# Implications of ceasing to be a controlled foreign company: A comparative study on total exit tax


**VV Chauke**

**orcid.org/0000-0002-2387-7601**


Mini-dissertation accepted in partial fulfilment of the requirements for the degree Master of Commerce in South African and International Taxation at the North-West University

Supervisor: Dr A Storm

Graduation: May 2020

Student number: 28229037

## ACKNOWLEDGEMENTS

I thank the almighty God for giving me strength and wisdom to complete this mini-dissertation. "I can do all things through Christ who strengthens me" Philippians 4:13

I would like to thank the following people:

- I extend my gratitude to my supervisor, Dr Ansia Storm for her guidance and support throughout the process of writing this mini dissertation. It would not have been possible without her.
- My husband, Jabulani Milondzo and my daughter, Unahina for their love, encouragement and support throughout this journey.
- My mother, Grace Chauke, and my late father, Peter (PW) Chauke for instilling the value of education when I was young until today.
- My siblings, Rivoningo Chabalala, Masana Chauke and Tekani Chauke for their support and prayers.

# ABSTRACT

The Controlled Foreign Company (CFC) rules were introduced in South Africa in 1997 under section 9D of the Income Tax Act (58 of 1962) to protect the South African taxation base. The CFC rules are supported by the Organization for Economic Co-operation and Development (OECD) in order to avoid profit shifting as Base Erosion and Profit Shifting (BEPS) Action 3. CFC rules tax the income of controlled foreign subsidiaries in the hands of resident shareholders. For most countries, these rules are used to prevent shifting of income either from the parent jurisdiction or from the parent and other tax jurisdictions.

This study focuses on the tax consequences when a corporation ceases to be a CFC in South Africa. South Africa joined many countries around the world in using the CFC rules as part of their tax legislation. For the purpose of this study, two countries were selected to compare to South African tax legislation in order to determine if South Africa conforms to the international norms when a corporation ceases to be a CFC.



**KEYWORDS:** Controlled Foreign Company; Controlled Foreign Corporation; Unrealised Capital Gains Tax; Exit tax charge.

# ABBREVIATIONS

| | |
|---|---|
| BRICS | Brazil, Russia, India, China and South Africa |
| CFC | Controlled Foreign Company / Controlled Foreign Corporation |
| CGT | Capital Gains Tax |
| FDI | Foreign Direct Investment |
| FBE | Foreign Business Establishment |
| HMRC | Her Majesty's Revenue and Customs |
| IAS | International Accounting Standard |
| IRC | Internal Revenue Code |
| JSE | Johannesburg Stock Exchange |
| PGM | Platinum Groups Metal |
| SA | South Africa |
| SARS | South African Revenue Services |
| TCGA | Taxation of Chargeable Gains Act |
| UK | United Kingdom |
| USA | United States of America |

# TABLE OF CONTENTS

**LIST OF TABLES**

# CHAPTER ONE

# AN INTRODUCTION TO EXIT TAX IMPLICATIONS OF CESSATION TO BE A CONTROLLED FOREIGN COMPANY

## 1.1 INTRODUCTION

According to Naude and Sibiya (2015), South African multinational companies often enter into transactions that involve the acquisition, merger, disposal or restructure of their interests held in local and foreign companies. More often than not, these types of transactions are entered into for commercial reasons, which could be, among others:

1. To gain a competitive advantage over their competitors;
2. To gain a larger market share;
3. To diversifying a product range or service line;
4. To cut costs or to achieve economies of scale; or
5. To increase the liquidity for owners.

According to Naude and Sibiya (2015:2), South Africa is a country that is rich with minerals. Many of the South African mining companies are owned by non-residents which means that there is investor confidence in South Africa. The group of companies' structures that normally include a CFC can change due to various reasons including mergers and acquisitions, sale of investments, and partnerships which can result in a deemed disposal of assets (Naude and Sibiya, 2015).

According to the Income Tax Act (58 of 1962), South Africa's tax system is based on the source status for residents and non-residents. All income from sources within South Africa is taxed irrespective of the residency status as described in the gross income definition in the Income Tax Act (58 of 1962).

Section one states that

*gross income, in relation to any year of assessment means* –

- *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*
- *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 the Republic* (Income Tax Act, 1962).

South African residents are taxed on their worldwide income (Income Tax Act, 1962). "Accordingly, a capital gain arising from the sale of shares in a foreign company will be subject to South African tax unless an exemption applies, or a double tax agreement provides otherwise" (SAICA, 2013:1). The double taxation agreement is also known as a tax treaty. The Organization for Economic Co-operation and Development (OECD, 2017) defines a tax treaty as an agreement between two (or more) countries for the avoidance of double taxation.

According to section 9D of the Income Tax Act (58 of 1962), the company does not have to be registered in South Africa for it to be regarded as a resident (Income Tax Act, 1962). A foreign company can be regarded as a South African CFC if it meets the definition of section 9D of the said Act.

The CFC was introduced in South Africa in 1997 under section 9D of the Income Tax Act (58 of 1962) to protect the South African taxation base. Section 9D initially only taxed passive income but later the scope was extended to also include active income (TAXAND, 2018:1).

A CFC is defined in section 9D(1) of the Income Tax Act (58 of 1962) as any foreign company where more than 50 per cent of the total participation rights in that foreign company is directly or indirectly held, or more than 50 per cent of the voting rights in that foreign company is directly or indirectly exercisable, by one or more persons that are residents other than persons that are headquartered companies (Income Tax Act, 1962).

According to Naude and Sibiya (2015), the change on the status of the CFC will have tax consequences in the hands of the resident either as capital gains tax or income tax. The change on the status of the CFC can happen by:

1. Either a CFC issuing more shares resulting in the resident losing control; or
2. By the disposal of shares by the resident; or
3. When the shareholder ceases to be a resident in South Africa (Naude & Sibiya, 2015).

The CFC is one of the tools that countries use to ensure that residents of that country do not shift value to other jurisdictions with lower tax rates. Without the CFC, taxpayers would invest in a low tax jurisdiction to receive higher profits (Davis Tax Committee, 2014:9). "CFC rules are an anti-avoidance mechanism designed to prevent a company from artificially moving its profits abroad to a country with a more favourable or lower tax rate" (PWC, 2016:1).

As previously mentioned, a company is a CFC for South African tax purposes "if South African residents hold more than 50 per cent of the participation rights and can exercise more than 50 per cent of the voting rights in the foreign company" (Income Tax Act, 1962; Musviba, 2014:1).

For a CFC to meet the requirements of section 9D of the Income Tax Act (58 of 1962) it must either have more than 50 per cent of the voting rights or participating rights held by the residents. Participation rights in relation to a foreign company is described in section 9D of the Income Tax Act (58 of 1962) as the right to participate in all or part of the benefits of the rights (other than voting rights) attached to a share, or any interest of a similar nature, in that company (Income Tax Act, 1962). Participation rights refer to the right to profits, like dividends, or ownership of preference shares in the company (Contador accountants, 2017; Department of National Treasury).

Section 9H(3)(b) of the Income Tax Act (58 of 1962) states that where a corporation ceases (otherwise than by becoming a resident) to be a CFC during any foreign tax year of that foreign company, the CFC must be treated as having –

*disposed of each of the assets of that CFC; and*
*reacquired each of the assets disposed of as contemplated in subparagraph (i) on the day on which that corporation ceased to be a CFC, for an amount equal to the market value of each of those assets.*

If a foreign company ceases to be a CFC after the shares have been disposed of, there will be a deemed disposal in the hands of the CFC under the provisions of section 9H of the Income Tax Act (58 of 1962). However, where any capital gain or capital loss was disregarded under paragraph 64B(1) of the Eighth Schedule to the Income Tax Act (58 of 1962), there is no deemed disposal triggered under the exit charge provisions of section 9H(3)(b)(i) (Naude & Sibiya, 2015:2). The company will cease to be a CFC after the shares are disposed of and resulting in the remaining shareholding by South African residents of that CFC to be less than 51 per cent. Paragraph 64B(1) of the Eighth Schedule to the Income Tax Act (58 of 1962) deals with the tax exemptions on the disposal of equity shares in foreign companies.

The definition of paragraph 64B of the Eighth Schedule to the Income Tax Act (58 of 1962) states a person other than a headquarter company must disregard any capital gain or capital loss determined in respect of the disposal of any equity share in any foreign company if:

- *that person (whether alone or together with any other person forming part of the same group of companies as that person) immediately before that disposal –*
    - *held an interest of at least ten per cent of the equity shares and voting rights in that foreign company, and held an interest for a period of at least 18 months prior to that disposal, unless*
        - *that person is a company;*
        - *that interest was acquired by that person from any other company that forms part of the same group of companies as that person; and*
        - *that person and that other company in aggregate held that interest for more than 18 months; and*
- *that interest is disposed of to any person that is not a resident* (Income Tax Act, 1962).

Section 9H of the Income Tax Act (58 of 1962) was introduced with effect from 1 April 2012 to impose the exit-charge provisions on a person who ceases to be a resident, ceasing to be a CFC (otherwise than becoming a resident) or a headquarter company. When a corporation ceases to be a CFC, that corporation will be treated as having disposed of each of its assets on the date immediately before the day it ceases to be a CFC for an amount received or accrued equal to the market value of the assets and to have immediately reacquired those assets for expenditure equal to the market value at which the deemed disposal had incurred. However, section 9H(5) of the Income Tax Act (58 of 1962) provides a carve-out from section 9H(3)(b)(i) deeming provision in so far as the capital gain or capital loss determined is disregarded under the provisions of paragraph 64B(1) of the Eighth Schedule.

In other words, on the basis that any capital gain or capital loss was disregarded under paragraph 64B(1) of the Eighth Schedule to the Income Tax Act (58 of 1962), there is no deemed disposal triggered under the exit-charge provisions of section 9H(3)(b)(i) of the Income Tax Act (58 of 1962). Conversely, if the capital gain or capital loss was not disregarded under paragraph 64B of the Eighth Schedule of the said Act, the deeming provisions in section 9H(3)(b)(i) will apply.

It is important to note that the deemed disposal under section 9H(3)(b)(i) of the Income Tax Act (58 of 1962) is triggered in the corporation that ceases to be a CFC (as a result of the disposal of its shares) and not in the hands of the person disposing of the shares in the CFC. To this end, it must be accepted that section 9H(3)(b)(i) cannot impose a tax (actual or deemed) in the hands of a foreign company. Only through the provisions of section 9D can tax be imposed in the hands of the resident(s) in relation to which the foreign company constitutes a CFC (Income Tax Act, 1962; Naude & Sibiya. 2015:8).

The CFC will be deemed to have disposed of all of its assets as per section 9H of the Income Tax Act (58 of 1962) irrespective of whether the assets have actually been sold or not. The deemed capital gains will then be included in the net income of the CFC in accordance with section 9D on the Income Tax Act (58 of 1962). The South African residents who hold the percentage of that particular CFC will then be taxed on the deemed disposal through section 9D of said Act (Income Tax Act, 1962).

The introduction of section 9H of the Income Tax Act (58 of 1962) was mainly as a result of the verdict reached in *The Commissioner for the South African Revenue Services (CSARS) v Tradehold Limited (2012)* (hereafter “Tradehold”). Tradehold was a company incorporated and effectively managed in South Africa. A decision was made to hold a board meeting in Luxembourg which changed the place of effective management from South Africa to Luxembourg. The change in effective management resulted in Tradehold no longer being considered a resident of South Africa. SARS deemed the change in residence of Tradehold to have triggered deemed disposal and argued that capital gains tax must be paid. SARS did not have section 9H of the Income Tax Act (58 of 1962) to base its argument on, but they based their argument on the then definition of a resident.

The definition of a resident was amended in section one of the Income Tax Act (58 of 1962) after the Tradehold case. Before the Tradehold case, the definition of a resident was defined as a person (other than a natural person) who is incorporated, established or formed or has its place of effective management in the Republic. The amendment stated that a person will not be treated as a resident in South Africa if that person is exclusively deemed to be resident of another country for the purpose of double tax agreement with that other country (Income Tax Act, 1962).

> *The court ruled that the tax treaty takes preference to the domestic law. Tradehold contended that if there was a deemed disposal of the assets, the capital gain that resulted from that disposal was not taxable in South Africa but in Luxembourg due to the fact that at the time the capital gain arose, the respondent was deemed to be a resident of Luxembourg in terms of article 4(3) of the double tax agreement entered into between South Africa and Luxembourg* (Musviba, 2012).

On 2 July 2002, at a meeting of Tradehold's board of directors in Luxembourg, it was resolved that all further board meetings of the company will be held in Luxembourg. This had the effect that, as of 2 July 2002, Tradehold became effectively managed in Luxembourg. Tradehold remained a resident of South Africa for tax purposes, notwithstanding the relocation of its effective management to Luxembourg, by reason of the definition of the term "resident" in section one of the Income Tax Act (58 of 1962) as it applied at that time, due to its incorporation in South Africa. This definition was amended, with effect from 26 February 2003, resulting in Tradehold ceasing to be a "resident" as envisaged in the definition in section one of the Income Tax Act (58 of 1962)" (Ensafrica, 2012).

The tax treaty between South Africa and Luxembourg resulted in Tradehold not being liable to pay deemed capital gains tax in South Africa. The tax treaty between South Africa and Luxembourg stated that where a person (other than a natural person) qualifies as a resident of both Luxembourg and South Africa, such person shall be deemed to be resident where their place of effective management is situated, which was therefore Luxembourg. SARS included section 9H to the Income Tax Act (58 of 1962) as a result of the outcome of this case (Vermeulen, 2013:2).

In order to determine the taxable capital gains tax for ceasing to be a CFC, the base cost of assets need to be determined. An asset is defined in paragraph one of the Eighth Schedule to the Income Tax Act (58 of 1962) as a property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency but including any coin made mainly from gold or platinum; and a right or interest of whatever nature to or in such property (Income Tax Act, 1962).

"South African immovable property interest includes a shareholding of 20 per cent or more in a foreign company where 80 per cent of the market value of that foreign company derives from

South African immovable property that is not held as trading stock” (FIN24, 2014:1; Income Tax Act, 1962).

The base cost of the asset relating to the CFC is defined in paragraph 20(1)(h)(iii) of the Eighth Schedule of the Income Tax Act (58 of 1962) as follows:

- a right in a CFC held directly by a resident, an amount equal to the proportional amount of the net income (without having regard to the percentage adjustments contemplated in paragraph 10) of that company and of any other CFC in which that CFC and that resident directly or indirectly have an interest, which was included in the income of that resident in terms of section 9D during any year of assessment, reduced by the amount of any foreign dividend distributed by that company to that resident during any year of assessment which was exempt from tax in terms of section 10B(2)(a) or (c);
- a right in a CFC held directly by another CFC, an amount equal to the proportional amount of the net income (without having regard to the percentage adjustments contemplated in paragraph 10) of that first-mentioned CFC and of any other CFC in which both the first- and second-mentioned CFC directly or indirectly have an interest, which during any year of assessment would have been included in the income of that second-mentioned CFC in terms of section 9D had it been a resident, reduced by the amount of any foreign dividend distributed by that first-mentioned CFC to the second-mentioned CFC if that dividend would have been exempt from tax in terms of section 10B(2)(a) or (c) had that second-mentioned CFC been a resident (Income Tax Act, 1962).

## 1.2 MOTIVATION OF TOPIC ACTUALITY

According to the Department of Trade and Industry, South Africa is one of the most sophisticated, diverse and promising emerging markets globally. Strategically located at the tip of the African continent, South Africa is a key investment location, both for the market opportunities that lie within its borders and as a gateway to the rest of the continent, a market of about one billion people. South Africa has a wealth of natural resources (including coal, platinum, gold, iron ore, manganese, nickel, uranium, and chromium) and it enjoys increased attention from international exploration companies, particularly in the oil and gas sector (Department of Trade and Industry, 2019).

South Africa ranks high worldwide for investor protection and the extent of disclosure. These characteristics enhance the efficiency of the country’s financial markets. And the more efficient markets are (e.g., the more securities are correctly valued based on fundamentals such as plausible forecasts of future cash flows), the more investors can count on the benefits of global diversification (Forbes, 2017).

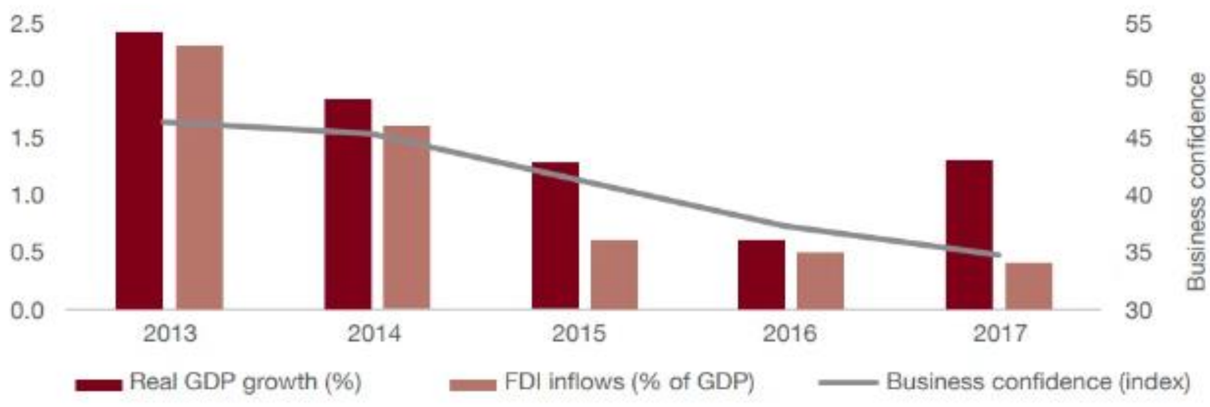
According to Viljoen (2018), there are 19 important variables considered by potential investors of which corporate tax rates are the only ones applicable to this study. The tax consequences of being a CFC in South Africa are one of the considerations that the investors look at before investing in South Africa, however political stability of the country is also taken into consideration (Anon, 2013 *as cited by* Viviers, 2014:18). According to Robinson (2016:1) In 1990 the South African mining industry was predominantly domestically based and was dominated by six mining houses, which all had their head offices in Johannesburg with their primary listings on the Johannesburg Stock Exchange (JSE). However, radical changes in the domestic and international political and economic environments during the 1990s resulted in the demise of the domestic mining house system and the two largest mining houses, Anglo American and Glencore (which was incorporated into Billiton) moved their head offices and primary listings to London as programmable logic controller (Plc) and their subsidiaries listed at the JSE (Robinson, 2016:1).

