1 above).

This brought to a close the initial phase in the history of South African CFC taxation history. Chapter 3 considers the specifics of South African CFC tax legislation in its present form.

Chapter 3

SOUTH AFRICAN CFC TAX LEGISLATION

3.1 Introduction

This chapter analyses the operation, effects and consequences of South Africa's anti-avoidance provisions (as embodied in Section 9D of the Income Tax Act), which is one of the secondary objectives of the thesis as listed in Chapter 1.6. It sets out the trajectory by which key issues in the South African CFC legislation become the focal point of scrutiny for this study, and against which international comparisons are to be made. It highlights salient shortcomings in the South African CFC regulations pertaining to key issues in respect of which possible recommendations are indicated in the concluding chapter of the thesis. These key issues include place of effective management, foreign business establishment, definitional requirements of a CFC, shareholder qualification, attribution rules, exemptions, capital gains, and relief tax provisions.

This analysis (basically, of the anti-avoidance measures to deter the transfer of income by South African residents to companies in tax havens or low-tax jurisdictions) is pursued in fairly great detail to establish the legislation (Section 9D) as the starting point for the comparative assessment in Chapter 4 of South African CFC provisions set against the corresponding principles laid down in this regard in the Model Tax Conventions put out by the OECD and the UN, and the illustrative instances in Chapters 5 and 6 of CFC clauses embodied in the anti-avoidance tax provisions of other selected jurisdictions that can be regarded as pioneers in the enactment of CFC legislation. The chapter will also note other significant limitations, anomalies, discrepancies or areas of concern, not covered in the current investigation, that could be of interest for future researchers.

3.2 CFC legislation in a South African Context (S 9D)

3.2.1 An amount to be included in the income of a resident

Section 9D(2) requires for a given year of assessment the inclusion in the income of a South African resident shareholder in a CFC (other than a "headquarter company" as defined in Section 1) of a notional amount calculated in the relative proportion of the participation rights of the resident to the total participation rights in a CFC. The amount is determined by applying the proportion of participation rights to the net income (discussed in more detail in 3.3 below) of the CFC, which in respect of the CFC's foreign tax year is determined as "an amount equal to the taxable income of that company as if that CFC had been a taxpayer, and as if that company had been a resident" for the purposes of various Sections as outlined in Section 9D(2A). The inclusion applies where such participation rights are held either on the last day of the foreign tax year (Section 9D(2)(a)) or on the

day before a foreign company ceased to be a CFC (Section 9D(2)(b)). Three provisos define circumstances in which no such amount relating to the net income of a CFC is to be included in a resident's income in terms of Section 9D(2)(a) and (b), if one of the provisos to Section 9D(2) is fulfilled (Proviso (A),(B) and(C) to Section 9D(2)) (see 3.3.3 below).

The criteria that a foreign company will need to fulfil in order that a proportionate amount of CFC income be included in the income of a South African resident shareholder in respect of the CFC's foreign tax year include defining a foreign company, definition of a CFC, attribution criteria in terms of Section 9D(2), calculation of net income in terms of Section 9D(2A), exemptions available to South African resident shareholders (Section 9D(9)), and relief tax measures and administrative requirements for Section 9D shareholders (Section 72A and Taxation Administrative Act (TAA) – 2011). Table 3-1 lists key issues in the South African CFC regulations to be dealt with in this chapter.

Table 3-1 Chapter Sections dealing with key SA CFC issues

Subject	Chapter Sect. s	South African Sources SA Act and Interpretation Note
Defining a foreign company	3.2.1.1	Sect. s 1 and 9D(1)
Determining a CFC:	3.2.1.2	Sect. 9D(1)
<i>Directly or indirectly –</i>		
Participation and voting rights	3.2.1.2	Sect. 9D(1)
<i>Specific exclusions –</i>		
Voting Rights	3.2.12	Sect. 9D(1)(a)(b)
Deemed not be a resident	3.2.1.2	Sect. 9D(1)(c)
Defining country of residence	3.2.1.3	Sect. 9D(1)
Place of effective management	3.2.1.3	Sect. 1 SARS <i>Interpretation Note 6</i>
Relief from effective management test	3.2.1.4	Sect. 1
SA headquarter company	3.2.2	Sect. 9I(1)
Attribution of CFC income	3.3.	Sect. 9D(2)(a)(b)
Timing of control	3.3.2	Sect. 9D(2)(a)(b)
Criteria for attribution	3.3.3	Sect. 9D(2)(a)(b)
Exceptions to attributions	3.3.3	Provisos (A)(B)(C) Sect. 9D(2)
Computation of net income	3.3.4	Sect. 9D(2A)
Exemptions from Sect. 9D	3.4	Sect. 9D
High-taxed net income	3.4.2	Proviso – Sect. 9D(2A)
Postponement of CFC income	3.4.3	Sect. 9A
Foreign business establishment	3.4.4	Sect. 9D(9)(b)
Long-term insurance	3.4.5	Sect. 9D(9)(c)
Exemption Interest and Royalties	3.4.6	Sect. 9D(9)(d)
Exemption of SA taxable income	3.4.7	Sect. 9D(9)(e)
Related-party dividend exemption	3.4.8.1	Sect. 9D(9)(f)
Related-party interest, royalties	3.4.8.2	Sect. 9D(9)(fA)
Relief tax provisions	3.5	Sect. 6 <i>quat</i>
Administrative requirements	3.6	Sect. 72A

3.2.1.1 Defining a foreign company

Introduction

One of the fundamental requirements of CFC legislation is the identification of a foreign company to which the legislation applies. A definition is therefore essential for the identification of a foreign company, which will also reflect its relationship with resident taxpayers in a country applying CFC legislation. This chapter section examines the definition of a foreign company and the underlying principles that are used to determine a foreign company.

Revenue Laws Amendment Act 74 of 2002 introduced the term “controlled foreign company” into the South African Income Tax Act (in Section 9D) to replace the term “controlled foreign entity”. This made it clear that the entity in question, for South African CFC legislative purposes, needed to be a foreign company. A foreign company is defined in Section 1 as “any company which is not a resident”.

A foreign company is further specifically defined for the purpose of Section 9D(1) as

- a) a cell or segregated account contemplated in the definition of “protected cell company”;
- b) a protected cell company to the extent that –
 - i) specified assets of that company are not segregated into structurally independent cells or segregated accounts as contemplated in paragraph (a) of the definition of “protected cell company”; or
 - ii) specified assets and liabilities of that company are not linked or attributed to cells or segregated accounts as contemplated in paragraph (b) of the definition of “protected cell company”; or
- c) a foreign company, as defined in Section 1, other than a protected cell company.

The definition of a “foreign company” came into operation on 1 January 2012 for the purposes of Section 9D(1), and applies to a foreign tax year of a CFC ending during years of assessment commencing on or after that date.

A “protected cell company” means any entity incorporated, established or formed, whether by way of conversion or otherwise, under a law of a country other than South Africa,

- a) if its principal trading activities constitute the business of an insurer, and
- b) when that law makes provision for –
 - i) the segregation of specified assets into structurally independent cell or segregated accounts,
 - ii) the linking or attribution of specified assets and liabilities to those cells or segregated accounts, or
 - iii) separate participation rights for each such cell or segregated account,

irrespective of whether or not that law provides that the establishment or formation of a cell or segregated account creates a legal person distinct from that entity. (Section 9D(1))

The definition of a “protected cell company” in Section 9D(1) came into operation on 1 January 2012 and applies to a foreign tax year of a CFC ending years of assessment commencing on or after that date.

The application of CFC legislation in protected cell companies (PCCs)

Foreign statutory cell companies (often referred to as “protected cell companies” or “segregated account companies”) effectively operate as multiple limited liability companies, separated into legally distinct cells. These cell companies are often found in the jurisdictions of Bermuda, Guernsey, Gibraltar, Isle of Man, Vermont, Mauritius and Seychelles. The cell company is a single legal entity that operates in two distinct parts: the core and the other cells. There is only one core, but there can be an unlimited number of other cells. The core is owned by the founding members of the company who are the service providers and central managers of the company as a whole. The other cells are designed to isolate risk for the “customer” users. Cell companies often issue two classes of shares: ordinary voting shares issued to the practical owners of the core, and non-voting preference shares issued to the “customers” using the other cells (with a separate class of preference shares issued to each set of owners of each separate cell). (South Africa, 2011a:114.)

In the case of cell company insurers, each of the other (non-core) cells is funded by the insured’s own capital contributions and premiums collected. The insured cell participant can only collect pay-outs via the insurance agreement and typically can only receive distributions upon termination of the cell’s functions. Cells operate under a limited liability principle with each cell having full limited liability protection against the other cells (that is, the creditors of the cells cannot make claims against the other cells). However, the core can be subject to the claims of other cells in limited circumstances. (South Africa, 2011a:114.)

This chapter will consider the South African CFC regulations in a broad and generalised context without specific regard to types of business operations (e.g., insurance, shipping, transport etc.).

Applicable law

A key consideration in determining if an entity is a CFC is to establish whether it is a foreign company. In a South African context a foreign company is defined in both Section 1 and Section 9D(1) of the Income Tax Act (refer above for definition). A resident, in turn, is also defined in Section 1. Under paragraph (b) of the definition of a “resident”, a resident person other than a natural person will be a resident if it is

- incorporated, established or formed, or
- has its place of effective management in South Africa.

(See 3.2.1.4 below for discussion of the relief from the effective management test in the case of high-taxed CFCs.)

Consequently, the definition of a foreign company identifies two key considerations: firstly, that the foreign entity must be a company as defined in Section 1 of the South African income tax legislation (the Income Tax Act) and secondly, that it must qualify as a non-resident. Since 1 January 2011, a “foreign company” is defined to mean any company which is not a resident (Section 1). Further, the Income Tax Act in Section 1 includes the definition of a company.

Therefore, the companies thus referred to will qualify as foreign companies, providing they are not resident in South Africa and they fulfil the definitional requirements of a company in Section 1. An example would be a company which is incorporated in South Africa but has its place of effective management outside South Africa. Such a company would be regarded as a foreign company, based on the tie-breaker rule in the case of a residence-residence conflict, where the place of effective management test is used to determine the residency of a company (OECD, 2010a:art 4 para 3). Since there is no definition of the term place of effective management in Section 1 of the Income Tax Act, SARS has issued *Interpretation Note No. 6* on the determination of the place of effective management (dated 26 March 2002) setting out its own interpretation, despite differing from the OECD and UN interpretations, on the place of effective management.

One of the key alternatives for the determination of a foreign company is contained in paragraph (b) of the definition of company in Section 1 of the Income Tax Act, where it is clear that a foreign company is one that is formed or incorporated under the law of the foreign country, and not in terms of the law of the Republic of South Africa. Therefore, in order to determine the legal status of the foreign entity, the foreign law needs to be applied and not South African law. Alternatively, there could exist a situation in which a South African company (incorporated in terms of paragraph (a) of the definition of company in Section 1 of the Income Tax Act) is considered a foreign company; this could be the result of a South African company, under treaty law, having its place of effective management in the other treaty State and, consequently, being classified as a non-South African resident. (Olivier & Honiball, 2011:565.)

Another example of a foreign company would be a collective investment scheme as defined in Section 1(e) (ii) of the Income Tax Act. Co-operatives and close corporations were included in the definition of company. Before 2 November 2006 a close corporation was not included in the definition of a foreign company in Section 9D(1), resulting in such close corporation escaping the South African tax

net in respect of its foreign investment income. Through the inclusion of a close corporation in the definition of a foreign company, Section 9D thus widened its applicability to include a special type of business entity that is specific, particularly, to South Africa.

CFC legislation will not apply if the foreign entity is a trust. Income that is received by or accrues to a foreign trust will not be attributable to South African resident beneficiaries under CFC legislation. The income derived by a foreign trust will fall within the South African taxing system only when it is distributed to the beneficiaries in terms of Section 25B, unless another South African taxing provision, for example, Sections 7(5) or 7(8), comes into operation. Sections 7(5) and 7(8), and their capital gains tax (CGT) equivalent provision (para 72 of the Eighth Schedule) operate in a manner similar to that of the CFC rules. The exception is that, unlike the taxing regime of Section 9D, there exist no available exemption or exclusion as part of their legislative operations (Olivier & Honiball, 2011:564). Therefore, Section 9D does not apply to foreign trusts. Where, however, a foreign trust is regarded as a company under the law of the State in which it is incorporated, South African CFC legislation will apply as the entity will be regarded as a company under paragraph (b) of the definition of company in Section 1 of the South African Income Tax Act.

Further, Section 9D will also apply to a foreign trust if it is regarded as a company under paragraph (e)(ii) of the definition of “company” in Section 1. Under paragraph (e)(ii) of this definition a collective investment scheme (the legal nature of which often takes the form of a trust) carried out outside South Africa is regarded as a company and, depending on the circumstances, as a CFC (Olivier & Honiball, 2011:564). In essence, this definition refers to a unit trust or mutual investment fund, the legal nature of which often takes the form of an offshore trust (Olivier & Honiball, 2011:564). Consequently, for CFC legislation to apply, an offshore unit trust has to meet the requirements of a “controlled foreign company” as defined in Section 9D(1), which is discussed in greater detail in the subsequent Sections of the chapter.

In paragraph (c) the definition of controlled foreign company in Section 9D(1) provides that where an entity is regarded as a company under paragraph (e)(ii) of the definition of company in Section 1, in determining the percentage holding, a holding of less than 5 per cent of the participation or voting rights must be ignored to determine if the person is a resident for purposes of the more than 50 per cent of total participation rights or voting rights in a foreign company (see 3.2.1.2). The practical effect of this deeming provision is that most collective investment schemes (previously known as unit trusts) carried out outside South Africa will not be considered as CFCs, even if all the participants are South African residents (Olivier & Honiball, 2011:564).

Foreign partnerships, as defined, have from 24 August 2010 been expressly excluded from the definition of company and consequently cannot be foreign companies as defined. In general, CFC rules are not applicable to foreign partnerships. However, it is possible that CFC legislation could apply to certain types of non-tax-transparent incorporated partnerships that are considered companies in certain foreign jurisdictions. Since the definition of the term “company” in Section 1(b) of the Income Tax Act includes “any association, corporation ... under the law of any country other than the Republic”, the legal status of a foreign company has to be determined according to foreign law.

Therefore, the recognition of a company (in para (b) of Section 1) of a foreign entity incorporated under the law of a foreign jurisdiction could result in certain tax anomalies arising for the South African taxing authorities. Paragraph (b) would now include certain foreign incorporated entities, considered an equivalent to a South African company, which would not normally constitute a company under South African law. It would also include a trust under paragraph (e) of the definition of companies; this would normally constitute collective investment schemes. (Mvovo, 2007:4.)

Further tax anomalies that could arise relate to the application of paragraph 64B of the Eighth Schedule of the Income Tax Act. Paragraph 64B deals with the disposal of equity shares in foreign companies, it lays out the requirements that need to be fulfilled in order that any capital gain or capital loss is disregarded. For example, prior to a company claiming a capital gains tax exclusion in accordance with paragraph 64B of the Eighth Schedule, a certain percentage of the equity share capital of a foreign company must be held by the South African tax resident. The problem with the “equity share capital” requirement is that an entity such as a limited liability partnership (LLP) in the United States or a LLP in the United Kingdom “will arguably never have ‘equity share capital’ as defined in Section 1 of the [Income Tax] Act” (Mvovo, 2007:4). Consequently, this would mean that the paragraph 64B exclusion could not be claimed; as such types of LLPs do not have the infrastructural equity requirement of a South African company in terms of the “equity share capital” requirements for companies.

Unlike France, for example, where a permanent establishment is subject to CFC legislation in an attempt to avoid the abuse of its territorial system of taxation, in South African domestic law an entity can be a CFC only if it is a separate person (as in the case of a company). In a South African context, a foreign company has to be a body corporate in some form or other under the laws of the relevant foreign jurisdiction in order that CFC legislation become applicable, otherwise CFC legislation will not have any relevance (for example, in the instance of an unincorporated entity, even if it has limited liability unless such entity is a body corporate). (Olivier & Honiball, 2011:563.)

As per the definition of a “company” in Section 1 of the Income Tax Act in which a clear distinction is made between companies established in South Africa (para (a)) and those established under foreign law (para (b)), the legal status of the partnership will therefore be determined under foreign law. However, in instances where limited liability partnerships are not considered as incorporated legal entities (in jurisdictions such as the Cayman Islands), then CFC legislation would not be applicable, as such entities would be construed as “flow through” or “fiscally transparent entities”. (Oguttu, 2007:114.)

3.2.1.2 Determining a controlled foreign company

Introduction

Having set out the fundamental requirements for the identification of a foreign company, the next issue to consider is the legislation that needs to be in place in order that a foreign company qualifies as a South African “controlled foreign company”. This chapter section will therefore analyse the term “control” in a South African CFC tax legislation context. The following definition of the term “controlled foreign company” in Section 9D(1) of the Income Tax Act will serve as the basis of our discussion in the current Section :

“controlled foreign company” means any foreign company where more than 50 per cent of the total participation rights in that foreign company are directly or indirectly held, or more than 50 per cent of the voting rights in that foreign company are directly or indirectly exercisable, by one or more persons that are residents other than persons that are headquarter companies.

Up until 2002 both “participation rights” and “voting rights” were taken into consideration in determining whether the 50 per cent interest was exceeded: both requirements of *individually or jointly* in the ownership of the participation rights in the CFC, or the entitlement to exercise more than the requisite percentage of the votes in the CFC, were taken into consideration (Section 9D(1)). However, the requirement that the interest of the South African residents, whether “individually or jointly”, had to be taken into consideration in the determination of a CFC had created enormous uncertainty. In its broadest context, “jointly” referred to the participation or voting rights of South African resident shareholders exceeding 50 per cent, irrespective of whether they were aware of the other shareholders’ existence. In essence, the word “jointly” was to be construed as meaning “aggregate”, and not that the residents were to have had a “common purpose” or were required to act “in concert”. (Olivier & Honiball, 2011:568.)

Jooste (2001:476) is of the view that, as the aim of Section 9D is to prevent South African residents from keeping their foreign-sourced income outside the South African tax net, a common purpose does not have to exist for the application of Section 9D. “Where no common purpose existed among the

South African resident shareholders then it cannot be argued that a deliberate attempt was made to prevent the income from falling into the tax net” (Olivier & Honiball, 2011:568).

For years of assessment ending on or after 13 December 2002 the “individually or jointly” requirement has been deleted in the Income Tax Act. This created the impression that whatever the position might have been, collusion between South African residents is no longer a requirement for the existence of a CFC. There is, however, the view that if collusion among South African residents is not a requirement, then it may virtually be impossible for South African shareholders to determine in all cases if other South African residents hold shares in the same foreign company. For example, if a South African resident holds 20 per cent in a foreign company, and a United Kingdom company holds 50 per cent of the shares in the same foreign company, and unconnected South African resident shareholders in turn own the entire shareholding of this United Kingdom company, the foreign company will qualify as a CFC. However, it may be impossible for the South African resident shareholders to obtain information from the United Kingdom company regarding its shareholding so as to determine if the foreign company is a CFC. (Olivier & Honiball, 2011:568.)

Definition of controlled foreign companies

The definition of a CFC was amended in respect of any foreign tax year that commenced on or after 8 November 2005. The amended definition reintroduced the concept of “voting rights” as one of two alternatives determining whether a foreign company qualified as a South African CFC. Prior to this amendment, “participation rights” were the sole determining criterion in this respect.

The definition of “participation rights” has been updated with effect from 1 April 2012 (South Africa, 2011d: Section 25b(1(b))), however there is expected to be “no essential change in meaning” for most practical purposes (Potgieter, 2010:26). Section 9D(1)(a) thereafter defines participation rights, in relation to a foreign company, as “the right to participate directly or indirectly in the share capital, share premium, current or accumulated profits or reserves of that company, whether or not of a capital nature”. Paragraph (b) of the definition of participation rights in Section 9D(1) specifically states that it is only “in the case where no person has any right in that [foreign] company as contemplated in paragraph (a) or [where] no such rights can be determined for any person, [that] the right to exercise any voting rights in that company” becomes a participation right. Therefore, voting rights, which are not defined, become pertinent in cases where no person has any right in the foreign company, or no rights can be determined for any person, as contemplated in paragraph (a) of the definition of “participation rights” (in Section 9D(1)). Voting rights are thus an alternative test to “participation rights” for purposes of the definition of “controlled foreign company”. In essence, the definition makes provision for a foreign company to qualify as a CFC in the case where more than 50 per cent of the voting rights in that foreign company are directly or indirectly exercisable by one or more (South

African) residents. Consequently, in a company where only 30 per cent of the share capital is held by a resident, and that the resident shareholder also holds 65 per cent of the voting control in the foreign company, such a company will qualify as a CFC in terms of Section 9D(1) (Olivier & Honiball, 2011:566-567).

However, voting control will not necessarily give rise to attribution in terms of Section 9D(2), because the participation rights definition must also be taken into consideration. The holding of exclusive voting rights in a CFC, for the purpose of the determination of control, will still require the shareholder to make available, when requested, copies of the latest financial statements of the CFC in terms of Section 72A(2), even though no income may be attributed to such shareholder. This should not be construed as an “anomaly”, but rather as a method by which SARS would “be able to review the mismatch (if any) between the profit participation and the voting rights of the resident” (Olivier & Honiball, 2011:567).

Although the term “participation rights” quite distinctly refers to the rights of shareholders to participate in the profits of the foreign company, the situation is less decisive in respect of the interpretation of the term “voting rights” – a term that is lacking a precise definition in the Income Tax Act. The only guidance Section 9D provides on the meaning of the term “voting rights” is the reference in the definition of the term “controlled foreign company” in Section 9D(1) that when the voting rights in a foreign company are determined, no regard must be had to voting rights in a foreign company

- which is a listed company; or
- if the voting rights in the foreign company are exercised indirectly through a listed company

However, as voting rights, according to the definition of “participation rights”, are only taken into account when a person’s rights in the company cannot be determined, it is difficult to decipher when such companies (i.e. companies without defined rights) will ever constitute listed companies (Olivier & Honiball, 2011:567).

If the aim of Section 9D is to tax the income of a foreign company, of which South African shareholders have control (i.e., disregarding the separate existence of the CFC), it would then follow, as a natural consequence, that the concept of voting rights “should include all those who have control over the income of the foreign company”. For example, it would be clear from the official records of the foreign company whether the shareholders or directors have the necessary mandate to declare such dividends on behalf of the CFC. As Section 9D is considered “an anti-avoidance provision aimed at attributing income of a foreign company which a South African resident controls into the tax net, voting rights therefore arguably refer to any form of control over the distribution of profits or capital

exercised by a South African resident (whether as shareholder, director or otherwise).” (Olivier & Honiball, 2011:567-568.)

Directly or indirectly – participation rights and voting rights

The inclusion of the phrase “directly or indirectly” in the definition of the term “controlled foreign company” means that the interests of both registered and beneficial shareholders have to be taken into account. The implication is that where, for example, an individual resident in South Africa owns all the shares in a foreign company C, which in turn holds all the shares in another foreign company D, both companies C and D will be considered to be CFCs of the South African resident. However, a CFC will not exist in the case where a foreign company C has issued 100 ordinary shares, 50 each to a South African company and a foreign individual, and all the shares of the South African company are owned by an individual South African resident. The reason is that Company C does not qualify as a CFC because not more than 50 per cent of the shares are held by South African residents. (Oguttu, 2007:115-116.)

A question which has arisen in foreign jurisdictions in relation to a foreign company is whether a creditor who holds debentures or a mortgage bond over the CFC’s property could be considered to have participation rights in the CFC. Although it may be submitted that, until the security is called up, such a creditor has no direct right to participate in the profits or in the accumulated reserves of the company, the creditor may, on the other hand, have an indirect right to do so (Olivier & Honiball, 2008:438). The South African National Treasury is of the view that convertible debentures, options and similar interests do not represent a participation interest until converted into shares (South Africa, 2002a:3). The definition of “participation rights” does not limit an interest in a foreign company exclusively to share issues, but may extend to include an indirect interest in the accumulated profits or reserves of the foreign company (Olivier & Honiball, 2008:438). A similar argument could be invoked in the case of unsecured creditors of a company. An unsecured creditor will not be considered to have a direct right to participate in the profits or reserves of the company, but rather, an indirect right to do so. A question which then often arises is whether Section 9D also applies to such unsecured creditors. The legislator needs to express clarity over this issue and also to make it (emphatically) clear that the word “indirectly” refers to holding through another company and not to conditional holdings. (Oguttu, 2007:116.)

It is also worth mentioning that any reference to “indirectly” would carry the meaning that the interest of both the registered and the beneficial shareholders will have to be taken into consideration. Although in terms of Section 82 of the South African Income Tax Act, the onus of proof is on the taxpayer (i.e., the South African resident shareholder), the practical application of the provisions of

Section 9D(in respect of indirect interests) may often be found to be problematic. (Olivier & Honiball, 2011:569.)

However, the question remains whether the provisions of Section 9D can be applicable to a foreign company whose sole shareholder is a foreign trust with beneficiaries being South African residents with discretionary rights. At first glance, the foreign company would seem to be a CFC, since the South African resident beneficiaries are indirectly entitled to participate in more than 50 per cent of the participation rights of the company. However, this will depend on the provisions contained in the trust deed, and “the preferred view is that the provisions of Section 9D are not applicable in the case of a wholly discretionary trust” (Olivier and Honiball, 2011:571). It cannot even be argued that the beneficiary has an indirect right to participate in the accumulated profits (i.e., dividend declarations) of the company in such a case. The right belongs to the trust. As income beneficiary, the South African taxpayer merely has the right to participate in the income of the trust, once distributed (Olivier and Honiball, 2011:571). In ITC 76, 3 SATC 68 at 70, the court defined the term “contingent right” as a mere *spes* – an expectation which might never be realised.

On the other hand, where the foreign company’s sole shareholder is a foreign (offshore) vested trust whose beneficiaries are South African residents with vested rights, it would be merely academic to argue whether such a company qualifies as a CFC, since the distributions (i.e., dividends) are in any event taxable in South Africa (in terms of the provisions of Section 25B of the Income Tax Act). This debate is also academic in circumstances under which the provisions of Sections 7(5), 7(8), or paragraph 72 of the Eighth Schedule would apply, as the income or capital gains of a company held by a foreign trust or the income of the trust itself may be taxable in the hands of a South African resident donor regardless of whether the company is a CFC. In such circumstances it is arguable that “the provisions cannot simultaneously apply to effectively cause the income to be taxed twice.” (Olivier & Honiball, 2011:571-572.)

Various concerns were expressed over the inclusion of “voting rights” in the determination of whether a company should be regarded as a CFC, precipitated by the re-introduction of “voting rights” in the definition of a controlled foreign company by the Revenue Laws Amendment Act, No. 31 2005. A key concern that emerged is the determination of the exact meaning of “voting rights” in relation to the definition of a “controlled foreign company”. In response, the South African Revenue Services were of the opinion that the “ordinary meaning of the concept” should prevail. (Oguttu, 2007:117.)

Another concern was with the inclusion of “voting rights” as one of the two criteria for the determination of whether a foreign company qualifies as a “controlled foreign company” – which could lead to the income of the CFC being attributed to the South African resident, notwithstanding

the fact that the resident shareholder may never become entitled to such income. According to Oguttu, the attribution of net income of a CFC (using voting rights as a basis for attribution) to its shareholders will only be applied in the case where no person has any rights to the CFC's capital, profits or other reserves. Therefore, the method will only apply "as a backup to attribute practical control and not to legal control and the above problem would therefore not arise." (Oguttu, 2007:117-118.)

The purpose of the re-introduction of voting rights as a criterion for the determination of whether a company should be classified as a CFC is to bring the criteria (both participating and voting rights) "closer to the permissible range of foreign investments in terms of the exchange control dispensation" (South Africa, 2005b: Clause 14(sub-clause (a))). Therefore, voting rights may be considered "a better indication of actual control in transactions involving preference shares and certain hybrid instruments" (Oguttu, 2007:118). In terms of the definition of a CFC (subparagraph (b)), when determining if a foreign company qualifies as a CFC, consideration should be given not only to direct voting rights, but also to indirect voting rights. The effect of this new amendment is that, where a shareholder is able to exercise more than 50 per cent of the voting rights in a foreign company, then that shareholder is regarded as effectively controlling the relevant company. Therefore, where, for example, a resident could exercise 75 per cent of the voting rights in a foreign company that can in turn exercise 75 per cent of the voting in another foreign company, the indirect interest of the resident in the second foreign company is 75 per cent and not 56.25 per cent (75 per cent of 75 per cent) (South Africa, 2005b: Clause 14(sub-clause (a))). In addition, where the second foreign company in turn holds 55 per cent in a third foreign company and the balance of shares are held by non-residents, under provision (b) of the definition of a CFC, the resident is deemed to exercise the votes in the second foreign company directly and, consequently, the third foreign company would be considered as a CFC and further attribution will occur. It should be noted that provision (b) of the definition of a CFC, is not applicable for attribution purposes in the case of where the percentage holding in shares are determined. Where the percentage holding in the participation rights are determined, the effective percentage interest is calculated. Where a resident, for example, holds 80 per cent of the equity shares in another foreign company, the indirect interest of the South African resident in the second foreign company is 64 per cent (80 per cent*80 per cent) and not 80 per cent .(Olivier & Honiball, 2008:438.)

Determining participation rights and voting rights for attribution purposes – in terms of Section 9D(2A)

An important distinction between "participation rights" and "voting rights" is attributable to voting rights being taken into consideration only when no such rights (i.e., participation rights) can be determined for any person, that the right to exercise any voting rights becomes a participation right. This could often happen in certain hybrid companies that have no shares and only have voting rights.

Hybrid entities are characterised differently, for income tax purposes, in different tax jurisdictions; for example, a partnership which is normally taxed as a transparent entity may be taxed as a non-transparent entity (corporation) in the United States, when a “check-the-box” election is made (Olivier & Honiball, 2008:575-576). The “check-the-box” election allows a United States company to choose how an entity it controls, either domestic or foreign, will be treated for United States tax purposes. In general, United States tax rules classify a business organisation as either a corporation or a flow-through entity, such as a partnership. When a business organisation is treated as a flow-through entity all income attributable to the organisation flows through to its owners (see 6.3.4 below).

If a person has the right to participate in the equity of the company (no matter how small) then the voting rights are disregarded (Huxham & Haupt, 2007:307). If a foreign company is a listed company or if the voting rights in a foreign company is exercisable indirectly through a listed company, voting rights will not be taken into consideration in determining if that foreign company is a controlled foreign company (Section 9D(1)(a)). In circumstances where any voting rights in a foreign company is exercised directly by any other CFC in which that resident (together with any connected person in relation to that resident) can directly or indirectly exercise more than 50 per cent of the voting rights then those rights are deemed, for the purpose of the definition of a CFC, to be exercisable directly by that resident (Section 9D(1)(b)).

Persons deemed not to be resident – for determining if foreign company is a controlled foreign company

Sub-clause (c) of the definition of a CFC in Section 9D(1) describes the circumstances under which “a person is deemed not to be a resident for [the] purposes of determining whether residents directly or indirectly hold more than 50 per cent of the participation rights or voting rights in a foreign company”. Excluded from the definition of a CFC are residents who are not connected persons, and who in aggregate hold more than 50 per cent of the participation rights in the foreign listed company or a foreign collective investment scheme or arrangement, but individually hold less than 5 per cent of the participation rights in the listed company or hold less than 5 per cent of the participation rights and may not exercise at least 5 per cent of the voting rights in the foreign collective investment scheme or arrangement (or in the so-called equity unit trusts as contemplated in paragraph (e) (ii) of the definition of a company in Section 1). (Section 9D(c)(i)(ii).)

In paragraph (e)(ii) of Section 1 of the definition of a company, reference is made to a foreign collective investment scheme in which members of the public “are invited or permitted to contribute to and hold participatory interest in [a] ... portfolio through shares, units or any other form of participatory interest” (Section (1)(e)(ii)). A foreign collective investment scheme will usually be set up in a foreign country by a South African financial services group (which includes banks), to make

investments on behalf of South African residents who wish to utilise their exchange control foreign investment allowances. To qualify as a CFC, more than 50 per cent of the participation rights or voting rights of the foreign collective investment scheme is to be held by South African resident shareholders. Those residents or individuals who hold less than 5 per cent of the participation rights and who may not exercise at least 5 per cent of the voting rights in that scheme or arrangement will not be taken into consideration for the purposes of determining if more than 50 per cent of the participation rights or voting rights are held by South Africans residents, unless more than 50 per cent of the participation rights or voting rights in the foreign company are held by persons who are connected persons in relation to each other (Section 9D(1). (Olivier & Honiball, 2008:437.)

The objective of the exclusion is to simplify the administrative burden on tax authorities, as it is often difficult to determine the identity of the ownership of shares in large-scale entities where the interest is less than 5 per cent. It may also prove difficult to assimilate the necessary information required in terms of Section 72A pertaining to shareholding of less than 5 per cent. The exclusion clause (of shareholders having interest less than the 5 per cent shareholding requirement) is not applicable in a situation where connected persons own more than 50 per cent of the foreign company. As a result “the provisions of the Section cannot be circumvented by a group of economically linked parties by utilising the 5 per cent *de minimus* test.” (Olivier & Honiball, 2008.)

3.2.1.3 Defining a country of residence

Introduction

The country of residence is a criterion used in the South African CFC legislation to determine the country where the foreign company has its place of effective management (Section 9D(1)) . Since the South African Income Tax Act does not have a definition of the term place of effective management, SARS has issued *Interpretation Note 6* (South Africa, 2002d) as guide to the South African interpretation of this term. A brief discussion will follow of *Interpretation Note 6*.

Therefore, the place of effective management is an important consideration (as a tie-breaker rule) for the determination of a country of residence, for persons other than individuals, in any bilateral double tax convention. Double taxation could arise in a situation where resident-resident conflicts occur. Resident-resident conflicts occur in the situation where both countries regard such a person as resident for tax purposes under their domestic legislation. Therefore, all income that is earned by that person, irrespective of the jurisdiction it is earned in, will be subject to tax in both countries. To resolve the conflicts of double taxation, the OECD Model Tax Convention contains a tie-breaker clause which states that a non-individual shall be deemed to be resident only of the State in which its place of effective management is situated (OECD, 2010a:art 4 para 3).

At the outset it should be noted that foreign entities which have their place of effective management in South Africa are considered as South African residents and, consequently, they will not be regarded as South African CFCs (Section 9D(1)) (Davis, 2010:3) (in this respect see also 3.2.1.4 below for a discussion of the relief from the effective management test in the case of high-taxed CFCs). Davis had revisited this concept in a recent decision of the tax tribunal in the United Kingdom in which further light was shed on this concept – *Laerstate BV v Commissioners* (United Kingdom, 2009d).

Further discussion of the concept “place of effective management” in a South African context is given in Chapter 4, in which comparison is made between the South African interpretation of the concept and its interpretations in the OECD and the UN Model Tax Conventions, and also in Chapters 5 and 6 in relation United States and United Kingdom interpretations. More particular attention needs to be given next to the implications of the term for South Africa as considered in *SARS Interpretation Note 6*

SARS Interpretation Note 6

The term “place of effective management” is not defined in the South African Income Tax Act. It is, however, a common term used in tax treaties as the so-called “tie-breaker” rule – where a person is deemed for the purposes of a tax treaty to be resident in both Contracting States. A “tie-breaker” clause usually makes provision for a dual resident person, other than an individual, to be resident, for the purposes of a tax treaty, in the country in which it has its place of effective management (OECD, 2010a:art 4 para 3).

In an attempt to clarify the meaning of “place of effective management”, the South African Revenue Services has issued a guideline in its *Interpretation Note 6* of 2002. Broadly, *Interpretation Note 6* states that the concept of effective management is not the same as shareholder control or control by the board of directors. Consequently, management focuses on the company’s purpose and business and not on the shareholder-function (South Africa, 2002d:2). To determine the meaning of the place of effective management one should bear in mind the possibility of distinguishing between

- the place where central management and control is carried out by a board of directors;
- the place where executive directors or senior management execute and implement the policy and strategic decisions made by the board of directors and make and implement day-to-day/regular/operational management and business activities; and
- the place where the day-to-day business activities are carried out/conducted. (South Africa, 2002d:2.)

Determination of the place of effective management

General Approach

In terms of *Interpretation Note 6*, the place that is decisive in the determination of the place of effective management is where the company is managed on a regular or day-to-day basis by the directors or senior managers of the company, regardless of where the overriding control is exercised, or where the board of directors will normally meet. In other words, place of effective management refers to the place where policy and strategy decisions made by the board of directors are executed and implemented and not where they are taken. It can also be referred to as the place of implementation of the entity's overall group vision and objectives (South Africa, 2002d:2). In a United Kingdom case – *Wensleydale's Settlement Trustees v IRC* (United Kingdom, 1996) – Special Commissioner DA Shirley, sitting in private, made the remark that “effective implies a realistic, positive management.” Therefore, “the place of effective management is where the shots are called”. (The Taxpayer, 1998:84.)

Practical approach

Where management functions are executed at a single location, this location will be the place of effective management. This location may, however, not correspond with the place from where the day-to-day business operations or activities are actually conducted from or carried out. Where directors and senior managers manage their activities through distance communication (i.e. telephone, internet, video conferencing, etc.), the place of effective management will be the place from where the business operations or activities are actually carried out or conducted. Where these activities are conducted from various locations, the place with the strongest economic nexus will have to be determined. (South Africa, 2002d:2.)

Olivier and Honiball hold a different view on the concept of “place of effective management” from that which is contained in SARS *Interpretation Note 6*, when they state the following (Olivier & Honiball, 2011:28):

[T]he place of effective management ‘is the place where the higher level of day-to-day running of the business takes place’. Running of a business is not limited to implementation of decisions and administration. It also necessarily includes a range of decision-making steps necessary for the functioning of the business. However, it does not necessarily include the strategic decision making.

3.2.1.4 Relief from the effective management test: High-Taxed CFCs

To circumvent the potential for double taxation, the South African taxing authorities deemed it necessary that the “place of effective management test” for residency be annulled in the case of South African-owned foreign subsidiaries if: (a) the subsidiary is highly taxed, and (b) the subsidiary has a

foreign business establishment (South Africa, 2012:119) Therefore, it is considered that little is at stake for the South African fiscus in these circumstances as the South African tax liability is largely mitigated by the foreign tax rebates. Therefore, the definition of a company resident was accordingly amended to highlight this exclusion in respect of highly taxed CFCs.

3.2.1.5 Foreign tax year

A “foreign tax year in relation to a foreign company, means any year or period of reporting for foreign income tax purposes by that company or, if that company is not subject to foreign income tax, any annual period of financial reporting by that company” (Section 1). It has been noted that there may be uncertainty as to the determination of a “foreign tax year” of a CFC, especially if the CFC is not required to report for foreign income tax purposes in the country of its incorporation. Therefore, the annual period of financial reporting to the shareholders may be used. (Potgieter, 2012:36-37.)

3.2.2 The South African headquarter company regime

3.2.2.1 Background

In 2010, a new tax regime was promulgated to ensure that the tax system did not act as a barrier to the use of South Africa as regional headquarter company (chiefly for the Sub-Sahara African continent). The tax benefits attributable to a headquarter company is that the foreign subsidiaries of a headquarter company will not constitute CFCs in relation to the headquarter company, and consequently their net income will not be attributed to the headquarter company. However, these foreign subsidiaries will constitute CFCs in relation to South African shareholders of the headquarter company, if such shareholders indirectly hold more than 50 per cent of the participation rights or voting rights in the subsidiaries. (South Africa, 2010a:77.)

The new regime cleared three hurdles –

- relief from tax on dividends (to and from the headquarter company),
- relief from the CFC deemed income provisions, and
- relief from transfer pricing (including thin capitalisation) in respect of back-to-back loans. (South Africa, 2010a:77.)

To qualify as a headquarter company, a South African company has to satisfy the requirements of the three criteria as prescribed by Section 9I(2), namely: equity requirements; asset holding requirement and gross income requirement (Section 9I(2)) (see below).

Early experience with the headquarter-company regime highlighted certain anomalies that needed to be removed which rendered the regime partially impractical. Early information suggested that some groups were using the regime to undermine certain aspects of the pre-existing tax base. Certain

companies inadvertently fell into the regime without any intention of remaining in it. (South Africa, 2011a:93.)

3.2.2.2 The current regime for headquarter companies

Definition of headquarter company

A “headquarter company” is defined in in Section 9I(1) as any company that (a) is a resident; and (b) complies with the prescribed requirements of subsection (2), which may elect to be a headquarter company for any year of assessment.

Election

Under Section 9I(1), a company that

- is a resident, and
- complies with the requirements prescribed by Section 9I(2)

may elect in the form and manner determined by the Commissioner to be a headquarter company for its year of assessment.

Requirements

Section 9I(2) provides that a company complies with the requirements contemplated in s 9I(1)(b) for its year of assessment if

- for the duration of that year of assessment and of all its previous years of assessment, each shareholder in it (whether alone or together with any other company forming part of the same group of companies as it) held 10 per cent or more of its equity shares and voting rights,
- at the end of that year of assessment and of all its previous years of assessment, 80 per cent or more of the cost of its total assets was attributable to one or more of the following:
 - an interest in equity shares in,
 - an amount lent or advanced to, or
 - an intellectual property as defined in s 23I(1) that is licensed by it to,

a foreign company in which it (whether alone or together with any other company forming part of the same group of companies as it) held at least 10 per cent of the equity shares and voting rights.

There is a proviso to the requirement of the total cost of assets by the company. It requires that in the determination of its total assets, there must not be taken into account cash and a bank deposit payable on demand, and

- when its gross income for that year of assessment exceeds R5 million, 50 per cent or more of that gross income consisted of amounts in the form of one or both of the following:
 - A rental, dividend, interest, royalty or service fee paid or payable by a foreign company contemplated above, or
 - Proceeds from the disposal of an interest in the above equity shares or in the above intellectual property. (Section 9I(2).)

There is also a proviso to the requirement of gross income. It requires that in the determination of the gross income of the company, there must not be taken into account an exchange difference determined under Section 24I for an exchange item, as defined in that Section, to which it is a party.

3.2.2.3 Certain key consequences of the headquarter company regime

Because only a resident company can apply to be a headquarter company (Section 9I(1)(a)), a headquarter company is accordingly defined in Section 1 of the Income Tax Act as a South African resident and would therefore be taxed as a resident on its worldwide income, unless any exemptions are applicable. Further, as resident there may also be benefits, with regard to any foreign income, from South Africa's double tax agreement network.

With regard to any foreign company that qualifies as a CFC in which a headquarter company holds an interest, its participation rights and voting rights in the foreign company are not considered as those of a South African resident for the purposes of determining the foreign company's CFC status (Section 9D(1)). A headquarter company is further exempted from including in its income the notional amount of CFC net income attributable to such headquarter company, which, under normal circumstances, would be attributable to qualifying South African resident shareholders of a CFC (Section 9D(1) and (2)). Further, a resident investor in a headquarter company nevertheless has an indirect interest in any foreign subsidiary company of the headquarter company, to which normal CFC regulations would apply if the company falls within the CFC definition (for example, if more than 50 per cent of participation rights are held indirectly by resident shareholders of the headquarter company), and in such a case resident investors in the headquarter company would not escape the application of CFC rules, by virtue of the wording "directly or indirectly" in Section 9D(2) read in conjunction with proviso (B) of that subsection, unless any other exception applied (for example, if the investor held less than 10 per cent of participation rights and voting rights in the CFC as contemplated by proviso (A) of Section 9D(2)).

Section 31(5) additionally exempts a headquarter company from the transfer-pricing regulations in certain circumstances, in relation to financial assistance received by it from non-residents to the extent

that the financial assistance is extended in turn to a foreign company in which it (together with any other company in the same group of companies) holds (from 1 April 2012) at least 10 per cent (previously 20 per cent) of the equity shares and voting rights (Section 31(5)(a)). A similar exemption applies where a headquarter company, either on its own or together with any other company within the same group of companies as itself, grants financial assistance to a foreign company in which it (together with any other company in the same group of companies) holds (from 1 April 2012) at least 10 per cent (previously 20 per cent) of the equity shares and voting rights (Section 31(5)(b)). Consequently, where a headquarter company grants financial assistance to a CFC, or itself receives financial assistance from a non-resident, and in turn extends corresponding financial assistance to a CFC, the financial assistance, which could include loans, advances, debt and the provision of security or guarantees (definition of financial assistance in Section 31(1)), is exempted from the transfer-pricing regulations within Section 31.

Further, a headquarter company is treated similarly to a non-resident in that its own dividend declarations are not exempt in the hands of South African resident shareholders, being specifically excluded from the exemption granted in terms of Section 10(1)(k)(i). Therefore, South African residents need to include headquarter company dividends in their gross income as foreign dividends in terms of Section 1(k) of the definition of gross income and are exempted in terms of Section 10B, for which purpose a dividend paid or declared by a headquarter company is included in the definition of “foreign dividend” within Section 10B (1).

3.2.3 The exclusion of a foreign partnership as company in South African tax law

A company is resident in the Republic, according to paragraph (b) of the definition of “resident” in Section 1, if “incorporated, established or formed in the Republic or which has its place of effective management in the Republic”, unless deemed exclusively a resident of another country in terms of a double-taxation agreement or is classified as a high-taxed CFC (see 3.2.1.4 above). Section 9D(1) further defines the “country of residence” of a foreign company as being where its place of effective management is situated. These definitions of residence are consistent with the definition in Article 4 of the OECD and UN Model Tax Conventions on Income and on Capital (OECD, 2010a:24; United Nations, 2011:87) and are therefore in agreement with customary international law. The current definition of company excludes a foreign partnership, even “if the foreign jurisdiction accorded the partnership juristic personality” (De Koker, 2011:para 5.44).

In 2010, the definition of the term “company” in Section 1 of the Income Tax Act was amended to clearly exclude a foreign partnership. A new definition of foreign partnership was simultaneously introduced into Section 1 of the Income Tax Act. From the definition it had become evident that not

all non-South African resident partnerships will be regarded as foreign partnerships. To qualify as a foreign partnership, two key requirements have to be fulfilled: firstly, the entity has to be a partnership, association, body of persons or entity formed or established under foreign law; secondly, the entity must be fiscally transparent (Section 1(a)). An entity will be considered as fiscally transparent in the case where the country of formation or establishment has an income tax system, in terms of which that entity is not subject to taxation at entity level in such country. In countries which do not have an income tax system, an entity will be regarded as fiscally transparent if amounts received by or accrued to or expenditure incurred are allocated to the members under an agreement on an annual basis. The effect of the definition is such that, if an entity is considered as fiscally transparent in the country of incorporation or establishment, it will accordingly be considered a foreign partnership not qualifying for company status in South African tax law. (Olivier & Honiball, 2011:171-172.)

The potential for uncertainty is highlighted by the fact that SARS has in the past issued a Binding Private Ruling in terms of Section 76Q that a foreign limited partnership (having the requisite level of South African participation rights or voting rights) would be considered to be a CFC (South Africa, 2009b). Further it should be noted that the specific historic provisions for rulings formerly contained in Section 9D have been deleted from the statute book as of 1 April 2012 (South Africa, 2011d:Section 25(1)(l)), although the general advance tax ruling procedures provided by Section 76P, 76Q and 76R potentially remain available (Potgieter, 2012:26).

3.3 Attribution of CFC income (S 9D(2))

3.3.1 Introduction

An important step in this trajectory is to determine whether the net income of the CFC (as calculated) for the relevant foreign tax year should be attributed to the South African resident. In an international context, however, various simplified (alternative) methods are utilised to determine the amount which should be attributed, especially in circumstances whereby resident shareholders lack the necessary authority to obtain the requisite information pertaining to the income of the CFC, because they do not have the required amount of control to access such information. As an alternative measure, attribution calculations could also be based on, for example, the increase in market value of the taxpayer's interest in the CFC, the deemed rate-of-return method, or alternatively, an actual calculation method may be utilised; normally the method employed is at the taxpayer's option. (OECD, 1996:82.)

3.3.2 The timing of control

In the initial promulgation of Section 9D(during the year 1997), the legislators gave no indication as to the date on which residents must have acquired control of a foreign entity to have the legislation (CFE) applicable. Nor did the Katz Commission (in its 1997 report) make any reference to this issue (of the minimum time period requirement for the purposes of shareholder attribution). Internationally, there are two approaches that are generally used with regard to the timing of control for attribution purposes (Macheli, 2000:212):

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

The problem with the first approach is that it poses a heavy administrative burden on the taxing authorities when enforcing such legislation. One of the main reasons for this problem is that tax authorities do not have unremitting access to the books and records of the foreign company, and consideration also needs to be taken of the fact if such foreign company is willing to disclose pertinent information at various times during the year. With respect to the second approach, it is far simpler to implement and is less of an administrative burden on the revenue authorities. However, the latter approach seems to be more susceptible to manipulation, as this method could result in resident participators disposing of part of their interest shortly prior to the CFC's year-end and then re-acquiring it immediately after year-end, in order to divest themselves of control of the CFC and not be subject to attribution in respect of the proportionate amount of the CFC income. It could also result in unfairness, especially in view of the fact that the new shareholder will acquire control shortly before the CFC's year-end and be liable for attribution in respect of the proportionate amount of income of the CFC. Many countries adopting the second approach have general anti-avoidance provisions in their tax laws that would prevent such schemes of arrangement (Macheli, 2000:212).

The Revenue Laws Amendment Act 74 of 2002 addressed this shortcoming by enacting the following changes in the legislation:

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

Where a foreign company becomes a CFC during the foreign tax year, the South African resident shareholder has the option of including in his taxable income the proportionate amount of income in the CFC as follows:

- the income that accrued to or was received by the CFC during the actual days of the foreign tax year when the company was a CFC (Section 9D(2)(a)(ii)(aa); or
- an amount in proportion to the number of days the company was a CFC (Section 9D(2)(a)(ii)(bb)). (Olivier & Honiball, 2011:572-573.)

The resident's choice will depend (a) on whether accurate daily or monthly financial records are being kept and (b), provided these records are being maintained, on it being possible to allocate the relevant income between the period when the foreign company was not a CFC to the period when it was a CFC (Olivier & Honiball, 2011:573). Option (b) could therefore be used if detailed and accurate accounting records are kept by the controlled foreign company and is accessible to the South African resident shareholder. Option (a) could, however, have a negative tax impact (on the potential purchaser), if it relates to a company dealing in the sale of seasonal commodities. The potential purchaser should be made aware of the tax anomaly that could arise in respect of the above two methods. Where no detailed and accurate daily or monthly accounting records are maintained, a higher proportionate amount of income in the CFC will be attributed to the potential purchaser, thus resulting in a higher South African tax liability.

Where the foreign company ceases to be a CFC at any time during the foreign tax year (arising from the sale of the shareholder's interest), the principles involved in computing the tax liability of the South African resident in respect of the proportionate amount of income in the CFC for the foreign tax year are similar to the principles discussed above in Section 9D(2)(a)(ii) (Section 9D(2)(b)). (Olivier & Honiball, 2011:573.)

From these provisions it is clear that the last day of the foreign tax year is decisive. It would also appear that the legislator's intention for detailed regulation has potentially opened the door to tax avoidance. The specific reference to the end of the foreign tax year implies that the South African resident may move income from one CFC to another CFC with assessed losses during the year of assessment. However, care should be exercised that such transactions do not fall within the contours of the anti-avoidance regulations in Sections 80A – 80L and Section 103(2). In essence, Section 103(2) provides that where an agreement effecting any company has been entered into, or any change in shareholding takes place solely or mainly with the purpose of making use of an assessed loss, a set off of the assessed loss is disregarded. (Olivier & Honiball, 2011:573.)

Furthermore, moving income between CFCs, for example by means of management fees, was previously subject to South African transfer-pricing provisions under Section 9D(2A)(i) (currently under Section 31(2) and 31(3)), unless it was income that fell under one of the Section 9D(9) exemptions (for example, interest that was exempt under Section 9D(9)(fA)). If the foreign company is a CFC at the end of the foreign tax year, attribution will take place. However, where the company

was not a CFC for the entire tax year, the whole of the net income will not be attributed, but only a proportional amount. Where the foreign company was a CFC for the entire tax year, the percentage holding at the end of the foreign tax year will be used as a basis for attribution, irrespective of changes in shareholding during the year. (Olivier & Honiball, 2011:573.)

Discussing the rules pertaining to the attribution of a resident's income in a CFC (that either had become a CFC or ceased to be a CFC or in the acquisition of shares in an existing CFC during the year), Kolitz (2010:67) comments that whereas Section 9D provides for an apportionment of the net income of a CFC, when its status as a CFC commences or terminates during a particular foreign tax year, there is no corresponding apportionment provided for a shareholder, on whom it is incumbent to include a portion of the CFC's net income in his income, as a consequence of his acquisition of shares in a company that is already a CFC. As long as the qualifying resident shareholder holds participation rights in a CFC on the last day of the CFC's foreign tax year, he must include his proportional amount of net income "for that foreign tax year" as part of his income (Kolitz, 2010:67). According to Kolitz (2010:67) it would seem that this would apply in the following situations:

- if the shareholder has become a resident during the CFC's foreign tax year
- if the shareholder has acquired sufficient shares to become a shareholder that would subject him to the attribution rules (for example, he has acquired 20 per cent of the shares and hence of the participation rights during the foreign tax year) (Section 9D(2)(A))
- if his shareholding has breached the 10 per cent exclusion limit

Kolitz highlights an anomalous situation that arises in the application of the current law pertaining to changes in the shareholding of an existing CFC, with respect to the apportionment of the CFCs profits attributable to its South African resident shareholders.

According to Kolitz, the lack of a provision allowing for the apportionment of net income in a CFC for shareholders that have not held the shares throughout the year, "may seem unfair, but the new shareholders must remember the old adage *caveat emptor*" (2010:68). She reinforces the view that "a person buying 10 per cent or more of the shares in a CFC must realise that, in addition to acquiring the shares, he may also be acquiring an obligation to include a portion of the net income of the CFC for the entire foreign tax year in his income even though he may not have held his shares for the entire foreign tax year". (Kolitz, 2010:68.)

3.3.3 Criteria for the attribution of CFC income to SA shareholders

Section 9D(2)(a) and (b) makes provision for the inclusion of income in any year of assessment in which a South African resident (other than a resident that is a headquarter company) holds or held,

directly or indirectly, any participation right in a CFC, providing that any of the conditions in Section 9D(2) are fulfilled. However, a South African resident shareholder could be exempted from attribution in respect of the above subsection (2)(a) and (b) if one of the provisos contained in (A) or (B) or (C) of Section 9D(2) are fulfilled.

A South African resident that has participation rights in a CFC is generally subject to taxation on the net income of the CFC, under the presumption that the net income is immediately repatriated to resident shareholders in the year when it is earned by the CFC. Consequently, South African resident shareholders are deemed to receive the net income of a CFC only to the extent of their proportional ownership in the CFC. An exception to this rule is embodied in Section 9D(2)(A) where it is emphatically stated that the rules contained in Section 9D(2)(a) and (b) will not be applicable if the resident (together with any connected person in relation to that resident) holds less than 10 per cent of the participation rights and may not exercise at least 10 per cent of the voting rights in the CFC (Section 9D(2)(a)(i)). Therefore, the less than 10 per cent minimum threshold rule prevents the application of Section 9D(2) in respect of “minority owners who have no practical say over the CFE’s affairs”. (South Africa, 2002a:5.)

The other two exceptions contained in subsection 2(B) and (C) could also result in non-attribution of CFC income for South African shareholders in terms of Section 9D(2). Proviso (B) to Section 9D(2) “prevents a cascading effect whereby resident shareholders may hold an otherwise-qualifying level of at least 10 per cent of either indirect participation rights or voting rights in a [CFC] through one or more resident companies” as only the first resident company needs to include a proportionate amount of the net income in the CFC as part of its taxable income (Potgieter, 2012:21). Caution needs to be exercised however by any resident investors in a headquarter company (as defined in Section 1), as they would be taxable on an amount in relation to their indirect participation right in the net income of an underlying CFC, providing that their own indirect participation rights or voting rights in the CFC are at least 10 per cent (Potgieter, 2012:21).

It is apparent that the 10 per cent threshold limit seem to be in conflict with the anti-avoidance provisions contained in Section 9D, as it undermines the South African tax base by denying the Treasury taxation in that none of the income of the CFC is imputed to any South African resident shareholder. Resulting in the opportunity of South African (unconnected) shareholders designing a stratagem that would allow them to have a CFC (each having share ownership below the 10 per cent threshold) and none of the shareholders are taxed in respect of the CFC income. It is submitted that the legislator needs to review the legislation for unconnected persons in respect of the attribution of income in a CFC (especially with regard to the 10 per cent threshold limit).

The following examples illustrate attribution in terms of Section 9D(2)(B) of South Africa's CFC legislation, to the extent that the participation rights are held indirectly by the resident through any company which is a South African resident (Section 9D(2)(B)).

Example 3-1

Facts: A, natural person resident in South Africa, is the sole shareholder in Company X which is incorporated in South Africa and a resident as defined. Company X is a shareholder to the extent of more than 50% of participation rights in Company Y which is incorporated offshore and has its effective management in a country other than the Republic. Therefore Company Y is a CFC. Company Y has income as defined in Sect. 9D. Who is subject to South African tax? Company X, because it is a resident, or A because A, a resident, individually through Company X participates in more than 50% of the profits of Company Y, or both A and Company X, because they both fall within the ambit of Sect. 9D(2). (The Taxpayer, 1999:199).

Result: The National Treasury's Detailed Explanation to Section 9D of the Income Tax Act (South Africa, 2002a) did not offer any viable explanation in respect of the above situation. However, the insertion of Section 9D(2)(B) clarified this situation and the income of Company Y above will be imputed to Company X and not to A.

The promulgation of Section 9D(2)(B) also clarified the following situation in which a resident holding company (of both local and foreign shareholders) has a 100 per cent controlling interest in a foreign company (CFC).

Example 3-2

Facts: South African Company Sacco, (incorporated and resident in the Republic) holds 100% of the participation rights of Foreign Company B, a CFC. However, only some of the shareholders of the South African Company Sacco, are domestic residents. (Author)

Result: In Example 3-2 it is clear that the income earned from the Foreign Company B will be imputed to the South African Company Sacco as the South African company Sacco is a domestic resident and subject to exclusive attribution.

Section 9D(2)(B) also provided clarity on the following situation.

Example 3-3

Facts: Assume Mr A, a South African resident, holds 51% of Company B (a foreign company), Mr A also owns 20% of Company C (a South African company) which in turn holds 30% of Company B as well. Now, Mr A effectively holds 57% of Company B (51% directly) plus $(20\% \times 30\% = 6\%)$ through Company C (indirectly). Therefore, Company C holds 30% of the shareholding directly in Company B (Seonath, 2003:56).

Result: In Example 3-3, is Mr A to be taxed on 57 per cent and Company C on 24 per cent, or is Mr A to be taxed on 51 per cent and Company C on 30 per cent? Section 9D(2)(B) makes it quite clear that any income earned from a CFC through any indirect holdings in another resident company is to be attributed to that resident company and, in consequence, Mr A will be taxed on 51 per cent of the income of Company B, and Company B will be taxed on 30 per cent of the income of Company C. (Seonath, 2003:56.)

Although the Katz Commission did not address the issue of a minimum participation threshold, it may be inferred that its exclusion in the initial promulgation of the legislation could be based on the principle of simplicity which the Commission recommended must underlie the legislation (Katz Commission, 1997:para 8.2.4). Therefore, in its initial promulgation of CFC legislation (in 1997), South Africa had neither the minimum participation threshold nor constructive ownership rules to determine the attribution of CFC income to domestic shareholders. However, South Africa currently has in place the minimum participation requirement as a threshold for the attribution of CFC income (Section 9D(2)(A)).

3.3.4 Net income of CFC (Section 9D(2A))

3.3.4.1 Introduction

South African residents (other than a resident that is a headquarter company) holding qualifying participatory interest in a CFC need to determine the CFC's net income for the purpose of determining the proportional amount of income that is to be included in their taxable income (Section 9D(2) and (2A)). This involves performing a full South African taxable income calculation on the income of the foreign company. These residents should take cognisance of the specific Sections for which the company is treated as a resident for the purposes of determining the CFC's net income ("net income" definition in Section 9D(2A)).

Additional consideration needs to be given by such residents to the various provisions of Section 9D(2A) which limit deductions, ring-fence assessed losses, prohibit certain deductions in relation to transactions with other CFCs unless (prior to 31 March 2012) an election has been made in terms of

Section 9D(12) that the exemption provisions of Section 9D(9) should not apply for the particular foreign tax year of a CFC, define the valuation date upon becoming a CFC for the purposes of Schedule 8 of the Income Tax Act for the determination of taxable capital gains and losses, set the inclusion tax rate for resident participation holders in respect of capital gains for the following categories – resident individuals, special trust or insurer – regarding their individual policyholder fund, reinforce transfer-pricing regulations pertaining to transactions with connected persons of the CFC (which is subsequently deleted), and specify certain currency-related matters.

In calculating the net income of a CFC, companies will be required to keep two sets of books: one in the country of which the CFC is a resident and the other for South African income tax purposes. The latter would most probably be kept by the South African resident taxpayer and the former by the CFC itself. However, depending on the nature of the control being exercised by the South African resident over the CFC, both sets of books could, in all probability, be kept by the CFC itself. (Olivier & Honiball, 2011:575.)

Section 9D(2A) defines “net income” for the purposes of the section as “an amount equal to the taxable income of that company determined in accordance [with the manner set out therein]”. What is included therefore is not actually a replication of a direct part of the net income of a CFC but instead a computation being the equivalence of a sum “equal to” an amount derived in terms of the provisions of the Section . The reason such a notional amount is included in the South African CFC rules is attributable to the potential problems highlighted by the United Kingdom case of *Bricom Holdings Ltd v IRC* (United Kingdom, 1997), in which case the United Kingdom CFC legislation was successfully defended against the application of a double-taxation agreement as the underlying income was held to have lost its original character.

The following chapter section considers the methodology involved in the calculation of CFC income in accordance with the provisions contained in Section 9D(2A) which “put[s] it beyond doubt that all the provisions of the South African Income Tax Act are applicable to CFCs” (Olivier & Honiball, 2011:574). Consequently, the generally applicable principle that the net income of the CFC must be calculated as if the CFC is a South African resident is very pertinent. From a policy perspective, it is imperative that “the undistributed CFC income apportioned to the domestic shareholder should have the same treatment as it would have had under domestic legislation and treaty provisions had it been effectively distributed to the shareholder” (Olivier & Honiball, 2011:574). Accordingly, domestic and special treaty relief for dividends should remain available even when applying CFC rules. In essence, to determine whether an amount forms part of gross income or whether a deduction or allowance may be claimed, the provisions of the South African Income Tax Act are applicable (Olivier & Honiball, 2011:574).

3.3.4.2 Calculation of net income of CFC

Net income is defined in Section 9D(2A) as “an amount equal to the taxable income of that company” determined in accordance with the provisions of the South African Income Tax Act as if the company is a South African resident taxpayer. The net income of the CFC is computed at the end of the foreign tax year of the country in which the CFC is resident and is therefore included in the resident’s income at the end of the South African tax year. In calculating the net income of the CFC, the presumption is that the CFC is a South African tax resident specifically for the purposes of the definition of “gross income” (Sections 7(8), 10(1)(h), 25B and paragraphs 2(1)(a), 24, 70, 71, 72 and 80 of the Eighth Schedule). The result of this deeming provision is that the CFC will be taxed on its worldwide income and that despite the entire Income Tax Act is in principle applicable when the net income of the CFC is determined, the CFC is subject, however, to the following important provisos: restrictions regarding losses; restrictions regarding transactions with other CFCs; capital gains valuation date; functional currency of CFC; transfer-pricing and general anti-avoidance provisions; CFCs and capital gains tax (Section 9D(2A)).

3.3.4.3 Restrictions regarding losses

In terms of Section 9D(2A)(a), any deductions and allowances which may be claimed, or any amounts that may be set off against a CFC’s income in terms of the Income Tax Act are limited to the amount of that income. In terms of Section 9D(2A)(b), where the deductions of the CFC exceed its income and the result would be an assessed loss, the assessed loss may not be set off against income received by the South African resident from other trades outside the Republic, but must instead be carried forward to the immediately succeeding foreign tax year to be offset against the future income of such company in such succeeding year for the purpose of Section 20. Unlike certain South African domestic law provisions (see Section 20(2A)), no limitation exists on the carry forward of the excess deductions and allowances, providing the CFC continues trading and incurring expenses in the production of income (Olivier & Honiball, 2011:576).

3.3.4.4 Restrictions regarding transactions with other CFCs

In terms of Section 9D(2A)(c), no deduction is allowed for interest, royalties, rental or income of a similar nature paid or payable or deemed to be paid or payable by a CFC to another CFC. Included in this prohibition are similar amounts adjusted for transfer-pricing purposes (applicable to all the above categories of income) (Section 31) or any exchange difference determined under Section 24I (applicable to exchange items, for example, loans) or a reduction or a discharge of a debt owed to the CFC by another CFC within the same group of companies for less than its face value (Section 9D(2A)(c)). With regard to the deduction limitations regarding transactions with other CFCs it should be noted that Section 9D(9)(fA) correspondingly exempts from the net income of a CFC the income

items disallowed by proviso (c) to Section 9D(2A) above, thus ensuring symmetry in the treatment between the two CFCs.

3.3.4.5 Capital gains valuation date

For the purposes of determining capital gains within net income, paragraph (e) of the proviso to Section 9D(2A) specifies the valuation date. In terms of Section 9D(2A)(e) where a foreign company becomes a CFC after the date 1 October 2001 (when CGT was initially introduced), the valuation date for CGT purposes will be the day (or the date) before such company became a CFC. This has the effect of excluding capital gains or losses which occurred prior to such date from any inclusion in CFC net income.

Paragraph (f) of Section 9D(2A) specifies the CFC capital gains inclusion rate for the purposes of Section 26A for residents which are not companies, as in the case when the controlling resident is a natural person, special trust or an insurer in respect of its individual policy holder fund, the inclusion rate for purposes of CGT is 33.3 per cent of the net capital gain for the relevant foreign tax year. As a CFC is a company, the company rate would otherwise be applicable. The rates have increased for the 2013 tax year as follows: companies 66 per cent (2012:50 per cent) and persons other than companies 33 per cent (2012:25 per cent).

3.3.4.6 Functional currency of CFC

For the purposes of the application of paragraph 43 of the Eighth Schedule, “local currency” of a CFC other than in relation to a permanent establishment of the CFC, means the functional currency used by it for the purposes of its financial reporting (Section 9D(2A)(k)). In addition, paragraph 43B of the Eighth Schedule provides that where the functional currency of a CFC was attributable to a currency of a country that had abandoned its currency because it had an inflation rate of more than 100 per cent for the foreign tax year preceding the abandonment, then the CFC must, for the purpose of determining the cost of an asset of the CFC, be deemed to have acquired the asset in the new currency as follows: (a) on the first day of the foreign tax year of the CFC in which, an amount equal to the market value of the asset on the date on which the new currency was adopted by the CFC.

The following example illustrates the above in respect of a new currency of the CFC in relation to the revaluation of fixed assets at market value:

Example 3-4

A CFC, with a foreign tax year of 1 January to 31 December, acquired an asset in its functional currency for R200 000 on 1 January 2010. On 1 January 2011 the functional currency is changed at the time when the market value of the asset is R250 000. The CFC is deemed to have acquired the asset at R250 000 at 1 January 2011 (Olivier & Honiball, 2011:578)

3.3.4.7 Transfer-pricing and general anti-avoidance provisions

For the purposes of Section 31 (that includes transfer pricing and thin capitalisation issues) any transaction, operation or scheme or agreement or understanding between the CFC and any of its connected persons in relation to that CFC is subject to Section 31(2). The implication being that those transactions not at arm's length price between a CFC and any connected person in relation to the CFC may be adjusted under transfer pricing regulations (Section 31(2)) (previously included under Section 9D(2A(i)).

A CFC was previously deemed through proviso (i) to Section 9D(2A), for the purposes of the arm's length transfer pricing requirements of Section 31(2) of the Income Tax Act, to be a resident regarding a wide range of transactions, agreements or other understandings "between that CFC and any connected person in relation to that CFC" (proviso (i) to Section 9D(2A) up to 31 March 2012). From 1 April 2012 this provision is deleted (South Africa, 2011d: Section 25(1)(e)). "It would appear that its deletion has the effect that the application of Section 31 transfer pricing provisions from 1 April 2012 to transaction amounts of the CFC will initially therefore depend on whether the CFC is treated as a resident, or remains a non-resident, in particular circumstances" (Potgieter, 2012:35-36).

Olivier and Honiball (2011:658) explain that while the net income of a CFC is subject to Section 31, through the reference in Section 9D(2A) to "taxable income" – which includes Section 31 as it falls within the ambit of Part 1 of Chapter II of the Income Tax Act (definition of "taxable income" in Section 1) – the CFC is treated as a non-resident only for the purpose of calculating its net income and therefore remains non-resident (for instance, in relation to another CFC). For example, for the purposes of calculating CFC net income in terms of Section 9D(2A), a CFC is accordingly treated as if it is a resident for the purposes of the definition of "gross income" in Section 1, and it is clear from the wording of Section 11(a) that expenses actually incurred in the production of income arising from a trade of the CFC would be allowable in determining CFC net income.

Paragraph (a)(iv) of the definition of "affected transaction" in Section 31(1) specifically includes the position where a non-resident person deals with a connected person that is a CFC in relation to any resident. Therefore, in respect of any transaction between a CFC and a non-resident who is a

connected person with regard to the CFC which “results or will result in any tax benefit” to one of the parties thereto, the “taxable income or tax payable” by that party must be calculated as if “entered into on the terms and conditions that would have existed had those persons been independent persons dealing at arm’s length” (Section 31(2)). In addition, as a CFC is not a resident, paragraphs (a)(i) and (a)(ii) of Section 31(1) will be applicable in the relevant circumstances.

It should be further noted that the general anti-avoidance provisions of Section 80A to 80T and Section 103 could be utilised by the Commissioner in counteracting the effects of transfer pricing arrangements used to reduce the South African tax base. Furthermore, South African resident shareholders should be aware of the court’s ability to disregard simulated transactions under the common law principle. In *SARS vs. NWK Ltd* (South Africa, 2010b)(27/10) ZASCA 168 (2010), the Supreme Court of Appeal had extended its enquiry beyond the concealed intention of the taxpayer; the real intention of the taxpayer was to avoid tax under simulated business conditions, and therefore the contractual arrangements forming the basis of the tax deduction was disallowed.

3.3.4.8 CFCs and capital gains tax implications

There should be included in the taxable income of any person, in respect of any year of assessment, the taxable capital gain of that person in terms of the Eighth Schedule of the South African Income Tax Act. Therefore, any such taxable capital gain so determined must be included in a person’s taxable income in terms of Section 26A of the Income Tax Act. Capital gains and losses must be determined for all “disposals” of “assets” that take place on or after the valuation date, namely 1 October 2001 (Eighth Schedule, para 2(1)).

The Eighth Schedule of the Income Tax Act also contains certain deeming provisions in that a person is considered as having disposed of an asset for a specific amount, as in the case of paragraph 12(2) of the Income Tax Act, in which subparagraph (1) also applies, where a person who ceases to be a resident or a CFC, that person will be deemed to have disposed of his assets (subject to specific exclusions) at market value. The tax arising from such a disposal is often referred to as an “exit charge”. In paragraph 12(2)(a) of the Eighth Schedule of the South African Income Tax Act, which provides that when a South African tax resident ceases to be a tax resident (by virtue of the application of the provisions of a tax treaty entered between South Africa and another country), the resident must, subject to certain exceptions, be treated as having disposed all of his or its assets. The exclusions in respect of the above deeming provision (12(2)(a)) are contained in paragraph 2(1)(b)(i) and (ii) of the Eighth Schedule and comprise

- immovable property situated in the Republic held by that person or any interest or right of whatever nature of that person to or in immovable property situated in the Republic; or
- any asset which is attributable to a permanent establishment of that person in the Republic.

In terms of paragraph 13(1)(g) of the Eighth Schedule, the deemed disposal is effective at the time when the person ceases to be a South African tax resident. The result of this tax provision is that when a company, which is registered in South Africa, moves its place of effective management to another country, and the tax treaty between the two countries makes provision for the company to be considered a resident in the country in which it has its place of effective management, then a deemed disposal arises for capital gains tax purposes. In reality, it may not always be easily discernible to determine when exactly a company has ceased to be a South African resident, for example, when moving its place of effective management in another jurisdiction. This could either occur on a particular day or on the first day of the relevant tax year (in respect of the entire tax year). There are no specific domestic tax provisions pertaining to this matter. (Olivier & Honiball, 2008:83.)

Accordingly, Section 9D(2A) provides that, for purposes of Section 9D, the net income of a CFC must be calculated as if the CFC is a South African resident, and that when the CFC ceases to be a CFC, it simultaneously ceases to be a tax resident for purposes of the calculation of net income. Consequently, the termination of South African residency for the CFC has capital gains tax implications, in that the event is now construed as a deemed disposal for purposes of capital gains tax (in terms of paragraph 12 of the Eighth Schedule).

3.3.5 Exchange Rates (Section 9D(6))

This chapter section will discuss the functional currency used by the CFC in the determination of its net income. In addition, it will discuss, for the purpose of determining the amount to be included in the income of any South African resident during any year of assessment, that amount which is to be translated to the South African currency “by applying the average exchange rate for that foreign tax year” (Section 9D(6)).

Firstly, the net income of a CFC is to be determined in its own functional currency as defined in Section 1 of the Income Tax Act (Section 9D(6)). The term “functional currency” is defined in Section 1 of the Income Tax Act to mean in relation to a person: (a) “the currency of the primary economic environment in which the business operations of that person are conducted” and (b) “a permanent establishment of any person, means the currency of the primary economic environment in which the business operations of that permanent establishment are conducted”. Therefore, the

functional currency of a CFC would be the currency of its country of residence, provided that country is where most of its business is conducted. In the event of the CFC operating primarily outside its country of residence, or of it having a permanent establishment outside its country of residence, its functional currency or that of its permanent establishment may not actually be the currency of its country of residence.

Paragraph (k) of the proviso to Section 9D(2A) additionally specifies that the CFC's functional currency is to be the "local currency" for the purposes of paragraph 43 of the Eighth Schedule of the Income Tax Act, dealing with the acquisition or disposal of assets in foreign currency of a CFC. Paragraph (l) to Section 9D(2A) deals with an abandoned functional currency in a country where inflation was at least 100 per cent, such as in the case of Zimbabwe, deeming a CFC's existing assets to have been acquired for market value on the first day of the foreign tax year for an amount equal to the market value on the date on which a new currency was adopted by the CFC. "This provision would seem to be aimed at reducing the impact of the base cost of CFC assets being denominated in a severely depreciated, abandoned currency, resulting in excessive capital gains upon their disposal." (Potgieter, 2012:38.)

The second general rule is that for the purposes of including the amount (with reference to the relevant calculated portion of CFC net income) to include in the income of any resident, the average exchange rate for that currency (relative to the currency of the Republic) for the company's foreign tax year is to be used (Section 9D(6)), effective from 1 January 2012) (South Africa, 2011d:Section 25(1)(f)). Previously, the average for the resident's year of assessment applied, which was arguably less appropriate where this differed considerably from the foreign tax year should a significantly different rate have resulted. "Because of the effect of averaging, in the event of significant foreign currency exchange rate fluctuations, the conversion rate and method specified by the [Income Tax] Act may not accord with a currency conversion method designed to match the specific timing considerations with respect to the underlying transactions" (Potgieter, 2012:38).

The more specific rules listed below provide special cases whereby the relevant part of CFC net income must be calculated in the currency of the Republic (South African Rand) and thereafter be translated to the functional currency of the CFC by applying the average exchange rate for the year of assessment of the resident within which the foreign tax year of the CFC ends:

- The CFC's capital gains or capital losses from disposals of foreign equity instruments or from any asset "the capital gain or capital loss from the disposal of which is deemed to have been derived from a source in the Republic" (as per paragraph 43(4) of the Eighth Schedule to the Income Tax

Act) and which are not attributable to any permanent establishment outside the Republic (proviso (a) to Section 9D(6));

- Disposals of foreign equity instruments (as defined in Section 1) which constitute trading stock, and which are not attributable to a permanent establishment of the CFC outside the Republic (proviso (b) to Section 9D(6)); and
- When calculating gains or losses on foreign exchange transactions in accordance with Section 24I, “local currency” as referred to in that Section is deemed to mean the currency of the Republic (proviso (c) to Section 9D(6));
- The following are deemed not to be attributable to any permanent establishment of the CFC in any case where the relevant functional currency is that of a country with an official inflation rate exceeding 100 per cent for the foreign tax year of the CFC:
 - any asset or foreign equity instrument disposed of in a currency other than the CFC’s functional currency; and
 - any exchange item which is denominated in a currency other than the CFC’s functional currency (proviso (d) to Section 9D(6)).

It should be noted with regard to the foreign business establishment (FBE) exemption under Section 9D(9A)(iii)(bb) the foreign currency gains or losses on financial instruments are excluded from CFC net income if these arise “in the ordinary course of business of the principal trading activities” of the FBE, not being the activities of a “treasury operation or captive insurer”. In addition, the 5 per cent *de minimis* provision of Section 9D(9A)(iii)(cc) applies to the extent that the total amounts under Section 9D(9A)(iii)(bb)(A)(B) exceeds 5 per cent of the total of all amounts received by the CFC that are attributable to that foreign business establishment.

3.3.6 Taxation of foreign dividends

A current study of foreign dividends is relevant in order to determine the previously taxed amounts under Section 9D, thus avoiding double taxation. To give effect to the above, the pre-emptive clauses contained in Section 10(B) acts as the legislative tool to avert double taxation. (See below for Section 10(B) exemptions).

A foreign dividend is defined in Section 10B(1) as a either a foreign dividend as defined in Section 1, or a dividend paid or declared by a headquarter company.

Section 1 of the Income Tax Act, in turn, defines a “foreign dividend” as any amount that is paid or payable by a foreign company on a share in it when that amount is treated as a dividend or similar payment by it for the purposes of the laws relating to

- a) tax on income on companies of the country in which that foreign company has its place of effective management, or
- b) companies of the country in which that foreign company is incorporated, formed or established, where the country in which [it] has its place of effective management does not have ... applicable laws relating to tax on income. (Section 1.)

Dividends paid by resident companies or foreign companies listed in the Republic are from 1 April 2012 subject to withholding tax known as the “dividend tax”, as provided in part VIII of Chapter II of the Income Tax Act (Sections 64D to 64N), levied at the rate of 15 per cent (South Africa, 2011d:Section 6(1)). It should be noted that the dividends tax is a separate tax (Section 64E).

For normal income tax purposes (Section 5), both local and foreign dividends are included as part of gross income (Section 1: paragraph (k) of the “gross income” definition, read with the definitions of “dividend” and “foreign dividend” in that section. Despite this specific inclusion, local dividends (other than those paid or declared by a headquarter company) are exempted from normal income tax by Section 10(1)(k)(i), effectively preventing the inclusion of local dividends, but not foreign dividends unless any exemption applies, such as those contained in Section 10B, which replace the exemptions previously specified in Section 10(1)(k)(ii) from 1 March 2012 for natural persons, and from 1 April 2012 for other persons (South Africa, 2011d:Section 29(1)) as described below.

Foreign dividends are subject to four exemptions, as listed below:

- Participation exemptions: under this exemption, foreign dividends will be exempt if received by or accrued to a person who holds more than 10 per cent of the equity share and voting rights in the company declaring the foreign dividend.
- A country to country exemption: a CFC will be allowed to claim the participation exemption without regard to the 10 per cent participation requirement if the foreign dividends are paid by a foreign company which is situated within the same country as the CFC to which the foreign dividend is paid.
- The previously taxed income exemption.
- An exemption for cash foreign dividends in respect of JSE listed shares (because these are taxed under the Dividends Tax). (Section 10(B)(2))

The participation and country to country exemptions are subject to an override (Section 10 (B)(2)).

3.4 Exemptions from the application of Section 9D

3.4.1 Introduction

Exemptions in terms of Section 9D(9): Section 9D(9) forms an integral part of South Africa's CFC legislation as it incorporates the majority of the exemptions that are currently available to South African resident shareholders (in CFCs). In view of its importance, detailed analysis will be made of the various exemptions existing under Section 9D(9). These discussions (in respect of the various exemptions) will incorporate the following: the fundamentals that need to be in place in order to qualify for these exemptions, and a critical analysis and evaluation of the respective exemptions.

Therefore, the various exemptions in terms of Section 9D(9) are as follows:

- the business establishment exemption (Section 9D(9) (b))
- long-term insurance for non-resident policy holders (Section 9D(9)(c))
- exemption of interest and royalties (Section 9D(9)(d))
- the previously taxed exemption (Section 9D(9) (e))
- the related CFC dividend exemption – Section 9D(9)(f)
- related CFC income from interest, royalties, rentals and similar amounts (Section 9D(9)(fA))
- the capital gain on capital assets exemption (Section 9D(9) (fB))

Other legislative measures that prevent the application of Section 9D: Other statutory legislations that exclude the application of CFC regulations in terms of Section 9D(2) includes:

- the exemption regarding high-taxed net income (Section 9D(2A));
- postponement of inclusion of CFC net income (Section 9A);
- the proviso to Section 9D(2) which excludes certain resident investors from the application of Section 9D and includes:
 - a less than 10 per cent participating exemption (Section 9D(2)(A)),
 - an exemption of indirect holdings via a resident company, other than a headquarter company (Section 9D(2)(B))
 - a long-term insurance company (Section 9D(2)(C)) (see 3.3.3 above).

Legislative amendments: The Taxation Laws Amendment Act, No. 24 of 2011 had introduced significant changes to the foreign business establishment exemption criteria as contained in Section 9D(9)(b), also introducing a new Section 9D(9A) into the South African tax legislation, acting as acolyte and complementing the metamorphosed Section 9D(9)(b). The reasons given by National Treasury for the far-reaching changes effected to Section 9D(9)(b) were that although “the CFC

regime has largely closed the straightforward movement of passive income offshore and the comparable use of shell companies to divert income offshore through unsustainable transfer pricing [policies]”, these problems still persist (South Africa, 2011a:103).

The tainted income calculation is excessively complex and creates uncertainties; for example, the inordinately rigid nature of the regime “triggers tainted income for non-tax driven commercial income and often allows taxpayers to artificially manipulate problematic income so as to avoid tainted treatment, especially in the case of diversionary-type transactions” (South Africa, 2011a:103). In addition, “[c]ertain interpretations have also emerged that seemingly allow taxpayers to create a marginal nexus in respect of employment or activity to tax havens so as to claim exemption when the ‘supposedly’ exempt income lacks any meaningful economic substance” (2011a:103). Lastly, the CFC legislation “additionally contains certain elections and ruling mechanisms that [instigates] complexity with little benefit for the tax system” (2011a:103).

This chapter section will therefore consider in detail the subject of exemptions – primarily, within the legislative parameters of Section 9D(9) – and includes a discussion of the requirements that need to be in place in order to qualify for these exemptions. Consideration will also be given to the new Section 9D(9A) acting as backstop to the current Section 9D(9)(b), and other legislative exemptions falling beyond Section 9D(9) (see 3.4.2 and 3.4.3 below). In concluding this chapter, shortcomings in the South African CFC legislation will be highlighted, and, where possible, recommendations are to be made (for possible legislative changes) in the concluding chapter of the thesis.

3.4.2 Exemption regarding high-taxed net income (Section 9D(2A))

This exemption is contained in the proviso to Section 9D(2A) and applies where the income of the CFC is subject to a minimum level of tax. The purpose of the exemption is to disregard CFC income “if little or no South African tax is at stake once South African foreign tax credits in Section 6quat of the [Income Tax] Act are taken into account” (Mendes, 2011:1). At first, the proviso seems simple to apply; if the CFC is subject to a minimum level of tax, there is no CFC income. “However, a deeper examination of the proviso reveals that its application is very complex and gives rise to a number of unanswered questions.” (Mendes, 2011:1.)

Section 9D comprises “complex rules as to how the net income of the CFC is calculated and the circumstances in which amounts are included or excluded from the net income calculation” (Mendes, 2011:1). The proviso to Section 9D(2A) provides that the net income of a CFC will be nil if the amount of foreign tax payable by the CFC is equal to or greater than 75 per cent of the South African income tax that would have been payable by the CFC for the foreign tax year of the CFC had the CFC been a South African tax resident. In determining the foreign tax payable by the CFC, tax payable to

all spheres of government, the provisions of any applicable double tax agreement and any credit, rebate or right of recovery of the foreign tax must be taken into account. Any tax losses of the CFC and any tax losses of any other company (if the CFC is in a country which applies group tax) must not be taken into account. Therefore, in determining whether the CFC qualifies for the exclusion, taxpayers cannot assume that if the corporate income tax rate of the CFC is at least 21 per cent (75 per cent of 28 per cent) or more the proviso will apply.

According to Mendes (2011:1), certain difficulties may arise in the calculation of the South African taxable income in determining whether the proviso is applicable:

- The proviso was included by the Taxation Laws Amendment Act, 17 of 2009, promulgation on 30 September 2009 and with retrospective application to any foreign tax year of a CFC ending during years of assessment ending after 1 January 2008. It is therefore possible that a taxpayer completing his income tax return for the 2008 year of assessment during 2009 could have included in his CFC income for the 2008 year amounts which should have been excluded in terms of the proviso. There appears to be no mechanism in the legislation or income tax return to correct this.
- Certain capital allowances such as the Section 12C allowances are deductible when plant or equipment is first brought into use by the taxpayer; however, it is not clear in applying the proviso whether the provisions of Section 12C are applicable as the equipment may not have been brought into use for the first time by the CFC in the 2008 year of assessment when the proviso was first applied. If the Section 12C allowance cannot be used it is possible that the 75 per cent test would not be met if the CFC is entitled to a similar allowance under the rules of the jurisdiction where it operates.
- An income tax deduction is allowed for bad debts in terms of Section 11(i) of the Income Tax Act but only if, inter alia, the amount was included in the taxpayer's income in the current or prior year of assessment. On a strict interpretation of Section 11(i), amounts which accrued to a CFC before the effective date of the proviso but which become bad after the effective date of the proviso cannot be deducted in determining whether the proviso applies.
- Numerous other provisions in the Income Tax Act will be difficult to apply in calculating a CFC's taxable income for purposes of determining whether the proviso applies: certain warranty reserves being granted as a tax deduction in foreign jurisdictions; large amounts of deposits received for goods sold, not being treated as gross income in foreign jurisdictions. (Mendes, 2011:1.)

The rationale for this provision appears to be that "little South African normal tax would be payable after the Section 6quat rebate is taken into consideration" (Potgieter, 2012:41). Furthermore, it should be noted that relief should be claimed under Section 6quat, and not relief under an application of

double-taxation agreement, because the inclusion of CFC income is “an amount equal to” the proportional amount of the net income of the CFC for the applicable foreign tax year (Section 9D(2)). This notional amount of income is arguably not the same as the income of the CFC itself, following the outcome in the Bricom case (United Kingdom, 1997) “It is therefore submitted that a South African resident should rather follow the certainty of Section 6*quat* in this regard” (Potgieter, 2012:41).

It further emerges that the calculation and associated complexity required to arrive at this particular relief is excessively onerous to arrive at a conclusion for the nullification of net income and therefore compares poorly, in this regard, to the United Kingdom’s “excluded territories” exemption, which simply requires a headline tax rate which exceeds 75 per cent of the United Kingdom rate (United Kingdom, 2012c:18; 2012d:5).