Amongst factors considered by any foreign investor when investment opportunities in foreign countries are considered is the economic stability of the country (Viviers, 2014:89). South Africa is the second-largest economy in Africa after Nigeria (BusinessTech, 2018a). The foreign investors are not only interested in the mining sector but also in other sectors in South Africa.

During 2015, it appears that South Africa has become an investment destination of choice to the world's biggest companies, for example, BMW invested R6 billion in 2015. The government of South Africa is unlocking the economic growth potential in marine transport and manufacturing, offshore oil and gas exploration, aquaculture, marine protection and extending into the mining sector (Davis, 2015).

However, reports during 2018 showed that Foreign Direct Investments (FDI) declined between 2013 and 2017 (BusinessTech, 2018b). According to Schussler (BusinessTech, 2018c), investors were consistently inquiring about investment opportunities in other African countries. At the end of 2017, the net FDI was -31 per cent expressed as a percentage of GDP. The negative value showed the balance of investment lies outside South Africa (BusinessTech, 2018c).

**Figure 1-1: Economic decline**




Source: BusinessTech (2018b)

One of many solutions suggested by Schussler is to ease the tax burden to make the country a more attractive investment destination. "If South Africa just improved slightly, it would make a difference and certainly the improvement in business confidence, and consumer confidence are a good start" (BusinessTech, 2018c). "FDI is critical to stimulate economic growth and financial sustainability. In particular, for emerging economies, foreign investment inflows are vital for transferring money and expertise from multinationals to local enterprises" (Viljoen, 2018:1).

The confidence of foreign investors can be built and maintained by a way of proposing an alternative way of taxing the corporation when it ceases to be a CFC. South Africa is a country that is rich with minerals. Many of the South African mining companies are owned by non-residents which means that there is investor confidence in South Africa. The group of companies' structures that normally includes a CFC can change due to various reasons including the mergers and acquisitions, sale of investments and partnerships which can result in a deemed disposal of assets as discussed in the introduction of this chapter. The motivation of this study is to find alternative ways of taxing the ceasing of being a CFC in order to contribute to encouraging foreign investments (Naude & Sibiya, 2015).

## 1.3 RESEARCH QUESTION

What are the implications of ceasing to be a controlled foreign company, and can this cessation be taxed differently in South Africa?

## 1.4 RESEARCH OBJECTIVES

### 1.4.1 Main objective

The main objective is to determine if the South African exit tax implications of ceasing to be a CFC could be taxed differently by comparing the applicable sections in the Income Tax Act (58 of 1962) with similar sections contained in the tax legislation of the United Kingdom (UK) and the United States of America (USA).

### 1.4.2 Secondary objectives

In order to achieve the main objective, the following secondary objectives were identified:

1.4.2.1 The research design and research methodology that will be used to achieve the main objective will be identified and discussed in Chapter two.

1.4.2.2 A detailed analysis of the South African tax law regarding the cessation of a CFC as contemplated in section 9D of the Income Tax Act (58 of 1962) will be done in chapter three.

1.4.2.3 A comparison of the South African tax law (specific reference to capital gains tax) regarding the cessation of a CFC to that of the UK and the USA to determine the difference in the tax legislation of these three countries. This will be discussed in chapter three.

1.4.2.4 To identify and propose an alternative way of taxing the CFC on unrealized capital gains tax, based on the information obtained in chapter three. This will be discussed in chapter four.

1.4.2.5 To conclude on the research done and to make recommendations for future research. This will be done in chapter five.

### 1.4.3 Motivation for the selection of countries

The United Kingdom (UK) was selected mainly because the UK is considered a developed country while South Africa (SA) is still a developing country. SA is a member of the BRICS Association of five major emerging national economies, and one of the objectives of BRICS is to act as a bridge between developed and developing countries to achieve regional development (Morazàn, Knoke, Knoblauch & Schäfer, 2012). SA and UK's laws are based on common law, which is one of the reasons why the tax legislation of these two countries are similar to each other. Another reason for the similarity in legislation lies in the history of SA and the UK; SA was a colony of the UK from 1795 to 1802 and again from 1806 to 1961 (South African History Online, 2019; National archives, 2019).

In 2017, the UK collected more taxes from the CFCs in comparison with the total corporation tax. The Oxford University for Business Taxation reported that multinational companies paid the majority, 55 per cent of UK corporation tax in spite of constituting only three per cent of the population of companies in the UK (Habu, 2017). Britain's rules on "controlled foreign companies" were introduced in the 1980s to prevent companies with operations in many countries from artificially shifting profits between jurisdictions to avoid paying taxes (The Financial Times, 2017).

The United States of America (USA) was the first country to introduce the CFC rules. It was introduced in 1962 in order to eliminate the shifting of profits to a lower tax jurisdiction by USA shareholders. This piece of legislation – better known as the Subpart F rules – was a diluted version of the original proposal put forward by the Kennedy Administration, which more generally intended to introduce what later has been described as the policy of capital export neutrality (Schmidt, 2016). It is thus the opinion of the researcher that a country with more than 50 years' experience in CFC rules should form part of a study where one of the objectives is to determine if South Africa can tax CFCs' differently in the light of a developed country's legislation. According to Vardy (2016), despite the high economic growth rates of developing nations, the USA is by far the world's wealthiest nation as measured by Gross Domestic Product (GDP) which is the broadest measure of economic wealth (Vardy, 2016).

## 1.5 RESEARCH DESIGN AND METHODOLOGY

Research has been described as a systematic investigation (Burns, 1997) or inquiry whereby data are collected, analysed and interpreted in some way in an effort to "understand, describe, predict or control an educational or psychological phenomenon or to empower individuals in such contexts" (Mertens, 2005:2).

### 1.5.1 Research design

The research design refers to the overall strategy that one may choose to integrate the different components of the study in a coherent and logical manner (USC, 2018). This research will be conducted through a literature review by way of scholarly articles, scholarly journals, tax laws, case law, previous dissertations, and amendment bills. The data gathered from the literature review will be the primary source of this research. The purpose of the literature review is to determine whether South African's exit tax consequences of ceasing to be a CFC are in line with the international norms and to determine if the total exit tax can be calculated differently and at a lower rate. The research design for this study will be discussed in detail in chapter two.

### 1.5.2 Research Methodology

This paragraph describes actions to be taken to investigate a research problem and the rationale for the application of specific procedures or techniques used to identify select, process, and analyse information applied to understand the problem, thereby, allowing the reader to critically evaluate a study's overall validity and reliability. The methodology section of a research paper answers two main questions:

1. How was the data collected or generated? and,

2. How was it analysed? (USC, 2018).

The research method used is the qualitative method and it will be conducted in order to answer the research question (paragraph 1.3) and to meet the research objectives (paragraph 1.4). Qualitative research takes a particular approach towards the research process, the setting of research questions, the development, and use of theory, the choice of research strategy, and the way that findings are presented and discussed. Qualitative research follows a research design that heavily influences the choices made throughout the research process as well as the analysis and discussion of findings (Laerd Dissertation, 2017). The research methodology will be discussed with more thoroughness in chapter two.

## 1.6 LIMITATION OF SCOPE

This study is conducted with the assumption that the exemption rule of paragraph 64B of the Eighth Schedule to the Income Tax Act (58 of 1962) is not applicable. The assumption was made to say that the person who is disposing of or deemed to dispose of the shares, held less than ten per cent of the equity shares and voting rights and that person held the shares for less than 18 months. The double tax agreements between any country other than South Africa will not be taken into consideration. If the double tax agreements are taken into account, the scope of this study will be too broad.

## 1.7 RESEARCH OVERVIEW

This study will consist of the following chapters:

### Chapter one

This chapter will outline the background of the study, the motivation of topic actuality, the research question, the research objectives, the research design and methodology, the motivation on countries selected, the limitation of scope, as well as the chapter divisions.

### Chapter two

This chapter will describe the research design and methodology developed in order to achieve the secondary objectives, and ultimately the main objective.

### Chapter three

A detailed analysis of section 9D of the Income Tax Act (58 of 1962) will be done in this chapter to achieve secondary objective 1.4.2.3.

A comparison of tax legislation (specific reference to capital gains tax) of ceasing to be a resident or a CFC in South Africa to that of the UK and the USA, will be performed. The objective is to determine if South Africa’s legislation is in line with that of said countries, as well as to determine if the cessation of CFCs’ can be taxed differently in South Africa.

**Chapter four**

This chapter will analyse the tax legislation with the objective to identify and propose an alternative way of taxing CFCs on unrealized capital gains tax, based on the information obtained in chapter three. Specific consideration will be given to section 9H of the Income Tax Act (58 of 1962) and paragraph 12 of the Eighth Schedule to the Income Tax Act (58 of 1962).

The main difference between section 9H of the Income Tax Act (58 of 1962) and paragraph 12 of the Eighth Schedule is the exceptions contained within paragraph 12. A comparison will be done to show the difference between when paragraph 12 of the Eighth Schedule to the Income Tax Act (58 of 1962) is applicable and when it is not applicable.

**Chapter five**

This chapter will contain a summary, conclusions, and recommendations for future research based on the results of the research done in the previous chapters.

# CHAPTER TWO

# RESEARCH DESIGN AND METHODOLOGY

The previous chapter illustrated the need to consider SA's CFC rules in light of economic decline and the need for FDI (paragraph 1.2, Chapter 1). The aim of this chapter is to determine the correct research design and research methodology path that will lead to achieving the secondary objectives (paragraph 1.4.2, Chapter 1) and the main objective (paragraph 1.4.1, Chapter 1).

## 2.1 RESEARCH DESIGN

As discussed in paragraph 1.5 of Chapter 1, the research design selected was the literature review.

A literature review is seen by teachers and students as a set of methods for examining the richness and diversity of experience. The primary documents used for investigating may consist of national histories, world events, the individual psyche, race, class, gender, science, economics, religion, the natural world, leisure, and the other arts. It is among the most interdisciplinary of any field of study due to its engagement with countless other disciplines (Literary Studies, 2019).

This study made use of scholarly articles, books, previous dissertations, conference proceedings, and other resources that were relevant to a particular issue, area of research, or theory and provides context by identifying past research. Research tells a story and the existing literature assist in identifying the position and path of the researcher (Greenfield, 2002). This study commenced with a literature review of which the purpose of a literature review can be summarised as follows:

- Identifies gaps in current knowledge;
- Assist in discovering the research already conducted on a topic;
- Sets the background on what has been explored on a topic so far;
- Increases the breadth of knowledge in the researcher's area of research;
- Helps identify seminal works in the researcher's area;
- Allows the researcher to provide the intellectual context for his or her work and position the research with other, related research;
- Provides the researcher with opposing viewpoints; and
- Assist the researcher to discover research methods which may be applicable to the work (Greenfield, 2002).

## 2.2 PHILOSOPHY OF SCIENCE

According to Ponterotto (2005)

> *philosophy of science refers to the conceptual roots undergirding the quest for knowledge. Incorporated within philosophy of science are beliefs or assumptions regarding ontology (the nature of reality and being), epistemology (the study of knowledge, the acquisition of knowledge, and the relationship between the knower [research participant] and would-be knower [the researcher]), axiology (the role and place of values in the research process), rhetorical structure (the language and presentation of the research), and methodology (the process and procedures of research)"* (Ponterotto, 2005:127).

Each of these beliefs of the philosophy of science will be discussed below.

### 2.2.1 Ontology

The philosophical field concerned with the study of the nature of reality is called ontology. Ontology addresses the question of the form and nature of reality, as well as what can be known about that reality (Ponterotto, 2005:130). According to Ritchie and Lewis (2003), there are three distinct ontological positions that could be taken:

- **Realism:** There is a distinction between the way the world is and the meaning and interpretation of that world held by individuals.
- **Materialism:** Claims that there is a real-world but that only material features, such as economic relations, or physical features of that world hold reality. Values, beliefs or experiences are regarded as "epiphenomena": features that arise from, but do not shape, the material world.
- **Idealism:** Reality is only knowable through the human mind and through socially constructed meaning. Most qualitative researchers following an interpretivist or critical theory perspective fall within this category (Ritchie & Lewis, 2003).

This study falls in the "Idealism" category of ontology due to the researcher making use of the qualitative, interpretivist paradigm. The comparison of the South African tax system to that of the UK and USA will answer the reality of the research questions. The current tax systems of the UK, USA and South Africa in taxing the CFCs is the reality of this study. The outcome of this study will form the reality of how the exit tax is being addressed in South Africa compared to the UK and the USA, and if it could be taxed differently.

### 2.2.2 Epistemology

As described above, ontology is the study of the nature of reality and what can be known about that reality. Epistemology is the philosophical field concerned with the study of knowledge and how to reach it, thus is concerned with the relationship between the “knower” and the “would-be knower” (Ponterotto, 2005:131).

Epistemology and methodology are closely related because epistemology is the philosophy of how you come to know and methodology is the practice (methods) wherein you try to understand the world better (Trochim & Donnelly; 2008). The researcher came to know that there can be a different way of taxing companies that ceased to be a CFC by studying the applicable tax legislation of two other countries to establish it. The methodology used to get to this knowledge is discussed in paragraph 2.4 of this chapter.

## 2.3 RESEARCH PARADIGM

Thomas Samuel Kuhn is one of the most influential philosophers of science of the twentieth century (Zalta, 2004). Kuhn (cited by Shuttleworth & Wilson, 2018:1) suggested that a paradigm includes “the practices that define a scientific discipline at a certain point in time”. Paradigms contain all the distinct, established patterns, theories, common methods and standards that allow us to recognize an experimental result as belonging to a field or not (Shuttleworth & Wilson, 2018:1).

A research paradigm is “the set of common beliefs and agreements shared between scientists about how problems should be understood and addressed” (Kuhn, 1962:25). There are various research paradigms and each of these paradigms will be discussed briefly in this paragraph. According to Ponterotto (*cited by* Denzin & Lincoln, 2000b), the paradigm selected guides the researcher in philosophical assumptions about the research and in the selection of tools, instruments, participants, and methods used in the study.

Paradigm choice is by and large a reflection of how the researcher views the world (ontology) and believes that knowledge is created (epistemology). That is, these implicit beliefs, along with the researcher’s disciplinary focus and past experiences, will influence his or her philosophical approach to research, even before the topic is chosen (McKerchar, 2008).

The method that was chosen for this study was the qualitative method, based on the way the researcher of this study views the world in terms of international taxation and value shifting. The theoretical paradigms relevant to this study are described below.

### 2.3.1 Interpretivism

Interpretivism provides an understanding of social reality that is based on the subjective interpretation of the researcher. It does not provide a hard and fast explanation from which causal relationships can be identified and predictions made (McKerchar, 2008). The interpretative research will provide the findings of this study through interpretation based on reality. The outcome of this research will be based on the reality of the tax treatments within the selected countries. The interpretivism paradigm is relevant to the qualitative method which was selected for this study.

The position of interpretivism in relation to ontology and epistemology is that interpretivists believe the reality is multiple and relative (Hudson and Ozanne, 1988, *as cited by* Edirisingha, 2012). Lincoln and Guba (1985, *as cited by* Edirisingha, 2012) explain that these multiple realities also depend on other systems for meanings, which make it even more difficult to interpret in terms of fixed realities (Neuman, 2000, *as cited by* Edirisingha, 2012). The knowledge acquired in this discipline is socially constructed rather than objectively determined (Carson *et al.*, 2001:5 *as cited by* Edirisingha, 2012) and perceived (Hirschman, 1985; Berger & Luckman, 1967:3; Hudson & Ozanne, 1988 *as cited by* Edirisingha, 2012). The interpretivist paradigm assisted with this research because the researcher was free to analyse various literature in order to meet the objectives of this study as discussed in paragraph 1.4 of Chapter 1. The researcher was free to adapt (if necessary) according to any new tax laws or proposed tax laws throughout the research process.

### 2.3.2 Positivism

On the other hand, positivist ontology believes that the world is external (Carson *et al*., 1988 *as cited by* Edirisingha, 2012) and that there is a single objective reality to any research phenomenon or situation regardless of the researcher's perspective or belief (Hudson & Ozanne, 1988 *as cited by* Edirisingha, 2012). The positivist paradigm is not relevant for this study because the researcher believes that there are various objectives and solutions to this research question (paragraph 1.3, Chapter 1). The various objectives of this study were discussed in paragraph 1.4. The reality of the taxation laws has different interpretations and views for the selected countries (paragraph 1.4.3) which was used in this study.

The goal of positivist researchers is to make time and context-free generalizations. They believe this is possible because human actions can be explained as a result of real causes that temporarily precedes their behaviour and the researcher and the research subjects are independent and do not influence each other (Hudson & Ozanne, 1988 *as cited by* Edirisingha, 2012). Accordingly, positivist researchers also attempt to remain detached from the participants of the research by creating distance between themselves and the participants. This is an important step in remaining emotionally neutral to make clear distinctions between reason and feeling as well as between science and personal experience. Positivists also claim it is important to clearly distinguish between fact and value judgment. As positivist researchers, they seek objectivity and consistently use rational and logical approaches to research (Carson *et al.* 2001; Hudson & Ozanne 1988 *as cited by* Edirisingha, 2012).

### 2.3.3 Critical theory

Critical theory serves to disrupt and challenge the status quo (Kincheloe & McLaren, 1994, 2000, *as cited by* Ponterotto, 2005). The critical-ideological paradigm is one of emancipation and transformation, one in which the researcher's proactive values are central to the task, purpose, and methods of research. Like constructivists, criticalists advocate a reality that is constructed within a social-historical context. However, more so than constructivists, criticalists conceptualize reality and events within power relations, and they use their research inquiry to help emancipate oppressed groups. The reader can see the impact and influence of the researcher's proactive values in critical theory; a characteristic contrast to the positivist and post-positivist paradigms (Ponterotto, 2005). The taxation laws of the selected countries require critical thinking and interpretation; hence critical theory is relevant for this study.

## 2.4 RESEARCH METHODOLOGY

As discussed in paragraph 1.5.2 of Chapter 1, the research methodology selected for this study will be qualitative research.

Qualitative research began in the 1900s, is more commonly used in the social sciences, and is a complex and still evolving paradigm. Qualitative research requires inductive reasoning to be employed rather than logic and often calls for more creative and indirect means of collecting data or evidence (McKerchar, 2008). The collection of data and evidence was done through a literature review. Once the data was collected, it was analysed by comparing SA’s tax legislation to that of the UK and the USA.

### 2.4.5 Features of qualitative research

According to Hoepfl (1997), the features of qualitative research can be described as follows:

#### 2.4.5.1 Natural setting

Qualitative research uses the natural setting as the source of data. The researcher attempts to observe, describe and interpret settings as they are (Hoepfl, 1997). The natural setting feature is relevant for this study as the taxation laws of the selected countries are interpreted as they are and took into account any tax law amendments during the research process.

#### 2.4.5.2 Researcher as the key instrument

The researcher acted as the “human instrument” of data collection (Hoepfl, 1997). The researcher collects data through the literature review discussed in paragraph 1.5.1. The researcher was the main instrument throughout the research process and data was collected from various sources.

#### 2.4.5.3 Multiple methods

Qualitative research reports are descriptive, incorporating expressive language and the "presence of the voice in the text" (Eisner, 1991:36 *as cited by* Hoepfl, 1997). The researcher gathered data through multiple sources relevant to this study.

#### 2.4.5.4 Complex reasoning

Qualitative researchers predominantly use inductive data analysis (Hoepfl, 1997). Qualitative researchers build their patterns, categories, and themes from the "bottom-up," by organizing the data inductively into increasingly more abstract units of information. This inductive process involves researchers working back and forth between the themes and the database until they establish a comprehensive set of themes. It may also involve collaborating with the participants interactively so that they have a chance to shape the themes or abstractions that emerge from the process (Qld, 2017). While the researcher was conducting this study, she kept abreast of all economic, political and taxation changes that may impact the objectives of this research as discussed in paragraph 1.4 of Chapter 1.

## 2.5 CONCLUSION

This chapter identified and described the research design and research methodology applied to achieve the main objective (paragraph 1.4.1, Chapter 1). The research design was described as being a literature review of relevant documents taken from various sources. The method utilized was qualitative in nature within an interpretivism paradigm; secondary objective number 1.4.2.1 was achieved. The next chapter contains a detailed analysis of the South African tax law regarding the cessation of a CFC as contemplated in section 9D of the Income Tax Act (58 of 1962). It also contains a comparison regarding the tax legislation (specific reference to capital gains tax) on the cessation of a CFC in SA to that of the UK and the USA to determine the difference in the tax legislation of these three countries.

# CHAPTER THREE

# DETAILED ANALYSIS OF THE SOUTH AFRICAN TAX LAW REGARDING THE CESSATION OF A CFC AS CONTEMPLATED IN SECTION 9D OF THE INCOME TAX ACT (58 OF 1962)

The aim of this chapter is to give a detailed analysis of section 9D of the Income Tax Act (58 of 1962) to achieve secondary objective number 1.4.2.2, Chapter 1. After the analysis, a comparison between South Africa, the UK, and the USA's tax legislation will be performed to achieve secondary objective 1.4.2.3, Chapter 1.

## 3.1 INTRODUCTION

As mentioned in paragraph 1.6, Chapter 1: The double tax agreements between any country other than South Africa will not be taken into consideration for the rest of this study for purposes of limiting the scope. As the main objective (paragraph 1.4.1, Chapter 1) is to determine if the exit tax implications of ceasing to be a CFC in South Africa could be taxed differently by comparing the Income Tax Act (58 of 1962) with similar sections contained in the tax legislation of the UK and the USA.

Section 9D(2A)(l) of Income Tax Act (58 of 1962) states that –

- *the net income of a CFC in respect of a foreign tax year shall be deemed to be nil where;*
    - *the aggregate amount of taxes on income payable to all spheres of government of any country other than the Republic by the CFC in respect of the foreign tax year of that CFC is at least 75 per cent of the amount of normal tax that would have been payable in respect of any taxable income of the CFC had the CFC been a resident for that foreign tax year; or*
    - *all the receipts and accruals of that CFC are attributable to any foreign business establishment of that CFC and not required to be taken into account in terms of subsection (9A)* (Income Tax Act 1962).

According to section 9D of the Income Tax Act (58 of 1962), Foreign Business Establishment in relation to a Control Foreign Company means -

- *A fixed place of business 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, where —*
    - *that business is conducted through one or more offices, shops, factories, warehouses or other structures;*

- *that fixed place of business is suitably staffed with on-site managerial and operational employees of that CFC who conduct the primary operations of that business;*
- *that fixed place of business is suitably equipped for conducting the primary operations of that business;*
- *that fixed place of business has suitable facilities for conducting the primary operations of that business, and*
- *that fixed place of business is located outside the Republic solely or mainly for a purpose other than the postponement or reduction of any tax imposed by any sphere of government in the Republic* (Income Tax Act, 58 of 1962).

### 3.1.1 The Platinum Groups Metal (PGM) mining sector value chain

The PGM mining sector value chain will be used for the remainder of this study for illustration purposes. The South African mineral value steps are explained by Baartjes (2011) as follows:

- The first step is exploration which includes geophysical, drilling and surveys.
- The second step is mining which includes drilling, cutting, hauling and hosting.
- The third step is the mineral processes which include crushers and mills, hydromet plant, material handling, and furnaces.
- The fourth step is smelting and refining which includes smelters, furnaces, electrowinning cells, and casters.
- The last step is the value addition which includes the rolling, moulding, machining and assembling.

According to Kay (2018), South Africa is a country that is rich with PGM minerals making South Africa the world's top platinum-mining country and a major producer of palladium. It holds the largest-known reserves of PGMs globally at 63 million kilograms and currently extracts 75 per cent of the planet's platinum. South Africa’s mineral wealth in PGM (with associated copper, nickel and cobalt mineralization), chromium and vanadium bearing titanium iron ore formations as well as large deposits of the industrial minerals, including fluorspar and andalusite is found in the bushveld complex (Baartjes, 2011:7). The mining sector grew by 12.2 per cent in 2017 and contributed 12.2 per cent to GDP compared to a GDP contribution of 12 per cent in 2016 (Chamber of Mines, 2017).

Many of SA mining companies are owned by non-residents of which the structure will be illustrated with an example. A mining company will be registered and effectively managed in South Africa and it will meet the definition of a resident in accordance with section one of the Income Tax Act (58 of 1962), thus this company will be taxed in South Africa. The mining value chain and beneficiation will happen in South Africa as explained at the beginning of this paragraph.

Beneficiation is defined as the transformation of a primary material (produced by mining and extraction processes) to a more finished product, which has a higher export sales value (Department of Mineral Resources, 2019). As previously mentioned, many South African mining companies are owned by non-residents; the following paragraph will illustrate the structure of these non-resident owners.

### 3.1.2 Practical Illustration

The South African mining company will be referred to as "Company A". The CFC will be established by Company A mainly for the marketing of the PGM in international markets. The CFC that will be configured by Company A will be referred to as "Company B" and it will be registered and managed in the UK. The net income of Company B will be included in Company A's taxable income. When Company A is done with the beneficiation, it will sell the refined product to Company B and Company B will sell and market the PGM to the international markets. The last step in the mineral value chain as described earlier in this chapter is the value addition which includes the design, marketing, and distribution. For the purpose of this study, the marketing of PGM happens in the UK. Baartjies (2011:35) reported that the PGM has a higher demand in Europe hence Company B is reconfigured in Europe so it can be close to the international markets.

Company B meets the requirements of the Foreign Business Establishment (FBE) because the business has been conducted in a fixed place of business in the UK for more than a year. Company B owns a property in the UK where all managerial and operational employees conduct the primary operations of the business which is to market PGM. The general requirement of the FBE definition is directed to ensuring that the CFC should have a substantial presence in a country in which it operates (Chaffey , 2016). The fixed place of business is located in the UK not to avoid tax but to be closer to the international markets where the demand for PGM is very high. The aggregate amount of all taxes payable in the UK is at least 75 per cent of the amount of normal tax that would have been payable in respect of any taxable income of Company B had the company been a resident for that tax year. Company B is therefore not liable for tax as per section 9D(2A)(l) of the Income Tax Act (58 of 1962), however subsection (9A) needs to be considered.

Subsection 9D(9A)(iA) of the Income Tax Act (58 of 1962) states that –

- *Any amount which is attributable to a foreign business establishment of a CFC must be taken into account in determining the net income of that CFC if that amount —*
  - *is derived from the sale of goods by that CFC to a person, other than a connected person (in relation to that CFC) who is a resident, where that CFC initially purchased those goods or any tangible intermediary inputs thereof from one or*

*more connected persons (in relation to that CFC) who are residents* (Income Tax Act, 1962).

The term "connected person" is described in section one of the Income Tax Act (58 of 1962) as:

- *in relation to a company*
    - *any other company that would be part of the same group of companies as that company if the expression "at least 70 per cent of the equity shares, of the definition of "group of companies" in this section were replaced by the expression "more than 50 per cent of the equity shares or voting rights…* (Income Tax Act, 1962).

As previously mentioned, Company B sells PGM at the international markets. Company B does not have control as to who buys the metals. Some of the metals are bought by resident companies to be used for various reasons including the catalytic manufacturing of cars, dental equipment and providing power off the grid (Anglo-American, 2015). A catalytic converter is a device found in most car engines that turn pollutants (such as carbon monoxide and nitrogen oxides) in the exhaust into benign gases (air, like nitrogen, carbon dioxide, and water vapour) that can be released into the air. Catalytic converters trigger a chemical reaction that converts the harmful pollutants with the use of a ceramic tool shaped like a honeycomb and coated with PGMs. It's placed in the exhaust system between the engine and the muffler, and when the engine heats up the metals, the process neutralizes the pollutants (Investing News, 2018).

The net income of Company B will be imputed in the net income of Company A as a result of some metals to non-connected companies in South Africa as contemplated in section 9D(9A)(iA). If Company B ceases to be a CFC as a result of either Company A selling some of its shares in Company B, or as a result of Company B issuing new shares which can result in Company A losing the 51 per cent shareholding. There will thus be a deemed disposal of assets which will result in Capital Gains Tax (CGT) as per section 9H(3)(b) of the Income Tax Act (58 of 1962).

Another reason that can result in Company B ceasing to be a CFC can be due to changes in participation rights. Participation rights also include preference shares. According to UCT Tax Institute (2016:7), the preference shares participation rights may vary annually subject to the profitability of Company B. A foreign company may become a CFC in some years and cease to be a CFC in other years based on the profitability of that CFC. The assets of Company B will constitute property and equipment, investments in associates, and available for sale investments.

**Conclusion**

The definition of section 9D of the Income Tax Act (58 of 1962) was discussed in detail by taking into account the subsections. It was discussed that a CFC might be exempt to pay tax in South Africa before taking the subsections into account. The mining sector value chain was used for the purpose of this study and it was discovered that the CFC is taxable in South Africa mainly because of subsection 9D(2A)(l) of the Income Tax Act (58 of 1962).

In paragraph 1.2, Chapter 1 was discussed that South Africa tax legislation, political stability, and economic conditions (among others) plays a critical role in foreign investors' decisions. South Africa is the largest producer of PGM, therefore, it is critical to maintaining the foreign investors' confidence which in turn will increase GDP. The taxation of CFCs is a good measure for tax avoidance in accordance with Base Erosion and Profit Shifting (BEPS) but on the other hand, the taxation of the CFCs must not be seen as a discouragement to foreign investors.

## 3.2 COMPARISON OF TAX LEGISLATION

### 3.2.1 The United Kingdom (UK)

As discussed in paragraph 1.4.3, the UK was selected mainly because the UK and South African legislation is very similar due to South Africa's colonization by the British during the late 18th century. Both South Africa and the UK's legislation are based on common law.

#### 3.2.1.1 Definition of a CFC

According to paragraph one of Schedule Twenty of the Finance Act (14 of 2012), a CFC is a non-UK resident company which is controlled by a UK resident person or persons. In other words, a CFC is a company that is not registered in the UK but controlled in the UK due to the CFC requirements contained in the Finance Act (14 of 2012).

There are different types of control as defined in 371RB of Chapter 18 of Schedule Twenty of the Finance Act (14 of 2012) namely:

1. The legal control test;
2. The economic control test;
3. The 40 per cent rule of the economic and legal control test; and
4. The accounting control test.

Each of these control test types will be discussed below as each of these controls have different requirements and a corporation can be seen as a CFC as long as it meets one of the control types.

The word "control" is defined in section 371RB of Chapter 18 of Schedule Twenty of the Finance Act (14 of 2012) as follows:

- *A person "controls" a company by way of a legal control as per section 371RB(1) if—*
    - *by means of the holding of shares or the possession of voting power in or in relation to a company or any other company, or*
    - *by virtue of any powers conferred by the articles of association or other document regulating a company or any other company,*

      *A person has the power to secure that the affairs of a company are conducted in accordance with a person's wishes.*
- *A person "controls" a company by way of economic control as per section 371RB(2) if it is reasonable to suppose that a person would—*
    - *if the whole of a company's share capital were disposed of, receive (directly or indirectly and whether at the time of the disposal or later) over 50 per cent of the proceeds of the disposal,*
    - *if the whole of a company's income were distributed, receive (directly or indirectly and whether at the time of the distribution or later) over 50 per cent of the distributed amount, or*
    - *in the event of the winding-up of a company or in any other circumstances, receive (directly or indirectly and whether at the time of the winding-up or other circumstances or later) over 50 per cent of a company's assets which would then be available for distribution.*

Section 371RC of Chapter 18 of Schedule Twenty of the Finance Act (14 of 2012) talks about the 40 per cent rule of the legal and economic control.

- *This section applies to a non-UK resident company if—*
    - *two persons ("the controllers") control a company, and*
    - *one of the controllers is UK resident and the other is non-UK resident.*
    - *If conditions X and Y are met, a company is to be taken to be a CFC (if a company would not otherwise be).*
    - *Condition X is that the UK resident controller has interests, rights, and powers representing at least 40 per cent of the holdings, rights, and powers in respect of which the controllers fall to be taken as controlling a company.*
    - *Condition Y is that the non-UK resident controller has interests, rights and powers representing—*
- *at least 40 per cent, but*
- *no more than 55 per cent, of the holdings, rights, and powers in respect of which the controllers fall to be taken as controlling the company.*

The meaning of the different types of control is further discussed in Her Majesty's Revenue and Customs (HMRC) manual. HMRC INTM191100 states that the CFC rules contain a definition of what is meant by UK control, which can be established by:

- Legal control - a test that uses shareholdings and other legal documents to determine whether UK persons control the CFC.
- Economic control - a test that looks to establish whether "economically" the CFC is controlled by UK persons. Even if persons do not own enough of the shares in the CFC to meet the legal control test, they would still be expected to retain the economic benefit of the CFC's activity through rights to profits, rights to assets in the event of a winding-up and rights to the proceeds on the disposal of the CFC.
- Accounting control - a test using an accounting definition of a parent undertaking to determine whether the CFC is a subsidiary.

The CFC rules also applies to a joint venture company where two or more persons control the CFC, one of those persons is a UK resident company that controls at least 40 per cent, and one of the other persons is a non-UK resident and controls between 40 per cent and 55 per cent of the CFC (HRMC INTM191100).

As per the definition above, a company is regarded as a CFC in the UK if it meets the requirements of Chapter Eighteen of Schedule Twenty of the Finance Act (14 of 2012). The word "control" is an important determining factor in deciding whether a company in the UK will be regarded as a CFC or not. Menzies (2014) summarised the definition of "control" as:

- More than 50 per cent of the shares are held by UK residents;
- Factors indicate that legal, economic or accounting control is in the UK;
- It is a joint venture company, and more than 40 per cent is controlled from the UK.

The above definition is widely drawn and may include situations where the legislation applies (Menzies, 2014). "Control" will meet the requirements of the definition of a CFC in the UK if the factors indicate that there is legal, economic or accounting control. The definition of each of the types of control was discussed above. The definition requirements of the said different factors of controls are discussed below.

#### 3.2.1.2 Legal control test

"Legal control" is defined in section 371RB(1) of Chapter 18 of Schedule Twenty of the Finance Act (14 of 2012) as the holding of shares (either directly or indirectly), the possession of voting power or any other similar power a person is able to secure that the affairs of a company are conducted in accordance with his wishes. Legal control is extended so that where two or more persons have the power to secure that the affairs of a company are conducted in accordance with their wishes, they are treated as having control of it. The two (or more) persons do not have to be connected to each other to have control; two unconnected persons holding 30 per cent of a company's voting power each will be treated as controlling the company. Legal control can be established by reference to powers conferred by the articles of association of the non-UK resident company or other documents that regulate the company or any other company (Finance Act 14 of 2012).