3.4.3 Postponement of inclusion of CFC income (Section 9A)

While not a provision of Section 9D itself, Section 9A operates to provide relief if an amount which is required to be included in the income of a resident during any year of assessment “may not be remitted to the Republic during that year as a result of currency or other restrictions ... imposed in terms of the laws of the country where the amount arose”. (Section 9A(1)) With regard to the calculation of net income of a CFC, Section 9A(3) provides such relief by way of a deduction “from the net income of the [CFC] for that foreign tax year an amount equal to so much of the amount or portion which may not be remitted if a CFC is subject to such restrictions or limitations”. Section 9A(4) then provides that the amount of such a deduction is deemed to be an amount received by or accrued to the CFC in the following foreign tax year of the CFC.

3.4.4 The Foreign Business Establishment Exemption (Section 9D(9) (b))

CFC rules do not apply when the net income of the CFC is attributable to a foreign business establishment (including the disposal of any assets forming part of that permanent establishment) of a company based in a foreign jurisdiction and being controlled by South African shareholders. Previously, Section 9D referred to a business establishment, but this term was deleted from the Income Tax Act and replaced with the term foreign business establishment by the Revenue Laws Amendment Act, No. 20 of 2006.

At its core, and from a tax neutrality perspective, this exemption strives “to promote international competitiveness by allowing South African-owned foreign entities to compete with their foreign owned competitors on equal terms from a tax point of view”. On the other hand, there is the propensity for taxing authorities “to achieve equity between South African residents earning income

at home and those earning income abroad” (Jooste, 2001:486). Consequently, Section 9D(9)(b) could be construed as a legislative attempt “to strike a balance between granting an exemption to income derived from legitimate business activities and that derived from illusory or non-substantive business undertakings (i.e. mobile and diversionary business income and mobile passive income)” (Olivier & Honiball, 2011:581).

In analysing the implications of the FBE exemptions contained in the South African CFC regulations, Macheli (2000:304) expresses the view that

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

Jooste is of the view that the foreign business establishment exemption seeks to achieve a balance between the above two objectives by consenting to South African CFCs’ operating abroad and “without imputation of their income to their South African owners, in terms of Section 9D” if, from a tax neutrality perspective, a legitimate motive exists for operating abroad which presents no threat to the South African tax base (Jooste, 2001:486). This was reaffirmed by National Treasury in their publication, a “Detailed Explanation to Section 9D” of the Income Tax Act, in which it is commented that, as a policy matter, this exemption promotes international competitiveness so long as the income poses no threat to the South African tax base (South Africa, 2002a:8). Therefore, the business establishment exemption seeks to achieve this balance by effectively exempting – from the operation of Section 9D – all foreign income of the CFC, except for tainted income categorised as follows: mobile foreign business income, diversionary foreign business income, and mobile foreign passive income (Jooste, 2001:486-487).

3.4.4.1 Requirements for the foreign business establishment exemption – Section 9D(9)(b)

At the outset of this chapter section we noted that, to a certain extent, the definition of “foreign business establishment” broadly resembles the definition of “permanent establishment” in the Model Tax Conventions of both the OECD and the UN. The latter definition, however, has been qualified in several respects and may therefore be found not to be in total agreement with the definition contained in Section 9D(1) of the South African income tax legislation. Further, the foreign business establishment definition contains numerous specific substance requirements not found in the definition of the permanent establishment. (Olivier & Honiball, 2011:584.)

A foreign business establishment would essentially constitute “a business that has some permanence, some economic substance and a non-tax business reason for operating abroad rather than at home” (South Africa, 2002a:9). These three criteria would effectively exclude paper businesses (i.e. mobile

foreign business income) that would otherwise be located in South Africa except for the tax savings purposes (especially on passive assets). Paper-like businesses do not enjoy the legislative exemption, as this type of endeavour “suggests that no real business activity exists for international competitiveness to act as a consideration” (2002a:9). The next chapter section accordingly considers the following three concepts in the context of the foreign business establishment exemption (2002a:9):

- locational permanence
- economic substance
- business purpose

Locational permanence: A tax exempted foreign business establishment must, firstly, operate through a fixed location – a manifestation of some form of permanence (that the business of the enterprise is somewhat immobile). The fixed location requirement is an assurance that the business of the enterprise is not merely a mailing address, website, or an ad hoc single business project. Consequently, the fixed location test may be fulfilled if the CFC, in conducting its business, fulfils any one of the following criteria:

- The business of the CFC must be conducted through one or more offices, shops, factories, warehouses or other structures for a period of not less than one year in order for that location to qualify as a foreign business establishment. The one-year occupation requirement could either be a direct ownership of the property or a lease agreement. The word “use” implies that there be some form of activity taking place and not the mere possession of ownership or leasing rights which are insufficient to justify the fixed place of business (South Africa, 2002a:9) (para (a) of Section 9D(1)).
- CFCs with mines, oil or gas wells, a quarry or any other prospecting or exploration operations for natural resources are carried on outside the Republic or any other place outside the Republic where mining or production operations of natural resources are carried on. Operations in these places “demonstrates a clear level of permanence to the foreign location involved because the geographically unique nature of the holding makes that holding immobile as a practical matter” (South Africa, 2002a:9) (para (b) of Section 9D(1)).
- A construction or installation site outside the Republic of buildings, bridges, roads, pipelines, heavy machinery or other projects of a comparable magnitude, will satisfy the location test providing that these sites last for a period of not less than six months – reinforcing permanency. The six month requirement period is designated as a means of ensuring that the CFC is providing an activity that amounts to much more than a mere transient service (South Africa, 2002a:9) (para (c) of Section 9D(1)).

- The CFC acquiring any agricultural land in any country other than the Republic, used for *bona fide* farming activities. The geographically unique nature of agricultural land holdings is a clear indication of the level of permanence in the foreign location – reinforcing immobility and permanence (para (d) of Section 9D(1))

No minimum time limit is laid down for mining, farming and operations of certain vessels and aircraft, the reason being that, “owing to the relatively unusual nature of each of these types of activities it is highly unlikely that there will be no permanency, economic substance or business purpose” (Olivier & Honiball, 2008:449).

No fixed locational permanence: Permanency is not a requirement to satisfy the FBE criteria in respect of the following cases: a vessel, vehicle, aircraft or rolling stock (rail) used for or engaged in transportation or fishing, prospecting or the exploitation of natural resources or mining or the production of natural resources outside South Africa for such purposes, where that vehicle, aircraft or rolling stock is operated directly by the CFC or by another company which has the same place of effective management as the CFC (i.e. the country of residence) and forms part the same group of companies as the CFC (para (e) to Section 9D(1)) (Olivier & Honiball, 2011:584).

Since 2006 it is no longer a requirement that the vehicle, aircraft or rolling stock must be used solely for the stated methods of transportation. Although it is a requirement that the transportation has to take place outside South Africa, the temporary return of foreign transport to South Africa will not lead to the denial of the foreign business establishment status as long as that return is not for purposes of generating transport income. Therefore, the return of ships and aircraft solely for local repair will not be an issue (Olivier & Honiball, 2011:584).

Economic Substance: The location of the foreign business establishment must demonstrate further substance in terms of operation and in terms of business purpose. In operational terms, the business must be suitably equipped with on-site operational managers and employees, equipment and other facilities to conduct the primary (core) operations of the CFC. The substance element ensures that the business of the CFC is more than just a paper transaction or a disguised form of passive income. Consequently, the economic substance requirement ensures that the income (relative to the foreign business establishment) will not be exempt if the foreign business exists merely on paper and not in substance. To qualify as a foreign business establishment it is not sufficient to have employees who only take management decisions at the foreign business premises; persons who exercise the day-to-day operational management decisions also need to be present (Olivier & Honiball, 2011:582). In addition, these personnel have to be in the full-time employment of the CFC. In *SIR v Downing*

(South Africa, 1975) it was pointed out that the use of independent agents do not qualify a business as a foreign business establishment.

Business Purpose: The business purpose requirement attempts to ensure that income derived by a CFC that complies with the necessary permanence and economic substance requirements will still not be exempt if the business activities are not conducted for *bona fide* business purposes, but to obtain a tax benefit. In determining whether the place of business is conducted outside South Africa for *bona fide* business purposes, the Commissioner does not need to rely on the requirements of the general anti-avoidance provision of Section 80A. It would suffice if, on the facts, the reason for conducting the business activities outside South Africa is to avoid, postpone or reduce taxation. (Olivier & Honiball, 2008:449.)

3.4.4.2 The FBE exemption in terms of Section 9D(9)(b)

As already mentioned, the FBE exemption is considered to be the main exemption from the imputation of Section 9D. The exemption seeks to exclude the active business income attributable to an FBE of a CFC. Up until 31 March 2012, the full FBE exemption was contained in Section 9D(9)(b) and included a number of exclusions, the intricate nature of which prompted Olivier and Honiball (2011:58) to label the FBE exemption as “one of the most complicated provisions in the South African Income Tax Act”. The new Section 9D(9)(b) is seen as a shorter version of the legislation than its predecessor (old Section 9D(9)(b)), coming into effect as from 1 April 2012 (South Africa, 2011a:Section 25(h)). The new regime “continues to contain a more generalised FBE exemption [with] some new instructions for its applications, and is complemented by the diversionary rules contained in [the new] Section 9D(9A)” (Potgieter, 2012:43).

The FBE arm’s length principle: The new FBE exemption criteria contained in Section 9D(9)(b) of the [Income Tax] Act as from 1 April 2012 imposes arm’s length requirements consistent with transfer pricing principles, whereby an FBE is to be treated as if it were a “distinct and separate enterprise” which is “dealing wholly independently” with the CFC of which it is a part (Section 9D(9)(b)(i)). When determining both the *quantum* attributable to an FBE and whether an amount is indeed attributable to the FBE the determination is required to be made as if the amount resulted from terms and conditions that would have existed between “independent persons dealing at arm’s length” (Section 9D(9)(b)(ii)). The revised FBE exemption is further subject to (and accordingly needs to be read together with) the exceptions and refinements which are from 1 April 2012 set out in the new Section 9D(9A) (South Africa, 2011d:Section 25(k)). It should be noted that the revision of the FBE exemption rule, while intended “to be a simplification” are “with [due] respect, considerably more complex than the previous rules” (Guzman-Martinez et al., 2012:1).

There is no definition of the term “arm’s length” in the Income Tax Act, although the term is also used in Section 31 in relation to transfer pricing requirements. SARS advises that in the case of dealings between connected parties, “the transaction should have the substantive financial characteristics of a transaction between independent parties, where each party will strive to get the utmost benefit from the transaction” (South Africa, 1999:para 7.1). The term “arm’s length” is well established internationally, being referred to, for example, in the first paragraph of the OECD’s Commentary on Article 9 of the OECD Model Tax Convention in which reference is made to the “commercial or financial relations” between “associated enterprises” under conditions which differ from those which would exist between independent enterprises (OECD, 2010b:181). The arm’s length principle has been described as requiring “that transfer prices charged between related parties are equivalent to those that would have been charged between independent parties in the same circumstances” (Raby, 2010:9), and “it is submitted that South African courts would apply a similar [interpretation]” (Potgieter, 2012:57).

Section 9D(9)(b)(i) and (ii) (from 1 April 2012) resonates transfer pricing principles by means of which these rules act as deterrent to “multinational group of companies to price intra-group transactions so that profits are taxed in low-tax jurisdictions, while deductions are obtained in high tax jurisdictions” (Olivier & Honiball, 2011:620). Furthermore, “profits could also be shifted intra-group to high tax countries which have special tax benefits, such as tax holidays or special headquarter company regimes or to countries where the group is able to utilise tax losses” (Olivier & Honiball, 2011:620). These requirements accords with the principles of Section 31, the general international transfer pricing provision, which in its definition of “affected transaction” specifies that an affected transaction exists where a “transaction, operation, scheme, agreement or understanding” between the various combinations of connected persons (in relation to one another) as specified therein has terms and conditions which differ “from any term or condition that would have existed had those persons been independent persons dealing at arm’s length” (Section 31(1)).

The effect of paragraphs (i) and (ii) of Section 9D(9)(b) may perhaps be illustrated by comparing an amount of gross income received by a FBE versus that received by a CFC outside of an FBE. In the case of the FBE, the gross income “must not be taken into account” for the purposes of the Section 9D(2A) determination of CFC net income (Section 9D(9)(b)). Consequently, the CFC would not be treated “as if that company had been a resident” in relation to the FBE’s gross income, for purposes of Section 9D(2A). Therefore, in relation to the transfer pricing provisions of the Income Tax Act, the CFC would be treated as non-resident in relation to such gross income, which would be the usual position for a foreign company. By contrast, in the case of non-exempted CFC gross income, not being attributable to an FBE and which is taken into account for the purposes of Section 9D(2A), the CFC gross income is treated “as if that company had been a resident” (Section 9D(2A)). Therefore, in

relation to the transfer pricing provisions of the Income Tax Act, the CFC would in this case be treated as a resident. (Potgieter, 2012:58.)

The requirement of Section 9D(b) that an FBE must be treated as a “distinct and separate enterprise” could have far-reaching implications in respect of the records to be kept by a CFC, as the financial records of the CFC would not only need to be separated between those transactions and amounts which are attributable to the FBE, and those transactions and amounts which are not, but the amounts themselves also need to be evaluated against the “distinct and separate enterprise” criteria as between the FBE and the rest of the CFC (Olivier & Honiball, 2011:641). These intra-transactions between the FBE and the rest of the CFC could be potentially subjective and should therefore be done within the framework of a sound and objectively justifiable transfer pricing policy.

As a direct consequence of the legislative requirements of Section 9D(9)(b), transfer pricing regulations are imposed on the transactions of a FBE of a CFC, which may result in the assessment of a different amount of net income with regard to the CFC (and consequently the amount of taxation for the resident taxpayer by virtue of the amount included in income via Section 9D(2)) should the resident taxpayer not be able to demonstrate that the transaction amount represents an arm’s length price. Furthermore, should the amount not represent an arm’s length price, the fact that the FBE is required to be treated as “wholly independent” from the CFC itself would mean that in determining the net income of the CFC (being treated under the Section as wholly independent from the FBE) a resident taxpayer would be required to adjust (as between the FBE and the CFC) any difference between an arm’s length price and the actual agreed transaction price. “It is submitted that any such adjustment would attach to the CFC and would result in a different net income figure for the CFC, thereby effectively neutralising the effect of any artificial manipulation of the transaction price as far as the imputation of net income of the CFCs concerned”. (Potgieter, 2012:58.)

Furthermore, because the subparagraphs in Section 9D(9)(b) also apply to the determination of whether an amount is “attributable to” the FBE of a CFC, “it would appear that the legislator opens up scope for a finding on assessment, by virtue of the requirements of independence and of arm’s length relationship, that an amount is ‘attributable to’ the CFC itself, but not to the FBE of the CFC” (Potgieter, 2012:58). The consequence of such a determination would be to exclude the amount in relation to such transactions from the FBE exemption, resulting in these transactions being included in the net income calculation of the CFC.

The significance of the term “attributable to”: The term “attributable to” is used several times in Section 9D, although there is no definition as to the meaning of this term in the South African Income Tax Act. One of the uses of the term is contained in Section 9D(9)(b) in which the FBE exclusion

applies only to the extent that an amount is “attributable to any foreign business establishment” of the CFC. In this context, the meaning of the term is crucial for determining whether or not a particular transaction forms part of CFC net income or not, as if the amount is attributable to an FBE and it is exempted from Section 9D.

The term is used by the OECD in their Model Tax Convention (MTC) and Commentary in a somewhat analogous context: Article 7, which deals with business profits, utilises the term to indicate that where an enterprise carries on business in another Contracting State which is subject to a double tax agreement following the OECD Model Tax Convention, “the profits that are attributable to the permanent establishment ... may be taxed in that other State” (OECD, 2010a:art 7 para 1). In that specific context the term is clarified as meaning “the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through other parts of the enterprise (OECD, 2010a:art 7 para 2). The term is, however, also used fairly extensively in other contexts in both the OECD Model Tax Convention and its Commentary. A salient issue that emerges is that the meaning assigned to “attributable to” in the context of the OECD Model Tax Convention and its Commentary may not be entirely symmetrical to the interpretation of the meaning “attributable to” given in the South African CFC tax legislation (Section 9D(9)(b)), especially with regard to the differing objectives over the use of the term “attributable to”.

Diversiory foreign business income: CFCs with income attributable to a foreign business establishment will usually receive the benefit of the foreign business establishment tax exemption, providing that the incomes (arising from these transactions) are not attributable to diversiory sales and services. Diversiory sales and services potentially exist if the sales or services are mainly the income flow from transactions between a CFC and South African resident connected person – in other words, income arising from transactions in which the possibility of price manipulation exists. (South Africa, 2002a:16.)

3.4.4.3 New Section 9D(9A) inclusions relating to the FBE criteria

To avert the previously complicated workings involved in the calculation of the exempt portion relating to the FBE criteria, The Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011 had advocated a simplified version of the FBE criteria by employing certain tests that will be more closely integrated with transfer pricing and without any reliance “on an overly objective (and misdirected) criteria” (South Africa, 2011a:103). The tainted income treatment of mobile income will also be segregated into discreet elements “so has to be more closely aligned with the relevant issues of

concern” (2011a:103). This led to the promulgation of Section 9D(9A), serving as supporting legislation to Section 9D(9)(b). The next chapter section accordingly discusses the key elements in Section 9D(9A) in relation to the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011.

As a general rule, mobile income accruing to a CFC will be automatically taxable unless specific exemptions relevant to it apply. The FBE exemption does not apply even though the mobile income may be attributable to FBE activities. Unlike the previous regime which mixed mobile income into one set of rules, the current regime would target mobile income under four broad distinct categories: (i) financial instruments; (ii) rentals and sales of tangible movable property; (iii) royalties and disposals of intellectual property; (iv) insurance premiums. (South Africa, 2011a:141.)

Financial Instrument income

Income from financial instruments includes income from debts, shares, derivatives instruments and financial leases. The concept “financial instrument” is defined broadly in Section 1 of the Income Tax Act. Income from financial instruments also consists of capital gains derived from the disposal of financial instruments. Lastly, income from financial instruments includes exchange differences determined on these financial instruments. (South Africa, 2011a:105.)

Income from financial instruments derived by a CFC is taxable, unless the CFC is a bank, financial services provider or insurer, or the income is subject to the working capital exemption. But for this working capital exemption to apply, the income must not result in a tax deduction for a South African connected person. These exemptions already exist but have been amended in line with the initially intended principles. (South Africa, 2011a:105.)

Financial instrument income is not tainted if it arises from the principal trading activities of a bank, a financial services provider, or an insurer (other than a treasury operation or captive insurer). More specifically, to qualify for this exemption, the CFC must carry on the principal trading activities of a bank, financial services provider or insurer through a FBE, the financial instrument must be attributable to that FBE, and the activities of the CFC should not constitute activities of a treasury operation or captive insurer. A determination of whether a CFC is a treasury operation or captive insurer is based on a particular facts and circumstances analysis. (Section 9D(9A)(a)(iii)(aa)). (South Africa, 2011a:106.)

It should further be noted that the new financial instrument income dispensation provides a special exemption pertaining to s 24I exchange differences relating to financial instruments. To qualify for this additional exemption, the exchange differences must arise in the ordinary course of the core business of the CFC. This dispensation does not apply if the exchange difference is attributable to the

activities of a treasury operation or captive insurer (as set out above) (South Africa, 2011a:107-107) (Section 9D(9A)(a)(iii)(bb)).

Working capital exemption

The working capital exemption has replaced the 10 per cent *de minimis* exemption. The working capital exemption applies only if tainted financial instrument income is associated with financial instrument receipts and accruals that do not exceed 5 per cent of total CFC receipts and accruals. It should be noted, however, that the working capital *de minimis* exemption does not apply to other forms of mobile income since working capital is typically held only in the form of financial instruments (South Africa, 2011a:107) (Section 9D(9A)(a)(iii)(cc)).

South African deductible payment override

The above exemptions do not apply to financial instrument income associated with a deduction from the same or an interdependent financial instrument. This anti-avoidance provision applies because of the high tax avoidance risk posed by mobile income. The purpose of the provision is to prevent the round-tripping of amounts to undercut the tax system (as an additional method on top of the general anti-avoidance provision, the latter of which takes into account alleged business purposes). Deductible payments relating to financial instruments (especially debt) goes offshore tax free and returns to South Africa in the form of an exempt dividend, (while effectively remaining within the same corporate group).

Insurance premiums derived by a CFC are generally taxable. But an exception exists if the premiums are derived from the CFC's principal trading activities as an insurer, unless the insurer is a captive insurer. Whether it is a captive insurer depends largely on the particular facts and circumstances. But an insurer is always deemed to be a captive insurer if

- the CFC fails to conduct more of its principal trading activities in its country where its FBE is located than in any other country, or
- its principal trading activities do not involve the regular transaction of the business of an insurer with clients who are not connected persons, or
- the amounts derived from its principal trading activities with unconnected persons are less than 50 per cent of the total amounts attributable to the activities of its foreign business establishment. (South Africa, 2011a:107) (Section 9D(9A)(a)(vii).)

Capital gain determined in respect of disposal of intellectual property: The current provisions applicable to royalties and capital gains from the disposal of intellectual property have been largely retained in their current form. In the main, royalties and intellectual property gains derived by a CFC

will be taxable unless the CFC actively develops the underlying intellectual property. These relief mechanisms do not apply if the intellectual property is tainted. (Tainted intellectual property largely involves intellectual property that was once within the South African tax net) (South Africa, 2011a:108) (Section 9D(9A)(a)(vi)).

Immovable property (rentals and sales): Rentals derived by a CFC from the leasing of immovable property are exempt from tainted mobile income treatment. The disposal of immovable property is similarly eligible for the FBE exemption without deviation. Despite their passive nature, these forms of passive income fall outside the mobility issues of concern (South Africa, 2011a:108).

Tangible movables (rentals and sales): Rentals derived by a CFC from the leasing of movables are fully taxable unless the lease is an operating lease or a financial instrument. The exemption of operating leases covers genuine leasing operations where the lessor substantially bears the economic risk of the assets involved. More specifically, the expression ‘operating lease’ is defined as a lease of movable property concluded by a lessor if

- the property can be hired by members of the general public for a period of no more than five years,
- the costs or activities of maintenance and repairs occasioned by normal wear and tear are borne by the lessor, and
- the lessee does not assume liability for the loss or destruction of the property, except if the lessee has failed to take proper care.

Relief under this regime excludes financial instruments, for example, finance leases. In the case of finance leases the lessee effectively bears the ultimate risk and rewards associated with ownership of an asset. These leases will instead be considered for exemption under the financial instrument provisions. A capital gain from the disposal of the tangible movable property is entitled to the FBE exemption without deviation (South Africa, 2011a:108-109) (Section 9D(9A)(a)(iv)).

The use or right of use of intellectual property: Section 9D(9A)(a)(v) provides that an amount that is attributable to a foreign business establishment of a CFC as contemplated in s 9D(9)(b) must, notwithstanding that provision (exemption or exclusion from net income), be taken into account in the determination of its net income if that amount arises from the use or right of use of or permission to use ‘intellectual property’ as defined in Section 23I, unless it directly and regularly creates, develops or substantially upgrades intellectual property as defined in s 23I that gives rise to that amount (Section 9D(9A)(a)(v)).

A proviso to Section 9D(9A)(a) states that if an amount that is attributable to a foreign business establishment of a CFC as contemplated in Section 9D(9)(b) is, solely as a result of the application of s 9D(9A)(a)(iii) (from a financial instrument (see above)), not taken into account in the determination of its net income, that amount must be so taken into account

- (A) to the extent that a deduction is allowed in respect of any other amount incurred by its connected person (in relation to that CFC) who is a resident, and
- (B) where that amount is attributable to that other amount. (Section 9D(9A)(a)(A) and (B).)

3.4.4.4 Challenges for the new FBE requirement

The new Section 9D(9A) (taking effect from 1 April 2012), and also the proviso to Section 9D(9)(b) (prior to 1 April 2012), is fairly lengthy and complex. It is submitted that the structure and organisation of the new FBE requirement may continue to pose challenges for both the South African taxing authorities and resident shareholders of CFCs, especially in relation to its interpretation. Regular changes to the FBE requirement and with specific reference to the recent substantive changes effected through Act No. 24 of 2011, considered an overhaul of the FBE requirement, could engender disquietude among South African investors in CFCs. Despite the legislator's intent to make the FBE criteria more concise and relevant, the onerous requirements of the "arm's length" principle and the concomitant independent requirements of the new Section 9D(9)(b), effective from 1 April 2012, may further create considerable uncertainty for South African resident investors in a CFC, particularly, those CFCs having FBEs.

3.4.5 Long-term insurance for non-resident policy holders (Section 9D(9)(c))

The Revenue Laws Amendment Act, No. 31 of 2005 introduced (by Section 14(1)(n)) the current provision contained in Section 9D(9)(c) – relating to long-term insurance for non-resident policy holders. The provision in Section 9D(9)(c)

is attributable to any policyholder that is not a resident or a controlled foreign company in relation to a resident in respect of any policy issued by a company licensed to issue any long-term policy as defined in the Long-term Insurance Act, 1998 (Act No. 53 of 1998), in its country of residence.

The legislation has given recognition to the general principle that certain CFCs of Republic insurance companies earn profits that will eventually be awarded to policy holders who do not fall within the South African (local) tax system. In order that these profits are not taxable under South African CFC legislation, an exemption has been introduced in the form of the current Section 9D(9)(c) which applies to the net income of the CFC that is attributed to a non-resident policy holder who is not a

CFC. However, the income will only qualify for exemption from attribution if the policy was issued by a company which is licensed to issue any long-term policy as defined in the Long-term Insurance Act 53 of 1998 in the country of residence of the policyholder (Section 9D(9)(c)).

3.4.6 Exemption of interest and royalties as CFC inclusions (Section 9D(9)(d))

Background: Prior to the proposed amendment that took effect on 1 January 2013, payments of cross-border interest to a CFC were exempt from withholding tax on interest. Further, royalties received or accrued to a CFC were excluded from the withholding tax on royalties (South Africa, 2011a:117).

Prior to the proposed amendment taking effect on 1 January 2013, interest and royalties received by CFCs potentially gave rise to CFC (i.e., Section 9D) inclusions for certain South African holders of participation rights (arising from share ownership) in a CFC. The CFC net income calculation is based on a hypothetical taxable income as if the CFC were a South African resident for a variety of purposes, including the receipt or accrual of interest. Therefore, interest received or accrued by CFCs were not exempt from CFC inclusion, under the cross-border interest exemption described above, because the CFC was not considered as a foreign person for the purposes of Section 9D of the South African Income Tax Act. However, royalties and interest will continue to be subject to CFC inclusion, unless they are subject to withholding taxes. (South Africa, 2011a:117.)

The previous system (prior to the legislative change) appeared to have waived withholding taxes in favour of potential CFC inclusions. This waiver had the effect of catapulting “interest and royalties received or accrued by CFCs outside [the] direct South African taxing jurisdiction in favour of secondary taxing jurisdiction arising from CFC income” (South Africa, 2011a:117). The latter form of taxation levied on CFC income was notably harder to enforce and contained many more exemptions. The purpose of the new CFC rules is largely to extend the South African tax base, therefore “no reason exists to have CFC rules that effectively reduce direct South African taxing jurisdiction” (2011a:117).

In view of the above, it is proposed that the CFC exemptions of interest and royalties in respect of cross-border withholding taxes be fully removed. Cross-border interest and royalties will be fully subject to withholding taxes unless a treaty applies to reduce or eliminate the tax. In effect, CFCs will be treated like any other foreign company for withholding tax purposes.

Both forms of cross-border amounts will be treated like any other amounts received or accrued by a CFC for purposes of determining potential CFC (i.e., Section 9D) inclusions. However, an exemption from Section 9D will exist if the amount is subject to any level of South African cross-border

withholding (i.e. after taking tax treaties into account) tax. This latter rule prevents double taxation (i.e., direct and indirect South African taxation).

The proposed amendment became effective for amounts that are paid or payable during years of assessment beginning on or after 1 January 2013.

3.4.7 Exemption of SA taxable income (Section 9D(9)(e))

The net income of a controlled foreign company will not be taxed in the hands of resident shareholders if the actual income of the CFC is subject to South African tax (i.e., the CFC itself is taxed as a body corporate in South Africa) where the income is derived from an actual or deemed South African source (Section 9D(9)(e)). This exemption is considered as an essential exemption to the avoidance of economic double taxation in respect of the imposition of South African taxation on South African sourced income of a non-resident corporation as well as the taxation of (the same) income attributable to South African residents (in respect of CFC legislation).

This is explained further by the fact that should a CFC be subject to South African tax on its net income, after which resident participants are taxed on their share of the net income of the CFC, the result would be unacceptable double counting. In consequence of the above actions, resident participants would effectively be paying tax twice on the same income – once through the CFC (whose income is in effect partly the taxpayer's), and again in its own personal capacity in terms of Section 9D. National Treasury is of the view, therefore, that “no reason exists to tax this income under Section 9D because this income is already accounted for by the South African tax system.” (South Africa, 2002a:21.)

Therefore, the fact that net income is in principle subject to South African tax is not necessarily conclusive evidence for the granting of the above exemption. The net income, in addition, must not be exempt or taxed at a reduced rate as a result of the application of a double tax agreement (Olivier & Honiball, 2011:596). If, as a result of a double tax agreement, the South African sourced income of a CFC is not taxed in South Africa, the exemption does not apply because the originally sourced income was not taxed in South Africa (Seonath, 2003:83). It therefore follows that South African residents are unable to avoid tax on their South African income by operating through CFCs falling within the South African tax treaty network. This is an impartial practice as the income would have been taxed if earned directly by South African residents. It is submitted (and in agreement with Seonath) that the current exemption prevents the same income actually being taxed twice, as the underlying objective of CFC legislation is to see to it that the income of a CFC which is not subject to any of the exemptions in terms of Section 9D(9) is taxed once and does not entirely escape the South African tax network. (Seonath, 2003:84.)

3.4.8 The related and intra-group exemptions

To promote competence in the international business arena, Section 9D embraced legislative provisions that would allow related CFCs “to shift income among one another without triggering tax” (South Africa, 2002a:21). Multinational structures frequently contain multiple foreign subsidiaries that act as a single economic unit. The multi-level natures of these structures (often involving holding companies) have legitimate non-tax reasons, such as isolation of risk to particular countries in which the economic activities arise. Although tax reasons may exist for these multi-level structures, any efforts by the taxpayer at tax reduction will be aimed solely at reducing foreign tax as opposed to South African tax. Therefore, any “structures of this kind [will] allow South African multinationals to compete in an environment where their foreign multinational competitors utilise similar foreign tax reducing structures” (2002a:21). Accordingly, and in response to the above, Section 9D(9) provides for the following three types of exemptions:

- the related CFC dividend exemptions (Section 9D(9)(f))
- related CFC income from interest, royalties, rentals and similar amounts (Section 9D(9)(fA))
- the disposal of CFC intra-group assets exemption (Section 9D(9)(fB))

3.4.8.1 The related CFC dividend exemption – Section 9D(9)(f)

The income of a CFC shall not be included in the income of South African resident participants – to the extent that such income earned by the CFC actually constitutes dividends received from another CFC in relation to the same resident participant (Section 9D(9)(f)). National Treasury comments, that “in order for the payor and payee [CFCs] to be related for this purpose, both [CFCs] must qualify as a [CFC] in relation to the same South African resident (i.e., be more than 50 per cent directly or indirectly owned by the same South African resident)” (South Africa, 2002a:21). Dividends are exempt under this provision as “the underlying earnings of the [CFC] payor generating the dividends are either earnings from a [CFC] business establishment or were already taxed directly”. This rule effectively allows South African multinationals to use holding company structures “without triggering South African tax merely upon the receipt of dividends from lower-tier subsidiaries”. (2002a:21.)

The exemption contained in Section 9D(9)(f) in essence excludes a foreign dividend declared to a CFC by another CFC (in relation to the resident taxpayer) from the net income of the former CFC which receives the dividend. This exclusion only applies to the extent that the foreign dividend does not exceed an amount calculated as follows:

- The aggregate of all amounts included in the resident’s income in respect of any (current or past) year of assessment relating to the net income of the CFC declaring the dividend (Section 9D(9)(f)(i)), plus

- The aggregate of all amounts included in the resident's income in respect of any (current or past) year of assessment relating to the net income of any other company held indirectly through that CFC by the resident (Section 9D(9)(f)(ii)).

less

- The aggregate of the proportional amounts of any foreign tax payable in respect of the amounts so included above via Sections 9D(9)(f)(i) and (ii) (Section 9D(9)(f)(aa))

less

- The sum of all foreign dividends or portions thereof which have been excluded from the CFC net income because of either: Section 9D(9)(f); or (from 1 April 2012) Section 10B(2)(a), (b) or (c) (or Section 10(1)(k)(ii)(dd) on or before 31 March 2012), which provisions exempt from tax dividends from any foreign companies in which the so-called "participation exemption" are held, being from 1 April 2012 greater than 10 per cent (previously 20 per cent) of equity shares and voting rights; or by virtue of prior inclusion by Section 9D itself. (Section 9D(9)(f)(bb).)

This exemption effectively caters for "the redeployment of offshore operating income (that is, other than passive income) without imputation in terms of Section 9D by allowing a South African multinational group to re-invest such income offshore without it falling into the South African tax net" (Jooste, 2001:499). Therefore, the exemption allows such multinational groups to preserve the value of offshore tax concessions on operating income, at least as long as the funds are actively invested offshore, by consenting to a CFC (in an intermediate foreign holding company) to receive dividends from another connected CFC without any imputation (in terms of Section 9D), even though the dividends constitutes passive income. The rationale for the exemption is that the earnings underlying the dividends are generally earnings generated by a business establishment or are already taxed directly. (Jooste, 2001:499.)

Therefore, aside from promoting international competitiveness among multinational groups, this legislation in effect, prevents double taxation – for example, if a foreign dividend is declared to CFC A by another company B and a portion of the net income of B is already attributed to a South African resident, then Section 9D will not be applicable to the portion of the net income of A which relates to the dividend distributed by (or received from) B. The rationale for the exempting of dividends declared by a company to a CFC is that the profits out of which the dividend is declared have already been attributed to the South African resident or qualify for the exemption under Section 9D(9). The aim of this legislative exemption is to avoid double taxation (Oguttu, 2007:138).

3.4.8.2 Related CFC income from interest, royalties, rentals and similar amounts (Section 9D(9)(fA))

According to National Treasury, “this rule effectively [allowed] South African Multinationals to utilise finance or treasury foreign subsidiaries as a tax-free means for channelling collective group loans, licenses and leases”. This type of organisational structures usually “[allowed] a group to borrow within a single administrative structure, thereby creating opportunities for reduced group rates” (South Africa, 2002a:22).

In response, South Africa had initially made legislative provisions (in both Sections 9D(2A)(c) and Section 9D(9)(fA)) to cater for these types of transactions – especially interest, royalties, rentals, exchange differences etc., that transpired between two CFCs which formed part of the same group of companies. Accordingly, Section 9D(fA) then provided that in the determination of the net income of the CFC in terms of Section 9D(2A), there must not be taken into account an amount that is attributable to

- interest, royalties, rental or income of a similar nature that is paid or payable or deemed to be paid or payable to that company by any other CFC (including a similar amount adjusted in terms of Section 31 – so-called transfer pricing and thin capitalisation),
- an exchange difference determined in terms of Section 24I on an exchange item to which it and another CFC are parties,
- an exchange difference on a forward exchange contract or foreign currency option contract entered into to hedge the above exchange item, or
- a reduction or discharge by another CFC of a debt owed by it to another CFC for no consideration or for a consideration less than the amount by which the face value of the debt has been so reduced or discharged

when that CFC and the other CFC form part of the same group of companies. (Section 9D(fA))

Therefore, proviso (c) to Section 9D(2A) and Section 9D(fA) applied to the two sides of the same transaction. Proviso (c) to Section 9D(2A) applied to the CFC that incurred, among other expenses, interest, royalties, rentals or similar amounts that were paid or payable by it to another CFC (in relation to the South African resident). On the other hand, Section 9D(fA) applied to the recipient CFC – in respect of interest, royalties, rentals or similar amounts accruing to it, and was made payable by another CFC that formed part of the same group of companies. (Mitchell, 2009:10.)

The (fA) election has been deleted by Section 25(I)(j) of Act No. 24, 2011, with effect from 1 April 2012, and applicable in respect of those foreign tax years of CFCs ending during years of assessment commencing on or after that date (South Africa, 2011d).

3.4.8.3 Disposal of capital assets

Disposal of any asset-attributable to any foreign business establishment of any other CFC (that forms part of the same group) – Section 9D(9)(fB)

Capital gains and losses realised from the disposal of an asset are exempt under two different subsections of Section 9D. The proceeds derived from the disposal of assets attributable to the foreign business establishment of the CFC are exempt under Section 9D(9)(b) and assets, as defined in the Eighth Schedule (other than any financial instrument and intangible asset as defined in paragraph 16 of the Eighth Schedule), attributable to the foreign business establishment of another CFC are exempt provided that both CFCs form part of the same group of companies (Section 9D(9)(fB)). The meaning of the term “attributable” (in terms of Section 9D(9)(fB)) “is not defined and arguably means the same as attributable in the context of a permanent establishment, namely, it is not only a legal attribution but also an economic attribution test” (Olivier & Honiball, 2011:598). According to National Treasury, “this exemption essentially allows attribution of group assets to [CFC] business establishments as long as both the [CFC] owning the asset and the [CFC] utilising the asset are within the same group of companies (same economic unit)” (South Africa, 2002a:22-23). Financial instruments are accordingly defined in Section 1 of the Income Tax Act.

Therefore, the intangible assets that are excluded from the exemption are as follows:

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

As the exemption is only available if the capital asset (in respect of which the gain arose) is attributable to a business establishment, it is, by implication, required that “at least one of the CFCs in the group of companies qualifies as a business establishment” (Olivier & Honiball, 2011:599). It is therefore not a requirement that the CFC disposing of the capital asset meets the business establishment test. It is also evident (in Section 9D(9)(fB)) that no reference is made to the existence of a lease agreement between the two CFCs, the exemption will be applicable irrespective of the reason for the use of the capital asset by the other CFC. In practice, however, the exemption will most likely be invoked when a CFC leases capital assets to another CFC within the same group of companies

(Olivier & Honiball, 2011:599). This is reinforced by National Treasury which also holds the view that “the exemption typically arises when one [CFC] leases an asset to another [CFC] in order for the latter to conduct its business” (South Africa, 2002a:23). These types of transactions frequently involve sale and leaseback activities. In essence, “sale proceeds on leased intra-group [CFC] assets are exempt to the same extent as the net income attributable to a specific [CFC]” (South Africa, 2002a:23).

Sale of an Interest in a foreign company

The basic exemption is contained in paragraph 64B (1) of the Eighth Schedule, which provides that the capital gain or capital loss arising from the disposal of an interest in a foreign company will be exempt provided that

- the person (in the case of a company, together with any other company in the same group of companies) disposing of the interest held at least 10 per cent of the equity share and voting rights in that foreign company immediately before and held such interest for at least 18 months prior to the disposal (paragraph 64B(1)(a)(i)(ii));
- the disposal is to a non-resident (other than the CFC) for an amount that is equal to or exceeds the market value of the interest (paragraph 64B(1)(b)).

Hybrid instruments are not taken into consideration when determining the foreign company’s total equity share capital. A hybrid instrument is defined as: “an instrument, usually a financial instrument, which is characterised differently for income tax purposes in different tax jurisdictions, for example, a preference share which is treated as a loan in the United States but as an equity investment in South Africa” (Olivier & Honiball, 2011:600). In the case of where a foreign entity does not have equity share capital, for example, in the case of a limited liability partnership which is regarded as a company, because it is not a foreign partnership as defined, the exemption will not be available. This is despite the fact that the foreign entity is considered as a company under paragraph (b) of the definition of company in Section 1 of the South African Income Tax Act, and it is subject to all the other provisions applicable to companies. (Olivier & Honiball, 2011:600.)

In determining the period for which the interest was held, the period in which the interest was held by any other company in the same group of companies is also to be taken into consideration, provided that the company and the other companies (in the same group of companies) held the interest in aggregate for a period of more than eighteen months.

According to the Explanatory Memorandum (2005), “the capital gains participation exemption acts as an analogue to the participation exemption for foreign dividends” (South Africa, 2005b:57). The exemption of capital gains tax in paragraph 64B(1) is intended to facilitate internal restructuring of offshore foreign subsidiaries. The exemption also allowed for the sale of certain foreign shareholdings

to foreign persons with the expectation that the loss of foreign shareholdings would be replaced with valuable consideration. However, it had become apparent (over a period of time) that some multinationals were seeking to utilise the exemption as a mechanism to divest themselves of their foreign subsidiaries – with foreign subsidiary ownership transferring abroad with little or no consideration remaining within South Africa’s jurisdiction. Simultaneously, some of these transactions further contained schemes that attempted to avoid any STC, so as to achieve a wholly tax-free divestiture. (South Africa, 2005b:57.)

3.5 Tax relief provisions for Section 9D shareholders

3.5.1 Introduction

A country’s CFC tax legislation may potentially give rise to a number of circumstances in which double taxation could result, as the income of the CFC is subject to tax in its country of residence and domestic shareholders are simultaneously taxed on their proportionate share of income in the CFC. The simultaneous imposition of taxation, in respect of the same income, and on the relevant participants, could result in international double taxation arising from the reigning conflict attributable to the jurisdictional taxation of foreign-sourced income. Therefore, the three types of double taxation arising from conflicts over tax jurisdictions are

- Source-source conflicts: Two or more countries assert the right to tax the same income of a taxpayer because they all claim the income is sourced in their country.
- Residence-residence conflicts: Two or more countries claim the right to tax the same income of a taxpayer because they make the assertion that the taxpayer in question is a resident of their respective country.
- Residence-source conflicts: A country claims its right to tax foreign-sourced income of a resident taxpayer on the basis that such taxpayer is a resident of its country; while another country asserts the right to tax the same income because the source of the income is attributable to such other country. (Arnold & McIntyre, 2002:27; Olivier & Honiball, 2011:442.)

International double taxation may therefore take two forms: economic double taxation, which is the imposition of comparable taxes by at least two tax jurisdictions on different taxpayers in respect of the same income, and juridical double taxation, which is the imposition of comparable taxes by at least two tax jurisdictions on the same taxpayer in respect of the same income (including capital gains) (Arnold & McIntyre, 2002:29; Olivier & Honiball, 2008:315).

Therefore, in the international arena, jurisdiction to tax goes hand in hand with the concept of sovereignty. A country’s authority to tax extends only so far as its sovereignty. Consequently, non-

sourced income received by or accrued to a non-resident cannot be taxed directly by a domestic jurisdiction, even if the foreign entity is completely owned by residents of a domestic country. The only alternative, in respect of the above, is, therefore, to directly tax domestic residents controlling such foreign entity on the basis that the income is deemed to have been distributed to (or earned by) them. Therefore, the state in which the foreign entity is resident will, in all probability, also tax the income, thus resulting in double taxation.

3.5.2 Tax relief measures in South Africa

In a South African context, the problem is often solved by providing a foreign tax credit in domestic law (as contained in Section 6quat) for South African Section 9D shareholders. When the CFC income is eventually distributed in the form of a dividend, this dividend is usually exempt from taxation (in terms of Section 10B(2)). No international consensus has been reached on the most appropriate method for the granting of tax relief in respect of international double taxation. However, the following three methods are in common use internationally:

- Deduction method: The residence country of the taxpayer permits a deduction for taxes, including income taxes, paid to foreign governments in respect of foreign-sourced income.
- Exemption method: The residence country makes provision for the exemption of foreign-sourced income in respect of domestic taxpayers.
- Credit Method: The residence country provides its taxpayers with a credit against domestic tax liability arising from foreign-sourced income – paid to a foreign government (Section 6quat). (Olivier & Honiball, 2011:442-444.)

In South Africa, relief from international double taxation is obtained both unilaterally in terms of domestic law and bilaterally in terms of tax treaty law. Domestic law relief takes the form of all of the above three relief methods used internationally, namely the exemption method, the credit method and the deduction method. Section 6quat, which contains both the tax rebates in respect of foreign taxes on income (Section 6quat(1)), and the tax deduction for foreign taxes (Section 6quat(1C)), is an example of the credit method to the extent that it deals with rebates, as well as an example of the deduction method to the extent that it deals with deductions. Section 6quat(1) is the only example of the credit method found in South African domestic law. Implicit in the credit method and therefore in the operation of the rebate portion of Section 6quat is the principle that the income or capital gains would have been subjected to tax twice, once in the source State and once in South Africa. The same applies in relation to Section 6quat(1C), the tax deduction for foreign taxes (Olivier & Honiball, 2011:443). As stated above, Section 6quat(1C), which provides a deduction from the income of a resident for foreign taxes is an example of the deduction method found in South African domestic

law. According to Arnold & McIntyre (2002:32), the deduction method is the least generous method of granting relief from international double taxation as it simply grants a deduction as if the foreign tax was a current expense.

Both the OECD Model Tax Convention and the UN Model Tax Convention, with regard to relief from double taxation under tax treaty law, provide for two methods under Article 23: the exemption method (Article 23A) and the credit method (Article 23B). However, the deduction method is not followed in either the OECD or UN Model Tax Conventions (Olivier & Honiball, 2011:443). On the other hand, both the old United States Model Tax Convention (1996) and the new United States Model Tax Convention (2006), released 15 November 2006, only allow for the credit method (Article 23). South Africa has in the past mainly adopted the credit method when negotiating its tax treaties, and currently only adopts this method. Under the exemption method, the country of residence generally exempts income derived from or capital situated in the other country. The exemption may take the form of a complete exclusion from the tax base (called the full exemption method), or it may take the form of recognition of such income or capital solely for the determination of the tax liability in respect of the remaining income or capital. This latter method is referred to as the “exemption with progression” method. (Olivier & Honiball, 2011:443.)

The current chapter section will briefly discuss the tax relief provisions available to South African resident shareholders of CFCs, primarily in the context of the Section 6quat rebate of the South African Income Tax Act (No. 58 of 1962).

3.5.3 Foreign taxes paid (Section 6quat(1))

Section 6quat provides for a unilateral tax credit, currently referred to as a rebate, in respect of foreign taxes paid on non-sourced South African income. The rebate is only available to South African residents and therefore cannot be claimed by non-residents on their South African sourced income, for example, branches of foreign companies operating in South Africa. Effectively, the rebate is deductible from the normal taxes payable by a South African resident in whose taxable income are included the specified categories of income (Section 6quat(1))

3.5.4 Determination of foreign taxes payable that qualifies for a Section 6quat(1A) rebate

Section 6quat(1A) makes provision to the effect that the rebate shall be an amount equal to the sum of any taxes on income proved to be payable to any sphere of government of any country other than the Republic. This, indeed, is very widely stated and would “arguably include regional taxes like [the] Swiss Cantonal taxes and the United States State taxes in addition to the applicable national or federal

taxes” (Olivier & Honiball, 2011:451). *Interpretation Note No. 18* (of 31 March 2003) reaffirms the above view that taxes payable to a foreign government will take on different levels, for example, national, state, provincial, local or any other level of government. Consequently, taxes imposed by any level of a foreign government will be regarded as taxes payable to a foreign government. Internationally, taxes payable on capital gains are regarded as taxes on income. Thus any reference to taxes payable on income will therefore include taxes payable on capital gains. A liability for interest, fines, penalties or any other similar obligation imposed in terms of any foreign law may not be regarded as a tax on income and therefore does not qualify for a rebate (in terms of Section 6quat). (South Africa, 2003:2.)

3.5.5 Calculations of and limitations on the rebate granted (6quat(1B))

Section 6quat(1B)(a) provides that the rebate or rebates of a tax proved to be payable as contemplated in s 6quat(1A) must not in aggregate exceed an amount that bears to the total normal tax payable the same ratio as the total taxable income attributable to the income, proportional amount, taxable capital gain or amount, that is included as contemplated in s 6quat(1), bears to the total taxable income. The amount of foreign taxes which qualifies for the Section 6quat rebate is limited to a pro rata amount calculated in accordance with the prescribed formula. (South Africa, 2003:4.)

In terms of Section 6quat(1B)(a)(ii), where the sum of any foreign taxes proved to be payable exceeds the rebate as determined, then the excess amount may be carried forward to the immediately succeeding year of assessment and shall be deemed to be a tax on income paid to the government of any other country in that year. It may then be set off against the amount of normal tax payable by that resident during that year. Excess credits therefore arise when the sum of the foreign taxes proved to be payable exceeds the allowable rebate determined by applying the formula and limitation provisions contained in the Income Tax Act. The excess amount may not be “carried forward for more than seven years reckoned from the year of assessment when such excess amount was for the first time carried forward”. (Section 6quat(1B)(iii).)

3.5.6 Deduction of foreign taxes (6quat (1C) and (1D))

To give effect to tax relief in respect of South African residents who have been taxed twice on the same receipt or accrual, a credit is duly granted against their South African normal tax liability in the form of a rebate (s 6quat(1A) – see above). Tax credits are, however, available only to the extent that foreign taxes become payable on foreign-sourced income and not against the resident’s South African sourced income. Certain countries are incorrectly claiming source jurisdiction over services conducted within the territorial boundaries of South Africa. They subsequently claim that withholding tax is required. While the fiscus is not prepared to give a s 6quat rebate for a South African-source activity,

it is prepared, however, to treat these foreign taxes as a deductible expense. Under Section 6quat(1C), certain foreign taxes proved to be payable will be deductible. But under Section 6quat(1D) this deduction cannot exceed the underlying income giving rise to the foreign tax. (Mitchell et al., 2012:147.)

3.5.7 Method of foreign tax deduction (Section 6quat(2))

No rebate may be deducted if the income (e.g., foreign dividend) in respect of which the tax was paid is exempt from domestic taxation and accordingly not included in the taxable income of the South African resident. Section 6quat(1) which is subject to Section 6quat(2), provides that the rebate and deduction (in terms of Sections 6quat(1) and (1C)) shall not be granted in addition to any relief provided under a double tax treaty. It may, however, be granted in lieu of a double tax treaty relief. It is therefore submitted that the taxpayer has a choice of a Section 6quat relief or a double tax treaty relief. For example, if the treaty provides that the foreign income shall be exempt it would be preferable to choose treaty relief if the foreign tax is a rate lower than the domestic tax rate.

3.5.8 Taxes on income (Section 6quat(3))

The term “taxes on income” is defined in s 6quat(3) as excluding a compulsory payment to the government of another country that constitutes a consideration for the right to extract mineral or natural oil.

3.5.9 Conversion of foreign tax into Republic currency (Section 6quat (4) and (4A))

Section 6quat(4) outlines its own translation method and requires that any foreign taxes payable (as contemplated in subsection (1A) or (1C)) be translated into South African Rand on the last day of that year of assessment by applying the average exchange rate for that year of assessment (Section 6quat(4)). If the amount of the foreign taxes being translated into South African Rand includes a number of cents (i.e. less than R1), then the amount of the translated foreign taxes must be rounded off to the nearest Rand (Section 6quat(4A)).

3.5.10 Revised assessments (Section 6quat(5))

Section 6quat(5) now provides, notwithstanding the provisions of s 79 or s 81(5) (certain prescription provisions), an additional or reduced assessment for a year of assessment to give effect to s 6quat(1) and s 6quat(1A) may be made within six years from the date of the original assessment for that year.

3.6 Administrative requirements for Section 9D shareholders

3.6.1 Introduction

To fulfil the administrative requirements of Section 9D, it is imperative that South African resident shareholders make available to SARS all the necessary information that would facilitate the proper administration of the Income Tax Act by both the resident taxpayer and SARS. Section 72A deal with the reporting requirements (tax returns) in respect of South African CFCs. This provision is aimed at facilitating the gathering of such information and therefore places a huge administrative burden on certain resident shareholders. (Jooste, 2001:500.)

3.6.2 The provisions of Section 72A

The provisions of Section 72A require that any South African resident who, on the last day of the foreign tax year or immediately before a foreign company ceases to be a CFC, directly or indirectly, together with any connected person in relation to that resident, holds at least 10 per cent of the participation rights in any controlled foreign company (otherwise than indirectly through a company which is a resident) to submit to the Commissioner such return as may be prescribed by the Commissioner (Section 72A(1)). Until 2005, the Income Tax Act stipulated that the following information needed to be supplied:

- the name, address and country of residence of the CFC;
- a description of the various classes of the participation rights in the CFC;
- the percentage and class of participation rights held by the resident, whether directly, indirectly or together with connected persons;
- an indication of the right of the South African resident and connected persons to participate not only in dividends declared by the CFC but also in distributions upon liquidation of the CFC;
- the determination of the net income of the CFC and the calculation of the South African resident's proportional amount; and
- a description of any amount of tax paid by the CFC to the government of any other country on income, including particulars relating to the country in which the tax was paid and the underlying profits to which the foreign tax relates (Section 72A(1)). (Olivier & Honiball, 2008:469.)

Currently, the Income Tax Act itself does not prescribe the information that has to be supplied, except to the extent that the resident must have available for submission to the Commissioner, when so requested, a copy of the financial statements of the CFC for the relevant tax year (Section 72A(2)). It could now be presumed that, despite the deletion in the Income Tax Act of the previously stipulated

information to be made available by the taxpayer, there exists, by implication, an understanding, that SARS could still request more than the previously required information.

If a resident fails to submit a copy of the financial statements of the CFC for the relevant foreign tax year, and no reasonable grounds exist either for that failure which is outside the control of the person entrusted with the reporting obligation to SARS, or for that person to believe that he was not subject to such a requirement, then the proportional amount which must be included in the income of the South African resident in terms of Section 9D will be determined with reference only to the receipts and accruals of the CFC. Consequently, no deductions may be claimed in the computation of the taxable income of the CFC (Section 72A(3)(b)(i)). In addition, the Section 6quat rebate will also not be applicable or available, as failure to provide the necessary financial statements will result in the disallowance of the Section 6quat rebate (Section 72A(3)(b)(ii)). This subsection is only operative in instances where the requested copies of the financial statements are not available for submission to SARS. Therefore, this subsection is not operative in respect of the failure to submit any other information requested by SARS (in terms of other Sections in the Income Tax Act).

3.6.3 The Taxation Administration Act, No. 28 of 2011

The following discussion has relevance for the South African resident shareholder of CFCs: The previous criminal penalties imposed in terms of Section 75 and 104 have now been deleted by the Taxation Administration Act, No. 28 of 2011 (hereafter the TAA). The additional tax imposed on a taxpayer in the event of default or omission with regard to the submission of tax returns and the furnishing of any other information or document that were required by SARS in terms of Section 76 has also been deleted by the TAA. The previous requirement by Section 73A(i) requiring a taxpayer to retain all records relevant to a return for a period of up to 5 years from the date of submission of the return to the Commissioner in support of a tax return has also been deleted by the TAA.

The TAA was promulgated in Government Gazette No. 35491 on 4 July 2012, coming into effect on 1 October 2012 (except for certain provisions relating to interest on tax). Section 29 of the TAA, for example, sets out the duty to keep records and the periods for which these records must be kept. The keeping of records supporting a tax return, remains unchanged, and the taxpayer has to keep the relevant records for up to 5 years from the date of submission to SARS. Chapter 6 (comprising of Section 67-74) of the TAA sets out the limits of the secrecy provisions to which SARS is subject. It replaces the secrecy provisions in the previous Tax Acts (such as Section 4 of the Income Tax Act). A breach of the secrecy provisions will invoke penalties in terms of Section 236 of the TAA.

Sections 101 to 150 of the Taxation Administration Act deal with dispute resolution. These rules are the same as existed prior to the implementation of the TAA in which Section 102 replaces Section 82

of the Income Tax Act relating to “burden or onus of proof”. It states that the taxpayer bears the onus of showing that amount is not taxable etc. The only onus resting on SARS is to show that the amount of an estimated assessment under Section 95 is reasonable, or that an understatement penalty under Chapter 16 is based on correct facts. If the taxpayer objects to an assessment, the onus is on the taxpayer to show that the assessment is incorrect.

The administrative non-compliance penalties are concentrated in Chapter 15 (from Sections 208-220). The administrative non-compliance penalties are imposed in respect of: for example, failure to keep proper records, failure to report any reportable arrangements, non-compliance with a request for information, obstruction of SARS officials etc. Criminal offences and the general provisions of the TAA are contained in Chapters 17 and 19 respectfully.

3.7 Chapter conclusion

The existence of CFC rules is designed to deal with the problem of deferral of income, and at a fundamental level, represents unilateral measures which may be used by countries seeking to tax their residents on a worldwide income. In a broader context, these rules are directed at the prevention of the deferral of taxation of foreign companies controlled by their residents (Pinto, 2009:50).

Therefore, Section 9D could form part of the strategic decision of South African investors to invest locally (in South Africa) or through foreign companies. In this respect, it would be fair to say that global competitiveness is often in direct conflict with domestic tax policies, and that investors (both residents and non-residents), faced with a global choice of jurisdictions, structure their affairs or even change their residence so as to avoid CFC regulations. Further, in the light of the introduction of the headquarter regime by Section 6(1)(o) of the Taxation Laws Amendment Act, No. 7 of 2010, the extent of the exemptions granted to a South African headquarter company from the provisions of Section 9D may influence the extent to which foreign investors might consider making use of South Africa as a jurisdiction to incorporate either a regional holding company or a headquarter company. The interaction of Section 9D with this new regime warrants special consideration in view of the fact that National Treasury elevated Section 9D as one of the “three sets of South African tax rules” which it “identified as significant barriers” to enabling South Africa to operate as “an ideal holding company jurisdiction”. (South Africa, 2010a:77.)

South Africa has been cited, in an African Progress Report, as one of the five countries in Africa in which economic growth is impeded by the huge illicit financial outflows from domestic economies. It is estimated that illicit outflows from the continent over the past 39 years could be as high as R14 trillion – almost double the total amount of global foreign aid and assistance over this period. The estimate for 2008 alone is between R290 billion to R415 billion. This being attributable to a “global

shadow financial system comprising tax havens, secrecy jurisdictions, disguised corporations, anonymous trust accounts, fake foundations, trade mispricing and money-laundering techniques”. (Hazelhurst, 2010:16.)

The chapter therefore concludes with a summary of shortcomings in respect of key issues in the South African CFC legislation – thus forming the basis for discussion in the concluding chapter of the thesis in which possible remedial measures and recommendations will be highlighted for possible legislative changes.

Control: The current requirements for the determination of control of South African foreign companies are: direct and indirect participation and voting rights by South African resident shareholders (see 3.2.1.2 above). The litmus test in this regard, will therefore be the holdings of more than 50 per cent, directly or indirectly, of the total participation rights or the exercising of the more than 50 per cent, directly or indirectly, of the voting rights by one or more persons that are residents other than headquarter companies.

However, the absence of any direct reference to the term “connected persons” in the definitional requirements of the CFC for the determination of control, vis-à-vis a foreign company, could lead to much equivocation and ambiguity in the determination of control of foreign companies, especially with regard to the interpretation of the term “indirectly”, as one of the criteria for the determination of control. Despite the reference to “connected persons” being made in Section 1(b) and 1(c)(ii) – pertaining to the exclusionary clauses of voting and participation rights – no such direct reference is made in the definitional requirements of the CFC. The use of the term “indirectly held” as one of the criteria for the determination of a CFC leaves much scope for contemplation – as to its exact meaning, since the Income Tax Act in Section 1 and Section 9D do not provide a definition of the term “indirectly held”, and whether the legislature intended to cover “connected persons” under the premise of the “indirectly held” presumption is not easily decipherable.

In addition, other considerations, considered as buttressing elements, need to be clearly and unambiguously incorporated into the South African CFC legislation – and not by allusion – so as to widen the net of the qualification criteria for foreign companies qualifying as CFCs. These buttressing elements which would constitute share ownership by spouses, children, partners of partnerships, shareholders of companies, beneficiaries with vested interest in a trust etc., are certain of the considerations that require visitation by South African legislators in order to overtly and unambiguously extend the net of the qualification criteria of CFCs. These supporting elements have become to be known, in international literature, as the constructive and attribution rules for the

purpose of attributing shares to individuals, non-vesting trusts, and company shareholders of foreign companies. (see 3.2.1.2 above).

Entity restriction: One of the key limitations of South Africa's CFC legislation is that it applies only to companies. Unlike the 1997 CFC legislation when South Africa first promulgated the anti-avoidance legislation, which applied to companies and trusts, the current legislation only applies to companies. From a tax neutrality perspective, it could be argued that it is unfair to shareholders of CFCs to be subject to a rigorous regime in the manifestation of CFC regulations, while foreign interest held by South African shareholders in foreign non-companies are not subject to such legalistic rigour that invokes immediate taxation of foreign income. Examples of foreign non-company types of investments include: trusts; partnerships; hybrid entities etc. Therefore, the taxing authorities need to have in place buttressing legislation to counter both the deferral and avoidance of taxation in respect of the above shortcomings. (see 3.2.1.1 above).

Limited liability partnerships: If a South African resident in collaboration with a United Kingdom resident incorporates a limited liability partnership (LLP) in the United Kingdom (providing it does not fulfil the definitional requirements of foreign partnership in the South African Tax Act), it is unclear whether South African CFC rules can be applied to tax the South African shareholder. It may be argued that since Section 1(b) of the definition of "company" in Section 1 of the Income Tax Act covers foreign companies, CFC rules could potentially apply to the LLP. But for CFC legislation to apply, it is a requirement that South African residents hold more than 50 per cent of the total participation or voting rights in the foreign company. Since the LLP has no shareholders or share capital, it is doubtful whether CFC legislation can be applied to South African members of the LLP. According to Oguttu "this anomalous situation could be manipulated to avoid taxes" and therefore requires legislative redressing (see 3.2.1.1 above). (Oguttu, 2007:211.)

Attribution arising from the conversion of voting rights to participation rights: A South African shareholder holding less than 10 per cent of shares in a foreign company and at the same time holding more than 50 per cent of the voting rights in the foreign company (arising from a significant loan granted to foreign company), will not be liable for attribution in terms of Section 9D(2), even though the foreign company will qualify as a CFC. In terms of the definition of participation rights in Section 9D(1)(b), that where no person has any right in a foreign company as contemplated in paragraph (a) or where no such rights may be determined for any person, then the right to exercise any voting right in the company becomes a participation right. Such a circumstance requires greater legislative clarity on the point of whether the shareholder should be subject to profit attribution (and, if so, to what extent) and the extent of the shareholders' obligations to SARS for submission of annual returns and related documentation (see 3.2.1.2 above).

Share fragmentation and the South African attribution rule: Proviso (A) to Section 9D(2) exonerates a South African CFC shareholder from CFC imputation (in terms of Section 9D(2)(a) and (b)) if the criterion in proviso (A) is fulfilled.

From a policy perspective, the less than 10 per cent attribution rule is an attempt to achieve equity or impartiality by the exclusion of minority shareholders with small interests in foreign companies from the scope of CFC attribution rule. While this may be desirable from a tax administration point of view, it constitutes a limitation of the rules, since deferral is not eliminated for all resident shareholders of CFCs. It also leads to inevitable tax planning opportunities as resident shareholders rearrange their activities or fragment their ownership interests in foreign companies to avoid the attribution of CFC income. A common occurrence of the above is in respect of widely-held share ownership of foreign mutual funds (in Section 1(e)(ii) of the definition of company) – resulting in such funds not being sufficiently controlled by South African resident shareholders so as to induce the operation of CFC rules (see 3.3.3 above).

Share fragmentation and buttressing legislation: The current proviso (A) to Section 9D(2) (see above) creates tax planning opportunities for resident shareholders to arrange their affairs so as to prevent attribution by circumventing the minimum threshold ownership requirements of CFC rules. Therefore, in a widely-held CFC in which South African shareholders hold less than a significant interest in the foreign company (being less than the 10 per cent of participation or voting rights), will result, inevitably, in the avoidance of CFC imputation. Arnold (1986:109) has noted that many countries have found it necessary to complement their CFC regimes by adopting foreign investment fund (FIF) rules to support their CFC regulations in situations where the CFC rules may not be applicable. Therefore, in a South African context, no such buttressing rules are presently in force to counter this type of tax avoidance. From a tax neutrality perspective, it is unfair to those South African shareholders who are currently subject to CFC regulations, while the less than 10 per cent shareholders of participation or voting rights of the CFC receive benefits that may go untaxed for several years until the foreign company declares a dividend. Further, with astute planning and careful tax manipulation a South African resident could invest in many foreign companies – holding investments in each company below the 10 per cent threshold limits (of participation or voting rights) – thus, deferring tax liability indefinitely until dividends are received. This could, indeed, come to be a costly denial of revenue to SARS.

Minimum share ownership as qualification criteria for CFC: With certain of the exceptions contained in the definition of the CFC as per Section 9D(1), the qualification criteria of a CFC does not entail a minimum threshold limit of, for example, in excess of 10 per cent or more, of qualifying shareholding that will be taken into account in respect of the 50 per cent or more participatory or voting rights in a

foreign company. Therefore, currently – in a South African context, all shareholders are taken into consideration for the purposes of determining a foreign company as a CFC. This rule could result in an anomalous situation, such as a CFC having one hundred shareholders – each having a single share – and no single shareholder is subject to attribution of CFC income. On the other hand, if there are, for example, two shareholders and each holding 10 per cent or more participation rights then they will accordingly be taxed on their proportionate share of the CFC income, while the remainder shareholders holding less than 10 per cent each will not be subject to taxation. From a tax neutrality perspective, especially from the capital export neutrality perspective, it will be considered unfair to the shareholders having a 10 per cent or more shareholding as they are subject to immediate taxation on their proportionate share of CFC income. Therefore, from a South African perspective, some form of buttressing legislation (see above) that needs to be in place in order that the less than 10 per cent shareholders of the CFC are subject to immediate South African taxation in respect of their CFC income – counteracting delays or deferral to the immediate taxation of foreign-earned income (see 3.2.1.2 and 3.3.3 above).

Change of shareholding in CFC: There is a need for legislative interpretation (or clarity) in respect of the apportionment of net income for shareholders of a CFC that have not held their shares in the CFC for the entire tax year arising from a change in the percentage shareholding of the shareholder of the CFC. Where the foreign company is a CFC for the entire tax year, the percentage holding by the South African shareholder at the end of the foreign tax year will be used as a basis for attribution, irrespective of the changes in shareholding during the year (Olivier & Honiball, 2011:573) (see 3.3.2 above).

The FBE exemption requirement: South Africa's CFC legislation is unique, in comparison to international practices of CFC regulations (serving as examples are the United Kingdom and the United States), in that it mainly grants its exemption to CFCs via the FBE criteria. To grant each FBE operating through a CFC the exemption afforded by Section 9D(9)(b) is an onerous task as each FBE unit has to be evaluated separately and each unit (FBE) has to accordingly fulfil the exemption criteria in order to be granted the exemption. The uniqueness of the South African FBE exemption is that individual units (known as foreign business establishments) are seen as independent components of the CFC, operating independently and at arm's length. Therefore, in essence, the exemption is not directly attributable to the CFC but to those individual units (FBEs) operating within the CFC, providing they fulfil the FBE requirement. The international practice is to grant the exemption directly to the CFC. Under the entity approach, if the CFC fails to fulfil the exemption criteria afforded by its legislation then the entire CFC income is subject to taxation. Under the transactional approach – specified types of passive income and foreign base company income are subject to taxation. The FBE criteria used in the South African legislation is closely aligned to the Permanent Establishment (PE)

criteria as expounded in Article 5 of the OECD and UN Model Tax Conventions. However, the use by South African taxing authorities of the FBE criteria to grant tax immunity to its South African-owned CFCs is unique by international standards, as the international practice is to use the PE criteria in order to grant taxing rights to foreign countries in respect of permanent establishments (branches) operating within their jurisdictions that are owned by foreign companies, providing the permanent establishment (branch) in question fulfils the PE criteria (OECD, 2010a: Article 7, para 1). Therefore, the South African tax legislators need to revisit the use of the FBE criteria in granting tax exemptions to CFCs set against international use of the permanent establishment criteria (see 3.4.4.1 above).

FBE to be treated as “distinct and separate enterprise”: The requirement of Section 9D(9)(b) that an FBE must be treated as a “distinct and separate enterprise” could have far-reaching implications in respect of the records to be maintained by a CFC, as the financial records of the CFC would not only need to be divided between those transactions and amounts which are attributable to the FBE, and those transactions and amounts which are not, but also the actual amounts themselves need to be evaluated against the “distinct and separate enterprise” test as between the FBE and the rest of the CFC. It is submitted that this area of the arm’s length principle is potentially subjective and should therefore be done within the framework of a sound and objectively justifiable transfer pricing policy. Further, should the amounts not be found to represent an arm’s length price, the fact that the FBE is required to be treated as “wholly independent” from the CFC itself would mean that in determining the net income of the CFC (being treated under the Section as wholly independent from the FBE) a resident taxpayer would be required to adjust “as between the FBE and the CFC” any difference between an arm’s length price and the actual agreed transaction price. I submit, therefore, that any such adjustment would be attributable to the CFC and would result in a different net income figure for the CFC, thus effectively neutralising the effect of any artificial manipulation of the transaction price in relation to the imputation of net income of the CFC concerned.

Taxation: The current 75 per cent high-taxed exemption serving as a proviso to Section 9D(2A) provides no relief from the multiple determinations which are required to arrive at the point of exemption. Limitations exist on setting off of CFC losses, with no relief given for subsidiaries – especially in the loss-generating developmental phase of their business life cycle or following a corporate acquisition, in which case, no grace period exists to meet exemption requirements. Restrictions also apply with regard to deductibility of certain expenses in relation to other CFCs and transfer pricing requirements may also introduce considerable uncertainty with respect to net income calculations, especially since there is no current advance pricing agreement mechanism under South African tax law to help residents achieve a higher level of certainty.

The paradox of the headquarter company regime being applied to South African resident indirect shareholders of CFCs: The requirement that a resident investor in a headquarter company has an indirect interest in any foreign subsidiary company of the headquarter company, to which normal CFC rules would apply if the foreign company falls within the CFC definition, places an onerous burden on South African resident investors in headquarter companies by virtue of the wording (directly or indirectly) in Section 9D(2) and the resulting application of Section 9D. Despite the qualification in proviso (B) to Section 9D(2) which grants South African resident shareholders of CFCs tax exemption in respect of any participation rights that are indirectly held by them through any company which is a resident (other than a headquarter company), the requirement undermines the financial interest of South African resident shareholders of CFCs. From a tax neutrality perspective, the above practice in the regulations is arguably unfair to South African resident shareholders of headquarter companies in that it shifts the burden of taxation in respect of CFC income from the headquarter company to South African resident shareholders under the guise of the “indirect shareholding” in the foreign company, which means that foreign shareholders in a headquarter company will carry no South African tax liability for the income of the CFC earned by the headquarter company, and could result in an undue tax burden on South African shareholders, creating liquidity problems.

South Africa’s CFC legislation and its treaties: The issue of the compatibility of CFC legislation and tax treaties has not received adequate attention in South Africa. This is notwithstanding the fact that South Africa, under its CFC legislation, taxes its residents on notional amounts – in line with the *Bricom Holdings Ltd v IRC* (United Kingdom, 1997) case which determined that the compatibility of South Africa’s CFC legislation and its tax treaties is not a settled matter. If the conflict is not resolved, “South Africans may be faced with a litany of court cases that challenges the applicability of its CFC legislation in a particular treaty situation” (Oguttu, 2007:240).

Compliance costs: In designing and instituting CFC rules, not only should corporate tax rates be taken into consideration but also the compliance costs. The compliance costs that flow from over-complicated legislation should be weighed against the direct and indirect revenue derived from taxing foreign entities. The tax legislators should also review their policy in respect of instituting regular legislative amendments to South Africa’s CFC legislation, as this could prove costly to both SARS and taxpayers in terms of training and administration costs to keep abreast with the legislative changes.

Official publications of Section 9D: The convoluted state of South Africa’s CFC legislation requires some form of regular official publication which should be simplified and accessible to interested persons, in order that they be given the opportunity of acquainting themselves with the legislation, thus exploring the rationale and operation of Section 9D. It also bears mentioning that National

Treasury issued its first and only published comprehensive document on Section 9D as far back as June 2002 (South Africa, 2002a). It is submitted that given the extensive changes to Section 9D since the first publication by National Treasury, it would be appropriate if regular detailed publications were made available reflecting these changes in the legislation.

This chapter having outlined the operation, effects and consequences of South Africa's CFC legislation, an international comparative perspective is presented in the next three chapters, beginning (in Chapter 4) with discussion of the OECD and UN Model Tax Conventions.

Chapter 4

SOUTH AFRICAN CFC LEGISLATION IN RELATION TO OECD AND UN MODEL TAX CONVENTIONS

4.1 Introduction

This chapter compares the interpretations of key elements in the South African CFC legislation with corresponding interpretations of these in both the OECD and the UN Model Tax Conventions, seeking to determine the extent to which key concepts in the South African CFC legislation conform to, diverge from, or fall short of the interpretations provided in the OECD and United Nations Model Tax Conventions (secondary objective of thesis as in chapter 1.6).

The concepts selected for detailed assessment and comparison are the following: “resident”, “place of effective management”, “permanent establishment”, “foreign business establishment”, “business profits” and “transfer pricing” in Section 9D of South Africa’s CFC Tax legislation and in the respective articles of the OECD and UN Model Tax Conventions on Income and on Capital.

These concepts are each significant in their own right, and their inclusion for comparison here, while hopefully shedding light on the positioning of South Africa’s approaches vis-à-vis international or bilateral conventions, does not necessarily imply divergence in the respective South African and international interpretations ascribed to them.

These key determinants of residence, place of effective management and permanent establishment are important concepts for the determination of business profits in the context of a permanent establishment and for the regulation of transfer pricing policies in a multinational group context. Other concepts (such as dividends, interest, rents, royalties etc.) found in both the South African CFC legislation and in the OECD and UN Model Tax Conventions have not been included in the study as they have less significance in determining the taxing rights of countries in a double-taxation agreement, and the meanings ascribed to them in the South African CFC regulations and in the OECD and UN Model Tax Conventions are sufficiently similar to eliminate the need to investigate them in the present study.

With the rapid rise in globalisation and a significant increase in cross-border transactions between countries, there is a clear necessity for some form of international convention that would eradicate double taxation and facilitate international trading between countries (Ware & Roper, 2001:119-120). The articles of the OECD and UN Model Tax Conventions provide us with a set of regulations that are to be used as the basis in bilateral treaties or conventions between contracting countries. The

objective of this chapter, therefore, is to examine the similarities or differences in the meanings ascribed to these selected key concepts in the South African regulations, and in an international context, as reflected in the respective articles of the OECD and UN Model Tax Conventions.

This chapter will also incorporate a discussion of the UN Model Tax Convention on Income and on Capital and its related commentaries, in respect of the above-mentioned concepts, and especially where it differs from the OECD Model Tax Convention. In an attempt to address “the main criticism against the OECD Model Treaty that it is aimed at protecting the interest of capital-exporting countries above those of capital importing countries”, the United Nations in 1980 published its own Model Tax Treaty (Olivier, 2002:868). The criticism levelled against the OECD Model Tax Convention was based on the premise that the source country is often required to give up its taxing rights, and this had an “adverse impact on developing countries, which are almost all, by definition, net capital importers” (Olivier, 2002:868). Currently, many of the provisions contained in the UN Model Treaty are identical or very similar to those of the OECD Model Treaty except for the fact that the UN Model Tax Treaty imposes lesser restrictions on the source country’s right to tax.

An understanding of the extent to which Section 9D, in close conjunction with the other relevant Sections of the South African Income Tax Act, and the articles of the OECD and UN Model Tax Conventions on Income and on Capital, relate to one another in respect of their interpretations to the above-mentioned concepts, is crucial for the framing and/or implementation of bilateral treaties between South Africa and other countries, so that material anomalies or deficiencies in the South African interpretations of these selected concepts can be identified and attended to. The aim of this chapter is therefore to highlight material anomalies and discrepancies in respect of certain key concepts in the South African tax regulations, and where appropriate, to make recommendations (set out in the concluding chapter of the thesis).

The South African interpretation of these key concepts will be analysed chiefly in relation to the formulations contained in the Income Tax Act, read in conjunction with Interpretation Note No. 6 and Practice Note No. 7 (a new Practice Note is, however, currently being redrafted and is to replace Practice Note No. 7, in response to the promulgation of the new Section 31) (see 4.5.2.1 below), along with various other contemporary publications. Discussions of the OECD and UN interpretations will, mainly, be in relation to the formulations contained in the OECD (2010) and the UN (2011) Model Tax Conventions on Income and on Capital and their related commentaries, the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2010), and other pertinent information contained in contemporary international publications.

4.2 “Resident” and “place of effective management”

Table 4-1 “Resident” and “place of effective management”

Subject	RSA Tax on Income	OECD Model Tax Convention	UN Model Tax Convention
Definition of resident	Sect. 1 – SA Act No. 58 of 1962 (see 4.2.2)	Article 4(1) (see 4.2.1)	Article 4(1) (see 4.2.1)
Definition of natural persons	Sect. 1 (see 4.2.2.2)	Article 4(1) (see 4.2.1.1)	Article 4(1) (see 4.2.1.1)
Definition other than natural persons	Sect. 1 (see 4.2.2.2 & 4.2.2.3)	Article 4(1) (see 4.2.1.2)	Article 4(1) (see 4.2.1.2)
Residence-residence conflict (tie-breaker) –natural persons	Refers to Article 4(2) OECD and UN MTCs and SARS <i>Interpretation Note 3</i> (see 4.2.2.2)	Article 4(2) (see 4.2.1.1)	Article 4(2) (see 4.2.1.1)
Residence-residence conflict (tie-breaker) –other than natural persons	Sect. 1 – guided by SARS <i>Interpretation Note 6</i> (see 4.2.2.3 & 4.2.2.4)	Article 4(3) (see 4.2.1.2)	Article 4(3) (see 4.2.1.2)

Author

4.2.1 “Resident” and “place of effective management” in Art 4 of the OECD Model Tax Treaty

The OECD Model Tax Treaty is used as a guideline for the drafting of double-taxation conventions, including those entered into by South Africa. It is therefore important to review the provisions of the OECD Model Tax Treaty in respect of Article 4, so as to obtain an understanding of the term “resident of a Contracting State” and the term “place of effective management” as used in double-taxation agreements. Article 4(1) of the OECD Model Tax Treaty defines the term “resident of a Contracting State” as “any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof”. The definition of the term “resident of a Contracting State” in Article 4(1) of the UN Model Tax Treaty is similar to the definition of a “resident of a Contracting State” in Article 4(1) of the OECD Model Tax Treaty, except that the definition of the term in the UN Model Tax Treaty also includes place of incorporation. (OECD, 2010a:art 4 para 1; United Nations, 2011:art 4 para 1.)

4.2.1.1 OECD Tax Model: resident (individuals)

Article 4(2) relates to the case where, under the provisions of paragraph 1, an individual is a resident of both Contracting States. The provisions of Article 4(2) set out the so-called tie-break rules for

natural persons. These rules come into effect when there are residence-residence conflicts because an individual is considered a resident of more than one state. A double tax conflict would normally occur when the countries involved use divergent tests to determine the residency of a natural person for income tax purposes. In establishing a solution to the conflict of residence, in the case of an individual, Article 4(2) lays down the following guidelines:

The individual shall be deemed to be a resident of the State in which he has a permanent home available to him. A permanent home is any form of accommodation which is continuously available to a resident for his personal use. It does not necessarily need to be owned by the resident. A property which is temporarily let out will not be a permanent home, as it would not continuously be available to either the lessee or the lessor. If a permanent home is available in both States then one should move on to the next test. (OECD, 2010b:art 4 para 12.)

If a permanent home is available in both States, the individual is deemed to be a resident of the State with which his personal and economic relations are closer (centre of vital interests). The concept of “personal and economic relations” is a wide expression intended to cover the full range of social, domestic, financial, political and cultural links. Considerations based on the resident’s personal acts are given special importance. The fact that somebody has moved to South Africa, but still retains in the foreign State a home and family possessions, are important considerations in the determination of residency for such a person (OECD, 2010b:art 4 para 15). In the absence of the foregoing the individual is deemed to be a resident of the State in which he has a habitual abode. This concept means the State in which the resident stays more frequently over a reasonable period. The comparison should be made over a sufficient length of time to determine whether residence has become habitual (OECD, 2010b:art 4 para 19).

If, on the other hand, the individual has a habitual abode in both States or in neither of them, he is deemed to be a resident only of the State of which he is a national (OECD, 2010a:art 4 para 2(c)). And if the individual is a national of both States or neither of them, the competent authorities of the Contracting States are to settle the question by mutual agreement (OECD, 2010a:art 4 para 2(d)).

Article 4(2) of the UN Model Tax Treaty is similar to Article 4(2) of the OECD Model Tax Treaty in respect of a residence-residence conflict for the determination of residency of a natural person for income tax purposes (United Nations, 2011:art 4 para 2).

4.2.1.2 OECD Model Tax Convention: defining “resident” and “place of effective management”

Article 4(3) of the OECD Model Tax Convention lays down the guideline for the so-called tie-breaker rules to apply to a person other than an individual. This provision of Article 4(3) comes into effect when there are residence-residence conflicts. Residence-residence conflicts arise when a person other

than an individual is a resident of more than one country, because the countries concerned have divergent or differing domestic tax legislations in place to determine residence. For example, if a company is incorporated in a country that regards the test for residence as being the place of incorporation, and is managed and controlled in a country which stipulates that a company is resident where it is managed and controlled. (Olivier & Honiball, 2011:37.)

In these cases both countries may tax the entire income. The provisions of Article 4(3) attempts to fix residence in one or the other of the States. For a person other than an individual, that is a resident of both Contracting States, Article 4(3) of the OECD Model Tax Convention deems that person “to be a resident only of the State in which its “place of effective management” is situated” (OECD, 2010a:art 4 para 3). The requirement for the place of effective management in Article 4(3) of the UN Model Tax Treaty is similar to the requirement of Article 4(3) of the OECD Model Tax Treaty (United Nations, 2011:art 4 para 3). Although the term “place of effective management” is not defined in Article 4(1) of the OECD Model Tax Convention, the following amended paragraph 24 in the Commentary on Article 4, offers some guidance on the meaning of this term, and reinforcing the point that the place of effective management is a question of fact, and is therefore to be determined by the circumstances of each particular case:

As a result of these considerations, the “place of effective management” has been adopted as the preference criterion for persons other than individuals. The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity’s business as a whole are in substance made. All relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one place of management, but it can have only one place of effective management at any one time. (OECD, 2010b:art 4 para 24.)

In *Indofood International Finance Ltd v JP Morgan Chase Bank United Kingdom* (United Kingdom, 2006b) it was held that “place of effective management” referred to the place where the key management and commercial decisions that are necessary for the conduct of the entity’s business, are in substance made. It was found not to be sufficient for declaring a place as the place of effective management if merely the directors who make the decisions regarding the keeping of books, management of the audit, handling charges and how to utilise equity capital reside within a Contracting State. (Olivier & Honiball, 2008:80.)

Vogel (1997:262) comments as follows on the continental approach by Germany with respect to the place of management:

According to this case law, the place of management of an enterprise is where the management’s important policies are actually made.... What is decisive is not the place

where the management directives take effect but rather the place where they are given. According to consistent case law,... the centre of management activities of a company generally is the place at which the person authorized to represent the company carries on his business managing activities. A place from which a business is merely supervised would not qualify. If the commercial and the non-commercial side of a business are managed at different places, the location of commercial management will be controlling. If the place of effective management cannot be determined by application of these criteria, the top manager's residence will regularly determine the residence of the company.

4.2.1.3 OECD Discussion Draft: suggested changes to "place of effective management" concept

Inconsistent interpretations by different countries of the term *place of effective management*, coupled with the absence of a defined common term in double-taxation agreements entered between countries, resulted in either double taxation or, in some instances, no taxation at all. To address this problem, in May 2003 the OECD publicly released for comments a discussion draft entitled "Place of Effective Management Concept: Suggestions for Changes to the OECD Model Tax Convention". This discussion draft discusses two alternative proposals that were developed by the Technical Advisory Group (TAG). The first proposal "refined" the concept of place of effective management, "by expanding the Commentary explanations as to how the concept should be interpreted". The second proposal introduced the "Hierarchy of tests", including commentary thereon, which is an "alternative version of paragraph 3 of Article 4 of the Model Tax Convention" (being the tie-breaker rule for persons other than individuals). The second proposal "[in] itself [included] three different options as regards a possible second tie-breaker test" (OECD, 2003:1). The place of effective management test, however, will still remain the first test to determine the residency of a company.

Hierarchy of tests: This entails the application of four different rules that apply in succession to resolve the dual-residence conflict, the same approach used in the case of individuals. "Three different options have been offered as regards the second rule that would apply if the situation could not be solved through the place of effective management test" (OECD, 2003:2). These proposed tests are:

- a) where a person is resident in both Contracting States, the entity is deemed to be resident in the Contracting State in which it has its place of effective management;
- b) where the place of effective management cannot be determined or where it is situated in neither of the Contracting States, the entity shall be resident in the State in which it has the closest economic relationships (Option A) or in which its business activities are primarily carried on (Option B) or the State in which its senior business executive decisions are taken (Option C);
- c) if the State [with which its economic relations are closer] [in which its business activities are primarily carried on] [in which its senior executive decisions are primarily taken] cannot be determined, it shall be deemed to be a resident of the State from the laws of which it derives its legal status;

- d) where it derives its legal status from both States or from neither of the States or its legal status cannot be determined, its residency should be settled by the competent authorities of the Contracting States by mutual agreement. (OECD, 2003:3.)

This follows with an abridged version of certain key particularities contained in the discussion draft pertaining to the following options (Option A, B, and C)

Option A – The application of this test will involve examining various factors, such as in which State the entity has most of its employees and assets, carries on most of its activities, derives most of its revenues, has its headquarters, carries on most of its senior management functions or from which State the entity derives its legal status. If an examination of these and other relevant factors taken as a whole clearly shows that the entity is more economically related to one State than to the other, then it will be considered to be a resident only of that State.

Option B – In these cases subparagraph b) gives preference to the State in which the entity’s business activities are primarily carried on. This will require determining, on the basis of a functional analysis of the activities performed by the entity in the two Contracting States, in which of these two States the functions performed by the entity are clearly the most important. Goosen (2006:23-24) comments that “this option is a narrower test than Option A and one that is capable of objective determination”, although little guidance is given “as to the method of measurement of the relative value of business functions carried out in different countries”] (OECD, 2003:5).

Option C – In these cases subparagraph b) gives preference to the State in which the entity’s senior executive decisions are primarily taken. This will require determining from which country the clear majority of senior executive decisions (e.g. the decisions of executive officers such as the president, vice-presidents, treasurer, etc.) are taken. This will usually be the State in which the headquarters of the entity are located, to the extent that they are primarily located in one State. For that purpose, the headquarters would be where one would expect to find the senior executives in charge of the business of the entity. (OECD, 2003:5-6.)

According to Van der Merwe, owing to modern technology, “management has become much more mobile and traditional places of effective management may rotate”; technology has, furthermore, made it possible to manage without the requirement for a “group of persons to be physically located or to meet in one place, for [example] at the company’s headquarters.” As a result “of these changed management structures and technology, effective management, based on where the directors meet, becomes a matter of choice and manipulation” (Van der Merwe, 2006: 124). Even when based on a broader interpretation “of key management and decision making”, it is acknowledged that “technology makes it difficult to pin effective management down to one constant or [single] location”,

and this could result in more than one residence or, perhaps, in even non-residence status, arising from these technological advancements (2006:124-25).

According to the OECD Working Party, the dual residence of legal persons, encountered in practice, did not justify substituting the present concept of place of effective management with the “approach based on a hierarchy of tests” that was put forward in the discussion draft (May, 2003) (OECD, 2008: 7).