The legal control test contains powers conferred by the articles of association or another document that stipulates how the company is regulated. The other documents that can confirm the shareholding will be share certificates, however, the articles of association take priority for the purpose of this section. The "articles of association" is defined as the article that will set out how the company is run, governed and owned by the members (Company Wizard, 2018).

Section 371RB of Chapter 18 of Schedule Twenty of the Finance Act (14 of 2012) states that a person must have voting power in a CFC in order to meet part of the requirement of the definition of control. The legal control definition is not only focused on the shareholding or voting power, but also on determining whether a person has the power to conduct the affairs of the company according to that person's wishes.

The term "connected person" is defined in Appendix 19 of Capital Gains and other Taxes Manual as follows:

In relation to a company an individual is connected with:

- any company or individual with whom they act to secure control or exercise control over that company;
- any company or individual who acts on their instructions in securing or exercising control of that company.

Individuals are connected with a company if:

- they have control; or
- they and connected persons have control.

A company is connected with another company if:

- the same person has control of both. Persons who are connected will each have control of both companies;
- it controls another company where a group of two or more persons has control of both. The group of two or more persons does not have to be connected (UK.GOV, 2017).

The shareholding in a foreign company can be either directly or indirectly held by a UK resident company. Indirect shareholding can be a result of a UK resident company holding more than 50 per cent of shares or voting power in a non-UK resident (Company A) which in turn owns more than 50 per cent of another non-UK resident (Company B). The UK resident company will, therefore, be regarded as indirectly having a shareholding in the non-UK resident Company B and therefore non-UK resident Company B will be regarded as a CFC. The UK resident company has the power to conduct the affairs of non-UK resident Company B, therefore it has legal control.

#### 3.2.1.3 Economic control test

"Economic control" is defined in section 371RB(2) of Chapter 18 of Schedule Twenty of the Finance Act (14 of 2012). A person controls a company 'economically' if it is reasonable that the person would receive (whether directly or indirectly) the majority of one or more of the following:

- the disposal proceeds in the event of a disposal of the whole of the company's share capital;
- the income on distribution if the whole of the company's income was distributed; or
- the company's assets on a winding-up or other circumstances;

whether at the time of the disposal, distribution or winding up or at any later time.

The term "indirectly" means that a UK person can control a CFC where one or more non-UK resident companies or entities are interposed between the CFC and those persons. The interpretation of a person receiving any proceeds, amounts or assets is extended to include references to the proceeds, amounts or assets being applied directly or indirectly for their benefit. A situation where a UK resident company can have an indirect shareholding was illustrated above on the discussion of legal control (HMRC INTM236250).

The interpretation of a person receiving any proceeds, amounts or assets is extended to include references to the proceeds, amounts or assets being applied directly or indirectly for their benefit. For example: Company A (resident in the UK) owns 100 per cent of the ordinary shares in non-UK resident Company B, which in turn owns 100 per cent of the ordinary shares in non-UK resident Company C. If Company B sells its shares in Company C and use the proceeds to settle a debt of Company A, it is reasonable to suppose that the proceeds have been applied for the benefit of Company A (HMRC INTM236250).

Economic control considers a resident's rights to the profit and, in certain circumstances like dissolution or liquidation, rights to capital and assets (Mozule, 2016). Economic control does not only consider the profit the CFC makes from its normal day to day activities, but also the profits made from the sale of business or proceeds from liquidation. A UK-resident company can have economic control without having shares in a CFC. This can happen if the UK-resident company is entitled to some proceeds on liquidation of a CFC. According to Pinetz and Schaffer (2017), the OECD considers the economic control test to be similar to the legal control test: Fairly simple, and easy to manipulate test which focuses on facts that can be objectively assessed (Pinetz, & Schaffer, 2017:121).

#### 3.2.1.4 Legal and economic control: The 40 per cent rule

The legal and economic 40 per cent rule is defined in section 371RC of Chapter 18 of Schedule Twenty of the Finance Act (14 of 2012). The legal or economic control tests are extended to particular cases where a non-UK resident company is controlled by a UK resident person and a non-UK resident person. This is likely to apply mostly in the case of joint ventures. The non-UK resident company is treated as a CFC if the conditions of the '40 per cent rule' are met. The conditions are as follows:

- two persons (one UK resident and the other non-UK resident) taken together control the company (the controllers);
- the UK resident controller 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-UK resident controller has interests, rights, and powers representing at least
  40 per cent but no more than 55 per cent of such holdings, rights, and powers.

The 40 percent in this context means 40 percent of the measure of either legal or economic control, where more than 50 per cent would give a person control of the non-UK resident 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 the rule applies only where there are two persons who together control (directly or indirectly) a non-UK resident 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-UK resident controller holds 55 per cent of a company and a UK resident controller holds the remaining 45 per cent, the rule will apply and the company will be treated as a CFC, even though on its own the non-UK resident controller might otherwise be considered to have control of the company (HMRC INTM236275). The 50 per cent or more shareholding falls away in a joint venture agreement. A non-UK resident can be seen as a CFC even if the voting power and rights are less than 51 per cent.

#### 3.2.1.5 Accounting control test

"Accounting control" is defined in S371RE of Chapter 18 of Schedule Twenty of the Finance Act (14 of 2012). Control can also be determined by a test based on accounting principles. In broad terms, if the results of a non-UK resident company are consolidated in the accounts of a UK company then the non-UK resident company is a CFC. However, the accounting test is limited to cases where the non-UK resident company would have at least 50 per cent of its profits apportioned as chargeable profits to a UK resident person. The accounting test is based on Financial Reporting Standard 102 (FRS 102) as issued and updated by the Accounting Standards Board in the UK.

A person controls a company at any point in time if that person is the company's "parent". For the purposes of this section, it does not matter if the company does not prepare, or is not required to prepare consolidated financial statements in accordance with Financial Reporting Standard 102 (HMRC INTM236400). The scope of FRS 102 states that the consolidated financial statements of listed groups are required by the IAS Regulation to be prepared under EU-adopted IFRS's. Financial Reporting Standard 102 may be applied by any other entity or group, including parent and subsidiary companies within a listed group (FRS102, 2018). Some companies are not required to prepare the consolidated financial statements, but this does not mean that the accounting control test is not applicable. The accounting control test mainly tests if there is a parent and subsidiary relationship even if the financial statements are not prepared.

The definition of the CFC must be analysed in order to determine how to apply the shareholding requirement, legal test, economic test, and the 40 per cent rule. If a UK resident company has more than 50 per cent shareholding in a non-UK resident company, then the non-UK resident company will be regarded as a CFC. If this requirement is met then there is no need to consider the legal, economic, accounting control tests or the 40 per cent legal and economic control rule vice versa. The test of determining if a non-UK resident company is a CFC or not must be done in sequence as per the CFC definition in Chapter 18 of Schedule Twenty of the Finance Act (14 of 2012).

A *de facto* control test is needed to determine the legal and economic factors of the non-UK resident company. According to Pinetz and Schaffer (2017), a quasi-residence test is considered. This test objectively considers the legal and economic facts, all facts and circumstances of each structure, and together with a subjective analysis, successfully acts as an anti-avoidance rule that guarantees that no circumvention of both the legal and economic control tests occur.

An example of a *de facto* control test is where a local individual who acts as an employee or representative of a foreign entity, owns a local entity that drives the local business of the foreign entity. Only a *de facto* test would treat such a local entity as a CFC.

After the requirements of control has been met for the CFC, the next step is to determine the taxable profits of a CFC. The taxable profits are determined by the CFC gateway as per Chapter Two of Schedule Twenty of the Finance Act (14 of 2012).

#### 3.2.1.6 Capital gains tax consequences when a corporation ceases to be a CFC

This section will analyse the capital gains tax consequences when a corporation ceases to be a CFC. A corporation can cease to be a CFC either by the sale of shares in a CFC by a UK-resident company or it can happen that a CFC issue new shares which can result in a UK-resident company losing control of the CFC.

The Taxation of Chargeable Gains Act (TCGA) (1992) deals with the capital gains tax consequences on chargeable gains. Section one of Part One of the TCGA (1992) states that:

- The tax shall be charged in accordance with this Act in respect of capital gains, that is to say, chargeable gains computed in accordance with this Act and accruing to a person on the disposal of assets.
- Companies shall be chargeable to corporation tax in respect of chargeable gains accruing to them in accordance with section six of the Taxes Act and the other provisions of the Corporation Tax Acts.
- Capital gains tax shall be charged for all years of assessment in accordance with the following provisions of this Act.

Part Two of this section further states that, a person shall be chargeable to capital gains tax in respect of chargeable gains accruing to him in a year of assessment during any part of which he is resident in the UK, or during which he is ordinarily resident in the UK.

Chargeable capital gains tax is defined in the HMRC capital gains tax section as the gain when a person sells the following:

- most personal possessions worth £6,000 or more, apart from your car;
- property that's not your main home;
- your main home if you have leased it or used it for business;
- shares that are not in an Individual Savings Account (ISA) or Personal Equity Plan (PEP); and
- business assets.

Individuals who are domiciled and resident in the UK are subject to capital gains tax on all chargeable assets, regardless of where they are situated (Deloitte, 2016). The UK residents are taxed on their worldwide capital gains on all chargeable assets which include the shares held in a CFC as well as other assets held through the CFC. The rates that are used for the calculation of capital gains tax depends on whether the taxpayer is paying at a higher tax rate or a basic tax rate. A taxpayer paying at a higher rate pays capital gains tax at a rate of 28 per cent on gains from residential property, and 20 per cent on gains from other chargeable assets. A taxpayer paying at a basic rate pays capital gains tax at a rate depending on the size of the gain, taxable income, and whether the gain is from residential property or other assets (UK.GOV, 2017).

Part two of Schedule 7AC of the TCGA (1992) contains the exemptions for the disposal of substantial shareholding. According to section one of part one of this Schedule, a gain accruing to a company ("the investing company") on a disposal of shares or an interest in shares in another company ("the company invested in") is not a chargeable gain if the requirements of this Schedule are met. The requirements are the substantial shareholding requirement and also the requirement in relation to the investing company and the company invested in.

Substantial shareholding is defined in paragraph seven of Schedule 7AC as follows: A company holds a "substantial shareholding" in another company if it holds shares or interests in shares in that company by virtue of which –

- it holds not less than ten per cent of the company's ordinary share capital;
- it is beneficially entitled to not less than ten per cent of the profits available for distribution to equity holders of the company; and
- it would be beneficially entitled on a winding-up to not less than ten per cent of the assets of the company available for distribution to equity holders.

If the shares in a CFC are held by one UK resident company then it means that it meets the definition of substantial shareholding, assuming that the UK resident has more than 50 per cent shareholding in that CFC. This statement is not taking the *de facto* control test into account. If the shares in a CFC are however held by a group of UK residents and one of them has less than 10 per cent shareholding, then that particular person will not meet the definition of substantial shareholding.

The substantial shareholding exemption was introduced in 2002 with the aim of eliminating the potential double taxation of trading profits in a company or sub-group being disposed of when these are realized by the shareholder by way of a disposal of their shareholding. This exemption also aims to facilitate the restructuring of groups without triggering a tax charge.

The substantial shareholding exemption is defined in paragraph three of Part One of the TCGA (1992) and applies in relation to a gain or loss accruing to a company ("the investing company") on a disposal of shares or an interest in shares in another company ("the company invested in").

- This paragraph applies if—
  - the requirement in paragraph seven is met (substantial shareholder requirement and it was discussed above);
  - the requirement in paragraph nineteen is not met (requirement relating to a company invested in and it is discussed below); and
  - the investing company is not a disqualified listed company (the disqualified listed company requirements are discussed below)
- If immediately before the disposal, 80 per cent or more of the ordinary share capital of the investing company is owned by qualifying institutional investors, no chargeable gain or loss accrues on the disposal.
- If, immediately before the disposal, at least 25 per cent but less than 80 per cent of the ordinary share capital of the investing company is owned by qualifying institutional investors, the amount of the chargeable gain or loss accruing on the disposal is reduced by the percentage of the ordinary share capital of the investing company which is owned by the qualifying institutional investors.

  A company is a "disqualified listed company" for the purposes of this Part of the Schedule if—

- any of the shares forming part of the ordinary share capital of the company are listed on a recognized stock exchange;
- the company is not a qualifying institutional investor; and
- the company is not a qualifying UK REIT.

It is assumed that the company "CFC" is not a qualified listed company for the sake of this study in order to be able to do a comparison to that of SA.

As mentioned above, the "disqualified listed company" regarding the shares being listed in a recognized stock exchange, will have an impact in determining whether the company invested in will qualify for the substantial shareholding exemption. If shares of the company invested in are not listed on any recognized stock exchange, then the substantial shareholding exemption will be available. For the purpose of this study, it is assumed that the shares of the company invested in are not listed on any stock exchange.

Requirements relating to the company invested in are defined in paragraph 19 of this Schedule. The company invested in must—

- have been a qualifying company throughout the period
- beginning with the start of the latest twelve-month period by reference to which the requirement of paragraph seven (the substantial shareholding requirement) is met, and
- ending with the time of the disposal, and
- be a qualifying company immediately after the time of the disposal.

For the purpose of this Schedule a “qualifying company” means a trading company or the holding company of a trading group or a trading subgroup.

The trading company is defined in paragraph 20 of Part Three of the TCGA 1992 as a company carrying on trading activities whose activities do not include, to a substantial extent, activities other than trading activities. Trading activities means activities carried on by the company—

- in the course of, or for the purposes of a trade being carried on by it;
- for the purposes of trade that it is preparing to carry on;
- with a view to its acquiring or starting to carry on trade; or
- with a view to it acquiring a significant interest in the share capital of another company that—
  - is a trading company or the holding company of a trading group or trading subgroup; and
  - if the acquiring company is a member of a group, it is not a member of that group.

According to Deloitte (2016), capital gains form part of a company’s taxable profits. Gains or losses on the disposal of substantial shareholdings in both the UK and foreign companies can be exempt. The main conditions broadly require the selling company to have continuously owned at least ten percent of the shares of the company being sold for at least 12 of the 24 months before disposal and the selling company/company being sold both must be trading or members of a trading group (without, to a substantial extent, any non-trading activities) for at least 12 months before disposal (24 months in some cases) and immediately after the disposal. When an election has been made to exclude the profits of permanent establishments (PEs), the exclusion also may apply to gains and losses of certain capital assets of the PE. A non-resident company generally is not subject to tax on its capital gains unless the asset is held through a UK PE or, in certain cases, where UK residential property is owned. A non-resident company is not subject to a capital gain unless the assets are held through a UK PE and the non-UK resident is not subject to capital gains tax as per the requirements to substantial shareholding (Deliotte, 2016).

The term permanent establishment (PE) is defined in HMRC INTM264300 as having:

- *a fixed place of business in the UK through which the business of the company is wholly or partly carried on; or*
- *an agent acting on behalf of the company has and habitually exercises UK authority to do business on behalf of the company*.

An illustration of how a UK resident can be exempt from capital gains tax on the disposal of its shares in the CFC will be done below.

For the purpose of this illustration, the PGM industry will be used in order to align with the motivation of the topic actuality as discussed in paragraph 1.2, Chapter 1. The PGM mining company (referred to as Company 1) is set up in the UK and all of the mining value chain as described in paragraph 3.1.1 of this chapter takes place in the UK. The PGM demand is there in the UK but there is an even more popular demand in India. Company 1 decided to have two PGM marketing companies for the purpose of marketing and promoting the PGMs: One is set up in the UK (referred to as Company 2) and the other one is set up in India (referred to as Company 3). Company 1 holds 100 per cent for both Company 2 and Company 3. Company 2 is a UK resident company and Company 3 is a non-UK resident company. Company 3 is regarded as a CFC because a UK resident company holds more than 50 per cent of its shares. Company 3 is assumed to not have a PE in the UK which means that it does not have a fixed place of business in the UK, and it is only trading in India. If Company 3 sells some of its assets, then it will not be subject to capital gains tax in the hands of a UK resident because it does not have a PE in the UK.

Furthermore, the UK resident meets the definition of substantial shareholding because it holds shares of more than ten per cent and in this example, it holds 100 per cent. The UK resident also qualifies for substantial shareholding exceptions as a result of it holding more than 80 per cent of the ordinary shares of the CFC (Company 3). Schedule Twenty of the Finance Act (14 of 2012) does not state anything about a deemed disposal when a CFC ceases to be a CFC. If for any reason, Company 1 decides to sell 70 per cent of its shareholding in Company 3 and therefore cease to be a CFC.

Company 1 now holds 30 per cent of the shareholding in Company 3; with Company 3 no longer a CFC. It is assumed that all the control tests requirements (paragraphs 3.2.1.2 to 3.2.1.4) were not met, thus the capital gains tax consequences are only applicable when the actual 70 per cent shares in a CFC are disposed of. It must be noted that the capital gains tax is only applicable to the disposal of shares and not the other assets held by Company 3 because Company 3 did not sell any assets.

If Company 3 did sell some of its assets, then the company would have been exempt from capital gains tax because of the substantial shareholding requirements of Company 1 holding more than 80 per cent of the ordinary share capital of Company 3. Capital gains tax will also not be applicable under PE requirements because Company 3 does not have any fixed place of business in the UK. If the status of a CFC changes to a non-CFC then there will be no deemed disposal to the remaining 30 per cent shareholding of Company 1 in Company 3.

There is no deemed disposal rule when a CFC ceases to be a CFC and, therefore, no exit charge when a CFC ceases to be controlled in the UK. On the assumption that the UK tax resident directly owns the shares in the CFC that will cease to be a CFC in the UK, any capital gains or capital loss will only be taxable or relievable when the UK tax resident ultimately disposes of the shares in the foreign company (Vermeulen, 2013: 56).

#### 3.2.1.7 A comparison of the tax consequences of ceasing to be a CFC in the United Kingdom versus South Africa

The comparison of the definition of a CFC in the UK and in South Africa is illustrated in Table 3-1. The UK's definition of a CFC has a wider meaning and requirements compared to that of SA.

**TABLE 3-1: A comparison of the tax consequences of ceasing to be a CFC in the UK versus SA**

| SA CFC legislation (Section 9D of the Income Tax Act 58 of 1962) | UK CFC legislation (Finance Act 14 of 2012) | Commentary |
|---|---|---|
| A foreign company where more than 50 per cent of the total participation rights or voting rights in that foreign company are directly or indirectly held / exercisable, by one or more persons that are residents. (paragraph 1 of Chapter 1) | CFC is a non-UK resident company which is controlled by a UK resident person or persons as a result of satisfying the control test. | SA legislation satisfies the CFC definition if more than 50 per cent is owned by residents while the UK legislation does not use the more than 50 per cent rule as a determining factor for a corporation to be a CFC. The UK uses the control test as discussed below. |
| N/A | The UK uses the control test to determine if a corporation is a CFC. | The UK legislation regards the corporation to be a CFC if one of the four control tests are met. The control test is the determining factor to assess whether the company meets the definition of a CFC or not (paragraph 3.2) |

(Source: author)

The tax consequences of the sale of shares or deemed disposal of shares in a CFC will be illustrated in Table 3-2.

**TABLE 3-2: Illustration of tax consequences on the sale (or deemed disposal) of shares**

| SA CFC legislation (Section 9H of the Income Tax Act 58 of 1962) / (Schedule Eighth of the Income Tax Act 58 of 1962) | UK CFC legislation (Finance Act 14 of 2012) / (The Taxation of Chargeable Gains Act ) | Commentary |
|---|---|---|
| Where a corporation ceases to be a CFC during any foreign tax year of that foreign company, the CFC must be treated as having disposed of each of the assets of that CFC and reacquired each of the assets disposed on the day on which that corporation ceased to be a CFC, for an amount equal to the market value of each of those assets. (paragraph 1 of Chapter 1) | N/A | The South African tax legislation has a deemed disposal when a corporation ceases to be a CFC while the UK does not have such legislation. |
| The actual disposal of shares in a CFC is taxed in accordance with section 9D and 9H of the Income Tax Act (58 of 1962). (paragraph 1 of Chapter 1) | The actual disposal of shares in a CFC is tax in accordance with TCGA (1992). (paragraph 3.2) | The South African tax legislation first tax the proceeds from the corporation when it ceases to be a CFC as per section 9H.<br>Section 9H CGT then flows down to the South African resident and is taxed in accordance with section 9D by including the net income of the CFC.<br>The UK tax legislation taxes the actual sale of shares in accordance with the TCGA (1992). |

| SA CFC legislation (Section 9H of the Income Tax Act 58 of 1962) / (Schedule Eighth of the Income Tax Act 58 of 1962) | UK CFC legislation (Finance Act 14 of 2012) / (The Taxation of Chargeable Gains Act ) | Commentary |
|---|---|---|
| The disposal of shares in a CFC can be exempt in accordance with the paragraph 64B(1) of the Eighth Schedule | The disposal of shares in a CFC can be exempt in accordance with the Substantial Shareholding Exemption as described in TCGA (1992). (paragraph 3.2) | Paragraph 64B of the Eighth Schedule is outside the scope of this study. The disposal of shares in a CFC can be exempt under certain circumstances as described in paragraph 64B of the Eighth Schedule.<br>The UK tax legislation can reduce or not tax the proceeds from the sale of foreign shares nobody the Substantial Shareholding Exemptions. |

(Source: author)

### 3.2.2 The United States of America (USA)

As discussed in paragraph 1.4.3 Chapter 1, the USA was selected mainly because it was the first country to introduce CFC rules.

#### 3.2.2.1 Definition of a CFC

Internal Revenue Code Subpart F contains the CFC legislation of the USA. The taxation of foreign income earned by USA CFCs drastically changed with the introduction of Subpart F into the Internal Revenue Code in 1962. Subpart F deals with the USA taxation of amounts earned by CFCs. It provides that certain types of income of CFCs, though undistributed, must be included in the gross income of the USA shareholder in the year the income is earned by the CFC (IRC). The USA shareholders of a CFC are subject to current income tax on "certain" income of the CFC. Generally, foreign investment income and certain kinds of foreign-source business income are subject to current taxation to USA shareholders (Avcadvisory, 2018).

IRC section 7 states that Subpart F of the code takes precedence over the foreign personal holding company sections. Further, the rules contained in Subpart F are to be applied after the income of the CFC has been adjusted to conform to US income tax legislation.

A CFC is defined in subchapter N of Subpart F of IRC section 957(1a) as any foreign corporation of which more than 50 per cent (or such lesser amount as is provided in section 957(b) or section 953(c)) of either;

- The total combined voting power of all classes of stock of the corporation entitled to vote; or
- The total value of the stock of such corporation is owned (within the meaning of section 958(a) or is considered as owned by applying the rules of ownership of section 958(b), by USA shareholders on any day during the taxable year of such foreign corporation.

The 50 per cent voting power of all classes of stock includes for example; preference shares and ordinary shares. The 50 per cent includes all authorized and unauthorized shares (Erwin, Rastogi, Shan & Zanet, 2018).

According to Vlahos (2018), the USA residents are subject to tax on their worldwide income, whether derived in the USA or abroad (Vlahos, 2018). This is interrelated as a country that taxes the residents on a residence basis. The USA has no taxing authority over a foreign corporation with no USA source income and no permanent establishment in the USA. The USA tax laws do have taxing authority over USA shareholders of foreign corporations.

According to sections 952 to 954 of Subpart F of the IRC, the USA source income means income derived from conducting a trade or business in the USA, income from services performed in the USA and income from property located in the USA. It also includes dividends on the stock of US corporations and interest on bonds or other evidence of debt from US sources (Avcadvisory, 2018). The USA source income is excluded from the CFC taxable income because it has already been taxed in the US when the services were rendered, or goods sold.

The USA shareholder in relation to any foreign corporation is defined in Subchapter N of IRC section 951(b) as a USA person who owns directly, indirectly, or constructively ten per cent or more of the total combined voting power of all classes of stock entitled to vote in a foreign corporation.

The emphasis of this definition is that the USA shareholder must own different classes of stock which means that it can be either the ordinary shares or preference shares. According to IRC, direct and indirect ownership is determined by the value of the stock, including whether any shares have different rights resulting in different values and ownership of the value of stock. It is also important to determine who is the majority shareholder of the CFC if the USA shareholder appears to be a minority. Determining the majority will be key to determine if the USA shareholders have an indirect shareholding in a CFC.

The definition of a CFC is met when the combined shareholding in a CFC by USA shareholders is more than 50 per cent, and when the USA shareholders have a direct or indirect shareholding of ten per cent or more. However, a foreign corporation with 20 USA shareholders with equal shares of five per cent of the foreign corporation is not a CFC. The 50 per cent shareholding in a CFC must be made up by shareholders which individually hold more than ten per cent direct or indirect shareholding otherwise that foreign corporation cannot be seen as a CFC (AVCadvisory, 2018).

The source of the foreign corporation income is another determining factor to assess whether the foreign corporation can be taxed in the USA or not, even if that company is not a CFC. According to AVCadvisory (2018), a foreign corporation, whether owned by USA shareholders or foreign shareholders, may be subject to USA income taxation. In a nutshell, the foreign corporation will be taxed irrespective of its CFC status. If the foreign corporation is subject to USA income taxation and it also has USA shareholders, then later distributions to those shareholders, if treated as dividend distributions, will be subject to an additional personal income tax for those USA shareholders. The USA source business income is defined in section 861 of Subpart F of IRC.

As discussed earlier, a company will be regarded as a CFC if the USA taxpayer owns ten per cent or more of the voting power of that foreign corporation and that corporation's shareholders consisted of US shareholders holding more than 50 per cent. Section 951 of IRC states that a USA shareholder in a foreign corporation must include the following amounts on their taxable income for the taxable year:

- pro rata shares of the corporation's Subpart F income for such year, and
- the amount determined under section 956 with respect to such shareholder for such year.

A pro-rata share the USA shareholder of Subpart F income is the amount:

- which would have been distributed with respect to the stock which such shareholder owns in such corporation if on the last day, in its taxable year, on which the corporation is a CFC it had distributed pro-rata to its shareholders an amount which bears the same ratio to its Subpart F income for the taxable year, as the part of such year during which the corporation is a controlled foreign corporation bears to the entire year, reduced by;
- the amount of distributions received by any other person during such year as a dividend with respect to such stock, but only to the extent of the dividend which would have been received if the distribution by the corporation had been the amount (i) which bears the same ratio to the subpart F income of such corporation

for the taxable year, as (ii) the part of such year during which such shareholder did not own such stock bears to the entire year.

Dividends are exempt from the taxable income of a domestic corporation that has a direct shareholding in a CFC. The dividends are first included as an income of the USA shareholder that has a direct shareholding in a CFC, and then afterwards deducted as a dividend received. The dividends are only exempt for the tax in the USA if the CFC shareholding was held directly by allowing a 100 per cent deduction for the foreign-source portion of dividends received. The dividends received as a result of the indirect shareholding in a CFC are not exempt from taxation.

According to Vlahos (2018), the term “dividend received” is intended to be interpreted broadly. For example: if a domestic corporation indirectly owns stock of a CFC through a partnership, and the domestic corporation would qualify for the participation dividend received deduction with respect to dividends from the CFC if the domestic corporation owned such stock directly, the domestic corporation would be allowed a participation dividends received deduction with respect to its distributive share of the partnership’s dividend from the CFC (Vlahos, 2018).

There are certain rules that must be adhered to in order to qualify for the dividends received deduction. This deduction is not available for any dividend received by a USA shareholder from a CFC if that particular CFC received a deduction or other tax benefit from taxes imposed by a foreign country. Conversely, no foreign tax credit or deduction is allowed for any taxes paid or accrued with respect to any portion of a distribution treated as a dividend that qualifies for the dividends received deduction, including any foreign taxes withheld at the source (Vlahos, 2018).

Another requirement for dividends received deduction to be applicable is the holding period. The share must have been held by the USA domestic corporation for at least 366 days during the 731-day period beginning on the date that is 365 days before the date on which the share becomes ex-dividend with respect to the dividend. The holding period requirement will be met only if the specified ten per cent-owned CFC is a specified ten per cent-owned CFC at all times during the period, and the taxpayer is a USA shareholder with respect to such specified ten per cent-owned foreign corporations at all times during the period (Vlahos, 2018). If at a certain point the shareholding in a CFC was less than ten per cent, then that particular USA shareholder will not qualify for the dividends received deduction and will be taxed on the whole amount.

In order to determine whether the USA shareholder qualifies for the dividends received deduction or not, it must be assessed whether the USA shareholder is an S-corporation or

C-corporation. A C-corporation is a business term that is used to distinguish this type of entity from others, as its profits are taxed separately from its owners under Subchapter C of the Internal Revenue Code. In an S-corporation, the profits are passed on to the shareholders and are taxed based on personal returns. This is done under Subchapter S of the Internal Revenue Code (Business Dictionary, 2018).

A C-corporation is a CFC regarded as a USA shareholder that holds shares directly from the CFC and the dividends received deduction is applicable. The S-corporation indirectly held the shares in a CFC and the dividends received deduction is not applicable, the income of the S-corporation is deferred until it is payable to the shareholder.

The S-corporation is required to report on its income tax return the amount of accumulated foreign earnings includible in gross income, as well as the amount of the allowable deduction, and it must provide a copy of such information to its shareholders. Any shareholder of the S-corporation may elect to defer his portion of this tax liability until the shareholder's taxable year in which a prescribed triggering event occurs (Vlahos, 2018). To summarize, the shareholder of an S-corporation is only taxable on the income once it is repatriated.

Three types of events may trigger an end to the deferral of the tax liability of an S-corporation namely:

- a change in the status of the corporation;
- the liquidation, sale of substantially all corporate assets, termination of the of business, or similar event; and
- a transfer of shares of stock in the S-corporation by the electing taxpayer, whether by sale, death or otherwise, unless the transferee of the stock agrees with the IRS to be liable for tax liability in the same manner as the transferor (Vlahos, 2018).

If a shareholder of an S-corporation has elected deferral, and a triggering event occurs, the S-corporation and the electing shareholder are jointly and severally liable for any tax liability (Vlahos, 2018).

Under certain circumstances, the current earnings of a CFC may be deferred from USA tax if not actually distributed to the USA shareholder. Since domestic entities are currently taxed, it is essential that the relationships between CFCs and domestic entities be at arm's length (IRC).

As previously discussed, the definition of a CFC refers to a USA resident who owns directly, indirectly, or constructively ten per cent or more of the total combined voting power of all classes of stock entitled to vote in a foreign corporation. The words “directly and indirectly” play a critical role in determining whether the CFC income can be deferred or not.

According to Vlahos (2018), income earned directly (or that is treated as earned directly) by a USA shareholder from its conduct of a foreign business, is subject to USA tax on a current basis; for example, the income generated by the USA shareholder’s branch in a foreign jurisdiction. The income that is treated as earned directly can be as a result of a USA partner in a partnership that is engaged in business overseas. Income that is earned indirectly, through the operation of foreign business by a CFC, is generally not subject to USA tax on a current basis. Instead, the foreign business income earned by the CFC is generally not subject to USA tax until the income is distributed as a dividend to a USA owner (Vlahos, 2018).

In general, indirect shareholding income is deferred, and it is not taxed immediately; the income is taxed when it is repatriated as a dividend to the USA shareholder. The deferring of income is, however, subject to the CFC anti-deferral regime and these anti-deferral regime rules are discussed below.

The CFC anti-deferral regime may cause a USA owner of a CFC to be taxed currently in the USA on its pro-rata shares of certain categories of income earned by the CFC in accordance with Subpart F income, regardless of whether the income has been distributed as a dividend to the USA owner (Vlahos, 2018). The categories that are taxed as an anti-deferral regime includes foreign base company sales income and foreign base company services income as well as certain passive income. The CFC anti-deferral regime also requires the USA shareholder to include in his income, the pro-rata shares of the CFC’s untaxed earnings that are invested in certain items of US property, including tangible property located in the USA, stock of a USA corporation, and an obligation of a US person (Vlahos, 2018).

Subpart F of the Internal Revenue Code includes the definition of a CFC and also the amounts that are included in the computation of a CFC. Subpart F further outlines the exclusion of certain income in determining the taxable income of a CFC. Section 952(b) states that Subpart F income does not include any item of income from sources within the USA which is effectively connected with the conduct by such corporation of a trade or business within the USA unless such item is exempt from taxation (or is subject to a reduced rate of tax) pursuant to a treaty obligation of the USA. The income from sources within the USA is not taxed in the hands of a CFC because it is already taxed when the service is rendered, or goods sold. The CFC would have received an amount net of tax.

Section 952(c) talks about the limitation of the CFC taxable income. The limitation is as follows:

- Subpart F income limited to current earnings and profit
    - The Subpart F income of any controlled foreign corporation for any taxable year shall not exceed the earnings and profits of such corporation for such taxable year.
- Certain prior year deficits may be taken into account
    - The amount included in the gross income of any USA shareholder under section 951(a)(1)(A) for any taxable year and attributable to a qualified activity shall be reduced by the amount of such shareholder's pro-rata share of any qualified deficit.

The term "qualified deficit" means any deficit in earnings and profits of the CFC for any prior taxable year which began after 31 December 1986, and for which the CFC was a CFC. The emphasis on the qualifying deficit is that the deficit is attributable to the same qualified activity as the current activity that is being used to offset. The income of a CFC may be exempt in certain circumstances as per section 959 of Subpart F.

According to Vlahos (2018) several exceptions to the definition of Subpart F income, including the "same country" exception, may permit continued deferral for income from certain business transactions. Another exception is available for any item of business income received by a CFC if it can be established that the income was subject to an effective foreign income tax rate greater than 90 per cent of the maximum USA corporate income tax rate. A USA shareholder of a CFC may also exclude from its income any actual distributions of earnings from the CFC that were previously included in the shareholder's income (Vlahos, 2018).

In order to test that the CFC has an effective foreign tax rate greater than 90 per cent compared to as if the CFC was taxed in the USA, the taxable income of a CFC must be calculated using the USA tax legislation. The income tax is then calculated using the USA effective tax rate. If the USA income tax is less than the foreign income tax rate by 90 per cent, then that particular CFC is exempt from paying tax in the USA. The aim of using this rule is to test the tax avoidance of the CFC being incorporated outside the USA. If the foreign income tax payable is 90 per cent higher than that of the USA, then there was no intention of shifting profits by incorporating the company outside the USA.

#### 3.2.2.2 Capital gains tax consequences when a corporation ceases to be a CFC

According to Cornell Law School (2018), there are special rules when a corporation ceases to be a CFC. If any foreign corporation ceases to be a CFC during any taxable year—

- The determination of any USA 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 in which the foreign corporation is a CFC,
- 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
- 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 (Cornell Law School, 2018).

An illustration of the capital gains tax consequences of a corporation when it ceases to be a CFC will be based on the PGM sector (paragraph 1.2, Chapter 1). Mining is one of the key economic activities in the USA, as the country holds significant mineral resources. According to NSenergybusiness (2018), mining is one of the key economic activities in the USA, as the country holds significant mineral resources. The USA mining industry supplies coal, metals, industrial minerals, sand, and gravel to businesses, manufacturers, utilities and others. The USA mining industry’s activities include extraction, beneficiation, and processing of naturally occurring solid minerals from the earth. It is assumed that the mining sector value chain as described in paragraph 3.1.1 takes place in the USA.