4.2.2 The term “resident” in South African CFC Legislation

4.2.2.1 Income falling within the jurisdiction of South African Tax Law

The South African taxation system presently operates under a residence basis of taxation and all income (irrespective of source or territorial limitation) is accordingly included as “gross income”, in the computation of taxable income in respect of all South African resident taxpayers. The specific interpretation of the term “resident” in taxation terminology is a matter that we shall come to in due course; at this point it suffices to caution that the term does not necessarily have the same meaning as in more general contexts.

For an amount to be imputed under South African income tax legislation, it must satisfy the statutory requirements of Gross Income as defined in Section 1 of the Income Tax Act, where “Gross Income” is defined as

- i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or
- ii) in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within or deemed to be within the Republic. (Section 1)

The two criteria that come into play for income to be attributed as gross income within the jurisdiction of South African Income Tax law are therefore either (a) to be resident, or (b) for non-residents, income from a source within or deemed to be within the Republic. “Residence” and “source principles” are thus both key concepts that need to be understood in applying the provisions of the gross income definition, which leads us to note that the source basis of taxation does, nonetheless, still persist in South African tax law in that non-residents are taxed on all income received by them or accruing to them from a South African source or deemed South African source. The following sections will therefore discuss the term “resident” from a South African perspective in relation to: (a) individuals (natural persons); (b) persons other than natural persons.

4.2.2.2 Definition of “resident” in terms of Income Tax Act, No. 58 of 1962 (as amended)

For Section 9D of the South African Income Tax Act to be applicable for purposes of attribution, the participating shareholder has to qualify as a South African “resident”, as defined. This Section sets out the principles that need to be fulfilled for a person to qualify as a South African resident for taxation purposes. It commences with the requirement that needs to be in place for an individual (natural person) to qualify as a South African resident. This is followed by the requirements that need to be fulfilled for a person (other than natural person) to qualify as a South African resident taxpayer. South African tax legislation thus draws a distinction between natural persons and incorporated associations for South African income tax purposes. Natural persons could therefore qualify as residents if they fulfil either one of the following two categories: ordinarily resident and physical presence test (see below).

Ordinarily resident test – natural persons: The determination of the term “ordinarily resident” has not been without problems in the context of South African taxation. A person who is ordinarily resident in South Africa is regarded as a resident for taxation purposes, but the South African Income Tax Act does not define the term, and the interpretation given by the courts will therefore play an important role in establishing its interpretation.

The leading Canadian case is *Thomson v. Minister of National Revenue*, 2 DTC 812, [1946] SCR 209 in which it was held that a person is ordinarily resident in the place “where in the settled routine of his life he regularly, normally or customarily lives” or “at which he in mind and in fact settles into or maintains or centralises his ordinary mode of living with its accessories in social relations, interest and conveniences” (Huxham & Haupt, 2009:22).

In South Africa, the court held in *Cohen v CIR* (South Africa, 1946b) that “ordinarily resident” refers to “the country to which he would naturally as a matter of fact return from his wanderings, as contrasted with other lands, it might be called his usual or principal residence and would be described more aptly than other countries as his real home.” This approach was confirmed in *CIR v Kuttel* (South Africa, 1992) (Emslie et al., 2008:157-166).

The South African *Interpretation Note 3* makes it clear that, “the question whether a person is ordinarily resident in a country is one of fact and each case must be decided on its own facts having regard to principles already established by case law, meanings expressed in the text books, etc.” (South Africa, 2002c:4). *Interpretation Note 3* reaffirms the view that “the circumstances of the person must be examined as a whole and the personal acts of the individual must receive special attention” (South Africa, 2002c:5).

Physical presence test – natural persons: The so-called “physical presence” test (the 91 day/915 day test) only applies if an individual was not at any time during the tax year ordinarily resident in South Africa. Consequently, the physical presence test cannot apply in a tax year during which an individual takes up ordinary residence in South Africa or ceases to be ordinarily resident in South Africa. Under this test a person who has spent more than 91 days in aggregate in the current year and in each of the previous 5 years plus more than 915 days in aggregate during the previous 5 years, will become a tax resident for the first day of the sixth year. Physical presence for part of a day will count as a full day (Section 1 of the Income Tax Act, No. 58 of 1962). (Olivier & Honiball, 2011:52.)

Residence under the physical presence test ends retrospectively when an individual is physically absent from South Africa for a period or periods exceeding 330 days in aggregate during the 12 month period after which he or she ceases to be physically present in South Africa. A person is then regarded as being a non-resident from the date on which he or she ceased to be physically present in South Africa. Consequently, this could occur at any time during the tax year (Section 1 of the Income Tax Act No. 58 of 1962) (Olivier & Honiball, 2011:52-53).

Companies: Limiting discussion to the situation as it affects companies, a company will have its place of residence in South Africa if it meets either one of the following two requirements:

- the company is incorporated, established or formed in South Africa, or
- it has its place of effective management in South Africa. (Section 1 of Act No. 58 of 1962)

The inclusion of these alternatives notably widens the definition of residence in the case of companies; this means, for example, that a company which is incorporated in South Africa is a resident irrespective of where its place of effective management is and, conversely, a company which has its place of effective management in South Africa is a resident irrespective of where it is incorporated or established except for “High-Taxed Controlled Foreign Companies” (Haupt, 2013:29) (see below).

The place of incorporation or establishment in South Africa is a question of fact and should not give rise to any confusion. As Brincker *et al.* observe, once a company is incorporated, established or formed in South Africa, the company will be regarded as being a South African resident “until the termination of its corporate personality, even if it has long since left South African shores” – adding the caution that “although the place of incorporation test provides simplicity and certainty to both [tax collectors] and taxpayers, it is [also] easy to manipulate”. However, if a company is incorporated outside South Africa, “its South African residence may change from year to year”, depending on where the company has its place of effective management. (Brincker et al., 2004: 18.)

Relief from the effective management test in the case of high-taxed CFCs: The Explanatory Memorandum on the Taxation Laws Amendment Bill, 2012, to eliminate the potential for double taxation, proposed that the “place of effective management test” for residency be eliminated in the case of South African-owned foreign subsidiaries if: (a) the subsidiary is highly taxed, and (b) the subsidiary has a foreign business establishment. Little is at risk for the South African fiscus in these circumstances because the South African tax liability should be largely eliminated by tax rebates (South Africa, 2012:119). Accordingly, “no ... rationale exists for taxing controlled foreign subsidiary income under the effective management test if the income from that foreign subsidiary is otherwise specifically excluded from the controlled foreign company (CFC) regime” (South Africa, 2012:119).

The effective management test for company residency will therefore be waived if the following three conditions are satisfied:

- the foreign incorporated company qualifies as a controlled foreign company (determined without regard to the effective management test);
- the foreign company has a foreign business establishment during the year of assessment; and
- the foreign company is subject to a high level of tax (an aggregate effective rate of 75 per cent of the South African rate that would otherwise be imposed) during the relevant year of assessment. For purposes of this 75 per cent threshold, foreign taxes on income imposed by all foreign spheres of government (national, provincial and local) must be taken into account. The calculation of the aggregate effective rate also takes into account all income tax treaties, rebates, credits or other rights of recovery. Lastly, the rate is calculated after disregarding carryover losses as well as group losses.
- The proposed effective management test exemption will be determined and will apply on an entity basis. Stated differently, this relief applies to all of the company’s income (i.e. not merely the high-taxed portions nor merely the business establishment portions). (South Africa, 2012:119-120.)

4.2.2.3 “Place of effective management” in terms of Income Tax Act.

Section 1 of the South African Income Tax Act does not provide any definition of “place of effective management”, which is one of the alternative requirements currently in force for determining the residency of South African companies. At the outset it is important to note that a CFC which has its place of effective management located in South Africa is a South African company, and should not fall within the taxing jurisdiction of Section 9D unless for years of assessment commencing on or after 1 January 2013; the definition of “resident” excludes a foreign company that qualifies as a high-taxed CFC (Section 1).

Van der Merwe expresses some reservation as to the interpretation of what constitutes a place of effective management. He comments that

a “place of effective management” is a less artificial measure used by many countries worldwide to decide entity residence for tax purposes. The test is, [therefore], one of substance over form. It is also commonly [used] in international double- tax agreements as a dual-residence tie-breaker rule (2006: 122).

The Katz Commission recommended in its fifth interim report in 1997 “that the concept of effective management as referred to in Article 4(3) of the OECD Model Tax Convention be used consistently to designate the tax residence of persons other than natural persons” (Katz Commission, 1997:para 6.1.2.1). On the recommendation of the Katz Commission, the Revenue Laws Amendment Act 59 of 2000 introduced the definition of “resident” into Section 1 of the Income Tax Act, and the term “place of effective management” was incorporated into to this definition.

The Income Tax Act, however, does not define the term place of effective management. The ordinary meaning of the words, taking into account international precedent and interpretation will therefore assist in ascribing a meaning to the term. The term *effective management* or *effectively managed* is used by various countries throughout the world, as well as by the Organisation for Economic Co-operation and Development in its publications and documentations (OECD). This term, however, does not have a universal meaning. The various countries and members of the OECD have attached different meanings to it (South Africa, 2002d: 1).

According to Goosen (2006: 9), “these differences in interpretation” that are attached to the concept of place of effective management could “have a huge impact on the tax liabilities of an international company”, especially with regard to double taxation. To pursue this question further, the next matter for consideration is *Interpretation Note 6*, issued by the South African Revenue Services on the 26 March 2002 (South Africa, 2002d).

4.2.2.4 “Place of effective management” in terms of *Interpretation Note No. 6*.

The place of effective management concept has been extensively reviewed by Van der Merwe, who notes that “there is no South African case law guiding our own interpretation of the phrase place of effective management” (Van der Merwe, 2006:122), but further clarification on determination of the place of effective management has been provided by SARS in its *Interpretation Note No. 6* (dated 26 March 2002), which sets out its own interpretation of the term.

The phrase ‘place of effective management’ is not [adequately or] comprehensively defined and SARS chose to advance their interpretation by providing a General Approach, assisted by an introduction, practical application and non-exhaustive list of relevant facts and circumstances (Van der Merwe, 2006: 122).

The introduction of “place of effective management” by the Revenue Laws Amendment Act 59 of 2000, as one of the tests to determine the residency of a person, other than a natural person, brought about a more uniform approach in the Income Tax Act and replaced the “inconsistent use of the concepts [such as] ‘managed and controlled’, ‘managed or controlled’ and ‘effectively managed’” (South Africa, 2002d:1). In terms of *Interpretation Note 6*, when determining the place of effective management one should keep in mind the possibility of distinguishing between the following three important locations:

- the place where central management and control is carried out by a board of directors;
- the place where executive directors or senior management execute and implement the policy and strategic decisions made by the board of directors and make and implement day-to-day/regular or operational management and business activities;
- the place where the day-to-day business activities are carried out/conducted. (South Africa, 2002d.)

In his review of SARS *Interpretation Note 6*, Van der Merwe (2006: 122) associates “residence” with the “place where central policy and strategic decisions, or in other words, the entity’s group vision and objectives are *implemented*”. As he explains it, this “is a lower level of management and has been described as the ‘management of the business’ of an entity and not the management of the entity”.

Interpretation Note 6 outlines both a general approach and a practical application in its interpretation of the place of effective management:

General Approach

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

Management by these directors or senior managers refer to the execution and implementation of policy and strategy decisions made by the board of directors. It can also be referred to as the place of implementation of the entity’s overall group vision and objectives.

Management structures, reporting lines and responsibilities vary from entity to entity, depending on the requirements of the entity, and no hard and fast rules exist. It is therefore not possible to lay down absolute guidelines in this regard. (South Africa, 2002d:3.)

Practical application

If these management functions are executed at a single location, that location will be the place of effective management. This location might or might not correspond with the place from where the day-to-day business operations/activities are actually conducted from/carried out.

If these management functions are not executed at a single location due to the fact that directors or senior managers manage via distance communication (e.g., telephone, internet, video conferencing, etc.) the view is held that the place of effective management would best be reflected where the day-to-day operational management and commercial decisions taken by the senior managers are actually implemented, in other words, the place where the business operations/activities are actually carried out or conducted.

If the nature of the person, other than a natural person, is such that the business operations/activities are conducted from various locations, one needs to determine the place with the strongest economic nexus. (South Africa, 2002d:4.)

Expanding on the implications of *Interpretation Note 6*, Van der Merwe notes that since “the phrase “place of effective management” is not comprehensively defined” in South Africa, SARS decided to furnish us with “their [own] interpretation by providing a *General Approach*, assisted by an introduction, practical application and a non-exhaustive list of relevant facts and circumstances”. In terms of SARS’s *General Approach*, “effective management” is vested in the regular day-to-day management by directors or senior managers of the entity’s operations through the implementation of the policy and strategic decisions of its board of directors. (Van der Merwe, 2006:122.)

In Van der Merwe’s understanding of SARS’s *General Approach*, “the location of the first level of management activity – central management and control as exercised by the board of directors – does not play a decisive role in determining South African entity residence.” More significant, he indicates, is the second level of management, namely, “the implementation, by executive directors and senior management, of policy and strategic decisions made by the board of directors and the making and implementation of regular, day-to-day operational management and business activities.” It is primarily the “location of this level of management that will determine South African entity residence” (Van der Merwe:126). Included here would be “the execution and implementation of the board’s policy decisions and ... the making and implementation of regular, daily operational management and business decisions” (2006:126). A third distinction refers to “the place where the actual, day-to-day business activities are carried out or conducted”. This may “correspond with the place where the second level management functions are carried out or conducted from” (2006:127).

In the general approach taken in *Interpretation Note 6*, to the practical location of the place of effective management, an “interesting mix of [alternatives] is proposed” (Van der Merwe, 2006:126). Firstly, there is the refinement of the place of effective management test. Secondly, *Interpretation*

Note 6 provides “alternative measures, similar to a tie-breaker rule in the OECD Model, should the test of effective management fail to provide a clear allocation of single residence.” What the practical application effectively does “is clearly to provide a single place of effective management, and consequently a single residence, within a particular tax year” (2006:127).

In terms of its practical application, when “business operations or activities are conducted from various locations [then] one will need to determine the place with the strongest economic nexus”. The Interpretation Note neither explains the meaning of the phrase ‘economic nexus’ nor does it provide any guidelines in this respect (Van der Merwe, 2006:126-129). According to Van der Merwe, “it is not a new invention and, depending on the context and meaning attached to it, it may have had its origin in the theory of economic allegiance” (2006:129). It was also recently referred to by the OECD “as a possible alternative for the replacement of effective management or as one element in a hierarchy of tie-breaker tests”.

In the SARS general approach, the following example illustrates what constitutes “implementation” in terms of *Interpretation Note 6*:

In certain cases this may be obvious, in others less so. For example, a decision is taken locally by a company director resident in South Africa to raise finance from a foreign bank. A phone call is made by the South African resident director while based locally to arrange for the finance. However, the director flies [abroad] to sign the finance agreement. The question arises as to whether this transaction was ‘implemented’ locally or overseas. Generally, the most obvious way to avert any doubt in this regard would be for all of these decisions and actions to be taken and implemented overseas and for all relevant documentation (for example, board resolutions) to reflect this (Olivier & Honiball, 2011:26-27).

As there are generally no acceptable set of rules that could be laid down when determining the place of effective management, it is a requirement that each case should be examined on its own merit, and in close conjunction with the existing set of facts. The type of entity, management structures, reporting lines, and responsibilities, must be taken into consideration, as this may differ from company to company.

Olivier and Honiball go on to note that

the place where the board of directors or trustees convene meetings is only one of the factors that will be taken into account and would certainly not be the deciding factor. Ultimately, this will turn on a question of fact as to whether these directors or trustees are in fact the decision-makers and implementers or whether they are simply men of straw or persons who rubber-stamp the decisions of the real decision makers, for example, the shareholders (2011:26).

Another possible case, on which *Interpretation Note 6* is silent, is what the situation would be if there is no day-to-day management of the company. According to Goosen, “the day-to-day management will then shift to management and control”. The term *management and control* “refers to the place where the board of directors convene meetings and [make] important decisions, which is not necessarily the place where the decisions are implemented [or exercised]”. (2006: 15.)

Interpretation Note 6 raises a further question as to whether South African courts are obliged to follow an Interpretation Note. “It is settled [and acceptable in] law that Practice Notes or Interpretation Notes are not law”. This was reinforced in ITC 1675 62 SATC 219 (South Africa, 2000b), where the representative of the Commissioner “went so far as to argue that ... SARS is not bound by its own Practice Notes” (Olivier & Honiball, 2008:82). This principle was confirmed by the Appellate Division (now the Supreme Court of Appeal) in CIR v Downing (South Africa, 1975). The Appellate Division (in CIR v Downing) upheld the decision of the lower court that used the OECD Commentary as an aid for its interpretation. Furthermore, in ITC 1503 53 SATC 342 (South Africa, 1990) the “application of the treaty according to the [OECD] commentary was subject to the court’s agreement, [and] that [which] was tacitly given” (Clegg, 2008:60). In a treaty context, South Africa is bound to take cognizance of the guidelines and interpretation issued by the OECD in its commentaries and other related documentations. This is reinforced in Section 232 of the South African constitution, which states that our courts are bound to apply customary international law rules and practices (Olivier & Honiball, 2008:82).

4.2.2.5 Controlled foreign entity

Section 9D of the Income Tax Act, a key consideration in this study, is an anti-avoidance provision that relates to CFCs, and the concepts of residence and place of effective management thus far discussed are important considerations for determining the residence of a foreign company.

A foreign company that has its place of effective management in South Africa and does not qualify as a “high-taxed CFC” is regarded as a resident in terms of Section 1 of the Income Tax Act and is therefore subject to income tax on its worldwide income. This type of a company will, however, not qualify as a “controlled foreign entity”, as defined in s 9D(1) of the Income Tax Act, in relation to another resident (South Africa, 2002d:5) (see 4.2.2.2 and 4.2.2.3 above).

4.2.3 Comparison: “Resident” and “place of effective management” in South African CFC legislation and in the OECD and UN Model Tax Conventions

Table 4-2 “Resident” & “place of effective management”: SA & OECD/UN compared

Subject	RSA tax on income	OECD Model Tax Convention	UN Model Tax Convention	Comment
Definition of <i>residence</i>	Sect. 1 – Act No. 58 of 1962 (see 4.2.2.2)	Article 4(1) (see 4.2.1.1)	Article 4(1) (see 4.2.1.1)	Holistic definition includes natural and persons other than natural
Definition of <i>natural persons</i>	“Ordinarily resident” and “physical presence” test (Sect. 1) (see 4.2.2.2)	Domestic law to determine resident – if he or she is liable to tax. (Article 4(1)) (see 4.2.1.1)	Domestic law to determine resident – if he or she is liable to tax. (Article 4(1)) (see 4.2.1.1)	OECD and UN MTCs similar requirement (see 4.2.3.1)
Definition of <i>other than natural persons</i>	Incorporated and established or place of effective management (Sect. 1) (see 4.2.2.2 & 4.2.2.3)	Domestic law to determine resident – place of management or other criterion – if it is liable to tax Article 4(1) (see 4.2.1.2)	Domestic law to determine resident – place of management or other criterion – if it is liable to tax Article 4(1) (see 4.2.1.2)	South Africa and OECD and UN MTCs seem to be similar (see 4.2.3.2)
Residence-residence conflict (tie-breaker) – natural persons	No specific domestic legislation – refers to Article 4(2) OECD and UN MTCs and SARS <i>Interpretation Note 3</i> (see 4.2.2.2)	To overcome conflict, tie-breaker clause in Article 4(2) of OECD MTCs becomes operative (see 4.2.1.1)	To overcome conflict, tie-breaker clause in Article 4(2) of UN MTCs becomes operative (see 4.2.1.1)	South Africa and OECD and UN MTCs are symmetrical in this respect (see 4.2.3.1)
Residence-residence conflict (tie-breaker) – other than natural persons	Place of effective management test (Sect. 1), guided by SARS <i>Interpretation Note 6</i> (see 4.2.2.2 & 4.2.2.3)	To overcome conflict, tie-breaker clause in Article 4(3) of OECD – place of effective management (see 4.2.1.2 & 4.2.3.2)	To overcome conflict, tie-breaker clause in Article 4(3) of UN – place of effective management (see 4.2.1.2 & 4.2.3.2)	Disparity exists in this interpretation between SA and OECD and UN (see 4.2.3.2)

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Having outlined the South African and OECD (including UN) perspectives on the concepts “resident” and “place of effective management”, there now follows a comparative assessment of these two sets of (national and international) perspectives (Table 4-2). The comparison will highlight the differences in formulations of the two concepts in South African CFC tax legislation and in the OECD and UN Model Tax Conventions; related recommendations, where appropriate, will be given in the concluding chapter of the thesis.

4.2.3.1 Residence of individuals

Article 4(1) of the OECD Model Tax Convention (2010) defines a resident “of a Contracting State” as a person who, under the laws of that state, is liable to tax in that state, “by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof.” In the case of a residence-to-residence conflict, Article 4(2) lays down the alternative provision that needs to be followed in establishing the

residence of an individual person. The provision is similar to the “facts and circumstances test [that] is applied as an alternative to the physical presence test to determine a person’s residence.” This test takes a variety of factors into consideration, such as “the availability of a permanent home, ‘the centre of vital interests,’... habitual, usual or customary place of abode, intention to stay permanently..., nationality” (Olivier & Honiball, 2011:20). In order for a natural person to qualify as a resident for South African Income Tax purposes, the person has to be ordinarily resident in the Republic or satisfy the physical presence test (see 4.2.2.2). “Ordinarily resident” is not defined in the Income Tax Act, and therefore the interpretations given by the courts will have to be given due consideration in determining the residency of a natural person. The requirements that need to be fulfilled for the physical presence test are contained in Section 1 of the South African Income Tax Act, under the definition of “resident”.

4.2.3.2 Interpretation of “place of effective management” in OECD Model Tax Convention and in South African Tax legislation

Article 4(3) “attaches importance to the place where the company, etc. is actually managed” and it is therefore used as a tie-breaker rule in the case of a residence to residence conflict for companies. The place of effective management is given priority, over the place of registration of the company, to which the OECD Article considers “a purely formal criterion” (OECD, 2010b:art 4 para 22). Therefore, in terms of Article 4(3) of the Model Tax Convention, a company which is regarded as a resident of both Contracting States, arising from the application of their respective domestic tax legislation, “shall be deemed to be a resident only of the State in which its place of effective management is situated” (OECD, 2010a:art 4 para 3).

The 2008 changes to the OECD Commentary on Article 4 essentially removed all references to the board of directors, and the proposed changes to “place of effective management” could therefore result in the extension of executive powers to other personnel of the company, who could carry out duties similar to those of the board of directors. Clegg (2008:60) states that these deletions bring the meaning of the term “place of effective management”, for treaty purposes, much more into line with “the function of executive or strategic management of an organization” and that which is “distinct from both control or setting of policy by the board and from the operational decision making of junior, middle and (sometimes) senior management” (2008:60).

The result, therefore, is that board meetings are no longer the decisive factor in determining the place of effective management, “except to the extent that the board does, in fact, exercise management functions in addition to directing and controlling the company” (Clegg, 2008:60). This situation could materialize in the case of a portfolio investment company in which there is “frequently little operational activity and most decisions and actions actually take place in and around the board

meeting itself.” Clegg, in addition, draws attention to “a member of the board [who] sits at his desk in South Africa in between board meetings and ‘calls the shots’ on the strategic decisions of foreign subsidiaries.” The situation is contrasted to “putting a subordinate in place in the offshore location, who ostensibly takes these decisions but in reality always checks with ‘head office’ and is frequently ‘advised’ on strategic issues, does no more than put a sticking plaster on the problem” (Clegg, 2008:61). The first location could be construed as the proper place of effective management while the latter example will not qualify as the place of effective management.

According to Luker (2010:78-79) the OECD Model Tax Convention tie-breaker clause relating to companies (“place of effective management” test) is not an effective criterion in determining the residency of companies. This is mainly due to the difficulty experienced in pinpointing a single location where the place of effective management is located, attributable to the present-day improvement in communication technology which means that decision makers no longer need to hold meetings in a particular location. Also, multinational companies are established worldwide, resulting in the increased mobility of top-level management and directors. The tie-breaker clause becomes ineffective because of changes to the generic managerial structures of the past. Accordingly, this has made it very difficult to determine where the effective management, top-level management and day-to-day management is situated.

Olivier and Honiball, on the other hand, regard the place of effective management as “the place where the higher level of [the] day-to-day running of the business takes place.” In their opinion, “running of a business” is not limited to “implementation of decisions and administration” but also includes “a range of decision-making steps that are necessary for the functioning of the business [which may] not necessarily include the strategic decision-making [steps]”. They therefore conclude, commenting on a given example, that “there is little doubt that the day-to-day business is run in country Y, and that the effective management is also located there”. (Olivier and Honiball, 2011: 28.)

4.2.4 Implications for the South African context

The South African interpretation of “place of effective management” (in terms of *Interpretation Note 6*) thus differs from the meaning of the term given in the Commentary on Article 4 in the OECD Model Convention. In a South African context, “place of effective management” is “the place where executive directors or senior management execute and implement the policy and strategic decisions made by the board of directors” and where these personnel “make and implement day-to-day ... operational management and business activities” (South Africa, 2002d:3). On the other hand, paragraph 24 of the OECD Commentary on Article 4, regards the place of effective management “as

the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made" (OECD, 2010b:art 4 para 24).

In a South African context, therefore, the divergence on this point between *Interpretation Note 6* and paragraph 24 of the OECD Commentary on Article 4 (2010) could create anomalies in bilateral double-taxation agreements between South Africa and a foreign Contracting State – incorrectly allocating taxing rights to a foreign contracting country in a bilateral double-taxation convention, which could jeopardise income potential for the South African Treasury. Therefore, for South Africa to conform with international standards (particularly in relation to the OECD and UN Model Tax Conventions) it should consider incorporating the pertinent international conventions regarding place of effective management in South African domestic tax law.

4.3 Permanent establishment

The following table outlines the constituents of the permanent establishment criteria in the OECD and UN Model Tax Conventions, giving a generic overview of the qualifying criteria of a permanent establishment in the OECD and UN Model Tax Conventions and also highlighting disparities between them in their qualification requirements.

Table 4-3 OECD and UN Model Tax Conventions: Article 5: Permanent Establishment

	Article 5(1): Components of General definition	Article 5(2): Examples of permanent establishment:	Article 5(3): Construction clause	Article 5(4): Exclusions from permanent establishment:	Article 5(5): Agency clauses Dependent agent	Article 5(6) Agency clauses – Independent agents	Article 5(7)	Article 5(8): Relationship of control
OECD	Fixed place of business Place of business Business carried on through the fixed place of business The business of an enterprise	A place of management A branch An office A factory A workshop A mine, an oil or gas well, a quarry or any other place of extraction of natural resources	A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months	Activities of a preparatory or auxiliary character are excluded from the scope of a permanent establishment	The activities of a dependent agent who regularly exercises his/her authority to conclude contracts in the Contracting State in the name of the enterprise is deemed to be permanent establishment unless the activities are excluded by Article 5(4)	The activities of an independent agent who acts in the ordinary course of his/her business will not constitute a permanent establish. in the Contracting State	Relationship of control Regardless of the level of control exercised by the parent company, a subsidiary company is not a permanent establishment of the parent company – because a subsidiary is a separate legal entity	
United Nations	Fixed place of business Place of business Business carried on through the fixed place of business The business of an enterprise	A place of management A branch An office A factory A workshop A mine, an oil or gas well, a quarry or any other place of extraction of natural resources	(a) A building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than six months (b) The provision of services including consultancy services by an enterprise through employees, only if activities exceed 183 days in any 12 month period commencing or ending in the fiscal year	Activities of a preparatory or auxiliary character are excluded from the scope of a permanent establishment	(a) The activities of a dependent agent who regularly exercises his/her authority to conclude contracts in the Contracting State in the name of the enterprise is deemed to be permanent establishment unless the activities are excluded by Article 5(4) (b) Has no such authority, but habitually maintains stock of goods from which regular deliveries are made on behalf of enterprise – is considered to be a PE	Enterprise qualifies as PE if it collects premium and insures risk in foreign country through dependent agents – except independent agent as per para 7	Requirements for permanent establishment The activities of an independent agent who acts in the ordinary course of his/her business will not constitute a permanent establishment in the Contracting State Activity will amount to PE if not done at arm's length	Regardless of the level of control exercised by the parent company, a subsidiary company is not a permanent establishment of the parent company – because a subsidiary is a separate legal entity.

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4.3.1 Permanent establishment in Art 5 of OECD Model Tax Treaty

4.3.1.1 Introduction

A frequently invoked determinant in international tax is a permanent establishment. The tax implications for this type of an establishment, which is usually accompanied by some form of physical presence in the source country, “is that it gives the country in which it is situated the right to tax the entity under its domestic laws, notwithstanding the fact that the permanent establishment has no separate legal existence” (Olivier & Honiball, 2008:95). This is reinforced in the OECD Commentary on Article 5 which states that “the concept of a permanent establishment is to determine the right of a Contracting State to tax the profits of an enterprise of the other Contracting State” (OECD, 2010b:art 5 para 1). The same OECD Commentary also states that, “under Article 7 a Contracting State cannot tax the profits of an enterprise of the other Contracting State unless it carries on its business through a permanent establishment situated therein” (OECD, 2010b:art 5 para 1). Therefore, in an international context, the term “permanent establishment” “not only [carries] a specific meaning, but [also] serves a specific purpose, namely to grant taxing rights to the country in which the permanent establishment is situated” (Olivier, 2002:866).

Trading in an international context carries the inherent risk of “international double taxation” and that which is defined as the “imposition of comparable income taxes by two or more sovereign countries on the same item of income (including capital gains) of the same taxable person for the same taxable period” (Arnold & McIntyre, 2002:29). Therefore, double taxation could result in a country or jurisdiction taxing its residents on their worldwide income, while at the same time a foreign country or jurisdiction taxes its non-residents on income that is sourced from within its territorial boundary (referred to as a ‘source’ principle). Relief from double taxation may be given “either under the domestic law of the country in which the taxpayer is resident or under a treaty entered into by the two countries concerned” It is in the latter domain that the term “permanent establishment” becomes more significant. (Olivier, 2002:867.)

Relief in terms of a tax treaty agreement could take two different forms, one in which the country of residence will forfeit its right to tax the income derived by the permanent establishment, in favour of the country in which the permanent establishment is situated, and this method is referred to as the exemption method. The alternative method is the credit system method in which the country of residence retains its right to tax, but allows credit for taxes paid in the source country. In the first of these two alternatives, “the existence of a permanent establishment [grants] exclusive taxing rights to the source country” and in the second alternative, both the source country and the country of residence could tax the income of the permanent establishment, and with the country of residence providing a tax credit relief for the taxes incurred in the source country (Olivier, 2002: 867-868). This is reinforced in both the OECD and the UN Model Tax Conventions, which provides for two methods of

tax relief against international double taxation, under Article 23: the exemption method (Article 23A) and the credit method (Article 23B). However, the deduction method is not followed in either the OECD or the UN Model Tax Conventions.

Article 5 commences with a definition of the term “permanent establishment”, followed by a list of examples of what could constitute a permanent establishment, and in view of the wide scope of the definition of a permanent establishment, it also contains a list of exclusions in respect of certain activities that would not give rise to a permanent establishment, and a deeming provision that classifies certain kinds of activities as constituting a permanent establishment.

4.3.1.2 Definition

The OECD Model Tax Convention (2010) defines a permanent establishment as: “a fixed place of business through which the business of an enterprise is wholly or partly carried on” (OECD, 2010a:art 5 para 1).

In the OECD definition, three different constituents can be identified:

- the existence of a “place of business”, i.e. a facility such as premises or, in certain instances, machinery or equipment;
- this place of business must be “fixed”, i.e. it must be established at a distinct place with a certain degree of permanence;
- the carrying on of the business of the enterprise through this fixed place of business. This means usually that persons who, in one way or another, are dependent on the enterprise (personnel) conduct the business of the enterprise in the State in which the fixed place is situated. (OECD, 2005a:art 5 para 2.)

Although the term ‘business’ inherently implies some element of profit making, the OECD definition does not require that the permanent establishment have a productive character; in other words it does not require that it should contribute to the profits of an enterprise. The reason is that although it is assumed that each part of an enterprise contributes to the productivity of the enterprise as a whole, each part does not necessarily need be productive on its own (OECD, 2005a:art 5 para 3). The next items for consideration are the different elements of the definition of permanent establishment in Article 5(1) of the OECD Model Tax Convention.

“Place of Business”

In the OECD Commentary on Article 5 “the term ‘place of business’ covers any premises, facilities or installations used for carrying on the business of the enterprise whether or not they are used exclusively for that purpose” (OECD, 2010b:art 5 para 4). It could also exist in the case “where no premises are available or required for carrying on the business of the enterprise and it simply has a certain amount of space at its disposal” (OECD, 2010b:art 5 para 4).

In terms of both the OECD and the UN Model Tax Conventions, “a permanent establishment will only exist if the enterprise has a physical presence in the source [or host] country”; in other words: “a permanent establishment will only exist if a tangible office, shop, factory, workshop, etc. exists in the host country” (Olivier & Honiball, 2011:336). It is therefore irrelevant if “the premises, facilities or installations are owned or rented by or are otherwise at the disposal of the enterprise” (OECD, 2010b:art 5 para 4). A place of business may thus constitute “a pitch in a market place, or [] a certain permanently used area in a customs depot (e.g. for the storage of dutiable goods)” (OECD, 2010b:art 5 para 4). A place of business may also be based in “the business facilities of another enterprise”, and this could be the case where, for instance, “the foreign enterprise has at its constant disposal certain premises or a part thereof owned by the other enterprise” (OECD, 2010b:Article 5 para 4). It is also not a requirement that “the place of business be attached to the surface of the earth or that it [be] visible above ground [level]” (Olivier & Honiball, 2011:336). Therefore, an underground pipeline may qualify as a permanent establishment (Olivier & Honiball, 2011:336). A question that often arises is “the amount of transactions which must arise before it can be said that business is being carried on in the source State”. In *Thiel v Federal Commissioner of Taxation* (Australia, 1990), it was held that, for the purposes of the treaty between Australia and Switzerland, an isolated transaction could constitute a business being conducted in the source country. The provision in the relevant Treaty is similar to that in the OECD Model Tax Convention (Olivier & Honiball, 2011:329.)

In the general definition of “permanent establishment” in both the OECD and the UN Model Tax Convention no specific time period is laid down during which the place of business must exist before it is considered to be a permanent establishment. However, there exists a prescribed time period in Article 5(3) of both the OECD and the UN Model Tax Conventions in respect of a building site, a construction, an assembly or installation, etc., that is required to be fulfilled in order for these activities to qualify as a permanent establishment. The longer time period laid down in Article 5(3) of the OECD Model Tax Convention to qualify as a permanent establishment, indicates that it is generally easier to avoid creating a permanent establishment in the source country under the OECD Model Tax Convention than it is under the UN Model Tax Convention. This is a distinct case of the UN Model Tax Convention allocating taxing rights to the source country much sooner than the OECD Model Tax Convention in respect of these activities in Article 5(3).

In terms of Article 5 paragraph 2 of the OECD Model Tax Convention (2005b), the following are specifically included to constitute a permanent establishment:

- a place of management;
- a branch;
- an office;
- a factory;

- a workshop; and
- a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

Article 5(2) of the OECD Model Tax Convention provides us with examples, as reflected above, of what could constitute a permanent establishment, and the commentary also makes the assertion that the above examples should not be considered as being exhaustive. The Commentary, further, makes it clear that the above examples must “be [viewed] against the background of the general definition given in paragraph (1)” of the OECD Model Tax Convention (OECD, 2010b:art 5 para 12). The term place of management has been separately disclosed “because it is not necessarily an ‘office’” and where, however, no distinction is made between the “place of management” and an “office” in the laws of the Contracting States, then “there will be no need to refer to the former term in their bilateral convention” (OECD, 2010b:art 5 para 13). “[A] mine, an oil or gas well, a quarry or any other place of extraction of natural resources” are considered permanent establishments (OECD, 2010a:art 5 para 2). However, the term “any other place of extraction of natural resources” should be broadly interpreted and it includes, for example, “all places of extraction of hydrocarbons whether on or off shore” (OECD, 2010b:art 5 para 14).

Article 5(3) of the OECD Model Tax Convention expressly provides that “a building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months” (OECD, 2010a:art 5 para 3). There is no specific provision in the articles of the OECD Model Tax Convention dealing with consulting or related services. In contrast, the UN Model Tax Convention in Article 5(3)(a) provides that “a building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than six months” will qualify as a permanent establishment. In addition, Article 5(3)(b) of the UN Model Tax Convention provides that “the furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose”, will be a permanent establishment “only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than 183 days in any 12 month period commencing or ending in the fiscal year concerned”. Therefore, the UN Model Tax Convention clearly favours the host country or source State by requiring a shorter window period in respect of construction and related activities to qualify as a permanent establishment. However, the UN Model Tax Convention does not favour the source State in respect of consulting activities as it prescribes a window period or periods aggregating more than six months within any twelve month period. The OECD Model Tax Convention, on the other hand, does not prescribe a window period for consulting activities. (Olivier & Honiball, 2011:343.)

“Fixed”

According to the definition of a permanent establishment, “the place of business has to be a ‘fixed one’” (OECD, 2010b:art 5 para 5). Thus, in an ordinary sense of the word, “there has to be a link between the place of business and a specific geographical point” (OECD, 2010b:art 5 para 5). This is referred to as the “location test”. The “location test” relies on the fact that a link exists between the place of business and a specific geographical point, although the place of business does not necessarily need to be physically connected to the land (OECD, 2005a:art 5 para 5). Olivier and Honiball are of the view that “where no distinct place of business exists, no permanent establishment [will] exist, irrespective of the length of time which the operation continues” (2011:338). The authors are thus reinforcing the view that a specific geographical point needs to exist in order that the place of business can be identifiable. The Commentary on Article 5 further states that the place of business does not necessarily need to be physically connected to the land (OECD, 2010b:art 5 para 5).

Further, the practices followed by member countries have not been consistent in so far as time requirements are concerned, and experience has shown the following with regard to the degree of permanency:

- where the business is conducted for less than 6 months, a permanent establishment would normally not exist; (OECD, 2008:art 5 para 6)
- where business is conducted for a period longer than 6 months, but less than 12 months, a permanent establishment possibly exists; and
- where the business is conducted for a period longer than 12 months, a permanent establishment is likely to exist. (Olivier & Honiball, 2011:338-339.)

However, the requirement of “fixedness” has come under strong criticism, as it is no longer appropriate for modern trade practices, especially in the area of electronic commerce, to conduct business entirely through a fixed place of business. Therefore, due to the nature of e-commerce it is possible to conduct substantial business operations within a country without having a fixed place of business in that country (Olivier & Honiball, 2011:338).

In response to the above situation prevailing in an electronic commerce environment, the OECD conducted a study on the issues relating to the taxation of e-commerce with the objective of developing its own policies in an e-commerce environment. Emanating from this study was a discussion document published under the title “Clarification on the application of the permanent establishment definition in e-commerce: Changes to the Commentary on the Model Tax Convention on Article 5” (22 December 2000), which focused on (OECD, 2000)

- conducting e-commerce in a country through a web site;

- the use in a country of computer equipment, such as a server, to store or provide access to electronic files or otherwise to assist a taxpayer conducting its business operations; and
- the use in a country of an agent, such as an Internet Service Provider (ISP), to obtain access to the internet or to host a web site. (Olivier & Honiball, 2008: 98.)

Although the discussion document has resulted in amendments to the OECD Commentary in 2000 and subsequently, the Model Tax Convention on Article 5 itself had not yet been amended as of the 2010 OECD Commentary updates (Olivier & Honiball, 2011:338).

“Through which business is carried on”

The third requirement is that the business of the enterprise needs to be carried on wholly or partly through the fixed place of business and not, for example, through another place of business that does not qualify as a permanent establishment in the host country. When an enterprise sets up a fixed place of business in the host country, but subsequently rents it out and does not undertake to maintain the place of business, then the third requirement of the permanent establishment definition is not fulfilled (OECD, 2005a: Article 5 para 8). The business of an enterprise is “mainly [conducted] by the entrepreneur or persons who are in a paid-employment relationship with the enterprise (personnel)” (OECD, 2010b:art 5 para 10). These personnel include employees and other related persons receiving instructions from the enterprise (e.g., dependent agents) and that the powers of these “personnel in [their] relationship with third parties are irrelevant” (OECD, 2010b:art 5 para 10). As a result, “it makes no difference whether or not the dependent agent is authorized to conclude contracts if he works at the fixed place of business” (OECD, 2010b:art 5 para 10).

A permanent establishment may also come into existence in an electronic environment “if the business of the enterprise is carried on mainly through automatic equipment, the activities of the personnel being restricted to setting up, operating, controlling and maintaining such equipment” (OECD, 2010b:art 5 para 10). However, a permanent establishment does not come into existence “if the enterprise merely sets up the machines and then leases the machines to other enterprises” (OECD, 2010b:art 5 para 10). A permanent establishment may, however, come into being “if the enterprise which sets up the machines also operates and maintains them for its own account” (OECD, 2010b:art 5 para 10). This could also include “machines [that] are operated and maintained by an agent dependent on the enterprise” (OECD, 2010b:art 5 para 10).

In 2010, the OECD Commentary to Article 5 was amended to make it clear that where an enterprise “is merely obtaining transmission or transportation services provided by the operator of the cable or pipeline and does not have the cable or pipeline at its disposal”, then no permanent establishment is created thereby (OECD, 2010b:art 5 para 26.1 [2010 update]). Further, in 2010 the OECD

Commentary to Article 5 was amended to make it clear that “a permanent establishment may only be considered to be situated in a Contracting State if the relevant place of business is situated in the territory of that State” (OECD, 2010b:art 5 para 5.5 [2010 update]). Applying this principle to satellites situated in space, the Commentary states that the location of such satellites is not part of the territory of the Contracting State under international law. Consequently, a satellite cannot create a permanent establishment, even if the satellite’s “footprint” extends over several States (OECD, 2010b:art 5 para 5.5 [2010 update]).

Similarly, the transfers of mobile telephone calls under a network roaming agreement from a foreign mobile network operator to the home mobile network operator cannot be regarded as a place which is at the disposal of the home mobile network operator for purposes of it carrying on its place of business wholly or partly in the foreign country. Therefore, neither the foreign mobile network operator nor the foreign mobile network itself creates a permanent establishment of the home mobile network operator in the foreign country (OECD, 2010b:art 5 para 9.1 [2010 update]). On this basis, the decision by the Indian Supreme Court in *DIT v Morgan Stanley & Co* (India, 2007), to the effect that seconded employees who remain on the foreign company’s payroll will create a permanent establishment for such foreign company in India, “is arguably incorrectly decided, as the foreign company was not carrying on business in India through such employees” (Olivier & Honiball, 2011:341). While this decision was made before the 2010 Update, “the above amendments to the OECD Commentary are arguably simply confirmation of the ordinary meaning of the words ‘through which the business is carried on’” (Olivier & Honiball, 2011:341).

4.3.2 Determination of a permanent establishment

4.3.2.1 Permanent establishment in an e-commerce environment

According to Du Plessis and Viljoen, the concept of a “fixed place of business” is based on the principle “that taxing rights should be [related] to a certain level of physical presence, where physical presence can mean assets, or personnel, or both” (Du Plessis & Viljoen, 2008: 7). The philosophy underlying the physical presence test comes under pressure in the case “where a business is able to exploit a market in a country without establishing a significant physical presence there.” (2008: 7). With e-commerce, a similar pressure arises in respect of the physical presence test. The fundamental question here is “whether a web site or a server, owned or used by a foreign company, can create a physical (taxable) presence in a country, taking into [consideration] that there would not necessarily be any employees of the company present in the host country” (2008: 7). According to Du Plessis and Viljoen, there could be difficulties in establishing “whether a web site and web page could create a permanent establishment” in an e-commerce environment, and similar uncertainties could arise in respect of the use of servers when determining the existence of a permanent establishment (2008: 7).

4.3.2.2 Activities that do not give rise to a permanent establishment

Article 5(4) of the OECD Model Tax Convention (2010), lists a number of business activities which are classified as exceptions to the general definition laid down in paragraph 1, and that such activities do not give rise to a permanent establishment, even though these activities are carried on “through a fixed place of business.” (OECD, 2010b:art 5 para 21).

The common feature of these activities is that in general they are of “a preparatory or auxiliary nature” (OECD, 2010b:art 5 para 21). This is explicitly described in the case of the exception mentioned in subparagraph (e), “which actually amounts to a general restriction of the scope of the definition contained in paragraph 1” (2010b:art 5 para 21). This is further reinforced in subparagraph (f), which refers to the fixed place of business solely held to conduct the activities mentioned in subparagraphs (a) to (e), and providing “that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character” (2010b:art 5 para 21). Thus, the provisions of Article 5(4) “are designed to prevent an enterprise of one State from being taxed in the other State, if it carries on in that other State, activities of a purely preparatory or auxiliary character” (2010b:art 5 para 21).

4.3.2.3 Deeming provisions for the establishment of a permanent establishment

Dependent and independent agents

Article 5(5) of the OECD Model Tax Convention (2010) is a deeming provision in terms of which it becomes possible that, even though the enterprise does not have a fixed place of business in the host country, a permanent establishment may still come into operation when specific persons are appointed to act on behalf of the enterprise in the host country. According to Rohatgi (cited in Olivier & Honiball, 2008: 104), “the dependent agent sub-Article replaces the requirement of a fixed place of business under the basic rule contained in art 5(1), as is the case with the building site and construction site window period contained in art 5(3).”

Although it is not a requirement for an employer–employee relationship to exist between the enterprise and the agent, a permanent establishment will not necessarily result from the activities of all its agents. Therefore, Article 5(5) of the OECD Model Tax Convention, “proceeds on the basis that only persons having the authority to conclude contracts can lead to a permanent establishment for the enterprise maintaining them”. Then, “in such a case the person has [to have] sufficient authority to bind the enterprise’s participation in the business activity in the State concerned” (OECD, 2010b:art 5 para 32). The power to “conclude contracts must cover contracts relating to operations which constitute the business proper of the enterprise”. In addition, “the authority has to be habitually exercised in the other State” and with due consideration to the “commercial realities of the situation”. (2010b:art 5 para 33.)

The UN Model Tax Convention extends the concept of an independent agent a step further by making provision in Article 5(5)(b) of its tax convention that an agent without the necessary authority could also constitute a permanent establishment, provided that he or she habitually maintains a stock of goods in the host country and from which a regular delivery of goods or merchandise is made on behalf of the enterprise based in the home country (United Nations, 2011 Article 5 para (5)(b)). Under both Model Tax Conventions, where an authority only extends to those activities specifically exempt, a permanent establishment will not arise. The requirement that the authority needs to be habitually exercised requires that the person making use of the authority must do so repeatedly and not merely in isolated cases. In addition, the authority needs to be exercised in the host country and not, for example, in the resident's country. (OECD, 2010b:art 5 para 5.)

The meaning attached to a dependent agent should be contrasted with that of an independent agent: where business is conducted through the activities of a broker, general commission agent or any other agent of an independent status, and the income will not "be taxed in the other Contracting State in respect of those dealings, if the agent is acting in the ordinary course of his business" (OECD, 2010b:art 5 para 36). To foil tax planning and give greater taxing rights to the source country, the United Nations provides in its tax convention that where an agent undertakes his activities wholly, or almost wholly, on behalf of the enterprise, and where the relationship between the parties indicates that they are not dealing at arm's length, then the agent will be deemed to be a dependent agent in respect of the relevant subparagraph. The implication of this is that an agent who represents a single client and who does not deal on an "arm's-length" basis with such a client will not qualify as an independent agent. (United Nations, 2001a : Article 5 para 7.)

In the insurance industry, for example, agents often do not have the necessary authority to bind the insurer company, as the risk has to be first assessed by the insurer. Since these agents are regarded as independent agents, a permanent establishment will not arise in the source country. To avoid the "dilution of the taxing rights of the source country", the UN Model Tax Convention in Article 5(6) specifically provides that the enterprise is deemed to have a permanent establishment in the host country if, except with regard to reinsurance, it

- collects premiums in the host country; or
- insures risks situated in the host country through dependent agents. (Olivier and Honiball, 2011: 346.)

The OECD has decided against the inclusion of an identical deeming provision in its Model Tax Treaty on the basis that, as the factual and legal situation may differ from country to country, no general rule of application could be prescribed in this regard (OECD, 2008:art 5 para 39). The OECD is also of the view that the above provision will not be frequently invoked in practice and therefore it did not recommend a similar provision for insertion in its tax convention. Further, in terms of

paragraph 37 of the OECD Commentary to Article 5(6), only when a person is independent of the enterprise both legally and economically, and when such person acts in the ordinary course of his business when acting on behalf of the enterprise, will such person not constitute a permanent establishment of the enterprise on whose behalf he acts. However, despite this, the starting point is to determine if the person is acting on behalf of the enterprise in the first place (as broker, general commission agent or other agent), and only once this is determined must a person's independence be tested. For purposes of the application of Article 5(5), this is made clear by the reference to the conclusion of contracts in the name of the enterprise, a requirement which is absent from Article 5(6) of the OECD Model Tax Convention.

4.3.2.4 Determination of permanent establishment in a multinational group context

The concept of control in a multinational group context is now discussed to determine whether a permanent establishment will come into existence. Multinational groups regularly set up subsidiary companies in foreign countries, rather than establishing permanent establishments in foreign jurisdictions. Article 5(7) of the OECD Model Tax Convention and Article 5(8) of the UN Model Tax Convention have taken cognizance of this situation and stipulate that the mere fact that a parent company controls a subsidiary does not in itself give rise to a permanent establishment. Similarly, a parent company is not *per se* a permanent establishment of its subsidiary (OECD, 2010a:art 5 para 7; United Nations, 2011:art 5 para 8). A permanent establishment is therefore not based on ownership, control or association between related enterprises (Olivier & Honiball, 2011:347).

4.3.3 Foreign business establishment in South African CFC legislation

4.3.3.1 Defining foreign business establishment criteria

The definition of “foreign business establishment” was inserted by Section 9(1)(c) of Act No. 20 of 2006 in Section 9D. The foreign business establishment exemption is one of the most complicated provisions in the South African Income Tax Act. From the interpretation of Section 9D(9)(b) it becomes clearly evident that the legislator, in granting the exemption, “attempted to strike a balance between granting an exemption to income derived from legitimate business activities and that derived from illusory or non-substantive business undertakings (i.e., mobile and diversionary business income and mobile passive income)”. (Olivier & Honiball, 2011:581.)

To a certain extent, the term “foreign business establishment” broadly resembles the definition of permanent establishment in both the OECD and the UN Model Tax Conventions. However, the latter definition has been qualified in many respects and, consequently, is found not to be in total agreement with the definition of a foreign business establishment prevailing in Section 9D(1) of South Africa's CFC legislation (Olivier & Honiball, 2011:584). The definition of the term in Section 9D(1) provides for five different categories, each category with its own requirements. These categories are as follows:

Paragraph (a): The fixed place of business must be located in a country other than the Republic that is used or will continue to be used for the carrying on of the business of that CFC for a period of not less than one year. The fixed place of business located outside South Africa has in turn also to meet five requirements to qualify as a fixed place of business. Four of these five components relate to the nature of the business in which minimum requirements are stipulated in respect of structure, employees, equipment and facilities, and the fifth requirement relates to the purpose with which the business is conducted. Therefore, in order to qualify as a foreign business establishment under paragraph (a) of the definition, both an ‘economic substance’ and a ‘business purpose’ test must be complied with:

- *The ‘economic substance’ test:* This test requires that income will not be exempt if the foreign business exists merely on paper and not in substance. Consequently, it is not sufficient to have employees who only take managerial decisions at the foreign business premises, but it is also a requirement that persons who participate “in the day-to-day management decisions (operational)” of the company should also be present (Olivier & Honiball, 2011:582). Prior to 1 September 2009, it was also required that the employees need to be in the full-time employ of the CFC. Although this is no longer a requirement, it is doubtful that independent agents or independent consultants will qualify as they generally cannot be regarded as employees (Olivier & Honiball, 2008: 448). In a South African context, it was established in CIR v Downing (South Africa, 1975) that in terms of a double tax agreement entered into between South Africa and the Swiss Federal Council, an independent stockbroker who managed a portfolio of shares on behalf of a non-resident in South Africa did not have a permanent establishment in South Africa. (Olivier & Honiball, 2011:346.)
- *The ‘business purpose’ requirement:* The revised definition of foreign business establishment requires that the fixed place of business of the foreign business establishment be 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”. This requirement is referred to by National Treasury as the “business purpose test” (South Africa, 2009a:75). This requirement attempts to ensure that income derived by a CFC and which fulfils the necessary permanence and economic substance requirements, will still not be exempt if the business activities are not conducted for *bona fide* business purposes, but rather for a tax benefit. In determining whether the place of business is held outside the Republic for *bona fide* business purposes, the Commissioner will not be required to rely on the general anti-avoidance section, Section 80A. Consequently, “it [will be] sufficient if, on the facts, the reason for conducting the business outside the borders of South Africa is to avoid, postpone or reduce tax”. (Olivier & Honiball, 2011:583.)
- *Overview of the single country requirement for a group of companies:* Since the activities of a single business are often divided between different legal entities, the revised foreign business establishment definition allows for the structures, employees, equipment and facilities of other

group companies to be taken into account when determining the existence of a foreign business establishment (South Africa, 2009a:76).

The Explanatory Memorandum on the Taxation Laws Amendment Bill, 2009 (South Africa, 2009a:76) lists the following conditions for this requirement:

- The other entities must be subject to tax in the foreign country by virtue of residence, place of effective management or other criteria of a similar nature.
- The other entities must be part of the same group of companies as the CFC.
- The structures, employees, equipment and facilities must be located in the same foreign country as the CFC.

In *Transvaal Associated Hide and Skin Merchants vs Collector of Taxes, Botswana* 29 SATC 97, the taxpayer, being a company, purchased hide and skins and other by-products of livestock, such as hooves and horns, at abattoirs in Botswana, from where the animals were slaughtered and subsequently disposed of (as products) in South Africa. Prior to the skins being transported to South Africa, they were salted and cured in Botswana. These hides and skins and by-products were subsequently sold from the company's head office in Johannesburg, South Africa. The High Court of Botswana concurred with, or upheld, the decision of Botswana's taxing authorities that the income from the sale of these products was from Botswana and consequently taxable in Botswana. The company then lodged an appeal to the Court of Appeal of Botswana which was dismissed on the basis that "the dominant ... and basic cause of the taxpayer's income in question was its activities in Botswana, and it was ... there that the source of the income was located" (Emslie et al., 2001:124). It could therefore be inferred from the evidence before the court that the company, while having its head office in Johannesburg, South Africa, actually did have a permanent establishment in Botswana, where the skins and hides were salted, and that the originating cause of the source of the income was Botswana.

Paragraph (b): A place based outside South Africa where prospecting, or exploration for natural resources is carried on by the CFC or where mining or production operations are carried out by the CFC: unlike the test in paragraph (a), the test in paragraph (b) does not require any economic substance. The absence of the economic substance requirement is presumably attributable to the fact that the fixed nature of the activities makes it virtually impossible to concoct them for tax planning purposes. In addition, if these activities are fabricated, no or little income will be derived which qualifies for the exemption. This is also the reason, presumably, why no time period is laid down for these activities. From the wording of paragraph (b) it is clear that the CFC should conduct the preliminary exploring or the actual exploration and extraction activities itself, and not merely have an interest in such activities. "This presupposes that the CFC itself must have a business and that the

relevant vessel, aircraft or mine on its own does not constitute the business of the CFC” (Olivier & Honiball, 2011:584).

Paragraph (c): A site for the construction or installation of buildings, bridges, roads, pipelines, heavy machinery or other projects of comparable magnitude that last for at least six months, where that CFC carries on those construction or installation activities.

Paragraph (d): Agricultural land outside South Africa used for *bona fide* farming activities directly carried on by a CFC. As with the requirement in paragraph (a), a foreign business establishment for agricultural land will only exist if the activities are carried out in a single country outside South Africa.

Paragraph (e): A vessel, vehicle, aircraft or rolling stock (rail) used for or engaged in transportation or fishing, prospecting or the exploitation of natural resources or mining or the production of natural resources outside South Africa for such purposes, where that vehicle, aircraft or rolling stock is operated directly by the CFC or by another company which has the same place of effective management as the CFC (that is a country of residence) and forms part of the same group of companies as the CFC. Since 2006, it is no longer required that the vehicle, aircraft or rolling stock must be used solely for the stated methods of transportation (Olivier & Honiball, 2011:584).

4.3.4 Comparison: “foreign business establishment” in South African CFC legislation & “permanent establishment” in OECD and UN Model Tax Conventions

Table 4-4 compares the key objectives of the permanent establishment criteria in the OECD and UN Model Tax Conventions with the foreign business establishment criteria in the South African CFC regulations (Van Schaik, 2010:93).

Table 4-4 Permanent / foreign business establishment criteria: SA & OECD / UN

	Permanent establishment (Article 5 – OECD and UN MTCs)	Foreign business establishment (Sect. 9D(1))
Context in which the concepts are used	Provides criteria for the existence of a permanent establishment in order to determine the rights of the jurisdiction to tax the profits of a permanent establishment for purposes of the application of double tax agreements	An exemption from the CFC provisions in Sect. 9D of the Income Tax Act which determines that income derived from legitimate and substantive business activities is not subject to taxation in the hands of South African residents while non - substantive business undertakings remain subjective to the CFC legislation
Taxpayers affected by the concepts	Applies to an entity of one Contracting State which has a permanent establishment in another Contracting State (source State)	Applies to the resident shareholders of CFCs
Objective of the concepts	Provides the criteria for the existence of legitimate and substantive business activities within a foreign tax jurisdiction	Provides the criteria for the existence of legitimate and substantive business activities within a foreign tax jurisdiction
		Author

Table 4-5 compares the key constituents of the definition of “permanent establishment” in the OECD and UN Model Tax Conventions with the definition of “foreign business establishment” in the South African CFC regulations.

Table 4-5 Permanent / foreign business establishment definitions: SA & OECD / UN

Permanent establishment (Article 5 of OECD and UN MTCs)	Foreign business establishment (Sect. 9D(1))	Comment
A fixed place of business (Article 5, para 1, OECD & UN MTCs) (see 4.3.1.2)	A fixed place of business The location of the fixed place of business in a country other than the Republic Time requirement of not less than one year. The fixed place of business is suitably staffed. The fixed place of business is suitably equipped. The fixed place of business has suitable facilities. (Sect. 9D(1)(a)) (see 4.3.3.1)	Both MTCs and Sect. 9D(1) have the same meaning – fixed place of business.
A place of business (para 1, OECD and UN MTCs) (see 4.3.1.2)	A place of business. (Sect. 9D(1)(a)) (see 4.3.3.1)	Similar interpretation in both MTCs and Sect. 9D(1).
Business carried on through this fixed place of business (para 1, OECD and UN MTCs) (see 4.3.1.2 above)	The fixed place of business is used or will continue to be used (Sect. 9D(1)(a)) (see 4.3.3.1)	Similar interpretation between MTCs and Sect. 9D(1).
The carrying on of the business of an enterprise. (para 1, OECD and UN MTCs) (see 4.3.1.2)	The carrying on of the business of the CFC (Sect. 9D(1)(a)) (see 4.3.3.1)	MTCs definition wider scope than Sect. 9D(1).
Examples of permanent establishments: a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry or any other place of extraction of natural resources (para 2, OECD and UN MTCs) (see 4.3.1.2)	The business is conducted through one or more offices, shops, factories, warehouses or other structures. (Sect. 9D(1)(a)(i)) Prospecting or exploration operations for natural resources. (Sect. 9D(1)(b)) <i>Bona fide</i> farming activities. (Sect. 9D(1)(d)) Transport entities (Sect. 9D(1)(e)) (see 4.3.3.1)	MTCs examples have a wider scope than Sect. 9D(1).

Permanent establishment (Article 5 of OECD and UN MTCs)	Foreign business establishment (Sect. 9D(1))	Comment
Construction clause: a building site, construction or installation project will only constitute a permanent establishment if it lasts more than twelve months (para 3, OECD) or more than six months (para 3(a), UN) MTCs (see 4.3.1.2)	Construction or installation projects which lasts for a period of not less than six months. (Sect. 9D(1)(c)) (see 4.3.3.1)	UN MTC and Sect. 9D(1) similar – 6 months period while the OECD has a waiting period more than 12 months.
Construction clause: furnishing of services (e.g. consultancy) by an enterprise via employees, personnel – will qualify as PE only if period/periods of activities exceed 183 days in any 12 month period commencing or ending in the fiscal year concerned (para 3(b), UN MTC) (see 4.3.1.2 above)		Article 3(b) unique, only found in UN MTC.
Exclusions from the permanent establishment definition: activities of a preparatory or auxiliary nature are excluded from the concept permanent establishment. (para 4, OECD and UN MTCs) (see 4.3.2.2)		No such requirement in Sect. 9D(1). OECD and UN MTCs have similar requirement.
The agency clauses: provisions relating to a dependent agent (as PE) (para 5, OECD and para 5(a) & (b) and para 6, UN MTC) and to an independent agent (no PE) (para 6, OECD MTC & para 7, UN MTC) (see 4.3.2.3)		No independent and dependent agents deeming provision in Sect. 9D(1).
The control relationship between group companies does not contribute to the existence of a permanent establishment. (Article 5, para 7, OECD MTC & para 8, UN MTC) (see 4.3.2.4)	The single country requirement for a group of companies (proviso to Sect. 9D(1)(a)) (see 4.3.3.1)	Control requirements in the MTCs are not same as the Sect. 9D(1) single country requirement.
	The business purpose: the fixed place of business is located outside the Republic solely or mainly for a purpose other than a tax related purpose (Sect. 9D(1)(a) and proviso to Sect. 9D(2A)) (see 4.3.3.1)	No such requirement in the MTCs but business purpose test is present in Sect. 9D(1).

(Adapted from Van Schaik, 2010:94-96)

4.3.5 Implications for the South African context

The concept of a permanent establishment as utilised in an international context does not entirely correspond with the definition of a foreign business establishment in South Africa's CFC tax legislation. In an international context, the term "permanent establishment" has a specific meaning which may "comprise an extension of the existing legal entity in the foreign tax jurisdiction, [operating] as a branch of the enterprise" (Steyn Committee, 1951:46) (see 4.3.2.4 above). In South Africa's tax legislation the term "foreign business establishment" is reserved exclusively for South African CFCs. Therefore, unlike the definition of a permanent establishment in both the OECD and the UN Model Tax Conventions, which essentially grants taxing rights to foreign jurisdictions in which the permanent establishment (branch) is based, South Africa's use of the term "foreign business

establishment” applies exclusively to the granting of tax exemptions to foreign business establishments of South African CFCs.

Further, the use of the FBE requirement in the South African CFC legislation for the granting of exemptions to CFCs is a unique criterion by international standards. It must be noted that although these concepts have differing objectives – the permanent establishment criteria grants taxing rights to a foreign source country in which the permanent establishment (branch) is based, and the FBE criteria grants tax exemption to CFCs fulfilling the FBE criteria – their fundamental principles are in symmetry insofar as both postulate the existence of legitimate and substantive business activities in the foreign tax jurisdiction.

However, divergence between the two sets of criteria, for permanent establishment and for foreign business establishment in the South African Income Tax Act, could result in differing interpretations being given by South African courts, thus impeding “clarity and certainty for those affected by it” (Van Schaik, 2010:111). A key issue that emerges in this study is that the FBE requirement could be construed as a superfluous criterion in the South African CFC legislation and should be replaced by the permanent establishment criterion, with necessary adaptations. The permanent establishment criterion is an internationally recognised and accepted tax concept. Accordingly, the use of the permanent establishment criterion in the South African Income Tax legislation enhances international compatibility of the Income Tax Act.

4.4 Business profits

Table 4-6 Business profits

Subject	RSA Tax On Income	OECD Model Tax Convention	UN Model Tax Convention
Meaning of Enterprise	-	Article 3(1)(c)(d) (see 4.4.1.1)	Article 3(1)(c) (see 4.4.1.1)
Meaning of Business Profits	Sect. 9D(2A) (see 4.4.2.1)	Article 3(1)(h) (see 4.4.1.2)	-
Carrying on business in the Source State – through PE	-	Article 7(1) and 7(2) (see 4.4.1.3 and 4.4.1.4)	Article 7(1) and 7(2) (see 4.4.1.1 and 4.4.1.2)
The arm's length principle	Sect. 9D(9)(b) and 9D(9A) and Sect. 31 (see 4.4.2.2 and 4.4.3)	Article 7(2) (see 4.4.1.3 and 4.4.1.4)	Article 7(2) (see 4.4.1.3)
Limited force of attraction of PE includes: (i) Similar goods and other business activities as PE	-	-	Article 7(2)(a)(b) & (c) (see 4.4.1.3)
Exclusion clause: no deductions for royalties, commission and interest on monies lent (except banks)	-	-	Article 7(3)
Customary methods to attribute profits to PE	-	-	Article 7(4)
Consistency in attribution of profits to PE – year-by-year	-	-	Article 7(5)
Adjustment in Contracting State, not doing the original adjustment – prevent double taxation on same income	-	Article 7(3) (see 4.4.1.4)	-
Profits including income covered by other articles of the Convention	-	Article 7(4) (see 4.4.1.4)	Article 7(6)

Author

4.4.1 Business profits in Article 7 of the OECD Model Tax Treaty

Article 7 deals with the taxation of business profits in the context of a permanent establishment or branch that is based in a foreign jurisdiction. Article 7 could, therefore, be regarded, “in many respects, [as] a continuation of Article 5 on the definition of the concept of permanent establishment” (OECD, 2008:30). The permanent establishment criterion is commonly utilised in international double-taxation conventions “to determine whether a particular kind of income [will] be taxed in the country from which it originates”; however, the permanent establishment criterion “does not of itself provide a complete solution to the problem of double taxation of business profits”. (OECD, 2008:art 7 para 1.)

To avoid double taxation it becomes necessary to supplement the definition of a permanent establishment with “an agreed set of rules” that would be used as a basis to calculate the profits

attributable to the permanent establishment. The agreed set of rules would therefore be applicable “when an enterprise of a Contracting State carries on business in the other Contracting State” and the authorities of the latter State will be required to fulfil the following conditions before they would be able “to levy tax on the profits of the enterprise”: firstly, they would have to determine if the enterprise has “a permanent establishment in their country”; if the answer is in the affirmative then the next question is what, if any, the profits are on which that permanent establishment should pay tax. The principles underlying the taxation of a permanent establishment are accordingly set out in Article 7 of the OECD Model Tax Convention, which serves as a basis for the taxation of a permanent establishment. (OECD, 2008: Article 7 para 1.)

Only profits that are attributable to the permanent establishment may be taxed in the other Contracting State (i.e. source State). The attribution of profits, referred to as “business profits”, and pursuant to the various amendments often referred to simply as profits, “must be made as if the permanent establishment [is] separate and distinct from the main enterprise, and as if it [is] dealing wholly independently under the same or similar conditions in terms of the same or similar activities under which independent enterprises would have dealt” (Olivier & Honiball, 2011:322). This is referred to as the separate entity approach.

Before the 2010 Update to Article 7 of the OECD Model Tax Convention, the enterprise could select various methods of profit attribution but the method of profit attribution selected by the permanent establishment had to be consistent year by year, unless there was good and sufficient reason to the contrary. In determining the profits of the permanent establishment, no profits must be attributed by reason of the mere purchase of goods or merchandise for the enterprise by the permanent establishment, and all expenses incurred, irrespective of where they were incurred, must be taken into account. It should be noted that these latter requirements in the previous Article 7(3), 7(5) and 7(6) have been deleted in the 2010 update to Article 7 of the OECD Model Tax Convention.

4.4.1.1 The meaning of “enterprise”

In terms of Article 7(1) of both the OECD and the UN Model Tax Conventions, an enterprise must exist in the home State in order for this Article on business profits to be operative. Article 3(1)(c) of the OECD and the UN Model Tax Conventions defines the term enterprise as including the “[application] to the carrying on of any business” and as meaning “an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State” (OECD, 2010a:art 3(1)(c)(d); United Nations, 2011:art 3(1)(c)). The absence of an exhaustive definition of the term *enterprise* could lead to interpretation problems, especially in view of the Commentary on Article 3 where it is stated that the term must be interpreted according to the provisions of the domestic laws of the Contracting States – which is why no comprehensive definition

of the term is contained in Article 3 of the OECD Model Tax Convention (OECD, 2010b:art 3 para 4).

According to Olivier and Honiball, the use of the term enterprise in the context of Article 7 of the OECD Model Tax Convention “does not require that a business actually be conducted in the home or residen[t] State” (2011:324). All that is required is that there be an enterprise which is effectively managed or incorporated in the resident State and which carries on business in the other Contracting State (the source State) through a permanent establishment situated therein. This view is supported by the OECD Commentary on Article 5 (para 1(6)), which gives an example of a business that is exclusively carried on in the source State (OECD, 2010b:art 7 para 6). Therefore, the entity as a whole must be tax resident in the resident State, which generally will require that its place of effective management is in the resident State (Olivier & Honiball, 2011:324).

4.4.1.2 The meaning of “business profits”

Both the OECD and the UN Model Tax Conventions have an Article 7 dealing with business profits, providing that where an enterprise of one Contracting State has no permanent establishment in the other Contracting State, then the other latter State may not levy tax on the business profits of the enterprise. This principle has been retained in the 2010 OECD Update. However, where the enterprise does have such a permanent establishment, the latter State can tax only so much of the business profits as are attributable to that permanent establishment. In addition, the State of residence of the enterprise which has the permanent establishment in the other Contracting State, may also tax those business profits attributable to the permanent establishment. To avoid double taxation, Article 23A and 23B of the OECD and UN Model Tax Conventions will be applicable in granting a tax credit in respect of the resulting double taxation that would ensue in the State of residence in which the enterprise is based.

Neither the OECD nor the UN Model Tax Conventions has a specific definition of the term *business profits*, although what is meant by the term may be inferred from Article 7 as a whole, together with the definition of the term *business* in Article 3(1)(h) of the OECD Model Tax Convention. The OECD Commentary on Article 3 states that “the Convention does not contain an exhaustive definition of the term ‘business’, which ... should generally have the meaning ... under the domestic law of the State that applies the Convention” (OECD, 2010b: Article 3 para 10.2). However, the definition of “business profits” is supplemented by the definition of “business” in Article 3(1)(h) of the OECD Model Tax Convention, where it is stated that the term includes, “the performance of professional services and of other activities of an independent character”.

A common provision in income tax treaties is therefore that business profits do not include items of income dealt with separately in other provisions of the Convention (Article 7(6) of the UN Model Tax

Convention (2011) and Article 7(4) of the OECD Model Tax Convention (2010)). This does not however mean that the other items of income escape full taxation: items of income set aside from business profits, “including interest, compensation for services, [dividend] and royalties, are nonetheless taxed as though they were business profits when similarly derived from a permanent establishment” (Isenbergh, 2000:209-210).

A dispute that often arises is whether specific income falls under the relevant specific income provision or whether it constitutes business profits in terms of Article 7. It is uncertain, for example, whether business income derived from films or the hiring of equipment falls within the ambit of Article 12 on royalties, or whether it constitutes business income (Article 7) (Olivier & Honiball, 2011:326). It is important, from the perspective of the source country, to establish the nature of the income in respect of films or the hiring of equipment: if it constitutes royalty income, it would generally be subject to a withholding tax and if, on the other hand, it constitutes business income, then tax may only be levied on it if the non-resident has a permanent establishment in the source country. It therefore follows from the above that Article 7 will be applicable to business profits which do not belong to certain categories of income covered by the other articles in the Model Tax Convention. (OECD, 2010b, Article 7, para 74.)

Both the OECD and the UN Model Tax Conventions, in Articles 10(4) and 11(4) respectively, and in OECD Model Tax Convention Article 12(3) and UN Model Tax Convention Article 12(4), provide an exception in respect of those “cases [in which] the holdings etc. form part of a permanent establishment maintained by the enterprise in the State of source”. In practice, “the main consequence of this is that ... the State of source, rather than being able to impose tax on the gross amounts of the dividends, interest or royalties, may tax only the net amount of the business profits”. This will result in the source State being unable to impose withholding tax on the gross amounts but rather applying normal tax rates on the net amounts. (Vogel, 1997:565.)

Therefore, dividend, interest and royalties will be taxable in the source State as part of business profits, if such income (for example royalties) is paid in respect of rights or property forming part of the assets of the permanent establishment or otherwise effectively connected with that establishment (OECD, 2010b: Article 12 para 20). According to Vogel (1997:568), “effectively connected” should be likened to the term “really connected” – meaning connected not only in form, but also in substance – and serving the purposes of the permanent establishment. In certain instances, income from the branch or permanent establishment may have to be reallocated to head office, and this will have to be done in accordance with the requirements of tax treaty law that is centred on the arm’s length principle and based on profits that arise economically from the business activities of the permanent establishment (Vogel 1997:409).

4.4.1.3 Calculation and attribution of business profits

From a close examination of the OECD Model Tax Convention in Article 7(1), there are two main factors that we need to take into consideration in respect of the taxation of business income attributable to a permanent establishment of an enterprise. The first is the generally accepted principle of double-taxation conventions that an enterprise of one State shall not be taxed in the other State unless it carries on business in that other State through a permanent establishment situated therein (OECD Comment, 2010b: Article 7 para 10). It has come to be an accepted norm in international fiscal matters that until an enterprise of one State sets up a permanent establishment in another State it should not properly be regarded as participating in the economic life of that other State to such an extent that it comes within the jurisdiction of that other State's taxing rights (OECD, 2008:para 9).

The second principle discussed in the OECD Commentary on Article 7(1) relates to the fact that “the right to tax of the State where the permanent establishment is situated does not extend to profits that the enterprise may derive from that State but that are not attributable to the permanent establishment” (OECD, 2010b: Article 7 para 12). On this point the OECD Commentary observes that there has been considerable divergence in the tax regimes of various OECD member countries. Some jurisdictions

pursued a principle of general ‘force of attraction’ according to which income, such as other business profits, dividends, interest and royalties arising from sources in their territory was fully taxable by them if the beneficiary had a permanent establishment [situated] therein even though such income was clearly not attributable to that permanent establishment (OECD, 2010b: Article 7 para 12).

In some bilateral tax conventions there are included “a limited anti-avoidance rule” that is based on a “restricted force of attraction approach [which] only applies to business profits derived from activities similar to those carried on by a permanent establishment” (OECD, 2010b: Article 7 para 12). However, the *general force of attraction* approach described above has now been revoked as an international tax treaty practice by OECD member countries. The principle that is now generally acceptable in double-taxation conventions is based on the premise “that in taxing the profits that a foreign enterprise derives from a particular country, the tax authorities of that country should look at the separate sources of profit that the enterprise derives from their country” and should subsequently “apply to each the permanent establishment test, subject to the possible application of other Articles of the [Model] Convention.” (OECD, 2010b: Article 7 para 12). This practice will allow for “simpler and more efficient tax administration and compliance,” and one that is “more closely adapted to the way in which business is commonly [conducted]” (OECD, 2010b: Article 7 para 12).

Vogel reaffirms the view of the OECD Model Tax Convention in Article 7(1) by opposing the principle that “where there is a permanent establishment, the State of the permanent establishment should be allowed to tax all income derived by the enterprise from sources in that State” regardless of “whether or not such income is economically connected with the permanent establishment” (Vogel,

1997:409). With respect to the profits earned by the enterprise in the State of the permanent establishment, Vogel additionally upholds the view of the OECD Convention by stating that “a distinction must always be made between those profits which result from the permanent establishment’s activities and those made ... by the head office or any other part of the enterprise” (1997:409). The UN Model Tax Convention, on the other hand, goes a step further in Article 7(1), by making provision for what is commonly known as a “limited force of attraction principle”. In terms of the UN Model Tax Convention in Article 7(1)(b)(c), profits, not only those attributable to the permanent establishment, but also those derived from the following two types of transactions, that may also be taxed in the source country in which the permanent establishment is based:

- sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment (art 7(1)(b))
- other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment (art 7(1)(c)).

Therefore, the additional two provisions in Article 7(1) of the UN Model Tax Convention are a clear indication of the UN favouring the source country. Despite the inclusion to tax the above two transactions, the UN Model Tax Convention does not pursue a general or full force of attraction principle by subjecting to tax other unconnected income derived by the enterprise in the State where the permanent establishment is situated. Although the OECD has recognised the arguments for a wider tax base, it has come to the conclusion that the source country’s right to tax should only extend to profits that are attributable to the permanent establishment (OECD, 2010b:art 7 para 12).

4.4.1.4 2010 OECD update of Article 7 MTC

Introduction: On 22 July 2010 the OECD released its 2010 Update to the Model Tax Convention, which contained a substantial revision of the previous Article 7. Despite the substantial revision of Article 7, it retains the basic tenet that unless an enterprise of a Contracting State has a permanent establishment situated in the other State, the business profits of that enterprise may not be taxed by that other State unless they fall in one of the other special income categories (OECD, 2010b:art 7 para 2). The reason for the substantial revision of Article 7 is stated in the 2010 Update of the OECD Commentary: being attributable to the considerable variation in interpretation of the general profit attribution principles, giving rise to problems of double taxation and of double non-taxation (Olivier & Honiball, 2011:330-331).

Article 7(1) (2010 Update): The purpose of Article 7(1) is to limit the right of one Contracting State to tax the business profits of enterprises of the other Contracting State. Therefore, the converse of the general rule contained in Article 7(1) is that the right to tax of the State where the permanent establishment is situated does not extend to profits that the enterprise may derive from that State which are not attributable to the permanent establishment. Consequently, the general “force of

attraction” principle which allows for such taxation has been unequivocally rejected and the taxing authorities of the source State should look at the separate sources of profit which the enterprise derives in such State and should apply to each the permanent establishment criteria as set out in Article 5. (OECD, 2010b:art 7 para 12.)

Article 7(2) (2010 Update): The fiction that the permanent establishment is a separate enterprise operating independently of the rest of the enterprise, is therefore maintained in the 2010 version of Article 7(2). The principle of the separate entity approach, in a South African context, was confirmed in *Sackstein NO vs Proudfoot SA (Pty) Ltd* 2003 4(SA) 348 (SCA). While the words “arm’s length” are not expressly used in Article 7, the OECD Commentary does expressly refer to this principle, as was the situation prior to the 2010 Update. (OECD, 2010b:art 7 para 17.)

Article 7(3) (2010 Update): The OECD Transfer Pricing Guidelines have been developed in order to eliminate the risks of the double taxation arising inter alia from the application of Article 7. To the extent that double taxation nevertheless arises due to differing interpretations, Article 7(3) requires an appropriate adjustment in the Contracting State not doing the original adjustment. This corresponding adjustment is not automatic but must only be made if the other State considers that the adjusted profits conform with Article 7(2). (OECD, 2010b:art 7 para 59.)

Article 7(4) (2010 Update): Article 7(4) – which provides that, where profits include items of income which are dealt with separately in other articles of the Model Tax Convention, the provisions of those articles are not then affected by Article 7 – only becomes relevant when those other articles give a different tax result to Article 7.

Advance binding rulings: Although advance binding rulings are available in South Africa under the Advance Tax Rulings procedure contained in Sections 76B to 76S of the South African Income Tax Act, “it is uncertain whether it is possible to apply for a ruling relating to the attribution of profits to a permanent establishment” (Olivier & Honiball, 2011:354). The reason for this uncertainty is that Section 76G, which contains the list of exclusions, refusals and rejections in respect of which a ruling cannot be obtained, does not specifically exclude a ruling about the attribution of profits to a permanent establishment and merely excludes “the pricing of goods or services supplied by or rendered to a connected person in relation to the applicant” (Section 76G(1)(a)(iii)). As a permanent establishment is not a connected person, as defined, vis-à-vis the rest of the enterprise, a ruling pertaining to the attribution of profits to a permanent establishment “is arguably not one of the specific exclusions, despite the fact that transfer pricing principles are involved” (Olivier & Honiball, 2011:354).

4.4.2 Business profits in South African CFC legislation

4.4.2.1 Introduction

The computation of business profits in South Africa's CFC legislation is regulated by Section 9D(2A), which contains specific rules pertaining to the calculation of net income for South African CFCs. The opening words to Section 9D(2A), "put it beyond [all] doubt, that all the provisions of the South African Income Tax Act are applicable to CFCs" (Olivier & Honiball, 2011:574). It is also specifically provided in Section 9D(2A) that, for the purposes of the subsequent sections or paragraphs, a CFC is deemed to be a South African resident: Section 1 (gross income); Section 7(8) (donations made by a resident or non-resident); Section 10(1)(h) (interest accrued to or received by a non-resident); Section 25B (income of trusts and beneficiaries of trusts); paragraphs. 2(1)(a), 24, 70, 71, 72 and 80 of the Eighth Schedule on Capital Gains Tax. The result of this deeming provision is, for example, that the CFC will be taxed on its worldwide income.

4.4.2.2 The arm's length principle in South Africa's CFC legislation

A CFC was previously deemed, through proviso (i) to Section 9D(2A), for the purposes of the arm's length transfer-pricing requirements of Section 31(2) of the Income Tax Act, to be a resident regarding a wide range of transactions, agreements or other understandings "between that [CFC] and any connected person in relation to that [CFC]" (proviso (i) to Section 9D(2A)) up to 31 March 2012). As from 1 April 2012 this provision has been deleted (South Africa, 2011d:Section 25(1)(e)). "It would appear that its deletion has the effect that the application of Section 31 transfer pricing provisions from 1 April 2012 to transaction amounts of the CFC will initially therefore depend on whether the CFC is treated as a resident, or remains a non-resident, in particular circumstances" (Potgieter, 2012:35).

4.4.3 Comparison: Business profits in South African CFC legislation and OECD and UN Model Tax Conventions

Article 7(1) of the OECD Model Tax Convention is reproduced here as a focal point of discussion in evaluating the relationship of Article 7(1), in the OECD and UN Model Tax Conventions, to South Africa's CFC legislation:

Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State. (OECD, 2010a:art 7 para 1.)

The UN Model Tax Convention, on the other hand, goes a step further in its Article 7(1) by making provision for what is commonly known as a "limited force of attraction principle". In terms of UN

Model Tax Convention Article 7(1)(b)(c), profits, not only those attributable to the permanent establishment, but also those derived from certain types of transactions, may also be taxed in the source country in which the permanent establishment is based (see 4.4.1.3 above).

Determining the relevance of business profits in Article 7(1) (of both Model Tax Conventions) to business profits in South Africa's CFC legislation, leads to the question that often arises in the current debate on CFC legislation of whether CFC legislation results in double taxation. Wenehed (as quoted by Andersson, 2006) is of the view, with respect to Article 7(1), that "the income [of an enterprise] shall be taxable only in the company state" and that a country's CFC legislation allows for the "taxation of the shareholder on the profits in the CFC, is contrary to Article 7(1) in the OECD Model Convention" (Andersson, 2006:23). This is reinforced by Sandler who holds the view that the *Bricom Holdings v IRC* (United Kingdom, 1997) case, would have been more successful if the taxpayer (*Bricom Holdings Ltd*) relied on the article on business profits (Sandler & Chartered Institute of Taxation, 1998:471-472). Sandler based his argument on the principle contained in Article 7(1) that "the profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other ... State through a permanent establishment." This would have resulted in the Dutch subsidiary, *Spinneys' International BCV*, being taxed only in Holland – with no tax levied on the shareholders through CFC measures in the United Kingdom – for the interest received by *Spinneys' International BCV*, on the basis that "the profits of a Contracting State shall be taxable only in that State". (OECD, 2010a:art 7 para 1.)

Article 7, on business profits, in either the OECD or the UN Model Tax Convention is not directly pertinent to the calculation of business profits in South Africa's CFC tax legislation. Article 7(1), in both Model Tax Conventions, refers to "profits of an enterprise of a Contracting State" or when an "enterprise carries on business in the other Contracting State through a permanent establishment situated therein". In this respect, and in a treaty context, the South African CFC is not an enterprise of South Africa, nor does the CFC qualify as a permanent establishment in terms of either Model Tax Conventions. The foreign business establishment exemption criterion in South Africa's CFC legislation, in terms of Section 9D(9)(b), also does not qualify as permanent establishment in terms of articles 5 and 7 of the OECD and UN Model Tax Conventions, as the objective of the South African FBE criterion is unique by international standards in seeking chiefly to grant tax exemptions to qualifying FBEs of CFCs. The PE criterion, on the other hand, grants taxing rights to foreign jurisdictions in respect of qualifying PEs based in their (source) jurisdictions.

4.4.4 Implications for the South African context

The use of the term *business profits* in Article 7 of the OECD and UN Model Tax Conventions does not entirely coincide with the use of the term in Section 9D(2A) of South Africa's CFC legislation.

There are differing objectives in the application of the term *business profits* in South Africa's CFC legislation and in the OECD and UN Model Tax Conventions. Articles 7 of both Model Tax Conventions confine the term *business profits* to computation of business profits in respect of the enterprise of a Contracting State or the permanent establishment of an enterprise (usually a branch) that is based in a foreign (source) country. Article 7 could therefore be regarded as "an agreed set of rules by reference to which the profits attributable to the permanent establishment are to be calculated" (OECD, 2008:art 7 para 1).

Business profits in South Africa's CFC legislation, by implication, would refer to the calculation of the net income of the CFC in respect of its foreign tax year. The computation of the net income of the CFC is to be done within the legislative requirements of Section 9D(2A), and also in compliance with the transfer pricing provisions contained in Section 31 (taking into consideration the legislative changes brought about by Act No. 7 of the Taxation Laws Amendment Act, 2010) and also in the new transfer pricing regulations contained in Sections 9D(9)(b) and 9D(9A) (brought about by the Taxation Laws Amendment Act, No. 24 of 2011).

Notwithstanding the disparity in the respective use of the term *business profits* in the Model Tax Conventions and in Section 9D(2A) of the South African CFC legislation, in each case the arm's length principle remains a key requirement. The arm's length principle is enshrined in Article 7(2) of both the Model Tax Conventions, highlighting the need for fiscal independence and the avoidance of tax manipulation (i.e., nullifying the effects of tax distortions in reporting profits of multinational companies especially with regard to the transferring of profits to lower-tax jurisdictions).

The "arm's length" principle is therefore a key component in neutralising the effects of transfer pricing distortions in related-party transactions.

4.5 Transfer pricing

Table 4-7 Transfer pricing

Subject	OECD Model Tax Convention	OECD Transfer Pricing Guidelines	UN MTC	South African Tax Legislation
Arm's length principle	Article 9(1) (see 4.5.1.2)	Chapter 1 (see 4.5.1.2)	Article 9(1) (see 4.5.1.2)	Sect. 9D(9)(b) and 9D(9A) Sect. 31(b) (see 4.5.2.2)
Separate enterprise	Article 9(1) and 9(2) (see 4.5.1.2)	Chapter 1 (see 4.5.1.2)	Article 9(1) and 9(2) (see 4.5.1.2)	-
Transfer pricing methods	-	Chapter 2 and 3 (see 4.5.1.3)	-	-
Determination of arm's length price	Article 9(1) and 9(2) (see 4.5.1.3)	Chapters 1, 2 and 3 (see 4.5.1.3)	Article 9(1) and 9(2) (see 4.5.1.3)	Sect. 31(2) &(3) (updated) (see 4.5.2.2)
Adjustment to arm's length price	Article 9(2) (see 4.5.1.3)	Chapter 4 (see 4.5.1.3)	Article 9(2) (see 4.5.1.3)	Sect. 31(3) (see 4.5.2.2)
Anti-avoidance legislation	-	-	-	Sect. 31 and Sect. s 80 (see 4.5.2.2)
Legal Proceedings	-	-	Article 9(3) (see 4.5.1.4)	-
Granting financial assistance or use of intellectual property (Sec 23(1))	-	-	-	Sect. 31(4) (see 4.5.2.2)
Relief from transfer pricing, high-taxed CFCs	-	-	-	Sect. 31(6) (see 4.5.2.2)
Resolving of transfer pricing disputes	-	Chapter 4 (see 4.5.1.3)	-	-

Author

4.5.1 Transfer pricing in Art. 9 of OECD and UN Model Tax Conventions

4.5.1.1 Introduction

In considering how transfer pricing regulations are handled in the OECD guidelines, Article 9 of the OECD Model Tax Convention (2010), which deals specifically with transfer pricing, needs to be read in conjunction with the OECD Report, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010*. Identifying the regulatory framework under which the OECD transfer pricing policies are formulated will enable comparison with South Africa's transfer pricing regulations in the latter part of this chapter section. The aim of the comparison is to highlight shortcomings in the South African transfer pricing regulatory framework to which possible recommendations are to be made in the concluding chapter of the thesis. Arnold and McIntyre (2002: 55) describe a transfer price as

[A] price set by a taxpayer when selling to, buying from, or sharing resources with a related person. For example, if A Co. manufactures goods in country A and sells them to its foreign affiliate, B Co., organized in country B, the price at which that sale takes place

is called a transfer price. A transfer price is usually contrasted with a market price, which is the price set in the market place for transfers of goods and services between unrelated persons.

Since prices that apply within a group are controlled, the usual market forces that establish prices for such transactions between unrelated parties may not apply. Therefore, the selection of the transfer price will affect the allocation of the total profit among the different parts of the company. This is a key concern for fiscal authorities who are concerned with the fact that multinational entities may set transfer prices on cross-border transactions in order to reduce or decrease taxable profits in their jurisdiction.

According to the OECD Centre for Tax Policy and Administration,

Once you take on board the fact that more than 60 per cent of world trade takes place within multinational enterprises (MNEs), the importance of transfer pricing becomes clear ... Transfer prices are useful in several ways. They can help an MNE identify the most and least efficient parts of the enterprise. Furthermore, an MNE could suffer double taxation on the same profits without proper transfer pricing (as cited in KPMG, 2007: 3).

4.5.1.2 OECD and UN MTC adoption of the arm's length principle

The phrase “arm’s length principle” does not appear in either the OECD (2010) or the UN Model Tax Conventions (2011). However, Article 9(1) of the Model Tax Conventions provides an authoritative statement on the underlying concept:

[When] conditions are made or imposed between ... two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

This statement endorses the approach that is to be adopted when applying the arm’s length principle, namely, that the members of MNEs should be treated as independent entities, “rather than inseparable parts”, of a single conglomerate business. Emphasis is therefore placed on the “nature of the transactions” between the members of the group (OECD, 2001:para 1.6; 2010c:para 1.6).

In terms of the OECD Commentary, paragraph 1 of Article 9 of the Model Tax Convention (2010) authorizes tax authorities to rewrite the accounts of associated enterprises for the purpose of calculating tax liabilities if, “as a result of the special relations between the enterprises, the accounts do not show the true taxable profits arising in that State” (OECD, 2005a:art 9 para 2). The question that therefore arises “for both the taxpayer and tax [authorities] to address is whether the conditions in the commercial or financial relations of associated enterprises are at arm’s length or whether non-arm’s length conditions are present” (Allan, 2007:11-12). According to Allan, “the importance of this

statement is that, it [levels] out the field for both related and independent enterprises as [these] transactions are [treated] equally” (Allan, 2007: 12).

The OECD Commentary on paragraph 2 of Article 9 of the Model Tax Convention (2010) gives consideration to the possible application of “economic double taxation (taxation of same income in the hands of different persons)” that could arise from the possible rewriting of the accounts and the non-arm’s length principle being present in the relationship or dealings between associated enterprises (OECD, 2010b:art 9 para 5). If, for example, “enterprise of State A whose profits are revised upwards, will [now] be liable to tax on an amount of profit which has already been taxed in the hands of its associated enterprise in State B,” then the taxing authorities in State B shall therefore make an “appropriate adjustment” of taxation in their jurisdiction so as to mitigate or relieve the effect of double taxation (OECD, 2005a:art 9 para 5).

The arm’s length principle is considered “an international standard for assigning transfer prices because it provides a substantial level playing field for both MNEs and independent enterprises.” (Allan, 2007:12). Allan is of the view that “there is general international consensus that the arm’s length principle has become the international transfer pricing standard of most countries and of almost all tax treaties” (Allan, 2007: 12).

4.5.1.3 Application of the arm’s length principle

OECD Proposed methods

The OECD Transfer Pricing Guidelines, in conjunction with Art 9 of the Model Tax Convention (2010), outline the methods and procedures that should be utilised when applying the arm’s length principle. These methods are divided into the following groups:

- Traditional transaction methods: Comparable Uncontrolled Price Method (CUP); Resale Price method (RP); Cost Plus method (CP) (OECD Transfer Pricing Guidelines, 2010, (OECD, 2010c: para 2.12).
- Transactional profit methods: Transactional Profit-Split Method; Transactional Net-Margin Method (TNMM) (OECD, 2010c: para 2.56).

The arm’s length principle “does not require the application of more than one method,” and that “undue reliance on such an approach could create a significant burden for taxpayers” (OECD, 2010c: para 2.11), nor is it a requirement for “either the tax examiner or taxpayer to perform analysis under more than one method”. However, in certain cases, “the selection of a method may not be straight forward and [that] more than one method may be initially considered”, but, generally, it will be possible, for the selection of a single method “that is apt to provide the best estimation of an arm’s length price” (2010c: para 2.11). With respect to the difficult cases, where no particular approach is conclusive, “a flexible approach would allow the evidence of various methods to be used in

conjunction [with one another]” (2010c: para 2.11). In such cases, “an attempt should be made to reach a conclusion [that is] consistent with the arms’ length principle”, after taking into account “the facts and circumstances of the case, the mix of evidence available, and the relative reliability of the various methods under consideration” (OECD, 2001: para 1.69; 2010c)).

The traditional transactional method is the preferred method of the OECD:

Traditional transactions methods are the most direct means of establishing whether conditions in the commercial and financial relations between associated enterprises are arm’s length. As a result, traditional transaction methods are preferable to other methods. (OECD, 2001: para 2.49.)

The following have been identified in the OECD guidelines as factors that must be taken into consideration by tax authorities when applying the arm’s length principle to transfer pricing issues: comparability analysis; recognition of actual transactions undertaken; losses; the effect of government policies; use of customs valuations (OECD, 2001: Chap 1 para 1.69; 2010c)).

The traditional transaction methods

Chapter II of the OECD guidelines (2010c)(2010) provides a detailed description of the traditional transaction methods that are used in the application of the arm’s length principle. These methods are categorised into the following three groups:

- The comparable uncontrolled price (CUP) method
- The resale price (RP) method
- The cost plus (CP) method (OECD, 2010c: para 2.12.)

The traditional transactional method is regarded as the most direct way to authenticate if the conditions which exist between associated enterprises are at arm’s length. It compares the prices charged in controlled transactions undertaken between those associated enterprises with prices charged in comparable transactions undertaken between independent enterprises (OECD, 2010c: para 2.3). This is considered to be the most direct approach, as “any difference in the price of a controlled transaction from the price in a comparable uncontrolled transaction can normally be traced directly to the commercial and financial relations made or imposed between the [associated] enterprises.” (2010c: para 2.3). Therefore the arm’s length principle “can be established by directly substituting the price in the comparable uncontrolled transaction for the price of the controlled transaction.” (2010c: para 2.3). “The application of the arm’s length principle is generally based on a comparison of the price, margin or profits from particular controlled transactions with the price, margin or profits from comparable transactions between independent enterprises (2010c: para 2.6).

Comparable uncontrolled price method (CUP)

In terms of paragraph 2.13, “the comparable uncontrolled price (CUP) method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances” (OECD, 2010c:ch 2). This makes it, theoretically, the easiest way to establish the arm’s length price. In this case, the arm’s length price is determined by the sale price between two unrelated enterprises. However, should there be any difference between the two prices; this would be an indication of the fact “that the conditions [in] the commercial and financial relations of the associated enterprises are not [at] arm’s length” (2010c: para 2.13). Consequently “the price in the uncontrolled transaction may need to be substituted for the price in the controlled transaction” (2010c: para 2.13).

Cost plus method

The cost plus method is most useful where

- semi-finished goods are sold between associated parties, where associated parties have concluded joint facility agreements, or
- long-term buy-and- supply arrangements, or
- where the controlled transaction is the provision of services (OECD, 2010c: para 2.39).

The cost plus method commences “with the costs incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to an associated purchaser” (2010c: para 2.39). Thereafter, “an appropriate cost plus mark-up is then added to this cost, to make an appropriate profit in light of the functions performed and the market conditions.” (2010c: para 2.39) . The figure “arrived at after adding the cost plus mark-up to the above costs may be regarded as an arm’s length price of the original controlled transaction” (2010c: para 2.39). “The cost plus mark-up of the supplier in the controlled transaction should ideally be established by reference to the cost plus mark-up that the same supplier earns in comparable uncontrolled transactions (‘internal comparable’).” Therefore, “the cost plus mark-up that would have been earned in comparable transactions by an independent enterprise may serve as a guide (‘external comparable’).” (2010c: para 2.40.)

Resale price method

In situations where comparable transactions may not be easily found, the resale price method is used. This method considers the price of a product which has been purchased from an associated enterprise and is resold to an independent enterprise. The resale price is then reduced by an appropriate gross margin on this price that covers the reseller’s selling and operating costs so as to provide an

appropriate profit, having taken into consideration the functions performed, assets used and risks assumed by the reseller. The balance is then regarded as the arm's length price. The resale price method is most useful where it is applied to marketing operations" (OECD, 2010c: para 2.21).

The resale price margin of the reseller in the controlled transaction may be calculated "by reference to the resale price margin that the same reseller earns on items purchased and sold in comparable uncontrolled transactions ('internal comparable')" (OECD, 2010c: para 2.22). Therefore, "the resale price margin earned by an independent enterprise in comparable uncontrolled transactions may serve as a guide ('external comparable')" (2010c: para 2.22).

Transactional profit methods

There are a number of non-traditional methods available for determining the arm's length price. The most common are "the profit-split (PS) method and the transactional net-margin method (TNMM)" (OECD, 2010c: para 2.56).

Profit-split method (PS)

Under the profit-split method, the combined profit of the connected parties is split between them. This is achieved by approximating the profit that would have been anticipated had agreement been made at arm's length. This method is generally applied where transactions are so interrelated that they cannot be evaluated separately (OECD, 2001: para 3.5). The practical problem in applying this method is that it relies on the ability to access worldwide group data, which may be difficult to obtain or access (Oguttu, 2006a: 397).

In a very simplified example in which a South African company A sends four of its researchers to an Australian subsidiary B, to assist in the improvement of its wine quality. The wine is consumed in the Australian market. Subsidiary B also has six of its equally salaried researchers to assist in the same improvement. It was agreed upon that Subsidiary B would pay Company A 40 per cent of the ultimate profits as a royalty fee for the technical knowledge provided by Company A's researchers. (Allan, 2007: 30.)

Transactional net-margin method (TNMM)

In terms of the 'transactional net-margin method', the net profit margin that a taxpayer realises from a controlled transaction is examined relative to an appropriate base of, for example, costs, sales or assets (OECD, 2010c: para 2.58). A profit-level indicator of an enterprise in a controlled transaction is then determined and this is then compared to the profit-level indicators of comparable uncontrolled transactions or independent parties" (2010c: para 2.58).

According to Oguttu,

the problem of relying on this method is that the controlled enterprise and the uncontrolled enterprise involved in the comparison would need to be structurally similar, which is not usually the case in practice. Often, the net margin of a taxpayer can be affected by other factors that do not necessarily have an influence on price or gross margins. (Oguttu, 2006a: 397)

4.5.1.4 The UN Model Tax Convention in respect of legal proceeding and penalties

Except for paragraph 3 in Article 9 of the UN Model Tax Convention, the OECD Model Tax Convention in paragraphs 1 and 2 of Article 9 are similar to the respective paragraphs in the UN Model Tax Convention. However, during 1999 The Group of Experts had made an amendment to Article 9 of the UN Model Tax Convention by inserting a new paragraph 3. The paragraph provides that paragraph 2 of this convention, “shall not apply where the judicial, administrative or other legal proceedings have resulted in a final ruling that, by actions giving rise to an adjustment of profits under paragraph 1, one of the enterprises concerned is liable to penalty with respect to fraud, gross negligence or wilful default”. Therefore, “a taxpayer may be subject to non-tax and tax penalties” (United Nations, 2011:art 9 para 3). This paragraph is not contained in the OECD Model Tax Conventions.

4.5.2 Transfer pricing regulations in South African CFC legislation

4.5.2.1 Introduction

This chapter section will focus on South African transfer pricing legislation especially with regard to the new regime of Section 31. With the substitution of Section 31 of the Income Tax Act by the Taxation Laws Amendment Act, No. 7 of 2010, a new chapter had begun in South African transfer pricing regulations (Section 31), with the new regulatory framework coming into effect on 1 October 2011, and applicable to all financial years beginning on or after 1 October 2011 (South Africa, 2010c). “The new transfer pricing rules are closely aligned with the wording of the OECD and UN Model Tax Conventions and are in line with tax treaties and other international tax principles” (South Africa, 2010a:76). Accordingly, South Africa will continue to subscribe to the OECD Transfer Pricing Guidelines with regard to both: “transfer pricing in general and the power to re-characterise transactions in the application of the transfer pricing rules” (South Africa, 2010a:76).

Thus, the “revised Section [31] includes a wider net of transactions and is worded in a manner that is similar to an anti-avoidance Section, in an attempt to close off loopholes that have been used by taxpayers in the past” (Siwele, 2011:39). The revised legislation makes it compulsory for all international transactions between connected persons to be concluded at arm’s length prices and that the discretion to adjust to arm’s length prices no longer lies with the Commissioner, as was the case

previously. Taxpayers are therefore required to account for transfer pricing on an arm's length basis, without SARS intervention. "SARS also has the power to adjust the terms and conditions of a transaction, operation, scheme, arrangement or understanding to reflect the terms and conditions that would have existed at arm's length" (South Africa, 2010a:76).

A point to be noted is that with the introduction of the amended Section 31 (came into effect 1 October 2011) a new Interpretation Note is currently being drafted by the South African Revenue Services, which will replace Practice Notes 2 and 7. Therefore, with the impending publication of a the new Practice Note, the current study will not include any detail discussion of either of the above Practice Notes. Accordingly, the new Section 31 was revised to align South African income tax legislation with the OECD and UN Model Tax Conventions and more specifically to include the arm's length principle as postulated in the OECD and UN Model Tax Conventions (South Africa, 2010c).

The discussion will cover the following topics: the inauguration of the new Section 31 by the 2010 Taxation Laws Second Amendment Bill; impact of transfer pricing on Section 9D; comparison: transfer pricing in South Africa and the OECD and UN Model Tax Conventions; conclusion.

4.5.2.2 Revised Section 31 (2010 Taxation Laws Second Amendment Bill)

Structural analysis and interpretation of the new Section 31

Section 31 of the South African Income Tax Act contains the core legislative provisions pertaining to transfer pricing. The South African transfer pricing rules essentially require that an arm's length, i.e. market related price be paid/charged in respect of the cross-border supply of goods or services between connected persons. Therefore, in the context of the new Section 31 regulations, transfer pricing applies to any transaction, operation, scheme, agreement or understanding that has been directly or indirectly entered into between connected persons or that has been directly or indirectly entered into for the benefit of either or both connected persons. Effectively, therefore, transactions between third parties could potentially influence the price of the transactions between the connected persons. (Olivier & Honiball, 2011:662.)

According to the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2010, the previous wording of the South African transfer pricing rules caused structural problems and uncertainty because the literal wording in the Income Tax Act focused unduly on separate transactions, "as opposed to overall arrangements driven by an overarching profit objective" (South Africa, 2010a:75). This narrow focus gave "rise to artificial arguments by certain taxpayers seeking an excessive emphasis on literal terms of the transaction, as opposed to a focus on the overall economic substance and commercial objective of the arrangement" (South Africa, 2010a:75). In addition, SARS was of the view that the language in the act gave "rise to an excessive emphasis of the

comparable uncontrolled price (CUP) method as opposed to other more practical transfer pricing methodologies” (Transfer Pricing Associates, 2011:1). Further, SARS was of the opinion that the emphasis in the previous legislation on “price” as opposed to “profits” did not “align with the wording in the associated enterprises article in the tax treaties concluded by South Africa” (South Africa, 2010a:75).

To alleviate the above uncertainties, the new transfer pricing rules have been closely aligned with the wording of Article 9 of the OECD and UN Model Tax Conventions, with the focus being on the economic substance of the arrangements between related parties, rather than the pricing of specific transactions (Transfer Pricing Associates, 2011:1). Accordingly, the new Section 31(2) will apply where

- any transaction, operation, scheme, agreement or understanding had been directly or indirectly entered into between connected persons with a cross-border nexus;
- any term or condition of that transaction, operation, scheme, agreement or understanding is different from any term or condition that would have existed had those parties been independent persons dealing at arm’s length; and
- the transaction, operation, scheme, agreement or understanding results or will result in a tax benefit being derived by any party to it. (Section 31(2).)

In these circumstances, therefore, the taxable income of each person deriving a tax benefit from that transaction, operation, scheme, agreement or understanding, must be calculated as if that transaction, operation, scheme, agreement or understanding had been entered into on the terms and conditions that would have existed in an arm’s length environment (Section 31(2)).

In terms of the legislative requirement of the former Section 31, transfer pricing and thin capitalisation provisions were dealt with separately under Section 31(2) and (3) respectively. Section 31(2) only applied to direct transactions whereas Section 31(3) applied to both direct and indirect transactions. The new Section 31 changed this by merging both transfer pricing and thin capitalisation principles into a single subsection, resulting in the 3:1 thin capitalisation debt to equity ratio – safe harbour – as per Practice Note 2 being declared ineffective, as the revised Section 31 requires all transactions to be determined at arm’s length prices. (South Africa, 2010a:75-76.)

Thin capitalisation rules

In response to the above, the South African taxing authorities deemed it necessary that “the current thin capitalisation rules parallel the transfer pricing rules”, based on the fact that the OECD and UN Model Tax Conventions “deal with thin capitalisation as part of the associated enterprises article, so thin capitalisation rules are merely seen as an extension of the transfer pricing rules” (South Africa, 2010a:75). This “cohesion provided by the international paradigm offer greater certainty and

minimises the scope for interpretational difficulties both domestically and under mutual agreement procedures” (South Africa, 2010a:75). Therefore, the new regulations require that the arm’s length principle be applied to financial assistance in the same way it is applied to any other transaction, operation, scheme, agreement or understanding. In practice, this will have the result that the taxpayer will have to determine what amounts it would have been able to borrow (i.e., its lending capacity) in the open market: on what overall terms and conditions and at what price. (Transfer Pricing Associates, 2011:2.)

Although the introduction of the arm’s length standard to the thin capitalisation rules “seems to be commendable”, in reality “the application of the arm’s length principle in the context of thin capitalisation has proven to be extremely difficult, as the factors considered by third-party providers of financial assistance are often multi-faceted and not necessarily limited to an analysis of the debt to equity ratio” (Transfer Pricing Associates, 2011:2). SARS has acknowledged this and has undertaken to the issuing of “an interpretation note in respect of the new transfer pricing rules in general and the application of the arm’s length principle to thin capitalisation [rules]” (Transfer Pricing Associates, 2011:2).

The arm’s length concept in the new transfer pricing regulation

The previous emphasis on the pricing of cross-border transactions between related parties has been replaced with a more holistic approach in that the focus will no longer be only on the pricing of transactions, but rather on all aspects of the relationship between contracting parties. In terms of the new rules, any transfer pricing adjustments will have to be made by the taxpayer that is party to the affected transaction in the tax return (Section 31(2)). This differs from the previous rules, which did not allow for a transfer pricing adjustment to be made by the taxpayer itself, but rather provided SARS with the discretion to make such an adjustment, if SARS was of the opinion that the transaction had not been priced on an arm’s length basis. (Joubert, 2013:1.)

The onus to make any transfer pricing adjustment therefore shifts from SARS to the taxpayer, placing a considerably greater onus on taxpayers, while not diminishing the powers of SARS. This obliges taxpayers, at year end, to make any transfer pricing adjustments that may be necessary (Section 31(2)). In addition, the obligation to make a transfer pricing adjustment is automatically triggered if the intra-group cross-border transaction contains one or more terms or conditions that are different to that which would have existed under an arm’s length relationship and which results in a tax benefit being derived by a South African contracting party. (Joubert, 2013:1.)

The new transfer pricing regulations indicate that, to the extent that there is a difference between the arm’s length price and the price actually charged, the amount of that difference will constitute a deemed loan for the purposes of Section 31(3) of the Income Tax Act. An arm’s length interest must

be applied to the amount of the deemed loan. The deemed interest will accrue to the taxpayer for each year of assessment until the deemed loan is repaid. According to Joubert, “the practical implications of this change are quite daunting and there have been informal indications from SARS that the deemed loan may be abolished” (Joubert, 2013:1). Accordingly, “a possible, practical alternative would be a deemed dividend, with a consequent liability for dividend tax for the South African entity”, parallel to the previous rule in Section 31 which imposed STC on transfer pricing adjustments (Joubert, 2013:1).

Comparability

The main challenge that South Africa encounters in determining arm’s length profits is the lack of domestic comparables, as detailed information on public companies and information on private companies is generally not publicly available. The perfect comparable, in a South African context, therefore remains elusive and almost unattainable. Exacerbating the problem is the absence of any database containing comparable South African-specific, or for that matter African-specific, data. Accordingly, SARS has stated in Practice Note No. 7 that it accepts the use of foreign financial databases but may require that adjustments to the data be carried through for use in the South African market (Transfer Pricing Associates, 2011:5).

Relief from transfer pricing regulations – high-taxed CFCs

The government has introduced a number of initiatives aimed at reducing potential double taxation for South African companies investing into Africa. One of the initiatives is that transfer pricing regulations pertaining to certain cross-border financial assistance transactions (e.g., loans) and certain cross-border uses of intellectual property do not apply. More specifically, transfer pricing will not apply to holders (i.e., creditors) of a loan or holders of intellectual property if

- The holder is a South African company;
- The obligor is a CFC in relation to the South African holder and 10 per cent of the equity shares and voting rights in the obligor is directly owned by that holder (whether alone or together with any other company forming part of the same group of companies as the holder);
- The CFC has a foreign business establishment; and
- The CFC is highly taxed (an aggregate effective rate of 75 per cent of the South African rate that would otherwise be imposed). For purposes of this 75 per cent threshold, foreign taxes on income imposed by all foreign spheres of government (national, provincial and local) must be taken into account. (South Africa, 2012:120-121.)

Effective date of applicable provision Section 31(6): This amendment came into effect on 1 January 2013 (by Section 64(1)(e) of Act No. 22 of 2012 of the Taxation Laws Amendment Act) and will apply in respect of any year of assessment commencing on or after that date.

4.5.2.3 The Impact of transfer pricing on Section 9D

Determination that Section 31 of the Income Tax Act will apply to a CFC in the calculation of its net income was previously confirmed by the specific references to transfer pricing in Section 9D(2A)(c) and (i). The implication of the above proviso was that interest, as an example, could have been imputed on an interest-free loan made by a CFC to a non-resident connected person in relation to the CFC.

Until 2002, uncertainty existed as to whether the transfer pricing provisions were applicable to transactions or agreements entered into between two CFCs. On the one hand, the view was held that since both CFCs are regarded as South African residents for the purposes of the calculation of their net income, transfer pricing provisions should not be applicable. On the other hand, it was contended that a CFC is considered as a South African resident only for the purposes of the calculation of that CFCs net income, and that for all other intents and purposes it remains a non-resident. As a result, when the net income of CFC A is computed, CFC B remains a non-resident in relation to CFC A (Olivier & Honiball, 2011:638). This uncertainty was clarified by the promulgation of Section 9D(2A)(i), “which puts it beyond [all] doubt that for transfer pricing purposes, transactions, operations or schemes entered into between a CFC and a person connected to the CFC are deemed to be an international agreement (or, since 1 October 2007, a supply of goods and services) and the CFC is deemed to be a resident” (Olivier & Honiball, 2011:638) (proviso (i) to Section 9D(2A) applicable up to 31 March 2012). From 1 April 2012 this provision has been deleted (South Africa, 2011a: Section 25(1)(e)), and “it would appear that its deletion has the effect that the application of Section 31 transfer pricing provisions from 1 April 2012 to transaction amounts of the CFC will initially therefore depend on whether the CFC is treated as a resident, or remains a non-resident, in particular circumstances” (Potgieter, 2012:35).

The result is that an international agreement (or, since 1 October 2007, any supply of goods or services) entered into between a CFC and a person who is a non-South African resident, but is a connected person in relation to the CFC, is in principle subject to transfer pricing regulations. Further, an international agreement (or, since 1 October 2007, any supply of goods or services) entered into between a CFC and its South African resident shareholder would also be subject to transfer pricing regulations, as this is from the perspectives of calculating the taxable income both of the CFC and of the South African resident shareholder (Section 31(1) and 31(2)). The transfer pricing provisions will apply “irrespective of whether the transaction is entered into between a CFC which is a business

establishment with fully-fledged operations outside South Africa and another CFC which is also a business establishment with similar substance” (Olivier & Honiball, 2008: 502).

Income attributable to FBE (Taxation Laws Amendment Act, No. 24 of 2011): Section 25(1)(h) of Act No. 24 of the Taxation Laws Amendment Act 2011 had introduced an additional requirement to the FBE criteria of the South African CFC legislation – that not only will income relating to a substantive business qualify as income being attributable to a FBE, but also for income to be attributable to a FBE it must fulfil the arm’s length transfer pricing criteria in Section 9D(9)(b). In fulfilling the arm’s length criterion, the “attribution to a FBE must account for the functions performed, assets used and the various risks of the foreign business establishment”. (South Africa, 2011a:104.)

4.5.3 Comparison: Transfer Pricing in South African CFC legislation and the OECD Model Tax Convention

Transfer pricing in South African CFC legislation is mainly regulated by Section 31, especially in the light of the deletion of the previously applicable proviso (i) to Section 9D(2A) that was effective up to 31 March 2012. However, the inclusion of the arm’s length principle in Section 9D(9)(b) as an additional FBE criterion in the South African CFC legislation means that not only will income relating to a substantive business qualify as attributable to a FBE, but also that for income to be attributable to a FBE it will have to fulfil the arm’s length transfer pricing criteria set out in Section 9D(9)(b) (South Africa, 2011a:104). This is a significant step in concurring with Article 9 of the OECD and UN Model Tax Conventions and the OECD Transfer Pricing Guidelines (2010). Therefore, the discussion on transfer pricing, in the context of the South African CFC legislation, will mainly be based on Section 31.

The transfer pricing regulations in the new Section 31 regime may be outlined as follows:

Old rules: Broadly speaking, the old rules required that an arm’s length price be paid or charged in respect of the cross-border supply of goods or services between connected persons. Further, the old rules allowed the Commissioner to adjust the consideration paid in respect of such a transaction according to his discretion should it not reflect an arm’s length price, thus instigating a potentially higher tax liability for the taxpayer. In addition, the excessive portion of the consideration (i.e., the adjustment amount determined by the Commissioner) was subject to secondary tax on companies (STC) at a rate of 10 per cent, because of the excessive amount being regarded as a deemed dividend under Section 64(C)(2)(e) of the Income Tax Act.

New rules: In an attempt to address the concerns (see 4.5.2.2 above) of the old Section 31, the new rules essentially introduced three significant changes:

- The first and most significant change is that the new rules move away from the transactional based focus, where the arm's length price for a transaction had to be determined, to a more entity-based approach, where the taxable income of an entity has to be calculated as if all the affected transactions were concluded on an arm's length basis.
- The second significant change is that the Commissioner's discretion to adjust prices to ensure that an arm's length consideration is charged for goods and services provided, has been substituted by an obligation on the taxpayer to ensure that taxable income has been determined as if all affected transactions were concluded on an arm's length basis.
- Thirdly, an amount representing an adjustment is no longer regarded as a deemed dividend, subject to dividend tax. Instead, such an amount is deemed to represent a loan, bearing interest at a market related interest rate, should the loan not be repaid within the same financial year during which it was extended. (Brodbeck & Gers, 2012:1.)

Although not a member of the OECD, South Africa subscribes to the OECD Model Tax Convention and guidelines in embracing an internationally accepted method of determining the allocation of profits among a group of companies. Therefore, "by utilising the arm's length method South Africa is effectively confirming with Article 9 of the OECD Model Tax Treaty" (Olivier & Honiball, 2008:491). Paragraph 1 of Article 9 of the OECD Model Tax Convention is the foundation for comparability analysis because it introduces the need for

- comparison between conditions (including but not limited to prices) made or imposed between associated enterprises, and those made between independent enterprises to determine whether rewriting the accounts for the purposes of calculating tax liabilities of associated enterprises is authorized under Article 9 of the OECD Model Tax Convention (OECD, 2010b: Article 9, para 2).
- determination of the profits, which would have accrued at arm's length, in order to determine the quantum of any rewriting of accounts. (Sweidan, 2012:1.)

Internationally, including in a tax treaty context, it is acceptable that certain loans may be of an equity nature in certain specific circumstances, and in which case there will be no need to charge interest. The OECD Transfer Pricing Guidelines acknowledges this by stating that "where the economic substance of a transaction differs from its form", then it may be "both appropriate and legitimate for a tax administration to [disregard] the structure adopted by [the] taxpayer in entering into a controlled transaction" (OECD, 2010c: para 1.65).

Table 4-8 Main differences between old and new rules of Section 31

Old rules	New rules
Transaction-based approach	Shift to analysis of overall arrangements rather than individual transactions
Tests the price of the transaction	Test the profits of the arrangements
Preference for CUP method	No hierarchy of methods
Provides the Commissioner with the discretion to make adjustments	No discretion for Commissioner – but an obligation on each party to calculate taxable income on an arm's – length basis
No scope for voluntary transfer pricing adjustments by the taxpayer	Obligation on taxpayer to make transfer pricing adjustment in a tax return (self-assessment)
Transfer pricing adjustment treated as a deemed dividend and subject to STC	Excessive portion of income deemed to be a loan, in respect of which interest should be charged
Separate thin capitalisation rules	No separate thin capitalisation rules
3:1 debt: equity safe harbour rate	Application unclear

(Brodbeck & Gers, 2012:3.)

4.5.4 Implications for the South African context

South Africa's transfer pricing legislation has undergone a historic change as the South African taxing authority "attempts to keep up with international trends in transfer pricing regulations and with the changing landscape in global taxation" (Siwele, 2011:43). The introduction of the arm's length principle into the South African transfer pricing legislation by the Taxation Laws Amendment Act, No. 7 of 2010 (Section 31) is considered a milestone in South African taxing history as it attempts to align domestic transfer pricing legislation with Article 9 of the OECD and UN Model Tax Conventions and the OECD Transfer Pricing Guidelines, 2010 by compelling companies to now transact at arm's length prices when entering into international transactions with connected persons. A salient issue that emerges in this new trajectory laid out for South Africa's transfer pricing regulations is that the previous Section 31(2) which empowered the Commissioner to adjust the consideration relating to "international agreements, to reflect an arm's length price for the goods or services supplied in terms of the international agreement" (South Africa, 1999: para 4.2) is no longer valid under the new legislative dispensation on transfer pricing. Therefore, market forces must now act as the propellant to the arm's length principle which is a fundamental requirement for related-party international transactions.

The new Section 31(3) deems a transfer pricing adjustment to be a loan, on which interest at an arm's length rate should be charged. This represents a significant change from the previous Section 31, which deemed any adjustment made under Section 31 to be a dividend on which STC was levied. The proposed change effectively introduces a secondary adjustment on the South African taxpayer's taxable income in the form of interest on the deemed loan amount. The problem relating to this

changeover arises from the fact that the “adjustment made is deemed to be a loan until the point in time where the difference in pricing between the two related parties is settled through the repatriation of funds or through a possible mutual agreement procedure (MAP)” (Kruger, 2012:1). “In particular, it is uncertain how foreign tax authorities might treat a deemed loan, especially if there is a disagreement on what constitutes an arm’s length amount for the transaction in question” (Brodbeck & Gers, 2012:2). Situations may arise where exchange control regulations or other rules of foreign jurisdictions do not sanction the repayment of a deemed loan. Furthermore, even if such repayment would be permitted, the foreign party’s minority shareholders or joint venture partners may not agree to the repayment of a deemed loan. Although it may not be apparent in the beginning, “taxpayers might, as a result of the new rules, effectively become obliged to carry the consequences of historic transfer pricing adjustments forward indefinitely, resulting in deemed interest being charged on deemed interest”. (Brodbeck & Gers, 2012:2.)

There are, however, other concerns and limitations relating to the implementation of the South African transfer pricing regulations (Section 31), especially when compared to international practices in relation to OECD and UN publications:

- Although the arm’s length principle produces a sound outcome, South Africa’s lack of domestic comparable uncontrolled transactions makes it difficult to apply, encouraging the use of foreign comparables, which leads to further complications such as the ability to make adjustments to enhance comparability (Siwela, 2011:45).
- South Africa, unlike the leading OECD member countries, does not have advanced transfer pricing agreements (APAs) as part of its domestic tax legislation, putting it at a great disadvantage with regards to legal certainty. APAs would also provide certainty that foreign investors are looking for, which would in turn benefit the South African economy. Although South Africa has a working advanced tax rulings (ATR) regime in place, transfer pricing issues are currently specifically excluded from the scope of the ATR Regime (Siwela, 2011:46).
- Electronic trading could also have a negative impact on the South African transfer pricing legislation. Finding comparable uncontrolled e-commerce transactions is even more difficult as it is hard to determine exactly what the transactions involve due to their uniqueness. Separate transactions can also be so closely linked that it becomes impossible to evaluate them individually (Lord, 2007:60). It may be useful for South Africa to consider the way in which the United Kingdom has defined a transaction in its transfer pricing legislation to include a “series of transactions” where separating transactions may not enable the assessment of the arm’s length conditions (Schwarz, 1999:168).
- The traditional approach is also negatively impacted by the use of Intranets (internal electronic communication structures) within multinational enterprises, as, according to Oguttu (2006b:148-149) analysis with independent transactions cannot then be done

4.6 Chapter conclusion

The chapter compares interpretations of these key constituents in the South African tax legislation and its related interpretation notes with the formulations in the OECD and UN Model Tax Conventions. The nucleus of this comparison is highlighting key shortcomings in the South African CFC legislation, particularly with regard to the differing formulations attached to these constituents in the South African tax legislation when compared to international practices reflected in the OECD and UN Model Tax Conventions.

The principal elements that have been considered are resident and place of effective management, permanent establishment, foreign business establishment, business profits, and transfer pricing. The chapter concludes with a brief summary on each of these constituents with regard to shortcomings in the South African CFC legislation. Possible recommendations pertaining to these shortcomings will be made in the concluding chapter of the thesis.

Resident and place of effective management: The differing conceptions of “place of effective management” in the South African *Interpretation Note No. 6* and “permanent establishment” in the OECD and UN Model Tax Conventions are a matter of concern for South African taxing authorities; if taxing rights are incorrectly awarded to a foreign Contracting State in a double-taxation agreement with South Africa, this could result in potential income tax revenue being denied to the South African fiscus. In the longer term, if taxing rights are incorrectly granted to a foreign Contracting State, then SARS could lose substantial revenue.

The South African taxing authorities should therefore address this issue as a matter of urgency and ascribe internationally recognised meaning to the “place of effective management” concept, bringing it in line with current international practices as reflected in the OECD and UN Model Tax Conventions and other international tax publications (see also 4.3.5 above).

Permanent establishment and foreign business establishment: The term “permanent establishment” in the OECD and UN Model Tax Conventions differs in intent from the “foreign business establishment” concept in South Africa’s CFC regulations. The objective of the permanent establishment criteria in the Model Tax Conventions is to determine the existence of a permanent establishment in a foreign tax jurisdiction in order to confer on such jurisdiction the right to tax the profits of the permanent establishment. The objective of the foreign business establishment criteria in South African tax legislation is to grant tax exemptions to CFCs in respect of the qualifying active business operations pertaining to their FBEs, where the foreign business establishment must meet the criteria set out in Sections 9D(1), 9D(9)(b), and 9D(9A) if it is to qualify for this exemption.

Leaving aside the existing disparity between permanent establishment criteria in the Model Tax Conventions and foreign business establishment criteria in the South African CFC legislation, there

remains a need for internationally established terminologies to be used in the South African tax legislation, and specifically its CFC regulations, that are familiar and acceptable to both foreign investors and foreign tax authorities.

Therefore, exclusive use (with the necessary adaptations) of the term “permanent establishment” in the South African tax legislation, and more specifically its CFC regulations, to replace the term “foreign business establishment”, will put key elements in the South African CFC legislation on par with international practices as reflected in the OECD and UN Model Tax Conventions.

Business profits: The term *business profits* as employed in Article 7 of both the OECD and the UN Model Tax Conventions is not entirely symmetrical with the same term as employed in Section 9D(2A) of South Africa’s CFC legislation. The objectives of the Model Tax Conventions and of the South African CFC legislation in using the term are determined by their respective legal and tax considerations, and the differences in objective arise from the asymmetrical functions of business profits criteria in the Model Tax Conventions and the South African CFC legislation.

In fulfilling the requirements of a permanent establishment in terms of Article 5, Article 7 acts as the regulatory framework for the calculation and imputation of profits attributable to the permanent establishment. By comparison, *business profits* in the South African CFC legislation are determined in accordance with the provisions of the South African Income Tax Act, as if the CFC is a South African taxpayer for all taxing provisions and for the purposes of the calculation of the CFC’s net income in respect of its foreign tax year. The computation of net income is to be done within the legislative requirements of Section 9D(2A) and in close collaboration with the South African transfer pricing regulations (Sections 31, 9D(9)(b) and 9D(9A)) (see 4.4.1 above).

Notwithstanding differences in the use of the term *business profits* in Article 7 of the OECD and UN Model Tax Conventions and in Section 9D(2A) of South Africa’s CFC legislation, both the Model Tax Conventions and the South African CFC regulations regard the arm’s length principle as a strategic requirement for the preparation of financial information.

Transfer pricing: The recent spate of legislative changes to Section 31 is considered a landmark in South Africa’s transfer pricing legislation, as the South African tax authority “attempts to keep up with international trends in transfer pricing regulations and with the changing landscape in global taxation” (Siwele, 2011:43). Thus, the introduction of the arm’s length principle into the South African transfer pricing legislation by the Taxation Laws Amendment Act, No. 7 of 2010 (Section 31), is a clear indication that “the new transfer pricing rules are closely aligned with the wording of the OECD and UN Model Tax Conventions” and are “in line with tax treaties and other international tax principles” (South Africa, 2010a:76). Accordingly, South Africa’s commitment to follow the OECD Transfer Pricing Guidelines “both with respect to transfer pricing in general and the power to

re-characterise transactions in the application of the transfer pricing rules” is a major step in creating alignment with international tax practices. Another keystone change effected to the FBE requirement in the South African CFC regulations (brought about by the Taxation Laws Amendment Act, No. 24 of 2011) is the additional requirement that for income to be attributable to a FBE it also has to fulfil the arm’s length transfer pricing criteria (Sections 9D(9)(b) and 9D(9A)).

Despite South Africa having made strides in its transfer pricing regulations, the following concerns pertaining to the implementation of its transfer pricing regulations (Section 31) remain in measuring South African approaches against international practice:

- the lack of comparable South African uncontrolled transactions for the implementation of the arm’s length principle
- the legislative absence of the APA as part of the South African transfer pricing tax legislation when compared to international tax practice
- uncertainty over how foreign tax authorities may treat a deemed loan, especially if there is a disagreement on what constitutes an arm’s length amount
- restrictions created by foreign jurisdictions or foreign exchange control by not sanctioning repayment of a deemed loan
- need for a new Practice Note to replace *Interpretation Notes 2 and 7*

With this chapter having compared South African CFC regulations with corresponding provisions in the OECD and UN Model Tax Conventions (as specified in the thesis objectives at 1.6 above), Chapter 5 extends the international comparative perspective with a discussion of CFC regulations in the United Kingdom.

Chapter 5

CFC REGULATIONS: UNITED KINGDOM

5.1 Introduction

This chapter compares South African CFC regulations with corresponding provisions in the tax legislation of the United Kingdom, considering the following sets of issues (see secondary objectives of thesis at 1.6 above):

- comparison of the approaches to CFC regulations: jurisdictional-entity approach (United Kingdom) and the global-entity approach (South Africa)
- comparison of key features in the South African CFC legislation with analogous features in the United Kingdom CFC legislation, including: definition of CFC; qualification of CFC status; domestic taxpayers subject to taxation; computation of attributed income, exemptions, relief provisions; administrative aspects
- discussion of the similarities pertaining to certain key issues in both the South African and United Kingdom CFC legislations, emerging from the international comparisons
- discussion of the key divergences and anomalies in South African CFC legislation (emerging from the United Kingdom comparison) to which appropriate recommendations is to be made in the concluding chapter of the thesis

The following issues in United Kingdom CFC legislation will be the chief points of comparison between the United Kingdom regulatory approach and the South African regulatory approach: hisotical background; maning of CFC; residence; control requirements for a foreign company to qualify as a CFC; exemptions from CFC legislation; computation and apportionment of chargeable profits; special reductions in the apportionment of chargeable profits; apportionment of creditable taxes; relief tax provisions; other related provisions in CFC legislation; compatibility of United Kingdom CFC legislation with its tax treaties and European Union treaties¹.

¹ References to United Kingdom legislation, unless otherwise indicated, imply United Kingdom. 1988a. Finance Act 1988. The following standard abbreviated forms (with year date as applicable) are used for other frequently cited United Kingdom statutes:

CTA	Corporation Tax Act
FA	Finance Act
ICTA	Income and Corporation Taxes Act
TIOPA	Taxation (International and Other Provisions) Act

5.2 Historical background

The issue of tax territoriality is fundamental to tax law, and in the United Kingdom this basic tenet of taxation was highlighted by Lord Herschell in *Colquhoun v Brooks* (United Kingdom, 1889):

The Income Tax Acts ... impose a territorial limit, either that from which the taxable income is derived must be situate in the United Kingdom or the person whose income is to be taxed must be resident there.

This approach does however create scope for tax avoidance – especially in circumstances where a taxpayer conducts business in jurisdictions where the income or gains will not be taxed at all, or will only incur a modest amount of taxation. In counteracting this type of avoidance, it is clearly appropriate to extend the taxing jurisdiction to include income or gains relating to a non-resident entity, and to where the source is also located outside of the resident state. Accordingly, this metamorphosis in the United Kingdom taxing system could be attributable to the inauguration of CFC tax legislation (Ullah, 2004:607).

The United Kingdom was relatively late in promulgating CFC legislation as part of its domestic taxing regime. In 1984, when CFC rules were first enacted in the United Kingdom, a number of countries had already introduced CFC legislation as part of its domestic tax regimen: United States (1962); Germany (1972); Canada (1976); Japan (1978); France (1980) (Arnold & McIntyre, 2002:89). A reason for this delay in the introduction of CFC rules in the United Kingdom is preservation of the underlying principle in *Colquhoun* (above) whereby Inland Revenue has focused on the residence of the entity in question. The concept of residence, being based on *central management and control*, is considered to be very broadly defined in United Kingdom case law. This is well enunciated in the leading case of *De Beers Consolidated Mines Limited v Howe* (United Kingdom, 1906), in which De Beers was held to be a tax resident of the United Kingdom.

After protracted consultation, the United Kingdom taxing authorities introduced CFC regulations in the Finance Act of 1984. The promulgation of a CFC regimen followed the abolition of exchange controls in 1979, whereby United Kingdom taxing authorities contemplated a significant increase in the accumulation of funds in tax havens – especially by United Kingdom-resident corporations. United Kingdom CFC rules were therefore designed to counteract the following two types of tax-avoidance schemes (Ullah, 2004:609):

- diversion of profits from the United Kingdom tax net to foreign jurisdictions – where they will be subject to minimum or nil tax, and
- accumulation of profits in foreign jurisdictions – where they will suffer minimum or nil tax (profits derived abroad which, but for tax reasons, one would contemplate being remitted to the United Kingdom as taxable dividends).

The taxing authorities were particularly concerned with certain perceived abuses in relation to the following types of foreign companies being incorporated in low-tax jurisdictions, primarily for the purposes of tax avoidance in the United Kingdom: dividend-trap companies; money-box companies; patent-holding companies; captive insurance companies; and sales and distribution of selling companies (Ullah, 2004:609).

5.3 Overview of United Kingdom CFC legislation

Interim changes to United Kingdom CFC legislation

The recent spate of European Court of Justice decisions on United Kingdom CFC legislation has prompted government to enter upon a new trajectory for its CFC regulations, commencing with interim improvements in Finance Bill 2011, and an overhaul of its CFC regulations in Finance Bill 2012 (see 7.4 below).

The interim changes introduced in United Kingdom Finance Bill 2011 are intended to improve the current CFC rules, and take effect for accounting periods beginning on or after 1 April 2011 (McGowan et al., 2011:1).

Aims of CFC interim improvements

The intent of United Kingdom authorities was to make United Kingdom CFC rules easier to implement and also to increase the country's international competitiveness. The package of these interim improvements included modernisation of aspects of the CFC rules to grant exemption to commercially justifiable activities (on which both business and HMRC are in agreement) that do not erode the United Kingdom tax base, assistance to United Kingdom businesses intending to undertake foreign acquisitions and reorganisations, and consideration of other worthwhile improvements suggested during the consultation period that are consistent with both the aims and scope of the interim improvements. (United Kingdom. HMRC, 2010a:1.)

Specific changes in the CFC interim improvements

The main thrust of the change is to exempt CFCs which conduct a range of "foreign to foreign" activities involving transactions wholly or partly with other group companies, providing that there is little or no risk of erosion to the United Kingdom tax base. The exemption is designed to produce a proportionate outcome in contrast to the "all-or-nothing" approach generally taken by the existing CFC exemptions. The specific changes are as follows:

- An exemption for a CFC carrying on intra-group trading activities where there is minimal connection with the United Kingdom and little risk that United Kingdom profits have been artificially diverted;

- An exemption for a CFC with a main business of intellectual property (IP) exploitation where the IP and the CFC have minimal connection with the United Kingdom;
- An exemption which runs for three years for foreign subsidiaries that, as a consequence of a reorganisation or change to United Kingdom ownership, come within the scope of the CFC regime for the first time; and
- Improving the de minimis exemption and deferral of the withdrawal of the exemption for certain holding companies. (United Kingdom. HMRC, 2010a:2.)

5.4 Meaning of CFC in United Kingdom legislation

This chapter section considers the requirements in the United Kingdom tax legislation for a foreign company to qualify as a CFC. In terms of Section 747(1) and (2) of the Income and Corporation Taxes Act (ICTA), a foreign entity will qualify as a CFC and be subject to United Kingdom taxation on its chargeable profits if the following requirements are fulfilled: Firstly, the entity must be a company for the purposes of CFC legislation. Secondly, the company must be tax resident outside the United Kingdom. Thirdly, the company must be controlled by persons resident in the United Kingdom. Fourthly, the company must be subject to a lower level of taxation in the country of its residence (being less than 75 per cent of the tax charge in the United Kingdom).

5.4.1 Shareholder – resident company

While the term “persons” may include individuals, unincorporated associations, partnerships etc., as well as companies, the charge to tax under the CFC regulation is only applicable to a “resident company”, namely, a company resident in the United Kingdom. Accordingly, the United Kingdom Inland Revenue’s view is that a partnership cannot be a person, despite the wide definition of this term in the Interpretation Act 1978 as constituting a body of persons to include corporate or unincorporated entities. (Ullah, 2004:614.)

5.4.2 Foreign entities

The basic definition of a CFC in the United Kingdom is exclusively applicable to a company. The term *company* is not defined in the relevant section of the Taxes Act dealing with the taxation of CFCs. Consequently, the definitions of company used in Sections 832(1) and 832(2), ICTA, 1988 are applicable. In terms of Section 832(1) of the ICTA, 1988, a company is considered as “any body-corporate or [an] unincorporated association but does not include a partnership, a local authority or a local authority association”. Therefore, in the case of any doubt being expressed as to the determination of the status of a company, it will be prudent to obtain the necessary constituting documents in order to ascertain the relevant foreign legal provisions. While the simplicity of this approach – to focus on companies alone – promotes a great deal of certainty, there is, however,

significant scope for the avoidance of CFC regulations. One potential avoidance scheme is, for example, to inaugurate a foreign partnership. (Ullah, 2004:615.)

5.4.2.1 United Kingdom company residence

Although residence has always been a material consideration, especially for companies, in determining its tax jurisdiction, statute law has not always laid down comprehensive rules for the determination of residency of companies, and until 1988 it was left entirely to the courts' discretion to make the necessary determination for companies in instances of uncertainty. Section 66 of the Finance Act of 1988 introduced legislation to the effect that a company incorporated in the United Kingdom is, with certain exceptions, considered a resident of the United Kingdom for the purposes of the Income and Corporation Taxes Act. Case law may however be used to determine the residence of companies excepted from the incorporation rule or which are incorporated outside the United Kingdom (United Kingdom. HMRC, 2010d).

Companies incorporated in the United Kingdom (Section 66(1) – Finance Act 1988)

This clause provides that a company incorporated in the United Kingdom is a resident of the United Kingdom for Corporation Tax purposes. On the other hand, if a different place of residence is given by any rule of law, such other place shall no longer be taken into consideration for the purpose of the determination of residency of the company. These clauses are based on Section 66(1) of FA, 1988.

Companies not incorporated in the United Kingdom (Section 66(2) – Finance Act 1988)

This clause outlines the rules pertaining to the residency of companies which are not incorporated in the United Kingdom. Companies which were treated as United Kingdom residents immediately before they ceased trading or came under the control of a foreign liquidator continue to be treated as a United Kingdom resident. This clause confirms that the provision applies only to companies which are not incorporated in the United Kingdom, as this is less clear in the original. Any United Kingdom incorporated company which ceases trading or is being wound up outside the United Kingdom is already treated as a United Kingdom resident under the rule in the previous clause – Section 66(1). The purpose of the rule in this clause is to provide that a company which is resident in the United Kingdom through central management and control remains a resident of the United Kingdom. Such a company could otherwise become non-resident if central management and control leaves the shores of the United Kingdom.

Schedule 7 – Exceptions to rule in Section 66(1) – Finance Act 1988

The incorporation rule applies to companies incorporated in the United Kingdom, and is subject to the exceptions in Schedule 7 of FA 1988 in respect of some companies incorporated before 15 March 1988.

Section 66(1) of this Act shall not apply in relation to a company which, immediately before the commencement date –

- was carrying on business;
- was not resident in the United Kingdom, having ceased to be so resident in pursuance of a Treasury consent; and
- where that consent was a general consent, was taxable in a territory outside the United Kingdom. (Schedule 7(1) FA 1988.)

Carrying on business

The exceptions to the incorporation test in Schedule 7 depend in part on the company carrying on business at a specified time or during a relevant period. The question of whether a company carries on business is one of fact that has to be decided in accordance to the particular circumstances of the company. Detailed guidance is not practicable but Her Majesties Revenue and Customs (HMRC) is of the view that “business” has a wider meaning than “trade”; it can include transactions, such as the purchase of stock, carried out for the purposes of a trade about to be commenced and the holding of investments including shares in a subsidiary company. Such a holding could consist of a single investment from which no income was derived. A company such as a shelf company whose transactions have been limited to those formalities necessary to keep the company on the register of companies will not be regarded as carrying on business. (United Kingdom. HMRC, 2010d.)

Taxable in a territory outside the United Kingdom

A further requirement for certain companies to be excepted from the incorporation test is provided for in Schedule 7 Para (1)(c) and Para 5(1), FA, 1988. The company has to be taxable in a territory outside the United Kingdom. “Taxable” means that the company is liable to tax on income by reason of domicile, residence or place of management. This is analogous to the approach adopted in the residence provisions of many double-taxation agreements. Territories which impose taxes on companies by reference to incorporation or registration or any similar criteria are covered by the term “domicile”. Territories which impose taxes on companies by reference to criteria such as “effective management, central administration, head office or principal place of business are covered by the term place of management” (United Kingdom. HMRC, 2010d). A company has to be liable to tax on its income in order to fulfil the above criteria, thus excluding a company which, for example, is only liable to a flat rate fee or lump sum duty, as such a company does not fulfil the above criteria. On the other hand, a company is considered as being liable to tax if it falls within the taxing ambit of a particular territory, even though it may effectively not pay any taxes on its income, for example, in instances where it makes losses or invokes the double-taxation relief (DTR) measures. (United Kingdom. HMRC, 2010d.)

Treasury Consent

The Treasury Consent rules required companies, in certain circumstances, to obtain permission from the Treasury before entering into commercial transactions. This requirement is considered no longer consistent with modern business practices, administratively burdensome, and places a restriction on the ability of businesses to function appropriately in the context of the current global economic environment. In addition, the government does not consider the existing criminal sanction as being appropriate for the new reporting system. Instead, a retributive measure for non-compliance will be the imposition of a fiscally-driven fine on defaulting United Kingdom companies. (United Kingdom. HMRC, 2008b:73.)

In response, government abolished the following existing regimes in relation to the international movement of capital in Schedule 17 of Part 1 of the Finance Act 2009:

- Section 765 (prior Treasury consent required for certain transactions involving movement of capital outside Europe),
- Section 765A (HMRC to be given information about certain transactions involving movement of capital within Europe),
- Section 766 (offence of failure to comply with Section 765), and
- Section 767 (interpretation).

A set of regulations to be cited as the International Movement of Capital (Required Information) Regulations 2009 has been published in draft and is to replace the above deletions (United Kingdom. HMRC, 2008b:73).

In response, government introduced (in Finance Act 2009, Schedule 17, Part 2, Section 8, para 1) “a modernised post-transaction reporting requirement that applies to transactions with a value of £100 million or more, subject to a number of exclusions”. These include several of the old rules based on the “general consent” rules, and there are exclusions for certain trading transactions. Companies will be required to make a report within the period of six months from the date of the inception of the transaction. (Professional Training Partnership, 2009:10.)

5.4.2.2 The Case law test

The test of company residence is illustrated the ruling in *De Beers Consolidated Mines Limited v Howe* (Surveyor of taxes) (United Kingdom, 1906) given by Lord Loreburn at the beginning of the last century:

A company resides, for the purposes of Income Tax, where its real business is carried on.... I regard that as the true rule; and the real business is carried on where the central management and control actually abides.

The term *central management and control* was subject to judicial scrutiny, resulting in the company being declared a United Kingdom tax resident (see 5.2 above for discussion on the De Beers Consolidated Mines Ltd case). The issue of central management and control was also considered in *Unit Construction Company Limited v Bullock (Inspector of Taxes)* (United Kingdom, 1959) by Lord Radcliffe at page 738 as being

as precise and unequivocal as a positive statutory injunction.... I do not know of any other test which has either been substituted for that of central management and control, or has been defined with sufficient precision to be regarded as an acceptable alternative to it. To me ... it seems impossible to read Lord Loreburn's words [in De Beers Consolidated Mines] without seeing that he regarded the formula he was propounding as constituting the test of residence.

In the case under review, three wholly-owned subsidiaries were incorporated in Kenya. Powers of management were vested in the directors, who were based in Kenya. In practice, however, the board of directors of the United Kingdom parent made all the crucial decisions. As a consequence of these decisions being made in the United Kingdom the Kenyan subsidiaries were held to be United Kingdom residents. The court considered that "the business is not the less managed in London because it ought to be managed in Kenya" (Delechat & Fichardt, 2010:5). These two cases have established, firstly, that the place of central management and control is primarily a question of fact and that, secondly, it is the highest level of control of the business which is to be taken into consideration (United Kingdom. HMRC, 2010c).

According to HMRC, the central management and control test for residence is now pertinent only to companies not incorporated in the United Kingdom. However, United Kingdom incorporated companies may qualify for the exception to the incorporation rule so long as their central management and control is outside the United Kingdom. HMRC has, in principle, accepted the formulation in the *De Beers* case: namely, "A company resides ... where its real business is carried on ... and the real business is carried on where the central management and control actually abides" (United Kingdom. HMRC, 2010c). HMRC accepts that the case-law concept of central management and control is, in broad terms, directed at the highest level of control of the business of the company. It is to be distinguished from the place where the main operations of a business are to be located, though these two places may often coincide. In addition, the exercise of control does not necessarily demand any minimum standard of active involvement: it may, in appropriate circumstances, be exercised tacitly through passive oversight. (United Kingdom. HMRC, 2010d.)

The place of directors' meetings is crucial only to the extent that the meetings constitute the medium through which central management and control are exercised. If, as an example, the directors of a company were together actively engaged in the United Kingdom in the entire administration of the business which was wholly located in the United Kingdom, the company in effect would not be

considered as resident outside the United Kingdom, merely because the directors held formal meetings outside the United Kingdom. While it is possible to highlight those extreme situations in which central management and control are, or are not, exercised by directors in formal meetings, the conclusion in any case is wholly one of fact, depending on the relative weight given to the various factors. HMRC is of the view that any attempt to lay down rigid guidelines would only be misleading. (United Kingdom. HMRC, 2010d.)

5.4.2.3 Impact of residence, dual residence and the tie-breaker

A company may, for example, conduct its business in South Africa in such a manner that its key business decisions are implemented here, and at the same time in the United Kingdom in so far as its directors meet and reside there and it is the place where board meetings are held and board decisions are made. In such a case, the company may have its effective management in South Africa, and on that basis, it will be subject to tax in South Africa on its worldwide income, irrespective of whether income is derived from within or outside South Africa. At the same time the company is centrally managed and controlled in the United Kingdom, and it may be subject to corporation tax on its worldwide income in the United Kingdom. The issue of effective management was first considered in the United Kingdom in *Wensleydale Settlement Trustees v IRC* (United Kingdom, 1996) where the ordinary meaning of the language was emphasised. The term “effective” implies “realistic, positive management” (see 3.2.1.3 above for discussion on the *Wensleydale Settlement Trustees v IRC* case.

Consequently dual residence may result, in which case both South Africa and the United Kingdom taxing authorities may claim entitlement to tax the income. In the South African and United Kingdom double-tax agreement (DTA), where the issues of dual residence arise, the relevant South Africa–United Kingdom DTA provides for a tie-breaker to resolve the issue in favour of one of the States. In the DTA, the tie-breaker rule is contained in Article 4(3) of the OECD Model Tax Convention and reads as follows:

Where by reason of the provisions of paragraph 1 of this Article a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident solely of the State in which its place of effective management is situated.

Therefore, if a company is a dual resident (in that it is deemed to be a resident of both the United Kingdom and another treaty country), the DTA uses the so-called “tie-breaker” rule which is contained in the OECD Model Tax Convention to determine in which country the company will be resident for purposes of the treaty. In terms of Section 249 of the FA 1994, a company which is treated as non-resident by virtue of a treaty is deemed to be non-resident in the United Kingdom for all corporation tax purposes. Legislation was introduced in 2002, however, to limit the effect of this rule in the context of CFCs. Thus, a company treated as a non-resident for corporation tax purposes is

disregarded for CFC purposes (Section 90 of the FA 2002). The purpose of this provision was to bring Section 249 of the FA 1994 in line with the CFC legislation.

The question of dual residency of companies was considered in two cases: *Laerstate BV v Revenue and Customs Commissioners* (United Kingdom, 2009d) and *Trustees of Trevor Smallwood v Revenue and Customs Commissioners* (United Kingdom, 2008). In *Laerstate BV v Revenue and Customs*, the First Tier Tribunal found that the company, which was incorporated in the Netherlands, was centrally managed and controlled in the United Kingdom, and that its profits were de facto taxable in the United Kingdom.

In *Trustees of Trevor Smallwood vs Revenue and Customs Commissioners* [2008], which went on appeal before the Supreme Court of Appeal, in which the appellants (S and his wife) appealed against an earlier decision [2008] STC (SCD) 629 in which their original appeal against certain amendments to their tax returns for the 2001 tax year was dismissed, which included chargeable gains of more than £6 million arising on the disposal of assets by trustees based in Mauritius, the Court ruled in favour of the appellants on the grounds that Article 13(4) of the United Kingdom–Mauritian DTA gave the right to tax capital gains to the state in which there was residence at the time of the disposition. That state was, at that date, Mauritius. Accordingly, Mauritius had the right to impose taxation and not the United Kingdom. (Gazette, 2012.)

5.4.2.4 Implications of residence of companies for CFC rules

It is important that residence of companies be correctly determined in order to evaluate if domestic CFC legislation is applicable. In the United Kingdom, a company is regarded as resident if it is incorporated in the United Kingdom, or if it is centrally managed and controlled in the United Kingdom; such companies would generally not be considered as CFCs in the United Kingdom. Foreign companies controlled by United Kingdom residents could be subject to domestic CFC legislation if the company is incorporated outside the United Kingdom (and is also centrally managed and controlled outside the United Kingdom), and domestic United Kingdom companies incorporated in the United Kingdom (but centrally managed outside the United Kingdom) could also be subject to CFC legislation. These companies would be considered as foreign companies in terms of the OECD and UN tie-breaker rule. (OECD, 2010a:art 4, para 3.; United Nations, 2011:art 4 para 3)

5.5 Control

The residence status of the persons who control an overseas company may have to be considered in order to determine whether the company is controlled by persons resident in the United Kingdom. An overseas company should be regarded as controlled by United Kingdom residents if the persons (both individual and corporate) who control it are resident in the United Kingdom for tax purposes.

Since 21 March 2000, the Income and Corporation Tax Act, 1988 (ICTA, introduced by Finance Act 2000) provides specific tests for determining whether a company is controlled by persons resident in the United Kingdom for the purposes of Chapter IV. For example, Section 755D

- mirrors the well-established meaning of control in Section 840, ICTA, 1988, which includes the conferring of power on a shareholder: in relation to the holding of shares or the possession of voting power or any equivalent powers conferred by the Articles of Association, thus enabling the shareholder to conduct the affairs of the company in accordance with his wishes.
- includes specific rules for international joint ventures (such as the 40 per cent test in Section 747(1A), ICTA, 1988); and
- includes anti-avoidance rules that attribute to a person, for example, interests, rights and powers held by another person (such as the attribution rules contained in Section 755D(5)-(9), ICTA, 1988). (United Kingdom. HMRC, 2010e.)

The amendment was introduced by FA 2000 Schedule 31, which tightened the definition of “control” and also introduced a definition of “control” unique to CFCs. In terms of this definition, a person is deemed to control the CFC where he has the power to ensure that the CFC’s affairs are conducted in accordance with his wishes either by means of the holding of shares or the possession of voting power in or in relation to the company or any other company; or by virtue of any powers conferred by the articles of association or other document regulating the company or any other company (Section 755D(1) of the ICTA, 1988).

When two or more persons, taken together, have the power to ensure that the affairs of a company are conducted in accordance with their wishes, they are treated as having control of the company (Section 755D(2), ICTA, 1988). These powers contained in Section 755D(1), ICTA, 1988, are related to the holding of shares or by the powers conferred in the articles of association or other related documents. It is also important to realise that the powers conferred on the parties may be contained in any document, so that it is imperative to review all the necessary documentation and not to restrict the examination only to the articles of association. (Wilkinson & Howells, 2008:18.)

The test is not a mechanical one based simply on, for example, shareholding or voting rights. The objective is to establish whether a person (or persons) has the power to ensure that the affairs of a company are conducted in accordance with his (or their) wishes. If such power is exercisable only as a result of shareholding, it is to the shareholdings that one would look to determine control but it will not be a simple mechanical or mathematical test. (United Kingdom. HMRC, 2010e.)

5.5.1 Additional control tests (the 40% test): (Section 755D(3) and (4), ICTA, 1988)

In addition to the preceding control tests mentioned above, HMRC introduced a new 40 per cent test (Section 747(1A), Section 755D(3) and (4), ICTA, 1988), which in essence, is broadly in line with the control test used in the transfer pricing regulations in Schedule 28AA, ICTA, 1988. HMRC has subsequently decided to extend, with the belief of modernising, its control test, in order to counter the increasingly sophisticated and complicated tax structures being used by multinational groups to avoid CFC regulations. Offshore joint venture companies– in which United Kingdom shareholders owned slightly less than 50 per cent of the shares – were becoming increasingly popular structures to avoid the previous control test requirement contained in United Kingdom CFC legislation. In response, and to counter these arrangements, the 40 per cent control test was introduced (Wilkinson & Howells, 2008:18). A company is therefore also treated as being controlled by a United Kingdom person if

- two persons (one United Kingdom resident and the other non-United Kingdom resident) together control the company; and
- the United Kingdom person has interests, rights and powers representing at least 40 per cent of the holdings, rights and powers by which the company is controlled; and
- the non-United Kingdom person has interests, rights and powers representing at least 40 per cent but not more than 55 per cent of such holdings, rights and powers. (Section 755D(3) and (4))

The 40 per cent test in this context means 40 per cent of a situation where more than 50 per cent would give a person control of the company, and refers to 40 per cent of all the interests, rights and powers of the kind which gives the two persons in question control of the company. The fact that this test applies only where there are two persons who together control (directly or indirectly) a company, does not mean that it does not apply where one of those two persons has the power to control the company on their own. Where, for example, a non-resident person holds 55 per cent of a company and a United Kingdom person holds the remaining 45 per cent, the test will be satisfied and the company will be treated as controlled by United Kingdom persons. (United Kingdom. HMRC, 2010e.)

5.5.2 Extension of control test: (Section 755D(1A), ICTA 1988)

According to HMRC's 2008 Budget Notes (United Kingdom. HMRC, 2008a) in respect of the following situation pertaining to a certain type of tax-avoidance scheme, an offshore trust owned more than 50 per cent of the shares in an overseas company. The users of the scheme claimed that the company was not controlled by United Kingdom residents, even though the United Kingdom residents who held the remaining shares retained the right to receive all of the company's profits (United Kingdom. HMRC, 2008a:59). Therefore, for determining control at any time on or after 12 March 2008 the definition of control has been extended to include control by rights to the majority of

- any distribution of the company's income, were such a distribution to be made or
- the proceeds of any sale of the company's share capital, were such a sale to take place or
- the assets in the event of a winding-up of the company. (Section 755D(1A), ICTA 1988.)

5.5.3 Attribution rules

The control provisions also contain detailed attribution rules (Section 755D(5)-(9), ICTA, 1988). The rights and powers held by another person that can be attributed to a person for the purposes of deeming control are

- those that a person who (while not holding them at the relevant time) is either entitled to acquire at a future date, or which he will be entitled to acquire at a future time
- those through a nominee
- those held by connected persons – where both are United Kingdom-resident

Attribution rights should only be taken into consideration when there is a future entitlement to the acquisition of rights via “the natural effluxion of time” (Wilkinson & Howells, 2008:19). They should not include future events that may or may not result in differences in ownership rights (see case study below). The attribution rules also include a provision that acts as a counter measure to the types of structures that have been engineered to circumvent the CFC legislation by the use of nominee companies. The last attribution rule relates to connected persons. The question of whether one person is connected to another is determined in accordance with Section 839 of ICTA, 1988 (encompassing relatives, trustees and companies). However, partners of a joint venture will not be treated as connected persons to each other by virtue of their respective interests in the joint venture. Therefore, no attribution can be made from one joint venture partner to another under the connected partner rules, unless there is a connection between the partners other than through the joint venture itself.

When reviewing complex structures that potentially include CFCs, it is necessary to review the entire shareholding structure. In circumstances where several shareholders own a company, the attribution rules may be applicable and it is therefore imperative to establish if there exists any chain of connection between them. Serving as an example would be a company that has three shareholders, X, Y and Z, where X is connected with Y, and Y is connected with Z; however, X and Z are not connected. Despite X and Z not being connected to each other, any rights and powers of any one of them will be attributed to the other two. (Section 755D(9), ICTA, 1988.)

5.6 Lower level of taxation

Once it has been determined that a company is resident outside the United Kingdom and that it is controlled by United Kingdom residents, the next step, being the final test in Section 747(1), is to

ascertain if the non-resident company is paying a lower level of taxation in its territory of residence than it would do if it were a United Kingdom resident taxpayer. The Income and Corporation Taxes Act 1988, Section 750(1), states that a non-resident company is considered as being subject to a lower level of taxation in its territory of residence if the amount of tax (“the local tax”) payable under the laws of its foreign territory, in respect of the profits of the company which arise in any accounting period, is less than three-quarters of the tax that is payable if the company is a United Kingdom-resident taxpayer.

5.6.1 Territory of residence: Section 747(1)(c) and Section 749(1) ICTA, 1988

Rules for determining where an overseas company is resident are necessary to establish whether it is subject to a lower level of taxation in its territory of residence and also for the purposes of the exempt activities test in paragraph 5(2) of Schedule 25, ICTA, 1988. The objective is to identify a territory which treats the company as resident there under its own laws. The central management and control test is not necessarily relevant in all situations, as most foreign jurisdictions have a concept of residence which is not based on central management and control. The Chapter IV test is accordingly based on the approach commonly embraced in the residence articles of double-taxation treaties (United Kingdom. HMRC, 2010f). The general rule is that a company resident outside the United Kingdom is regarded as resident in the territory in which it is liable to tax on its profits by reason of domicile, residence or place of management throughout the relevant accounting period (Section 749(1), ICTA, 1988). A company would be considered to be liable to tax on its profits in a territory even though it may not actually pay any tax in such a jurisdiction. This could, for example, be attributable to losses suffered by the company, or any double-taxation relief granted to the company, or because the taxing authorities, for whatever reason, do not in practice assess or collect the tax for which the company is legally liable. (United Kingdom. HMRC, 2010f.)

5.6.2 Residence in more than one territory: Section 749(2) to (4) and (6), ICTA, 1988

A company is resident in the territory in which it is liable to tax by reason of domicile, residence or place of management and this may in certain cases result in a company being resident in more than one territory. For example, a company may be liable to tax in one territory because it was incorporated there and in another because it is managed there. Section 749(2), ICTA, 1988, provides the rules to be employed in determining the territory to be considered as the residence of the company for the purpose of Chapter IV, ICTA, 1988:

- It will be the place of effective management if this was in one place for the entire accounting period (Section 749(3)(a), ICTA, 1988);

- If, throughout the accounting period, the place of effective management is in two or more places, the territory of residence will be one where the greater part of the company's assets were situated at the end of the accounting period (Section 749(3)(b), ICTA, 1988);
- If neither of the above can be satisfied, the territory of residence will be where the greater amount of the company's assets are situated at the end of the accounting period (Section 749(3)(c), ICTA, 1988);
- If none of the above produces a single territory of residence (for example, because all the company's assets and its effective management are situated outside the territories in which it is liable to tax) the company (representing one or more persons who together have a majority assessable interest in the company) may make an election to be treated as resident in a territory (Section 749(3)(d), ICTA, 1988);
- Where an election has not been made within the statutory time limit the Board may designate a territory to be the territory of residence (Section 749(3)(e), ICTA, 1988).

In determining in which of two or more territories the greater amount of a company's assets is situated, account is taken only of those assets situated in the territories immediately before the end of the relevant accounting period. The amount of the assets is to be determined by reference to their market values (Section 749(6), ICTA, 1988). (United Kingdom. HMRC, 2010f.)

5.6.3 Companies with no territory of residence: Section 749(5) ICTA, 1988

The rule in Section 749(1), ICTA, 1988, that a company is resident in the territory in which it is liable to tax by reason of domicile, residence or place of management, will sometimes result in a company having no territory of residence. Certain territories (such as Bermuda) have no system of corporate taxation in place, some (for example, Jersey) impose no tax on the profits of certain categories of company, while others (such as Brazil or Hong Kong) impose tax on companies not by reference to domicile, residence or place of management but by reference to the existence of sources of income within the territory concerned. A company could, indeed, be domiciled and managed at all levels in such a territory without being resident there within the meaning of Section 749(1), ICTA, 1988. If it were not resident elsewhere, it would not have a territory of residence for Chapter IV purposes. The above practices result in a company having no territory of residence. Therefore, the main consequence of a company having no territory of residence in this way is that it is conclusively presumed to be subject to a lower level of taxation – as it pays no tax and is not subject to taxation anywhere (Section 749(3), ICTA, 1988). (United Kingdom. HMRC, 2010f.)

5.6.4 Companies with no territory of residence: excluded countries regulations

For the purposes of the Excluded Countries Regulations, a company which has no territory of residence under Section 749(1), ICTA, 1988, is treated as resident in the country where it is incorporated. For accounting periods beginning on or after 3 December 2004 this definition was amended to treat a company as resident in the country where it is incorporated and liable to tax in that territory on its profits (United Kingdom. HMRC, 2010f).

5.6.5 Treaty non-resident (“TNR”) companies

Provision has been made for any company which is resident in the United Kingdom for the purposes of the Taxes Act and which is also regarded for the purposes of a double-taxation agreement as resident outside the United Kingdom to be treated as resident outside the United Kingdom (Section 249, FA, 1994).

5.6.6 Designer rates: Section 750A, ICTA, 1988)

Finance Act 2000 introduced the new so-called designer-rate tax provisions – an anti-avoidance measure to bring the above schemes within the ambit of the CFC legislation even if they are taxed at 75 per cent or more of the United Kingdom tax rate. Section 750A of the ICTA, 1988, inserted by the Finance Act 2000, overrules the normal requirement that a company is liable to CFC regulation only if it has paid tax at a level of less than 75 per cent of that which it would have paid if it had been resident in the United Kingdom. Therefore, if a company is resident outside the United Kingdom and is taxed at a rate of 75 per cent or more of the United Kingdom equivalent tax on its profits (providing the local tax is determined under designer-rate provisions); it will be subject to a lower level of taxation for CFC purposes in the accounting period concerned. (Section 750A of the ICTA, 1988.)

5.6.7 Amount of local tax

The local tax taken into consideration for the purposes of the lower level of taxation test is the tax actually paid under the local law on the company's profits, exclusive of chargeable gains. Accordingly, it is restricted to taxes which qualify for the tax credit relief against United Kingdom taxes on income under the normal taxation rules. Taxes on capital profits, or taxes computed on some basis other than profits such as indirect taxes or taxes on insurance premiums, are excluded from local tax.

5.6.8 Tax paid in third countries

Relief for third country taxes incurred is given against both the local tax and the corresponding United Kingdom tax. The local tax paid in the country of residence of the CFC will take account of the

payment of third-country taxes according to the methods of double-taxation relief (credit or exemption), which applies in the territory of residence. The latter (United Kingdom) is reduced by double-taxation relief for third country tax under the normal rules in Part XVIII ICTA, 1988, following the assumption in Schedule 24, ICTA, 1988, that the company is resident in the United Kingdom.

5.7 Exemptions from the application of CFC legislation

A key consideration in the application of CFC regulations is their relevance in domestic tax law pertaining to a foreign company which is now considered a resident of the United Kingdom. The CFC's chargeable profits are consequently now subject to United Kingdom corporation tax (Schedule 24, para 1(1), ICTA, 1988). The computation of chargeable profits (exclusive of capital gains) is calculated in broadly the same way as domestic United Kingdom companies. A foreign company could, however, be absolved from the application of United Kingdom CFC legislation if any of the statutory exemptions (in Section 748, ICTA, 1988) are applicable to the CFC. A discussion of these exclusions follows.

No apportionment of profits is due for an accounting period of a CFC if during the period the company fulfilled any one of the statutory exclusions in Section 748, ICTA, 1988. On the other hand, these statutory exclusions are not applicable if Treasury has designated the jurisdiction as one in which all CFCs would automatically fall within the charge to tax (Section 748A, ICTA, 1988).

A detailed discussion follows of the prevailing statutory exclusions in Section 748, comprising the following: the exempt activities test, the *de minimis* exemption, the motive test, and the excluded countries exemption.

5.7.1 The Exempt Activities Exemption (Section 748(1)(b), Schedule 25, ICTA, 1988)

The purpose of the exempt activities test is to exclude from Chapter IV those CFCs which, because of the nature of their activities in the territories of residence, can reasonably be assumed not to be used for reducing United Kingdom tax. The exclusion covers a wide spectrum of trading activities and certain types of holding company. Most of the overseas subsidiaries of United Kingdom groups (especially those which carry on a trade) are likely to satisfy the test. However, the conditions are strict and companies carrying on particular types of trade will not necessarily be able to secure seclusion under the test and will, as an alternative, have to consider one of the other exemptions. Failure to satisfy the exempt activities test does not in itself imply that the controlled foreign is being used to reduce United Kingdom tax.

To fulfil the exempt activities test for an accounting period, a CFC must satisfy all of the following requirements:

- It must have a territory of residence for the purpose of the test (Schedule 25, para 5(2), ICTA, 1988)
- It must have a “business establishment” in its territory of residence throughout the accounting period (Schedule 25, para 6 and 7, ICTA, 1988)
- It must be “effectively managed” in its territory of residence throughout the accounting period (Schedule 25, para 6(1)(b) and para 8(1)(a) and (b), ICTA, 1988)
- It must not have as its main business any one of the activities precluded by the terms of Schedule 25, para 6(2), ICTA, 1988, with the exception of certain types of companies holding shares and securities in subsidiaries for sound commercial reasons, and are not to be used to reduce United Kingdom tax liabilities. These companies will satisfy either the exempt activities test or motive test.

When a CFC satisfies the exempt activities test it is accordingly excluded from the scope of a Chapter IV charge. The legislation does not permit the apportionment of only part of a company’s profits: for example, the part represented by the investment income of a trading company. (United Kingdom. HMRC, 2010h.)

The next chapter section discusses the conditions that need to exist in order to fulfil the exempt activities test.

5.7.1.1 Territory of residence

It is a requirement for the purposes of the exempt activities test to establish a single territory of residence in respect of a CFC. In most instances, however, the territory of residence will have been established for the purposes of determining the lower level of taxation test under Section 749, ICTA, 1988.

Companies with no territory of residence – Exempt Activities Test – (Schedule 25, para 5(2), ICTA, 1988)

Where, a CFC has no territory of residence in accordance with Section 749(5), ICTA, 1988, it may therefore be regarded, solely for the purposes of the exempt activities test, as resident in the territory in which its business affairs are effectively managed, and providing that

- the territory of effective management is outside the United Kingdom; and
- the territory of effective management is not one in which companies are liable to tax by reason of domicile, residence or place of effective management. (Section 747(1)(c) and Section 749(1), ICTA, 1988; United Kingdom. HMRC, 2010.)

5.7.1.2 Business establishment – Exempt Activities Test (Schedule 25, para 6 and 7, ICTA, 1988)

Paragraph 6(1)(a) of Schedule 25, ICTA, 1988, requires that to satisfy the exempt activities test a CFC must have a business establishment in its territory of residence throughout the accounting period under review. For the purpose of the exempt activities test, business establishment means premises

- which are, or are intended to be, occupied and used with a reasonable degree of permanence; and
- from which the company's business in its territory of residence is wholly or mainly carried on.

5.7.1.3 Effectively managed in territory of residence (Schedule 25, para 6(1)(b) and para 8(1)(a) and (b), ICTA, 1988)

A CFC cannot be engaged in exempt activities unless its business activities are effectively managed in its territory of residence throughout the accounting period under review (Schedule 25, para 6(1)(b), ICTA, 1988). This specification differs from the description in Section 749(3)(a), ICTA, 1988, which refers to the company's place of effective management. Although the factors may be similar, the exempt activities test focuses on the management of the business.

The requirement that the business affairs are effectively managed is further expanded by the conditions in Schedule 25, paras 8(1), (5) and (6), ICTA, 1988. The legislation differentiates between companies resident in European Economic Area (EEA) territories and those that are not resident in EEA territories in respect of accounting periods beginning on or after 6 December 2006 (Schedule 25, para 8(1) and (5), ICTA, 1988).

5.7.1.4 Main business precluded in terms of the exempt activities test in Schedule 25, para 6(2), ICTA, 1988

A CFC which satisfies the preceding requirements, as set out in Schedule 25, will fulfil the requirements of the exempt activities test unless

- a) its main business during the accounting period in question consists of either –
 - i) “investment business”
 - ii) dealing in goods for delivery to or from the United Kingdom or to or from connected or associated persons, or (Schedule 25, para 6(2)(a), ICTA, 1988)
- b) in the case of a company which is mainly engaged in “wholesale, distributive, financial or service business”, 50 per cent or more of the gross trading receipts of that particular business is derived directly or indirectly from persons falling within subparagraph 2A below (Schedule 25, para 6(2)(b), ICTA, 1988)

Those persons referred to in the above instance comprise the following in Schedule 25, para 6(2A), ICTA, 1988:

- a) The persons referred to in (b) above are those set out in Schedule 25, para 6(2A), ICTA, 1988; that is: connected and associated persons (as defined by Sections 417, 839 and 783(10), ICTA, 1988);

- b) persons who would have a 25 per cent assessable interest in the company for that accounting period (that is, a person to whom, on a apportionment of chargeable profits, at least 25 per cent of the controlled foreign company's chargeable profits would be apportioned); and
- c) persons connected or associated with certain joint venture partners (that is, where the 40 per cent test in Section 755D, ICTA, 1988 is met).

And for accounting periods beginning on or after 27 November 2002, all

- a) United Kingdom-resident companies;
- b) United Kingdom permanent establishments of non-United Kingdom-resident companies;
- c) individuals who are habitually United Kingdom-resident. (Schedule 25, para 6(2A), ICTA, 1988.)

The objective of these limitations is to prevent investment companies (other than certain holding companies) and companies which have certain types of trading activity as their main business, from fulfilling the exempt activities test. Consequently, these companies do not qualify for exclusion from Chapter IV under the exempt activities test. (United Kingdom. HMRC, 2010i.)

There is no statutory definition of the term "main business". It is a question of fact: which of a CFC's activities constitutes its main business. In most instances the evidence will be clear, but in cases of doubt – the factors to be taken into consideration will include: the levels of turnover, the amounts of capital investment and the levels of profitability of the company's various activities. (United Kingdom. HMRC, 2010j.)

Investment business (Schedule 25, para 9, ICTA, 1988)

For the purposes of the exempt activities test each of the following activities constitutes investment business:

- (a) The holding of securities, [or intellectual property]
- (b) Dealing in securities, other than in the capacity of a broker
- (c) The leasing of any description of property or rights
- (d) The investment in any manner of funds which would otherwise be available, directly or indirectly, for investment by or on behalf of any person (whether or not resident in the United Kingdom) who either has control of the controlled foreign company, alone or together with others, or is connected or associated with persons having control of the controlled foreign company. (Schedule 25, para 9, ICTA, 1988.)

Dealing in goods (Schedule 25, para 6(2)(a)(ii)) and para 10, ICTA, 1988)

A CFC cannot satisfy the exempt activities test if its main business consists of dealing in goods for delivery to or from the United Kingdom or to or from connected or associated persons (Schedule 25, para 6(2)(a)(ii), ICTA, 1988). However, goods which are actually delivered into the company's territory of residence are not taken into account for this purpose (Schedule 25, para 10, ICTA, 1988).

Goods manufactured in a territory by one company and sold to another company resident in the same territory cannot be left out of account since they will not have been delivered into the territory.

Wholesale, distributive, financial or service business (Schedule 25, para 6(2)(b) and para 11, ICTA, 1988)

Where a CFC is principally engaged in wholesale, distributive, financial or service business, it cannot fulfil the requirements of the exempt activities test if 50 per cent or more of its gross trading receipts are derived from certain affiliates or unconnected United Kingdom persons (Schedule 25, para 6(2)(b), ICTA, 1988). The definitions of wholesale, distributive, financial and service business and of investment business are considered not to be mutually exclusive, and it is possible, although unlikely in practice, for a company's main business to be both financial and investment business. In such an instance it is not necessary to apply the 50 per cent gross receipts test as the company will inevitably not fulfil the requirements of the exempt activities test in terms of Schedule 25, para 6(2)(a)(i), ICTA, 1988.

5.7.2 The *de minimis* exemption (Section 748(1)(d), ICTA, 1988)

No attribution is due in respect of an accounting period of a CFC in which its chargeable profits do not exceed £50 000. If the accounting period is less than twelve months, the amount of £50 000 is proportionally reduced. An apportionment will become due, if none of the other exemptions are applicable, irrespective of however small the amount by which the *de minimis* limit is exceeded. (Section 748(1)(d), ICTA, 1988.)

Part 2 of the Schedule in the Finance (No. 3) Bill, 2011, amends this exemption provided by Section 748(1)(d) of ICTA, 1988, in relation to CFCs with a low level of profits – the *de minimis* exemption. The *de minimis* threshold is increased to £200 000 per annum for CFCs that are members of a large group, a group that does not have any members which are micro, small or medium size enterprises (SMEs). The £50 000 *de minimis* will continue to apply to companies that are not members of a “large” group. The relevant profits to which the new *de minimis* thresholds apply will be determined by reference to GAAP (Generally Accepted Accounting Practice) (but ignoring any capital gains/losses) replacing the previous requirement of working through a full United Kingdom tax computation. For the purposes of the higher (£200 000) limit, the transfer pricing rules are applicable if they would increase the relevant profits by more than £50 000. New anti-avoidance provisions relating to the *de minimis* thresholds provide that a CFC assessment will not be prevented where a scheme is entered into and the main purpose, or one of the main purposes, of the scheme is to apply “the *de minimis* thresholds, for example, by shifting value away to a CFC which could otherwise benefit from the exemption”. (McGowan et al., 2011:4.)

5.7.3 The Motive Test exemption (Schedule 25, paras 16–19 and Section 748(3), ICTA, 1988)

5.7.3.1 Introduction to the motive test

The exemption in Section 748(3), ICTA, 1988, is the motive test which applies especially when none of the above-mentioned exemptions are applicable. The motive test was inaugurated in the statute book because it proved impractical to formulate comprehensive objective tests that ensured that all United Kingdom controlled foreign subsidiaries with profits derived from genuine overseas activities were excluded from the CFC's charge. Its legislative appearance emphasises that the United Kingdom CFC rules are primarily aimed at countering tax avoidance.

The objective tests provide groups with the certainty that the vast majority of foreign subsidiaries will be exempt from the CFC regulations. The motive test then sweeps up those companies that, while not set up to avoid United Kingdom tax (and therefore not within the intended scope of the CFC rules), nonetheless do not fit within the specific criteria of the objective tests. The intended implications are that only foreign subsidiaries existing, or conducting transactions, with the aim of circumventing United Kingdom tax will be liable to a charge under the CFC rules. (United Kingdom. HMRC, 2010k.)

5.7.3.2 The conditions of the motive test (Section 748(3), ICTA, 1988)

No apportionment is due in respect of an accounting period of a CFC if the requirements of the motive test are fulfilled for that accounting period. It is therefore possible for a CFC to satisfy the test in one period and fail the test in another accounting period, since the test looks at each accounting period separately. A CFC satisfies the motive test for an accounting period if it meets both of the following conditions:

- where a transaction (or two or more transactions taken together) which is reflected in the CFC's profits for that accounting period has (or have) achieved a reduction in the United Kingdom tax, either
 - the reduction was minimal, or
 - it was not the main purpose or one of the main purposes, of the transaction (or transactions) to achieve that reduction (Section 748(3)(a), ICTA, 1988);
- and it was not the main reason, or one of the main reasons, for the company's existence in that accounting period to achieve a reduction in United Kingdom tax by a diversion of profits from the United Kingdom. (Section 748(3)(b), ICTA, 1988.)

Whether or not the requirements of the motive test are fulfilled will be determined by the precise factors of each individual case.