The PGM mining company in the USA will be referred to as Company AA for the rest of the illustration. Company AA has a marketing company set up and incorporated in Singapore for the purpose of marketing and promoting the PGM metals and this company will be referred to as Company BB for the rest of the illustration. Company AA has a 100 per cent shareholding in Company BB and this makes Company BB a CFC because more than 50 per cent of its stock is owned by a USA shareholder. If Company AA decides to sell 60 per cent of its shareholding in Company BB and resulting in Company BB ceasing to be a CFC then the consequences will be as follows:

Any gain from the sale of CFC stock that would be treated as a dividend would also constitute a dividend received for which the dividends received deduction may be available (Vlahos, 2018). A gain on the sale of Company BB stock by Company AA will not constitute capital gains tax. Gains recognized on the sale or exchange by a USA resident of stock in a foreign corporation must be included in the gross income of the USA resident as a dividend to the extent of the foreign corporation’s earnings and profits that were accumulated while the stock was held by the USA resident and the foreign corporation was a CFC (International tax blog, 2016). The gain on sale of stock that needs to be included in gross income must be limited to the profits earned throughout the years when the stock was still held by the USA shareholder. The gain to be included in gross income will be the difference between the proceeds of the sale and the profits that were accumulated throughout the years.

Any gain on the subsequent sale of the foreign corporation stock is treated as dividend income to any USA shareholder who owns ten per cent or more of the stock at any time within five years before the sale of the stock.

For the PGM illustration above, the stock owned by Company AA was more than 10 per cent which means that this requirement is met. Gains from the sale of stock by shareholders who do not directly, or indirectly own ten per cent of the company are eligible to be treated as a long-term capital gain rather than being taxed as ordinary income. For ten per cent or greater shareholding, it does not matter if the earnings of the foreign corporation are distributed as dividends or if the stock is sold at a gain (Avcadvisory, 2018).

The focus of this study was the tax consequences of a CFC when it ceases to be a CFC, the gains on the sale of the stock for the USA shareholders who own ten per cent or more of all stock value will be treated as a dividend and included in income. The dividends-received deduction will be applicable for those USA shareholders who directly own the stock in a CFC. For the PGM illustration above, the gains on the sale of stock will first be included as a dividend and limited to the profits earned throughout the years when Company BB stock was still held by Company AA.

There are no capital gains consequences in the hands of a CFC when it ceases to be a CFC, the USA shareholders are the only ones who will be taxed on their income as dividends. The dividends income in the hands of Company AA will be exempt by a dividend received reduction because Company AA is a C-corporation. Company AA is a C-corporation because it is a USA shareholder that holds shares directly in a Company BB which is a CFC and therefore a dividend received deduction is available.

Furthermore, there is no deemed capital gains tax when Company BB ceases to be a CFC as a result of Company AA disposing of the 60 per cent shareholding in Company BB. This means that the remaining 40 per cent do not have any deemed capital gains tax and deemed dividends received consequences.

It was discussed in paragraph 3.2 that the S-corporation shareholder refers to the USA shareholders who own the stock indirectly in a CFC. Any gains on the sale of stock by the S-corporation will only be taxed to the USA shareholder as dividends once the gains have been repatriated. On the other hand, any gains on the sale of stock by the C-corporation will be taxed directly to the USA shareholder as discussed in the paragraph above.

#### 3.2.2.3 A comparison of the tax consequences of ceasing to be a CFC in the United States of America versus South Africa

The word “CFC” has a different meaning in the USA as in South Africa, but it refers to the same terminology. “CFC” in the USA refers to a Controlled Foreign Corporation while in South Africa it refers to a Controlled Foreign Company. The word “company” and the word “corporation” has the same meaning. The comparison of the definition of a CFC in the USA against South Africa will be illustrated in Table 3-3 below.

**TABLE 3-3: A comparison of the tax consequences of ceasing to be a CFC in the USA against South Africa.**

| SA CFC legislation(Section 9H of the Income Tax Act 58 of 1962) / (Schedule Eighth of the Income Tax Act 58 of 1962) | USA CFC legislation Internal Revenue Code (IRC) Subpart F | Commentary |
|---|---|---|
| A foreign company where more than 50 per cent of the total participation rights or voting rights in that foreign company are directly or indirectly held / exercisable, by one or more persons that are residents.<br>(paragraph one of chapter one) | A foreign corporation of which more than 50 per cent total combined voting power of all classes of stock or the total value of the stock of such corporation is owned by the USA Shareholder.<br>(paragraph 3.2) | The requirement is similar for the USA and South Africa because both countries classify the CFC if more than 50 per cent of the foreign company's voting rights are owned by the residents. The more than 50 per cent requirement is the same for both countries because it states that it must be held directly or indirectly by the residents. |
| A person is deemed not to be a resident for the purpose of determining whether residents directly or indirectly hold more than 50 per cent of the participation rights or voting rights in a foreign company.<br><br>If the 50 per cent or more of the participating or voting rights are made up of shareholders with less than five per cent shareholding. | The USA shareholder is a person who owns directly, indirectly or constructively ten per cent or more of the total combined voting power of all classes of stock entitled to vote in a foreign corporation. | The USA legislation stated that for a corporation to be regarded as a CFC, each USA shareholder must have at least ten per cent or more voting rights in a CFC. According to AVCadvisory (2018) a foreign corporation with 20 USA shareholders with equal shares of five per cent of the foreign corporation is not a CFC.<br><br>The South African tax legislation states that If the 50 per cent or more of the participating or voting rights are made up of shareholders with less than five per cent shareholding then the company cannot be seen as a CFC.<br><br>The only difference with this requirement is that the USA has a ten per cent threshold while SA has a five per cent threshold. |

(Source: author)

The tax consequences of the sale of shares or deemed disposal of shares in a CFC will be illustrated in the table (Table 3-4) below.

**TABLE 3-4: The tax consequences of the sale (or deemed disposal) of shares in a CFC**

| **SA CFC legislation (Section 9H of the Income Tax Act 58 of 1962) / (Schedule eighth of the Income Tax Act 58 of 1962)** | **USA CFC legislation Internal Revenue Code (IRC) Subpart F** | **Commentary** |
|---|---|---|
| Where a corporation ceases to be a CFC during any foreign tax year of that foreign company, the CFC must be treated as having disposed of each of the assets of that CFC and reacquired each of the assets disposed on the day on which that corporation ceased to be a CFC, for an amount equal to the market value of each of those assets. (refer to paragraph one of chapter one) | N/A | The South African tax legislation has a deemed disposal when a corporation ceases to be a CFC while the USA does not have such legislation. |
| The actual disposal of shares in a CFC is taxed in accordance with section 9D and 9H of the Income Tax Act (58 of 1962). (paragraph 1 of chapter one) | Any gain from the sale of CFC stock that would be treated as a dividend would also constitute a dividend received for which the dividend received deduction (DRD) might be applicable. (paragraph 3.2) | The South African tax legislation first tax the proceeds from the corporation when it ceases to be a CFC as per section 9H. Section 9H's CGT then flows down to the South African resident and be taxed in accordance with section 9D by including the net income of the CFC.<br>The USA tax legislation taxes the actual sale of shares in accordance with Subpart F of IRC. The gain on sale of stock that needs to be included in gross income must be limited to the profits earned throughout the years when the stock was still held by the USA shareholder. |

| **SA CFC legislation**<br><br>**(Section 9H of the Income Tax Act 58 of 1962) / (Schedule eighth of the Income Tax Act 58 of 1962)** | **USA CFC legislation Internal Revenue Code (IRC) Subpart F** | **Commentary** |
|---|---|---|
| | | The gain to be included in gross income will be the difference between the proceeds of the sale and the profits that were accumulated throughout the years. |
| According to section 9D(2A)(I) of the Income Tax Act (58 of 1962) the net income of a CFC will be deemed to be nil if the foreign taxes payable by that CFC is at least 75 per cent of the amount of normal tax that would have been payable; had the CFC been a resident all the receipts and accruals of that CFC are attributable to any foreign business establishment of that CFC. | According to section 959 of Subpart F, the income of a CFC may be exempt if any item of business income received by a CFC if it can be established that the income was subject to an effective foreign income tax rate greater than 90 per cent of the maximum USA corporate income tax rate. | This requirement is the same for both countries, the only difference is that SA has a 75 per cent rule and the USA has a 90 per cent rule |
| The disposal of shares in a CFC can be exempt in accordance with paragraph 64B(1) of the Eighth Schedule.<br><br>(paragraph 1 of chapter one) | Any gain from the sale of CFC stock that would be treated as a dividend would also constitute a dividend received for which the dividends received deduction may be available.<br>(paragraph 3.2) | Paragraph 64B of the Eighth Schedule is outside the scope of this study. The disposal of shares in a CFC can be exempt under certain circumstances as described in paragraph 64B of the Eighth Schedule.<br><br>The dividends are only exempt for the tax in the USA if the CFC shareholding was held directly by allowing a 100 per cent deduction for the foreign-source portion of dividends received. |

(Source: author)

## 3.3 CONCLUSION

### 3.3.1 A comparison of the tax consequences of ceasing to be a CFC in the United Kingdom, the United States of America, and South Africa

As discussed in paragraph 3.2.2, both the USA and South Africa classify the corporation as a CFC if more than 50 per cent of the foreign company's voting rights are owned directly or indirectly by the residents. According to UK legislation, however, a corporation will be regarded to be a CFC if one of the four control tests are met (paragraph 3.2.1).

A difference was identified between the USA and South African legislation when it comes to the minimum voting rights threshold: For the USA, a corporation is a CFC if each USA shareholder has at least ten per cent or more voting rights in the CFC. South African legislation states that should the shareholders with less than five per cent shareholding of which the voting rights are made up of, the company cannot be seen as a CFC.

### 3.3.2 The tax consequences of the sale (or deemed disposal) of shares in a CFC

The South African tax legislation has a deemed disposal when a corporation ceases to be a CFC while the USA and the UK do not have such legislation.

The South African tax legislation first tax the proceeds from the corporation when it ceases to be a CFC as per section 9H. Thereafter, the capital gains (as per section 9H) is included in the gross income of the South African resident in accordance with section 9D. As already mentioned in paragraph 1.6, Chapter 1, paragraph 64B of the Eighth Schedule is outside the scope of this study. The disposal of shares in a CFC can be exempt under certain circumstances as described in paragraph 64B of the Eighth Schedule.

According to the USA and the UK tax legislation, the actual sale of shares is taxed. The gain on sale of stock that needs to be included in gross income must be limited to the profits earned throughout the years when the stock was still held by the USA shareholder (Subpart F of IRC). The gain to be included in gross income will be the difference between the proceeds of the sale and the profits that were accumulated throughout the years. The dividends are only exempt for the tax in the USA if the CFC shareholding was held directly by allowing a 100 per cent deduction for the foreign-source portion of dividends received. According to the Substantial Shareholding Exemptions, the UK tax legislation can reduce, or not tax the proceeds from the sale of foreign shares.

The secondary objective (paragraph 1.4.2, Chapter 1) was to compare the South African tax legislation (specific reference to capital gains tax) regarding the cessation of a CFC to that of the UK (paragraph 3.2.1) and the USA (paragraph 3.2.2) to determine the difference in the tax legislation of these three countries. This was done in the paragraphs above and a deeper insight was obtained which will assist to identify and propose an alternative way of taxing the CFC on unrealized capital gains.

# CHAPTER FOUR

# TO IDENTIFY AND PROPOSE AN ALTERNATIVE WAY OF TAXING THE CFC ON UNREALISED CAPITAL GAINS

The aim of this chapter is to identify and propose an alternative way of taxing unrealized capital gains of a corporation when it ceases to be a CFC (paragraph 1.4.2.3, Chapter 1). This will be done by utilizing the information obtained in Chapter 3 where comparisons were done between South Africa, the UK, and the USA's tax legislation.

To test if this alternative way of taxing unrealized capital gains can be considered as a possibility, a case study will be used to compare the calculations of the current tax law against this alternative way identified.

## 4.1 INTRODUCTION

As previously discussed in paragraph 1, Chapter 1, a CFC is defined in section 9D(1) of the Income Tax Act (58 of 1962) as any foreign company where more than 50 per cent of the total participation rights in that foreign company is directly or indirectly held, or more than 50 per cent of the voting rights in that foreign company is directly or indirectly exercisable, by one or more persons that are residents other than persons that are headquartered companies (Income Tax Act, 1962).

A CFC can be exempt from tax if it meets certain exclusions as discussed in Chapter 3. According to section 9D(2A)(I) of the Income Tax Act (58 of 1962) the net income of a CFC will be deemed to be nil if the foreign taxes payable by that CFC is at least 75 per cent of the amount of normal tax that would have been payable; had the CFC been a resident all the receipts and accruals of that CFC are attributable to any foreign business establishment of that CFC. As discussed in Chapter 3, the intentions of the foreign corporation being formed and effectively controlled outside South Africa need to be assessed (Income Tax Act, 1962).

On the other hand, the CFC can be taxed in South Africa even if it meets the requirements of section 9D(2A)(I) of the Income Tax Act (58 of 1962) because of subsection (9A). Subsection (9A) of section 9D of the Income Tax Act (58 of 1962) states that any amount that is attributable to the FBE of that CFC will be taken into account in determining the net income of that CFC if that amount is derived from the sale of goods by that CFC to a person who is not connected to that CFC and who is also not a resident; where that CFC initially purchased the goods from one or more connected persons (Income Tax Act, 1962).

An analysis of the exchange rate used to calculate the capital gains will be done as per section 9H(7) of the Income Tax Act (58 of 1962) and paragraph 43(1A) of the Eighth Schedule to the Income Tax Act (58 of 1962) and to determine which exchange rate to use.

As discussed in Chapter 1, a corporation can cease to be a CFC for various reasons. There is a deemed capital gains tax in the hands of a foreign corporation when it ceases to be a CFC. Section 9H(3)(b) of the Income Tax Act (58 of 1962) states that where a corporation ceases (otherwise than by becoming a resident) to be a CFC during any foreign tax year of that foreign company, the CFC must be treated as having –

- disposed of each of the assets of that CFC; and
- reacquired each of the assets disposed of as contemplated in subparagraph (i) on the day on which that corporation ceased to be a CFC, for an amount equal to the market value of each of those assets (Income Tax Act, 1962).

The net income of the CFC is calculated in that particular CFC's currency then converted to South African Rand (ZAR) before being imputed in the net income of the South African shareholders. Section 9D(6) of the Income Tax Act (58 of 1962) states that the net income of a CFC in respect of a foreign tax year shall be determined in the functional currency of that CFC and shall, for purposes of determining the amount to be included in the income of any resident during any year of assessment under the provisions of this section, be converted to the currency of the Republic by applying the average exchange rate for that foreign tax year (Income Tax Act, 1962).

Provided that any exchange item denominated in any currency other than the functional currency of that CFC shall be deemed not to be attributable to any permanent establishment of the CFC if the functional currency is the currency of a country which has an official rate of inflation of 100 per cent or more for that foreign tax year (Income Tax Act, 1962).

Paragraph 43(1A) of the Eighth Schedule to the Income Tax Act (58 of 1962) states that for the purpose of determining the capital gains and losses on the disposal of the assets translate –

- the proceeds into the local currency at the average exchange rate for the year of assessments in which that asset was disposed of or at the spot rate on the date of the disposal of that asset;
- the expenditure incurred in respect of that asset into the local currency at the average exchange rate for the year of assessment during which that expenditure was incurred or at the spot rate on the date on which that expenditure was incurred (Income Tax Act, 1962).

Both section 9D(6) and paragraph 43(1A) of the Eighth Schedule to the Income Tax Act (58 of 1962) talks about the average exchange rate to be used in determining the net income to be imputed in the income of the South African shareholder and to determine the capital gains tax. The Income Tax Act (58 of 1962) does not specify as to which section between section 9D(6) or paragraph 43(1A) of the Eighth Schedule takes priority over the other.

The term “functional currency” is defined in section 1(1) of the Income Tax Act (58 of 1962) as the currency of the primary economic environment in which the business operations of a person or a PE, as the case may be, are conducted. The term primary economic environment is defined in International Accounting Standard 21 (IAS) in which an entity operates as normally being the one in which it primarily generates and expends cash. IAS further describe the functional currency as the currency in which –

- sales prices of goods and services are denominated and settled, or
- the costs of providing goods or services are denominated or settled (SARS, 2015).

A CFC’s foreign tax year may be different to the years of assessment of the residents holding participation rights in that CFC that are required to include a portion of the CFC’s net income in their taxable income. The average exchange rate that is used to convert a CFC’s net income from its functional currency to the ZAR must be based on the foreign tax year of the CFC and not the years of assessment the residents held participation rights. In the case of a corporation that ceases to be a CFC before its foreign tax year-end, then that CFC’s tax year will be deemed to have ended immediately the day before it ceases to be a CFC. Section 9H(3)(d) of the Income Tax Act (58 of 1962) states that where a CFC ceases to be a CFC during any foreign tax year of that CFC –

- that foreign tax year must be deemed to have ended on the date immediately before the day on which that CFC so ceased to be a CFC, and
- the next succeeding foreign tax year of that CFC must be deemed to have commenced on the day on which that CFC so ceased to be a CFC (Income Tax Act, 1962).

The base cost of the assets of the CFC will have to be determined in the functional currency and then converted into ZAR. The definition of the base cost was discussed in paragraph 1.1 of Chapter 1.

A practical illustration was used in paragraph 3.1.2, Chapter 3 will continue in this chapter. The intention of Company A when they invest in Company B will need to be determined in order to access if it is expenditure of a capital nature, which is taxable in accordance with the Eighth Schedule of the Income Tax Act (58 of 1962), or in accordance with section 11(D) of the Income Tax Act (58 of 1962). The word “intention” is not defined in the Income Tax Act (58 of 1962) therefore case law will be used to determine the intention of Company A.

In the case of Commissioner of Inland Revenue (CIR) v Visser (1937) it was held that *in order to determine the matter, we have to consider the nature of his transaction and what his intention was when he entered into this transaction. His intention is not necessarily determined by what he says was his intention, but by the inference as to the intention to be drawn from the facts of the case*.