5.7.3.3 United Kingdom CFC test case – rejection of motive test exemption

In the *Association of British Travel Insurers Ltd v CIR* (United Kingdom, 2003), the Special Commissioners rejected a claim by the Association of British Travel Agents (ABTA) that the motive test exemption was available to avoid a charge under the current United Kingdom CFC rules. However, in order to qualify, both criteria of the motive test exemption had to be fulfilled in terms of Section 748(3) (see above) in relation to the two Guernsey captives. It concluded that the second of the two tests did not fulfil the motive test requirement as one of the main reasons for the captive's existence was to achieve a reduction in United Kingdom tax by a diversion of profits from the United Kingdom. (Tomsett, 2003:12.)

5.7.4 The excluded countries exemption (Section 748(1)(e), Section 748(1A), ICTA, 1988)(SI1998/3081)

Where a CFC is resident in a territory listed in the excluded countries regulations and satisfies the particular requirements in respect of its income or gains, no apportionment falls to be made for that accounting period (United Kingdom. HMRC, 1998: SI No 3081). The purpose of this test is to exempt those companies which, because of the territory in which they are resident and the nature of their income, can reasonably be assumed not to be involved in United Kingdom tax-avoidance schemes (United Kingdom. HMRC, 2010g).

5.7.5 CFC interim improvements (Finance (No. 3) Bill, 2011)

5.7.5.1 Exemptions for companies with Limited United Kingdom Connection (see 5.9.5 below)

In Part 1 of Schedule 1, paragraph 1(3), Finance (No. 3) Bill, 2011, introduced two new exemptions to the CFC regime. The first exemption applies to a CFC which carries on trading activities where there is minimal business connection with the United Kingdom, irrespective of the extent of intra-group transactions. The second exemption applies to a CFC with a main business of IP exploitation where the IP activity and the CFC have minimal connection with the United Kingdom, again irrespective of the extent of intra-group transactions (para 1(3), Finance (No. 3) Bill, 2011). A CFC which does not fully meet either of the above two exemptions, may submit an application to HMRC for a reduction of the full CFC charge to reflect the extent to which the conditions have been satisfied – Section 751AB, ICTA, 1988 (See 5.9.5 below) (United Kingdom, 2011a:Part 1, Schedule 1, para 2(1)).

5.7.5.2 Temporary exemptions following reorganisations etc. (see also 5.9.6 below)

Schedule 1, Part 3, paragraph 7 of Finance (No. 3) Bill, 2011, introduced a new temporary period of exemption vis-à-vis certain acquisitions and reorganisations. The approach taken is to exempt companies whose accounting periods end within a set exempt period. The start of the exempt period is determined by the date on which the company first become subject to the United Kingdom CFC rules.

The end of the exempt period will either be 24 months after the end of the first exempt accounting period (in practice an exempt period of up to three years) or at an earlier time if the company enters into certain types of arrangements (early termination events). (United Kingdom, 2011a:Part 3, Schedule 1, para 7.)

The new Section 751AC thus enables the CFC charge which is attributable to the early termination event, to be reduced by reference to the tax effect of the change that brought about the termination. The Section 751AC mechanism is broadly similar to the Section 751AB mechanism for trading and IP companies (See also 5.9.6 below).

5.8 Computation of chargeable profits and creditable tax

5.8.1 Introduction

Attribution of chargeable profits of a company not resident in the United Kingdom is calculated as follows:

- to calculate the amount of its “corresponding United Kingdom tax” (Section 750(1), ICTA, 1988) for the purposes of the lower level of taxation test
- to establish the amount of profits which is to be apportioned to persons having an interest in the company, if an apportionment is due (Section 747(6), ICTA, 1988)
- to ascertain whether the chargeable profits exceed the de minimis limit (Section 748(1)(d), ICTA, 1988). (United Kingdom. HMRC, 2010l.)

Chargeable profits are computed in broadly the same way as the company’s Corporation Tax profits (exclusive of capital gains) would be computed – as if the CFC is resident in the United Kingdom. The assumptions under which chargeable profits are to be computed are set out in Schedule 24, ICTA, 1988 – prescribing, additionally, a limited number of modifications to the normal Corporation Tax rules. These are considered as necessary to prevent avoidance of tax and to ensure continuity in the computation of chargeable profits, since a CFC may not be subject to an apportionment in each subsequent accounting period. (United Kingdom. HMRC, 2010l.)

5.8.2 Definition of chargeable profits

The chargeable profits of a company resident outside the United Kingdom are defined as the total profits, computed in accordance with the provisions of Schedule 24, ICTA, 1988, on which, after taking into due consideration any of the available deductions, Corporation Tax is chargeable in the United Kingdom (Section 747(6)(a), ICTA, 1988) – the key factor being that a company resident outside the United Kingdom should be assumed to be resident in the United Kingdom and thus be within the charge to Corporation Tax in the United Kingdom (Schedule 24, para 1(1), ICTA, 1988).

The assumption is that the company's chargeable profits may now be computed on the basis that the company is a United Kingdom resident. As an example, any dividends received by the CFC from any United Kingdom companies will be subject to the new Section 1285, CTA, 2009 (previously Section 208, ICTA, 1988). Chargeable gains are excluded from chargeable profits but, apart from this, the term "profits" in Chapter IV, ICTA, 1988, has the same meaning as it has for the purposes of Corporation Tax, except where the provisions of Schedule 24, ICTA, 1988, require otherwise. (United Kingdom. HMRC, 2010l.)

The definition of chargeable profits has been extended by changes to Section 747(6), and the additions of Section 747(7), (8) and (9) to ICTA, 1988. The effects of these provisions are to include in chargeable profits income accruing in a trust for which the company is a settlor or beneficiary. These subsections include measures to avoid taxing the same income twice. The new provisions are applicable to income accruing on or after 12 March 2008 – if the legislation applies and an accounting period of the CFC straddles 12 March 2008, then that accounting period is split into the period before and the period on or after 12 March in applying the new legislation (Section 64(9), FA 2008). (United Kingdom. HMRC, 2010l.)

5.8.3 Assumed residence and apportionment

5.8.3.1 Assumed residence (Schedule 24, para 1(1), ICTA, 1988)

For the purposes of Chapter IV, ICTA, 1988, a foreign company has to be assumed to be resident in the United Kingdom in order that a charge of Corporation Tax be levied on its income from all sources (except on its chargeable gains). Dividends received from United Kingdom-resident companies will not be included as part of chargeable profits in accordance with Section 1285, CTA, 2009 (previously Section 208, ICTA, 1988), as if the foreign company is United Kingdom-resident. The company's assumed residence commences on the first day of the first accounting period for which an apportionment is due and continues until the company ceases to be controlled by persons resident in the United Kingdom (Schedule 24, para 2(1), ICTA, 1988). The assumed residence continues irrespective of whether apportionments are due for subsequent accounting periods. It is part of the assumption of United Kingdom residence that the CFC loses its actual residence. It cannot therefore be either dual resident nor retain its actual residence for the purposes of a claim under a double-taxation agreement (*Bricom Holdings Ltd v Inland Revenue Commissioners*) (United Kingdom, 1997). (United Kingdom. HMRC, 2010m.)

When a company makes a claim to bring forward, for tax relief purposes, trading losses incurred before the first period for which an apportionment is made, the company's assumed residence, instead, commences from the beginning of the first accounting period for which the losses claimed were actually incurred (Schedule 24, para 9(3), ICTA, 1988) (United Kingdom. HMRC, 2010m).

5.8.3.2 Assumed apportionment (Section 750(3), ICTA, 1988)

A foreign company's chargeable profits and corresponding United Kingdom tax for an accounting period need to be calculated to determine whether an apportionment is due for that period. To enable the computation to be made it is assumed that an apportionment falls to be made for that period. The company shall be assumed to have become resident in the United Kingdom and, accordingly, within the charge to Corporation Tax, at the beginning of the first accounting period in respect of which an apportionment under Section 747(3), ICTA, 1988, falls to be made (Schedule 24, para 2(1), ICTA, 1988). A company is assumed thereafter to be continuously resident in the United Kingdom from the earliest accounting period for which a direction was made (irrespective of whether or not any apportionment falls to be made in any subsequent accounting periods) until the company ceases to be controlled by persons resident in the United Kingdom (Schedule 24, para 2(1), ICTA, 1988). (United Kingdom. HMRC, 2010m.)

For the purposes of calculating a company's chargeable profits or corresponding United Kingdom tax for any accounting period which is not the first such period referred to in subparagraph 2(1), Schedule 24, ICTA, 1988, and in particular, for the purpose of applying any relief which is relevant to two or more accounting periods, "it shall be assumed that a calculation of chargeable profits or, as the case may be, corresponding United Kingdom tax has been made for every previous accounting period throughout which the company was, by virtue of subparagraph (1) above, assumed to have been resident in the United Kingdom" (Schedule 24, para 2(2), ICTA, 1988). In this way continuity is preserved, for example, capital allowances and trade losses may be carried forward under Section 393(1), ICTA, 1988, in the normal way despite apportionments not being made for all the intervening periods. (United Kingdom. HMRC, 2010m.)

5.8.3.3 Deemed change of residence during an accounting period

Where a company is deemed to become, or ceases to be, resident in the United Kingdom on a date which is not the date to which its accounts are drawn up, the profits of the period of account straddling the date on which residence status changes will have to be apportioned. Profits of the entire period of account may, where necessary, be apportioned to the periods of non-residence and residence on a time basis. It is preferable, however, to establish the true profit of the period of deemed residence by reference to transactions etc. of that period, where this can be carried out at a reasonable cost. (United Kingdom. HMRC, 2010m.)

5.9 Apportionment of chargeable profits and creditable tax

Where a foreign company falls within the definition of a CFC (Section 747(1), ICTA, 1988), and none of the legislative exemptions are available to the CFC (in terms of Section 748(1), ICTA, 1988), then the chargeable profits and creditable tax must be apportioned among the persons with an interest in it.

Where Chapter IV applies for an accounting period of a CFC, the chargeable profits and creditable tax of the company are apportioned, in terms of Section 752, among the persons (whether resident in the United Kingdom or not) who had an “interest” in the company at any time during the accounting period under review (Section 747(3), ICTA, 1988). The apportionment of chargeable profits may result in profits being apportioned to both the individual and companies and to residents as well as non-residents. However, assessments under Chapter IV are only to be made on companies resident in the United Kingdom. (Section 747(4), ICTA, 1988.)

5.9.1 Profits and creditable tax apportionment – assessment of liability (Section 747(3) and (4) and Section 754(2), ICTA, 1988)

The assessment under Chapter IV is to a sum equal to Corporation Tax at the appropriate rate on the apportioned profits less any creditable tax included in the apportionment (Section 747(4)(a), ICTA, 1988). In terms of Section 747(4A), ICTA, 1988, if the CFC profits are computed in a foreign currency, the amount apportioned is converted to sterling at the prevailing rate at the end of the CFC’s accounting period. The net sum assessed is payable by the resident company as if it were an amount of Corporation Tax. The assessment is due for the accounting period of the resident company in which the accounting period of the CFC ends. The appropriate rate of Corporation Tax for Chapter IV purposes is the full Corporation Tax rate in force for the accounting period concerned of the resident company for which an assessment is made (Section 747(4)(a), ICTA, 1988). If the accounting period falls into two financial years, the rate to be charged is the average of the Corporation Tax rates in force over the accounting periods (United Kingdom. HMRC, 2010o).

5.9.2 Substantial interest requirement (Section 747(5), ITCA, 1988)

Where chargeable profits of a CFC are apportioned to a United Kingdom resident company, no assessment may be made in respect of those profits unless the aggregate of the following amounts is at least 25 per cent of the total chargeable profits of the CFC. The amounts to be aggregated are

- the amount of the chargeable profits which have been apportioned to the resident company, and
- the amount of the chargeable profits which have been apportioned to persons (whether corporate or individual) who are connected or associated with the resident company. (Section 747(5), ICTA, 1988.)

The increase in the minimum threshold from 10 per cent to 25 per cent was made to reduce compliance costs by removing additional shareholdings from potential tax charge (Schedule 17, Section 1(5)(b), FA 1998) (United Kingdom. HMRC, 2010p).

5.9.3 Interests in a CFC (Section 749B, ICTA, 1988)

Where an apportionment falls to be made, the CFC's chargeable profits and creditable tax are apportioned among the persons who had an interest in the company at any time during the accounting period under consideration (Section 749B, ICTA, 1988). In many instances the only interest needing to be considered will be shareholdings. However, there are other ways in which a person may effectively control or derive benefit from a company, for example, through special rights in a winding-up or through contingent rights. The definition of persons with an interest in a CFC has been widely drafted (in the legislation) to give due recognition to the above situation (United Kingdom. HMRC, 2010q). Therefore, for the purposes of the CFC provisions, the following persons have an interest in a CFC:

- any person who possesses, or is entitled to acquire, share capital or voting rights in the company;
- any person who possesses, or is entitled to acquire, a right to receive or participate in distributions of the company;
- any person who is entitled to secure that income or assets (whether present or future) of the company will be applied directly or indirectly for his benefit; and
- any other person who, either alone or together with other persons, has control of the company. (Section 749B(1), ICTA, 1988.)

Loan creditors are not considered as having an interest in a CFC, although a company can be a CFC by virtue of control by a loan creditor (Section 416, ICTA, 1988). "For the purpose of subsection 1(b) above the definition of 'distribution' in [Part 23 of CTA 2010] shall be construed without any limitation to companies resident in the United Kingdom" (Section 749B(3), ICTA, 1988).

5.9.3.1 "Entitled to acquire" and "entitled to secure" (Section 749B(4), ICTA, 1988)

The terms "entitled to acquire" and "entitled to secure" in (a), (b) and (c) of Section 749B(1) (as above) are applicable to both where a person is presently entitled to acquire or secure an asset at a future date and where a person will at a future date be entitled to acquire or secure that asset. They do not extend, however, to situations where, in an exclusively arm's length transaction, one party temporarily has future rights over the other's property, for example, in the period between exchange of contracts and completion of a sale of land (Section 749B(4), ICTA, 1988). (United Kingdom. HMRC, 2010r.)

5.9.3.2 Indirect interests (Section 749B(5) – (7), ICTA, 1988)

A person may hold an indirect interest in a CFC, for example, where a company (C) has an interest in another company (D) and another company (B), or two or more persons together, has an interest in company (C), company (B) has the same interest in company (D) as does company (C). When two or

more persons jointly have a beneficial interest in a company then they are treated as having the same interest in equal shares. (Section 749B(5) – (7), ICTA, 1988.)

5.9.3.3 Relevant interests (Section 752A, ICTA, 1988)

The objective of the relevant interest rules is to ascertain who is subject to an apportionment of profits in a CFC. Any United Kingdom-resident company with a relevant interest will, subject to exemptions, have to self-assess the tax arising on an apportionment to them. Not everyone with an interest in a CFC has a relevant interest. For example, when two United Kingdom companies have an interest in a CFC – one holding the shares directly and the other holding the shares in the United Kingdom company – then only the first United Kingdom company will be holding the relevant interest, and only that company will be required to self-assess the chargeable profits (Section 752A(2) and (3), ICTA, 1988). (United Kingdom. HMRC, 2010s.)

5.9.3.4 Interest by virtue of ordinary shares alone (Section 752(2) – (3), ICTA, 1988)

In the majority of instances, relevant interests in a CFC will arise solely by the holdings of ordinary shares either directly or via holding companies. Where all of the following requirements are fulfilled, apportionment should be made among the “relevant interests” in direct proportion to the ordinary shares held in the CFC. (Section 752(2) – (3), ICTA, 1988.)

5.9.3.5 Calculation of interest based on ordinary shares (Section 752B, ICTA, 1988)

Where the interest is represented by ordinary shares in the CFC and is held indirectly, the interest of each higher company in the chain is calculated by reference to the percentage of total ordinary shareholding that each company holds in the company that is linked by ordinary shares to the CFC. Where, however, the relevant interest is not held wholly through the same intermediate company, each shareholding percentage will need to be computed separately and aggregated.

5.9.3.6 Interests other than by virtue of ordinary shares alone (Section 752(4), ICTA, 1988)

Where the relevant interest in a CFC are not held solely by virtue of ordinary shares and in consequence of which Section 752(3), ICTA, 1988, is not applicable, the apportionment of chargeable profits and creditable tax for the relevant accounting period is to be made on a just and reasonable basis among the persons who have relevant interests in the company at any time in that period (Section 752(4), ICTA, 1988). For a basis to be considered just and reasonable it should reflect the power the interest has to enjoy in relation to the income of the CFC either as a distribution or on a winding-up. (United Kingdom. HMRC, 2010t.)

5.9.3.7 Determination of apportionment by Board (Section 754(2A), ICTA, 1988)

Where an apportionment falls to be made in terms of Section 752(4), ICTA, 1988, (interests held other than by virtue of ordinary shares alone), and a company tax return is made or amended using a

particular basis adopted by the company, the Board may determine that another basis is to be used in respect of the apportionment. In other words, Inland Revenue can determine that a different “just and reasonable” basis be used to apportion profits than the basis used by the company in its self-assessment (Section 754(2A), ICTA, 1988). (United Kingdom. HMRC, 2010u.)

5.9.4 New United Kingdom CFC regulations governing EEA States: deduction for net economic value against apportionment (Section 751A)

Despite United Kingdom CFC legislation being compatible with European law as interpreted by the ECJ in the Cadbury Schweppes case, the government did recognise that there might have been “circumstances at the margins where it may not have been entirely clear” (United Kingdom. HMRC, 2010v). Therefore, in response, government decided to amend United Kingdom CFC legislation in Chapter IV of Part XVII, ICTA, 1988, “to reflect the judgement explicitly in the rules”, and to provide a clear guideline by which companies could produce evidence to corroborate the extent of a CFC’s genuine economic activities (undertaken through a business establishment) in another Member State. The outcome of the new legislation (in Section 751A) is to “establish what amount (if any) of a controlled foreign company’s profits should be excluded from the [CFC] charge” and coming into effect as from 6 December 2006. (United Kingdom. HMRC, 2010v.; 2010w)

CFCs that have business establishments in EEA territories, and which do not qualify for any of the general exemptions contained in Section 748, ICTA, 1988, may now have at their disposal a tax mechanism for excluding profits from apportionments to a United Kingdom-resident company (Section 751A, ICTA, 1988). To satisfy the requirements of Section 751A, a United Kingdom-resident company, acting on behalf of its foreign subsidiary, must fulfil the following conditions:

- a) an apportionment under Section 747(3) falls to be made as regards an accounting period (“the relevant accounting period”) of a controlled foreign company,
- b) throughout that period the controlled foreign company has a business establishment in a EEA territory,
- c) throughout that period there are individuals who work for the controlled foreign company in that territory, and
- d) a company resident in the United Kingdom (“the United Kingdom resident company”) has a relevant interest in the controlled foreign company in that period. (Section 751A(1), ICTA, 1988.)

If the Commissioners grant the application,

- the chargeable profits are treated as reduced by the specified amount, and
- the controlled foreign company’s creditable tax (if any) for the period is treated as reduced by so much of that tax as, on a just and reasonable basis, relates to the reduction in those chargeable profits of the CFC,

for the purpose of applying Section 747(3) to (5), for determining the sum (if any) chargeable on the United Kingdom-resident company under Section 747(4)(a) (but for no other purpose). (Section 751A(3), ICTA, 1988.)

5.9.5 Reduction in chargeable profits: failure to qualify for exemptions – Section 751AB

Schedule 1, Part 1, paragraph 2, Finance (No. 3) Bill, 2011, introduced a new Section 751AB of ICTA, 1988, which enables a reduction in a CFC charge in circumstances where the conditions of the new exemptions, in Section 748(1)(ba) or (bb) (in terms of paragraph 1(3), Finance (No. 3) Bill, 2011), are not met in full. Therefore, Section 751AB(1), ICTA, 1988, becomes operative when the following conditions are fulfilled:

This Section applies if

- a) an apportionment under Section 747(3) would fall to be made as regards an accounting period (“the relevant accounting period”) of a CFC,
- b) but for a relevant failure, Section 748(1)(ba) or (bb) would have prevented such an apportionment, and
- c) a company resident in the United Kingdom (“the United Kingdom resident company”) has a relevant interest in the CFC in that period. (Schedule 1, Part 1, para 2(1), Finance (No. 3) Bill, 2011.)

Section 751AB(2) outlines the circumstances under which failure to meet the conditions of the new exemptions will enable the United Kingdom company to lodge an application under Section 751AB(3) – which effectively allows for a reduction in the CFC apportionment. In the case of Section 748(1)(ba), one or both of the following: either that the level of United Kingdom connection exceeds 10 per cent but does not exceed 50 per cent, and/or the combined finance and IP income of the CFC exceeds 5 per cent of gross income but the relevant IP income of the CFC does not exceed 5 per cent of gross income (Section 751AB(2)(a), ICTA, 1988). In the case of Section 748(1)(bb): a failure to meet the requirements of paragraph 12L of Schedule 25(finance income), Part 2B, ICTA, 1988. (Section 751AB(2)(b), ICTA, 1988.)

The United Kingdom-resident company may apply to HMRC for the reduction of the chargeable profits of the CFC for the relevant accounting period, to be reduced to a specified amount (including nil) (Section 751AB(3), ICTA, 1988). If the Commissioners grant the application, then the chargeable profits are treated as reduced to the specified amount, and the related creditable tax (if any) is reduced accordingly, on a just and reasonable basis – for the purposes of applying Section 747(3) to (5) for determining the sum (if any) chargeable on the United Kingdom-resident company. (Section 751AB(4), ICTA, 1988.)

However, the Commissioners may grant the application only if they are satisfied that the specified amount is not less than the relevant amount, and they have not previously granted an application made

by the United Kingdom-resident company in respect of the relevant accounting period under Section 751A or 751AC. (Section 751AB(5), ICTA, 1988)

5.9.6 Reduction in chargeable profits following an exempt period – Section 751AC

Paragraph 8 of Schedule 1, Finance (No. 3) Bill, 2011, introduced a new Section 751AC, ICTA, 1988, which permits a reduction in the chargeable profits of a CFC in circumstances where the temporary exemption period has been terminated. The new Section 751AC(1) sets out the conditions under which an application can be made by a United Kingdom-resident company which would otherwise suffer an apportionment of the full chargeable profits of the relevant CFC. It refers to the termination events set out in the new paragraph 15C(2), but specifically excludes terminations in relation to acquisition vehicles (new paragraph 15C(3)(b)).

A United Kingdom-resident company may lodge an application to the Commissioners for HMRC to reduce the CFC chargeable profits to a “specified amount” specified in the application (which may be nil) (Section 751AC(2), ICTA, 1988). If the Commissioners grant the application, the chargeable profits are treated as reduced to the specified amount, and the related creditable tax is reduced accordingly, on a just and reasonable basis, for the purposes of applying Section 747(3) to (5) for determining the sum (if any) chargeable on the United Kingdom-resident company under Section 747(4)(a) (but for no other purpose) (Section 751AC(3), ICTA, 1988). The Commissioners may grant the application only if they are satisfied that the specified amount is not less than the relevant amount, and that they have not previously granted an application under Section 751A or Section 751AB. This prevents overlapping applications in respect of the same profits. (Section 751AC(4).)

5.9.7 Creditable tax and apportionment (Section 751(6), ICTA, 1988)

Where the provisions of Chapter IV, ICTA, 1988, are applicable to a CFC, then both chargeable profits and creditable tax should be apportioned accordingly (Section 747(3), ICTA, 1988). Creditable tax is broadly defined as the aggregate of the following amounts (Section 751(6), ICTA, 1988):

- a) the amount of any relief from corporation tax in respect of income which (on the assumptions set out in Schedule 24 and assuming the company to be liable for corporation tax on the chargeable profits of that accounting period) would fall to be given to the company by virtue of any provision of [Part 2 of TIOPA 2010 (double-taxation relief)] in respect of foreign tax attributable to any income which is brought into account in determining those chargeable profits; and
- b) any amount which (on those assumptions) would fall to be set off against corporation tax on those chargeable profits by virtue of [Section 967 of CTA 2010]; and
- c) the amount of any income tax or corporation tax actually charged in respect of the chargeable profits of that accounting period, less any of that tax which has been or falls to be repaid to the company, whether on the making of a claim or otherwise. (Section 751(6), ICTA, 1988.)

For the purposes of computing a company's chargeable profits and creditable tax, a CFC is assumed to be resident in the United Kingdom (Schedule 24, para 1(1), ICTA, 1988). The company thus meets the general requirement (in Section 26, TIOPA 2010), that double-taxation relief is only available to persons resident in the United Kingdom. Foreign taxes eligible for credit under Part 2 of TIOPA 2010 (double taxation) and Section 967 of CTA 2010, comprises of both taxes for which relief is granted under the provisions of a double-taxation agreement and also taxes qualifying for credit under the unilateral relief provisions of Sections 9 and 18 of TIOPA 2010. The definition of creditable tax includes all taxes qualifying for double-taxation relief in respect of income whether imposed under the laws of the CFC's territory of residence or any third country. Creditable tax includes taxes levied by political sub-divisions of a country, for example, the Swiss cantonal taxes, where these taxes qualify for double-taxation relief against United Kingdom taxes on income under the normal taxation rules. (United Kingdom. HMRC, 2010x.)

Double-taxation arrangements

Double-taxation arrangements are given effect by arrangements made in relation to other territories. In order for Section 2(1), TIOPA, 2010 to be operative, they are given legal effect in terms of Section 6, TIOPA, 2010. These taxes include:

- a) income tax,
- b) corporation tax,
- c) capital gains tax,
- d) petroleum revenue tax, and
- e) any taxes imposed by the law of the territory that are of a similar character to taxes within paragraphs (a) to (d). (United Kingdom, 2010d:Section 2(1) and (2) and (3).)

The meaning of double taxation: For the purposes of Sections 2 and 3, TIOPA, 2010, any amounts within Section 4(2), TIOPA, 2010, includes an amount of tax that would have been payable under the law of a territory outside the United Kingdom but for a relief

- a) given under the law of the territory with a view to promoting industrial, commercial, scientific, educational, or other development in a territory outside the United Kingdom, and
- b) about which provision is made in double-taxation arrangements. (United Kingdom, 2010d:Section 4.)

Double-taxation arrangements have effect in relation to income tax or corporation tax and capital gains tax so far as these arrangements provide for relief from income tax or corporation tax and relief from capital gains tax (United Kingdom, 2010d:Section 6(2) and 6(3)).

Unilateral relief arrangements

Unilateral tax relief arrangements, in relation to a territory outside the United Kingdom, is inclusive of the rules as laid down in Sections 9 to 17 (United Kingdom, 2010d:Section 8(1)). Therefore, any reference to unilateral tax relief measures in Sections 11 to 17 of Chapter 1 and in Chapter 2 (except

Section 29) of Part 2, TIOPA, 2010, includes tax payable or paid under the law of a territory outside the United Kingdom in respect of the following:

- taxes which are charged on income and which correspond to income tax,
- taxes which are charged to income or chargeable gains and which correspond to corporation tax, and
- taxes which are charged on capital gains and which correspond to capital gains tax. (United Kingdom, 2010d:Section 8(2).)

For the purposes of Section 8(2), TIOPA, 2010, tax payable under the law of a foreign territory may correspond to income tax, corporation tax or capital gains tax even though it –

- is payable under the law of a province, state or other part of a country, or
- is levied by or on behalf of a municipality or other local body. (United Kingdom, 2010d:Section 8(3).)

Double-taxation relief by way of credit

Entitlement to credit for foreign tax reduces United Kingdom tax by the amount of the credit under any double-taxation arrangements, or under any unilateral tax relief arrangements in respect of a territory outside the United Kingdom (Section 18(1), TIOPA, 2010). The amount of the taxes chargeable (with regard to the income or gain) is to be reduced by the amount of the credit (United Kingdom, 2010d:Section 18(2)).

“Credit” in Section 18(1), TIOPA, 2010, means the following:

- in relation to double-taxation arrangements, it means credit for tax payable under the law of the territory in relation to which the arrangements are made, and
- in relation to unilateral relief arrangements for a territory outside the United Kingdom, it means credit for tax payable under the law of that territory. (United Kingdom, 2010d:Section 18(3).)

5.10 Relief against CFC tax

5.10.1 Relevant allowances (Section 754(5) and Schedule 26, para 1(1) and (3), ICTA, 1988)

A self-assessment under Chapter IV, ICTA, 1988, is on an amount charged at the appropriate rate on the chargeable profits apportioned to a United Kingdom resident company in respect of its interest in a CFC, reduced by any creditable tax included in the apportionment (in terms of Section 747(3) and (4), ICTA, 1988). The legislation makes it clear that no reliefs other than those provided in Schedule 26, ICTA, 1988, are available to the United Kingdom Company to be offset against the potential Chapter IV tax charge. (Section 754(5), ICTA, 1988.)

The reliefs which qualify for set-off, subject to the conditions of Schedule 26, ICTA, 1988, are described as “relevant allowances”. The relevant allowances are as follows:

- a) any loss to which [Section 37 or 62(1) to (3) of CTA 2010] applies;
- b) any [qualifying charitable donation];
- c) any expenses of management to which [Section 1219(1) of CTA 2009] applies;
[(cc) any expenses deduction under Section 76(1);]
- d) so much of any allowance to which Section 74 of the 1968 Act applies as falls within subsection (3) of that Section ; ...
- e) any amount available to the company by way of group relief [and]
- f) any non-trading deficit on its loan relationships. (Schedule 26, para 1(3), ICTA, 1988.)

Where a United Kingdom company

- is subject to an apportionment of chargeable profits
- is entitled, or would on the making of a claim be entitled, in computing its Corporation Tax profits for the accounting period for which it has been assessed under Chapter IV, to a deduction in respect of any relevant allowance, and
- makes a claim,

a reduction in its liability under Chapter IV may be made in respect of the relevant allowance. (Schedule 26, para 1(1) and (5), ICTA, 1988.)

The reduction in the Chapter IV, ICTA, 1988, liability is given in terms of tax. The amount that is to be deducted from the Chapter IV liability is a sum equal to Corporation Tax at the “appropriate rate” on so much of the relevant allowance as is specified in the claim. It shall be set off against the company’s liability to tax under Section 747(4)(a) in respect of the chargeable profits apportioned to it. The “appropriate rate” is in practice the same rate as was used to compute the Chapter IV tax liability for the accounting period for which the claim is made. (Schedule 26, para 1(1) and (5), ICTA, 1988)

5.10.2 Reliefs to prevent double charge (Schedule 26, para 3 to 6, ICTA, 1988)

Paragraphs 3 to 6 in Schedule 26 contain specific provisions to mitigate the effect of double taxation – which may arise where a United Kingdom company is assessed under Chapter IV, ICTA, 1988, and either

- disposes of the shares in the controlled foreign company (or an intermediate holding company) which gave rise to the Chapter IV liability, or
- receives a dividend derived directly or indirectly from the profits of the controlled foreign company in respect of which the Chapter IV liability arose.

A double charge to taxation will arise under (a) above, where the profits which gave rise to the Chapter IV liability have been retained by the CFC so that the disposal proceeds arising from the disposal of the shares reflect the value of the profits apportioned to the United Kingdom company. Under these circumstances a tax liability arises – both under Chapter IV and on the chargeable gain accruing on the disposal of the shares. The form of relief to mitigate the effects of the double-taxation charge – is that the tax charged under Chapter IV is allowable as a deduction in computing the chargeable gain on the disposal of the shares.

A double charge to taxation will arise under the circumstances in (b) above, because the dividend paid out of profits which has given rise to a Chapter IV charge will be taxable in the normal way under Case V of Schedule D, ICTA, 1988. The form of relief to mitigate the effects of double taxation is to allow the tax charged under Chapter IV to be credited as underlying tax against the tax liability arising on the dividend (para 6(1)(c)). (United Kingdom. HMRC, 2010x.)

5.11 Other provisions of United Kingdom CFC legislation

5.11.1 Dividend distribution (Part 9A, CTA, 2009)

5.11.1.1 Introduction

Part 9A of Corporation Tax Act (CTA), 2009 (United Kingdom, 2009a), was introduced by Finance Act, 2009 (Section 34, Schedule 14), with effect for distributions made on or after 1 July 2009. It establishes the scope of the corporation tax charge in respect of company distributions of an income nature. It applies equally to distributions from either United Kingdom or foreign companies. Distributions are charged to corporation tax only if they are not exempt and Part 9A (CTA, 2009) is designed to ensure that the great majority of dividends and other distributions will be exempt. All dividends will be exempt unless they are paid out of profits which reflect the results of a transaction or series of transactions of which one of the main purposes is to achieve a reduction in United Kingdom tax.

For the purposes of this study, the following two Sections are pertinent:

- Exempt class – Distributions from controlled companies – (Section 931E, CTA, 2009):
- Anti-avoidance legislation – (Schemes involving manipulation of controlled company rules) – applies only to distributions which are exempt by reason of Section 931E and is relevant only to that exempt class. (Section 931J, CTA, 2009.)

5.11.1.2 Distribution from CFCs (Section 931E, CTA, 2009)

A distribution falls into an exempt class if it is paid by a company that is controlled by the recipient. A dividend or other distribution falls into an exempt class if either condition A or B is met in Section 931E(1) (CTA, 2009). Condition A is that the recipient controls the payer (Section 931E(2)). Condition B is that

- a) the recipient is one of two persons who, taken together, control the payer,
- b) the recipient is a person in whose case the 40 per cent test in Section 755D(3) of ICTA is satisfied, and
- c) the other is a person in whose case the 40 per cent test in Section 755D(4) of ICTA is satisfied. (Section 931E(3), CTA, 2009.)

The definition of control in Section 755D, ICTA, 1988, applies, but with the modification that Section 755D(6)(c) and (d) must be disregarded for the purposes of Part 9A, CTA, 2009 (Section 931E(4) and (5), CTA, 2009). The above subsections 6(c) and (d) set out certain conditions under which the rights and powers of connected United Kingdom-resident companies be attributed to a company for the purpose of establishing control. In their absence it is necessary to consider only the rights and powers of the recipient company when determining whether it exercises control over the paying company, including any which it is or may become entitled to acquire.

5.11.1.3 Schemes involving manipulation of CFC rules (Section 931J, CTA, 2009)

A dividend will fall within the ambit of an exempt class under Section 931E, CTA, 2009, provided that the payer is controlled by the recipient at the time the dividend is paid out. This creates a risk, however, that schemes might be set up whereby profits accruing during a period in which there is no control of the paying company, so there is no CFC defence against artificial diversion of profits, but the dividend is paid at a time when control by the recipient has been established. (Section 931J(2) and (3), CTA, 2009.)

Section 931J is relevant only in those cases where a dividend is exempt solely by reason of Section 931E. Profits that arose in a period before the recipient controlled the payer (refer Section 931E) are referred to as “pre-control profits”. However, profits can only be pre-control profits if they arose in an accounting period that ended on or after 1 July 2008 (Schedule 14, paragraph 32(3), FA, 2009).

In order for Section 931J to apply the following two conditions need to be fulfilled:

- There is a scheme that has as its main purpose, or one of its main purposes, to obtain exemption under Section 931E.
- The dividend is paid in respect of pre-control profits. (Section 931J(2) and (3), CTA, 2009.)

Where Section 931J applies it has the effect of preventing a dividend from falling into an exempt class in terms of Section 931E. To establish whether a dividend is paid in respect of pre-control profits in a

case where both pre-control profits and other profits exist (or have previously existed), it is necessary to consider whether that dividend and any earlier dividend paid after the pre-control profits arose fall into an exempt class by virtue of any Section other than Section 931E. Dividends that are exempt independently of Section 931E are treated as far as possible as paid in respect of profits other than pre-control profits, so it cannot reduce the pool of pre-control profits while any other profits remain distributable (Section 931J(4), CTA, 2009). Dividends that are exempt solely by reason of Section 931E are treated as far as possible as paid in respect of pre-control profits and so (if the purpose condition is also met) will fall within the scope of Section 931J and hence be taxable dividends (Section 931J(5), CTA, 2009) (United Kingdom. HMRC, 2010b).

5.11.2 Other United Kingdom anti-income tax deferral provisions

Other than its CFC legislation, the United Kingdom government also uses the provisions of Section 739, ICTA, 1988, as an anti-avoidance tax provision to prevent United Kingdom residents from transferring assets abroad where income becomes payable to a non-United Kingdom resident, thus resulting in the avoidance of United Kingdom taxes. Thus, Section 739, ICTA, 1988, could cover transactions falling outside United Kingdom CFC rules. For example, in the case where all the shares of a foreign company are owned by individuals, the foreign company will be a CFC but its United Kingdom shareholders will not be subject to any attribution in terms of Chapter IV, ICTA, 1988. However, its profits can be assessed in the hands of individuals under Section 739, ICTA, 1988.

5.11.2.1 Provisions relating to capital gains accruing to non-resident companies (Section 13 of the Taxation of Chargeable Gains Act (TCGA) 1992)

In addition to CFC legislation and Section 739 of the ICTA, 1988, the United Kingdom also has provisions designed to curb tax avoidance that occurs when capital gains accrue to non-resident companies. Section 13 of the Taxation of Chargeable Gains Act (TCGA) 1992 – “Attribution of gains to members of non-resident companies” – has accordingly been promulgated to deal with the above situation. However, this legislation is not applicable to CFCs, as the assumption in Schedule 24, para 4(1), ICTA, 1988, is that a CFC is not to be a close company.

Therefore, in order to tax United Kingdom residents on capital gains accruing to non-resident companies, the company must fulfil the following requirements:

- the company is not to be resident of the United Kingdom,
- the company would be a close company if it were resident in the United Kingdom. (Section 13(1), TCGA, 1992.)

5.11.3 Self-assessment provisions

In 1998, Section 117 and Schedule 18, FA were introduced to bring CFC provisions into line with the United Kingdom corporation tax self-assessment (CTSA) regime, which became effective as from 1 July 1999. Consequently, any company which has an interest in a CFC must complete a supplementary page to the CTSA return, unless

- the CFC satisfies the Excluded Countries Regulations, or
- the relevant interest, together with the interests of connected or associated persons, is less than 25 per cent.

Prior to the self-assessment rules, there were no obligations on United Kingdom companies to include details of its interest in a CFC in its tax returns, but with the legislative change in 1998 it is now incumbent on companies to disclose details of its interests in foreign subsidiaries and associated companies. For example, United Kingdom residents have to sign a return whereby they identify a particular exemption and then certify that to the best of their knowledge and belief each of their overseas subsidiaries satisfies the particular exemption claimed. Penalties are not imposed where a United Kingdom resident demonstrates that it has made reasonable efforts to self-assess its CFC's liabilities.

5.12 Compatibility of United Kingdom CFC legislation with its tax treaties and the European Union treaty

There has been significant debate in the United Kingdom in respect of the interaction between domestic CFC rules and double-tax treaties. This has been attributable to *Bricom v Inland Revenue Commissioners* (United Kingdom, 1997), in which the taxpayer, Bricom Holdings Ltd, was resident in the United Kingdom and the sole shareholder of Spinneys International BV ("Spinneys"), a company incorporated and resident in the Netherlands. Bricom Holdings Ltd borrowed substantial sums of money from Spinneys and paid interest on this money (Ullah, 2004:627). The United Kingdom Inland Revenue assessed Bricom to tax on the basis of an apportionment of the chargeable profits of Spinney (Ullah, 2004:627).

Bricom Holdings appealed the assessments on the basis that the assessments included amounts that should have been excluded from tax in the United Kingdom under the 1980 United Kingdom-Netherlands Double Taxation Convention (incorporated into United Kingdom domestic law by S1 1980/1961). The court held that the taxpayer could not rely on Article 11 of the United Kingdom-Netherlands Double Taxation Convention, as the "chargeable profits" as defined by Section 747(6)(a) of the ICTA, 1988, are a purely notional sum that do not represent any profits of Spinneys on which United Kingdom tax is chargeable, nor do they represent any actual payments or receipts of Spinneys, whether of interest or anything else. They were merely the product of a mathematical calculation

made on a hypothetical basis. The “chargeable profits” which are defined in Section 747(6)(a), exist only as a measure of imputation. Thus, what is apportioned to the taxpayer company and subject to taxation was not Spinneys’ actual profits, but a notional sum which was the product of an artificial calculation (United Kingdom, 1997); finding in favour of the IRC, the House of Lords therefore held that the CFC regime was not a corporation tax or substantially similar tax and so it did not qualify for relief under the treaty.

It is worth emphasising that, contrary to the court’s conclusions in the Bricom Holding case, it has been contended by some commentators that “chargeable profits” are not a “purely notional sum”. The purpose and effect of United Kingdom’s CFC legislation is that the “chargeable profits” of a CFC are, in fact, the profits of the CFC (excluding chargeable gains) calculated in accordance with United Kingdom tax laws (Oguttu, 2007:255). Therefore, it is difficult to reconcile the idea that the chargeable profits are on the one hand a manufactured or purely notional sum, and yet on the other hand have the same distinctive meaning as for corporation tax purposes (Ullah, 2004:620).

Sandler (Sandler & Chartered Institute of Taxation, 1998:206) is of the view that the Bricom case does not conclusively deal with the debate about a Treaty/CFC override, for two reasons: Firstly, it is regrettable that the taxpayer chose to base his argument on the interest article of the relevant treaty (Article 11) rather than on the business profits article (Article 7(1)). According to Sandler, the United Kingdom CFC legislation effectively subjects undistributed profits to tax, so that the reliance on the business profits article may have been more successful for the taxpayer. Therefore, CFC legislation taxes undistributed business profits which are covered by the business profits article in a tax treaty. This is especially true in that Article 7 applies not only to juridical double taxation, but also to economic double taxation. Secondly, the court’s conclusion that the nature of the “chargeable profits” in terms of United Kingdom CFC legislation is a purely notional sum may be criticised because the profits are, rather, the profits of the CFC calculated in accordance with United Kingdom corporate tax laws and are, consequently, no more notional than ordinary United Kingdom corporate tax. (Sandler & Chartered Institute of Taxation, 1998:208-209.)

5.13 Comparison of South African and United Kingdom CFC legislations

Key points of comparison between South African and United Kingdom CFC legislation which will be highlighted in this chapter section are:

- approaches to CFC legislation
- definition of a CFC
- qualification criteria of a CFC (inclusive of control measures)
- tax exemptions

- tax attributions
- relief tax provisions
- administrative and other requirements

Appropriate remedial measures where shortcomings are determined in the South African CFC legislation will be included as recommendations in the concluding chapter of the thesis.

Other issues that will be noted in the comparison include the following:

- national long-term tax policy objectives
- the extent to which government neutralises tax effects on the exportation of its domestic capital
- the international competitiveness of a country's CFC legislation
- the concerns of both tax authorities and domestic taxpayers to CFC legislation
- the ongoing evolution in CFC legislation and its continuing ability to act as a deterrent to both the avoidance of domestic taxation on foreign-sourced income and the transfer of domestic income to foreign companies, especially in tax havens and preferential tax regimes

An overview of key features in the CFC regulations of the two countries is presented in Table 5-1.

Table 5-1 S African / United Kingdom CFC legislation compared

TOPIC	SOUTH AFRICA	UNITED KINGDOM	INCOME TAX ACTS
Year CFC rules	1987	1984	
Policy objectives	- Prevent the diversion of income i.r.o. related-party or base company transactions to CFCs - Prevent the diversion of passive income in tax havens - Prevent the accumulation of the above incomes in CFCs based primarily in tax havens - Not interfere with legitimate foreign business activities of SA residents	- Prevent the diversion of passive and certain base company income to CFCs in tax havens - Prevent the accumulation of such income in CFCs in tax havens - Not interfere with legitimate foreign business activities of United Kingdom companies - Preserve London as an international financial centre	
Designated jurisdiction or global approach Definition of tax haven or low-taxed income	- Global and designated jurisdiction approaches - Foreign tax less than 75% of SA tax (Sect. 9D(2A)) (see 3.4.2) - Comparison between actual foreign tax paid and notional SA tax on same income (Sect. 9D(2A)) (see 3.3.4.2) - Related-party transaction is exempt if tax more than 50% of SA Tax (Sect. 9D(9A)(i)(aa)(bb) (see 3.4.4)	- Designated jurisdiction approach - Foreign tax less than 75% of United Kingdom tax - Administrative white list of non-tax havens - Comparison between actual foreign tax paid and notional United Kingdom tax on same income	S750(1) and (2), ICTA, 1988 S748(1)(e) and S748(1A), ICTA, 1988 S750(2), ICTA, 1988 (see 5.6)
Definition of a controlled foreign corporation (CFC)	- SA resident holds more than 50% of participation rights or holds more than 50% of voting rights (includes directly or indirectly) in CFC (Sect. 9D(1)) - No minimum ownership (see 3.2.1.2)	- A non-United Kingdom company controlled by United Kingdom residents and operates in a "low-tax" jurisdiction (see 5.6) - United Kingdom residents holding more than 50% of voting shares, of value shares, of rights to distributions, or of rights to value of assets on liquidation - Indirect and constructive ownership rules - No minimum ownership - Deemed control if one United Kingdom resident owns at least 40% and the non-United Kingdom person owns at least 40% but not more than 55%	S747(1), ICTA, 1988 S755D(1A), ICTA, 1988 S839, ICTA, 1988 Sect. 747(1A) S755D(3) and (4), ICTA, 1988 (see 5.5)
Transactional or entity approach	Entity approach	Entity approach	
Definition of tainted income	- All income inclusive of capital gains - Computed in accordance with SA tax rules - Computed for each CFC separately (Sect. 9D(2A)) (see 3.3.3)	- All income other than capital gains - Computed in accordance with United Kingdom tax rules - Computed for each CFC separately	S747(6), ICTA, 1988 Sch 24, ICTA, 1988 (see 5.8.1)

TOPIC	SOUTH AFRICA	UNITED KINGDOM	INCOME TAX ACTS
Domestic taxpayers to whom income of a CFC is attributed	- Any resident to which 10% or more of the CFC's income is attributed (Sect. 9D(2)(A)) (see 3.3.4) - Constructive ownership rules (Sect. 9D(2)(A)) - Ownership at any time of the year (inclusive of disposals and year-end stock holdings) (Sect. 9D(2)) (see 3.3.2)	- Any corporation to which 25% or more of the CFC's income is attributed (including connected or associated persons) (see 5.9.2) - Constructive ownership rules - Ownership at any time in the year - Inland Revenue has the power to attribute income to a domestic taxpayer other than a shareholder (e.g., a loan creditor) - CFC provisions in line with CTSA regime. Domestic companies to complete supplementary page to CTSA return (see 5.11.3)	S747(5), ICTA, 1988 S755D(5) – (9), ICTA, 1988 Schedule 18, FA, 1988
Exemptions			
1) Exempt Activities test		- CFC must have: a) a territory of residence b) with business establishment c) and be effectively managed in territory of residence - Main business of CFC is not investing or dealing in goods with connected persons; and for CFC in wholesale, distributive or financial business, less than 50% of the gross trading receipts derived from connected persons (see 5.7.2)	S748(1)(b), ICTA, 1988 Sch 25, ICTA, 1988
2) <i>de minimis</i> exemption		The chargeable profits must not exceed £ 50 000. Also increased to £200 000 p.a. for members of a large group – and not micro, small or medium enterprises (see 5.7.3)	S748(1)(d), ICTA, 1988
3) Motive test		It must be proven that the reduction in United Kingdom tax by a diversion of profits from the United Kingdom is not the main reason behind the CFC's existence (see 5.7.4)	S748(3), ICTA 1988 Sch 25, paras 16-19, ICTA, 1988
4) Excluded countries regulations		The CFC must be resident in a territory listed in the "Excluded Countries Regulations" and must satisfy certain income and gains requirements (see 5.7.5)	S748(1)(e), ICTA, 1988 S748(1A), ICTA, 1988
5) Foreign business establishment (FBE S. Africa)	- Requirement for FBE a) Locational permanence b) Economic substance c) Business purpose (Sect. 9D(1)) (see 3.4.4.1) - Additional requirements for FBE		

TOPIC	SOUTH AFRICA	UNITED KINGDOM	INCOME TAX ACTS
	a) Similar requirement for business profits of permanent establishment in OECD and UN MTC b) A similar arm's length requirement as in Sect. 31 of Act 58 of 1962 (see 3.4.4.2) • Tax exemptions – FBE: a) Capital gains b) Related-party – disposal of goods by CFC – jurisdictional approach – SA tax > 50% c) Related-party – services performed by CFC d) Principal trading activities – bank and financial service – insurer e) Rentals – movables • for operating leases and financial instruments a) CFC income – intellectual property (regularly creates or upgrades IP) b) CFC capital gains – intellectual property regularly creates or upgrades IP c) Insurance premium – principal trade activities of insurer		Sect. 9D(9)(b)(i) Article 7(2) OECD & UN MTC Sect. 9D(9)(b)(ii) Sect. 9D(9)(b) Sect. 9D(9)(9A)(a)(i) Sect. 9D(9A)(a)(ii) Sect. 9D(9A)(a)(iii) Sect. 9D(9A)(a)(iv) Sect. 9D(9A)(a)(v) Sect. 9D(9A)(a)(vi) Sect. 9D(9A)(a)(vii)
6) Other exemptions	• The 75% tax exemption – where total tax payable by CFC is at least 75% of SA tax (Sect. 9D(2A)(i)) (see 3.4.2) • Net income of CFC forms part of taxable income of SA company (Sect. 9D(9)(e)) (see 3.4.7) • Foreign dividend received by CFC from any other CFC (with the same SA residents) (Sect. 9D(9)(f)) (see 3.4.8.1)	EEA States – Net economic value – deduction (see 5.9.4) Reduction in chargeable profits : i) failure to qualify exemption (see 5.9.5) ii) following an exempt period (see 5.9.6)	S751A, ICTA, 1988 S751AB, ICTA, 1988 S751AC, ICTA, 1988
7) Capital gains	• Foreign business establishment is exempt from capital gains tax (Sect. 9D((b)) (see 3.4.4) • Capital gains exemption– asset disposed by FBE of another CFC – part of same group of CFCs (Sect. 9D((fB)) (see 3.4.8.3) • Other resident shareholders of CFCs are subject to capital gains tax (Sect. 26A, Schedule 8, ICTA, 1988)	• CFC not subject to capital gain tax in the United Kingdom (see 5.13.11)	Sect. s 13(1) – (5), TCGA, 1992 S747(6)(b), ICTA, 1988 Schedule 24, para 1(1), ICTA, 1988

TOPIC	SOUTH AFRICA	UNITED KINGDOM	INCOME TAX ACTS
	33.3% of net capital gain is subject to tax i.r.o. natural persons, special trust or insurers at 25% as resident shareholders (Sect. 9D(2A)(e)(f)) (Schedule 8, part 2, para 10) 66.6% of net capital gain is subject to tax i.r.o. companies as resident shareholders (Schedule 8, part 2, para 10) (see 3.3.4.5)		
8) Buttreasing legislation to CFC regimen	Not available	Sect. 739 chief defence against tax avoidance – offshore companies	S739, ICTA, 1988
Relief provisions			
9) Foreign taxes	- Credit allowed against SA tax for foreign taxes paid (S 6quat(1) (see 3.5.3) - Determination of rebate (S 6quat(1A)) (see 3.5.4) - Limit on rebate (S 6quat(1B)) (see 3.5.5) - Deduction of unqualifying rebate against SA income (S 6quat(1C)) - Rebate cannot exceed SA tax liability on foreign income (S 6quat(1D)) (see 3.5.6)	Credit allowed against United Kingdom tax for foreign taxes paid – apportioned to shareholders accordingly (creditable taxes) (see 5.9.7)	S751(6), ICTA, 1988 S18(1) and (2), TIOPA, 2010
10) Losses	trading losses carried forward indefinitely (S20; Sect. 9D(2A)(b)) (see 3.3.4.1)	- trading losses carried forward indefinitely - CFC may carry forward losses from the 6 years preceding the first year in which Inland Revenue applies CFC rules to it (see 5.13.12) - no consolidation	S393(1), ICTA, 1988 Sch 24, para 9(1), ICTA, 1988
11) Subsequent dividends	When CFC income is distributed in the form of dividends – exempted under S10B(but subject to Sect. 10B(4) (see 3.3.6)	- United Kingdom tax on attributed income treated as foreign tax paid and creditable against subsequent dividends (see 5.10.2) - United Kingdom introduced dividend exemption – on or after 1 July 2009. Dividend must be within exempt class (see 5.11.11)	Sch 26, para 4(1) – (3), ICTA, 1988 Sect. 931E, CTA, 2009
12) Subsequent capital gain (on sale of shares of CFC)	- Sale of interest in a CFC - Exempt in terms of paragraph 64B(2)(, Eighth Schedule, if certain requirements are fulfilled	- Capital gains on disposal of shares reduced by United Kingdom tax on attributed income (see 5.10.2) - Substantial shareholdings exemption (SSE) may exempt any gain/loss on disposal of shares providing certain holding and trading conditions fulfilled	Sch 26, para 3, ICTA, 1988

TOPIC	SOUTH AFRICA	UNITED KINGDOM	INCOME TAX ACTS
	Anti-avoidance measures applicable under Sect. 64B(3), Eighth Schedule if certain conditions are not fulfilled		
		(see 3.4.8.3)	
13) Income taxed under another country's CFC measures	no relief	no relief	
14) Relevant allowances	Not available	Specific reliefs in the form of "relevant allowances" qualifying for set-off against potential Chapter IV tax charge (see 5.10.1)	Sect. 754(5), ICTA, 1988 Schedule 26, para 1(1) and (3), ICTA, 1988

Author

5.13.1 Approaches to CFC legislation

United Kingdom: When the United Kingdom introduced CFC rules in 1984, following the abolition of exchange controls, the aim was to tax the artificial diversion of business profits from the United Kingdom. The United Kingdom taxes its CFCs based on the jurisdictional entity approach. Under this approach, CFC rules are generally applicable to companies resident in certain countries with low levels of taxation. Such countries are usually identified either by being named in a list, or according to whether their taxation levels fall below a specified threshold. Regarding the types of income and activities that are subject to the CFC rules, the United Kingdom adopts the entity approach, in which all of the entity's income may be subject to taxation. There are, however, exceptions for companies in which the bulk of their income arises from active business operations, even though the company is resident in a low-tax jurisdiction. Both the above constituents are taken into account in determining this approach, which has come to be known as the jurisdictional-entity approach.

South Africa: Unlike the United Kingdom, South Africa applies its CFC regulations to all CFCs wherever they are resident (or located) and irrespective of the foreign tax rates applicable (the “global” approach to CFC regulation). Regarding the types of income that are subject to taxation, South Africa also adopts the entity approach, under which all the income is taxable, unless a specific tax exemption applies. Therefore, South Africa, adopts the global-entity approach to the application of its CFC regulation.

Under this approach, all the CFC's income is subject to South African taxation, including capital gains (other than certain types of capital gains as noted in the table above under Exemptions, item 12 Capital gains). Typically, there are exceptions for companies (or entities) where the bulk of the income is from active business, notwithstanding the fact that the company is resident in a low-tax jurisdiction. A CFC resident in a tax haven may thus be wholly exempt from the legislation (even if a proportion of its income is passive in nature) if, for instance, all its income qualifies for the exemption under the criteria set out by the foreign business establishment exemption. (Section 9D(1) and 9D(9)(b).)

It has been noted that South Africa is one of the countries that is increasingly abandoning an exclusively global approach in the application of its CFC regulations by incorporating a form of the jurisdictional approach, as evidenced in its regulations by references to the aggregate tax payable by the CFC to any foreign government, where this is either 75 per cent or more (Section 9D(2A)), or above 50 per cent (Section 9D(9A)(a)), of the amount of normal taxes that would have been payable in respect of any taxable income of the CFC had the CFC been a resident for the respective foreign tax year.

Commentary: There is convergence in these two systems (United Kingdom and South Africa) to the extent that both systems employ the entity approach when imposing its CFC regulations on its resident shareholders. However, these systems are at variance with one another when applying their CFC regulations: the South African approach substantially employs the global entity approach, meaning that the legislation is applied indiscriminately to a foreign company regardless of its country of residence, while the United Kingdom approach is that only foreign companies qualifying as “lower-level” taxation jurisdictions would be subject to the legislation.

5.13.2 Definition of a CFC

United Kingdom: The first stage in establishing whether there is a Chapter IV, ICTA, 1988 liability is to determine whether the foreign company is a CFC. The Chapter IV liability refers to United Kingdom tax legislation in respect of its CFCs. In Section 747(1), ICTA, 1988, a CFC is defined as a company which in any accounting period is

- resident outside the United Kingdom;
- controlled by persons resident in the United Kingdom;
- subject to a lower level of taxation in its territory of residence.

South Africa: The starting point in determining whether an entity is a CFC is to establish whether it is a foreign company. The first issue that needs to be satisfied is whether the foreign company meets one of the definitional requirements of a company in Section 1 of the Income Tax Act. Secondly, the foreign company in question must be a non-resident either through incorporation or formation in a foreign jurisdiction or the place of effective management – in a tie-breaker – being determined in a foreign jurisdiction. Having established its foreign status, the next stage is to determine whether the foreign company qualifies as a CFC in terms of the South African Income Tax Act (Section 9D(1)).

Commentary: The United Kingdom has more extensive requirements than South Africa in establishing whether the foreign enterprise qualifies as a CFC (see 5.4, 5.5 and 5.6 above).

5.13.3 Foreign entities in domestic tax law

United Kingdom: The basic definition of a CFC in the United Kingdom is applicable exclusively to a company. The term “company” is not defined in the relevant section of the Taxes Act dealing with the taxation of CFCs. The applicable definitions of a company are accordingly those contained in Section 832(1) and 832(2), ICTA, 1988 (see 5.4.2 above).

South Africa: For a foreign entity to be capable of qualifying as a company for South African CFC purposes, it must first qualify as a company in terms of the definitional requirements of a company in

Section 1 of the South African Income Tax Act (No. 58 of 1962). Secondly, the company in question must be classified as a non-resident.

Commentary: In the United Kingdom, the term “company” is not defined in the relevant section of the Taxes Act dealing with the taxation of CFCs. Therefore, the definition of “company” used in Section 832(1) and 832(2), ICTA are applicable for the determination of both domestic and foreign companies, especially the determination of a foreign company for CFC purposes. No reliance is placed on foreign legislation (through domestic tax law) for the determination of a foreign company for CFC purposes.

Taking a closer look at the definitional requirements of a company in the South African Income Tax Act, an anomaly can be seen in the application of paragraph (b) – company (Section 1), where certain foreign entities will qualify as foreign companies for CFC purposes in the Income Tax Act even though they will not be able to fulfil the qualification requirements of Section 1(a) for the purpose of determining a domestic South African resident company. Paragraph (b) is, accordingly, defined as

Any association, corporation or company incorporated under the law of any country other than the Republic or any body corporate formed or established under such law

An example would be where a foreign trust, or an incorporated partnership which does not meet the definition of “foreign partnership” in Section 1, or some other entity, is regarded as a company under the law of the State in which it is incorporated. South African CFC legislation is applicable as the entities will be regarded as companies under paragraph (b) of the definition of “company” in Section 1 of the South African Income Tax Act. (Olivier & Honiball, 2011:564.)

5.13.4 Corporate residence

United Kingdom: In the United Kingdom a company is regarded as a resident if it is incorporated in the United Kingdom or if it is centrally managed and controlled in the United Kingdom (see 5.4.2.1 and 5.4.2.2 above).

Central management and control: In determining whether or not an individual company, outside the scope of the incorporation test rule, is a resident of the United Kingdom, it thus becomes necessary to locate its place of “central management and control”. The legislator did not attempt to give effect to a statutory definition of *central management and control* in United Kingdom tax law. Therefore, the case-law concept of central management and control is, in broad terminology, directed at the highest level of control of the business of a company (see 5.4.2.3 above). (United Kingdom. HMRC, 2010d.)

South Africa: In South Africa, a company is regarded as a resident if it is incorporated, established or formed in South Africa, or (except in the case of high-taxed CFCs) has its “place of effective management” in South Africa (Section 1 of the Income Tax Act).

Incorporation rule: A South African domestic company will come into force or effect immediately after its incorporation or registration. The presumption being that it has fulfilled one of the definitional requirements of a company in Section 1 of the Income Tax Act.

“place of effective management”: The concept “place of effective management” has no statutory definition in South African tax law, nor has it, until very recently (on 13 June 2011) in the matter between Oceanic Trust Co Ltd N.O. (OTC) v Commissioner for the South African Revenue Services (South Africa, 2011b), been the subject of any judicial interpretation by any South African court. The South African Revenue Services had previously issued guidelines (in *Interpretation Note No. 6*) on how this term is to be interpreted. In its view, the place of effective management is where the company’s strategic decisions are implemented.

Commentary: The terms *central management and control* in the United Kingdom and “place of effective management” in South Africa are not mutually compatible. In the United Kingdom the emphasis is substantially placed on the board of directors, sitting and functioning as such and acting as a conglomerate. Therefore, CMC is directed at the highest level of control of the business of a company and is to be distinguished from the place where the main operations of a business are conducted (HMRC, 2010d). In a South African context, the Commissioner considers the place of effective management to be the location where the day-to-day business operations and commercial decisions of senior managers or directors are actually implemented in operations. If these operations are located in various jurisdictions, then it is likely that the most economically important location will be regarded as the place of effective management. (South Africa, 2002d:4.)

5.13.5 CFC control

United Kingdom: Up until 21 March 2000, the provisions in the United Kingdom CFC legislation applied the definition of *control* as set out in Section 416, ICTA, 1988. However, a new definition of control was initially introduced as from 21 March 2000, based on the wording in Section 840, ICTA, 1988. Prior to the Finance Act 2000 amendments, to achieve “control” under the CFC legislation meant, broadly, that the greater part of share capital or voting rights are to be held by United Kingdom-resident companies. (Section 416, ICTA, 1988.)

Firstly, under the new legislative dispensation – currently in force – a person is deemed to control the CFC where he has the power to ensure that the CFC’s affairs are conducted in accordance with his wishes (see 5.5 above) (Section 755D(1) ICTA, 1988). Secondly, a person is also deemed to control a company if the person possesses, or is entitled to acquire, such rights as would (see 5.5.2 above):

- a) if the whole of the income of the company were distributed, entitle the person to receive the greater part of the amount so distributed,

- b) if the whole of the company's share capital were disposed of, entitle the person to receive the greater part of the proceeds of the disposal, or
- c) in the event of the winding-up of the company or in any other circumstances, entitle the person to receive the greater part of the assets of the company which would then be available for distribution. (Section 755D(1A), ICTA, 1988.)

Thirdly, control is also derived where two or more United Kingdom-resident persons, taken together, have the necessary power contemplated in subsection (1) or (1A) above, for the purposes of Chapter IV, ICTA, 1988, to control the company (see 5.5) (Section 755D(2), ICTA, 1988).

Additional control tests: In addition to the control tests highlighted above, HMRC has introduced a new 40 per cent test (Section 747(1A), Section 755D(3) and (4), ICTA, 1988) (see 5.5.1).

Attribution rules: The control provisions also contain detailed attribution rules (Section 755D(5)-(9), ICTA, 1988). (see 5.5.3 above) (Section 755D(5)-(9), ICTA, 1988)

South Africa: In South Africa, for determining control of a CFC, a foreign company must fulfil the definitional requirements of a CFC as contained in Section 9D(1). See 3.2.1.2 above for the definition of a CFC.

Commentary: The legislative changes in the United Kingdom (since 21 March 2000) have introduced a more comprehensive form of control when determining whether a foreign company qualifies as a CFC. The conventional practice of determining CFC status for United Kingdom holding companies (based on the greater part of the share capital or voting rights held by United Kingdom-resident companies) has no exclusive place in United Kingdom tax law, as the authorities have identified methods used by United Kingdom-resident companies to circumvent this rule which qualified a foreign company as a CFC.

New provisions for determining control of CFCs have been therefore instituted in United Kingdom CFC legislation as a direct countermeasure to the avoidance strategies being used by United Kingdom companies to circumvent the application of CFC rules.

In the South African CFC legislation, the determining of "control" of a foreign company by its residents is much more limited in both its scope and its application, since participation rights or voting rights are the only determinants. This limited version of control is enshrined in the definition in Section 9D(1) where a "controlled foreign company" means any foreign company in which South African residents hold, directly or indirectly, more than 50% either of the participation rights or of the voting rights.

With the exceptions provided for in Section 9D(1)(a), (b) and (c) which are not taken into account for the purposes of determining control of South African CFCs, all other forms of participation and

voting rights are to be taken into consideration when determining the status of a foreign company for South African CFC purposes (see 3.2.1.2 above).

5.13.6 The lower level of taxation

United Kingdom: This is one of the key requirements in United Kingdom CFC rules as it is one of the constituents in the definition of a CFC. The general rule in Section 750(1), ICTA, 1988, is that a company is subject to a lower level of taxation in its territory of residence if the tax paid under the law of that territory on profits arising in an accounting period (the local tax) is less than three-quarters of the corresponding United Kingdom tax payable on those profits. Corresponding United Kingdom tax is defined as the amount of corporation tax which would be chargeable in respect of the company's chargeable profits (Section 750(2), ICTA, 1988), computed on the basis of

- the assumptions in Schedule 24, ICTA, 1988, (including the assumption that the company is resident in the United Kingdom), and
- the assumptions and computational adjustments required by Section 750(3), ICTA, 1988,

South Africa: The lower level of taxation is used as one of the criteria in granting exemption to a CFC whose aggregate amount of tax payable, in its country of residence, is at least 75 per cent of the amount of normal tax that would have been payable had the CFC been a resident of South Africa in any given accounting period. The aggregate amount of tax payable is determined

- after taking into account any applicable agreement for the prevention of double taxation; and any credit, rebate or other tax recoveries from any sphere of government of any other country, except South Africa; and
- disregarding any prior year losses of the company or any such loss from any other company (see 3.4.2 above).

Commentary: The United Kingdom uses the lower level of taxation as one of the constituents in determining if a foreign company qualifies as a CFC. South Africa, on the other hand, uses the lower level of taxation as a mechanism of determining if the foreign company qualifies for tax exemption in respect of South African CFC legislation.

5.13.7 Exemptions

United Kingdom: The United Kingdom has a number of tax exemptions listed in Section 748, ICTA, 1988, which are available to United Kingdom companies' CFCs. Two of the more prominent tax exemptions in the United Kingdom legislation are the exempt activity test and the motive test (see 5.7 above).

In 2011, two new exemptions were introduced to the exempt activities test. The first is applicable to a CFC which carries on trading activities where there is minimal business connection with the United Kingdom, irrespective of the extent of intra-group transactions (Section 748(1)(ba)), ITCA, 1988). The second exemption is applicable to a CFC with a main business of IP exploitation and where the IP activity and the CFC have minimal connection with the United Kingdom, again regardless of the extent of intra-group transactions (Section 748(1)(bb)), ITCA, 1988) (para 1(3), Finance (No. 3) Bill, 2011) (see 5.7.6 above).

South Africa: The most important exemption with regard to CFCs in the South African tax law is the FBE exemption contained in Section 9D(9)(b). Key considerations in fulfilling the FBE criteria are: locational permanence, economic substance and business purpose test. Further, under the FBE criteria, the exceptions to the qualifying rules are very extensive, reflective of the considerable scope for tax manipulation in this area. Other statutory exemptions of Section 9D are reflected in the United Kingdom–South Africa comparative table (Table5-1) at the beginning of this chapter section (see 3.4.4 above).

Commentary: The United Kingdom CFC legislation offers a wider range of exemptions than does the South African legislation. These exemptions include the exempt activities test, *de minimis* exemption, the motive test, and the excluded countries exemption. These exemptions are entity based and postulated on the “all-or-nothing” approach, when applying its CFC regulations. Both Finance Bills’ 2011 and 2012 introduced for the first time in United Kingdom taxing history partial exemptions, thus aligning it more with the South African situation (see 5.7 above).

Despite there being other partial exemptions contained in the South African CFC legislation, the FBE exemption is the most significant in the South African legislation. The nucleuses of the FBE criteria in order to qualify for the exemption are the physical location, coupled with some form of business activity taking place.

Other ancillary exemptions flowing from the FBE test are: capital gains arising from FBE disposals; related-party disposal of goods and services performed by CFC; principal trading activities relating to banking and financial service; operating lease for rentals of movable assets and CFC income and capital gains for intellectual property (see 3.4.4.3 above) (Section 9D(9A)).

5.13.8 Attribution – minimum percentage rule

United Kingdom: In the United Kingdom the following rules must be in place for the attribution of CFC profits to United Kingdom-resident companies: Where chargeable profits of a CFC are apportioned to a United Kingdom-resident company, no assessment may be made in respect of those

profits unless the aggregate of the amounts is at least 25 per cent of the total chargeable profits of the CFC (see 5.9.2 above). (Section 747(5), ICTA, 1988.)

South Africa: A South African resident shareholder is exempt from attribution if the conditions contained in subsection (2)(A) are fulfilled (see 3.3.3 above). A South African resident holding at least 10 per cent of the participation rights in a CFC is accordingly subject to taxation on the proportionate share of the net income in the CFC, under the presumption that the net income is immediately repatriated to South African resident shareholders in the year when it is earned by the CFC. Therefore, South African shareholders are deemed to receive the net income of a CFC only to the extent of their proportionate shareholding in the CFC (Section 9D(2)(A). (South Africa, 2002a:5.)

Commentary: The United Kingdom requires a higher percentage shareholding of 25 per cent (inclusive of persons, corporate or individual, who are connected or associated persons with the resident company) for attribution purposes, whereas South Africa requires a minimum of 10 per cent shareholding (together with any connected person in relation to that resident) of the participation rights and may exercise at least 10 per cent of the voting rights of the CFC for attribution purposes.

5.13.9 Types of interest in a CFC for attribution purposes

United Kingdom: In the United Kingdom where an apportionment falls to be made, the CFC's chargeable profits and creditable tax are apportioned among the persons who had an interest in the CFC at any time during the accounting period in question (Section 749B, ICTA, 1988). In many cases the only interest needing to be considered will be shareholdings. However, the legislation may recognise other means by which a person may effectively control or derive benefit from a company: for example, through special rights in a winding-up or through contingent rights. Therefore, the definition of persons with an interest in a CFC has been widened (in the legislation) to give consideration to this situation (see 5.9.3 above). (United Kingdom. HMRC, 2010q) (Section 749B(1), ICTA, 1988.)

South Africa: The determination of interest in a CFC for the purposes of attribution is exclusively based on the ownership of participation rights by South African resident shareholders. The various rules in respect of attribution is concentrated in Section 9D(2), where the minimum percentage interest of 10 per cent (together with any connected person) is prescribed for attribution purposes. The legislator has not, however, given any clear guidelines on how voting rights will be used (when there are no participation rights available) to determine the proportionate amount of net income attributable to South African resident shareholders (see 3.3.3 above).

Commentary: The United Kingdom has a much wider net to determine the interest in a CFC for the purposes of attributing CFC profits to United Kingdom-resident shareholders. Interest in a CFC

includes, inter alia, shareholdings, voting rights, current rights and prospective rights to company distributions; rights to secure income or assets of the company; and the right to control the foreign company (Section 749B(1), ICTA, 1988). South Africa has a limited approach in determining the interest in a CFC for attributing CFC income to its resident shareholders – participation rights is the only criterion used for attribution purposes (Section 9D(2)).

5.13.10 Year of assessment used for translating CFCs profits

United Kingdom: The chargeable profits of a United Kingdom CFC in respect of any accounting period is to be translated to United Kingdom sterling (when any other currency is used), being an equivalent of the apportioned amount found in any currency other than sterling (Section 747(4A), ICTA, 1988). The translation required by subsection (4A) shall be made by reference to the London closing rate for the two currencies concerned in respect of the last day of the accounting period for the CFC concerned (Section 747(4B), ICTA, 1988). Therefore in the case of the United Kingdom, the end of the CFC's year of assessment is used as the basis of the conversion to sterling.

South Africa: The Taxation Laws Amendment Act, No. 24 of 2011 had effected changes to Section 9D(6). The previous provision in Section 9D(6) of the Income Tax Act requiring South African shareholders to translate their proportionate share of the net income of a CFC by utilising the average exchange rate based on the South African taxpayer's year of assessment has been replaced with reference to the CFC's foreign tax year, resulting in the inclusion of a proportionate amount of income translated to the currency of South Africa by using the average exchange rate for the CFC's foreign tax year. (Section 9D(6).)

Commentary: The United Kingdom and South Africa use a similar approach as both countries use the end of the CFC's year of assessment as a basis of conversion to their respective domestic currencies.

5.13.11 Capital gains

United Kingdom: Capital gains taxes are to be specifically excluded as part of the chargeable profits of a CFC (Section 747(6)(b), ICTA, 1988).

South Africa: A CFC is exempted from capital gains tax only when the disposal of an asset is related to a foreign business establishment (Section 9D(9)(b)). The exemption also includes (with the exception of financial instrument and intangible assets) assets disposed of by any FBE of any other CFC, provided that both form part of the same group of companies (Section 9D(9)(fB)). Other resident shareholders of CFCs are subject to capital gain tax arising from the disposal of any asset. The net capital gains subject to taxation varies between natural persons, special trust or insurer and companies. See Table 5-1 on the varying amounts (note 7).

Commentary: The South African CFC provisions relating to the taxation of capital gains (with the exception of FBEs) are aimed at maintaining symmetry with domestic tax legislation which taxes companies on capital gains arising from asset disposals and preventing the diversion of capital profits to CFCs.

5.13.12 Relief provisions

United Kingdom – Trade losses: Trading losses of the CFC are to be carried forward indefinitely (Section 393(1), ICTA, 1988). There is also a unique type of concessionary reprieve granted to CFCs, in which CFCs may carry forward losses from the six years preceding the first year in which HMRC applies CFC rules to it (Schedule 24, para 9(1), ICTA, 1988).

Relevant allowances: Specific relief measures in the form of qualifying “relevant allowances” are available to United Kingdom companies, to be used as a set off against potential Chapter IV tax charges (see 5.10 above) (Section 754(5), Schedule 26, para 1(1) and (3), ICTA, 1988).

South Africa – Trade losses: Trade losses are to be carried forward indefinitely (Section 20, Section 9D(2A)(b)), and relevant allowances are not available in the South African tax legislation on CFCs.

Commentary: The United Kingdom, in contrast to South Africa, grants a unique type of tax concession to CFCs that are being assessed for the first time by HMRC – to carry forward losses transpiring six years prior to the first year in which the CFC is assessed by Inland Revenue. The United Kingdom also, unlike South African tax legislation, grants a *sui generis* type of tax reprieve in the form of qualifying “relevant allowances” to United Kingdom companies, to be set off against potential Chapter IV tax liability – not available to South African resident shareholders of CFCs.

5.14 Chapter conclusion

This chapter has offered a comparative examination of the CFC regimen prevailing in the domestic tax legislation of two countries: the United Kingdom and South Africa. The arrival of the “new” global economy, and the propensity of domestic shareholders to use foreign companies as effective vehicles to circumvent domestic tax rules, have led to a proliferation of CFC regulations internationally, prompted by OECD advice that countries should institute CFC regulations in domestic economies as a counter measure to the growing economic threat presented by tax havens, preferential tax regimes, and damaging tax competition. It is against this background that a comparative assessment is being made of these two countries’ CFC regulations.

The labyrinthine CFC regulations of the United Kingdom, and the less convoluted South African CFC regulations, are investigated and analysed in the chapter, with the aim of making recommendations for possible changes to the South African regimen. The United Kingdom continues to amend its CFC

regulations to deal with its internal tax-avoidance dilemma, and the harmful tax competition caused by low-tax jurisdictions and tax havens, especially those that were former British colonies. It does so in response to the continuing effort by the OECD to eliminate harmful tax competition and the continuing supra-national unification endeavours of the European Union (Salis, 2009:3). The European Union's desire for a unitary type of tax system within the European Union region is accentuated in the recent spate of judgements delivered by the European Court of Justice (ECJ): (Cadbury Schweppes plc v Inland Revenue Commissioners (United Kingdom, 2006a); The Test Claimants in the CFC and Dividend Group Litigation v. Commissioners of Inland Revenue (European Court of Justice, 2008)ECJ [2008] Case C-201/05; Marks & Spencer plc v David Halsey (Her Majesty's Inspector of Taxes) (Justice, 2005) in which certain of the key issues in United Kingdom CFC legislation were the subject of judicial -scrutiny.

Key divergences, anomalies and, in certain instances, similarities with respect to key issues contained in the South African CFC regulations, emerging from the international United Kingdom comparison, are listed for quick reference in the recapitulation that follows below. Recommendations to the South African CFC regimen (especially in the form of remedial measures) will be made in the concluding chapter of the thesis.

Approaches to CFC regulations: The United Kingdom follows the jurisdictional-entity approach. South Africa, on the other hand, follows the global-entity approach. The United Kingdom initially identifies companies in specified lower tax jurisdictions to apply its CFC regulations. South Africa does not identify specific jurisdictions to apply its CFC legislations – it institutes the global approach, in essence, it applies its CFC regulations indiscriminately, irrespective of the location of a CFC (see 5.13.1).

Determination of a CFC: The United Kingdom uses its domestic law (in Section 832(1) and (2), ICTA, 1988) to exclusively determine the status of a foreign company for CFC purposes. South Africa, on the other hand, uses foreign law (invoked by its domestic tax legislation) to determine the status of a foreign company for CFC purposes. This could result in a conflicting situation in which the foreign company would qualify as a CFC, despite its not qualifying as a domestic company (Section 1, South African Income Tax Act,) (see 5.13.2 and 5.13.3 above).

Corporate residence – alternative to the incorporation rule: The United Kingdom uses the central management and control (CMC) test, outside the incorporation rule, to determine the status of a foreign company to qualify as a CFC. The rule attaches importance to the place where the company's board of directors meet. South Africa uses the place of effective management – as an alternative to the incorporation test rule – to determine residency of foreign companies. The concept of place of effective management is the location where the day-to-day business operations and commercial decisions of senior managers or directors are actually implemented in operations (South Africa,

2002d:4). The United Kingdom CMC test is a more reflective conception of place of effective management as contained in the OECD Model Tax Convention (OECD, 2010a:art 4 para 3). The South African interpretation of place of effective management is not entirely compatible with the definitional requirements of the place of effective management as contained in the OECD Model Tax Convention (OECD, 2010a:art 4 para 3) (see 4.2.3.2 and 5.13.4).

Control: The United Kingdom currently has in operation a very complex and elaborate form of control procedure (as one of the three definitional requirements) to determine whether a foreign company qualifies as a CFC. These control procedures are being incorporated into United Kingdom CFC regulations in response to the very convoluted structures being implemented by multinational groups to circumvent the CFC regulations (especially the greater than 50 per cent requirement in relation to either shareholding or voting rights) (see 5.5 and 5.13.5 above). South Africa, in comparison, has a less onerous requirement for the determination of the control of its foreign companies. Control in a South African context, and particularly in relation to its CFC “means any foreign company ... other than ... headquarter companies” (Section 9D(1)).

Set against the very complex and elaborate control procedures in the United Kingdom, the South African control procedures to identify CFCs may not be wide enough to classify more foreign companies as CFCs, thus resulting in potential loss of revenue to the South African fiscus.

Lower level of taxation: This is one of the criteria currently applied in the United Kingdom (in terms of Section 747(1), ICTA, 1988) for the identification of foreign entities qualifying as CFCs (see 5.6 above). South Africa, on the other hand, uses the lower level of taxation test to determine whether the CFC qualifies for tax exemption (in terms of Section 9D(2A)). In the United Kingdom the criterion is part of the jurisdictional-entity approach in deciphering whether a foreign company qualifies as a CFC. The South African CFC legislation uses the criterion as one of the tax exemption mechanisms for granting tax immunity to its South African resident shareholders from the imputation of controlled foreign company profits (see 5.13.6).

Exemptions: The three main statutory exemptions contained in Section 748, ICTA, 1988, if applicable, will exempt United Kingdom companies from the application of its CFC legislation. These three main exceptions to the apportionment of chargeable profits in the United Kingdom CFC regulations are: exempt activities (Section 748(1)(b)); motive test (Section 748(3)); excluded countries exemption (Section 748(1)(e) & 748(1A)). A common purpose in all of these exemptions is to ensure that the CFC is not based in a foreign jurisdiction for the purpose of reducing or avoiding United Kingdom taxes, or involved in any tax-avoidance schemes (see 5.7 above). The FBE criteria in the South African Income Tax Act is the most important exemption available to South African resident shareholders (Section 9D(9)(b)). The granting of the exemption is based on some form of locational

permanence, economic substance and non-tax business reasons being attributable to the FBE (see 5.13.7 above).

The United Kingdom, therefore, has a wider scope of exemptions being granted, especially, the partial exemptions being granted through Finance Bill 2011 and 2012 (see 5.13.7 above).

Attribution: In the United Kingdom the chargeable profits apportioned to resident company shareholders are only subject to assessment if the aggregate apportioned amount of the chargeable profits is at least 25 per cent of the total chargeable profits of the CFC for any given period. The apportioned amount to the shareholder includes the amount apportioned to persons (whether corporate or individual) who are connected or associated with the resident company (Section 747(5), ICTA, 1988). A South African shareholder is exempt from attribution if the shareholder in question (together with any connected person) holds in aggregate less than 10 per cent of the participation rights and may not exercise at least 10 per cent of the voting rights in the CFC (Section 9D(2)(A), ICTA, 1988).

Notably, in the United Kingdom only companies are subject to attribution, despite the fact that in determining the 25 per cent attribution threshold for United Kingdom companies both corporates and individuals (connected or associated with the resident company) are taken into consideration. In South Africa all types of shareholders (including natural persons, trusts and incorporated companies) are subject to the attribution rule providing they meet the 10 per cent threshold requirement (Section 9D(2)(A), ICTA, 1988).

There is a higher threshold requirement in the United Kingdom because the United Kingdom has a higher level of foreign direct investment (FDI) held by United Kingdom holding companies. This envisages a subsidiary or associated company relationship. Therefore, the legislature deemed it necessary to bring into the tax net only United Kingdom holding company shareholders, with a higher percentage shareholding threshold requirement for attribution purposes. Unlike the United Kingdom, in a South African context all types of shareholders are responsible for investing in a CFC, and it is not necessarily the case that investments are made mainly through a holding and subsidiary company relationship. Therefore the legislature deemed it necessary to bring all types of shareholders into the South African tax net with a lower threshold limit of participating shares for attribution purposes, unlike its United Kingdom counterpart – thus ensuring that the South African tax revenues are maintained (see 5.13.8 above).

Types of interest in a CFC for attribution purposes: In the United Kingdom, the holding of an interest in the CFC is widely defined for the purposes of attributing chargeable profits to resident shareholders (Section 749(B), ICTA, 1988) (see 5.9.3 above). In South Africa, only participation rights are used to determine the interest in a CFC for attribution purposes (Section 9D(1)) (see 5.13.9 above).

The South African approach of determining the interest in a CFC for attribution purposes is limited in comparison to the United Kingdom, and many potential South African shareholders could be escaping the South African tax net under the guise of a non-equity holding investment. A South African resident could, for example, hold substantial voting rights in a CFC, with no equity investments, but as a major loan creditor of the CFC.

Capital gains tax: In the United Kingdom, CFCs are not subject to capital gains tax as part of its chargeable profits (Section 747(6)(b), Schedule 24, para 1(1), ICTA, 1988). In South Africa (with the exception of capital gains arising from the disposal of any assets forming part of the FBE), any capital gain arising from the disposal of any asset of the CFC is subject to taxation at the relevant amounts (see note 7 – table of comparison) (Section 9D(9)(b), Section 9D(2A)(e)(f)). In addition, capital gains arising from the disposal of any other assets attributable to an FBE of another CFC (forming part of the same group of CFCs) are also exempted from taxation (Section 9D(9)(fB)) (see 5.13.11 above).

Relief provisions: United Kingdom domestic tax legislation incorporates two unique tax features, not found in the South African tax legislation, relating to CFCs: trade losses and relevant allowances (see 5.13.12 above). It may, however, not be feasible for South African tax authorities to incorporate this legislation into South African domestic tax law for the following reasons: the fiscus does not have the capacity to sustain these tax reliefs being granted against potential tax liability and the administrative burden on SARS.

Self-assessment provision: The Finance Act of 1998 introduced legislation to bring CFC provisions into line with the United Kingdom corporation tax self-assessment regime (CTSA) which became effective as from 1 July 1999. Consequently, any company which has an interest in a CFC must complete a supplementary page to CTSA returns, unless the exemptions are applicable. Companies are, accordingly, self-assessed, and HMRC will continue to enquire into returns as appropriate, according to established risk assessment processes (see 5.11.3.1 above). South African tax legislation does not currently have self-assessment provisions in operation for CFCs or domestic companies.

With this chapter having compared South African CFC regulations with corresponding provisions in the tax legislation of and United Kingdom (as specified in the thesis objectives at 1.6 above), Chapter 6 extends the international comparative perspective with a discussion of CFC regulations in the United States.

Chapter 6

CFC REGULATIONS: UNITED STATES

6.1 Introduction

This chapter compares South African CFC regulations with corresponding provisions in the tax legislation of the United States, considering the following key issues (see secondary objectives of the thesis at 1.6 above):

- comparison of the global-entity approach currently in force in the South African CFC regulations to the global transactional approach currently applied in the United States CFC legislation
- comparison of key characteristics in the South African CFC legislation to key characteristics, of equivalent significance, in the United States CFC legislation, including: definition of CFC; qualification of CFC status; domestic taxpayers subject to taxation; computation of attributed income; exemptions, relief provisions; administrative aspects
- discussion of similarities pertaining to certain key issues featuring in both the South African and the United States CFC legislations; emerging from the international comparison
- discussion of the key divergences and anomalies in the South African CFC legislation, emerging from the comparison with the United States
- recommendations for changes to the South African CFC legislation, arising from the comparison with the United States CFC legislation
- highlighting and discussion of the current lacunae in the field of international CFC legislation that have emerged from this study for future researchers to pursue

The chapter covers the following issues: historical background of United States CFC legislation; United States residency; detailed analysis of Subpart F; discussion of other relevant sections of the United States Income Tax Act that have a bearing on the United States CFC legislation; comparative examination of the United States and South African CFC legislations with suggestions for potential recommendations to be made to the South African CFC regulations in the concluding chapter of the thesis.

6.2 Historical background of United States CFC legislation

The Revenue Act of 1913, the first income tax law enacted after the 16th Amendment to the United States Constitution was ratified, established separate taxing regimes for individuals and corporations. Individuals were subject to both a “normal tax” of 1 per cent and graduated rate surtax, while corporations were subject only to the normal tax. The legislation imposed a tax on the income, from all sources, of corporations “organized in the United States, no matter how created or organized”, and

on certain United States source income of corporations “organized, authorized or existing under the laws of any foreign country” (United States, 2000:103-104). Subsequent United States income tax acts have followed this model, taxing individuals and corporations under separate regimes. Case law has, over the period of time, confirmed that United States tax law generally recognises a corporation to be a separate taxable entity from its shareholders (United States, 1934; 1943)(*Moline Properties Inc. v. Commissioner* 319 U.S 436 (1943); *New Colonial Ice Co. v. Helvering* 292 U.S 435, 442 (1934)) (United States, 2000:103).

The United States government subsequently enacted the “foreign personal holding companies” (FPHC) provisions in 1937, which were codified in Sections 551-558 of the Internal Revenue Code of 1954 (IRC) – thus making the United States the first country to enact legislation that prevents deferral of taxation by its residents in respect of foreign companies being established, especially in tax-haven jurisdictions (Oguttu, 2007:274-275). Under the FPHC rules, the incomes of foreign personal holding companies were taxed directly to their United States shareholders, which eliminated the tax advantage of using foreign corporations. A “foreign personal holding company” was accordingly defined in Section 552 of IRC, 1954, as a foreign corporation in which more than 50 per cent of the total voting power or the value of the outstanding stock was directly or indirectly owned by five or fewer United States citizens or United States residents. FPHC income was generally passive income such as dividends, interest, annuities, royalties, rents and gains on the sale of or exchange of securities, which should have accounted for 60 per cent or more of the foreign corporation’s gross annual income for it to be considered a FPHC (Section 553(a) of the Internal Revenue Code², 1954).