It was further held that "if we take the economic meaning of "capital" and "income," the one excludes the other. "Income" is what "capital" produces, or is something in the nature of interest or fruit as opposed to principal or tree. In the case of Commissioner of Taxes (COT) v Booysens Estates Ltd (1918) it was held that

*the question we have to ask ourselves is: is the amount in question profit or gain flowing from a business or trade or was the company primarily a gold mining company, and did it eventually sell not as part of its business but as any private owner might have sold who realizes an investment?*

In the case of Commissioner of Inland Revenue (CIR) v Richmond Estates (Pty) Ltd (1956), it was held that

*a company is an artificial person 'with nobody to kick and no soul to damn' and the only way of ascertaining its intention is to find out what its directors acting as such intended. Their formal acts in the form of resolutions constitute evidence as to the intentions of the company of which they are directors but where a company has only one director, who is also the managing director and the sole beneficial owner of all its shares, I can see no reason in principle why it should be incompetent for him to give evidence as to what was the intention of the company at any given time. The distinction, where it exists, arises of course from the fact that whereas the capacities of a natural person have no limitation so that any particular transaction need not be referred to any of them, a company is so bounded by its memorandum that it may be both permissible and essential to consider its authorized objects in connection with the actual transaction in question and even to seek for the principal purpose of its formation.*

In the case of Ochberg v CIR (1931), it was held that

*a company, being a juristic person, remains a juristic person separate and distinct from the person who may own all the shares, and must not be confused with the latter. To say that a company sustains a separate persona and yet in the same breath to argue that in substance the person holding all the shares is the company is an attempt to have it both ways, which cannot be allowed.*

Based on the analysis of the cases quoted above, the intention of Company A will be assessed in order to determine if it is of a capital nature or revenue nature by using case law. Company A was formed in South Africa for long term investment in mining the PGMs. Company B was formed to market and promote the PGMs which can be aligned to the intentions of Company A to hold a long-term investment. The intentions of Company B can be verified from its memorandum of association and the resolution of the directors as held in the case of CIR v Richmond Estates (Pty) Ltd (1956). In the case of (CIR) v Visser (1937) the intentions of Company A investing in Company B can be seen as capital because it bears the fruits in the form of dividends and profits made in Company B.

In the case of (COT) v Booysens Estates Ltd (1918) the intention of Company A will be assessed as questioning whether it was a business of selling PGM or trading shares. Company A did not invest in Company B with the intention of selling the shares at a profit. Company A is not in the business of trading with shares. Based on the facts of these cases, Company A's intention in investing in Company B is that of a capital nature and therefore the capital gains tax consequences will be applicable when the shares in Company B are sold or deemed to be sold.

According to section 9H(7) of the Income Tax Act (58 of 1962), the market value of any asset must be determined in the currency of expenditure incurred to acquire that asset. The term "market value" is defined in section 9H(1) of the Income Tax Act (58 of 1962) in relation to an asset, the price which could be obtained upon a sale of that asset between a willing buyer and a willing seller dealing at arm's length in an open market (Income Tax Act, 1962).

The cessation of a corporation to be a CFC and the deemed disposal or actual disposal of assets in a CFC will involve the use of a functional currency which is different from ZAR. This is because Company B is denominated in GBP. The use of a currency other than ZAR will have foreign gains or losses consequences. According to Van der Zwan (2016) section 24I of the Income Tax Act (58 of 1962) states that taxpayers include or deduct from their income the exchange differences arising from exchange items. Section 24I(3) of the Income Tax Act (58 of 1962) states that in determining the taxable income of any person there shall be included in or deducted from the income, as the case may be, of that person -

- any exchange difference in respect of an exchange item of or in relation to that person (Income Tax Act, 1962).

Section 24I of the Income Tax Act (58 of 1962) is applicable to a company, a trust carrying on a trade or any natural person who holds any exchange item. As mentioned in Chapter 3, this study is focusing on the deemed disposal of assets when a corporation ceases to be a CFC in a PGM mining industry. Section 24I of the Income Tax Act (58 of 1962) is therefore applicable to the mining company that was discussed in paragraph 3.1.2, Chapter 3 because it is a company.

According to Van Der Zwan (2016), the exchange gains or losses be taken into account for tax purposes, whether it has realized or not, and be taxed at the normal rate of tax at which any other income is taxed. Company A will have to include the exchange gains or losses when it calculates the capital gains tax consequences of ceasing to be a CFC in Company B. The foreign gains and losses for the PGM practical illustration will be regarded as unrealized because there is no actual disposal of assets but a deemed disposal.

The table below illustrates how the capital gains tax is calculated in the hands of the CFC (Company B) and how it is imputed in the net income of the South African shareholder (Company A). As discussed in Chapter 3, the assets of Company B will constitute property and equipment, investments in associates and available-for-sale investments. All the assets of Company B are recorded at their base cost of the functional currency which is GBP because it is incorporated and managed in the UK. When a corporation ceases to be a CFC for various reasons as discussed in Chapter 1, the CFC will be deemed to have sold all of its assets as discussed in section 9H(3)(b) of the Income Tax Act (58 of 1962). The total value of the base cost of company B is equal to £400,000.

According to Van Der Zwan (2016), SARS describes this method of calculating the capital gain or loss in the foreign currency and converting such gain or loss to ZAR as the "simple conversion method". The capital gains tax that is being taxed in the hands of the CFC is R4,2 million as per Table 4-1 below.

Company B has not actually sold the assets, but it is deemed to have sold the assets when it ceases to be a CFC. Company B is 100 per cent owned by company A which is a South African resident for tax purposes. The R4,2 million will be imputed in the net income of Company A in accordance with section 9D(6) of the Income Tax Act (58 of 1962). As mentioned in previous chapters, the tax treaty will not be considered in determining the capital gains tax consequences of Company A in order to limit the scope.

According to Van Der Zwan (2016), the simple method effectively uplifts the base cost to the depreciated ZAR exchange rate at the time of the disposal, which eliminates currency depreciation from the capital gain (SARS, 2013; Van Der Zwan, 2016).

**TABLE 4-1: The foreign exchange gains and losses when a corporation ceases to be a CFC.**

| | BASE COST | | | DEEMED PROCEEDS | | | CGT |
|---|---|---|---|---|---|---|---|
| | Base cost – GBP | Exchange rate GBP to ZAR | Base cost - ZAR | Proceeds - Market Value | Exchange rate GBP to ZAR | Proceeds - ZAR | CGT - ZAR to be taxed |
| **Property and Equipment** | 150,000 | 14.00 | 2,100,000 | 200,000 | 18.00 | 3,600,000 | 1,500,000 |
| **Investments in Associates** | 150,000 | 17.00 | 2,550,000 | 250,000 | 18.00 | 4,500,000 | 1,950,000 |
| **Available-for-sale assets** | 100,000 | 15.50 | 1,550,000 | 130,000 | 18.00 | 2,340,000 | 790,000 |
| | **400,000** | | **6,200,000** | **580,000** | | **10,440,000** | **4,240,000** |

(Source: author)

Table 4-1 above continues to illustrate how the exchange gains and losses are calculated when Company A bought the shareholding in Company B and when the deemed disposal happened. When Company A acquired the shares in Company B, it is assumed that the 100 per cent shareholding was acquired at an exchange rate of R13 per share and when the deemed disposal happened, the exchange rate was R18. Company A has therefore made an exchange gain of R5 (R18 – R13). This exchange gain of R5 will be taxable in the hands of Company A in accordance with section 24I of the Income Tax Act (58 of 1962).

It is important to note that the deemed disposal under section 9H(3)(b)(i) of the Income Tax Act (1962) is triggered in the corporation that ceases to be a CFC (as a result of the disposal of its shares) and not in the hands of the person disposing of the shares in the CFC. Only through the provisions of section 9D can a tax be imposed in the hands of the resident(s) in relation to which the foreign company constitutes a CFC (Income Tax Act, 58 of 1962; Naude & Sibiya. 2015:8). This means that the CFC is taxed on capital gains in accordance with section 9H(3) of the Income Tax Act (58 of 1962) and then the capital gains are taxed in the hands of the South African shareholder in accordance with section 9D of the Income Tax Act (58 of 1962).

## 4.2 CONCLUSION

This chapter recommends that the Income Tax Act (58 of 1962) should be clear as to which exchange rate to use when converting the capital gains from functional currency to ZAR. It seems that paragraph 43(1A) of the Eighth Schedule to the Income Tax Act (58 of 1962) and section 9D(6) of said Act are contradicting each other and there are no clear guidelines as to which section to use.

According to Walker (2016), a company would elect the most favourable exchange rates in determining the exit charge under section 9H(3)(a) and paragraph 43(1A). Since the "year of assessment" for a company under section 9H(3)(a) is deemed to have ended the day immediately before that company ceased to be resident, the average exchange rate for that "year of assessment" would be from the first day of the company's financial year until the day immediately before that company ceased to be resident, and not the average exchange rate for the entire 12-month period of that financial year of assessment (Walker, 2016).

Although SARS provides some guidance in Interpretation Note 63 (Issue 2) (SARS: 2015:17) for converting other currencies to the functional currency of a CFC, it seems that there are no specific rules in paragraph 43 of the Eighth Schedule to said Act for determining how to translate the capital gain or capital loss for assets acquired in currencies other than the functional currency of a CFC (Walker, 2016).

The ZAR is very volatile, and the spot rate and the average exchange rate will have a significant difference. South Africa has officially entered a technical recession (two successive quarters of negative economic growth (Fin24, 2018)) after Stats SA announced that the country's real gross domestic product had decreased by 0.7 per cent in the second quarter of the year (Fin24, 2018). The technical recession has a major volatility impact on ZAR as it extended losses after the South African economy slipped into a technical recession (Businessday, 2018).

The results of the study done in Chapter 3 regarding the tax legislation of the UK and the USA are recommended to be used in SA as an alternative solution. As discussed previously in paragraph 3.2.1.7, the UK does not have a deemed disposal when a corporation ceases to be a CFC. Tax is only levied on the actual disposal of shares in accordance with TCGA (1992). The UK tax legislation can reduce or not tax the proceeds from the sale of foreign shares in accordance with the Substantial Shareholding Exemptions.

The USA does not have a deemed disposal of shares when a corporation ceases to be a CFC (paragraph 3.2.2.3). The USA tax legislation taxes the actual sale of shares in accordance with Subpart F of the Internal Revenue Code. Any gain from the sale of CFC stock that would be treated as a dividend would also constitute a dividend received for which the dividends received deduction may be available. It is therefore recommended that the USA and the UK legislation be adopted as an alternative solution to address the deemed disposal.

It is evident from Chapter 3 that the USA and the UK do not have a deemed disposal and only tax the actual proceeds on the sale of foreign shares subject to certain exemptions and limitations. It is recommended that South Africa amends its section of the Income Tax Act (1962) to only tax the actual disposal of shares when a corporation ceases to be a CFC. This will encourage South African incorporated companies that are effectively managed in South Africa to invest in other countries.

The PGM mining industries must be free to set up marketing companies outside the country and to move around these companies as and when the PGM demand changes. According to Anglo American Platinum (2019) "they invest in a portfolio of activities to sustain and increase long-term global demand for Platinum Group Metals (PGMs), partnering directly with research institutions as well as customers in the industrial, jewellery and investment sectors. Their market development activities are aimed at stimulating demand for industrial PGM-based products, with a special focus on fuel cells.

Activities range from "research and development to product development and support for early-stage businesses whose products use or facilitate the use of PGMs". Anglo American Platinum further states that "Development of new PGM products starts with investing in research and development. We fund a number of PGM research programs across the world including the UK and South Africa. The investment represents a large growth opportunity for global platinum demand, which could reduce the impact of variable demand from the industrial and jewellery market segments and provide demand growth in its own right" (Anglo American Platinum, 2019:1).

As discussed in paragraph 4.1 setting up a marketing Company B in the UK was of a capital nature and long-term investment, however, if the demand changes in the UK and Company A decides to set up a new marketing company in another country or invest in another PGM marketing company outside South Africa.

As discussed in paragraph 3.1.2, Chapter 3 there are various reasons for Company B to cease to be a CFC. Company A should be free to invest in a marketing PGM industry outside the country without the consequences of being taxed on a deemed disposal of Company B when it ceases to be a CFC. Europe had the highest PGM sales in 2018 by Anglo American Platinum which is the highest platinum producer in the world; the demand for PGM in Europe is more than in South Africa (Anglo American Platinum, 2018).

The secondary objective (paragraph 1.4.2.4, Chapter 1) was to identify and propose an alternative way of taxing the CFC on unrealized capital gains, based on the information obtained in chapter three and chapter four. As can be seen from the paragraphs above, there is an alternative way of taxing the CFC on unrealized capital gains which may lead to an increase in foreign direct investment.

# CHAPTER FIVE

# SUMMARY, CONCLUSION, AND RECOMMENDATIONS

The aim of this chapter is to summarize the most important parts of chapters one to four, making conclusions based on the findings, and stating recommendations for future research based on these findings.

## 5.1 CHAPTER 1

This chapter was an introduction to exit tax implications (specifically capital gains tax) of cessation to be a controlled foreign company (CFC). This chapter outlined the background of the study, the motivation of topic actuality, the research question, the research objectives, the research design and methodology, the motivation on countries selected, the limitation of scope, as well as the chapter divisions.

The motivation of the topic actuality explained why this study was necessary. As stated in paragraph 1.2, during the 2015 financial year it seemed as though South Africa became an investment destination to the world's biggest companies. However, during 2018 it became clear that foreign direct investments declined between 2013 and 2017 (BusinessTech, 2018b). At the end of 2017, the net foreign direct investments were expressed as having a negative percentage of GDP. The negative value showed the balance of investment lies outside South Africa (BusinessTech, 2018c). One of many solutions suggested by Schussler is to ease the tax burden to make the country a more attractive investment destination.

The main conclusion reached in Chapter 1, is that to address the above-mentioned problem, the researcher will try to determine if the South African exit tax implications of ceasing to be a CFC could be taxed differently by comparing South African tax legislation (specifically capital gains tax) to that of the UK and the USA.

## 5.2 CHAPTER 2

The aim of this chapter was to describe the research methodology and design utilized to reach the main objective of this study. The research design selected for this study was the literature review. A literature review was done on scholarly articles, case law, academic journals, PGM industries' financial statements, previous dissertations, and the tax legislation of the UK, USA, and South Africa.

The philosophy of science was analysed and the following were relevant: “Ontology concerns the nature of reality and being more specific, ontology addresses the following question: What is the form and nature of reality, and what can be known about that reality?” (Ponterotto, 2005:130). The reality of this study was the fact that there are different tax treatments when a corporation ceases to be a CFC in different countries.

The research methodology for this study was the qualitative research method within the interpretivist paradigm. Qualitative research requires inductive reasoning to be employed rather than logic and often calls for more creative and indirect means of collecting data or evidence (McKerchar, 2008). The collection of data and evidence was done through a literature review research design.

The aim of this chapter was to achieve the objectives as stated in paragraph 1.4.2, Chapter 1 by selecting the most appropriate research design and research methodology to assist in achieving the main objective.

### 5.3 CHAPTER 3

This chapter was the introduction to the tax legislation of the UK and the USA regarding the CFCs. The definition of the CFC of each country was discussed as well as the tax consequences of corporations when it ceases to be a CFC.

The UK tax legislation regarding the CFCs was defined in Schedule Twenty of the Finance Act (14 of 2012) and HMRC manuals. The capital gains tax consequences of a corporation when it ceases to be a CFC in the UK were found in TCGA (1992) and the actual gain on disposal of shares was taxable but limited to certain exemptions. Based on the comparison of the tax legislation of the UK versus South Africa, it was evident that the UK does not have a deemed disposal of shares when a corporation ceases to be a CFC.

The USA tax legislation regarding the CFCs was defined in Subpart F of the Internal Revenue Code. The gain on sale of shares needs to be included in gross income but certain exemptions apply. Based on the comparison of the tax legislation of the USA versus South Africa, it was evident from the study done that the USA does not have a deemed disposal when a corporation ceases to be a CFC.

The conclusion of this chapter was that each of the three countries has a different tax system and that South Africa should consider these differences in legislation to change its own legislation in order to attract more foreign investors.

### 5.4 CHAPTER 4

The aim of this chapter was to identify and propose an alternative way of taxing unrealized capital gains of a corporation when it ceases to be a CFC (paragraph 1.4.2, Chapter 1). The comparison of the USA and the UK tax systems to that of South Africa was used as a base to propose an alternative solution. The Income Tax Act (58 of 1962) was further scrutinized to identify areas of improvement.

An analysis of the exchange rate used to calculate the capital gains was done as per section 9H(7) of the Income Tax Act (58 of 1962) and paragraph 43(1A) of the Eighth Schedule to the Income Tax Act (58 of 1962) and to determine which exchange rate to use because the Income Tax Act (58 of 1962) is not clear as to which exchange rate to use.

Case law was used to determine the intention of the resident company when it bought shares in a foreign company. The intention is important in order to determine if the income was that of a capital nature or a revenue nature.

The conclusion of this chapter was that there are no specific rules for determining which exchange rate to use when calculating the deemed disposal when a corporation ceases to be a CFC. The alternative solution was a recommendation to adopt the USA and the UK tax legislation and not tax a corporation when a company ceases to be a CFC.

### 5.5 RECOMMENDATIONS

The current Income Tax Act (58 of 1962) tax implications when a corporation ceases to be a CFC is seen as being harsh to the African shareholders. This is said as the South African tax legislation was compared to that of the UK and the USA in Chapter 3. As mentioned before, South Africa is a developing country and the UK and the USA are developed countries. South Africa should learn from these countries and relax its current tax consequences of a foreign corporation when it ceases to be a CFC in order to attract more foreign investments. It is recommended that the South African National Treasury consider adopting the USA or the UK tax legislation when it comes to the deemed disposal when a corporation ceases to be a CFC. As discussed in Chapter 3 of this study, the UK and the USA only tax their residents on the actual disposal of shares in a CFC subject to exemptions.