Subpart F – 1962: The FPHC provisions only affected closely-held foreign corporations that were controlled by five or fewer United States shareholders. Consequently, there was a need to enact legislation that dealt with widely-held foreign corporations. In 1962, new provisions were invoked, in the form of the “Subpart F provisions” to deal with controlled foreign corporations. The Subpart F provisions were the first form of comprehensive provisions to deal with controlled foreign corporations. These provisions went beyond the FPHC provisions by eliminating the deferral of United States taxes not only for passive income earned by a controlled foreign corporation, but also for certain foreign-source business income. As the FPHC provisions overlapped with the Subpart F provisions, Congress repealed the FPHC provisions in 2004 (American Jobs Creation Act of 2004, Public Law 108-357). The chapter will also briefly discuss certain important issues pertaining to Subpart F that are contained in the United States Job Creation and International Tax Reform Act of 2012 (see 6.9 below).

² Internal Revenue Code: referred to hereafter as IRC

Relationship between Section 482, IRC, and Subpart F: Congress enacted both Subpart F (in Sections 951 to 965) and Section 482 provisions to counter potential abuse by controlled foreign corporations of United States tax laws. Section 482 is the nucleus of the United States transfer-pricing tax regulations. Congress enacted both these regulations “as a counter base defense mechanism to accurately report the income of activities transacted within the United States” (Jacobs & Duke, 2007:57). For example, a multinational company could maximise its income by charging a foreign subsidiary (to which it shifted income) artificially low transfer prices and inaccurately reflect true income of the two entities (Myers, 1996:1089-1092).

6.3 Residency of natural persons and corporations in a United States context

6.3.1 Introduction

The following sections outline the qualification criteria for United States residency and citizenship of individuals and the qualification requirements for domestic companies and controlled foreign companies, together with the tax implications pertaining to the respective categories of taxpayers. Considered below are United States residents and citizens (individuals) who qualify as United States shareholders in terms of Section 951(b). Only United States persons (as defined in Section 957(c)) are eligible to qualify as United States shareholders of controlled foreign companies.

6.3.2 Residents – individuals

Before 1985, there was no statutory definition in the Internal Revenue Code (IRC) of “resident” or of “non-resident alien”, although the Treasury Regulations did provide guidelines in respect of certain factors considered to be relevant in establishing United States residency for individuals (Section 1.871-2(b), Code of Federal Regulations, 2011). The Regulations were, however, not always clear, and it consequently fell on the courts to determine the residency of individuals on a case-by-case basis. In making such a determination the United States courts had to determine the individual’s contact with the United States set against his contacts with other countries.

For taxation years beginning January 1, 1985, the Tax Reform Act of 1984 has established two methods for determining the residence of an individual for United States income tax purposes:

Resident alien

An alien individual shall be treated as a resident of the United States with respect to any calendar year if such individual meets the following requirements:

- (i) Lawfully admitted for permanent residence – such individual is a lawful permanent resident of the United States at any time during such calendar year (Section 7701(b)(1)(A)(i), IRC, 1986)

(ii) Substantial presence test: except when otherwise provided, an individual will meet the substantial presence test with respect to any calendar year if –

- (a) such individual was present in the United States on at least 31 days during the calendar year, and
- (b) The total number of days on which such individual was present in the United States during the current year and the two preceding calendar years (when multiplied by the applicable multiplier ...) equals or exceeds 183 days: The applicable – in the case of days in: multiplier is: Current year 1; 1st preceding year 1/3; 2nd preceding year 1/6. (Section 7701(b)(3)(A)(i)(ii), IRC, 1986.)

Exception to the substantial presence test

An individual shall not be treated as meeting the substantial presence test in any current year if

- such individual is present in the United States on fewer than 183 days during the current year, and
- it is established that for the current year such individual has a tax home in a foreign country and has a closer connection to such foreign country than to the United States. (Section 7701(b)(3)(B)(i)(ii), IRC, 1986.)

Non-resident alien

An individual is a non-resident alien if such individual is neither a citizen of the United States nor a resident of the United States (within the meaning of subparagraph (A)) (Section 7701(b)(1)(B), IRC, 1986).

In effect, the United States Internal Revenue Code subjects all individual residents except non-resident aliens to taxation on their worldwide income from all sources. Non-resident aliens are subject to United States taxation only on their United States-sourced income. Consequently, only individual residents of the United States and United States citizens (below) are effectively subject to worldwide United States taxation.

6.3.3 Citizens – individuals

Every person born or naturalized in the United States and subject to its jurisdiction is considered a United States citizen (Section 1.1-1 (c), Code of Federal Regulations, 2009). On the other hand, a noncitizen who has filed a declaration of intention of becoming a citizen, but who has not yet been granted citizenship by a final order of a naturalization court, is an alien.

Similarly to the taxation of United States residents, individual United States citizens are subject to United States taxation on their worldwide income even if they are resident outside the United States. This makes the United States unusual among the nations of the world in that it taxes its citizens on

their worldwide income regardless of their residence. In *Cook v Tait* (United States, 1924) – where the plaintiff, a citizen of the United States, was a resident of Mexico – the Supreme Court held that United States taxation on the taxpayer’s worldwide income violated neither the United States Constitution nor international law. The Court justified the taxation of the taxpayer on the grounds that the benefits of citizenship extend beyond territorial boundaries; for example, the United States seeks to protect its citizens anywhere in the world and citizens have the right to return to the United States at any time when they deem it necessary, in order that they may participate in the economic system of the United States. In effect, citizens of the United States have an insurance policy, and taxes are the cost of maintaining that policy. (Doernberg, 1989:19.)

6.3.4 Residency of companies

For United States tax purposes, companies are classified as domestic or foreign. A United States corporation is a corporation created or organised in the United States and is taxable on its worldwide income (Section 7701(a)(3)(4), IRC, 1986). A foreign corporation, on the other hand, is a corporation incorporated in a jurisdiction other than the United States, and is taxed by the United States only on income that has sufficient nexus in the United States (Section 7701(a)(5), IRC, 1986). Thus, the place of incorporation determines whether a corporation is treated as domestic or foreign for purposes of United States tax law, irrespective of other factors that might be thought to bear on a corporation’s “nationality”, such as the location of the corporation’s management activities, employers, business assets, operations, revenue sources, the exchanges on which the corporation’s stock is traded, or the residence of the corporation’s shareholders. (United States, 2008:8.)

While the residence of a corporation may be easy to determine under United States law, it is not always easy to determine whether a foreign entity is a corporation. Suppose entity F is incorporated in country Z by A and B, who are individual residents of the United States. Is the income earned by entity F income earned by a non-resident corporation, or is the income earned by a transparent partnership, in which case individuals A and B, United States residents, will be taxable? Historically, this has been a difficult problem, compounded by the fact that country Z might treat entity F as a corporation while the United States might treat entity F as a transparent partnership (or vice versa).(Doernberg, 2004:23.)

Foreign entity classification rules: Check-the-box (CTB) regulations thus govern the classification of an entity for United States tax purposes; another country may rely on its domestic law provisions in determining how it will treat the same entity for its tax purposes (Section 301.7701-3(a) and (b), Code of Federal Regulations, 2011).

The United States Treasury has issued check-the-box regulations that provide the following basic rules with respect to business entities: A business entity incorporated under United States federal or

state law is a corporation for United States tax purposes (Section 301.7701-1(d), Code of Federal Regulations, 2011). A business entity formed or created under foreign law is a corporation for United States tax purposes if that form of entity is specifically listed in the regulations (“*per se*” corporations) (Section 301.7701-2(b)(8), Code of Federal Regulations, 2011). Where a foreign business entity is not a *per se* entity, it is considered an “eligible entity” under Regulations Section 301.7701-3(a). An eligible entity is assigned a default entity classification based on both the number of its interest holders and their level of liability with respect to the entity.

It should be noted that the default classification rules (in respect of entity classification regulations) for foreign entities differ from the rules applicable to domestic entities. A foreign eligible entity in which no interest holder has unlimited liability will have a default classification as an association taxable as a corporation (Section 301.7701-3(b)(2)(i)(B), Code of Federal Regulations, 2011) }. If the foreign eligible entity has more than one interest holder and at least one such interest holder has unlimited liability, its default status will be a partnership (Section 301.7701-3(b)(2)(i)(A), Code of Federal Regulations, 2011). If the foreign eligible entity has only a single owner with unlimited liability, its default status will be as an entity disregarded as separate from its owner (Schmidt & Lady, 2007; Section 301.7701-3(b)(2)(i)(C), Code of Federal Regulations, 2011).

6.3.4.1 Effectively connected income – United States Source Income

If a foreign corporation is engaged in a trade or business in the United States, the foreign corporation is subject to taxation in terms of Section 11(a) and Section 55 as provided by Section 882, IRC, 1986, on income that is “effectively connected” with the conduct of the United States trade or business. The term “effectively connected” is defined in Section 864(c), IRC, 1986. If the foreign corporation is engaged in a trade or business in the United States, then, generally all sales, services, or manufacturing income from United States sources is considered as effectively connected income (ECI) (Section 864(c)(2) and (3), IRC, 1986). An example would be a foreign corporation that is engaged in a trade or business in the United States of selling electronic equipment to United States customers through its United States branch. Any income generated by the United States branch is clearly effectively connected income (Section 1.864-4(b), Code of Federal Regulations, 2011). Income from the performances of services in the United States is considered as United States source income (Section 864(c)(2), IRC, 1986; Section 1.864-4(c)(3), Code of Federal Regulations, 2011).

With respect to the determination of foreign corporations’ effectively connected income, a foreign corporation is allowed to deduct from its effectively connected gross income expenses that are properly allocated and apportioned to such gross income. The amount of these deductions attributable to effectively connected income is determined under certain defined allocation and apportionment rules. (Section 864(c), IRC, 1986.)

6.3.4.2 Non-business income from United States sources

Foreign corporations are subject to a 30 per cent tax levy (or lower tax treaty rate, if applicable) on several types of non-business income. The tax is imposed at the fixed rate of 30 per cent without any deductions or other allowances for costs incurred in producing the income and is generally collected through withholding taxes on non-residents. The taxes are applicable to interest, dividends, rents, royalties, and other “fixed or determinable annual or periodical” income (FDAP income) if the incomes are: includible in gross income; from United States sources and not effectively connected with the conduct of a United States trade or business. (Section 881, IRC, 1986.)

The 30 per cent tax on gross FDAP should be contrasted to the tax on net business income, which is applicable to income effectively connected to the conduct of a United States trade or business. The decision to tax FDAP income on a gross basis is generally exercised through the imposition of a flat rate of withholding tax of 30 per cent, which is considered to be “more a concession to economic reality than it is a policy decision” (Doernberg, 2004:83). While a non-resident corporation engaged in a trade or business in the United States often has assets (e.g. factory, office, machinery, equipment etc.) that could be seized if the non-resident company fails to pay the required tax, the non-resident, on the other hand, with FDAP income may escape the United States tax jurisdiction if no withholding tax is imposed prior to the recipient receiving the amount (Doernberg, 2004:83).

6.4 Subpart F

6.4.1 Introduction

The United States Congress enacted the Subpart F taxation anti-deferral regime in 1962 as a political compromise between two fundamentally opposed viewpoints. The Kennedy Administration, on the left, attempted to curb further erosion of the United States tax base through a worldwide taxation system in which all foreign-source income attributable to United States residents would be subject to United States taxation (Sweitzer, 2005:1). The Administration sought to give effect to the capital export neutrality principle, that, under its proposed legislation, “virtually all income earned by a United States corporation’s foreign subsidiaries would trigger current United States income tax liabilities to domestic shareholders” (Sweitzer, 2005:3-4). Foreign based income would thus be taxed as if it was generated at home (United States), thus increasing the United States federal tax base and eradicating the competitive advantage of subsidiaries operating in tax haven jurisdictions over those domestic companies operating exclusively in the United States (Sweitzer, 2005:3-4).

The Republican-led Congress and multinational business community, on the right, attempted to “encourage United States foreign investment and corporate profit generation through the continuance of a territorial taxation system that taxed only domestic-source income” (Sweitzer, 2005:1). The

Republicans argued that if the Kennedy proposal as then formulated became law subsidiaries already operating in tax-haven jurisdictions (without current United States tax liability) would face drastic consequences. These companies would be required to “pay taxes at the same corporate income tax rate as domestic United States corporations (capital export, or global tax, neutrality), but at a global rate higher than that imposed on their local foreign competitors (capital import, or international competitiveness, non-neutrality)”, resulting in United States foreign subsidiaries being placed at a competitive disadvantage. (Sweitzer, 2005:5.)

In 1962, Congress enacted, and President Kennedy signed into law, Sections 951 to 964 of the Internal Revenue Code – commonly referred to as Subpart F – as a legislative regime seeking to prevent the deferral of United States income tax liability in certain circumstances (Sweitzer, 2005:5).

In principle, one of the main purposes of “Subpart F is to discourage United States taxpayers from using foreign corporations to defer United States taxes by accumulating certain types of income in foreign base companies located in low-tax jurisdictions” (Doernberg, 2004:337). Subpart F is primarily directed at two types of incomes: passive investment income and income derived from dealings with related corporations (i.e., using a base company to shift income away from related parties in high-tax jurisdictions). Both of these types of income are “easily movable from one taxing jurisdiction to another” (Doernberg, 2004:337). In essence, it is the active business operations conducted by United States controlled foreign corporations that are exempted from United States domestic taxation, except for income relating to foreign base companies that are the subject of Subpart F scrutiny. (Sweitzer, 2005:1-6).

Encumbered with numerous revisions, additions, and exceptions, Subpart F is one of the most extensive and complicated of the prevailing international anti-deferral regimes in operation (Sweitzer, 2005:6). The types of income that are specified as Subpart F income are insurance income (as defined in Section 953), foreign base company income (FBCI) (as determined under Section 954), income from companies subject to international boycotts (as determined under Section 999), the amounts of any illegal bribes, kickbacks and similar payments (within the meaning of Section 162(c) paid by or on behalf of the corporation), and the income of any corporation being derived from any country during any period to which Section 901(j) applies.

In addition to the taxation of United States shareholders on their proportionate share of the controlled foreign corporation’s Subpart F income, the United States shareholder is also taxed on the investment of any earnings in United States property (under Section 956, IRC, 1986) (Section 951(a), IRC, 1986) (see 6.7 below).

The principal category applicable to most foreign corporations is foreign base company income which is defined to include

- foreign personal holding company income [Section 954(c), IRC, 1986]
- foreign base company sales income [Section 954(d), IRC, 1986]
- foreign base company services income [Section 954(e), IRC, 1986]
- foreign base company shipping income [Section 954(f), IRC, 1986 – deleted by Pub.L 108-357, Section 415(a)(2) of the American Jobs Creation Act of 2004]
- foreign base company oil-related income [Section 954(g), IRC, 1986]

Foreign base company income (FBCI) consists (after the deletion of foreign base shipping income) of four types of income, the first three being the types of income that are most often encountered by United States resident shareholders. The first FBCI, being foreign personal holding company income (FPHCI), currently taxes foreign-source income relating to dividends, interest, rents, royalties, annuities, and property sales resulting in one of these income types. The second FBCI is foreign-base company sales income (FBCSaI), which taxes foreign-source income earned when a foreign subsidiary purchases goods from outside its country of incorporation, sells the goods outside such country, and where either the corporation it purchased the goods from or sold the goods to is related to the controlled foreign corporation. The third FBCI is foreign-base company services income (FBCSvI), which generally constitutes of income (whether in the form of compensation, commissions, fees or otherwise) derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, and commercial or like services. For income to fulfil the FBCSvI criteria the controlled foreign corporation must perform services for or on behalf of any related person (within the meaning of Section 954(d)(3)), and the controlled foreign corporation must perform the services outside the country under which the laws of the controlled foreign corporation is created or organised.

Unlike the South African and United Kingdom legislation which provides specific exemptions for controlled foreign corporations engaged in *bona fide* commercial and industrial activities, the United States Subpart F does not contain specific exemptions relating to *bona fide* commercial and industrial activities.

According to Arnold,

Under the US approach, the exemption for active business income is delineated in a negative way to encompass all of a foreign corporation's income other than its tainted income; under the exemption approach of other countries, the active business income of a foreign corporation is specifically defined, and all other income is effectively tainted income. (Arnold, 1986:393.)

There are no blanket exceptions contained in Subpart F of United States CFC legislation, but certain unique exceptions are contained in the United States legislation that warrant special mention. These relate to particular classes or amounts of income that include: *de minimis* amounts, certain highly

taxed income, income in excess of annual earnings and profits, active rents and royalties, income earned by securities dealers, income earned from related parties in the controlled foreign corporation's country of organisation and income from some manufactured products. In addition, certain income earned in the active conduct of banking, financing, insurance or securities-dealing business, and qualifying dividend, interest, rent and royalty income from a related controlled foreign corporation that was non-passive under a look-through rule, were excluded from foreign-base company income under a temporary provision that was applicable to controlled foreign corporations for taxable years beginning before 2012. (Deloitte, 2011:50.) (See 6.6.4.1 and 6.6.4.2 below).

Notable points of comparison between the South African and United States CFC legislations include the relevant approaches to CFC regulations as determined by a country's domestic tax legislation, the types of transactions that are the subject of scrutiny between the relevant jurisdictions, the types of exemptions being granted in the respective country's CFC regulations, the computational basis being invoked in the calculation of chargeable profits or tainted income (for attribution purposes), the identification of special rules contained in CFC regulations that are applicable to specific types of income (for example, insurance income as defined in Section 953, IRC, 1986), relief provisions, and the anti-avoidance measures supporting CFC regulations. (Jacobs and Duke, 2007:35).

United States Job Creation And Tax Reform Act 2012: Further modifications to Subpart F: Treatment of low-taxed foreign income as Subpart F income (Section 201 of the bill and Section 952 of the Code) have been enacted in the recent United States Job Creation and International Tax Reform Act of 2012.

6.4.2 Definitions: United States shareholder and controlled foreign corporation

6.4.2.1 Definition of a United States shareholder

The authority for the taxation of United States shareholders on "Subpart F" income arises from the United States controlled foreign corporation regulations as contained in Section 951(a)(1)(A)(i), IRC, 1986:

A controlled foreign corporation is one in which U.S shareholders own more than 50 per cent, by vote or value, of the foreign corporation.

Only United States persons can be "US shareholders": IRC Section 957(c) refers to IRC Section 7701(a)(30) for the definition of a "US person" (very broadly defined to include individuals, partnerships, corporations, trusts and estates) according to the following criteria:

- (A) A citizen or resident of the United States [see 6.3.2 and 6.3.3 above for discussion in respect of a citizen or resident of the United States]

- (B) The term “partnership” includes a syndicate, group, pool, joint venture, or other unincorporated organisation, through or by means of which any business, financial operation or venture is conducted (Section 7701(a)(2), IRC, 1986).
- (C) The term “corporation” includes associations, joint-stock companies, and insurance companies (Section 7701(a)(3) and (4), IRC, 1986) [see 6.3.4 above for detailed discussion on both domestic and foreign companies].
- (D) Any estate (other than a foreign estate, within the meaning of paragraph (31), and
- (E) Any trust if
 - i) a court within the United States is able to exercise primary supervision over the administration of the trust, and
 - ii) one or more United States persons have the authority to control all substantial decisions of the trust. (Section 7701(a)(30), IRC, 1986.)

6.4.2.2 Definition of controlled foreign corporation

A “controlled foreign corporation” is defined as any foreign corporation in which more than 50 per cent of the total combined voting power of all classes of stock of such corporation entitled to vote, or the total value of the stock of such corporation, is owned directly or indirectly by United States shareholders on any day during the taxable year of such corporation (Section 957(a), IRC, 1986). A United States shareholder, for purposes of determining whether there is a controlled foreign corporation, is one who owns 10 per cent or more, by vote, of the foreign corporation (Section 951(b), IRC, 1986). Therefore, in determining the 10 per cent or more of the corporation’s voting power, the attribution rules (as described below) of both IRC Section 958(a) and IRC Section 958(b) are applicable. Only when it is determined (through direct ownership, indirect ownership under IRC Section 958(a) and constructive ownership under IRC (Section 958(b)) that there are, in aggregate, United States shareholders who own more than 50 per cent, by vote or value in the foreign corporation, is the company classified as a controlled foreign corporation.

Therefore, only United States shareholders that own (directly or indirectly) 10 per cent or more of the foreign corporation’s total combined voting power or stock are considered for inclusion in the “more than 50 per cent” ownership test. Thus, in the case of a foreign company having 25 United States shareholders with equal shareholdings of 4 per cent in the foreign corporation will not qualify such foreign corporation as a controlled foreign corporation. Alternatively, if a foreign person owns 50 per cent or more of the corporation, then no combination of United States persons will be able to own more than 50 per cent of the foreign corporation. On the other hand, if one United States person owns 40 per cent of a foreign corporation, and the other 10 United States persons each own 6 per cent, it is still not a controlled foreign corporation, despite 100 per cent of the stock being owned by United States persons. Only one of those United States persons is a “United States shareholder”, as defined for this purpose. (Jacobs & Duke, 2007:7.)

Each United States taxpayer's ownership percentage must accordingly take into consideration the attribution and constructive ownership rules as laid down in Section 958(a) and (b), IRC, 1986, for the purpose of determining if a foreign company qualifies as a controlled foreign corporation in terms of Section 957(a), IRC, 1986. Attribution rules in the context of the United States controlled foreign corporation legislation are operational in two distinct spheres: indirect ownership, and constructive ownership. Indirect ownership refers to the shares of the controlled foreign corporation which are owned by a foreign entity (i.e., a foreign corporation, foreign partnership, foreign trust, or foreign estate) and are deemed to be owned by the entity's shareholders, partners, or beneficiaries respectively (Section 958(a)(2), IRC, 1986). Stock of a controlled foreign corporation is constructively owned either through family attribution or through partnerships, estates, trusts, or other corporations (Section 958(b), and 318(a), IRC, 1986).

Indirect shares held through foreign entities are attributable to United States shareholders (Section 958(a)(2)). Suppose that the stock of the foreign corporation is owned equally by six individuals and six foreign corporations (each corporation's stock being owned by one of the six individuals). Each of the twelve shareholders holds directly an $8\frac{1}{3}$ per cent interest in the foreign corporation and so it appears that there are no United States shareholders. However, because the six individuals are deemed to own indirectly the stock owned by the wholly-owned corporations, each individual is deemed to be a $16\frac{2}{3}$ per cent shareholder and therefore a United States shareholder (Section 957 and 958(a)(2), IRC, 1986). Since the United States shareholders own more than 50 per cent of the stock of the foreign corporation (i.e., they own 100 per cent) the foreign corporation is a controlled foreign corporation. Similarly, when foreign partnerships, foreign trusts and foreign estates owned shares in foreign corporations, it is necessary to attribute the entity's ownership of the shares to the partners or beneficiaries (within the meaning of Section 7701(a)(31), IRC, 1986). In addition to indirect ownership, a United States person is deemed to constructively own stock owned by certain related persons (Section 958(b), IRC, 1986). For example, if Parent owns 8 per cent of the foreign corporation and Child owns 5 per cent, Parent is a United States shareholder for purposes of determining if the foreign corporation is a controlled foreign corporation. Child is also a United States shareholder, but stock cannot be counted twice in determining whether the foreign corporation is a controlled foreign corporation (Section 318(a)(2)(A), IRC, 1986).

If the foreign corporation is a controlled foreign corporation, the next step is to determine the extent to which any of the controlled foreign corporation's United States shareholders are subject to United States income tax on the controlled foreign corporation's income. Each individual 10 per cent United States shareholder of a controlled foreign corporation is subject to United States income tax on the shareholder's proportionate share of the controlled foreign corporation's "Subpart F income", which broadly comprises tainted income, being passive investment income and income derived from dealings with related corporations – using a base company to shift income away from related parties

in high tax jurisdictions (see 6.4.1 above). For this purpose, the shareholder's "proportionate share" is based on both the shareholder's voting shares and the shareholder's non-voting shares. A United States person who owns less than 10 per cent of the voting power of a controlled foreign corporation is, however, not subject to tax on the pro rata share of the controlled foreign corporation's Subpart F income even if ownership exceeds the 10 per cent threshold value of the controlled foreign corporation shares, as the United States person does not qualify as a United States shareholder. (Moore, 2008:2.)

The importance of voting power as a decisive mechanism of determining control of a controlled foreign corporation is illustrated in Regulation 1.957-1(b)(1), which accordingly lays out three special rules when determining if a foreign corporation will be deemed to be controlled by United States shareholders, when those shareholders can exercise some control over the corporation's directors despite the shareholders not having plenary voting control:

1. If the United States shareholders can elect, appoint, or replace a majority of that body of persons, who with respect to the foreign corporation, exercises the powers ordinarily exercised by the board of directors of a domestic corporation,
 2. If United States shareholders can elect exactly one-half of a board of directors but a person elected or appointed by the United States shareholders can break a deadlock of the board or assume the powers of the board while the board is deadlocked, or
 3. If someone other than the board of directors can exercise the powers of the board and the United States shareholders can elect, appoint, or replace that person.
- (Section : 1.957-1(b)(1), Code of Federal Regulations, 2011.)

In the Treasury Regulations referring to Section 957 (i.e., in the definition of a controlled foreign corporation) it is stated that in certain circumstances the nominal contribution of voting power will be ignored when it is not consistent with the reality of control. Concerning shifting of formal voting power, the Regulations state that "any arrangement to shift formal voting power away from [United States] shareholders of a foreign corporation will not be given effect, if in reality voting power is retained" (Section 1.957-1(b)(2), Code of Federal Regulations, 2011). Critics have questioned the assumption here that control is an active part of business operations. "In practice, the power of voting is its mere existence". (Blomstrand, 2005:30). In a successful business enterprise, for example, the owners are often willing to leave the operational part of the business to the management. Isenberg also argued that, in practice, the failure to vote can be a reason in itself to disregard voting power, which casts doubt on the validity of the Regulation, given its breadth. The statute's formulation suggests that control is a function of voting power, and not of who actually votes, which is the Regulations' interpretation. (Blomstrand, 2005:31.)

In *Kraus v. Commissioner* (United States, 1974) 490 F.2d 898 (2d Cir. 1974), the Tax Court conceded that 50 per cent of the voting stock of KRL was held by common stockholders, all of whom were United States shareholders, and the remaining 50 per cent was held by preferred shareholders, none of whom were United States shareholders. The Tax Court held that the taxpayer never intended to lose any voting control in KRL and that the preferred shareholders did not show any intention to use the voting power nominally carried by their stock. Therefore, “the Tax Court [concluded] that the voting preferred stock was merely a device utilised to give the appearance of compliance with Section 957(a) and that KRL was in fact a ‘controlled foreign corporation’”. (Blomstrand, 2005:31.)

6.4.3 Purpose of the rules pertaining to Section 958, IRC, 1986

The ownership rules of Section 958(a)(2), relating to attribution of stock owned by foreign entities, serve two principal purposes. Firstly, if attribution can be made to a United States person through their application, they can serve to subject the United States person to taxation under Section 951(a). Secondly, they may be used to determine status, mainly for purposes of classifying a person as a United States shareholder and, in turn, a corporation as a controlled foreign corporation. These results and the related uses of the attribution rules of Section 958(a)(2) are accomplished by providing that, for purposes of Subpart F, “stock owned” means to include also stock owned with the application of paragraph (2). (Section 958(a)(1), IRC, 1986.)

The constructive ownership rules of Section 958(b), which are based on the rules of Section 318(a), may be used for the purposes of Sections 951(b), 954(d)(3), 956(c)(2), and 957. Section 318(a) (which relates to constructive ownership of stock) shall apply, with certain important modifications, to the extent that the effect is to treat any United States person as a United States shareholder (under Section 951 (b)), to treat a person as a related person (under Section 954(d)(3)), to treat the stock of a domestic corporation as owned by a United States shareholder of the controlled foreign corporation (under Section 956(c)(2)), or to treat a foreign corporation as a controlled foreign corporation (under Section 957).

Since subsection (a)(2) and subsection (b) of Section 958 may both operate, the failure of subsection (a)(2) to attribute, for example, stock to a United States person so as to make a person a United States shareholder does not foreclose attribution under subsection (b). “Since there is no exclusivity of test,” subsection (a)(2) may be used, instead, even though subsection (b) is ineffective for the current purposes (Alexander, 1963:542). Notwithstanding the alternative nature of the test of subsections (a)(2) and (b) in many instances, “the basic difference in possible ultimate results is of vital importance” (Alexander, 1963:542). Although the application of subsection (b) may result in classifying a person as a United States shareholder, that person is taxed pursuant to Section 951(a),

unless the person actually owns stock or is deemed to own it under the rules of subsection (a)(2)(of Section 958) (Alexander, 1963:542).

6.4.4 Application of Subpart F

One of the most objectionable features of the entire concept of Subpart F is the levying of taxes on persons who do not have a direct interest in the corporation, on income on which they “are deemed to be the equivalent of actual owners by application of vague and unsatisfactory rules taken from provisions devised for entirely different purposes” (Alexander, 1963:569). It is believed “that the method employed may result in a particular case [of] taxing a person on income which is currently distributed to another person” (Alexander, 1963:569). In *Hoeper vs. Tax Commission of Wisconsin*, 284 U.S. 206, 215 (1931), the court stated that “[w]e have no doubt that, because of the fundamental conceptions which underlie our system, any attempt by a state to measure the tax on one person’s property or income by reference to the property or income of another is contrary to due process of law as guaranteed by the Fourteenth Amendment”

It must, however, be recognised that the piercing of foreign entities is a necessary prerequisite to the basic principle and application of Subpart F – that American persons who directly own stock in foreign corporations should be taxed on the proportionate share of income attributable to the corporation, notwithstanding the fact that these incomes may not be distributed to shareholders. Once the basic underlying philosophy of Subpart F is adopted, it is thereafter, necessary to determine more specifically the indirect shareholdings in foreign corporations through foreign entities – foreign holding companies, foreign partnerships, foreign trusts, or foreign estates – being used as vehicles for the avoidance of domestic taxation on foreign-sourced income.

Since the inception of Subpart F, “[the United States] Congress remains unconvinced that Subpart F embodies a mistaken policy and the principle now in the law must be retained”; however, cognizance should be taken of the following: (i) efforts should be directed to preventing “the attribution rules of Section 958(a)(2) from operating in such a manner as to impose tax on a person in respect of amounts which would go to others if distributed by and through the various foreign entities that are in the chain of ownership”; (ii) since subsection (b) of Section 958 “is applied only for the purpose of determining status, its problems are not of such vital importance, but in any review of the legislation possible improvements in the attribution rules of subsection (b) deserve consideration”. (Alexander, 1963:570-571.)

6.5 Insurance income

6.5.1 Introduction

This chapter section will discuss insurance income as one of the constituents of the Subpart F regime. The emergence and proliferation of foreign captive insurance companies (i.e., United States subsidiaries), especially after the September 2001 disaster, makes it a salient aspect of the Subpart F regime and accordingly requires an examination as part of the enquiry of the United States CFC legislation (Elliot, 2005:3). In the case of a controlled foreign corporation's insurance business, Subpart F income will generally include Section 953 "insurance income" and, "foreign personal holding company income" (FPHCI) as defined in Section 954(c)(1). However, for the purposes of Section 954(i)(1), FPHCI income does not include "qualified insurance income" of a "qualifying insurance company" (see 6.5.5.2 below for detail on qualified insurance income). Subpart F insurance income does not include "exempt insurance income" as defined in Section 953(e), IRC, 1986.

A more detailed outline is given below of the following: requirements for insurance income (Section 953(a)); kinds of insurance qualifying as insurance income (Section 953(a)(1)(A)); election by foreign insurance companies to be treated as domestic corporations (Section 953(d)); exempt insurance income (Section 953(e)); exclusion of foreign base company income (Section 954(a), IRC, 1986).

6.5.2 Requirements for insurance income

For purposes of Section 952(a)(1), the term "insurance income" means any income which

Is attributable to the issuing (or reinsuring) of an insurance or annuity contract, and would (subject to the modifications provided by subsection (b)) be taxed under subchapter L of this chapter if such income were the income of a domestic insurance company. (Section 953(a)(1), IRC, 1986)

Subpart F income of a controlled foreign corporation for any taxable year thus includes income earned by a foreign insurance corporation that meets two conditions: (1) the income is from premiums attributable to issuing (or reinsuring) a policy of insurance insuring against risks arising from or related to lives or activities in a country other than the country of the insurance company's controlled foreign corporation's place of incorporation, and (2) the company would be taxed (subject to certain modifications) as a domestic insurance company if the controlled foreign corporation were domestic (Section 953(a), IRC, 1986).

Insurance income is classified by the regulations as either related person insurance income (RPPI) or non-related person insurance income (non-RPPI), depending on whether the risks insured against are risks of a related person or a non-related person. Both RPPI and non-RPPI includes premium and investment income (Prop Treasury reg. 1.953-3(b)(1)). Under the Code of the Proposed Treasury

Regulations – precipitated by the changes made by the Tax Reform Act of 1986 – the categorisation of controlled foreign corporation insurance income is classified into one of four categories:

- same country insurance income (SCI income)
- related person insurance income (RPII)
- non-related person insurance income (non-RPII), and
- foreign personal holding company income which generally arises from investment of the controlled foreign corporation’s cash from operations (Prop Treasury reg. 1.953-1(a))

The three categories (2) to (4) relate to income treated as Subpart F income. Only SCI income is not considered as Subpart F insurance income or any other kind of Subpart F income (Prop Treasury reg 1.953-2(a)). Here a crucial distinction arises in relation to the Proposed Regulations, being the difference between RPII and non-RPII, since both are treated as Section 953 insurance income and hence both are Subpart F income (Rhoades & Langer, 2011:Section 953). The distinction between RPII and non-RPII is significant as it is only United States shareholders who are required to reflect Subpart F insurance income in their tax returns.

A reading of the relevant sections of both the Internal Revenue Code and the Federal Code of Regulations indicates that the distinction is based on how a controlled foreign corporation is defined. If RPII is generated solely for purposes of determining whether or not the United States stockholder has a constructive dividend, the definition of “United States shareholder” is changed from a person who owns, directly or indirectly, 10 per cent or more of the foreign shares to any United States person who owns shares in the corporation, no matter how small the percentage is (Section 953(c)(1)(A), IRC, 1986), and the United States ownership requirement drops from “more than 50 per cent” to “25 per cent or more” in order to establish that the foreign corporation is a controlled foreign corporation (Section 953(c)(1)(B), IRC, 1986).

Turning to definitions, the distinction between kinds of premium income is the situs of the risk insured (Prop reg 1.953-2(b)(1)). SCI income, for example, is income derived from any premium that relates to risks: of property loss if the property is located in the controlled foreign corporation insurance company’s country of incorporation (called the “home country”); of activity (e.g., a tort, a breach of contract, malpractice) if the activity is conducted in the home country; or of the life or health of a resident of the home country (Prop reg 1.953-2(a)(2)). Risks that are both within and without the home country will require the controlled foreign corporation to allocate or apportion its premiums received on the basis that the controlled foreign corporation may identify as just and reasonable (Prop reg 1.953-2(d)(1)). Finally, risks that are located in countries other than the “home country” (i.e., the country of incorporation) of the insurance company will generate Section 953, IRC, insurance income (i.e., RPII or non-RPII) (Prop reg 1.953-2(a)(1),(2)). As a result, the taxpayer must

accordingly have an understanding of the location of the particular risk covered by the insurance in order to properly classify the premium income received by the controlled foreign corporation (Rhoades & Langer, 2011:Section 953).

6.5.3 Kinds of insurance qualifying as insurance income

The term income from the insurance of risks outside the insuring company's country of incorporation includes the following types of insurance:

- Property insurance: the issuing or reinsuring of any insurance contract in connection with property located outside the insuring company's country of incorporation (Section 953 (a)(1)(A),IRC,1986).
- Liability insurance: the issuing or reinsuring of any insurance contract in connection with liability arising out of activity in a country other than the issuing company's country of incorporation (Section 953 (a)(1)(A),IRC,1986).
- Life insurance and annuities: the issuing or reinsuring of any insurance or annuity contract in connection with the lives of residents of a country other than the insuring company's country of incorporation (Section 953 (a)(1)(A),IRC,1986).
- Health insurance: the issuing or reinsuring of any insurance contract in connection with the health of residents of a country other than the insuring company's country of incorporation (Section 953 (a)(1)(A),IRC,1986).
- Artificial arrangements: all arrangements for avoiding Section 953, IRC, 1986, by the use of schemes or devices in which a controlled foreign corporation reinsures or issues insurance or annuity contracts on risks in that company's country of incorporation in consideration for a foreign corporation reinsuring or issuing insurance or annuity contracts on risks outside the controlled foreign corporation's country of incorporation where the premiums are substantially equal (Section 953 (a)(1)(B),IRC,1986). (Rhoades & Langer, 2011:Section 953.)

6.5.4 Elections by foreign insurance company to be treated as domestic corporation

6.5.4.1 Requirements for Section 953(d) elections

Under Section 953(d), a qualifying controlled foreign corporation (as defined under Section 953(c)(1)(A), and applying a 25 per cent or more test rule under Section 953(c)(1)(B)) which is engaged in the insurance business may elect to be treated as a domestic corporation for United States federal tax purposes. Making the election allows a company to avoid the complexities of complying with the Subpart F rules and prevents the company from being subject to the branch profits tax, the federal excise tax on insurance premiums received (Section 4371), and the withholding tax on any earned United States-sourced investment income. A foreign company that makes a Section 953(d)

election is subject to United States federal income tax on its worldwide income and must determine the tax due as if it is a domestic corporation subject to part I or part II of subchapter L (i.e., a life insurance company or a property and casualty insurance company). If, however, the electing corporation fails to timely file a return, pay the taxes due as stated on the return, or comply with any other requirements of the election contained in Revenue Procedure 2003-47 and Section 953(d), the Commissioner, in his discretion, may terminate the election as of the beginning of the taxable year immediately after the taxable year with respect to which the failure occurs. (Section 953(d)(2)(B), IRC, 1986.)

6.5.5 Types of income exempt from Subpart F

Congress made fairly significant changes to the controlled foreign corporation insurance rules in 1998. The effect of the changes is to allow a controlled foreign corporation insurance company to exempt certain types of insurance company income from its Subpart F income. To achieve this goal, Congress added a number of complex subsections to the Internal Revenue Code. Specifically Congress added Section 953(a)(3), 953(e) and 954(i). It also added some definitions:

- The revised rules only apply to “qualifying insurance companies”
- The amount excluded from Subpart F status is “exempt insurance income”
- That income must be derived from an “exempt contract”, and
- For foreign personal holding company purposes, the exempt amount is “qualified insurance income”. (Rhoades & Langer, 2011:Section 953(e).)

6.5.5.1 Exempt insurance income

The definition of “exempt insurance income” is important to a controlled foreign corporation which is a qualifying insurance company because exempt insurance income is excluded from the definition of “insurance income” for CFC purposes (Section 953(e)(1), IRC, 1986). Insurance income is a form of Subpart F income and hence is deemed to be distributed to the controlled foreign corporation’s United States shareholders at the end of each fiscal year (Section 952(a)(1), IRC, 1986). Exempt insurance income is income which is attributable to the issuance by the qualifying insurance company of “exempt contracts” and is treated as earned by the company’s or branch’s home country for purposes of that country’s tax laws (Section 953(e)(1)(A), IRC, 1986). The definition contains a fairly standard anti-abuse provision (Section 953(e)(1)(B), IRC, 1986).

An interesting aspect of the provision is the requirement that the income from the premiums be treated as earned by the home country’s tax laws. An anomalous situation which might arise from this rule is that a controlled foreign corporation incorporated in a country without income tax laws, such as the Cayman Islands, would not be able to demonstrate that the income is treated as “earned” under the Cayman’s non-existent tax law. The Caymans do, however, have a stamp duty which requires issuers

of policies to purchase tax stamps from the Cayman government and affix the stamps to issued policies, but that is the limit of the tax imposed on insurance companies. (Rhoades & Langer, 2011:Section 953.)

6.5.5.2 Qualifying insurance company

To be exempt, insurance income must be attributable to “exempt contracts”. Only “qualifying insurance companies” can issue “exempt contracts” (Section 953(e)(2)(A), IRC, 1986). A company is a qualifying insurance company if, in addition to both being regulated as an insurance company in its home country and acting as an insurance company, the company derives more than 50 per cent of its aggregate net premiums from contracts covering risks in its home country and as to which the insured is not a related person (a provision that precludes captive insurance companies from issuing exempt contracts) (Section 953(e)(3)(B), IRC, 1986).

With its customary propensity towards complexity Congress requires a controlled foreign corporation insurance company to fulfil the following five requirements in order to be a “qualifying insurance company”:

- The insurance company must be subject to regulation as an insurance company in its home country (Section 953(e)(3)(A), IRC, 1986). Thus, if the controlled foreign corporation is incorporated in Bermuda, the authorities in Bermuda which govern insurance companies must have licensed the controlled foreign corporation to be an insurance company (Rhoades & Langer, 2011:Section 953(e)).
- The controlled foreign corporation must be licensed to sell insurance or annuity contracts to unrelated persons in the controlled foreign corporation’s home country (Section 953(e)(3)(A), IRC, 1986) (Rhoades & Langer, 2011:Section 953(e)).
- The controlled foreign corporation must derive more than 50 per cent of its aggregate net written premiums for the year from insuring the “applicable home country risks” of unrelated persons (Section 953(e)(3)(B), IRC, 1986). Additionally, the controlled foreign corporation is to include premiums generated by its branches which are licensed in the branch’s home country to sell insurance products (Section 953(e)(4), IRC, 1986).
- The controlled foreign corporation must be in the insurance business (Section 953(e)(3)(C), IRC, 1986). Therefore, in order to meet the criteria, a controlled foreign corporation will need to operate as a legitimate insurance company and be engaged in substantial operations with unrelated persons in its home country (Rhoades & Langer, 2011:Section 953(e)).
- Finally, a qualifying insurance company must be one which, where it is a domestic corporation, would be subject to tax as an insurance company (Section 1297(b)(2)(B), IRC, 1986).

Therefore, if the controlled foreign corporation meets all of the above standards, it will be considered a qualifying insurance company.

6.5.5.3 Exempt contracts

An “exempt contract” is an insurance or annuity contract issued or reinsured by the qualifying insurance company (or its branch) which insures risk to property, lives or health of residents of a country other than the United States (Section 953(e)(2)(A), IRC, 1986). Additionally, a contract is not an exempt contract unless at least 30 per cent of the controlled foreign corporation’s net written premiums are derived from exempt contracts (Section 953(e)(2)(B)(i), IRC, 1986).

A contract which insures against risks (“cross-border risks”) other than those located in the controlled foreign corporation’s (or its branch’s) home country will be an exempt contract only if the controlled foreign corporation conducts substantial insurance activities in its home country and substantially all of the activities necessary to create the income generated by the contract are carried out in the home country (Section 953(e)(2)(C), IRC, 1986). Having determined that the controlled foreign corporation insurance company is a “qualifying insurance company”, the question is whether the contracts are “exempt contracts”. As an initial condition to qualifying as an exempt contract, the contract cannot insure against United States risks (Section 953(e)(2)(A), IRC, 1986) (Rhoades & Langer, 2011:Section 953(e)).

Finally, in order to issue exempt contracts in jurisdictions other than its home country, the controlled foreign corporation insurance company must conduct substantial insurance business activity in its home country and must perform in the home country substantially all of the activities necessary to generate the cross-border insurance income (Section 953(e)(2)(C), IRC, 1986).

6.5.5.4 Qualified insurance income

The phrase, “qualified insurance income”, is to be encountered in the foreign base company section of Subpart F. The phrase identifies a certain type of income which, when earned by a qualifying insurance company, is not treated as foreign personal holding company income (Section 954(i)(1), IRC, 1986). The basic concept of the rule is that certain investment income earned by the controlled foreign corporation insurance company is not foreign personal holding company income. Specifically, the type of investment income comprises income derived from investments purchased with the insurance company’s reserves allocable to exempt contracts or of 80 per cent of its unearned premiums from exempt contracts (Section 954(i)(2)(A), IRC, 1986), or income derived from investments of an amount of the qualifying insurance company’s assets allocable to a certain percentage of exempt contracts (one-third of premiums earned for property, casualty or health insurance contracts and 10 per cent of the reserves for life insurance or annuity contracts) (Section 954(i)(2)(B), IRC, 1986).

6.5.5.5 Anti-abuse rules

Section 953(e) contains “anti-abuse” rules. Under these rules, the Internal Revenue Service is authorized to disregard various transactions or to allocate contracts in order to more clearly reflect income (Section 953(e)(7), IRC, 1986).

6.5.6 Exclusion & special rules: foreign base company income & insurance income

None of a corporation’s income will be considered as insurance income or foreign base company income if the sum of the corporation’s gross insurance income and its foreign base company income for the taxable year is less than the lesser of 5 per cent of the corporation’s gross income or \$1 million (*de minimis rule*) (Section 954(b)(3)(A), IRC, 1986) (see 6.6.2.1 below)

If the sum of the corporation’s insurance income and its foreign base company income exceeds 70 per cent of the corporation’s gross income, the entire gross income of the corporation will be treated as insurance income or as foreign base company income (whichever is appropriate) (Section 954(b)(3)(B), IRC, 1986) (see 6.6.2.2 below)

For the purposes of Section 954(a) and Section 953, foreign base company income and insurance income shall not include any item of income received by a controlled foreign corporation if such income was subject to an effective tax rate of income tax imposed by a foreign country of greater than 90 per cent of the maximum corporate rate of tax specified in Section 11 (Section 954(b)(4), IRC, 1986) (see 6.6.2.3 below)

6.5.7 Concerns instigated by taxation of insurance income

The legislative enactment in 1986 which made all income of controlled foreign corporations engaged in insurance business subject to immediate taxation except for income from same-country risks was a significant event in United States taxing history. Concerned by the apparent Congressional perception of “movable” income, and a belief that the utilisation of tax havens was widespread, the legislators deemed it necessary for comprehensive legislation on the taxation of foreign insurance income earned by controlled foreign corporations. The major concerns raised by the new legislation were the situs of risks, because only home country underwriting was excluded; the appropriate reserve offset to investment income to determine the taxable amount; and the necessity to recompute foreign reserves on a United States tax basis, of a company otherwise having no United States connection (Rhoades & Langer, 2011:Section 953(e)).

6.6 Foreign base company income

6.6.1 Introduction

As noted from previous discussions, Subpart F income tends to be income that is easily movable to a low-tax jurisdiction and comprises several income categories (see 6.4.1 above). One of the more important categories is foreign base company income (FBCI) which includes the following categories (Section 954(a), IRC, 1986):

- foreign personal holding company income [Section 954(c), IRC, 1986]
- foreign base company sales income [Section 954(d), IRC, 1986]
- foreign base company services income [Section 954(e), IRC, 1986]
- foreign base company oil-related income [Section 954(g), IRC, 1986]

Foreign base company sales income, considered a major component of the FBCI category, is directed primarily at a holding structure where a United States parent corporation creates a foreign subsidiary (i.e., a base company) in an effort to isolate some of the income from the parent's active business in a low-tax jurisdiction. For example, a United States manufacturing parent might sell its products to a foreign subsidiary which then in turn sells the products to other end-user customers. By manipulating prices, some of the income from the manufactured products might be isolated in a low-tax jurisdiction. While it is true that Section 482, IRC, may allow the IRS to reallocate income between parent and subsidiary, the CFC provisions offer a more potent weapon which can apply, for example, even when the dealings between parent and subsidiary are at arm's length. (Doernberg, 2004:341-342.)

The following exclusions are applicable to all of the controlled foreign corporation's foreign base company income when certain criteria are fulfilled by the controlled foreign corporation: the *de minimis* rule, the full inclusion test, high foreign tax on income, and United States source income effectively connected, as outlined below.

6.6.2 Exceptions to the rules – foreign base company income

6.6.2.1 The de minimis rule

For tax years beginning after 1986, Section 954(b)(3)(A), IRC, provides a *de minimis* rule that excludes all gross income from being considered as foreign base company income or insurance income if the sum of the controlled foreign corporation's gross foreign base company income and gross insurance income is less than the lesser of 5 per cent of gross income or \$1 million.

6.6.2.2 Full inclusion test

Under the full inclusion rule of Section 954(b)(3)(B), IRC, if more than 70 per cent of the controlled foreign corporation's gross income is foreign base company income plus insurance income, then all of the controlled foreign corporation's gross income will be treated as foreign base company income (Section 954(b)(3)(B), IRC, 1986; Section 1.954-1(b)(1)(i), Code of Federal Regulations, 2011). The amount of gross income which is neither foreign base company income nor insurance income, but which is included in foreign base company income only as a result of the 70 per cent full inclusion rule, is characterised as a separate category of income. Income that fits this definition is identified as "full inclusion foreign base company income" (Section 1.954-1(b)(2), Code of Federal Regulations, 2011). That separate category requires the controlled foreign corporation to allocate deductions to that category as well as to the other foreign base company categories. The separation into categories is also relevant for purposes of applying the high tax exception.

The regulations contain a so-called anti-abuse rule which allows the Service to combine the incomes of two or more controlled foreign corporations if one principal purpose for separate controlled foreign corporations was to avoid the full inclusion or *de minimis* rule (Section 1.954-1(b)(4)(i), Code of Federal Regulations, 2011). The regulations go further by providing that two or more related corporations are presumed to have been formed or maintained to avoid the *de minimis* or full inclusion rule if they meet any one of the following standards (Section 1.954-1(b)(4)(ii)(c), Code of Federal Regulations, 2011):

- The assets or businesses were operated by one controlled foreign corporation in a prior year and are now operated by two controlled foreign corporations (Section 1.954-1(b)(4)(ii)(A), Code of Federal Regulations, 2011).
- The controlled foreign corporations carry on a business as partners in a partnership that is related to each of the controlled foreign corporations (Section 1.954-1(b)(4)(ii)(B), Code of Federal Regulations, 2011).
- The activities of the controlled foreign corporations would constitute a single branch operation under regulations promulgated under Section 367, IRC, if the activities were carried on by a United States person (Section 1.954-1(b)(4)(ii)(C), Code of Federal Regulations, 2011).

6.6.2.3 High foreign tax income

After the controlled foreign corporation calculates its net foreign base company income, the controlled foreign corporation is to reduce any of its foreign base company income by any net item of high tax income (Section 1.954-1(d)(1), Code of Federal Regulations; Section 954(b)(4), IRC, 1986).

An item of income qualifies for the high tax exception only if:

- the controlled foreign corporation makes the proper election (Section 1.954-1(d)(1)(i), Code of Federal Regulations, 2011), and
- the item of income is subject to an “effective” rate that is greater than 90 per cent of the maximum rate applicable to corporate income (Section 1.954-1(d)(1)(ii), Code of Federal Regulations, 2011)

During 2011, that rate was 35 per cent, so the minimum effective rate that the foreign tax must meet is 31.51 per cent (Section 11(b)(1)(D), IRC, 1986). The regulations set forth the method for calculating the effective rate of tax on an item of income. Specifically, the rate is determined by dividing the income taxes paid (or accrued) on an item of income by the item of income itself (Section 1.954-1(d)(2), Code of Federal Regulations, 2011).

6.6.2.4 United States source income – effectively connected with the United States

Another exception relates to United States income that is excluded from Subpart F income under Section 952(b) of the Code and is therefore also excluded from the foreign base company income category (Section 1.954-1(a)(2), Code of Federal Regulations, 2011). The Subpart F income exclusion relates to United States source income that is effectively connected with the conduct of a business in the United States, providing that the income is not exempt or subject to a reduced rate under a United States tax treaty.

6.6.3 Deductions from foreign base company income

Foreign base company income is defined to include the sum of the categories of income listed in Section 954(a), but in each case reduced by the deductions properly allocable to each item of income. In other words, the amount of foreign base company income which the United States shareholder is required to recognise is the net personal holding, sales, and services income which the corporation generates (Rhoades & Langer, 2011:Section 954).

The calculation of a controlled foreign corporation’s gross income, taxable income, and earnings and profits is discussed below. Briefly, the controlled foreign corporation is to calculate both its gross income and its net income as if it were a domestic corporation (Sections 1.952-2(a)(1); 1.952-2(b)(1), Code of Federal Regulations, 2011). As to items of particular income, however, the general method of accounting is not sufficient. Rather, each item of income is to be reduced by the expenses, taxes, and other deductions directly attributable to that income item or category. Interest paid by a controlled foreign corporation, for example, generates a deduction which is allocated first to any FPHC income, to the extent the controlled foreign corporation has that form of income, if, for example, the interest is paid to a shareholder or another controlled foreign corporation related to the shareholder (Section 1.861-8, Code of Federal Regulations, 2011). Deductions which cannot be allocated to an item or category of income are to be apportioned ratably to all categories of gross income unless there is a

deduction that does not apply to any item or category of foreign base company income (Section 954(b)(5), IRC, 1986).

The result of the above rule is that deductions in one category of foreign base company income are applied to reduce the income in that category (Section 4.954-1(c)(1), Code of Federal Regulations, 2011). The categories are the same as discussed previously (see 6.6.1) plus a catch-all (full inclusion foreign base company income category).

6.6.4 Foreign personal holding company income

For purpose of subsection (a)(1) of Section 954, the term “foreign personal holding company income” means the portion of the gross income which are taxable, unless an exemption applies, and consists of (Section 954(c)(1), IRC, 1986):

- dividends, interest, rent, royalties and annuities;
- gain from certain property transactions;
- gain from commodities transactions;
- foreign currency gain;
- income equivalent to interest;
- income from notional principal contracts;
- payments in lieu of dividends; and
- income from certain personal services contracts.

Income that potentially falls within more than one category of FPHCI is classified as income in the category with the highest order of priority (Skinner, 2010:4):

- Dividends, interest, rent and royalties;
- Income equivalent to interest;
- Gain from Section 988 transactions;
- Commodities transactions; and
- Certain property transactions.

When exempted income is assigned to a particular category it is not subsequently re-tested under the rules for a lower priority category. For example, assume a controlled foreign corporation sells property that fulfils the definitional requirements of a commodity; the gain from the sale will either be FPHCI or non-FPHCI under the rules for commodities transactions. If an exception under the rules for commodities transactions applies, then the income will not be re-tested under the rules for property that does not give rise to income. Similarly, if a commodities transaction generates a loss, the loss would be assigned to the commodities transactions category, not to some other category. Likewise,

assume a controlled foreign corporation derives gain from a foreign currency futures contract that is a Section 988 gain or loss, the gain is tested as FPHCI under the Section 988 gains category, despite the fact that it might also qualify as FPHCI under the commodities category. (Skinner, 2010: 4.)

6.6.4.1 Definition of the FPHC income constituents

Brief explanations will be given, primarily in the form of definitions of the individual income constituents that form part of the FPHCI category, and of the exceptions being granted to certain of these income constituents under the Subpart F regimen.

Dividends

The term “dividend” is not specifically defined for purposes of the FPHCI rules and therefore it is believed that the term should be defined by reference to general tax principles, except that it does not include certain dividends from related persons and previously taxed distributions under Subpart F rules (Section 1.954-2(b)(1)(i), Code of Federal Regulations, 2011). Under Section 316, the term “dividend” is defined generally as a distribution by a corporation to its shareholders of money or other property out of the current or accumulated earnings and profits of the corporation.

Other transactions, however, may also give rise to deem dividends for United States tax purposes. For example, under Section 304 gain from certain sales of stock between related corporations may be treated as a dividend for tax purposes. Similarly, part or all of the gain realised by a corporation on the transfer of shares in another corporation may be treated as dividend income to the transferor under Section 964(e) or the Section 367(b) regulations. Gain from the sale of a lower-tier controlled foreign corporation is also treated as a dividend to the same extent that the gain would have been a dividend if the selling controlled foreign corporation were a domestic corporation (Section 964(e)(1), IRC, 1986). Thus, if the second or lower-tier controlled foreign corporation which is sold had been a first-tier controlled foreign corporation and had retained earnings that had not been previously taxed, the gain from the sale (to the extent of retained earnings) would be treated as a dividend as if the controlled foreign corporation’s shareholder had been a United States shareholder. In that situation and to the extent that the gain would have been a dividend, the gain to the upper-tier controlled foreign corporation will be a dividend.

Deductions for dividends received by domestic corporations from certain foreign corporations (Section 101 of the bill and new Section 245A of the Code) have been enacted in the recent United States Job Creation and International Tax Reform Act of 2012. See discussion at 6.9.1.1 below.

Interest

“Interest” includes the usual items of interest as well as original issue discount (Section 1.954-2(a)(4)(i), Code of Federal Regulations, 2011), but it does not include export financing interest and

certain interest received from related persons (Section 1.954-2(b)(1)(ii), Code of Federal Regulations, 2011). Export financing interest is defined in Section 904(d)(2)(G), IRC. Interest that is treated as tax exempt (Section 103, IRC, 1986) is, nevertheless, FPHC income (Section 1.954-2(b)(3), Code of Federal Regulations, 2011). The United States Treasury did not arrive at this conclusion (to treat tax exempt interest as FPHC income) easily – having, however, arrived at a contrary position in an earlier situation. Under the current regime, a controlled foreign corporation that earns tax exempt interest is to include that interest in its FPHC income which is then deemed distributed to the controlled foreign corporation's United States shareholder as a constructive taxable dividend. (Rhoades & Langer, 2011:Section 954.)

Rents and royalties

“Rents and royalties” do not include certain of those items of income received from related persons when the property is used in the country where the payee controlled foreign corporation is created (Section 1.954-2(b)(5)(i)(2), Code of Federal Regulations, 2011). Additionally, rents and royalties generated in the active conduct of a business are not FPHC income (Section 1.954-2(b)(6), Code of Federal Regulations, 2011).

Concurrently with the repeal of the provisions treating aircraft and shipping income as Subpart F income (The American Job Creation Act of 2004), Congress added a provision to the FPHC provisions that gives a taxpayer a safe harbour for rents from aircraft or vessels used in foreign commerce (Section 954(c)(2)(A), IRC, 1986). Specifically, FPHC income does not include rental income derived from leasing an aircraft or vessel in foreign commerce so long as the active leasing expenses are at least 10 per cent of the profit on the lease and the rents are derived from an unrelated person.

Certain property transactions

“Certain property transactions” include sales or exchanges of: assets which generate dividends, interest, rents, royalties or annuities so long as the net proceeds generate a gain, not a loss (Section 1.954-2(e)(1)(i)), Code of Federal Regulations, 2011); an interest in a trust, partnership or REMIC (Section 954(c)(1)(B)(ii), IRC, 1986); or property which does not give rise to any income such as raw land, jewels or coins (Section 954(c)(1)(B)(iii), Code of Federal Regulations, 2011). If any of these items are held by the taxpayer in inventory, the gain from their disposition does not generate FPHC income (Section 954(c)(1)(B), IRC, 1986). Additionally, property that generates business income (a phrase inclusive not only of inventory but also of real estate used in a taxpayer's business) is not included within the phrase “certain property transactions” (Section 1.954-2(e)(1)(ii), Code of Federal Regulations, 2011). Thus, if the controlled foreign corporation is a coin dealer, his profits arising from the sale of coins (forming part of inventory) is not FPHC income under the controlled foreign corporation regulations (Section 1.954-2(e)(1)(ii), Code of Federal Regulations, 2011).

Gain from the sale of a lower-tier controlled foreign corporation

The Subpart F rules now provide that gain from the sale of a controlled foreign corporation subsidiary by its controlled foreign corporation parent is to be treated as if the parent were a domestic person (Section 964(e)(1), IRC, 1986). That means that the gain, to the extent of earnings and profits, is to be re-characterised as a dividend (Section 1248, IRC, 1986). The gain from the sale of shares of a lower-tier controlled foreign corporation will be treated as FPHC income because the shares of the controlled foreign corporation produce passive income (dividends) (Section 954(c)(1)(B)(i), IRC, 1986; Section 1.954-2(e)(2)(i), Code of Federal Regulations, 2011). That conclusion does not change even if a dividend from that lower-tier controlled foreign corporation would not be FPHC income because the controlled foreign corporation is incorporated in the same country as its controlled foreign corporation parent and the lower-tier controlled foreign corporation conducts the majority of its business in that country (Section 1.954-2(e)(2)(i)(B), Code of Federal Regulations, 2011).

Commodity transactions

FPHC income includes the excess of gains over losses from commodities transactions (Section 954(c)(1)(C), IRC, 1986). “Commodity transactions” include any purchase or sale of a commodity for immediate or future delivery, such as futures contracts, leveraged contracts, options, or straight sales or purchases (Section 1.954-2(f)(2)(ii), Code of Federal Regulations, 2011). That means that net income from commodity transactions is FPHC income. As with other sales, net losses do not reduce other FPHC income (Section 1.954-1(c)(1)(ii), Code of Federal Regulations, 2011). The phrase “commodities transactions”, for FPHC income purposes, does not include three types of transactions: gains or losses that arise out of (a) “commodity hedging transactions” (Section 954(c)(1)(C)(i), IRC, 1986); (b) active business gains or losses from the sale of commodities, so long as the commodities are the controlled foreign corporation’s inventory, depreciable property of the controlled foreign corporation, or property that the controlled foreign corporation consumes in its business (Section 954(c)(1)(C)(ii), IRC, 1986); and foreign currency gains or losses attributable to foreign currency transactions (Section 954(c)(1)(C)(iii), IRC, 1986).

Foreign currency gain

“Foreign currency gain” is any net Section 988, IRC, 1986, transaction gain (Section 1.954-2(g)(2)(i), Code of Federal Regulations, 2011). A Section 988 transaction includes any transaction which involves a non-functional currency (see below) in the sense that the taxpayer is to be paid in or is to pay with one or more non-functional currencies. Thus, for example, if the taxpayer’s functional currency is the United States dollar; a purchase of Euro-dollar is a Section 988 transaction. Additionally, a Section 988 transaction includes any forward or futures contract, option, or similar instrument which the Code does not require to be marked to market under the provisions of Section 1256(g)(1)(B), IRC, 1986.

Foreign personal holding company income does not include foreign currency gains arising from a transaction entered into by the controlled foreign corporation in the ordinary course of its business (Section 1.954-2(g)(2)(ii)(B)(1), Code of Federal Regulations, 2011), or from a *bona fide* hedging transaction (Section 1.954-2(g)(2)(ii)(B)(2), Code of Federal Regulations, 2011). The foreign currency rules have a number of aspects which are relevant in the controlled foreign corporation context. For example, the regulations offer the taxpayer two separate elections. One election allows the controlled foreign corporation to exclude foreign currency gain or loss from the FPHC income category and to relate the gain or loss to the category of Subpart F income from which the currency gain or loss arises (Section 1.954-2(g)(3)(i), Code of Federal Regulations, 2011). The election once made, may only be revoked with the consent of the Commissioner (Section 1.954-2(g)(3)(iii), Code of Federal Regulations, 2011).

Another election relates to the controlled foreign corporation's accounting treatment of all foreign currency gain or loss (Section 1.954-2(g)(5)(i), Code of Federal Regulations, 2011). If the controlled foreign corporation has foreign currency gains or losses or it has gains or losses from a Section 1256 contract, the controlled foreign corporation may elect to account for the gains or losses by including them in the controlled foreign corporation's other FPHC income. If the controlled foreign corporation makes that election, it does so for all related persons. (Section 1.954-2(g)(4)(i), Code of Federal Regulations, 2011.)

Income equivalent to interest

"Income equivalent to interest" includes the following categories of transactions:

- An investment in which the return predominantly reflects the time value of money;
- Financial arrangements which involve payments, the predominant portion of which are, in substance, payments for the use or forbearance of money, but are not generally treated as interest (Section 4.954-2(h)(1), Temp Treasury Regulations (Sept 6, 1995));
- Certain notional principal contracts (Section 1.954-2(h)(2)(i)(C), Code of Federal Regulations, 2011); and
- Various other transactions, such as the performance of services under certain conditions, a loan commitment and other transactions that IRS may later identify (Section 1.954-2(h)(2)(i)(D)-(H), Code of Federal Regulations, 2011.)

Portfolio interest

Portfolio interest paid to foreign persons is no longer subject to withholding tax. Although the rule applies even if the recipient is a controlled foreign corporation, the receipt of portfolio interest may impact adversely on the controlled foreign corporation under the following conditions:

- The withholding exemption does not apply if the payee is a controlled foreign corporation and the interest is received from a related person (Section 881(c)(3)(C), IRC, 1986). In other words, if a United States corporation issues public debt and a foreign subsidiary of the issuer acquires some of that debt, the interest paid to the controlled foreign corporation is still subject to withholding tax (assuming it is not exempt under an applicable tax treaty).
- Portfolio interest is Subpart F income even if the 5 per cent or \$1 million de minimis rule would otherwise have insulated the interest from that status (Section 881(c)(4)(A)(i), IRC, 1986).
- Portfolio interest is Subpart F income even if
 - the total Subpart F income is less than \$1 million and less than 5 per cent of gross income (Section 881(c)(4)(A)(i), IRC, 1986),
 - the portfolio income is subject to an effective rate greater than 90 per cent of the highest United States corporate tax rate (30.6 per cent as of the end of 1992) (Section 881(c)(4)(A)(ii), IRC, 1986),
 - the portfolio interest is received from a related person (Section 881(c)(4)(A)(iii), IRC, 1986).

The provisions contained in the first two of the above paragraphs are applicable whenever the controlled foreign corporation receives portfolio interest, even if the debenture or bond generating the interest were acquired by the controlled foreign corporation as an investment from a totally unrelated issuer or on the open market.

Notional principal contracts

Income from the holding or trading of notional principal contracts is treated as FPHC income (i.e., the income equivalence of interest) if the value of the income is determined solely by reference to interest rates or indices, providing that the contracts are denominated in the taxpayer's functional currency (Section 1.954-2(h)(3)(i), Code of Federal Regulations, 2011).

Income from hedging transactions poses another problem for taxpayers. A taxpayer may enter into hedging contracts to mitigate his exposure to currency fluctuations or other market risks. The income, gain or loss derived from these types of contracts, to the extent the contracts hedge risks arising from the ownership of assets that generate other FPHC income, is to be taken into consideration as if the income were related to the income derived from the assets (Section 954(c)(1)(F), IRC, 1986). Thus, if a controlled foreign corporation that holds bonds denominated in a non-functional currency, enters into a forward contract to hedge its currency risk, the income or loss from the forward contract is to be treated, for FPHC income purposes, as if it were interest (Rhoades & Langer, 2011:Section 954).

Personal service contracts

FPHC income includes certain types of income from personal service contracts. Personal service contracts that fall within the rule discussed in this chapter section are those contracts under which either some person other than the corporation has the right to designate in some manner the individual who is to perform the services or the individual who is to perform the services is identified in the contract (Section 954(c)(1)(I)(i), IRC, 1986).

Active Trade or Business Modification

Rents and Royalties: The first of two exceptions to the definition of FPHC income for controlled foreign corporation purposes relates to rents and royalties derived from the active conduct of a business providing the income is not received from a related person (Section 954(c)(2)(A), IRC, 1986; Section 1.954-2(b)(6), Code of Federal Regulations, 2011). These exceptions require the taxpayer to recognise the distinction between the active conduct of a business and a business which is not actively conducted. The regulations describe the type of activity in which the controlled foreign corporation must engage if it wishes to meet the “active conduct” standard (Section 1.954-2(c)(1), Code of Federal Regulations, 2011). The provisions clarify that the scope of the exclusion includes personal as well as real property. In respect of real property, the standard is that the activity required is the regular performance of active and substantial management by the employees of the controlled foreign corporation (Section 1.954-2(c)(1)(ii), Code of Federal Regulations, 2011).

Rental income from leasing personal property manufactured by the controlled foreign corporation is rent derived from the active conduct of a business. A controlled foreign corporation engaged in the car rental business is engaged in an active business. A controlled foreign corporation which owns an apartment building managed by an unrelated firm is not engaged in an active business while a controlled foreign corporation that owns an office structure, part of which it occupies and part of which is leased and managed by the controlled foreign corporation, is engaged in an active business (Section 1.954-2(c)(3), Code of Federal Regulations, 2011). Royalties will qualify for the active business exception if they are derived from licensing of property developed by the controlled foreign corporation in the regular course of its property developing business, or from property licensed as the result of the performance of substantial marketing activities in a foreign country (Section 1.954-2(d)(1), Code of Federal Regulations, 2011).

Income from certain banking, financing and similar activities: As part of the foreign personal holding company rules, foreign personal holding company (FPHC) income does not include “qualified banking or financing income” of an eligible controlled foreign corporation (Section 954(h)(1), IRC, 1986). To be eligible, a controlled foreign corporation must be predominately engaged in the active conduct of a banking, financing or similar business and must engage in “substantial” activity with respect to one of those businesses (Section 954(h)(2)(A), IRC, 1986). Employees of a related party

can be treated as discharging the “substantial activity” requirement if the related party meets the provisions of Section 954(h)(3)(A)(ii)(II) (Section 954(h)(3)(E), IRC, 1986). Banking or financing income is “qualified” if it is derived from customers located in a country other than the United States, if substantially all of its activities are carried on in the corporation’s home country or the home country of a branch of the controlled foreign corporation, and if the income which is generated by the controlled foreign corporation or its branch is treated as earned income by the host country of the controlled foreign corporation or branch for that country’s income tax purposes (Section 954(h)(3)(A), IRC, 1986).

Dealers in financial instruments: A controlled foreign corporation which acts as a dealer in certain types of property does not take income from those transactions into income as foreign personal holding company income. The excepted property is any type of property which generates dividends, interest, royalties, rents or annuities (i.e., primarily various forms of financial instruments such as stocks and bonds) as well as inventory held by dealers in forward contracts, option contracts, notional principal contracts, and instruments referenced to commodities. (Section 954(c)(2)(C), Code of Federal Regulations, 2011.)

Permanent extension of exceptions for active financing income (Section 203 of the bill and Section 953(e)(10), 954(h)(9) and 954(i) of the Code) have been enacted in the recent United States Job Creation and International Tax Reform Act of 2012.

Beginning with taxable years in 1998, certain income derived in the active conduct of banking, financing, or similar business, as a securities dealer, or in the conduct of an insurance business (collectively known as active financing income) has been excepted from treatment as Subpart F income. The exceptions expired at the end of 2011. Without the temporary exceptions, 10 per cent United States shareholders are subject to United States tax currently on their pro rata shares of active financing income earned by the controlled foreign corporation, whether or not the income is distributed to shareholders. Under the provision, the exception for active financing income is restored and made permanent. (United States, 2012b:28.)

Effective date: With respect to controlled foreign corporations, the provision is effective for taxable years that begin after 31 December 2011. For United States shareholders, the provision is effective for the taxable years during which taxable years of the controlled foreign corporations end.

Income from a related person

Certain dividends, interest, rents and royalties paid to a controlled foreign corporation by a related person are not FPHC income (Section 954(c)(3)(A), IRC, 1986). The exclusion is rather limited but useful when it applies. Before considering the two categories (dividends and interest; rents and royalties) it should be noted that the exclusion of those forms of FPHC income is not to be applied to

reduce the Subpart F income (or to increase the deficit that later may reduce the Subpart F income) of the person making the payment to the controlled foreign corporation (Section 954(c)(3)(B), IRC, 1986). Thus, if Rico S.A., a Panama corporation, generated \$150 000 of Subpart F income and paid \$15 000 of interest to Rico-Swiss S.A., also a Panama corporation, the exclusionary provision would not apply if Rico S.A. then had only \$135 000 of Subpart F income.

Dividends and Interest: Dividends and interest received by a controlled foreign corporation from a related party are not FPHC income if the payer meets the following requirements:

- The payer and the payee controlled foreign corporation are both formed in the same foreign country; and
- The payer uses a substantial part of its assets in a business located in that country. (Section 1.954-2(b)(4)(i)(A), Code of Federal Regulations, 2011.)

The regulations on Section 954, IRC, 1986, do offer some guidelines in respect of the following: the payer of the interest or dividends must have a substantial part of its assets in a business located in the foreign country, as mentioned above. The payer will meet that test only if, for each quarter during the fiscal year, the average value of its assets used in the business is over 50 per cent of the average value of all of the payer's assets (Section 1.954-2(b)(4)(iv), Code of Federal Regulations, 2011). In addition, property used in the business is deemed located in the foreign country if it is physically in the foreign country unless it happens to be temporarily out of the country for repairs or inspection (Section 1.954-2(b)(4)(vi)(A) and (B), Code of Federal Regulations, 2011).

The regulations have rules for intangible property, inventory, debt instruments and stock interests (Section 1.954-2(b)(4)(vii), (viii), (ix) and (x), Code of Federal Regulations, 2011).

Further, the Code contains a restriction on the same country dividend rule; the purpose of this restriction is to limit dividend trafficking. Even if a corporation were to meet the two requirements described above, the rule does not apply (meaning that dividends will be treated as FPHC income) if the dividend is derived from earnings accumulated by the paying corporation during a period the recipient controlled foreign corporation – the shareholder – did not hold the dividend paying corporation's stock. (Section 954(c)(3)(C), IRC, 1986.)

Rents and Royalties: FPHC income does not include rents and royalties received by a controlled foreign corporation from a related corporation for the use of property within the country where the controlled foreign corporation is incorporated (Section 954(c)(3)(A)(ii), IRC, 1986 ; Section 1.954-2(b)(5)(i), Code of Federal Regulations, 2011).

6.6.4.2 Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA)

On May 17, 2006, Congress enacted the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA). TIPRA introduced Section 954(c)(6), which had the effect that dividends, interests, rents and royalties received by a controlled foreign corporation from a related controlled foreign corporation will trigger the so-called “look-through rules”. The enactment of Section 954(c)(6) was not preceded by a great deal of discussion and the legislative history of TIPRA provides limited discussion of the reasons for enacting Section 954(c)(6), IRC.

Section 954(c)(6) substantially liberalises the application of Subpart F to payments between related controlled foreign corporations, in which dividends, interest, rents and royalties received or accrued from a controlled foreign corporation which is a related person, is not to be treated as FPHC income, to the extent attributable (determined under rules similar to the rules of subparagraphs (C) and (D) of Section 904 (d)(3)) to income of the related person which is neither Subpart F income nor income treated as effectively connected with the conduct of a trade or business in the United States. Interest includes factoring income which is treated as income equivalent to interest for purposes of paragraph (1)(E). (Section 954(c)(6)(A), IRC, 1986.)

The turning point in the promulgation of Section 954(c)(6)(A), is that dividends, interest, rents, and royalties received or accrued by a controlled foreign corporation from a related controlled foreign corporation are generally not treated as FPHC income, which, subject to the high-tax exception of Section 954(b)(4) and certain other exceptions, is, otherwise includable in income on a current basis by the controlled foreign corporation’s United States shareholders (Section 951(a), IRC, 1986). The definition of related person (which provides a more than 50 per cent vote or value test, taking into account the constructive ownerships rules as laid down in Section 958(b)) applies (Section 954(d)(3), IRC, 1986).

Despite its breadth, the relief provided by Section 954(c)(6) has some significant limitations: it applies only to income that is attributable to income of the related payer that is neither Subpart F income nor income effectively connected with a United States trade or business; although Section 954(c)(6) expressly applies to factoring income that is treated as income equivalent to interest (IEI) under Section 954(c)(1)(E), it does not apply to other forms of IEI such as notional principal contract income (Section 1.954-2(h), Code of Federal Regulations; and Section 954(c)(6) do not apply to gain from the sale of stock in a related controlled foreign corporation, other than gain treated as dividend income under Section 964(e), nor does it apply to gains from sales of other assets held for production of income that would be FPHC income but for the applicability of Section 954(c)(6). Also, Section 954(c)(6) provides Treasury with “regulatory authority to carry out the purposes of the provision, including express authority to promulgate anti-abuse regulations”. (Braiterman, 2007:568.)

Before TIPRA, Section 954 provided a limited “same country” exception to FPHC income treatment for payments between related persons. Under Section 954(c)(3)(A)(i), FPHC income does not include dividends and interest received from a related corporation that is created or organised under the laws of the same country as the controlled foreign corporation and has a substantial part of its assets used in a trade or business in that country. Also, under Section 954(c)(3)(A)(ii), rents and royalties received by a controlled foreign corporation from a related corporation in consideration for the use of property in the controlled foreign corporation’s country of creation or organisation are not treated as FPHC income. The same- country exception does not apply to income from payments of interest, rents, and royalties (IRR) that reduce the payer’s Subpart F income (Section 954(c)(3)(B), IRC, 1986). The exception is also inapplicable to dividends that are attributable to earnings and profits of the payer that were accumulated in periods in which the recipient did not own the relevant stock directly or indirectly through a chain of corporations to which the same-country exception could apply (Section 954(c)(3)(C), IRC, 1986).

Although most items to which the same-country exception applies are also covered by Section 954(c)(6), IRC, the same country exception has some continuing relevance during the period in which Section 954(c)(6) applies. Unlike Section 954(c)(6), Section 954(c)(3) potentially applies to payments from related foreign corporations that are not controlled foreign corporations, to payments that reduce a related foreign payer’s effectively connected income (ECI), and, in the case of rents and royalties, to payments from related domestic corporations. Braiterman considers it anomalous that the “same country exception does not apply to payments that reduce a related foreign corporation’s Subpart F income (presumably on the grounds that the payment reduces income that would be subject to current United States tax) but potentially does apply to payments that reduce a related foreign corporation’s ECI or a related domestic corporation’s income.” (Braiterman, 2007:568.)

From 2005 through 2011 (see above), certain payments of dividends, interest, rents, and royalties that would otherwise be included in FPHC income were excepted if the payments were received from a related controlled foreign corporation and were properly attributable and allocable to income of the payer that was neither Subpart F income nor treated as effectively connected to a United States trade or business. The bill revives the provision and makes it permanent. (United States, 2012b:28.)

6.6.5 Foreign base company sales income

6.6.5.1 Introduction

For the purposes of Subpart F, FBCI includes foreign base company sales income (FBCSaI) (Section 954(a)(2), IRC, 1986). FBCSaI is income (whether in the form of profits, commissions, fees, or otherwise) derived in connection with one of the following activities:

- The purchase of personal property from a related person and its sale to any person

- The sale of personal property to any person on behalf of a related person
- The purchase of personal property from any person and its sale to a related person
- The purchase of personal property from any person on behalf of a related person

where the purchased or sold property is manufactured, produced or grown outside the controlled foreign corporation's country of organisation and consumed outside the controlled foreign corporation's country of organisation. (Section 954(d)(1), IRC, 1986.)

Therefore, FBC income includes FBC sales income, which is income from transactions in personal property (goods) where related person is either the buyer or seller (Section 954(d)(1), IRC, 1986). A controlled foreign corporation's gross profit on a sale of goods is usually FBC sales income if the controlled foreign corporation acquired the goods by purchase and either bought the goods from or sold them to a related person. If a controlled foreign corporation acts as an agent for a related person in arranging a transaction in goods, its commission or fee is normally FBC sales income whether the related person is the buyer or the seller. FBC sales income is limited to income from transactions involving related persons because Congress was "primarily concerned [with] income of a selling subsidiary [that] has been separated from manufacturing activities of a related corporation merely to obtain a lower rate of tax for the sales income" (S.Rep No. 1881, 87th Cong, 2d Sess, reprinted at 1962-3 CB 703, 790). Income from a sale can be FBC sales income whether or not the sale is in the ordinary course of the controlled foreign corporations business. (Section 1.954-3(a)(1)(i), Code of Federal Regulations, 2011.)

The statutes exclude from this category of FBC income any income that a controlled foreign corporation realises from transactions in goods that are either produced in the country in which the controlled foreign corporation is incorporated or sold for use, consumption, or disposition in that country (Section 954(d)(1), IRC, 1986). Income on sales of goods manufactured or produced by the controlled foreign corporation is also excluded from FBC sales income, but this exclusion may be lost if the goods are sold through a branch of the controlled foreign corporation that is physically separate from the manufacturing facility and the manufacturing and sales operations are in different countries (Section 954(d)(2), IRC, 1986). Also, income on sales of an agricultural commodity is excluded if the commodity is of a kind not grown in the United States (Section 954(d)(1), IRC, 1986).

The definition of foreign base company sales income exempt certain agricultural commodities from Subpart F income treatment if those commodities are not grown in the United States in commercially marketable quantities (Section 954(d)(1), IRC, 1986). "Agricultural commodities" does not include timber or any commodity which requires substantial manufacturing or processing. The test is that the item is not an agricultural commodity if at least 50 per cent of its fair market value is attributed to manufacturing or processing (Section 1.954-3(a)(1)(ii)(a), Code of Federal Regulations, 2011). As in

other areas of Subpart F, handling, packaging, grading, storing, transporting, or slaughtering and harvesting costs are not included in the meaning of manufacturing or processing. The 1993 Act converted income of any kind that is derived from certain timber products to foreign base company sales income (Section 954(d)(4), IRC, 1986). The timber covered by the rule is any timber that is unprocessed, is softwood; and is grown in the United States (Section 865(b), IRC, 1986).

6.6.5.2 Related person

A sale transaction usually generates FBC sales income only if a related person is involved as seller or buyer. A “related person” is an individual or entity that controls the controlled foreign corporation, an entity controlled by the controlled foreign corporation, or an entity that is controlled by the person or persons that control the controlled foreign corporation (Section 954(d)(3), IRC, 1986; Section 1.954-1(f)(1), Code of Federal Regulations, 2011). For this purpose, “control” of a corporation is vested in the ownership of more than 50 per cent of its stock, by either voting power or value (Section 1.954-1(f)(2), Code of Federal Regulations, 2011). A partnership is controlled by any person owning more than 50 per cent (by value) of the capital or profit interests, and a trust or estate is controlled by any person owning more than 50 per cent of the beneficial interests. Ownership is determined with the indirect and constructive ownership rules of Section 958.

6.6.5.3 Exceptions to foreign base company sales income

Country of incorporation exclusions

Income from a sale is excluded from FBC sales income if the goods are manufactured, produced, constructed, grown or extracted in the country in which the controlled foreign corporation is organised (Section 954(d)(1), IRC, 1986; Section 1.954-3(2), Code of Federal Regulations, 2011). This exclusion applies if, for example, a controlled foreign corporation incorporated in country X purchases apples grown in country X and resells them to its parent corporation for distribution in the United States. Sales income is also excluded if the goods are sold for use, consumption, or disposition within the country of the controlled foreign corporation’s incorporation (Section 954(d)(1), IRC, 1986; Section 1.954-3(a)(3)(i), Code of Federal Regulations, 2011). This exclusion applies if, for example, a controlled foreign corporation organised in country X purchases clothing manufactured by its parent in the United States and resells them to retailers in country X. Congress provided these exclusions because “a lower rate of tax for [sales income] is likely to be obtained only through purchases and sales outside of the country in which [the controlled foreign corporation] is incorporated” (S.Rep. No. 1881, 87th Cong, 2d Sess, reprinted at 1962-3 CB 703, 790). Therefore, if the goods are produced or sold for use or consumption in the country of the controlled foreign corporation’s incorporation, then it is evidence enough that the country of incorporation was selected for business, not tax-avoidance, reasons.

For purposes of the second of the exclusions, goods sold to unrelated persons are generally deemed used, consumed, or disposed of at the destination specified for delivery in the sales transaction in which the controlled foreign corporation participates (Section 1.954-3(a)(3)(ii), Code of Federal Regulations, 2011). For example, if a controlled foreign corporation causes goods to be delivered to a common carrier in London for shipment to Paris, the goods are usually considered used, consumed, or disposed of in France. Therefore, the place of use, consumption, or disposition is the ultimate destination, not the place of any temporary interruption in the shipment of the goods. (Bikker & Lokken, 2009:4.)

Goods manufactured, produced or assembled by CFC

Congress's intention in respect of FBC sales income is to include only "income from the purchase and sale of property, without any appreciable value being added to the product by the selling corporation"; therefore foreign base company sales income is not to include any income in respect of "where any significant amount of manufacturing, major assembling, or construction activity is carried on with respect to the product by the selling corporation (S.Rep. No. 1881, 87th Cong, 2d Sess, reprinted at 1962-3 CB 703, 790). According to the regulations, a controlled foreign corporation manufactures, produces, or constructs personal property only if, "through the activities of its employees", it satisfies one of the three tests: a substantial transformation test, a substantial assembly test, or a substantial contribution test (Section 1.954-3(a)(4)(ii)(iii)(iv), Code of Federal Regulations, 2011). A controlled foreign corporation's "employees" include only its common law employees, determined under the definitions used for employment tax purposes (Section 1.954-3(a)(4)(i), Code of Federal Regulations, 2011).

According to Treasury Regulations, as amended in 2008, a controlled foreign corporation is not considered to have manufactured goods that it sells "merely because" the goods are "in a different form" from the property that it purchased and caused to be incorporated into the goods (Section 1.954-3(a)(4)(i), Code of Federal Regulations, 2011). For example, if a controlled foreign corporation purchases tomatoes, hires a contract manufacturer to make tomato soup from the tomatoes, and sells the soup to a related person, the controlled foreign corporation is not a manufacturer of the soup unless its employees participate in the manufacturing process in ways that satisfy one of the Treasury's regulatory tests (Bikker & Lokken, 2009:6). A controlled foreign corporation will have manufactured, produced or constructed personal property which the corporation sells only if such corporation satisfies one of the following provisions: substantial transformation test, substantial assembly test, substantial contribution test.

Substantial transformation test: A controlled foreign corporation is considered to have manufactured goods that it sells if personal property that it purchases and incorporates into goods sold is "substantially transformed" by the controlled foreign corporation before the sale (Section 1.954-

3(a)(4)(ii), Code of Federal Regulations, 2011). Examples of substantial transformation consists of the production of paper from wood pulp, making screws and bolts from steel rods, and canning fish (Section 1.954-3(a)(4)(ii), Code of Federal Regulations, 2011). A controlled foreign corporation satisfies this test only if it accomplishes such a transformation “through the activities of its employees” (Section 1.954-3(a)(4)(i), Code of Federal Regulations, 2011). For example, if a controlled foreign corporation purchases tomatoes, hires a contract manufacturer to make tomato soup from the tomatoes, and sells the soup to a related person, the tomatoes are substantially transformed, but because the transformation is not accomplished by activities of the controlled foreign corporation’s employees, the controlled foreign corporation does not satisfy the substantial transformation test (Bikker & Lokken, 2009:9).

The substantial assembly test: A controlled foreign corporation is also considered to have manufactured property that it sells if it purchases components and incorporates them into property that it sells by activities, carried on by its employees, “that are substantial in nature and generally considered to constitute the manufacture, production, or construction of property” (Section 1.954-3(a)(4)(iii), Code of Federal Regulations, 2011). For example, the Tax Court in *Bausch & Lomb Inc. v CIR* (United States, 1996a) held that a controlled foreign corporation’s assembly of sunglasses from components purchased from related persons was manufacturing. Although assembly operations did not require a large investment in physical capital and were not substantial in relation to the time and investment required to fabricate the assembled parts, assembly operations required a substantial investment in human capital (skill, training, and experience in assembly techniques), included a broad range of activities, and were considered in the industry to be manufacturing.

Substantial contribution test: In response, Treasury promulgated regulations which provide that, in addition to the “substantial transformation” and “substantive” tests, a taxpayer can now qualify for the manufacturing exception by satisfying the substantial contribution test. Thus, even where the taxpayer cannot satisfy the “substantial transformation” and “substantive” tests, the taxpayer can be considered to have manufactured personal property for purposes of the manufacturing exception (Section 1.954-3(a)(4)(iv), Code of Federal Regulations, 2011). Accordingly, a controlled foreign corporation will satisfy the “substantial contribution” test with respect to personal property only if the facts and circumstances evidence that the controlled foreign corporation makes a substantial contribution through the activities of its employees to the manufacture of that property (Section 1.954-3(a)(4)(iv)(b), Code of Federal Regulations, 2011). Treasury regulations provide that the activities of a controlled foreign corporation’s employees will be considered in determining whether the controlled foreign corporation makes a substantial contribution to the manufacture of personal property.

Assembly not sufficient to be manufacturing: If a controlled foreign corporation assembles goods in operations that are not manufacturing, an apportionment may be necessary. Income on a sale of goods

is not FBC sales income if the goods are neither purchased from nor sold to a related person, were produced in the country in which the controlled foreign corporation is incorporated, or are sold for use, consumption, or disposition in the country of incorporation. If assembled goods are sold to an unrelated person for use, consumption, or disposition outside the country of incorporation, only part of the income on the sale is FBC sales income if the controlled foreign corporation purchases some of the components from related persons and others from unrelated persons or some of the components are produced in the country of incorporation and others are not. The FBC sales income from such a sale equals the income on the sale multiplied by the ratio of the costs of components produced outside the country of incorporation that the controlled foreign corporation acquires from related persons to the costs of all components. (Section 1.954-3(a)(5), Code of Federal Regulations, 2011.)

6.6.6 Foreign base company services income

6.6.6.1 Introduction

The Internal Revenue Code provides rules that limit tax deferral on certain types of controlled foreign corporation income, generally known as “Subpart F income”. In particular, it provides, subject to several exceptions, that foreign base company services income (FBCSvI) is Subpart F income (Section 954(e), IRC, 1986). The Code defines FBCSvI as income derived in connection with the performance of services that are performed by the controlled foreign corporation

for, or on behalf of, any related person, and ... outside the country under whose laws the controlled foreign corporation is created or organised (Section 954(e)(1), IRC, 1986)

6.6.6.2 Conditions for applying Section 954(e): services performed on behalf of related person and outside the CFC’s country of incorporation

Types of services included: The statute (IRC, 1986) refers to income derived from the performance of “technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial or like services” (Section 954(e)(1), IRC, 1986). This is a broad definition of the type of services that potentially generate foreign base company services income. (Skinner, 2010:2.)

Performance of services “for or on behalf of a related person”: The regulations set out four instances under which services are considered as performed for, or on behalf of, a related party:

- (i) The controlled foreign corporation is paid or reimbursed by, is released from an obligation to, or otherwise receives a substantial financial benefit from a related person.
- (ii) The controlled foreign corporation performs services which a related person is, or has been, obligated to perform.
- (iii) The controlled foreign corporation performs services with respect to property sold by a related person, and the performance of such services constitutes a condition or material term of the sale.

- (iv) The controlled foreign corporation receives “substantial assistance” contributing to the performance of the services by a related person or persons. (Section 1.954-4(b)(1), Code of Federal Regulations, 2011.)

In the first three of the four cases above, the related person generally has the relationship with the customer (acts as the principal or general contractor) and delegates some performance to the controlled foreign corporation. The fourth case (the “substantial assistance” test), by contrast, is applicable where the controlled foreign corporation is the principal, but relies substantially on related persons to perform the services under the contract. Under issued Notice 2007-13, this test only applies if the assistance is furnished by related United States persons. (Skinner, 2010:3.)

As a general rule, the services will be deemed performed in the place where the person who is performing the services is located when the services are performed (Section 1.954-4(c), Code of Federal Regulations, 2011). That being the case, obviously some of the services may well be performed within the controlled foreign corporation’s country of incorporation (and not be considered as FBCSVI), and other services may be performed outside the country of incorporation. In such cases, an apportionment of the income between Subpart F income and non-Subpart F income is necessary. The taxpayer can obtain the proper apportionment by applying a formula based upon the time spent in each country, although some weight will be placed on the type of services rendered. Thus, if a job requires equal parts of skilled technical services and unskilled clerical services, greater value will be given to the skilled technical service. (Section 1.954-4(c), Code of Federal Regulations, 2011.)

Certain sales-related services are excluded from the definition of foreign base company services income. Specifically, the regulations exclude income that the controlled foreign corporation earns from performing services that directly relate to a sale of personal property manufactured by the controlled foreign corporation, which are performed before the sale or exchange of property is completed (Section 1.954-4(d)(1), Code of Federal Regulations, 2011). Similarly, if the services directly related to an offer to sell property manufactured by the controlled foreign corporation that was not consummated, they also are excluded (Section 954 (e)(2), IRC, 1986).

6.6.7 Foreign base company oil-related income

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) added a new category to the definition of “foreign base company” to include a controlled foreign corporation’s foreign base company oil-related income for the taxable year (Section 954(a)(5), IRC, 1986). The provision, in effect, treats oil-related income (from a major oil company as discussed below) as Subpart F income (Section 907(c)(2), IRC, 1986). The income is so treated, however, only if it is non-extraction income (Section 954(g), IRC, 1986). In essence, the category of income which the Section treats as foreign base company oil-related income is foreign-source income which is described in certain of the

subsections of the foreign tax credit rules (Section 907(c)(2) and (3), IRC, 1986). Since the phrase only relates to non-extraction income, however, the phrase does not include income from a foreign country in connection with

- oil or gas which was extracted from an oil or gas well located in that foreign country; or
- oil, gas or a primary product of oil or gas which is sold by the foreign corporation or a related person for use in that country or is loaded in that country on a vessel or aircraft for use as fuel by that vehicle. (Section 1.954-8(a)(1), Code of Regulations)(Section 954(g)(1),IRC, 1986.)

The effect of that rule is to focus on the source of the income, not, as in other foreign base company rules, the place of incorporation of the controlled foreign corporation.

Income which is included within the foreign base company rule includes income derived from processing, transporting, storing or re-selling of petroleum or their primary products. Income from the performance of services related to either extraction or non-extraction income is within the rule if the person performing the services (or a related person) is engaged in oil and gas extraction activities (S Rep No. 97-494, 97th Cong, 1st Sess 153 (1982)). However, foreign base company oil-related income does not include any foreign personal holding company income (Section 954(g)(1), IRC, 1986). Refining, marketing and transportation income have its own special rules (Section 1.954-8(c), Code of Federal Regulations, 2011). The controlled foreign corporation needs to determine which part of refining, marketing or transportation income qualifies for the “extraction exception”. The exception refers to the oil or gas extracted from a well located in the foreign country which is also the source of the income generated by that oil or gas (Section 1.954-8(a)(1)(i), Code of Federal Regulations, 2011) Foreign base company oil-related income also includes income derived from the sale of assets used by the taxpayer in generating other oil-related income (Section 907(c)(2)(D), IRC, 1986). (Rhoades & Langer, 2011:Section 954.)

Foreign base company oil-related income has a number of limitations and exceptions as follows:

- A controlled foreign corporation which is classified as a small oil producer cannot generate foreign base company oil-related income (Section 1.954-8(b)(1), Code of Federal Regulations, 2011) (Section 954(g)(2)(A), IRC, 1986).
- Income derived from sources within a particular foreign country is exempt if it relates to oil extracted by anyone from that country (Section 954(g)(1)(A), IRC, 1986).
- Income from non-extraction income is exempt if the oil is sold for use or consumption in the country from which it is extracted. Income from fuel sold and delivered to ships or aircrafts in the country of extraction is also exempt (Section 954(g)(1)(B), IRC, 1986).

6.7 Investment of earnings in United States property

6.7.1 Background to Section 956

The United States shareholder is taxable on the shareholder's proportionate share of the controlled foreign corporation's Subpart F income (primarily, foreign base company income) and the controlled foreign corporation's investment of any earnings in United States property (under Section 956, IRC, 1986). Section 956 was enacted to deter United States taxpayers from repatriating (through loans and other investments) earnings of a controlled foreign corporation in a tax-free manner, under conditions that would not have subject these types of repatriated earnings to United States taxation. Under the Section 956 regime, a United States shareholder is taxed on the shareholder's pro rata share of any increase in the earnings of the controlled foreign corporation's investment in United States property. In effect, the amount invested in United States property is treated as if distributed to the United States parent as a dividend. Foreign taxes associated with any inclusion under Section 956 can be credited by the United States shareholder. (Section 960(a)(1), IRC, 1986.)

Section 956 therefore taxes investments made by controlled foreign corporations in specified categories of "United States property" on a constructive dividend basis. The focus is on a controlled foreign corporation's repatriation of earnings through investments being made in certain specified United States property – in a manner which reflects that the investment is of a lasting nature and which would reasonably be expected to produce income for an indefinite period of time. Correspondingly, there is a set of exceptions to Section 956 that epitomizes Congress's "intent to allow controlled foreign corporations to engage in normal commercial transactions without the intention to permit the funds to remain in the United States indefinitely". (Skinner, 2011)

6.7.2 Scope of Section 956

6.7.2.1 General rule

Section 951(a)(1)(B) of the Internal Revenue Code requires each United States shareholder of a controlled foreign corporation to include in gross income the shareholder's pro rata share of the amount determined under Section 956 for that year, which amount is generally equal to the lesser of:

- (1) The excess (if any) of
 - (A) such shareholder's pro rata share of the average quarterly amounts of United States property held (directly or indirectly) by the controlled foreign corporation, over
 - (B) the amount of previously taxed income under Section 959(c)(1)(A), or
- (2) the pro rata share of the controlled foreign corporation's applicable earnings, of such controlled foreign company. (Section 956(a), IRC, 1986.)

The amount of investment under Section 956(1) with respect to any property shall be its adjusted basis as determined for purposes of computing earnings and profits, reduced by any liability to which the property is subject.

6.7.2.2 Special rules

Applicable earnings

For purposes of this chapter section, the term “applicable earnings” means, with respect to any controlled foreign company, the sum of

- (A) the amount (not including a deficit) referred to in Section 316(a)(1) to the extent such amount was accumulated in prior taxable years, and
 - (B) the amount referred to in Section 316(a)(2),
- but reduced by distributions made during the taxable year and by earnings and profits described in Section 959(c)(1). (Section 956(b)(1), IRC, 1986.)

Special rule for United States property acquired before CFC status

Application of Section 956(a) to any taxable year disregards United States property acquired by the foreign corporation before it became a controlled foreign corporation, provided that the total amount of property disregarded is less than the balance of the retained earnings immediately prior to qualification as a CFC (Section 956(b)(2), IRC, 1986).

Special rule where corporation ceases to be CFC

When a foreign corporation ceases to be a controlled foreign corporation during any taxable year –

- (A) the determination of any United States shareholder’s pro rata share shall be made on the basis of stock owned (within the meaning of Section 958(a)) by such shareholder on the last day during the taxable year on which the foreign corporation is a controlled foreign corporation,
- (B) the average referred to in subsection (a)(1)(A) for such taxable year shall be determined by only taking into account quarters ending on or before such last day, and

(C) in determining applicable earnings, the amount taken into account by reason of being described in paragraph (2) of Section 316(a) shall be the portion of the amount so described which is allocable (on a pro rata basis) to the part of such year during which the corporation is a controlled foreign corporation. (Section 956(b)(3), IRC, 1986.)

6.7.2.3 United States property defined

Section 956 applies to any of the following categories of property acquired by a controlled foreign corporation, unless an exception applies:

- Tangible property or real property located in the United States
- Stock in a domestic corporation
- An obligation of United States persons
- Any right to use in the United States of: a patent or copyright; invention, model or design (whether patented or unpatented) secret formula or process; or similar right, acquired or developed for use in the United States. (Section 956(c)(1), IRC, 1986.)

The statute also contains a number of exceptions in Section 956(2). “These exceptions implement the Congressional intent to allow a controlled foreign corporation to acquire United States property as part of ‘ordinary commercial transactions’ that do not effect a repatriation of foreign earnings” (Skinner, 2011:3). The principal exceptions to United States property treatment under the Code and regulations are as follows:

- Certain bank deposits (Section 956(2)(A), IRC, 1986);
- “Export Property” – defined as tangible property located in the United States that is purchased for export to, or use in, a foreign country (Section 956(2)(B), IRC, 1986);
- Obligations of a United States person in connection with the sale or processing of property, or performance of services, in an amount that is ordinary and necessary for the business (Section 956(2)(C), IRC, 1986);
- Stock and obligations of unrelated domestic corporations (Section 956(2)(F), IRC, 1986);
- Obligations of unrelated United States partnerships, estates or trusts (Section 956(2)(L)(ii)(II), IRC, 1986); and
- Short-term loans within the 30-day/60-day safe harbor of Notice 88-108.

Once it has been determined that a controlled foreign corporation has made a Section 956 investment, the legislation is applied to determine the amount of the United States property investment and deemed dividend to the United States shareholder, the use of previously taxed income (PTI), and the foreign tax credit under Section 960, IRC, 1986. The recently enacted Section 960(c), applicable to

Section 956 investments made after 31 December 2010, has effected important changes to the foreign tax credit calculations in “hopscotch” situations (Skinner, 2011:3).

6.8 Other relevant regulations relating to United States CFC tax regulations

6.8.1 Exclusion from gross income of previously taxed earnings and profits

6.8.1.1 Exclusion from gross income of a United States person

Section 959(a) states that earnings of a controlled foreign corporation that would be subject to tax as earnings invested in United States property or as excess passive assets are not to be taxed a second time if they have previously been deemed distributed to a United States shareholder. When the foreign base company income section is read in collaboration with the United States property and passive asset rules, one realises that the United States shareholder could be subject to tax more than once on the same earnings. To avoid this situation, IRC provides that earnings and profits attributable to amounts which either in the taxable year or an earlier year have been included in income of the United States shareholder are not to be again included in income of the United States shareholder if the earnings of the controlled foreign corporation are invested in United States property. (Section 959(a)(2), IRC, 1986.)

6.8.1.2 Exclusion from gross earnings of certain foreign subsidiaries

A distribution by a lower-tier controlled foreign corporation to a higher-tier controlled foreign corporation will not be treated as gross income by the higher tier if the amount distributed represents earnings and profits previously taken into income by the United States shareholder (Section 959(b), IRC, 1986). Therefore, Section 959(b), in effect, provides that earnings and profits distributed through the corporate chain are not to be included in the parent corporation’s earnings, to the extent that the distribution is “attributable” to amounts which have previously been included in the United States shareholder’s income.

6.8.1.3 Allocation of distributions

Section 959(c) addresses the issue in which only a part of the controlled foreign corporation’s earnings and profits have been previously included in a United States shareholder’s income. For the purposes of applying the exclusionary clauses of Section 959, the earnings and profits of a controlled foreign corporation are accordingly divided into three separate categories. These categories are listed as follows: the first category relates to earnings and profits invested in United States assets (Section 959(c)(1), IRC, 1986); the second category relates to Subpart F income (Section 959(c)(2)); and the third category relates to all other earnings and profits (Section 959(c)(3)).

The fundamental rule to bear in mind with respect to actual distributions from a controlled foreign corporation is that so long as any of the above three categories have a positive balance (the balance can never be negative – only zero or positive), the actual distribution, to the extent of the positive balance, is not taken into income. The ordering rule for allocation of actual distributions is to have the controlled foreign corporation first exhaust its current year's earnings and then to deplete its prior year earnings to each of the above three categories or accounts in a particular order – namely: earnings invested in United States assets, then to Subpart F earnings and, finally, to all other earnings. (Section 959(c), IRC, 1986.)

6.8.2 Adjustments to the basis of stock in CFCs and of other property

6.8.2.1 Increase in basis

A United States shareholder's basis in its controlled foreign corporation stock (or certain other property) is generally increased by the amount which Section 951(a) requires the shareholder to include in income. Section 961(a) limits the basis increase to the amount of United States tax paid on the amounts required to be included in income under Section 951(a) (Section 1.961-1(a)(2), Code of Federal Regulations, 2011).

Specifically, the inclusion of an amount in gross income under Section 951(a) precipitates a corresponding increase in the shareholder's basis for stock in the controlled foreign corporation (Section 961(a), IRC, 1986). The exclusion of an amount from gross income under Section 959 generates an opposite effect, namely a reduction in basis (Section 961(b)(1), IRC, 1986). (If the reduction exceeds the adjusted basis of the stock, the excess is treated as gain from the sale or exchange of property (Section 961(b)(2), IRC, 1986)). The increase in basis takes effect as of the last day in the taxable year of the corporation on which it is a controlled corporation; the reduction in basis is effective as of the time the excluded amount is received (Section 1.961-1(a)(1), Code of Federal Regulations, 2011).

When a lower-tier controlled foreign corporation earns Subpart F income, and the stock in that corporation is later disposed of by an upper-tier controlled foreign corporation, the gain is treated as a dividend to the extent provided under Section 1248, as if the controlled foreign corporation were a United States person (Section 964(e)(1), IRC, 1986).

6.8.2.2 Reduction in basis

Section 961(b)(1) of the Code provides, in part, that the adjusted basis of stock with respect to which a United States shareholder receives an amount that is excluded from gross income under Section 959(a) shall be reduced by the amount so excluded. Therefore, Section 961(b)(1) applies to amounts excluded from gross income under Section 959(a)(1) (actual distributions) and not to amounts

excluded from gross income under Section 959(a)(2) (constructive distributions attributable to increases in earnings invested in United States property). Such a result is logical since under Section 961(a) there is an increase in the basis of a shareholder's stock in a controlled foreign corporation in the amount included in the shareholder's gross income under Section 951(a) but not distributed to the shareholder. Upon distribution of such amounts, Section 961(b) provides for a corresponding reduction in basis.

6.8.3 Special rules for foreign tax credit

6.8.3.1 Background and relationship of Section 902 and Section 960 IRC

Since the concept of Subpart F is to treat the United States shareholder as if the shareholder had received the various kinds of tainted income described under Section 951, IRC, 1986, it is appropriate that the United States shareholders receive such benefits as there would be in actual distribution. One of those benefits is the deemed-paid foreign tax credit available to corporate shareholders in certain circumstances. Section 960 IRC, passes that credit on to the United States corporate shareholder, which is required to add Subpart F or other constructive distributions to its gross income under Section 951. Section 960, IRC, is substantially similar in operation to Section 902, and reflects on how the rules of Section 902, IRC, 1986 shall be applied.

In essence, the rules of Section 902(a) provide that a domestic corporation is deemed to have paid a portion of a foreign corporation's foreign income taxes equal to the ratio of the dividends the domestic corporation receives to the post-1986 undistributed earnings of the foreign corporation. This rule applies only to foreign corporations in which the domestic corporation holds 10 per cent or more of the voting stock. Section 902(b) extends this rule to corporations in a group. The rules of Section 960 apply only to corporate shareholders and constructive distributions (Section 960(a)(1), IRC, 1986). To qualify, the corporate taxpayer must own no less than 10 per cent of the voting stock of the first-tier subsidiary and the first-tier subsidiary must be a member of the qualified group and own at least 10 per cent in voting power of another member of the qualified group (Section 960(a)(1) and Section 902(b)(2), IRC, 1986).

6.8.3.2 Taxes paid by foreign corporation

Deemed-paid credit: Under the provisions of Section 960, IRC, 1986 if a domestic corporation is required to take into income as a constructive dividend an amount attributable to earnings and profits of a first- or lower-tier foreign subsidiary pursuant to the provisions of Subpart F, the domestic corporation will be deemed to have paid a proportion of the foreign income taxes paid by the foreign subsidiary to the same extent as if a distribution had in fact been made. The method of calculating the amount of the tax as to post-1986 foreign income taxes is to be the same as if a dividend had in fact been declared so that all the provisions of Section 902 come into play. (Section 960(a)(1), IRC, 1986.)

Distributions of previously taxed income: The Code ensures that the taxpayer does not generate two foreign tax credits on a single item of income. The common situation to which this subsection is addressed arises when the controlled foreign corporation has issued a constructive dividend and the United States shareholder has claimed a foreign tax credit as described in the previous paragraph. That dividend declaration had created a previously taxed income account for the United States shareholder allowing the shareholder to take a later actual distribution without the incurrence of any taxation. As a concomitant to the tax-free nature of the actual distribution of previously taxed income, the taxpayer is not allowed to claim a foreign tax credit on the distribution since the credit should have been claimed on the constructive dividend. (Section 960(a)(2), IRC, 1986.)

6.8.3.3 Rules regarding tax credit limitation and deemed-paid credit in separate category

General limitation rules: Basically, the limitation rules provide that the United States taxpayer cannot claim a tax credit in excess of the ratio of foreign-source taxable income to total taxable income.

The following example illustrates the above situation with regard to the limitation applicable in respect of the United States tax claimable for foreign-earned income:

Example 6-1

In 2009, Hurst Corp earned a total of \$100 000, including \$60 000 from Brazil on which \$30 000 in tax was paid, and on which the United States corporate tax was \$34 000. The amount of the maximum tax credit is calculated by the formula: United States Tax $\times$ (Total income from Brazil/Total taxable income).

Solution: $\$34\,000 \times (\$60\,000 / \$100\,000) = \$20\,400$. (Rhoades & Langer, 2011:Section 960(a))

Separate basket rule: Under the limitation rules, the taxpayer is required to create two separate accounting baskets: the passive income basket and the general limitation basket (each of which has its own limitation). Section 904(d)(2)(A) defines the term “passive category income” as passive income and specified passive category income, and defines the term “general category income” as income other than passive category income (Section 904(d)(2)(A), IRC, 1986). Section 904(d)(2)(B) defines the term “passive income” as any income received or accrued by any person which is of a kind which would be foreign personal holding company income (as defined in Section 954(c), IRC) and the term “specified passive income” as: (1) dividends from a Domestic International Sales Corporations (DISC) or former DISC to the extent such dividends are treated as income from sources without the United States and (2) distributions from a former Foreign sales Corporation (FSC) out of earnings and profits attributable to foreign trade income or interest or carrying charges derived from a transaction which results in foreign trade income (Section 904(d)(2)(B), IRC, 1986).

Income received by a United States shareholder from a controlled foreign corporation on account of its stock (i.e., as a deemed dividend) does not fall into a separate basket. The reason is that Section 904 contains look-through rules. Briefly, these rules provide that the character of income in the hands of the controlled foreign corporation carries over when the income is deemed distributed to the United States shareholder (Section 904(d)(3), IRC, 1986). The look-through rules discussed at this point only apply to constructive dividends reflecting the receipt of Subpart F income. The rules do not apply to constructive dividends taken into income as the result of investment of earnings in United States property. That type of constructive distribution is treated as an actual dividend. (Section 1.904-5(c)(4)(i), Code of Federal Regulations, 2011.)

Actual dividends are dispersed among the various baskets described in the foreign tax credit context in the same ratio that the earnings and profits attributable to the dividend were earned in each category (or basket) by the controlled foreign corporation (Section 1.904-5(c)(4)(i), Code of Federal Regulations, 2011). The following example illustrates the above situation:

Example 6-2

Rocco SA is a CFC owned entirely by Crico, a domestic corporation. Rocco's earnings and profits are \$200 000, generated from non-Subpart F general operations (\$120 000) and passive income (\$80 000). Rocco pays the \$40 000 dividend to Crico, of that amount 60% (\$24 000) falls into the general limitation basket and 40% (\$16 000) falls into the passive income basket (Rhoades & Langer, 2011:Section 960(a)).

Under the constructive dividend rules, the United States shareholder is allowed to receive a distribution tax-free of earnings previously taxed. Therefore, \$16 000 is attributable to the passive income basket and will be exempt under the constructive dividend rule as a tax-free distribution of earnings previously taxed (Section 960(a), IRC, 1986).

A separate foreign tax credit basket for foreign intangible income (sec. 212 of the bill and sec. 904 of the Code) has been enacted in the recent United States Job Creation and International Tax Reform Act of 2012. The provision creates a new income category (basket) in the computation of the foreign tax credit limitation under Section 904, IRC, 1986. The new limitation category for foreign intangible income is defined in the new Code Section 250(c), IRC, 1986 (Section 103 of the bill). The provision retains the existing separate limitation category for passive and active income in respect of income that does not fall within in the new category of foreign intangible income.

6.8.4 Election by individuals to be subject to tax at corporate rates

Section 962, IRC 1986 offers each individual who is a United States shareholder the election to be taxed on Section 951 IRC income as a domestic corporation is taxed. An individual United States shareholder may therefore elect to be taxed at corporate rates on amounts he includes in gross income under Section 951(a), IRC. In such case, tax is imposed under Chapter 1 of the Revenue Code on all amounts which are included in gross income for such taxable year under Section 951(a), being an amount equal to the tax which would be imposed under Section 11 if such amounts were received by a domestic corporation (Section 1.962-1(b)(1), Code of Federal Regulations, 2011). In addition, for purposes of applying Section 960(a)(1) (relating to foreign tax credit), such amounts shall be treated as if received by a domestic corporation (Section 1.962-1(b)(2), Code of Federal Regulations, 2011).

6.8.5 Gain from certain sales or exchanges of stock in certain foreign corporations

6.8.5.1 Introduction

While Subpart F sharply curtails the ability of United States taxpayers to defer or avoid United States taxation on certain types of income earned by controlled foreign corporations, non-Subpart F income (especially foreign active business income) earned by a controlled foreign corporation retains the deferral privilege. In the absence of a remedial provision, a United States shareholder could avoid ordinary income treatment that would occur on a distribution by selling the stock of the controlled foreign corporation thereby in some cases producing a tax favoured capital gain on the stock's appreciation arising from the corporation's income. "If the stock were sold to foreign shareholders, there would be no further United States tax to the shareholders upon any subsequent non-liquidating or liquidating distribution". (Doernberg, 2004:381.)

To ensure that the non-Subpart F income of a controlled foreign corporation is taxed at ordinary income tax rates whenever a United States shareholder cashes in on the appreciation, Section 1248 requires that the gain on a disposition of stock in a controlled foreign corporation that would otherwise be treated as capital gain be reported as ordinary income to the extent of the controlled foreign corporation's earnings and profits, other than those previously included in the United States taxpayer's income under Subpart F (Section 1248(d)(1), IRC, 1986). (Doernberg, 2004:381.)

6.8.5.2 General rule and limitation on tax applicable to individuals

Under Section 1248(a), any gain realised by a shareholder on the sale or exchange of the stock owned (directly, indirectly, or constructively under the rules contained in Section 958, IRC) of 10 per cent or more of the total combined voting power of a foreign corporation at any time during the 5-year period ending on the date of disposition, where the corporation was a controlled foreign corporation at some time during the period of the shareholder's 10 per cent ownership, is treated as a dividend "to the extent of the earnings and profits of the foreign corporation attributable ... to the stock which were

accumulated in taxable years ... beginning after 31 December 1962, and during the period or periods the stock sold or exchanged was held by the shareholder while such foreign corporation was a [controlled foreign corporation]” (Section 1.1248-1(c), Code of Federal Regulations, 2011). The taxpayer has the burden of establishing the amount of earnings and profits to be taken into account; otherwise the entire gain will be treated as a dividend (Section 1248(h), IRC, 1986). If the shareholder is a corporation, the dividend nature of the income may entitle the corporation to a credit for the foreign taxes paid by the foreign corporation on the earnings and profits producing the “dividend” (the deemed-paid credit of Section 902, IRC). (Section 1.1248-1(d)(1), Code of Federal Regulations, 2011.)

6.8.5.3 Sales or exchanges of stock in certain domestic corporations

This subsection curtails the avoidance of Section 1248(a) through the use of domestic holding companies. Under Section 1248(e), the sale or exchange of stock in a domestic corporation “formed or availed of principally for the holding, directly or indirectly, of stock of one or more foreign corporations”, is treated as a sale or exchange of the stock of the foreign corporation held by the domestic corporation. (Section 1248(e), 1248(a)(2), IRC, 1986.)

A gain that results from a sale or exchange covered by Section 1248(a) is to be included in the gross income of the United States person as a dividend under Section 1248(a) to the extent of the untaxed earnings and profits attributable under Regulations Section 1.1248-2 or Regulations Section 1.1248-3, whichever is applicable.

6.8.6 Taxation of passive foreign investment company

6.8.6.1 Introduction

Currently there are two major United States anti-deferral regimes in operation: controlled foreign corporation/Subpart F rules and the passive foreign investment company (PFIC) rules. Congress promulgated the PFIC rules in 1986, thus “further expanding the reach of United States tax laws to include current foreign income” (Darby & Sharma, 2008:2). The goal of the PFIC regime is to immediately tax all foreign-sourced passive income of United States taxpayers, regardless of the percentage of stock ownership in the foreign corporation. This regime more comprehensively taxes foreign passive income by eliminating the ownership regulations that at times made the FPHC and Subpart F rules easy to evade. (2008:2.)

In 1997, Congress eliminated the overlap between PFICs and controlled foreign corporations by enacting Section 951(c), which states that if a foreign corporation is both a PFIC and a controlled foreign corporation, the controlled foreign corporation rules will have control with respect to the United States shareholders (note that an entity which qualifies as a controlled foreign corporation with

respect to certain United States shareholders can still be a PFIC for the other United States persons who are not “United States shareholders”) (Section 951(c), IRC, 1986). Then, as part of the 2004 Jobs Creation Act, Congress decided to repeal in its entirety the FPHC provisions, thus leaving the controlled foreign corporation and PFIC regulations as the two major United States anti-deferral regimes in the statutory books. Simultaneously, with the repeal of FPHC provisions, a new FPHCI category was born in Section 954(c)(1).

6.8.6.2 Definition of a PFIC

A foreign corporation is treated as a PFIC for a tax year if 75 per cent or more of the corporation’s gross income for the taxable year is passive or investment-type income (“the PFIC Income Test”), or at least 50 per cent of the average percentage of its assets held during the year are assets that produce or are held for the production of passive income (“the PFIC asset test”) (Section 1297(a), IRC, 1986). The PFIC income test is determined by taking into consideration all gross income of the tested foreign corporation for its taxable year. The PFIC asset test is determined by taking into account the average quarterly value of the assets of the tested foreign corporation, as measured on the last date of each quarter of the corporation’s taxable year. The PFIC rules, however, alternatively require or permit a tested foreign corporation to utilise the adjusted basis of its assets rather than their fair market value for purposes of the PFIC asset test. (Section 1297(e), IRC, 1986.)

For purposes of determining whether an entity meets either one of the PFIC tests, three “look-through” rules are provided: the “related person look-through rule” (Section 1297(b)(2)(C), IRC, 1986); the “general look-through rule” (Section 1297(c)); and the “domestic look-through rule” (Section 1298(b)(8)) (Lee & Smiley, 2011). There are three statutory exceptions to the definition of a PFIC: the start-up exception (Section 1298(b)(2)); the change of business exception (Section 1298(b)(3)); and the CFC/PFIC overlap exception (Section 1297(d)). The start-up exception (Section 1298(b)(2)) applies only to the first taxable year in which a foreign corporation has gross income. Under the change of business exception (Section 1298(b)(3)), a corporation will not be treated as a PFIC for any taxable year if neither such corporation nor any predecessor was a PFIC for any prior taxable year; and if it is established to the satisfaction of the Secretary that substantially all of the passive income of the corporation for the taxable year is attributable to proceeds from the disposition of one or more active trades or businesses; that such corporation will not be a PFIC for either of the first two taxable years following such taxable year; and that such corporation is not a PFIC for either of such two taxable years. Under the CFC/PFIC overlap exception (Section 1297(d)), a controlled foreign corporation will not be treated as a PFIC with respect to at least a 10 per cent voting United States shareholder during the qualified portion of such shareholder’s holding period with respect to the stock in such corporation. “Another consequence of this rule is that a foreign corporation may be a PFIC with respect to some shareholders and not to others”. (Osacal & Tello, 2009:3.)

There is no United States shareholder control requirement under the PFIC regime; if a United States person holds even a *de minimis* amount of PFIC shares, it potentially will be subject to tax under the PFIC rules. In addition, while the test for determining PFIC status is based upon the income or assets in a given tax year, once a shareholder's investment in a foreign corporation has been characterised as a PFIC, it generally will be treated as a PFIC with respect to that shareholder in future years. This is known as a "PFIC taint" or the "once a PFIC, always a PFIC" rule (Lee & Smiley, 2011). Generally, where a foreign corporation qualifies both as a controlled foreign corporation and PFIC with respect to the same United States shareholder after 1997, such foreign corporation is treated solely as a controlled foreign corporation and subject to tax under the Subpart F income rules (Section 951(c), IRC, 1986).

6.8.6.3 PFIC ownership rules

The PFIC rules are applicable to United States shareholders who directly or indirectly own shares of a PFIC. Indirect ownership rules apply when, for example, a foreign trust owns the shares. Shares in a PFIC owned by a trust will be considered as owned proportionally by the beneficiaries of the trust (Section 1.1291-1(b)(8)(iii)(C), Proposed Regulations). PFIC shares directly owned by foreign entities are further attributed to United States persons who beneficially own the stock (Section 1298(a), IRC, 1986). They apply only when their effect is to treat a United States person as the owner of PFIC stock (Section 1298(a)(1)(A), IRC, 1986). The attribution rules do not, however, treat stock owned by a United States person as owned by another person, except as provided in regulations (Section 1298(a)(1)(B), IRC, 1986). If a single person owns, directly or indirectly, 50 per cent or more in value of the stock of a corporation, such person is treated as owning the stock owned directly or indirectly by or for the corporation, in proportion to the value of the stock owned in such corporation (Section 1298(a)(2), IRC, 1986). On the other hand, if a person is a minority interest holder in a foreign corporation, the stock owned by the foreign corporation is not treated as owned by the person unless the intervening corporation is itself a PFIC. In that case, the person is treated as owning his or her proportionate share of the stock held by the intervening PFIC (Section 1298(1)(2)(B), IRC, 1986).

6.8.6.4 United States federal taxation of PFIC ownership

A foreign company meeting the requirements of the PFIC income or asset test will be considered a PFIC with respect to each United States shareholder in the company. The PFIC regime is essentially a penalty provision. No favourable outcomes or planning opportunities arise once a shareholder falls within these rules.

6.8.7 Reporting requirements

In terms of Section 6038 and 6046, IRC, 1986, United States shareholders who own 10 per cent or more of the total combined voting power of all classes of voting stock of a controlled foreign

corporation must complete a copy of Form 5471 entitled “Information Return of United States persons with Respect to Certain Controlled Foreign Corporations” when submitting their tax returns. Form 5471 requires the completion and submission of the following pertinent information:

- Ownership information;
- Stock transaction;
- Shareholder and company transactions;
- Foreign tax details;
- Foreign bank and financial account information;
- Details of accumulated earnings and profits; and
- Currency conversion information.

Form 5471 is designed to report the activities of the foreign corporation and to function as a roadmap for the IRS on transfer pricing (Jacobs & Pasmanik, 2009:115). The preparer needs to secure information from the United States holding company in respect of all United States shareholders pertaining to the following; details of any stock transactions, dividends, or other capital transactions. Transaction details are also required for any transactions between any shareholders of the foreign corporation and any related entity or person of the foreign corporation. An extensive list is provided in Schedule M and includes intercompany sales or purchases, compensation, rents, license, license fees, royalties, dividends, loans, and interest.

6.9 United States Job Creation and International Tax Reform Act of 2012

On 9 February 2012 Senator Michael Enzi introduced the United States Job Creation and International Tax Reform Act of 2012. According to Enzi the bill “would incentivize American companies to create jobs in the United States, while at the same time leveling the playing field for United States companies in the global marketplace ... so that United States-based companies are competitive with their foreign counterparts” (United States, 2012b:1). This chapter section will therefore discuss certain of the significant proposals in relation to the Subpart F legislation.

6.9.1 Title 1 – Participation exemption system for taxation of foreign income

6.9.1.1 Deduction for dividends received by domestic corporations from certain foreign corporations (Section 101 of the bill and new Section 245A of the Code)

The United States Job Creation and International Tax Reform Act of 2012 (United States, 2012a) established a participation exemption system for foreign business income. This exemption system is effected by means of a 95 per cent deduction for the qualified foreign-source portion of dividends a domestic corporation receives from controlled foreign corporations of which they are United States shareholders. The deduction is available only if a one-year holding period requirement is fulfilled and

is unavailable for hybrid dividends (United States, 2012b:16). A “hybrid dividend” is a payment that is treated as a dividend for purposes of the Code but for which the controlled foreign corporation making the payment receives a deduction (or similar tax benefit) under the laws of the country in which the controlled foreign corporation was organised (United States, 2012b:18). Similarly to the exemption systems of certain other countries, 5 per cent of a dividend from a controlled foreign corporation remains taxable. The taxation is intended to be a substitute for the disallowance of deductions for expenses incurred to generate exempt foreign income. The bill retains Subpart F of the Code with modifications (to be discussed later). Consequently, although the foreign-source portion of a dividend generally is 95 per cent deductible when received by a United States shareholder from a controlled foreign corporation, the United States shareholder remains taxable in the United States on a current basis on its pro rata share of certain items of the controlled foreign corporation’s income. (United States, 2012b:16.) (see 6.6.4.1 above).

6.9.1.2 Application of dividends-received deduction to certain sales and exchanges of stock
(Section 102 of the Bill and Section 964 and 1248 of the Code)

The provision amends Section 1248 so that when a domestic corporation recognises a gain on the sale or exchange of stock of a foreign corporation held for at least one year; any amount treated as a dividend under Section 1248 is also treated as a dividend for purposes of applying the 95 per cent dividends-received deduction rules (see above). No deduction is allowed for any loss recognised by a domestic corporation from the sale or exchange of stock of a foreign corporation if (under Section 1248(a)(2)) the domestic corporation owned at least 10 per cent of the voting power of the foreign corporation at any time during the 5 years preceding the sale when the foreign corporation was a controlled foreign corporation. (United States, 2012b:20.)

The provision adds a new rule to Section 964(e) providing that when an upper-tier controlled foreign corporation sells or exchanges stock of a lower-tier controlled foreign corporation held for one year or more, and has a gain from the sale that is treated as a dividend under Section 964(e)(1), the qualified foreign-source portion of the deemed dividend is treated as Subpart F income of the upper-tier controlled foreign corporation; any 10 per cent United States shareholder of that upper-tier controlled foreign corporation must include in gross income its pro rata share (under Section 951(a)(2)) of that Subpart F income; and the 95 per cent dividends-received deduction is allowed to that 10 per cent United States shareholder for the Subpart F inclusion in the same manner as if that Subpart F inclusion were a dividend received from the upper-tier controlled foreign corporation. No foreign tax credit is allowed with respect to this Subpart F inclusion. (United States, 2012b:20-21.) (see 6.8.5.3 above).

6.9.1.3 Treatment of deferred foreign income upon transition to participation exemption system of taxation (Section 104 of the Bill and Section 965 of the Code)

A corporate 10 per cent United States shareholder may elect a one-time 70 per cent deduction for eligible amounts received from a controlled foreign corporation from pre-2013 earnings. The eligible amounts include both cash repatriated in the form of dividends and amounts that a taxpayer elects to treat as Subpart F income (“deemed repatriation”). The deduction is available only for the taxable year of the United States shareholder with or within which the first taxable year of the controlled foreign corporation beginning after 31 December 2012 ends. As a result of claiming the deduction, the taxpayer is not entitled to any credit or deduction for foreign taxes paid that would otherwise be available with respect to any portion of the dividends or deemed repatriations. In the absence of an election, foreign taxes paid with respect to pre-2013 earnings are creditable or deductible when the earnings are distributed, subject to relevant limitations. (United States, 2012b:22-23.)

6.9.2 Title II – Other international tax reforms (Modification of Subpart F and Foreign tax credit)

6.9.2.1 Treatment of low-taxed foreign income as Subpart F income (Section 201 of the Bill and Section 952 of the Code)

The bill introduced a new category of Subpart F income for low-taxed income. All gross income of a controlled foreign corporation is low-taxed income unless the 10 per cent United States shareholder establishes that the income was subject to foreign tax at an effective rate that exceeds one-half of the maximum rate of income tax applicable to United States corporations for the relevant taxable period. Under the current consideration, the effective tax rate is determined under United States principles similar in line to those used for the determination of the high-tax exception of Section 954(b)(4). Deductions properly allocable to the income in such country are taken into consideration in the determination of the amount of income. Income that was not subject to an effective rate of at least 17.5 per cent (one-half of the current maximum United States corporate rate of 35 per cent) may be excluded if it is qualified business income as described in the statute, other than intangible income within the meaning of new Section 250(c). (United States, 2012b:26-27.) (See 6.4.1 above).

6.9.2.2 Foreign base company income not to include sales or services income (Section, 204 of the Bill and Section 954 of the Code)

The provision narrows the anti-deferral rules in Subpart F by removing certain foreign sales and services income from the categories of foreign base company income that are includable in the income of United States shareholders as Subpart F income irrespective of whether the income has been distributed as a dividend. The remaining category of income from business operations included in foreign base company income for certain oil-related income is not modified. As a result, in combination with the other provisions (permanent extension of the look-thru provision and active financing income exception in Sections 202 and 203 respectively, and the active business exception

(other than for intangible income) in the new category of Subpart F income added by Section 201), Subpart F income is generally limited to passive income and low-taxed intangible income. (United States, 2012b:29.) (see 6.6.4.1, 6.6.4.2 and 6.9.2.1 above).

6.9.2.3 Modification of application of Section 902 and 960 with respect to post-2012 earnings (Section 211 of the bill and Section 902 and 960 of the Code)

The provision repeals the Section 902 deemed-paid credit for any dividend or portion of any dividend paid by a foreign corporation to the extent paid out of the corporation's post-2012 earnings and profits (computed in accordance with Sections 964(a) and 986). This rule disallows a deemed-paid credit in respect of dividends from foreign corporations regardless of whether the 95 per cent dividends-received deduction is available. (United States, 2012b:30.)

The Section 902 deemed-paid credit remains available in respect of dividends paid out of earnings and profits accumulated in taxable years beginning before 2013. Any distribution in a taxable year beginning in 2013 or later is treated as made first out of earnings and profits accumulated in taxable years beginning before 2013. Consequently, the provision allows the Section 902 deemed-paid credit to remain in effect for dividends received from a foreign corporation until the corporation's pre-2013 earnings and profits have been exhausted. In computing the amount of foreign income tax that a domestic corporation is deemed to have paid under Section 902 in respect of dividends attributable to a foreign corporation's pre-2013 earnings, the term "post-1986 earnings" does not include the corporation's post-2012 earnings and profits. (United States, 2012b:30.)

The provision amends the deemed-paid credit rules applicable to Subpart F inclusions. If a domestic corporation has Subpart F income with respect to any controlled foreign corporation in which the domestic corporation is a 10 per cent United States shareholder, and the Subpart F income is attributable to earnings and profits of the controlled foreign corporation (computed in accordance with Sections 964(a) and 986) accumulated in taxable years beginning after 31 December 2012, the domestic corporation is deemed to have paid the portion of the controlled foreign corporation's foreign income tax that is properly attributable to the Subpart F income. It is contemplated that the Treasury Secretary will prescribe regulations for determining the extent to which foreign income taxes paid or accrued by a controlled foreign corporation are considered properly attributable to Subpart F income of a 10 per cent shareholder of the controlled foreign corporation. (United States, 2012b:30.) (See 6.8.3 above).

6.10 Comparison of South African and United States CFC legislation

The salient points of comparison between South African and United States CFC regulations are as follows: policy objectives; the approach to a country's CFC regulations; definition of a CFC; foreign entities in domestic law; corporate residence; control; attribution – minimum percentage requirement;

exemptions; year of assessment used for translating CFC profits; capital gains and the subsequent sale of CFC shares; and relief provisions for double taxation (as discussed in the related chapters above). Where shortcomings emerge in the South African CFC regulations, appropriate remedial measures will be recommended in the concluding chapter of the thesis.

Other key issues that influence CFC regulations are:

- efficiency and optimization of domestic tax collections
- whether the country is a net exporter or importer of capital
- impact of the “capital export neutrality” principle as a form of tax equity on CFC regulations and domestic tax investors
- international relevance and competitiveness of a country’s CFC legislation
- ability of a country’s CFC regulation to act as a form of deterrence to the avoidance and deferral of taxation on foreign-sourced income
- curtailing the siphoning off of a country’s revenue to tax havens and preferential tax regimes

An overview of key elements in the respective sets of CFC regulations in the two countries is presented in Table 6-1.

Table 6-1 S African / United States CFC legislation compared

TOPIC	SOUTH AFRICA	UNITED STATES	INCOME TAX ACTS
Year of CFC rules	1987	1962	
Policy objectives	- To prevent the diversion of income i.r.o. related-party or base company transactions to CFCs - To prevent the diversion of passive income in tax havens - To prevent the accumulation of the above incomes in CFCs based primarily in tax havens - Not to interfere with legitimate foreign business activities of SA residents	- To prevent the diversion of passive and base company income to CFCs (in conjunction with foreign personal holding company rules) - To prevent the accumulation of passive income in CFCs in tax havens in excess of reasonable business needs - Not to interfere with legitimate foreign business of United States taxpayers	
Designated jurisdiction or global approach	Global and designated jurisdiction approaches	Global approach	
Definition of tax haven or low-taxed income	- Foreign tax less than 75% of SA tax (Sect. 9D(2A)) (see 3.4.2) - Comparison between actual foreign tax paid and notional SA tax on same income (Sect. 9D(2A)) (see 3.3.42) - Related-party transaction is exempt if tax more than 50% of SA Tax (Sect. 9D(9A)(i)(aa)(bb) (see 3.4.4)	Designated jurisdictional approach – low-taxed foreign income Subpart F (see 6.4.1 and 6.9.2.1)	United States Job Creation Act 2012 (Sect. 201 of the bill) Sect. 952 of the Code
Definition of a controlled foreign corporation	- SA resident holds more than 50% of participation rights or holds more than 50% of voting rights (includes directly or indirectly) in CFC (Sect. 9D(1)) - No minimum ownership (see 3.2.1.2)	- More than 50% by votes or value, of stock owned by “United States shareholders” (lower limits for insurance CFCs) at any time in the year for 30 days - Indirect and constructive ownership rules 10% minimum voting requirement - Anti-avoidance rule for stapled stock	Sect. 957(a), IRC, 1986 Sect. 957(b), IRC, 1986 Sect. 958(b), IRC, 1986 Sect. 951(b), IRC, 1986
		(see 6.4.2.2)	

TOPIC	SOUTH AFRICA	UNITED STATES	INCOME TAX ACTS
Transactional or entity approach	Entity approach	Transactional or income approach	
Definition of tainted income	- All income inclusive of capital gains - Computed in accordance with SA tax rules - Computed for each CFC separately (Sect. 9D(2A)) (see 3.3.3)	- Passive income, broadly defined, but excluding rents and royalties from active business and dividends and interest from related company in same country of CFC (see 6.4.1) - Base company income, broadly defined (see 6.6.1) - Special rules for investment by CFC in United States property (see 6.7.1) - Exemption for certain high-taxed income (see 6.6.2.3) - De maximis rule: if more than 70% of CFC gross income is base company income and insurance income, all net income of CFC is deemed to be tainted (see 6.6.2.2) - Computed in accordance with United States tax rules - Computed for each CFC separately - Special rules for allocating interest expense against tainted income	- Sect. 954(c), IRC, 1986 - Sect. 954(c)(2)(A), IRC, 1986 - Sect. 954(c)(3)(A), IRC, 1986 - Sect. 954(d) and (e), IRC, 1986 - Sect. 956(a), IRC, 1986 - Sect. 954(b)(4), IRC, 1986 - Sect. 954(b)(3)(B), IRC, 1986 - Sect. 1.861-8, Code of Federal Regulations
Domestic taxpayers to whom income of a CFC is attributed	- Any resident to which 10% or more of the CFC's income is attributed (Sect. 9D(A)) (see 3.3.4) - Constructive ownership rules (Sect. 9D(2)(A)) - Ownership at any time of the year (inclusive of disposals and year end stock holdings) (Sect. 9D2) (see 3.3.2)	- Any United States taxpayer with at least 10% voting power of CFC, directly or indirectly, at any time in the year and who owns shares, directly or indirectly, in the CFC at the end of the year (see 6.4.2) - Indirect and constructive ownership rules (see 6.4.2) - Treated as dividend for purposes of foreign tax credit	- Sect. 951(a)(b), IRC, 1986 - Sect. 958(a) and (b), IRC, 1986 - Sect. 318(a), IRC, 1986 - Sect. 960(a)(1), IRC, 1986
Types of tainted income	All-or-nothing income – entity approach (Sect. 9D(2A))	Subpart F: - income from insurance of United States risks (see 6.5) - foreign base company income (see 6.6) - passive income, broadly defined (see 6.6.4) - sales and service income from related-party transactions outside tax haven (see 6.6.5 and 6.6.6) - foreign income from extraction or sale of oil and gas (see 6.6.7)	- Sect. 953, IRC, 1986 - Sect. 954(a) and (b), IRC, 1986 - Sect. 954(c), IRC, 1986 - Sect. 954(d) and (e), IRC, 1986 - Sect. 954(g), IRC, 1986

TOPIC	SOUTH AFRICA	UNITED STATES	INCOME TAX ACTS
		low-taxed income (see 6.9.2.1)	Sect. 952, IRC, 1986 United States Job Creation Act of 2012 (Sect. 201 of Bill)
		Certain non-tainted income:	
		Investment by CFC in United States property (see 6.7)	Sect. 956(a), IRC, 1986
		De maximis rule: if more than 70% of CFC's gross income is foreign base company income and insurance income, all that income is tainted (see 6.5.6)	Sect. 954(b)(3)(B), IRC, 1986
		Items of income described in 4(a) and 4(b) above are not attributed if subject to an effective rate of foreign tax of > than 90% of maximum rate of United States tax rate – Sect. 11, IRC (see 6.6.2.3)	Sect. 954(b)(4), IRC, 1986
Exemptions			
	1) <i>De minimis</i> rule	Provides that Subpart F inclusion amount is zero if the sum of FBCI and Insurance income is less than the lesser of 5% of total gross income or \$1 million (see 6.6.2.1)	Sect. 954(b)(3)(A), IRC, 1986
	2) Full inclusion test	If the sum of the gross FBCI and gross insurance income exceeds 70% of the gross income, then all the gross income of CFC is treated as FBCI or insurance income (see 6.6.2.2)	Sect. 954(b)(3)(B), IRC, 1986
	3) The high-tax exclusion	Income does not include FBCI or insurance income that is subject to foreign taxes imposed at an effective tax rate of at least 90% of the highest United States corporate tax rate (see 6.5.6)	Sect. 954(b)(4), IRC, 1986
		(currently 35%)	Sect. 11(a), IRC, 1986
	4) Active business income – Rents and royalties	Exception applies to unrelated parties involved in the conduct of active business – rents and royalties (see 6.6.4)	Sect. 954(c)(2)(A), IRC, 1986
	5) United States source income – effectively connected in the United States	Excludes United States source income effectively connected with the conduct of business in the United States (see 6.6.2.4)	Sect. 952(b), IRC, 1986

TOPIC	SOUTH AFRICA	UNITED STATES	INCOME TAX ACTS
6) Related-party exception – Same country exception		- Includes dividends and interest from related party which: - is a corporation organised or created in the same country as CFC; - has a substantial part of its asset used in business located in the same foreign country (see 6.6.4) - Dividend exemption applies only to the period which stock is owned by recipient (see 6.6.4) - Rents and royalties received from a corporation which is a related person for use in the same Country in which CFC is created (see 6.6.4) - The above exemption (excluding dividends) does not apply if it reduces Subpart F income of Payer (see 6.6.4)	Sect. 954(c)(3)(A)(i), IRC, 1986 Sect. 954(c)(3)(C), IRC, 1986 Sect. 954(c)(3)(A)(ii), IRC, 1986 Sect. 954(c)(3)(B), 1986
7) Any country exception (TIPRA)		“Look through rule” to the related CFCs activities, to determine if applicable income is active and non-Subpart F income (see 6.6.4)	Sect. 954(c)(6), IRC, 1986 United States Job Creation Act of 2012 (see 6.6.4)
8) Active conduct – banking and financing businesses		Does not include “qualified banking or financing income” of eligible CFC (see 6.6.4)	Sect. 954(h)(1)3(A), IRC, 1986 United States Job Creation Act of 2012 (see 6.6.4)
9) Qualified insurance income		Qualified insurance income earned by qualifying insurance company – exempt from FPHC income (see 6.5.5.1)	Sect. 954(i)(1)2(A) and 2(B), IRC, 1986
10) Foreign business establishment (FBE SA)	- Requirement for FBE - Locational permanence - Economic substance - Business purpose (S9D(1)) (see 3.4.4.1) - Additional requirements for FBE: - Similar requirement for business profits of permanent establishment in OECD and UN MTC - A similar arm’s length requirement as in Sect. 31 of Act 58. of 1962 (see 3.4.4.2) - Tax exemptions – FBE: - Capital gains - Related party – disposal of goods by CFC – jurisdictional approach – SA tax > 50%		Sect. 9D(1) Sect. 9D(9)(b)(i) Article 7(2), OECD and UN MTC Sect. 9D(9)(b)(ii) Sect. 9D(9)(b) Sect. 9D(9A)(a)(i)

TOPIC	SOUTH AFRICA	UNITED STATES	INCOME TAX ACTS
	Related party – services performed by CFC		Sect. 9D(9A)(a)(ii)
	Principal trading activities – bank and financial service – insurer		Sect. 9D(9A)(a)(iii)
	Rentals – movables		Sect. 9D(9A)(iv)
	for operating leases or financial instruments		
	CFC income – Intellectual property (IP) regularly creates or upgrades IP		Sect. 9D(9A)(a)(v)
	CFC capital gains – Intellectual property regularly creates or upgrades IP		Sect. 9D(9A)(a)(vi)
	Insurance premium – principal trade activities of insurer		Sect. 9D(9A)(a)(vii)
	(see 3.4.4.3)		
11) Other exemptions	- The 75% tax exemption – where total tax payable by CFC is at least 75% of SA tax (see 3.4.2) - Net income of CFC forms part of taxable income of SA company (see 3.4.7) - Foreign dividend received by CFC from any other CFC (with the same SA residents) (see 3.4.8.1)		Sect. 9D(2A)(i)
			Sect. 9D(9)(e)
			Sect. 9D(9)(f)
12) Capital gains	- Foreign business establishment is exempt from capital gains tax (see 3.4.4) - Capital gains – asset disposed by FBE of another CFC – part of same group of CFCs (see 3.4.8.3) - Other resident shareholder of CFCs are subject to capital gains tax 33.3% of net capital gain is subject to tax i.r.o. natural persons and special trusts and insurers at 25% as resident shareholders 66.6% of net capital gain is subject to tax i.r.o. companies as resident shareholders (see 3.3.4.5)		Sect. 9D(9)(b)
			Sect. 9D(9)(fB)
			Sect. 26A, Schedule 8, ICTA, 1988
			Sect. 9D(2A)(e)(f) (Schedule 8, part 2, para 10)
			Schedule 8, part 2, para 10
13) Buttredding legislation to CFC regimen	Not available	PFIC rules (see 6.8.6)	Sect. 1297, IRC, 1986

TOPIC	SOUTH AFRICA	UNITED STATES	INCOME TAX ACTS
Relief provisions			
1) Foreign taxes	- Credit allowed against SA tax for foreign taxes paid (S 6quat(1)) (see 3.5.3) - Determination of rebate (S 6quat(1A)) (see 3.5.4) - Limit on rebate (S 6quat(1B)) (see 3.5.5) - Deduction of unqualifying rebate against SA income (S 6quat(1C)) - Rebate cannot exceed SA tax liability on foreign income (S 6quat(1D)) (see 3.5.6)	- for United States corporations (or individuals electing to be taxed as corporation), indirect foreign tax credit allowable in respect of foreign taxes paid by first -, second-, and third-tier subsidiaries; if credit allowed, attributed income must be grossed up by creditable foreign taxes (see 6.8.4) - for persons taxed as individuals, no credit allowable, but amount of foreign taxes is not included in income (see 6.8.4)	Sect. 960(a)(1) and (2), IRC, 1986 Sect. 962, IRC, 1986
2) Losses	trading losses carried forward indefinitely (S20; Sect. 9D(2A)(b)) (see 3.3.4.1)	- CFCs current losses (and, to very limited extent, deficits in accumulated profits) reduce its earnings and profits; losses carried forward indefinitely. A foreign loss within a separate basket must offset foreign-source income in other baskets prior to reducing United States source income. Losses are subsequently recaptured by treating later income as a particular category of Subpart F income. (see 6.8.3.3) - New income category basket – intangible income – Sect. 904 (see 6.8.3.3)	Sect. 904(f)(5)(A) and (B), IRC, 1986 United States Job Creation Act of 2012 (Sect. 212 of the Bill) Sect. 904 of the Code (IRC)
3) Subsequent dividends	When CFC income is distributed in the form of dividends – exempted under S10B(2)(but subject to Sect. 10B(4) (see 3.3.6)	Not taxable to extent of previously taxed CFC income (see 6.8.1.1)	Sect. 959(a), IRC, 1986
4) Subsequent capital gains (on sale of shares of CFC)	- Sale of interest in a CFC - Exempt in terms of paragraph 64B(2), Eighth Schedule, if certain requirements are fulfilled - Anti-avoidance measures applicable under Sect. 64B(3), Eighth Schedule if certain conditions are not fulfilled (see 3.4.8.3)	Relief by way of adjustments to cost basis of shares in both top-tier and lower-tier CFC (see 6.8.2)	Sect. 961, IRC, 1986
5) Income taxed under another country's CFC measures	No relief	No relief	

Author

6.10.1 Approaches to CFC Regulations

United States: The United States applies its CFC regulations to all controlled foreign corporations wherever they are resident or located, and irrespective of foreign tax rates. This is what is commonly referred to as the “global” approach to CFC regulations. Regarding the types of income and activities subject to the CFC rules, the United States adopts a tainted income approach (also known as the transactional approach). (Avi-Yonah & Sartori, 2012:13). Under this approach (first adopted in 1962), only the tainted income of the controlled foreign corporation is taxable to its shareholders. One of the most important categories of tainted income is passive income (dividends, interest, rent, royalties etc.). This is because passive income is very mobile and is thus generally subject to lower tax rates, making tax deferral very attractive. (Avi-Yonah & Sartori, 2012:18-1.9

The other important category of tainted income is foreign base company income, which is active income but with no real connection to the jurisdiction in which the CFC is located. Technically, this is defined as income from sales and services rendered between affiliated parties (located in different countries) when there is no significant modification of the product by the base company (United States definition). Migrating from a purely global approach to one that also incorporates a jurisdictional approach as part of its CFC regulations; the United States has adopted a new category of Subpart F income for low-taxed income. All gross income of a controlled foreign corporation is low-taxed income unless the 10 per cent United States shareholder establishes that the income was subject to foreign tax at an effective rate that exceeds one-half of the maximum rate of income tax applicable to United States corporations for the relevant taxable period. See 6.9.2.1 above for discussion on this new Subpart F income. (United States, 2012:26.)

South Africa: Similarly to the United States, South Africa applies its CFC regulations to all CFCs wherever they are resident (or located) and irrespective of the foreign tax rates applicable (the “global” approach to CFC regulation). Regarding the types of income that are subject to taxation, South Africa adopts the entity approach, under which all the income is taxable, unless a specific tax exemption applies. South Africa, therefore, adopts the global-entity approach to the application of its CFC regulation (see 5.13.1 above).

Commentary: There is a degree of convergence in the South African and United States approaches pertaining to their CFC regulations. Both countries have embraced the global approach, but are increasingly incorporating a form of the jurisdictional approach in their CFC regulations. Noteworthy divergences pertain to the types of income that are subject to taxation. In the United States only specified types of transactions are subject to taxation – in terms of the Subpart F provisions (see 6.4.1 above). In South Africa all the income, unless a specific exemption applies, is the criterion for the taxation of CFC income (known as the entity method).

6.10.2 Definition of a CFC

United States: A CFC is a foreign corporation that is controlled by United States shareholders. Control means that the United States shareholders own or control more than 50 per cent of the foreign corporation, by vote or value (Section 957(a), IRC, 1986). For this purpose, a “United States shareholder” is a United States person (Section 957(c), IRC, 1986) who owns (Section 958(a), IRC, 1986), or is considered to own (by the application of the rules of ownership of Section 958(b)), at least 10 per cent of the stock or the combined voting power of all classes of stock of a foreign corporation (Section 951(b), IRC, 1986). Only United States persons can be “United States shareholders”. Section 957(c) refers to Section 7701(a)(30) for the definition of a United States person that, very broadly, includes individuals, partnerships, corporations, trusts and estates (see 6.4.2 above).

South Africa: See 5.13.2 above

Commentary: In determining if a foreign company qualifies as a controlled foreign corporation, the United States takes a broader approach than South Africa, with more extensive regulations in the IRC provisions for the requirement of a foreign company to qualify as a CFC. Unlike South Africa, which adopts a narrower approach, the United States has an elaborate requirement as criteria for determining a CFC, through its direct and indirect controls (Section 958(a), IRC, 1986) and also its attribution and constructive ownership rules of Section 958(b). The purpose of the much wider United States approach is to extend the net so as to include foreign companies that would otherwise circumvent the application of the direct and indirect ownership rules for the purpose of determining a controlled foreign corporation (Section 958(a)(b), IRC, 1986). Therefore as criteria for the identification of foreign companies qualifying as CFCs, the United States has comprehensive indirect control test along with very elaborate attribution and constructive rules in place (Section 318(a), IRC, 1986).

6.10.3 Foreign entities in domestic law

United States: A foreign corporation is an entity not formed or organised in the United States, either under federal law or under the law of any member State of the United States (Section 7701(a)(4), IRC, 1986). If a United States person (or persons) establishes a corporation in any foreign country, that corporation will be treated as a foreign corporation under federal law (Section 7701(a)(5), IRC, 1986). The United States has also enacted regulations for determining entity classification status for United States federal tax purposes under the check-the-box regulations (CTB) (see 6.3.4 above).

Foreign entity classification rules (under CTB regulations): The “check-the-box” Regulations govern the classification of an entity for United States tax purposes; while other foreign countries may utilise its domestic law provisions for determining the status of an entity for its income tax purposes. Thus, a

foreign corporation can be treated as a flow-through entity for United States tax purposes via an election (Form 8832), which is made strictly for United States tax purposes. In the foreign jurisdiction, however, the foreign entity retains its corporate identity. An anomalous situation could arise through the exercise of the election whereby the same entity has corporate characteristics in one jurisdiction (home) and non-corporate characteristics in another (United States), thus resulting in what is referred to as a hybrid entity.

South Africa: See 5.13.3 above.

Commentary: There are parallels between the United States and the South African tax legislations pertaining to the use of foreign corporations (*per se*) for domestic tax legislation purposes. Both countries have legislation in place to recognise foreign entities as the equivalence of domestic corporations. Under United States CTB regulations, a business entity formed or created under foreign law is a corporation for United States tax purposes if that form of entity is specifically listed in the regulations (“*per se*” corporations) (Section 301.7701-2(b)(8), Code of Federal Regulations, 2011). In a South African context (see 5.13.3 above) an anomalous situation can arise through the application of paragraph (b) (Section 1), where certain foreign entities will qualify as foreign companies for CFC purposes in the South African Income Tax Act even though they fail to fulfil the qualification criteria of paragraph (a) (Section 1) for the purpose of determining a domestic South African resident company (Olivier & Honiball, 2011:565). In the United States certain foreign corporations not listed as “*per se*” corporations could elect to be a transparent entity for United States tax purposes (see above for the anomaly that could arise in this respect).

6.10.4 Corporate residence

United States: For United States tax purposes, companies are classified as domestic or foreign. A United States corporation is a corporation created or organised in the United States and is taxable on its worldwide income (Section 7701(a)(3)(4), IRC, 1986). A foreign corporation is a corporation incorporated in a jurisdiction other than the United States, and is taxed by the United States only on income that has sufficient nexus in the United States (Section 7701(a)(5), IRC, 1986). The decisive factor in determining United States residency of companies is the place of organisation or incorporation: The place of incorporation thus determines whether a corporation is treated as domestic or foreign for purposes of United States tax law, irrespective of other factors that might be thought to bear on a corporation’s “nationality”, such as the location of the corporation’s management activities, employees, business assets, operations, revenue sources, the exchanges on which the corporation’s stock is traded, or the residence of the corporation’s shareholders (United States, 2008:8).

South Africa: In South Africa, a company is regarded as a resident if it is incorporated, established or formed in South Africa, or it has its “place of effective management” in South Africa (Section 1 of the

South African Income Tax Act). See 5.13.3 and 5.13.4 above for discussion – from a South African perspective – of the incorporation rule or the “place of effective management” test as criteria for company residency.

Commentary: The United States tax authorities have adopted a narrow approach when recognising the residency of companies for United States federal tax purposes: unlike the position in many other countries, the only decisive factor in determining the residency of a United States company is the place of organisation or incorporation. In addition, CTB regulations in the United States accords to United States taxpayers the choice, under certain conditions, to “elect” their entity classification status for United States federal tax purposes in respect of non-“*per se*” entities. In these circumstances, the concessionary goals would normally operate to allow non-incorporated entities, including limited liability companies (LLCs) and partnerships, to “elect” corporate tax status for United States federal tax purposes. South Africa, on the other hand, uses either the incorporation test or the “place or effective management test” to determine residency of companies. See 4.2.2 .3 and 4.2.2.4 above for discussion of SARS *Interpretation Note No. 6* (on place of effective management) which takes into consideration various levels of influence, ranging from shareholder and board control down to the everyday management of operations. The *Interpretation Note* emphasises that differences in managerial influence or structure from entity to entity, make it necessary to consider the meaning of “effective management” on a situation-by-situation basis. (South Africa, 2002d:1.)

6.10.5 CFC control

United States: The United States ascribes uniquely comprehensive meanings to the term “control” for purposes of determining a foreign corporation as controlled foreign corporation. A foreign corporation is in turn defined to be any corporation incorporated outside the United States (Sections 7701(a)(3), 7701(a)(4) and 7701(a)(5), IRC, 1986). The test of whether a corporation is foreign or domestic is a legal formality and if a corporation is organised or incorporated under the laws of the United States, it is in turn considered to be a United States corporation. Another unique feature in the United States CFC legislation is that with regard to the control of the corporation, no consideration is given to the place of effective management, and that the place where the corporation carries on business is irrelevant (see 6.4.2.2 above).

Indirect control: Subpart F provisions provide for indirect ownership of shares in a foreign corporation. Shares of a foreign corporation owned by another foreign corporation, a foreign partnership, a foreign trust, or a foreign estate are considered to be owned by its shareholders, partners, or beneficiaries respectively (Section 958(a)(2), IRC, 1986). The indirect ownership rule applies both for determining whether the requisite ownership or control exists for controlled foreign corporation status and for determining the amount of income to be attributed to United States

shareholders. In contrast, the constructive ownership rule thus applies only for the purpose of determining control, not for the purpose of determining the amount of the foreign corporation's income to be attributed to a United States shareholder (see 6.4.2.2 above).

Constructive ownership rules: With certain limited exceptions, the constructive ownership rules in Section 318 of the Code are applicable for purposes of determining whether a person is a United States shareholder and whether a foreign corporation is a controlled foreign corporation, and for certain other specified purposes (see 6.4.2.2 above) (Section 958(b), IRC, 1986; Section 1.958-2, Code of Federal Regulations, 2011).

South Africa: Section 9D(1) of South Africa's CFC legislation prescribes "control" as a criterion for a foreign company to qualify as a CFC. A foreign company must therefore fulfil the definitional requirements as contained in Section 9D(1) to qualify as a CFC. Direct and indirect participation and voting rights are the criteria for qualification as a CFC (see 3.2.1.2 and 5.13.5 above for a discussion of control in South Africa's CFC legislation).

Commentary: In the United States, a foreign company is considered a controlled foreign corporation when United States shareholders own more than 50 per cent of the total combined voting power of stock or more than 50 per cent of the total value of stock (Section 957(a), IRC, 1986). A United States shareholder is, in turn, defined as a United States person (Section 957(c), IRC, 1986) owning at least 10 per cent or more of the total combined voting power of the corporation's stock (Section 951(b), IRC, 1986). The United States is in a unique situation in that it has a 10 per cent minimum ownership requirement for the purpose of determining control of a foreign corporation. The avoidance of this minimum ownership requirement through the fragmentation of share ownership is prevented by the broad indirect and constructive ownership rules discussed above (Arnold, 1986:378).

In the South African CFC regulations the concept of control is utilised as a criterion to identify foreign companies controlled by South African residents. Control in the CFC legislation is used to identify either direct and indirect participation rights or voting rights in the foreign corporation. For a foreign company to qualify as a CFC the following control measures must therefore prevail: South African shareholders must exercise more than 50 per cent of either voting rights or hold (directly or indirectly) more than 50 per cent ownership or participation rights in the foreign company. South Africa does not have comprehensive rules to counter fragmentation of shares, making it easy for shareholders to avoid being subject to CFC regulations (see 5.13.5 above for further discussion on control).

6.10.6 Attribution minimum percentage rule

United States: Only United States shareholders are subject to attribution of CFC income. If a foreign corporation is a controlled foreign corporation under Section 957(a) for an uninterrupted period of 30 days or more during the taxable year, each United States shareholder (who owns stock on the last day of the year) must include in income the sum of two major components: the shareholder's pro rata share of Subpart F income plus any earnings of the controlled foreign corporation invested in United States property (Section 951(a), IRC, 1986). A taxpayer's pro rata share of Subpart F income is based on direct and indirect ownership (but not constructive ownership) (Section 958(a), IRC, 1986). In effect, Section 951(a) treats United States shareholders as having received a current distribution out of Subpart F income plus any non-Subpart F foreign earnings invested in United States property.

South Africa: See 3.3.3 and 5.13.8 above for discussion on South Africa's attribution rules.

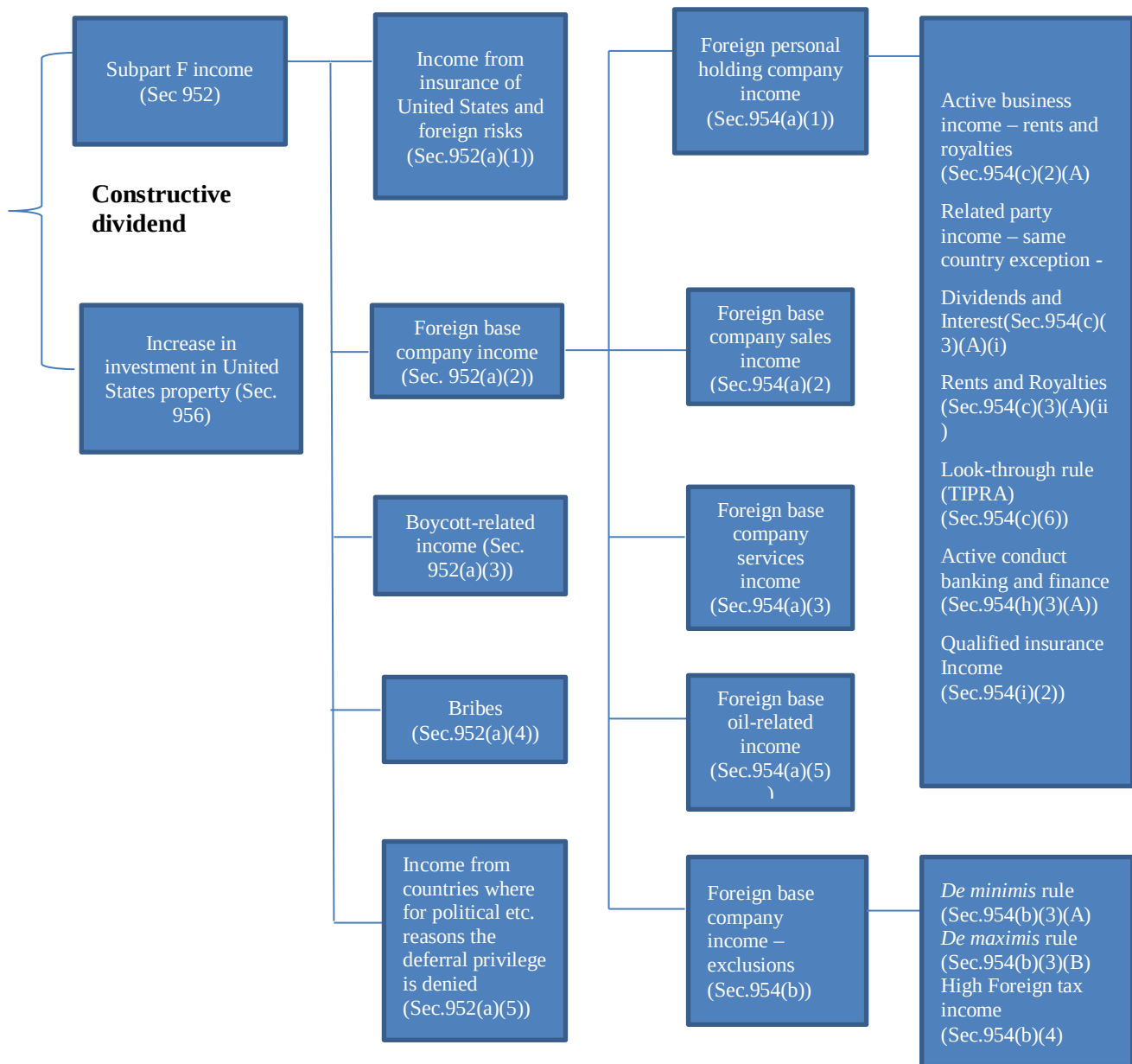
Commentary: Only United States shareholders (under Section 951(b)) who own stock within the meaning of Section 958(a) on the last day of the year in which the foreign corporation is a controlled foreign corporation will include in gross income the following: a proportion of Subpart F income and its increase in earnings invested in United States property. Therefore in the United States the 10 per cent voting stock requirement applies not only for the purpose of determining whether a foreign corporation is a controlled foreign corporation, but also for the purpose of determining to which domestic shareholders the Subpart F income of the controlled foreign corporation is attributed (Arnold, 1986:377-378; Section 951(a), IRC, 1986).

South Africa, on the other hand, requires a 10 per cent shareholding (together with any connected person in relation to the South African resident shareholder) of the participation rights, providing that such shareholder may exercise at least 10 per cent of the voting rights of the controlled foreign corporation in order for attribution purposes (Section 9D(2)(A), Income Tax Act).

6.10.7 Exemptions

United States: Unlike the South African CFC regulations, where the most important exemption currently is the FBE exemption contained in Section 9D(9)(b), the Taxation Laws Amendment Act, No. 24 of 2011 had introduced Section 9D(9A), which now acts as a collyer to the current Section 9D(9)(b). The United States approach, on the other hand, focuses on the tainted income of a foreign corporation. The tainted income of a controlled foreign corporation is defined to specifically include certain types of income as required by Section 952(a), IRC, 1986, and the most important of this is the foreign base company income (Section 954(a)(2), IRC, 1986).

The following flow chart indicates the types of income for which a United States shareholder of a controlled foreign corporation will be subject to taxation as constructive dividends, and the major kinds of exceptions being granted under the FBCI for the different categories of income:



Author

Figure 6-1 Subpart F and increased investment in United States property

Insurance of United States and foreign risks: A number of categories of exempt income can be found in Section 953(e). Among the categories of income exempt from taxation is income earned by the foreign insurance company (or its branch) in its home country. Qualified insurance income refers to certain types of income which, when earned by a qualifying insurance company, is not treated as FPHC income. The implication is that certain investment income earned by the controlled foreign corporation insurance company is not considered as FPHC income (Section 954(i)(1) and (2), IRC,

1986) . Also applicable are exclusion and special rules in respect of FBCI and insurance income (see below) (Section 954(b), IRC, 1986) (see 6.5.6 above).

General Exceptions to the definition of FBC income or insurance income: Exceptions to the definition of foreign base company income or insurance income reduce the burden of Subpart F. Subpart F income excludes certain categories of income (see 6.6.2 above):

Low-taxed income: The United States Job Creation and Reform Act of 2012 introduced a new category in Subpart F income for low-taxed income. All gross income of a controlled foreign corporation is low-taxed income unless the 10 per cent United States shareholder establishes that the income was subject to foreign tax at an effective rate that exceeds one-half of the maximum rate of income tax applicable to United States corporations for the relevant taxable period (see 6.9.2.1 above).

FBCI exceptions (Section 952(a)(2), IRC, 1986): The thrust of the exceptions currently being granted against the imputation of Subpart F income is concentrated in the FBCI and more specifically in the terrain of the FPHCI regimen. The types of income category falling within the contours of the FBCI regimen are reflected in the flow chart in Figure 6-1.

Foreign personal holding company income (FPHCI): The exception excludes rents and royalties received from an unrelated person if such payments are connected with the controlled foreign corporation's active conduct of a trade or business (Section 954(c)(2)(A)), or received from a related corporation for the use of property within the controlled foreign corporation's country of incorporation (Section 954(c)(3)(A)(ii), IRC, 1986). Dividends and interest are not FPHCI if received from a related corporation created or organised in the controlled foreign corporation's country of incorporation having a substantial part of its assets involved in a trade or business in that country (Section 954(c)(3)(A)(i), IRC, 1986) (see 6.6.4.1 above). The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) introduced Section 954(c)(6), which had the effect that dividends, interests, rents and royalties received by a controlled foreign corporation from a related controlled foreign corporation will trigger the so-called "look-through rules" (see 6.6.4.2 above). A special exclusion from the foreign personal holding company rules is available for qualified banking and finance income earned by a controlled foreign corporation that is predominantly engaged in the active conduct of a banking, financing, or a similar business when the controlled foreign corporation must engage in substantial activity with respect to one of those businesses (Section 954(h)(3)(A)) (see 6.6.4.1 above).

There are also exceptions for certain transactions not included or taxable as FPHC income and includes the following constituents of FPHC income:

- Certain property transactions: (see 6.6.4.1 above)
- Commodity transactions: (see 6.6.4.1 above)
- Foreign currency gain: (see 6.6.4.1 above)

Foreign base company sales income (FBCSAI): sales income excludes the profit earned when the goods are produced in the controlled foreign corporation's country of incorporation, sold for use in the controlled foreign corporation's country of incorporation, or manufactured by the controlled foreign corporation itself in its country of incorporation. Also, income from the sale of agricultural commodity is excluded if the commodity is not of a kind grown in the United States (Section 954(d), IRC, 1986).

Temporary exceptions: A unique feature in United States tax law is the granting of temporary tax exemptions for certain types of income falling within the taxing regime of Subpart F. These types of temporary exceptions could be prospectively removed from the statute book, or alternatively could be further extended on a temporary basis when their previous period has expired, or given permanent status and become a permanent feature of the domestic tax law, as indicated by the United States Job Creation and International Tax Reform Act of 2012 in respect of the following:

- Permanent extension of look-thru for controlled foreign corporations (Section 202 of the bill and Section 954(c)(6) of the Code) (see 6.6.4.2 above)
- Permanent extension of exceptions for active financing income (Section 203 of the bill and Sections 953(e)(10), 954(h)(9) and 954(i) of the Code) (see 6.6.4.1 above)
- Foreign based company income not to include certain foreign sales and services income from the categories of FBCI (Section 954 of the Code) (see 6.6.5.3 and 6.6.6.2 above)

South Africa: The South African CFC attribution provisions are subject to various exemptions including: the FBE exemption; a *de minimis* exemption; a high-foreign-tax exemption, and related-party exemption (see main table 6-1 above). The most important exemption, however, in South African tax law pertaining to CFCs is the FBE exemption contained in Section 9D(9)(b). Prior to qualifying for the use of the FBE exemption, the definitional requirements of the FBE as contained in Section 9D(1) have to be met. In this regard, see 5.13.7 above for discussion of the FBE requirements. The Taxation Laws Amendment Act, No. 24 of 2011 had introduced noteworthy changes to Section 9D(9)(b) in respect of tax transgressions arising from certain types of passive (or highly mobile) income and diversionary income, since tainted (passive or diversionary) income is fully taxable in South Africa and CFC ownership relating to these types of income poses a high risk to the tax base.

Commentary: The United States focuses on the tainted income of a foreign corporation. Exceptions, if applicable, are granted within the specific types of income (see Figure 6-1). The major exceptions are granted through the FPHCI category. The United States tax authorities grant temporary exceptions in

respect of certain types of transactions falling within the specific income category. These temporary measures could be prospectively deleted or become a permanent feature of the United States tax legislation. The 2012 United States Job Creation and Tax Reform Act had introduced some notable changes in respect of certain of these temporary exceptions: for example, the permanent extension of look-thru rule for controlled foreign corporations (Section 954(c)(6) of the Code); the permanent extension of exceptions for active financing income (Sections 953(e)(10), 954(h)(9) and 954(i) of the Code. The bill adds a significantly new category of Subpart F income for low-taxed income (see 6.9.2.1 above).

In South Africa, a major exception to the application of South Africa's CFC regulations is the FBE exemption granted by Section 9D(9)(b). The requirements to be fulfilled in respect of the FBE criteria are laid out in Section 9D(1). South Africa grants its exemption, on the all-or-nothing approach (the entity approach) after allowing for exceptions (see 6.10.1 above). Further, the introduction of Section 9D(9A) acting as supporting legislation to Section 9D(9)(b), also has to be fulfilled in order to satisfy the criteria of the FBE exemption – the Taxation Laws Amendment Act, No. 24 of 2011).

6.10.8 Year of Assessment used for translating CFC's profits

United States: Under the United States legislation, any amounts required to be included as income under Section 951(a)(1)(A) should be done using the average exchange rate for the taxable year of the foreign corporation (Section 989(b)(3), IRC, 1986). All determinations should be made in the taxpayer's functional currency (Section 985(b), IRC, 1986).

South Africa: Section 9D(6) has been replaced with reference to the CFC's foreign tax year instead of the previous reference to the South African shareholder's year of assessment. In its substituted form it provides that the net income of a CFC for a foreign tax year must be determined in its functional currency and must, for purposes of the determination of the amount to be included in the income of a resident during a year of assessment, be translated to the currency of South Africa by the application of the average exchange rate for the CFC's foreign tax year (Section 9D(6)).

Commentary: Both the United States and South Africa are in agreement with the conversion of foreign currency being done by the application of the average exchange rate of the CFC's foreign tax year.

6.10.9 Relief for subsequent dividends

United States: Where a United States shareholder receives dividends from a controlled foreign corporation out of earnings and profits that have been previously subject to tax under Subpart F, such dividends are excluded from the United States shareholder's gross income (Section 959(a), IRC, 1986). The exclusion for dividends paid out of previously taxed Subpart F income also applies to a

United States person who acquires the shares of a United States shareholder to whom the Subpart F income was taxable. The actual dividends paid by the foreign corporation are treated as taxable dividends unless they are paid out of earnings and profits of the foreign corporation that have been previously included in the income of the United States shareholder. Ordering rules are necessary with respect to dividends paid by controlled foreign corporations. Distributions made by a controlled foreign corporation are deemed to be paid first from its earnings invested in United States property, and its most recently accumulated Subpart F income (Section 959(c), IRC, 1986).

South Africa: Subsequent dividends received from a foreign corporation are tax exempt in terms of Section 10B(2), unless the rules of Section 10B(4) applies. A participatory shareholder's exemption is granted to the extent that foreign dividend does not exceed the aggregate of all amounts which have been included in the income of the South African resident in terms of Section 9D in any year of assessment (Section 10B(2)(c)).

Commentary: The United States, in essence, taxes the untaxed portion of active business income when dividends are finally received by United States shareholders. The taxation of Subpart F income mainly includes FPHC income and tainted active business income under the jurisdiction of the foreign base company sales and service income. Therefore, what remains to be taxed is chiefly the balance of the previously untaxed portion of active business income, and this occurs when actual distribution is received by United States shareholders. In South Africa subsequent dividends received from a foreign corporation are tax exempt in terms of Section 10B(2) but subject to the requirements of Section 10B(2)(c) and (4).

6.10.10 Capital gains arising from sale of CFC shares

United States: The cost basis of United States shareholders' shares in a controlled foreign corporation is increased by the amount previously included in income in respect of the corporation's Subpart F income and its investment in United States property (Section 961(a), IRC, 1986). Any dividends received by United States shareholders from the controlled foreign corporation are excluded from the United States shareholders' income if it was paid out of previously taxed Subpart F income and are therefore subtracted in computing the cost basis of United States shareholders' shares in the controlled foreign corporation (Section 961(b)(1), IRC, 1986). If the cumulative distributions exceed the cost basis, the excess is treated as a gain from the sale or exchange of the shares of the foreign corporation (Section 961(b)(2), IRC, 1986). If a United States shareholder owns the shares of a controlled foreign corporation indirectly through a foreign partnership or a foreign trust or estate, the cost basis adjustments described above are made to United States shareholders' interest in the partnership or trust (Section 1.961-1(b)(1), Code of Federal Regulations, 2011).

Any gain on the sale or exchange of shares in a controlled foreign corporation in which a United States person owns 10 per cent or more of the total combined voting power is treated as a dividend to the extent of the post-1962 earnings and profits of the foreign corporation that have not been taxed under Subpart F (Section 1248(a), IRC, 1986). Consequently, it is not possible for a United States shareholder to realise the earnings of a controlled foreign corporation as a capital gain arising from the sale of shares to the extent that any portion of such earnings have not been subject to current United States taxation (that is, have benefited from the deferral of United States tax). The full amount of the gain subject to earnings and profits limitation must be included in the United States shareholder's income.

The gain recognised on the sale or exchange of controlled foreign corporation stock is treated as a dividend to the extent of the earnings and profits that have not previously been distributed to its United States parents as dividends or included in income of the United States parent under Subpart F. The amount by which the gain is re-characterised as a dividend reduces the capital gain on the transaction by a like amount.

South Africa: South African CFCs are subject to capital gains tax in accordance with the requirements of Section 9D(2A)(e) and (f). The capital gain arising from the disposal of equity shares in a foreign company may qualify for exclusion under paragraph 64B of the Eighth Schedule of the South African Income Tax Act. This exclusion is referred to as a capital gains participation exemption. The basic exemption is contained in paragraph 64B(1), which provides that the capital gain or capital loss relating to the disposal of an interest in a foreign company (other than a headquarter company) will be exempt provided that:

- the person (together with any related company) held at least 10 per cent of the equity shares and voting rights immediately before and for at least 18 months prior to the disposal
- the disposal is to a non-resident other than a CFC (for example, the shares cannot be disposed to a resident or to a foreign subsidiary controlled by a resident)
- the disposal must occur for full consideration. Full consideration means consideration that has a market value that equals or exceeds the market value of the foreign equity shares transferred

Commentary: The United States taxes capital gains arising from the disposals of controlled foreign corporation shares. If the cumulative distributions exceed the cost basis, the excess is treated as a gain from the sale or exchange of the shares of the foreign corporation (Section 961(b)(2), IRC, 1986). However, the gain recognised on the sale of controlled foreign corporation stock is treated as a dividend to the extent of any portion of the earnings and profits that have not previously been distributed to its United States parents as dividends or included in income of the United States parent

under Subpart F. The amount by which the gain is re-characterised as a dividend reduces the capital gain on the transaction by a like amount.

Sale of equity interest of a CFC, in a South African context, is generally tax exempt in terms of Section 64B(1).

6.10.11 Relief provisions for double taxation

United States: The United States foreign tax credit (FTC) system is detailed and complex. Foreign tax credits may generally be claimed either on a paid or accrued basis. A credit for foreign taxes paid to a foreign government cannot exceed the United States tax liability on the foreign-sourced income, i.e., the United States will not allow foreign taxes to offset United States taxes on United States income, nor will it refund foreign taxes imposed at a higher rate than that imposed by the United States (Section 960, IRC, 1986). Not all taxes paid to a foreign government are creditable, only those taxes with the predominant character of being the equivalence of United States tax on income. The FTC rules are generally elective, and a taxpayer can elect to claim a deduction for foreign taxes paid in lieu of a foreign tax credit.

The indirect foreign tax credit, however, may only be claimed by a United States domestic corporation that owns at least 10 per cent of the voting stock of the foreign corporation. The indirect credit is a deemed-paid foreign tax credit that is available when a corporation receives an actual or deemed distribution from a foreign subsidiary. The amount of the deemed credit is based on the amount of foreign earnings distributed or deemed distributed by the foreign subsidiary and the underlying foreign taxes paid by the foreign subsidiary on those earnings (Section 902(a), IRC, 1986).

FTC basket limitation – A foreign tax credit limitation is applied on a basket-by-basket basis to avoid cross-crediting of taxes paid on business and investment income. The two current baskets of income used are the “general limitation basket” into which most active business income is placed and the “passive limitation basket” (e.g., dividends, interest, royalties, and capital gains) (Section 904(d)(2)(A) and (B), IRC, 1986). This system permits a United States taxpayer to place all worldwide active business foreign-source income in one basket and, accordingly, allows the taxpayer to claim foreign tax credit on all income taxes paid on that income in that basket. “The operation of the limitation produces an incentive for taxpayers to arrange the sources of their foreign [source] income in such a way that the blended rate of foreign tax on that income is equal to or less than the effective United States tax rate on that income” (Advisory Panel on Canada's System of International Taxation, 2008:24). The United States Job Creation and Reform Act of 2012 adds a new separate foreign tax credit category (basket) for foreign intangible income in the computation of the foreign tax credit limitation under Section 904 (see 6.8.3.3 above).

South Africa: In South Africa, tax reprieve is granted by providing a foreign tax credit (FTC) in domestic law (as contained in Section 6quat) for South African Section 9D shareholders. The FTC rules as manifested in the Section 6quat, provides both a direct and indirect foreign tax credit mechanism. A direct foreign tax credit may be claimed by all taxpayers in respect of taxes paid on foreign-source income earned by the taxpayer. The indirect foreign tax credit, however, may only be claimed by a South African resident (together with any connected person in relation to that resident) shareholder (Section 9D) who owns at least 10 per cent of the participation rights and may exercise at least 10 per cent of the voting rights in that CFC. The indirect credit is therefore a deemed-paid foreign tax credit that is available when a corporation receives an actual (in terms of Section 10B(2) but subject to Section 10B(2)(c) and (4) South African Income Tax Act) or deemed distribution from a foreign subsidiary. The amount of the deemed credit is based on the amount of foreign earnings distributed or deemed distributed by the foreign subsidiary and the underlying foreign taxes paid by the foreign subsidiary on these earnings (Section 6quat(1A)) (see 3.5 above)

Commentary: The United States foreign tax credit (FTC) system is detailed and complex, especially in the use of the FTC basket system. South Africa also has in place complex measures in granting tax relief for foreign-source income (especially Section 9D shareholders), but not as complex as the foreign tax relief system of the United States.

6.10.12 Relief provision for foreign losses

United States: Foreign losses are generally deductible in computing taxable income by a United States company but certain FTC implications may result. A foreign loss within a separate basket must offset foreign-source income in other baskets before reducing United States source income. If the foreign loss basket has a foreign gain in subsequent years, the loss that was allocated to income from another basket in an earlier year is characterised as income from another basket. If USCO generates an overall loss from foreign sources in a year, whether the loss is related to business operations or an allocation of expenses to foreign sources, an “overall foreign loss” is generated. Foreign-source income earned in subsequent years is resourced as domestic income to the extent of the lesser of the balance of the overall foreign loss or half of the taxpayer’s foreign-source income until the overall foreign loss is eventually recaptured (Section 904(f)(5)(A) and (B)).

South Africa: Despite net income of a CFC being imputed to a South African resident, the net loss of a CFC cannot be used by South African resident shareholders to reduce their taxable income in a given tax year. Similarly, the net loss suffered by a CFC cannot be used against the taxable income of another CFC (in the same group of companies) in respect of the latter’s tax computation. Deductions and allowances are limited to the amount of the income earned in relation to the CFC (Section 9D(2A)(a)). In respect of any losses incurred by the CFC, the Income Tax Act limits the allowable

loss to the amount of income earned by the CFC for the specific year and any excess of the deduction over income is to be set off against the income in the succeeding year of the CFC (Section 9D(2A)(b)).

The justification for this anti-loss rule is to ensure that under a worldwide system of taxation (or residence basis of taxation) South Africa does not suffer from an erosion of its tax base. The net loss may, however, be carried forward and be set off against the income of such (foreign) company in such succeeding year for the purposes of Section 20 (Section 9D(2A)(b)).

Commentary: Foreign losses are generally deductible in computing taxable income by United States Company (USCO) but certain FTC implications may result. South African shareholders, on the other hand, are unable to write off CFC losses against South African income.

6.11 Chapter conclusion

The chapter provides a comparative assessment of the CFC regulations prevailing in the domestic tax legislations of the United States and South Africa. A key issue of concern for United States tax authorities, in the absence of CFC legislation, is that the earnings of foreign subsidiaries owned by United States corporations are generally not taxed until they are actually repatriated as dividends or when United States shareholder corporations sell their equity interest in foreign corporations. This postponement of taxation is generally known as tax deferral and it inevitably prevents the timeous taxation of foreign corporations on their foreign-sourced income. A consequence of this tax deferral is “a reduction of the domestic effective tax rate (due to the time value of money)”. (Avi-Yonah & Sartori, 2012:2.)

CFC legislation places certain limits on tax deferral, and the OECD has clarified that “CFC rules have been developed for a variety of purposes in the light of the overall international tax policies of member countries” (OECD, 1998:41). In some instances, the policy focus is on tax-avoidance transactions and in others represents a broader limitation on the deferral of tax on income realised through foreign subsidiaries (OECD, 1998:41). A number of reasons have thus induced OECD member countries to adopt CFC regulations (such as the need to fight tax havens, the need to preserve certain financial centres, the need to give a response to European Union or OECD harmful tax competition projects, etc.), but the need to prevent tax deferral remains the most significant one (at least in the United States). A fundamental shortcoming in the controlled foreign corporation regulations of the United States is the pursuing of an exclusively transactional approach to the taxation of foreign tainted income. It has been stated that in order to “relieve some of the administrative burdens and give more certainty to transactions involving [CFCs] formed in tax havens, [the legislator should] expand Subpart F to add a jurisdictional test that would tax United States shareholders of a controlled foreign corporation formed in a tax haven”. (Prebble, 1987:25.)

In response to the above, and in respect of the paradigm shift of United States tax policy towards its CFC regulations (as embodied in the United States Job Creation and Reform Act, 2012), the United States migrates from an exclusively global approach to one that also incorporates the jurisdictional approach, as one of the key instruments of its CFC regulations, by the inclusion in its CFC regulations of the additional treatment of low-taxed foreign income as Subpart F income (Section 952, IRC, 1986) (see 6.9.2.1 above). South Africa has also made certain significant changes to its FBE exemption requirements (Section 9D(9)(b)) by abolishing certain of the former criteria that had been utilised to blemish certain transactions with related parties as diversionary income (see 3.4 above).

The CFC regulations of both the United States and South Africa are therefore the subject of scrutiny and enquiry in the current chapter, with the main aim of highlighting shortcomings and anomalies in the South African regulations and making appropriate recommendations in the concluding chapter of the thesis. An issue that emerges is that the United States has a highly complex and convoluted set of principles serving as its CFC regulations – supported by the global transactional approach – set against a less complex set of CFC regulations in South Africa.

Key divergences, anomalies and, in certain instances, similarities with respect to key issues contained in the South African CFC regulations, emerging from the international United States comparison, are listed for quick reference in the recapitulation that follows below.

Approaches to CFC regulations: The United States adopts a global transactional approach to its CFC regulations. South Africa, on the other hand, approaches its CFC regulations based on the global-entity approach. There is, however, a degree of convergence between the two countries in respect of their approaches to CFC regulations. As a starting point, both countries utilise the global approach – that is, there is total disregard (until recently) for a particular jurisdiction to be subject to its CFC regulations. However, disparities exist pertaining to the types of income that are to be subject to domestic taxation. United States CFC legislation is based on the transactional approach, in that only specified types of transactions are subject to taxation – in terms of Subpart F provisions (see 6.4.1 above). South Africa, on the other hand, mainly grants the FBE exemption (Section 9D 9(b)(9A)), (see 6.10.1 above) by following the entity approach in which, generally, all income will be subject to taxation if the FBE exemption criterion is not fulfilled or alternatively after allowing for other partial exemptions (see 6.10.1 above).

Definition of a CFC: The United States has elaborate criteria in place for a foreign company to qualify as a controlled foreign corporation. One of the main requirements is that more than 50 per cent of the shares, determined by votes or value, are owned by United States shareholders at any time in the controlled foreign corporation's tax year (Section 957(a), IRC, 1986). A United States shareholder is defined as any United States person who owns 10 per cent or more of the voting shares of the foreign

corporation (Section 951(b), IRC, 1986). Indirect and constructive ownership rules apply when determining whether a United States person has a 10 per cent interest, and whether a foreign corporation is controlled by United States persons (Section 958(b), IRC, 1986). South Africa has a less elaborate requirement for a foreign company to qualify as a CFC. In a South African context, therefore, ownership of more than 50 per cent of participation rights or voting rights are the main criteria for the determination of a CFC (Section 9D(1), Income Tax Act), providing the foreign company qualifies as a company in terms of the definitional requirements of a company in terms of Section 1 of the Income Tax Act (see 5.13.2 and 6.10.2 above).

Foreign entities in domestic law: There is an analogous situation in the recognition of foreign entities in the domestic tax legislation of the United States and South Africa, as both countries recognise foreign law as one of the criteria for a foreign company qualifying as a CFC. For example, the United States could recognise a foreign non-incorporated entity as controlled foreign corporation if the foreign entity makes the appropriate election in terms of the “check-the-box” elections (Section 301.7701-3(a), Code of Federal Regulations, 2011). However, an anomalous situation could arise by the application of this rule (check-the-box elections), as the entity in question will have corporate recognition in the United States and be treated as a non-corporate entity in its domestic jurisdiction – thus resulting in an hybrid entity (see 6.10.3 above).

Corporate residence: The United States, unlike many other countries (such as South Africa and the United Kingdom), uses only the place of incorporation or organisation as a decisive factor for the determination of United States residency of companies (Section 7701(a)(4), IRC, 1986). South Africa, on the other hand, recognises a company as resident if it is incorporated, established or formed in South Africa, or it has its place of effective management in South Africa (except for “high – taxed” CFCs) (Section 1 of the Income Tax Act) (see 5.13.4 above). In addition, under the “check-the-box” election of the United States a foreign non-incorporated entity could be given corporate status, thus extending United States residency corporate status to include non-incorporated foreign entities (see 6.10.4 above).

CFC control: Voting control is one of the alternative tests and the other is the value test based on share ownership, as criteria for determining if a foreign company qualifies as a controlled foreign corporation (Section 957(a), IRC, 1986). The exercise of voting control of a corporation is manifested in various forms such as the power to elect a majority of the board of directors or the right to make strategic decisions – for example, to compel the current distribution of the corporation’s earnings. Subpart F provisions provide for the indirect ownership of shares in a foreign corporation. Shares in a foreign corporation owned by foreign entities are considered to be owned by its shareholders, partners, or beneficiaries (Section 958(a)(2), IRC, 1986). With certain limited exceptions, the constructive ownership rules in Section 318 of the Code are applicable for the purpose of determining

whether a person is a United States shareholder and whether a foreign corporation is a controlled foreign corporation (see 6.10.5 above).

South Africa uses a simpler version of “control” as a criterion for a foreign company to qualify as a CFC. A foreign company must fulfil the definitional requirements in Section 9D(1) to qualify as a CFC. Direct and indirect – participation and voting rights, are the criteria for qualification as a CFC (see 5.13.5 above).

Attribution minimum percentage rules: The United States is in a unique position of using the 10 per cent voting stock criteria not only for the purpose of defining a United States shareholder but also for the purpose of determining to which domestic shareholders the Subpart F income of the controlled foreign corporation is to be attributed (Arnold, 1986:377-378). A United States shareholder is in turn defined as a United States person who owns, directly, indirectly, or constructively, at least 10 per cent of the total combined voting power of all classes of stock of a foreign corporation (Section 951(b), IRC, 1986) (see 6.10.6 above). South Africa, on the other hand, uses the 10 per cent shareholding (together with any connected person in relation to that resident) of the participation rights of the CFC exclusively for attribution purposes only (see 5.13.8 above).

Exemptions: The United States imposes tax on controlled foreign corporations having tainted income (Subpart F). Tainted income of a controlled foreign corporation is defined to specifically include the types of income required by Section 952(a), IRC, 1986, the most important of which is the FBCI (Section 952(a)(2), IRC, 1986). See flow chart at 6.10.7 above, which shows the types of Subpart F income, incomes constituting the FBCI and the exceptions, mainly relating to FPHCI. The United States taxing authorities grant temporary exceptions to certain types of transactions falling within the specific category. The 2012 Job Creation and Tax Reform Act had made significant changes by assigning permanent status to certain temporary exceptions (see 6.10.7 above).

South Africa’s CFC attribution provisions are subject to various exemptions, including: the foreign business establishment exemption, a *de minimis* exemption, a high-foreign-tax exemption and the related-party exemptions. The most important exemption granted in the South African CFC regulations is the FBE exemption (Section 9D(1) and 9(b)) (see 5.13.7 and 6.10.7 for a discussion on South African exemptions, especially the FBE exemption).

The approach, methodology, legislative mechanism and philosophical underpinnings of the United States in granting exceptions to the application of Subpart F does not correspond with the exemptions granted in the South African CFC legislation.

Year of assessment used for translating CFC’s profits: Under the United States regulation, any amounts required to be included as income under Section 951(a)(1)(A) should be done using the average

exchange rate for the taxable year of the foreign corporation (Section 985(b)(3) and 985(b), IRC, 1986). In South Africa, Section 9D(6) has been replaced with reference to the CFC's foreign tax year of assessment instead of the previous reference to the South African shareholder's year of assessment, by translating income in the functional currency of the CFC to the currency of South Africa, using the average exchange rate for the CFC's foreign tax year (see 6.10.8 above).

Both the United States and South Africa are in agreement with the conversion of the functional currency of the CFC being done by application of the average exchange rate of the CFC's foreign tax year.

Relief for subsequent dividends: When United States shareholders receive dividends the following analysis needs to be done in order to determine the portion of dividends taxable. The taxed portion of dividend income received, as being previously received as constructive dividend (in terms of Section 951(a)), is exempt in terms of Section 959(a). Fundamentally, what has actually eluded taxation is the untaxed portion of active business income (excluding, however, of previously taxed tainted active business income comprising of foreign base company sales or service income). Therefore, the untaxed portion of dividends constituting foreign active business income is subject to taxation. South Africa exempts the taxation of dividends in terms of Section 10B(2), but the dividends received in excess of previously taxed income in terms of Section 9D are subject to taxation (Section 10B(2)(c)) (see 6.10.9 above).

In essence, the similarity existing between the countries is that both the United States and South Africa tax dividends to the extent of the previously untaxed portion of active business income.

Capital gains and subsequent sale of CFC shares: The United States makes a distinction in respect of shares sold by United States shareholders as follows:

- previously taxed income as Subpart F constructive dividends and reflected as companies earnings and profits (Section 951(a), IRC, 1986)
- the untaxed portion of earnings and profits – previously untaxed active business income
- the realised capital gain on sale. (Sections 1248, IRC, 1986; Section 961, IRC, 1986.)

The previously untaxed portion of the company's earnings and profits (active business income) is taxed at normal corporate rates. The realised capital gains on sale of shares are taxed at capital gain rates. In South Africa, however, the capital gain arising from the disposal of interest in a foreign company may qualify for exclusion under paragraph 64B(1) of the Eighth Schedule if certain of the prescribed requirements of the subsection are fulfilled (see 6.10.10 above).

The United States thus taxes capital gains on the disposal of CFC shares – at capital gains tax rate. South Africa, however, mainly exempts the gains arising on the sale of CFC shares in terms of paragraph 64B(1) of the Eighth Schedule of the Income Tax Act.

Relief provisions for double taxation: The United States has a more complex system in place when United States shareholders seek relief for double taxation. A foreign tax credit limitation is applied on a basket-by-basket basis to avoid cross-crediting of taxes paid on business and investment income (Section 904(d)(5)(A) and (B), IRC, 1986) (see 6.10.11 above). South Africa provides tax relief to double taxation in terms of Section 6quat for South African Section 9D shareholders (see 6.10.11 and 3.5 for a discussion of the Section 6quat rebate).

In summary, the United States has more complex legislation than South Africa governing relief for double taxation of CFC income.

Relief provisions for foreign losses: Despite the complex mechanism for United States shareholders to claim relief for foreign losses of controlled foreign corporations, the United States seem to be liberal in allowing foreign losses, under certain circumstances, to be offset against the taxable income of the United States company (Section 904(f)(5)(A) and (B), IRC, 1986). South Africa keeps a tight rein on foreign losses of CFCs by only allowing the particular CFC to use its foreign losses against future taxable income (Section 9D(2A)(b)) (see 6.10.12 above).

With this chapter having compared South African CFC regulations with corresponding provisions in the tax legislation of the United States (as specified in the thesis objectives at 1.6 above), Chapter 7 closes this study with a review of its findings and sets out conclusions and recommendations to be drawn from these findings.

Chapter 7

FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

7.1 Introduction

Historically, CFC regulations were borne of the necessity for domestic economies relying on a source (or territorial) basis of taxation to counter potential loss of tax revenues through interposition, for investment purposes, of a foreign entity with separate legal incorporeity. In the South African response to this potential for tax evasion, comprehensive CFC regulations were instituted in 2001 by which all the income (after allowing for necessary exceptions) earned by a CFC was subject to taxation. This step was preceded by the transformation of the South African taxing system from a source (or territorial) basis of taxation to a fully-fledged residence basis of taxation. In the light of such changes, it has become necessary to assess the relevance and appropriateness of the South African CFC regulations in an international context, which is what this thesis has endeavoured to do in the more specific context of comparison with United Kingdom and United States CFC measures and in relation also to the OECD and UN Model Tax Conventions (although CFC issues tend to be a relatively tangential concern in these guideline conventions).

The primary objective of this thesis has therefore been to determine the extent to which the South African CFC tax legislation (as embodied, in particular, in the provisions of Section 9D of the Income Tax Act), conform to, diverge from, or fall short of international practices as postulated (a) in the directives and advisories of the OECD and UN, and (b) in the tax regimes of certain of the leading economies of the world, in particular the United Kingdom and the United States.

In concluding the thesis, this chapter highlights anomalies, divergences and shortcomings in the South African CFC legislation which appear from the comparisons, and offers recommendations where appropriate. Issues considered here include: place of effective management, criteria for permanent establishment and foreign business establishment, approaches to CFC legislation, shareholder qualification for determining a CFC, control requirements, exemptions, types of interest in a CFC for attribution purposes, the lower level of taxation test, and buttressing legislation.

Table 7-1 gives an overview of CFC regulations in the respective countries (South Africa, United Kingdom, and United States) and serves as the basis for the suggested recommendations to the South African CFC regulations.

Table 7-1 Principal elements of CFC Rules in South Africa, United Kingdom & United States

	South Africa	United Kingdom	United States
Designated Approach	Global Entity Approach (see 7.3.3)	Jurisdictional Entity (see 7.3.3) Global Entity (Finance Bill 2012)	Global Transactional Approach (see 7.3.3)
Definition of CFC	- SA resident holds more than 50% of participation rights or holds more than 50% of voting rights (includes directly or indirectly) in CFC (Sect. 9D(1)) - No minimum ownership (see 3.2.1.2)	- United Kingdom residents holding more than 50 % of voting shares, of value of shares, of rights to distributions, or of rights to value of assets on liquidation (S 839, ICTA, 1988) - Indirect and constructive ownership rules - No minimum ownership - Deemed control if one United Kingdom resident owns at least 40% and no other person owns 55% or more (S 755D (3) & (4) ICTA, 1988). (see 7.4.3)	- More than 50% by votes or value, of stock owned by United States shareholders (Low limits for insurance CFC's) at any time in year for 30 days (S 957(a), IRC, 1986) - Indirect and constructive ownership rules(S 958(a)(2) and (b), IRC, 1986)) 10% minimum ownership requirement (S 951(b), IRC, 1986) (see 7.3.4 and 7.3.5)
Definition of tainted income	- all income inclusive of capital gains - computed in accordance with SA tax rules - computed for each CFC separately (Sect. 9D(2A)) (see 3.3.3)	All income other than Capital Gains (Finance Bill 2011 & 2012 also introduced partial exemptions) (S747 (6), ICTA, 1988) & (Sch. 24, ICTA, 1988) (see 5.8 and 5.9)	- Passive income, but excluding income from active business and dividends from related company in same country (Sect. 954(c), IRC, 1986) - Base company income (S 954(d) & (e), IRC, 1986) - Investment in United States property by CFC (S 956(a), IRC, 1986) - Exemption for certain high-taxed income (Sect. 954(b)(4), IRC, 1986) - De-maximis rule: if more than 70% of the CFCs gross income is base company income or insurance income, all net income of CFCs is deemed to be tainted (S 954(b)(3)(B), IRC, 1986) - Special rules for allocating interest expense against tainted income (S 1.861-8, Code of Federal Regulations (see 6.5 to 6.7)
Domestic taxpayers subject to CFC attribution	- Any resident to which 10% or more of the CFC's income is attributed (Sect. 9D(2)(A)) - Constructive ownership rules (Sect. 9D(2)(A)) - Ownership at any time of the year (inclusive of disposals and year end stock holdings) (Sect. 9D(2)) (see 3.3.3)	- Any corporation to which 25% or more of the CFCs income is attributed (S747 (5), ICTA, 1988) (see 7.4.4) - Constructive ownership rules (S 755D (5)-(9), ICTA, 1988) (see 7.3.7)	- Any United States taxpayer with at least 10% voting power of CFC at any time in the year and who owns shares in the CFC at the end of the year (S 951(a)(b), IRC, 1986). (see 7.3.4) - Indirect ownership rules (S 958(a)and (b), IRC, 1986) (see 6.4.2)

	South Africa	United Kingdom	United States
Exemptions	- Foreign business establishment exemption (Sect. 9D(1), Sect. 9D(9)(b) & Sect. 9D(9A)) 75 % tax exemption (Sect. 9D(2A)) - Net income – SA taxable income (Sect. 9D(9)(e)) - Foreign dividend received from related CFC (Sect. 9D(9)(f)) - Capital gains FBE (Sect. 9D(9)(b)) - Capital gains FBE related to CFC (Sect. 9D(9)(fB)) (see 3.4)	- Exempt activities exemption (S 748(1)(b)), ICTA, 1988 - De minimis (S748(1)(d)), ICTA, 1988 - Motive test (S 748(3)), ICTA, 1988 - Excluded countries S 748(1)(e), ICTA, 1988 - Finance Bill 2012 - Exempt period - Low profits - Low profits margin - Tax exemption (see 7.3.6, 7.3.8 and 7.4.5)	- De minimis rule (S 954(b)(3)(A), IRC, 1986) - Full inclusion test (S 954(b)(3)(B), IRC, 1986) - High tax exclusion (S 954(b)(4), IRC, 1986) - Active business income (rents & royalties) (S 954(c)(2)(A), IRC, 1986) - United States source income- (effectively connected United States) (S 952(b), IRC, 1986) - Related-party exception (same country) (S 954(c)(3)(A)(i)) - TIPRA exception (S 954(c)(6), IRC, 1986) - Actively conduct banking (S 954(h)(1)3(A), IRC, 1986) - Qualified insurance income (S 954(i)(1)2(A) AND 2(B), IRC, 1986) (see 7.4.5)
Relief Provisions			
Foreign Taxes	Credit allowed against SA tax for foreign taxes paid (S 6quat(1)) (see 3.5)	Credit allowed against United Kingdom tax for foreign tax paid (S 751(6), ICTA, 1988) (see 5.9.7)	Foreign tax credit for underlying foreign taxes paid by CFC and withholding taxes on dividends received by CFC (S 960(a)(1)and(2), and S 962, IRC, 1986) (see 7.4.6)
Losses	Trading losses carried forward indefinitely (S20, Sect. 9D(2A)(b)) (see 3.3.4.3)	- Trading losses carried forward indefinitely (S 393(1), ICTA, 1988). - CFC may carry forward losses from the 6 years preceding the first year in which HMRC applies CFC rules to it (Sch, 24 para 9(1), ICTA, 1988) (see 5.10.1)	CFCs current losses (and, to very limited extent, deficits in accumulated profits) reduce its earnings and profits; losses carried forward indefinitely. A foreign loss within a separate basket must offset foreign source income in other baskets prior to reducing United States source income (S 904(f)(5)(A) and (B), IRC, 1986). (see 7.4.7)
Subsequent Dividends	When CFC income is distributed in the form of dividends – exempted under S10B(2) but subject to Sect. 10B(4) (see 3.4.8.1)	United Kingdom tax on attributed income treated as foreign tax paid and creditable against subsequent dividends (Sch 26, para 4(1)-(3), ICTA, 1988) (see 5.9.7)	Not taxable to extent of previously taxed CFC income (S 959(a), IRC, 1986) (see 6.8.1)
Subsequent capital gains	Sales of interest in a CFC exempt in terms of Para 64B (Eighth Schedule), if certain requirements are fulfilled. (see 3.4.8.3)	Capital gains reduced by United Kingdom tax on attributed income Sch, 26 para 3, ICTA, 1988). (see 5.9.7)	Relief by way of adjustments to cost basis of shares in both top-tier and lower-tier CFC (S 961, IRC, 1986) (see 6.8.2.2)
Income taxed under another country's CFC measures	No relief	No relief	No relief
Relevant Allowances	No relief	Specific reliefs for set-off against potential tax liability (S 754(5), Sch, 26para 1(1) & (3), ICTA, 1988) (see 5.10)	No relief

7.2 Absence of an international CFC paradigm

No single CFC regulatory framework exists that could serve as an international paradigm. It would not be unreasonable to say that international paradigms in this particular domain of tax regulations do not, and possibly cannot, exist. Promulgation of CFC regulations is determined on a country-by-country basis, shaped by the fiscal and macro-economic priorities of national governments, related to whether a particular country is capital importing or capital exporting, the level of tax non-compliance by its residents and the extent of foreign investments in tax havens and preferential tax regimes (PriceWaterhouseCoopers, 2012:1). Therefore, the above factors are the main constituents contributing to the variations in the configuration of domestic CFC regulations.

South Africa is considered to be a net capital importing country, in contrast to the United States and the United Kingdom, which are net capital exporting countries. Therefore the country-specific elements of South Africa's CFC regulations have largely been influenced by the relative scale of the country's economy and of its outgoing foreign direct investment, which has resulted in a less complex regulatory regime pertaining to: qualifications criteria of a CFC, attribution rules, exemptions and relief provision. It is apparent from this study that in developing its CFC regulations, South Africa, on a country-specific level, has not followed any particular jurisdiction, and specifically not the United Kingdom or the United States.

On a country-specific level, United States CFC regulation is migrating towards a territorially based taxing system, reflecting a positive need to keep abreast of changes in the international tax environment. One of the most notable changes in the ongoing trajectory of its CFC regulation is the treatment of low-taxed foreign income as Subpart F income. United States CFC regulation is also strongly influenced by political intervention such as the United States Job Creation and International Tax Reform Act of 2012 which introduced some key measures in its anti-avoidance rules – as exemplified by the participation exemption system for taxation of foreign income, the modification of Subpart F and foreign tax credit (see 6.9.2 above).

For its part, United Kingdom CFC regulation is undergoing a paradigm shift as it migrates from an exclusively jurisdictional approach to a territorially inclined tax system, more compatible with EU requirements and, is propelled in large measure by EU pressure-globalisation, highlighted in the recent series of judgements delivered by the European Court of Justice.

In each of these two national instances there are highly specific national priorities driving regulatory change, set against which South Africa's own country-specific needs inevitably constitute a markedly different driving force.

Notwithstanding these divergences, CFC rules do nonetheless exhibit a significant degree of convergence – and, in certain instances, there could even be direct transplantation of key provisions from one jurisdiction to another: residence, definition of CFC, control requirements, the requirements for shareholder attribution, computation of net profit, and relief provisions. The convergence arises from shared domestic fear that tax competition will result in the establishment of parent corporations in foreign jurisdictions in order to evade the imposition of CFC regulations domestically (for example, the migration of United States public corporations setting up parent companies in Bermuda, also United Kingdom companies establishing their operations in Ireland). (Avi-Yonah & Sartori, 2012:6.)

In response, the OECD in a recent action plan to counter Base Erosion and Profit Shifting (BEPS), presented to the G20 Finance Ministers meeting in Moscow on 19 July 2013 measures to strengthen OECD rules by developing recommendations for the design of domestic CFC rules. This is a new dawn in the history of the OECD (as to date being only a matter for national governments), despite CFC measures being familiar in many OECD member countries. (Deloitte, 2013a:1.)

7.3 South African CFC legislation: shortcomings and recommendations

7.3.1 Place of effective management

Although the term “place of effective management” is not defined in the South African Income Tax Act, SARS *Interpretation Note 6* makes it clear that the decisive sense of in place this regard is “where the company is managed on a regular or day-to-day basis by the directors or senior managers of the company, irrespective of where the overriding control is exercised, or where the board of directors meets” (South Africa, 2002d:3). In essence, therefore, “*place of effective management* refers to the place where policy and [strategic] decisions made by the board of directors are *implemented* and not where they are taken” (Olivier & Honiball, 2011:25). If management functions are executed at a single location, this location will be the place of effective management. Where directors and senior managers manage via distance communication (telephone, internet, video conferencing, etc.) then the place of effective management is “the place where the business operations/activities are actually carried out or conducted” (South Africa, 2002d:4). Where these operations/activities are conducted from various locations, then the place with the strongest economic *nexus* has to be determined (South Africa, 2002d:4) (see 4.2.2.3 and 4.2.2.4 above).

The term “place of effective management” is also not defined in Article 4(1) of the OECD Model Tax Convention, but paragraph 24 in the Commentary on Article 4, gives guidance on the interpretation of this term:

As a result of these considerations, the “place of effective management” has been adopted as the preference criterion for persons other than individuals. The place of

effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made. All relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one place of management, but it can have only one place of effective management at any one time. (OECD, 2010b:art 4 para 24.)

This interpretation was confirmed in *Indofood International Finance Ltd v JP Morgan Chase Bank* United Kingdom Court of Appeal (United Kingdom, 2006b), where it was held that the place of effective management refers to the place where the key management and commercial decisions that are necessary for the conduct of the entity's business, are in substance made. It does not suffice to declare a particular place as the place of effective management, even if the directors who make the decisions regarding the keeping of books, management of the audit, handling charges and how to utilise equity capital, reside within a Contracting State. (Olivier & Honiball, 2008:80.) (see 4.2.1.2 and 4.2.1.3).

Recommendation: In a South African context, the divergence between *Interpretation Note 6* and paragraph 24 of the OECD Commentary on Article 4 (2010) could result in an anomalous situation in relation, especially to bilateral double-taxation agreements between South Africa and other foreign Contracting States, where incorrect allocation of taxing rights to a foreign contracting country could potentially jeopardise income to the South African Treasury. For South Africa to keep in line with international standards (particularly in relation to the OECD and UN MTCs) it should therefore consider incorporating the principles of international conventions in South African domestic tax law in regard to place of effective management. (see 4.2.4 above).

7.3.2 Criteria for permanent establishment and foreign business establishment

Article 5 in both the OECD and the UN Model Tax Conventions set out the conditions that need to be fulfilled in order to determine a permanent establishment in a foreign source jurisdiction. The tax implication of such an establishment, which usually involves some form of physical presence in the source country, is that it gives the country in which it is situated the right to tax the entity under its domestic laws, notwithstanding the fact that the permanent establishment has no separate legal existence (Olivier & Honiball, 2008:95).

This point is further endorsed in the OECD Commentary on Article 5 which states that “the concept of a permanent establishment is to determine the right of a Contracting State to tax the profits of an enterprise of the other Contracting State” and also that “under Article 7 a Contracting State cannot tax the profits of an enterprise of the other Contracting State unless it carries on its business through a permanent establishment situated therein” (2010b: Article 5: para 1). In an international context, therefore, the term “permanent establishment” “[implies] a specific meaning and [also] serves a

specific purpose, namely, to grant taxing rights to the country in which the permanent establishment is situated” (Olivier, 2002:866). (see 4.3.1 and 4.3.2)

In South Africa, the foreign business establishment (FBE) criterion is currently invoked in granting tax exemptions to FBEs of South African CFCs (South Africa, 1997:Section 9D(1), 9D(9)(b), 9D(9A)). Although the FBE criterion as set out in Section 9D(1) of South Africa’s CFC legislation (Olivier & Honiball, 2011:584) broadly resembles the permanent establishment criterion in Article 5 of both the OECD and the UN Model Tax Conventions, the latter criterion is subject to a number of qualifications and thus differs in various respects from the FBE requirements in South Africa’s CFC tax legislation.

In South Africa’s tax legislation, the term “foreign business establishment” refers exclusively to South African CFCs (South Africa, 1997:Section 9D(1)). Unlike the concept of a permanent establishment in the OECD and UN Model Tax Conventions, that fundamentally grants taxing rights to foreign jurisdictions in which the permanent establishment (or branch) is based, the South African “foreign business establishment” concept applies exclusively to the granting of tax exemptions to foreign business establishments of South African CFCs (Section 9D(9)(b)). In this respect, the FBE requirement in the South African CFC legislation for the granting of exemptions to CFCs is a unique criterion by international standards. (see 4.3.3).

Recommendation: The FBE requirement in the South African CFC legislation should be replaced with the permanent establishment criterion as envisaged in Article 5 of the OECD and UN Model Tax Conventions, to bring South African CFC legislation in line with internationally accepted terminology. The objective in the use of the term permanent establishment in the South African CFC regulation should conform with the principles laid down in both the OECD and the UN Model Tax Conventions in granting of tax exemptions to foreign branches of CFCs operating in a country other than the CFC’s country of residence or incorporation. However, the South African taxing authorities should bear in mind that the permanent establishment concept in the South African CFC legislation should not be inappropriately used by resident taxpayers to attribute income to a foreign branch (i.e., permanent establishment) that was not earned by it, thereby avoiding or deferring South African taxation on foreign-sourced income. Stringent requirements should therefore be set in place to counter this practice: (i) the regulations as laid out in Article 5 should be rigidly enforced; (ii) a similar tax proviso to Section 9D(2A) should be incorporated in order for the permanent establishment to be exempted from taxation and should read as follows: that the permanent establishment will qualify for the exemption if the aggregate amount of tax payable in the source country (where the permanent establishment is based) is at least 75 per cent of the amount of normal tax that would have been payable had the permanent establishment been a resident of South Africa in any given accounting period (see 4.3.5 above).

A new regime should be introduced in the South African CFC legislation to replace the FBE exemption (see exemptions outlined below). Removal of the FBE criteria in the South African CFC legislation would eliminate the need for the new Section 9D(9A), which should accordingly be removed from the statute book.

7.3.3 Approaches to CFC legislation

South Africa currently applies its CFC regulations to all CFCs wherever they are resident (or located) and irrespective of the foreign taxes payable ('the global approach'). Regarding the types of income that are subject to taxation, South Africa adopts the entity approach under which, in general, all the income (after allowing for exemptions and net of expenses) is subject to South African taxation. In essence therefore, South Africa adopts the global-entity approach to the application of its CFC regulations. South Africa is also among those countries that now incorporate a jurisdictional approach in their CFC regulations, evidenced in the South African regulations by references to the aggregate tax payable by the CFC to any foreign government, where it is either 75 per cent or more (Section 9D(2A)), or above 50 per cent (Section 9D(9A)(a)), of the amount of normal taxes that would have been payable in respect of any taxable income of the CFC had the CFC been a South African resident for the respective foreign tax year (see 3.4.2).

Prior to Finance Bill 2012, the United Kingdom applied the jurisdictional-entity approach to its CFC regulations. The jurisdictional approach was determined by the application of the "lower level of taxation" test, being one of the definitional requirements for a foreign company to qualify as a CFC, which meant that if a foreign company did not pay a "local tax amount" of at least 75 per cent of the "corresponding United Kingdom tax", then it would be considered as a "lower level of taxation" company and be subject to United Kingdom CFC regulations. The United Kingdom entity approach was based on the all-or-nothing approach which meant that if a CFC qualified for one of the entity-level exemptions granted in the United Kingdom CFC legislation then its entire income was exempt from United Kingdom taxation. However, Finance Bill 2012 brought about a paradigm shift in the qualification criteria of foreign companies qualifying as United Kingdom CFCs; it is no longer a qualification criteria for foreign companies qualifying as CFCs to be subject to the "lower level of taxation" test. The "lower level of taxation" test is now given as one of the entity-based exemptions in United Kingdom's CFC legislation. (United Kingdom, 2012b.)

The United States is also migrating from a purely global approach to one that embraces a form of jurisdictional approach in its CFC regulations, initiated by the United States Job Creation and Tax Reform Act of 2012 (see 6.9.2.1 above) in which all gross income of a CFC is considered as low-taxed income unless the 10 per cent United States shareholder establishes that the income was subject to foreign tax at an effective rate that exceeds one-half of the maximum rate of income tax applicable

to United States corporations for the relevant taxable period, in order that income is excluded from the application of Subpart F. (United States, 2012:26-27.)

Recommendation: If South Africa does not incorporate the entity-level-based exemption known as the “tax exemption” (and outlined more fully at 7.3.6 below) then it has the alternative of incorporating this exemption as the “lower level of taxation” test to serve as one of the criteria for a foreign company to qualify as a CFC, rather than the current proviso to Section 9D(2A) which exempts a CFC’s income from attribution if the CFC fulfils the minimum 75 per cent taxation test (see 3.4.2 above). If this were to be put into effect then South Africa would be applying the jurisdictional-entity approach to its CFC regulations. From an administrative perspective, this approach would give SARS better insight of the high-taxed jurisdictions and, in addition, certain of the high-taxed foreign companies would not qualify as CFCs, thus avoiding the additional administrative work of first qualifying the foreign company as a CFC and then exempting it from attribution, as is the current practice.

However, should the South African tax authorities concede to the use of the “tax exemption” criteria as an entity-level-based exemption in South African CFC regulations, then it will not be feasible to use the “lower level of taxation” test as one of the criteria for a foreign company to qualify as a South African CFC. In this context South Africa should continue with the global-entity approach in its CFC regulations and incorporate the above as an entity-level-based exemption in its CFC regulatory framework.

7.3.4 Shareholder qualification for determining a CFC

Unlike United States CFC legislation, South African regulations do not prescribe a minimum shareholding percentage for determining the requirement of more than 50 per cent ownership (in value or voting rights) for the foreign company to qualify as a CFC. In the United States a foreign company is a CFC when United States shareholders (United States persons each owning directly, indirectly or constructively, at least 10 per cent or more of the voting stock of the foreign corporation) own more than 50 per cent of the voting power or value of the foreign corporation (United States, 1986:(Section 951(b) and Section 957(a), IRC). These thresholds are reduced for certain purposes in case of insurance companies (United States, 1986:Section 953(c)(1)(B), IRC) (see 6.4.2 and 6.5.2 above).

Currently in South Africa, the 10 per cent *de minimis* rule applies only for the purpose of attribution where a South African resident (together with any connected persons in relation to that resident) who holds at least 10 per cent of the participation rights and may exercise at least 10 per cent of the voting rights in a CFC, will accordingly be subject to taxation on the proportionate share of the net income of the CFC (see 3.3.3). This proportionate attribution is made under the presumption that the net income

is immediately repatriated to South African resident shareholders in the year when it is earned by the CFC (Section 9D(2)(A)). An anomalous situation could, however, arise where, for example, a foreign company having 100 South African shareholders (of equal shareholding) qualifies as a CFC, yet no shareholder qualifies for attribution in terms of Section 9D(2).

Recommendation: Following the example of the United States, South Africa should consider introducing a minimum shareholder qualification requirement in which only those shareholders having the prescribed minimum percentage of shareholding will be considered as shareholders for the purposes of determining a foreign company as a CFC (Section 9D(1)). This will preclude the possibility (such as indicated above) of no single shareholder being subject to South African taxation in respect of the CFC income. It is recommended (a) that the minimum percentage shareholder requirement should be equal to the required percentage for attribution purposes of South African CFC shareholders, and (b) that the current attribution rate of 10 per cent should be lowered to put it in line with the new percentage shareholder requirement. The lower requirement would bring more persons into the South African taxing net for attribution purposes.

7.3.5 Control

Compared with United States and United Kingdom practice, the concept of control in the South African CFC legislation warrants particular attention in view of the measures resorted to by many South African shareholders to circumvent control regulations with the intention of preventing a foreign company qualifying as CFC. As presently defined in the South African legislation, “controlled foreign company” means any foreign company where more than 50 per cent of the total participation rights in that foreign company are directly or indirectly held, or more than 50 per cent of the voting rights in that foreign company are directly or indirectly exercisable, by one or more persons that are residents other than persons that are headquarter companies.

The effect is that both “voting rights” and “participation rights”, held directly or indirectly, are taken into consideration for the purposes of determining a CFC. In Section 9D(1)(a), participation right is defined, in relation to a foreign company, as “the right to participate directly or indirectly in the share capital, share premium, current or accumulated profits or reserves of that company, whether or not of a capital nature”. Section 9D(1)(b) further specifies that it is only “in the case where no person has any right in that [foreign] company as contemplated in paragraph (a) or [where] no such rights can be determined for any person, [that] the right to exercise any voting rights in that company” becomes a participation right. Voting rights are thus only taken into account when the foreign company does not have equity (e.g., certain hybrid companies or foreign partnerships which are body corporates and fall outside the given definition of foreign partnership) or where the members’ interest in the capital of the company cannot be deciphered. (Olivier and Honiball, 2011: 567.) (see 3.2.1.2).

Although the term “participation rights” clearly refers to the rights of shareholders who participate in the profits, the position is less clear in relation to the term “voting rights”, which is not defined in the Income Tax Act. The only guidance which Section 9D provides on the latter term is a reference in the definition of “controlled foreign company” in Section 9D(1), which stipulates that when the voting rights in a foreign company are determined, no regard must be had to voting rights in a foreign company

- which is a listed company; or
- if the voting rights in the foreign company are exercised indirectly through a listed company

According to the definition of “participation rights”, voting rights are only taken into consideration when a person’s rights in the company cannot be determined, and it is thus difficult to understand when such companies (i.e., companies without defined rights) will ever constitute listed companies. Considering that the aim of Section 9D is to tax income over which a South African resident has control, “voting rights” should include all persons who have control over the income of the foreign company. It would, for example, be clear from the official documentation of the foreign company whether the shareholders or directors have the right to declare dividends. Since Section 9D serves as an anti-avoidance provision aimed primarily at attributing income, within the tax net, of a foreign company which is being controlled by South African residents, voting rights arguably signify any form of control over the distribution of profit or capital exercised by a South African resident, whether a shareholder, director, or otherwise. (Olivier & Honiball, 2011:567-568.)

The inclusion of “indirectly” in the definition of the term “controlled foreign company” means that the interests of both registered and beneficial shareholders have to be taken into account. Although in terms of Section 82 of the South African Income Tax Act the onus of proof is on the taxpayer (i.e. the South African resident shareholder), the practical application of Section 9D provisions to indirect interests may often be problematic. The reference to direct and indirect holdings means that where a South African resident individual owns all the shares in a foreign Company A, which in turn holds all the shares in another foreign company B, companies A and B will be both considered to be CFCs. (Olivier & Honiball, 2011:569-570.) (see 3.2.1.2).

A shortcoming in the South African CFC legislation pertaining to “control” is the absence of directives and supporting annotations in respect of two key issues: attribution, and constructive ownership rules pertaining to share ownership. Since the basic test of control of a foreign company is the ownership requirement of more than 50 per cent of the shares, in vote or value, it would be an easy matter for a taxpayer to avoid having control of a foreign corporation by transferring some of the shares to related persons or entities. Constructive ownership rules have, over time, become the international norm in CFC regulation in an attempt to prevent taxpayers from avoiding the control of a

foreign corporation through fragmentation of its share ownership. These constructive ownership rules operate by attributing to a taxpayer the ownership of shares in a foreign corporation owned by related persons or entities. Constructive ownership rules also apply for purposes of determining whether the minimum ownership requirement is satisfied. This is the case in the United States where the minimum share requirement of 10 per cent is used for qualification purposes of a United States shareholder (United States, 1986:Section 951(b), IRC), and constructive ownership rules are also used by other countries to identify domestic shareholders who are taxable on the undistributed income of a CFC (for attribution purposes). Currently, the only references in South African CFC legislation pertaining directly to constructive ownership and attribution rules are contained in proviso (A) to Section 9D(2), for attribution purposes and when determining a foreign company as a CFC in Section 9D(1)(c), in regard to “connected persons” (as defined in Section 1 of the Income Tax Act).

As constructive ownership and attribution rules are important for preventing potential CFCs from evading the South African tax net, consideration should therefore be given to incorporating the United States indirect and constructive ownership rules (United States, 1986:Section 958(a) and (b), IRC) as additional measures in the South African CFC tax legislation, under Section 9D of the Income Tax Act, to identify control of foreign companies – rather than relying solely on the definition of “connected persons” in Section 1 of the Income Tax Act.

Recommendation: The reference to “indirectly held” in the definition of a CFC in the South African Tax Act currently has very limited scope as a criterion for classifying foreign companies as CFCs, since in current practice the concept only applies in respect of indirect shareholdings in foreign companies held directly through other foreign companies. No further clarification is given regarding ownership of shares through “indirect shareholding”, where shares are owned in foreign companies through other entities such as foreign trusts, foreign estates or foreign partnerships. One could postulate that the definition of “connected persons” in Section 1 of the Income Tax Act is assumed (by the legislator) to be automatically applicable (without qualification) to the “indirectly held” concept in the Section 9D(1) definition of a CFC. The uncertainty of relying on such an assumption constitutes a lacuna for the South African taxing authorities where it would be appropriate for them to follow the lead of the United States (see below) and insert specific clarification of the term “indirectly held” into the CFC legislation. Key features of the United States legislation contained in Sections 958 (a)(2) and 958 (b) of IRC 1986 could potentially be recommended for the control measures currently in place in the South African CFC tax regulations.

Indirect ownership rules: The United States indirect ownership rule in Section 958(a)(2), IRC (United States, 1986) provides that stock owned directly or indirectly by or for a foreign entity shall be treated as owned proportionally by its shareholders, partners, or beneficiaries. For example, if P, a United States corporation, owns 75 per cent of the stock of R, a foreign corporation, and R owns 80 per cent

of the stock of S, then P will be treated as the owner of 60 per cent (80 per cent of 75 per cent) of the stock of S (United States, 1986:Section 958(a)(2), IRC). Similarly, if A is the sole beneficiary of T, a foreign trust, and T, owns 60 per cent of the stock of Q, a foreign corporation, then A will be treated as the owner of the 60 per cent of the stock owned by Q (United States Code of Federal Regulations, 2001: 1.958-1(d)(Ex 3)).

The benefit of this indirect ownership rule is that United States persons are unable to avoid the impact of Subpart F by transferring the stock of a foreign corporation to a foreign entity or to a chain of foreign entities under their control. The indirect ownership rule applies in determining the ownership of stock for most purposes under Subpart F. Therefore, a person treated as a United States shareholder of a CFC under the indirect ownership rule of Section 958(a), IRC, 1986, will be taxable under Section 951(a) on that person's pro rata share of the CFC income. Further, a shareholder that indirectly owns stock in a CFC is taxable on a deemed dividend from the CFC without the dividend passing through any intermediary foreign entities. Thus, the Section 951 income of a second-tier foreign affiliate would be taxable to the United States parent as a deemed dividend without the first-tier affiliate being treated as having received the deemed dividend. This method of taxing persons that indirectly own stock of a CFC is known as the hopscotch rule. (McIntyre, 2001:12.) (see 6.4.2.2 and 6.4.3).

Constructive ownership rules: United States constructive ownership rules are contained in Section 958(b), IRC, 1986. Under these rules taxpayers are treated, for certain limited purposes, as the owners of stock held by certain trusts, corporations, and other legal entities and by certain close relatives. The rules are applicable for purposes of determining whether a foreign corporation qualifies as a CFC under Section 957(a), IRC, 1986; whether a United States person is a United States shareholder under Section 951(b); whether a person is a related person within the meaning of Section 954(d)(3), IRC, 1986; and whether stock of a domestic corporation should be treated as owned by a United States shareholder of a CFC for purposes of Section 956(c)(2), IRC, 1986. In addition, some Code sections explicitly invoke the constructive ownership rules. In direct contrast to the indirect ownership rules, the constructive ownership rules do not cause a person to be treated as the owner of stock for purposes of being taxed on deemed dividends under Section 951(a), IRC, 1986 (see 6.4.3). Code 958(b) incorporates by reference, with some modifications, the complex constructive ownership rules contained in Section 318(a). The rules under Section 318(a) are applicable to transactions governed by subchapter C of the Code, relating to taxation of corporations and shareholders. See 6.10.5 above for a summary of the detailed and broad constructive ownership rules in Section 958(b), IRC, 1986.

In summary, the South African tax authorities should review the indirect and constructive ownership rules contained in the United States Internal Revenue Code, Section 958, 1986, for possible incorporation, with appropriate modification, into the South African CFC legislation for purposes of

determining a foreign company as a controlled foreign company and a shareholder for the CFC qualification criteria and attribution rules.

7.3.6 Exemptions

Since South Africa and the United Kingdom both incorporate the entity approach in their CFC regulations, recommendations offered here for the South African CFC legislation with regard to exemption from CFC attributions are drawn exclusively from the United Kingdom practice (see 7.4.5 below).

While the entity approach is common to both jurisdictions, they diverge in its application. The United Kingdom (prior to Finance Bill, 2012) applied the all-or-nothing approach, which meant that either all the income or none of the income was subject to taxation in the hands of United Kingdom shareholders. Prior to the Cadbury Schweppes case, the United Kingdom's exemptions were purely entity-based, which meant that no CFC charge was to be imposed in relation to any of the profits of the foreign company if any one of the exemptions was applicable to the CFC. The 2007 Cadbury Schweppes case introduced the first partial limitation on the scope of the United Kingdom's CFC regime: the reduction in chargeable profits to reflect qualifying work carried out in the European Economic Area (EEA) state (see 5.9.4 above). The Finance Act 2011 "interim improvements" also included the following partial limitations: trading companies with limited United Kingdom connections, companies exploiting IP with limited United Kingdom connections, and temporary exemptions (see 5.9.5 and 5.9.6 above). The United Kingdom's Finance Bill 2012 also introduced a number of entity-level-based exemptions: tax exemption, low profits exemption, low profit margin exemption, and excluded territories exemption. South Africa's entity-based approach, on the other hand, taxes all income (net of expenses) attributable to the CFC after allowing for specified exemptions listed in its CFC regulations.

The FBE criterion in the South African CFC legislation forms the nucleus of the exemptions currently being granted in this legislation – the legislator having "attempted to strike a balance between granting an exemption to income derived from legitimate business activities and that derived from illusory or non-substantive business undertakings (i.e., mobile and diversionary business income and mobile passive income)" (Olivier & Honiball, 2011: 581). The exemption seeks to exclude a portion of the active business income attributable to a FBE of a CFC. Up until 30 March 2012, the nucleus of the FBE exemption requirement was subsumed under Section 9D(9)(b) and had also included a number of exceptions to the application of the FBE criteria; however, the intricate nature of this exemption had propelled South African tax writers, Olivier and Honiball to decry it as "one of the most complicated provisions in the South African Income Tax Act". (2011: 581.) (see 3.4.4.2).

However, the South African taxing authorities were not entirely satisfied with the state of the FBE criteria being almost exclusively based in Section 9D(9)(b) and made changes in Taxation Laws Amendment Act, No. 24 of 2011. One main reason instigating the change was the introduction of the high-foreign-tax exemption that substantially mitigated the effects of previous provisions in Section 9D(9)(b) to prevent CFCs from being used to shift income offshore through the import and export of goods, and where the import of services was involved. (South Africa, 2011a: 104.)

Changes to Section 9D(9)(b) led to the incorporation of the new Section 9D(9A) in the South African Income Tax Act. The new FBE exemption criteria in Section 9D(9)(b) of the Income Tax Act (as from 1 April 2012) incorporates arm's-length principles consistent with transfer pricing regulations whereby an FBE is to be treated as if it were a "distinct and separate enterprise," which is "dealing wholly independently" with the CFC of which it is a part (Section 9D(9)(b)(i)). When determining both the *quantum* attributable to an FBE and whether an amount is actually attributable to the FBE in question, the determination must, under this presumption, be made as if the amount resulted from terms and conditions that would have prevailed between "independent persons dealing at arm's length" (Section 9D(9)(b)(ii)). The revised FBE exemption is further subject to (and is read in conjunction with) the exceptions and refinements which, from 1 April 2012, are set out in the new Section 9D(9A) (South Africa, 2011d: Section 25(k)). The new regime thus instigated by the Taxation Laws Amendment Act, No. 24 of 2011 targets mobile income under four broad distinct categories: (i) financial instruments; (ii) rentals and sales of tangible movable property; (iii) royalties and disposals of intellectual property; (iv) insurance premiums. (South Africa, 2011a: 105; Section 9D(9A).) (see 3.4.4.3).

Recommendation: Notwithstanding recent amendments to Section 9D(9)(b) (through the Taxation Laws Amendment Act, No. 24 of 2011) intended to bring FBE criteria in line with arm's-length requirements consistent with transfer pricing fundamentals, the continued use of the FBE criteria as the main form of exemption currently granted to CFCs remains unique to South African CFC legislation, set against the internationally established permanent establishment criteria, as set out in the Model Tax Conventions, and as invoked in bilateral tax conventions, which assign taxing rights of permanent establishments based in foreign jurisdictions to foreign taxing authorities under the presumption that the permanent establishment's presence in the foreign jurisdiction is dependent upon the host's country's infrastructural provisions and that taxing rights should accordingly be awarded to the foreign jurisdiction in which the permanent establishment is based (OECD, 2010a:art 5). Although South Africa's FBE criteria are closely aligned to the permanent establishment concept as contained in the Model Tax Conventions, incorporation of the FBE concept as a basis for exemption granted to South African CFCs in respect of genuine commercial activities conducted abroad means that South African CFC legislation differs from international practice. Whereas the permanent establishment criteria in the Model Tax Conventions determine the existence of a permanent establishment in a

foreign tax jurisdiction in order to confer on such foreign jurisdiction the right to tax the profits of that permanent establishment, the objective of the foreign business establishment criteria in the South African CFC tax legislation (in Sections 9D(1), 9D(9)(b), and 9D(9A)) is to qualify the CFC for tax exemptions in respect of its FBE's active business operations.

It is suggested that (a) the FBE criteria currently used as the main channel of exemption for South African CFC income be revisited by South African tax authorities and, if possible, an alternative regime be sought for such exemption, to replace the FBE criteria, and (b) the "permanent establishment" concept be inserted directly into the CFC regulations as part of the definitions contained in Section 9D(1) in such a way that its objectives concur with the principles as laid down in Article 5 of the OECD and UN Model Tax Conventions (i.e., to determine the existence of a permanent establishment in a foreign tax jurisdiction in relation to the CFC, in order to confer on such foreign jurisdiction the right to tax the profits of the permanent establishment).

The disparate objectives of the South African FBE criteria and the permanent establishment criteria of the Model Tax Conventions create potential for interpretation problems. The FBE criteria are unduly complex and opaque, creating unnecessary difficulty for South African resident shareholders, attorneys, tax consultants and foreign investors seeking information on South African CFC regulations. Their complexity also creates unnecessary difficulty for SARS administration in relation to the following issues in particular: (i) validating the existence of a FBE of a CFC; (ii) determining whether transactions between the FBE and CFC are done at arm's length; (iii) determining whether each FBE of a CFC maintained separate accounting records from the remainder of the CFC, and their accuracy; (iv) distinguishing between domestic branches (based in the CFC's country of incorporation) and foreign branches (based outside the CFC's country of incorporation) in order to identify domestic branches that could qualify for the Section 9D(9)(b) exemption and foreign branches that could qualify as permanent establishment in terms of Article 5 of the OECD and UN Model Tax Conventions (see 3.4.4.2). (Potgieter, 2012:58; Olivier and Honiball, 2011:641.)

An amended exemption to replace the FBE criteria with an entity-level-based determination whereby a qualifying CFC would pay no CFC charges in relation to any of its profits would constitute a paradigm shift for South African CFC regulations: abandoning a system of partial exemptions and specific exclusions in favour of a system founded on entity-level-based exemptions according to which the entire income of a CFC could potentially be excluded from the ambit of the South African taxing regime.

Aside from the inherent complexities that beset the FBE criteria, they also have doubtful adequacy as a tax-avoidance deterrent in that (with no tax-neutralising measures, in relation especially to tax equity) they leave it open for South Africans to invest in tax havens or preferential tax regimes and escape South African taxation on active business income that meets the FBE criteria. It would be

advisable therefore for South Africa to establish entity-level-based exemption criteria which block this possibility.

Tax exemption: The present FBE criteria exempt active income but not mobile or passive income (unless it benefits from the exception clauses), even if the mobile income is attributable to FBE activities, whereas entity-level-based exemption criteria would exclude all income from taxation, including passive income. Compensating for the new criteria under the entity approach, a CFC should be granted the exemption only if the local tax amount payable in relation to its profits in its territory of residence for a given accounting period was at least 75 per cent of the corresponding South African tax that would have been payable had the CFC been a tax resident of South Africa. Such a provision would follow the example of the entity-level exemption contained in Finance Bill 2012 pertaining to United Kingdom CFC legislation (Finance Act 2012), according to which the profits of the CFC are exempt from the CFC charge if, in respect of the CFC's accounting period, the local tax amount is at least 75 per cent of the corresponding United Kingdom tax. This requires comparison of the actual tax paid on the profits of the CFC in its territory of residence with the tax that would have been payable on a domestic tax measure of those profits, after allowing for permissible deductions (United Kingdom, 2012d). Were South African tax authorities to adopt such exemption criteria in their CFC legislation it would annul the existing proviso to Section 9D(2A) in respect of exemption for high-taxed net income (Section 9D(2A)), the purpose of which is to disregard CFC income "if little or no South African tax is at stake once South African foreign tax credits in Section 6quat of the Income Tax Act are taken into account". (Mendes, 2011:1.)

CFCs not meeting the new entity-level-based exemption criteria would be subject to South African taxation on their profits; as a tax reprieve, therefore, they should continue to be allowed certain of the following partial exemptions (in relation to CFC profits) currently in force in the South African CFC legislation: (i) long-term insurance for non-resident policy holders (Section 9D(9)(c)); (ii) exemption of interest and royalties as CFC inclusions (Section 9D(9)(d)); (iii) exemption of South African taxable income (Section 9D(9)(e)); (iv) related CFC dividend exemption (Section 9d(9)(f)) (see 3.4.5 to 3.4.8 above). Additional partial exemptions could also be incorporated into Section 9D of the Income Tax Act.

Mobile income: It refers to income derived from assets that are normally easily movable between the different jurisdictions. The assets will normally comprise of: bank cash deposits, share investments, intellectual property such as patents, copyrights, trademarks, etc. Income will normally constitute: annuities, interest, dividends, royalties, rentals, etc.

A separate taxing regime would be applicable to mobile income, should the CFC not qualify for the entity-level-based exemption criteria. Mobile income accruing to a CFC will in such a case be automatically taxable unless specific exemptions relevant to that income stream apply. In introducing

a new trajectory for taxation of mobile income, should the current FBE criteria be removed from the South African CFC legislation, no immediately comparable measures are to be found in United Kingdom or United States CFC regulations that would be appropriate for inclusion in the South African CFC regulations. Independent evaluation of the South African CFC legislation (see Chapter 3) indicates that the current system for taxation of mobile income should, with necessary adaptations, continue under four broad but distinct categories: (i) financial instruments; (ii) rentals and sales of tangible movable property; (iii) royalties and disposals of intellectual property; (iv) insurance premiums (Section 9D(9A)).(South Africa, 2011a:105.)

7.3.7 Types of interest in a CFC for attribution purposes

Determination of interest in a South African CFC for the purposes of attribution is based exclusively on the ownership of participation rights by South African resident shareholders where such shareholders (or persons connected to them) hold not less than 10 per cent of the participation rights and exercise at least 10 per cent of the voting rights in the CFC. No directive is given in the regulations on how voting rights will be used (when participation rights cannot be established) to determine the proportionate net income attributable to the South African resident (Section 9D(2)(A)). This suggests that South African legislators need to have a broader perspective on what types of interest will attract attribution to shareholders in a CFC (see 5.9.3 above).

Recommendation: United Kingdom regulations have a much wider scope in definition of persons with an interest in a CFC for attribution purposes, and include the following:

- a) any person who possesses, or is entitled to acquire, share capital or voting rights in the company;
- b) any person who possesses, or is entitled to acquire, a right to receive or participate in distributions of the company;
- c) any person who is entitled to secure that income or assets (whether present or future) of the company will be applied directly or indirectly for his benefit; and
- d) any other person who, either alone or together with other persons, has control of the company. (Section 749B(1), ICTA, 1988.)

There is a strong argument for incorporation of these provisions in the South African CFC regulation to counter avoidance of CFC rules on income attribution.

7.3.8 The lower level of taxation test

The “lower level of taxation” test is an important criterion in the CFC regulations of all three countries (South Africa, United States and United Kingdom). In the United Kingdom, prior to United Kingdom Finance Bill 2012, the “lower level of taxation” test has been one of the defining criteria for CFC determination (see 5.6 above). In the United States, the United States Job Creation and Tax Reform Act of 2012, introduced a new category of Subpart F income for low-taxed income, whereby

all the gross income of a CFC is considered as low-taxed income, unless the 10 per cent United States shareholder establishes that the income was subject to foreign tax at an effective rate that exceeds one-half of the maximum rate of income tax applicable to United States corporations for the relevant taxable period (see 6.9.2.1 above). In South Africa, on the other hand, the “lower level of taxation” test is a proviso to Section 9D(2A) which grants tax exemptions to CFCs if the aggregate tax payable by the CFC to any foreign government exceeds 75 per cent of the normal tax that would have been payable had the CFC been a South African tax resident for the relevant foreign tax year (see 3.4.2 above).

Recommendation: One or another, but not both, of two options could be adopted by the South African regulator: incorporate the “lower level of taxation” test either as part of a jurisdictional-entity approach for CFCs (see 7.3.3 above), or in a new legislative framework for the granting of entity-level-based exemptions to CFCs (see 7.3.6 above).

7.3.9 Buttressing legislation

South Africa does not have buttressing legislation to support its CFC regulations where a South African shareholder of a CFC is not subject to attribution because the shareholding falls below the attribution threshold set by the exemption rule in proviso (A) to Section 9D(2). The South African tax authorities should therefore take note of the respective buttressing provisions in United Kingdom and United States tax legislation.

Recommendation: In the United Kingdom regulations, Section 739, ICTA, 1988, functions as an anti-avoidance measure to prevent United Kingdom residents from transferring assets abroad where income becomes payable to a non-United Kingdom resident and results in the avoidance of United Kingdom taxes; it covers transactions falling outside the United Kingdom CFC rule. To give an example: where all the shares of a foreign company are owned by individuals, the foreign company will be a CFC but will not be subject to any attribution in terms of Chapter IV, ICTA, 1988; its profits may, however, be assessed in the hands of individuals under Section 739, ICTA, 1988 (see 5.11.2.1 above).

The United States PFIC rules, enacted in 1986, immediately tax all foreign-sourced passive income of United States taxpayers, regardless of the percentage of stock ownership in the foreign corporation. Section 951(c), enacted in 1997, subsequently eliminated the overlap between PFICs and CFCs by declaring that if a foreign corporation is both a PFIC and a CFC, the CFC rules will apply with respect to the United States shareholders (an entity which qualifies as a CFC with respect to certain United States shareholders can still be a PFIC for the other United States persons who are not “United States shareholders”) (United States, 1986:Section 951(c), IRC). Therefore, the PFIC rules may be applied to tax foreign-sourced income not covered by the United States CFC regulations (see 6.8.6 above).

South African taxing authorities should consider incorporating buttressing legislation in the South African Tax Act to support CFC regulations, especially with regard to shareholders not being subject to attribution in terms of the South African CFC rules (South Africa, 1997:Section 9D(2)(A)).

7.4 United Kingdom and United States CFC issues diverging from South African concerns

7.4.1 Corporate residence

In determining the residency of companies for United States federal tax purposes the United States regulator adopts a narrower approach than that which prevails in the United Kingdom and South Africa: the sole decisive factor is the place of organisation or incorporation (United States, 1986:Section 7701(a)(3)(4), IRC), and a foreign corporation is a corporation incorporated in a jurisdiction other than the United States (United States, 1986:Section 7701(a)(5)). The United Kingdom and South Africa both have alternative tests for residence of companies. In the United Kingdom a company is regarded as a resident if it is incorporated in the United Kingdom or if it is centrally managed and controlled in the United Kingdom (United Kingdom, 1988a:Section 66(1)). In South Africa a company is regarded as resident if it is incorporated or formed or has its place of effective management in South Africa (Section 1 of the South African Income Tax Act).

Unique to United States tax legislation are the check-the-box (CTB) regulations that accord United States taxpayers the option, under certain conditions, to elect their entity classification status for United States federal tax purposes in respect of non- “*per se*” entities (see 6.10.4 above). No argument presents itself for incorporating any counterpart to the CTB regulations in South African tax administration, particularly since South Africa does not give its taxpayers the opportunity of electing entity classification status for South African tax purposes.

Recommendation: It would not be useful to incorporate the United States CTB regulations in the South African tax legislation.

7.4.2 Place of effective management and central management and control

South Africa uses place of effective management test and the United Kingdom uses central management and control test as alternative measures for determining residency of companies. Neither of these concepts is entirely congruent with the definition of place of effective management in Article 4 of the OECD and UN Model Tax Conventions, nor does South Africa’s place of effective management test necessarily correspond to the CMC test in United Kingdom legislation. In the United Kingdom the emphasis is substantially on the board of directors, sitting and functioning as such and acting as a conglomerate. CMC thus applies at the highest level of control of the business of a company and is to be distinguished from the place where the main operations of a business are

conducted (United Kingdom. HMRC, 2010c). In South Africa the Commissioner considers the place of effective management to be the location where the day-to-day business operations and commercial decisions of senior managers or directors are actually implemented in operations. If these operations are located in various jurisdictions, then it is likely that the most economically important location will be regarded as the “place of effective management”. (South Africa, 2002d:4.)

Recommendation: It would not be useful to incorporate the United Kingdom CMC test as an alternative criterion for determining residency of companies in the South African tax legislation.

7.4.3 CFC control in the United Kingdom

United Kingdom CFC rules are broad and mechanical, and they look at direct or indirect voting control and (since 2008) direct economic rights. They also treat certain large shareholdings in joint ventures as equivalent to “control” (Sullivan & Cromwell, 2009:9). Since 21 March 2000, Section 755D, ICTA, 1988 (introduced by United Kingdom Finance Act 2000) provides specific rules for determining whether a company is controlled by persons resident in the United Kingdom for the purposes of Chapter IV. The amendment introduced by United Kingdom Finance Act 2000 Schedule 31 thus tightened the definition of “control” and also introduced a definition of “control” unique to CFCs.

In one of the United Kingdom definitions of control, a person is deemed to control the CFC where he has the power to ensure that the CFC’s affairs are conducted in accordance with his wishes either:

- a) by means of the holding of shares or the possessing of voting power in, or in relation to, the company or any other company; or
- b) by virtue of any powers conferred by the articles of association or other document regulating the company or any other company. (United Kingdom, 1988b:Section 755D(1).)

This definition has very wide scope and would be problematic to implement and administer, especially in determining the type of powers the person should possess for the CFC’s affairs to be conducted in accordance with his wishes – the necessary powers being vested in either of these two ways.

In addition, HMRC introduced a 40 per cent test (United Kingdom, 1988b:Section 747(1A), Section 755D(3) and (4)), with the object of modernising its control test criteria to cope with the increasingly sophisticated and complex tax structures being concocted by multinational groups to circumvent CFC regulations – offshore joint venture companies in which United Kingdom shareholders own slightly less than 50 per cent of the shares being increasingly popular structures for avoiding the previous United Kingdom control test (Wilkinson & Howells, 2008:18). Under the amended control requirement a company is accordingly treated as being controlled by a United Kingdom person if –

- two persons (one United Kingdom resident and the other non-United Kingdom resident) together control the company; and
- the United Kingdom person has interests, rights and powers representing at least 40 per cent of the holdings, rights and powers by which the company is controlled; and
- the non-United Kingdom person has interest, rights and powers representing at least 40 per cent but not more than 55 per cent of such holdings, rights and powers. (United Kingdom, 1988b:Section 755D(3) and (4).)

The 40 per cent test in this context means 40 per cent of a situation where more than 50 per cent would give a person control of the company and refers to 40 per cent of all the interests, rights and powers of the kind which gives the two persons in question control of the company (see 5.5.1 above).

The control measures thus outlined may not be appropriate or realistic measures for inclusion in South African CFC controls to determine whether foreign companies qualify as South African CFCs, since they are largely influenced by the particular behaviour patterns of United Kingdom shareholders in designing tax-avoidance schemes. South African tax administration has greater need for uncomplicated and simple CFC qualification tests that could be easily applied (by shareholders, SARS, foreign investors, etc.) to determine if foreign companies are controlled by South African shareholders.

Recommendation: It would not be a useful measure for South Africa's CFC regulations to incorporate United Kingdom's convoluted system of control for identifying and determining foreign companies as being controlled by United Kingdom residents, as this would be inappropriate and unrealistic in the South African situation, difficult to implement and not cost-effective to administer for South African tax purposes.

7.4.4 Substantial interest United Kingdom attribution requirement

A feature of United Kingdom CFC legislation that has no counterpart in South African regulations is that attribution to a resident company is only made where the aggregate amounts in question are at least 25 per cent of the total chargeable profits of the CFC. The amounts to be aggregated are:

- the amount of the chargeable profits which have been apportioned to the resident company, and
- the amount of the chargeable profits which have been apportioned to persons (whether corporate or individual) who are connected or associated with the resident company. (United Kingdom, 1988b:Section 747(5).)

The (25 per cent) substantial interest requirement for United Kingdom CFC attribution is not consonant with the South African attribution rule which (a) applies if the resident shareholder

(together with any connected person in relation to the resident) in aggregate holds 10 per cent or more of the participation rights and is able to exercise at least 10 per cent of the voting rights in the CFC, and (b) applies to all categories of person, inclusive of individuals, companies, trusts, etc. The United Kingdom 25 per cent attribution rule is concerned with larger shareholdings in foreign companies than South African provisions are designed to regulate and applies more narrowly to companies only, rather than the much wider diversity of potential shareholders that fall within the South African provisions.

Recommendation: It would not be a feasible proposition to incorporate United Kingdom's 25 per cent attribution rule in the South African CFC regulations.

7.4.5 Exemptions

Provisions for granting tax exemptions in South Africa, the United Kingdom and the United States do not wholly coincide – particularly as regards the United States, which has no blanket exceptions from the application of Subpart F. And although South Africa and the United Kingdom both have entity-based CFC exemption criteria these are applied differently by the two countries. Prior to Finance Bills 2011 and 2012, the United Kingdom applied an “all-or-nothing” entity approach in its CFC regulations, which meant that if a CFC satisfied the entity-level exemption no CFC charge was imposed on any of its profits. South Africa, on the other hand, has no absolute “all-or-nothing” entity approach in calculating whether a charge is to be imposed on any of the CFC's profits; except for the possibility of full tax exemption being granted against the chargeable profits of an FBE, the remainder of the CFC's profits are subject to partial exemptions.

Country-specific exemption regimes may be outlined as follows:

United States

No blanket exceptions are contained in Subpart F of United States CFC legislation. The definition of Subpart F income does, however, specify exceptions in relation to particular classes or amounts of income; these include *de minimis* amounts, certain highly taxed income, income in excess of annual earnings and profits, active rents and royalties, income earned by securities dealers, income earned from related parties in the CFC's country of organisation, and income from some manufactured products. Certain income earned in the active conduct of banking, financing, insurance or securities-dealing business, and qualifying dividend, interest, rent and royalty income from a related CFC that is non-passive under a look-through rule, are excluded from foreign base company income under a temporary provision applicable to CFC taxable years beginning before 2012 (Deloitte, 2011:50). (see 6.4.1 above).

United Kingdom

Prior to Finance Bills 2011 and 2012, the United Kingdom embraced a consolidated entity-level-based exemption (“all-or-nothing approach”) whereby the entire income of the CFC was exempted from United Kingdom taxation if any one of the exemption criteria were fulfilled by the CFC for any particular tax year. The exemptions chiefly comprised *de minimis* profits, exempt activities, motive test, and the excluded countries exemption. United Kingdom Finance Bill 2011 (prior to which Section 751A was promulgated as a partial exemption in response to the Cadbury Schweppes case) introduced interim partial exemptions which took effect on or after 1 January 2011, and comprised trading companies with a limited United Kingdom connection, companies exploiting IP with limited United Kingdom connection, and temporary exemptions (United Kingdom, 2012d) (see 5.3 above).

Finance Bill 2012: Finance Bill 2012 introduced to United Kingdom CFC legislation the “gateway” approach, according to which any profits of a CFC must pass through the gateway before they can be subject to the CFC charge. Following an “all out, unless brought in” principle, the new legislation only captures income that falls within the scope of, or passes through, the gateway; otherwise the legislation is not applicable. The gateway approach is invoked where there is a significant mismatch between key business activities in the United Kingdom and the profits arising from those activities that are allocated outside the United Kingdom.

Entity-level exemptions: Finance Bill 2012 brings in a number of entity-level-based exemptions; these include the exempt period exemption, the excluded territories exemption, the low profit exemption, the low profit margin exemption, and the tax exemption (see below).

Finance company partial exemptions: The finance company exemptions are probably the most important exemptions in the entire CFC legislation, being designed to encourage return to the United Kingdom of multinational groups which have, in recent times, moved their headquarters offshore. The finance company exemptions are different to the entity exemptions in that they only exempt certain profits of a CFC that qualify for the exemptions (unlike the entity exemptions that will exempt all of the profits of a CFC that fall within their scope).

South Africa

South Africa grants its exemptions mainly through the FBE criteria. Subject to restrictions and exceptions, an exemption is provided where the net income, including capital gains, of the CFC is attributable to a FBE in a foreign country, provided that the FBE effectively operates at arm’s length. The revised FBE exemption criterion is further subject to (and is read in conjunction with) the exceptions and refinements which are from 1 April 2012 set out in the new Section 9D(9A) (South Africa, 2011d:Section 25(k)). The new regime targets mobile income under four broad distinct categories: (i) financial instruments; (ii) rentals and sales of tangible movable property; (iii) royalties

and disposals of intellectual property; (iv) insurance premiums (South Africa, 2011a:105) (Section 9D(9A)). Other partial exemptions granted to South African CFC's include: long-term insurance for non-resident policy holders (Section 9D(9)(c)); exemption of interest and royalties as CFC inclusions (Section 9D(9)(d)); exemption of South African taxable income (Section 9D(9)(e)); related CFC dividend exemption (Section 9d(9)(f)).

With effect from 1 January 2011, a new taxing regime pertaining to headquarter companies was enacted in the South African Income Tax Act to ensure that the tax system did not act as a barrier to the use of South Africa for a regional headquarter company (HQC), especially for Sub-Saharan Africa. Under the new HQC regime, dividends received are exempt from income tax and dividends declared are not subject to the dividend withholding tax, the CFC rules in Section 9D are also not applicable in respect of foreign subsidiaries and certain transfer pricing and thin capitalisation rules are relaxed on financial assistance provided to and by the HQC. (SAICA, 2013:1-2.)

Salient issues emerging from the country comparisons in regard to exemptions

Considerations in respect of the exemptions examined above in the CFC regulations of the three countries (United Kingdom, United States and South Africa) are presented in the next four paragraphs. The specified transactional exceptions currently granted in the United States CFC regulations (as exemptions) are not compatible with South African CFC regulations because South Africa does not target specific types of transactions (as is the case in the United States) for taxation in its CFC regulations. In addition, certain entity-level base exemptions granted (through Finance Bill 2012) in the United Kingdom CFC legislation may be inappropriate for incorporation in the South African CFC legislation because they are not realistically suitable for South African CFC legislation; these include exempt period exemption, low profits exemption and low profit margin exemption. (See below). Further, the finance company partial exemptions (see below) are also not appropriate measures that may be incorporated in the South African CFC legislation as these ad hoc measures were promulgated to encourage multinational groups to return to the United Kingdom, which have, in recent times, moved their headquarters offshore. (Joscelyne & Wentworth-May, 2012.)

(i) Exempt period exemption: The exempt period exemption (EPE) (provided in Chapter 10, TIOPA, 2010) is designed to exempt a CFC if it is a “new joiner”, for example, if it is acquired by a United Kingdom group or its parent migrates to the United Kingdom. The exemption period is 12 months and is subject to the CFC undertaking any restructuring necessary to take it outside the CFC charge for subsequent periods, for example, by meeting one of the other entity-level-based exemptions or having no chargeable profits (Joscelyne & Wentworth-May, 2012).

(ii) Low profits exemption: The low profits exemption (LPE) (provided in Chapter 12, TIOPA, 2010) applies (Section 371LB) if either

- the CFC's accounting or assumed taxable total profits are not more than GB£50,000, or
- the CFC's accounting or assumed taxable total profits are not more than GB£500,000 and the non-trading element is not more than GB£50,000.

A CFC's accounting profits (determined by Sections 371VC and 271VD) are those shown in its financial statements provided they are prepared in accordance with an acceptable accounting practice: international accounting standards (IAS), United Kingdom generally accepted accounting practice (United Kingdom GAAP), and accounting practice generally accepted in the CFC's territory of residence. (Jocelyne & Wentworth-May, 2012.)

(iii) *Low profit margin exemption*: The low profit margin exemption (LPME) (contained in Chapter 13, TIOPA, 2010) applies if the CFC's accounting profits (before any deduction for interest) for the accounting period are no more than 10 per cent of the CFC's operating expenditure excluding the cost of goods purchased by the CFC, unless the goods are used by the CFC in its territory (therefore excluding the cost of goods purchased for resale without being imported to the CFC's territory), and excluding expenditure that gives rise to income of a person related to the CFC. (Jocelyne & Wentworth-May, 2012.)

(iv) *Finance company exemptions*: These exemptions are different to the entity exemptions in that they only exempt certain profits of a CFC that qualify for the exemptions (unlike the entity exemptions that will exempt all of the profits of a CFC that fall within their scope). A taxpayer needs to make a claim for the exemption to be applicable (Section 371IA(3)). If it does apply, then it takes precedence over Chapter 5 in determining what (if any) of the CFC's non-trading finance profits from its qualifying loan relationships (QLRs) pass through the gateway. The finance company exemptions do not apply to any non-trading finance profits that do not arise from QLRs. (Jocelyne & Wentworth-May, 2012.)

Recommendation: It would not be feasible to incorporate the specific transactional exceptions currently granted in the United States CFC legislation in the South African CFC regulations because South Africa imposes its CFC regulations on an entity basis, meaning that all the income (after allowing for exclusions) is subject to taxation rather than specific types of transactions. Further, it will also not be feasible to incorporate certain of United Kingdom's entity-level-based and finance company exemptions (see above) in the South African CFC regulations.

7.4.6 Relief provisions for double taxation

A unique feature of the United States taxing system is the foreign tax credit limitation which is applied on a basket-to-basket basis. In South Africa, foreign tax credit is granted through the application of Section 6quat.

Commentary: *United States FTC basket limitation:* In the United States a foreign tax credit limitation is applied on a basket-by-basket basis to avoid cross-crediting of taxes paid on business and investment income. The two current baskets of income used are the “general limitation” basket into which most active business income is placed and the “passive limitation” basket (e.g., dividends, interest, royalties, and capital gains) (United States, 1986:Section 904(d)(2)(A) and (B), IRC). This system permits a United States taxpayer to place all worldwide business foreign source income in one basket and accordingly allows the taxpayer to claim foreign tax credits on all income taxes paid on that income in that basket (Advisory Panel on Canada's System of International Taxation, 2008:74). The United States Job Creation and Reform Act of 2012 adds a new separate foreign tax credit category (basket) for foreign intangible income in the computation of the foreign tax credit limitation under Section 904 (see 6.8.3.3).

In the South African regulations on the other hand, concession is granted by providing a foreign tax credit (FTC) in domestic law (as contained in Section 6quat) for South African Section 9D shareholders. The FTC rules is contained in Section 6quat, which provides both a direct and indirect foreign tax credit to South African resident shareholders. A direct foreign tax credit may be claimed by all taxpayers in respect of taxes paid on foreign source income earned by the taxpayer. The indirect foreign tax credit, however, may only be claimed by a South African resident (together with any connected person in relation to that resident) shareholder who owns at least 10 per cent of the participation rights and may exercise at least 10 per cent of the voting rights in that CFC. The indirect credit is a deemed foreign tax credit that is available when a South African shareholder receives an actual distribution (in terms of Section 10B(2) but subject to Section 10B(2)(c) and (4) of the South African Income Tax Act), or deemed distribution from a foreign CFC subsidiary.

Recommendation: The foreign credit limitation currently applied in the United States on a basket-to-basket basis to avoid cross-crediting of taxes paid on business and investment income, is not a feasible legislative measure that could be incorporated into the South African taxing system as the two countries have different approaches to the application of their respective CFC regulations: South Africa (global-entity approach); United States (global transactional approach). The transactional approach in the United States thus allows for the recording of income between business and investment income. In essence, the overly complex legislation of the United States does not concur with the South African requirements of administrative simplicity and cost efficiency in tax administration. It would therefore not be useful for South Africa’s tax legislation to incorporate the United States criteria in granting relief for double taxation to CFC shareholders.

7.4.7 Relief provisions for foreign losses

Another unique feature in United States tax regulation is that “overall foreign losses” are generally deductible in computing the taxable income of a United States company. South Africa, on the other hand, does not apply such a rule, as the net loss of a CFC cannot be used by South African residents to reduce their South African taxable income.

Commentary: Foreign losses are generally deductible in computing taxable income by a United States company but certain FTC implications may result. A foreign loss within a separate basket must offset foreign source income in other baskets before reducing United States source income. If the foreign loss basket has a foreign gain in subsequent years, the loss that was allocated to income from another basket in an earlier year is characterised as income from another basket. (South Africa, 1997:Section 904(f)(5)(A) and (B).)

In South African tax law, despite the net income of a CFC being imputed to a South African resident shareholder, the net loss of a CFC cannot be used by South African resident shareholders to reduce their South African taxable income in a given tax year. Similarly, the net loss suffered by a CFC cannot be used against the taxable income of another CFC (in the same group of companies) in respect of the latter’s tax computation. Deductions and allowances are limited to the amount of the income earned in relation to the CFC. (South Africa, 1997:Section 9D(2A)(a).)

Recommendation: The United States approach, which, under certain circumstances, allows “overall foreign losses”, for example, incurred through foreign operations of CFCs, to be set against United States taxable income, would not be advisable in the South African context. Such a measure would entail a direct loss to the South African fiscus with potential tax collection being eroded by CFC losses, which the much smaller South African fiscus would not have the necessary reserves to sustain in the long term.

7.5 Scientific value and contribution

The research was prompted by the fact that no detailed comparative study could be found of the current state of South African CFC legislation in relation to corresponding anti-tax-avoidance measures of other leading economies (in particular, the United States and the United Kingdom). Nor has there been any systematic comparison of the key elements in the South African CFC legislation with the principles as set out in the OECD and UN Model Tax Conventions. The current research is therefore intended to fill these lacunae.

This research has been primarily qualitative in nature and is set within the context of axiomatic principles underpinning the OECD and UN Model Tax Conventions and the United Kingdom and United States CFC regulations. Therefore, the contribution made by the current research comprises of:

an updated assessment of the current state of the South African CFC regulations, with indications, where pertinent, of anomalies, discrepancies, inconsistencies or lack of clarity in the South African regulations when seen in a broader international context; recommendations for possible regulatory amendments; identification of areas that could be the subject of fruitful further investigation.

The thesis accordingly offers what it is hoped will, in the general absence of other relevant treatment in the literature, be a helpful scrutiny of the South African CFC regulatory framework, currently one of South Africa's key measures for countering tax-avoidance, in assessing comparatively the relevance and ongoing appropriateness of this framework in the international fiscal arena – even though the study has inevitably been limited by the sheer volume and complexity of the United Kingdom and United States CFC regulatory measures which made it impracticable to extend the comparative investigation to any additional countries.

7.6 Issues for future research

The dynamic and continually evolving nature of the CFC field also means that there is continuing need for extending the investigation of South African CFC regulations presented in this thesis to accommodate new circumstances, and it would also be appropriate to extend the comparative assessment of the South African legislation to take account of CFC approaches in other jurisdictions (certain of the BRICS countries, for example) beyond those considered here, where new transactional patterns might be a future concern.

Where treatment of key concepts in the South African CFC regulations – permanent establishment, foreign business establishment, shareholder qualifications, corporate residence, place of effective management and central management, CFC control, exemptions, and relief provisions – has diverged from practice elsewhere, local country-specific reasons in South Africa may account for such differences, and investigating and analysing possible South African National Treasury deliberations on such matters could well be a fruitful area for further research investigation.

In addition, ongoing paradigm shifts in the United States and (in particular) the United Kingdom regulatory approaches to CFCs would be worth revisiting in the relatively near future, to determine how their outcomes, yet to fully appear, might have pertinence for the South African regulators.

7.7 Conclusion

A key objective of this thesis has been to ascertain the legitimacy and appropriateness of South African CFC regulations as counters to domestic tax-avoidance by assessing their relevance in an international context. The two jurisdictions selected in this study for comparison exemplify CFC regulatory measures that are paradigmatic of the most important CFC strategies currently in force: the

jurisdictional entity approach (United Kingdom) and the global transactional approach (United States).

A salient issue emerging in this study is that countries are responsible for their own design and promulgation of CFC regulations, tailored in accordance to their own domestic requirements and, consequently, no single CFC regulatory measure may serve as a paradigm. However, despite each country being responsible for the designing of its own CFC regulations, a high degree of convergence between national systems exists. CFC rules are a significant instance of such convergence – even, at times, of direct transplantation of key provisions from one jurisdiction to another: residence, definition of CFC, control requirements, attribution requirements of shareholders, calculation of net profit, and relief provisions. Further, notwithstanding tax competition, countries continue to adhere to their CFC regulatory measures for the important role that they play in guarding the domestic tax base from income being shifted abroad, and while there is, indeed, significant convergence in CFC regulations, at a more detailed level significant national differences nonetheless persist, shaped by particular domestic tax and national fiscal policy requirements. (Avi-Yonah & Sartori, 2012:6.)

In addition, the following key findings have emerged in this study:

The paradigm shift in United Kingdom tax policy (see Chapter 5), as it migrates towards a territorially inclined tax system in CFC regulations, is more compatible with European Union (EU) requirements, and is propelled in large measure by EU-pressure globalisation, manifest in the recent series of judgements delivered by the ECJ.

The new trajectory in United States tax policy – again, towards a territorially based taxing system – reflects a need to keep abreast of changes in the international tax environment, precipitated not least by the economic downturn in international markets (see 6.9 above). Fearing a drop in competitiveness of United States companies in the global marketplace, legislative tax changes seek to rekindle expansion and growth of the United States economy through repatriation of foreign funds earned by CFCs (PWC, 2012).

It would be unrealistic to seek an absolute paradigm for reform or evolution of South African CFC regulations in either of the countries chiefly considered in this thesis (United Kingdom, United States), although South African and United Kingdom CFC measures show significant affinities in their entity-based mechanisms to grant full exemption (United Kingdom, prior to Finance Bill 2011) and partial exemptions (South Africa) of a CFC's chargeable profits. More particular constituents of CFC regulation in one or another of the two countries do, however, prove to be generally congenial to the South African situation and offer useful pointers for ongoing reform of South African measures, as outlined earlier in this chapter.

Other concepts in the United Kingdom or United States CFC regulations (see 7.4 above) are not directly appropriate for use in the South African context: tax principles that would be excessively complicated in South African circumstances, needlessly demanding for tax administrators and for South African shareholders, contradictory to South African tax principles, anachronistic, or not suited for the underlying global-entity approach in South Africa's regulations.

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