### 5.6 FUTURE STUDIES

It is recommended that future studies take into account section 25BC of the Income Tax Act (58 of 1962) which will be considered in the 2018 tax law amendment bill. “The proposed section 25BC provided that if any resident (other than a company) was a beneficiary of a non-resident trust or a foreign foundation, and that trust or foundation held a participation right in a foreign company which would have constituted a CFC had that trust or foundation been a resident, any amount received by or accrued to or in favour of that person from that trust or foundation, had to be included in that person's income. As the proposed changes were extremely broad in scope and controversial, they were withdrawn in the final 2017 bills. Nevertheless, Annexure C in the

Budget Review 2018 has indicated that these proposed changes would be reconsidered in the 2018 draft bills" (Brown & Gilmour, 2018:1).

It is further recommended that future studies consider the tax treaty agreements in determining the tax consequences when a corporation ceases to be a CFC. The tax treaty will indicate whether the income or capital gains are taxable in South Africa or not.

## 5.7 CONCLUSION

A systematic approach to researching and achieving the various secondary objectives was followed, and this ultimately leads to achieving the main objective which was to determine if the South African exit tax implications of ceasing to be a CFC could be taxed differently.

## LIST OF REFERENCES

Anglo-American. 2015. Seven Unexpected uses of Platinum Group Metals (PGMS). http://www.angloamerican.com/about-us/our-stories/seven-unexpected-uses-of-pgms Date of access: 10 June 2018.

Anglo American Platinum. 2018. Annual-financial-statements-2018. https://www.angloamericanplatinum.com/~/media/Files/A/Anglo-American-Group/Platinum/investors/annual-reporting/annual-financial-statements-2018.pdf Date of access: 28 August 2019.

Anglo American Platinum. 2019. PGM Market Development. https://www.angloamericanplatinum.com/products-services-and-development/pgm-market-development Date of access: 28 August 2019.

AVCadvisory. 2018. Controlled Foreign Corporation Tax Guide. http://www.avcadvisory.com/documents/pdf/CFC.pdf Date of access: 7 September 2018.

Baartjes, N. 2011. From Deposit to Mine from Mine to Mining Value Chains.

Brown, N & Gilmour, S. 2018:1. Proposed amendments to controlled foreign companies. https://www.bbrief.co.za/2018/04/13/controlled-foreign-companies-proposed-amendments/ Date of access: 30 October 2018

Businessday. 2018. Rand extends losses as SA slips into technical recession. https://www.businesslive.co.za/bd/markets/2018-09-04-rand-extends-losses-as-sa-slips-into-technical-recession/ Date of access: 13 October 2018.

Business dictionary. 2018. Definition of “C Corporation”. http://www.businessdictionary.com/article/37/what-is-a-c-corporation/ Date of access: 28 August 2018.

BusinessTech. 2018a. The biggest economies in Africa https://businesstech.co.za/news/finance/257337/the-biggest-economies-in-africa/ Date of access: 20 October 2018.

BusinessTech. 2018b. How the Zuma years killed foreign investment in South Africa. https://businesstech.co.za/news/business/277959/how-the-zuma-years-killed-foreign-investment-in-south-africa/ Date of access: 20 October 2018.

BusinessTech. 2018c. South Africa has dropped off the map for investors: economist. https://businesstech.co.za/news/finance/242071/south-africa-has-dropped-off-the-map-for-investors-economist/ Date of access: 20 October 2018.

Burns, R.B. 1997. Introduction to research methods. (3rd ed.) Australia: Longman.

Chamber of mines. 2017. Mining Industry Performance in 2017. http://www.chamberofmines.org.na/index.php/home-menu/mining-industry-performance-2015/ Date of access: 22 October 2018.

Chaffey, A. 2016. Controlled foreign companies – sharing substance. https://www.pwc.co.za/en/assets/pdf/synopsis-may-2016.pdf Date access: 15 June 2018.

Company Wizard. 2018. What are the Memorandum and Articles of Association? https://www.companywizard.co.uk/blog/what-are-the-memorandum-and-articles-of-association Date of access: 1 August 2018.

Contador Accountants. 2017. Foreign Investments and the Tax Implications of Section 9D. http://www.contadorinc.co.za/foreign-investments-tax-implications-section-9d Date of access: 12 April 2018.

Cornell Law School. 2018. Amounts included in gross income of United States shareholders. https://www.law.cornell.edu/uscode/text/26/951 Date of access: 2 April 2018.

Corporate Tax Act 2009 ***see*** United Kingdom.

Davis, R. Foreign investors flock to SA shores. https://www.gov.za/blog/foreign-investors-flock-sa-shores Date of access: 20 October 2018.

Davis Tax Committee. 2014. Addressing Base Erosion and Profit Shifting in South Africa. https://www.taxcom.org.za/docs/New_Folder/1%20DTC%20BEPS%20Interim%20Report%20-%20The%20Introductory%20Report.pdf Date of access: 21 September 2018.

Denzin, N & Lincoln,S. 2002. The qualitative inquiry reader. https://books.google.co.za/books?hl=en&lr=&id=Mg_SRyR425kC&oi=fnd&pg=PR9&dq=Denzin+%26+Lincoln,+2000b+paradigm&ots=tL0HcByUMR&sig=xMdtcSTxq7zH3sb6uP1hKhj_I34#v=onepage&q=Denzin%20%26%20Lincoln%2C%202000b%20paradigm&f=false Date of access: 20 September 2018.

Deloitte. 2016. United Kingdom. https://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/us-tax-ice-country-highlights-united-kingdom.pdf Date of access: 16 March 2018.

Department of Trade and Industry ***see*** South Africa. Department of Trade and industry.

Department of Mineral Resources ***see*** South Africa. Department of Mineral Resources.

Department of National Treasury ***see*** South Africa. Department of National Treasury.

Edirisingha, P. 2012. Interpretivism and Positivism (Ontological and Epistemological Perspectives). https://prabash78.wordpress.com/2012/03/14/interpretivism-and-postivism-ontological-and-epistemological-perspectives/ Date of access: 25 October 2018

Ensafrica. 2012. https://www.ensafrica.com/news/CSARS-v-Tradehold-Ltd-Supreme-Court-of-Appeal-judgment?Id=619&STitle=tax%20ENSight Date of access: 1 April 2018.

Erwin, B., Rastogi, N., Shah, S & Zanet, E. Changes to C.F.C. Rules – More C.F.C.'s, More U.S. Shareholders, More Attribution, More Compliance. http://publications.ruchelaw.com/news/2018-03/CFC-Fact-Pattern.pdf Date of access: 12 September 2018.

FIN24. 2014:1. Capital gains tax on overseas shares. http://www.fin24.com/Money/Money-Clinic/Tax/Capital-gains-tax-on-overseas-shares-20141114 Date of access: 4 September 2017.

FIN24. 2018. SA in technical recession as second quarter GDP falls. https://www.fin24.com/Economy/sa-in-technical-recession-as-second-quarter-gdp-falls-20180904 Date of access: 4 October 2018.

Greenfield, T. 2002. Research methods for postgraduates. http://guides.lib.umich.edu/dissertationlitreview Date of access: 4 March. 2018.

Forbes. 2017. 3 Reasons to Invest In South Africa https://www.forbes.com/sites/allaneberhart/2017/03/09/3-reasons-to-invest-in-south-africa/#1a28069729a8 Date of access: 01 July 2018.

FRS102. https://www.iasplus.com/en-gb/standards/uk-gaap/frs102 Date of access: 24 August 2018.

Habu, K. 2017. How much tax do companies pay in the UK? http://eureka.sbs.ox.ac.uk/6811/1/WP1714.pdf Date of access: 20 October 2018.

Hoepfl, M. 1997. Choosing Qualitative Research: A Primer for Technology Education Researchers. https://files.eric.ed.gov/fulltext/EJ553339.pdf Date of access: 25 October 2018.

Income Tax Act ***see*** South Africa.

International Tax Blog. 2016. Sale of Stock of a CFC. http://intltax.typepad.com/intltax_blog/2016/01/sale-of-stock-of-a-cfc-example-of-the-potential-benefit-of-code-1248b.html Date of access: 2 April 2018.

Investing News. 2018. Catalytic converters and the role of PGMs https://investingnews.com/daily/resource-investing/precious-metals-investing/platinum-investing/uses-of-platinum-metals-in-the-changing-automobile-industry/ Date access: 15 July 2018.

Kay, A. 2018. Investing News: 5 Top Countries for Palladium and Platinum Production. https://investingnews.com/daily/resource-investing/precious-metals-investing/platinum-investing/top-platinum-palladium-producing-countries/ Date of access: 20 October 2018

Kuhn, T.S. 1962:25. The structure of scientific revolutions. https://books.google.co.za/books?hl=en&lr=&id=3eP5Y_OOuzwC&oi=fnd&pg=PR5&dq=Kuhn,+T.S.+1962.+The+structure+of+scientific+revolutions.&ots=xV3KAbiKqH&sig=YL6d8JerN3cpNABw3fuzq4dD71k#v=onepage&q=paradigm&f=false Date of access: 18 October 2018

Laerd dissertation. 2017. Quantitative dissertations. http://dissertation.laerd.com/quantitative-dissertations.php Date of access: 5 August 2017.

Law reports ***see*** South Africa

Literary Studies. 2019. Modern & Classical Languages, Literatures and Cultures. UK College of Arts and Sciences. https://mcl.as.uky.edu/literary-studies Date of access: 10 August 2019.

McKerchar, A. 2008. Philosophical Paradigms, Inquiry Strategies and Knowledge Claims: Applying the Principles of Research Design and Conduct to Taxation. Date of access: 1 April 2018.

Menzies. 2014. Controlled Foreign Companies – the path of least resistance. http://www.menzies.co.uk/wp-content/uploads/2016/01/INTERNATIONAL-Outbound_2014_11_-NF_Controlled-Foreign-Company-overview.pdf Date of access: 13 August 2017.

Mertens, D.M. 2005. Research methods in education and psychology: Integrating diversity with quantitative and qualitative approaches. (2nd ed.) Thousand Oaks: Sage.

Moneyweb. 2016. Currency losses may be aggravated by certain tax consequences. https://www.moneyweb.co.za/mymoney/moneyweb-tax/direct-offshore-investment-tax-need-know Date of access: 15 September 2017.

Morazàn, P., Knoke, I., Knoblauch, D. & Schäfer, T. 2012. Directorate General for External Policies: The Role of BRICS in the Developing World. https://www.ecologic.eu/sites/files/project/2013/knoblauch_12_lot5_24_brics.pdf Date of access: 15 September 2019.

Mozule, L. 2016. Development and Effectiveness of Controlled-Foreign-Company Rules. Norway. Norwegian School of Economics. (Thesis-Masters).

Musviba, N. 2012. Media Summary CSARS v Tradehold Limited 2012 (132/11). www.sataxguide.co.za/media-summary-csars-v-tradehold-ltd-13211-2012-zasca-8-may-2012/ Date of access: 12 April. 2018.

Musviba, N. 2014:1. Disposal of foreign equity shares – proceed with caution. http://www.sataxguide.co.za/disposal-of-foreign-equity-shares-proceed-with-caution Date of access: 10 August 2017.

National archives. 2019. British empire living in the British empire africa http://www.nationalarchives.gov.uk/education/empire/g2/cs3/background.htm Date of access: 19 August 2018.

Naude, R. & Sibiya, B. 2015. Tax consequences on disposal of shares held by a CFC. https://journals.co.za/content/btclq/6/4/EJC181954 Date of access: 10 August. 2017.

Nsenergybusiness. 2018. Top mining companies in the US. https://www.nsenergybusiness.com/news/top-mining-companies-us/ Date of access 28 August 2019

OECD. 2017. Glossary of Tax Terms – OECD. https://www.oecd.org/tax/treaties/tax-treaties-2017-update-to-oecd-model-tax-convention-released.htm Date of access: 18 February 2018.

Ponterotto, J. G. 2005. Qualitative research in counseling psychology: A primer on research paradigms and philosophy of science. http://resolver.ebscohost.com.nwulib.nwu.ac.za/openurl?sid=google&auinit=JG&aulast=Ponterotto&atitle=Qualitative+research+in+counseling+psychology%3a+A+primer+on+research+paradigms+and+philosophy+of+science.&id=doi%3a10.1037%2f0022-0167.52.2.126&title=Journal+of+counseling+psychology&volume=52&issue=2&date=2005&spage=126&site=ftf-live Date of access 15 February. 2018.

Pinetz, E. & Schaffer, E. 2017. Limiting Base Erosion: Schriftenreihe IStR Band 104. https://books.google.co.za/books?isbn=3709408814 Date of access: 17 August 2018.

Pwc. 2016 :1. CFC rules are rigid. https://www.pwc.co.za/en/press-room/cfc-rules-are-rigid-and-may-hinder-doing-business-internationall.html Date of access: 5 April 2017.

Qld, C. 2017. 8 Characteristics of qualitative research. https://quizlet.com/217544612/8-characteristics-of-qualitative-research-flash-cards/ Date of access: 22 October 2018.

Robinson, I. 2016:1. Journal of the Southern African Institute of Mining and Metallurgy. http://www.scielo.org.za/scielo.php?script=sci_arttext&pid=S2225-62532016000800012 Date of access: 20 October 2018.

South African History Online. 2019. History of slavery and early colonisation in South Africa. https://www.sahistory.org.za/article/history-slavery-and-early-colonisation-south-africa Date of access: 19 August 2018.

South African History Online. 2019. The Union of South Africa: Movement towards Republic. https://www.sahistory.org.za/topic/union-south-africa-movement-towards-republic Date of access: 19 August 2018.

SAICA. 2013:1. Sale of shares in a foreign company. https://www.saica.co.za/integritax/2013/2202._Sale_of_shares_in_a_foreign_company.htm Date of access: 14 August 2017.

SARS. 2013. Comprehensive Guide to Capital Gains Tax. 2 September 2017.

SARS. 2015. Interpretation Note No. 63 (Issue 2). Rules for the Translation of Amounts Measured in Foreign Currencies other than Exchange Differences Governed by Section 24I and the Eighth Schedule. Date of access: 2 September 2017.

SARS. 2017. Valuation of Shares and Other Assets. http://www.sars.gov.za/TaxTypes/CGT/Pages/Valuation-of-shares-and-other-assets.aspx Date of access: 15 September 2017.

Schmidt, P. 2016. Taxation of Controlled Foreign Companies in Context of the OECD/G20 Project on Base Erosion and Profit Shifting as well as the EU Proposal for the Anti-Tax Avoidance Directive – An Interim Nordic Assessment. https://research-api.cbs.dk/ws/portalfiles/portal/46456274/peter_koerver_schmidt_taxation_of_controlled_foreign_companies_publishersversion.pdf Date of access: 14 September 2018.

South Africa. 1918. COT v Booysens Estate Ltd 1918 AD 567 32 SATC 10.

South Africa. 1931. Ochberg v CIR 1931 AD 215 5 SATC 93.

South Africa. 1937. CIR v Visser 1937 8 SATC 271.

South Africa. 1956. CIR v Richmond Estates (Pty) Ltd 1956 20 SATC 355.

South Africa. 1962. Income Tax Act No.58 of 1962.

South Africa. 2012. CSARS v Tradehold Limited 2012 (132/11) ZASCA 61.

South Africa. 2019. Department of Minerals Resources.

Shuttleworth, M. & Wilson, L. What is a Paradigm? https://explorable.com/what-is-a-paradigm. Date of access: 19 October 2018.

TAXAND. 2018. Controlled Foreign Companies. https://www.taxand.com/wp-content/uploads/2018/07/Taxand-Asia-Senior-School-2018-DTA-Session-4-CFC.pdf Date of access: 22 September 2018.

The Financial Times. 2017. EU to investigate UK tax scheme favoured by multinationals. https://www.ft.com/content/a8da9283-8b1e-30b9-9cce-2e7c4db25aa3 Date of access: 10 August 2018.

UCT Tax Institute. 2016. Does the South African Controlled Foreign Company regime overprotect the tax base and cause harmful economic effects? http://www.uct.ac.za/sites/default/files/image_tool/images/304/UCT-IBFD%20CFC%20workshop%2010.10.16.pdf Date of access: 23 September 2018.

UK.GOV. 1992. Taxation of Chargeable Gains Act 1992. https://www.legislation.gov.uk/id/ukpga/1992/12 Date of access: 3 April 2018.

UK.GOV. 2017. United Kingdom tax legislation. https://www.gov.uk/guidance/controlled-foreign-company-an-overview Date of access: 13 August. 2017.

United Kingdom. 2009. Corporate Tax Act 2009.

United Kingdom. 2012. Finance Act (14 of 2012).

United Kingdom. 2016. HMRC.

USC (University of Southern California). 2018. Organizing Your Social Sciences Research Paper: Types of Research Designs. http://libguides.usc.edu/writingguide/researchdesigns Date of access: 6 March 2018.

Vardy, N. 2016. How Does the U.S. Economy Compare To The World's? https://www.stockinvestor.com/21676/us-economy-versus-world/ Date of access: 16 September 2018.

Van der Zwan, P. 2016. The Tax Implications of Currency Gains made on Foreign Investments. http://www.thesait.org.za/news/309334/The-Tax-Implications-of-Currency-Gains-made-on-Foreign-Investments-.htm Date of access: 30 August 2017.

Vermeulen, A. 2013. An international comparison – tax implication of a controlled foreign company ceased to be controlled in South Africa. Pretoria. UP. (Dissertation – Mcom).

Viljoen, C. 2018:1. What do foreign investors really want from SA? https://www.businesslive.co.za/bd/national/2018-10-11-what-do-foreign-investors-really-want-from-sa/ Date of access: 20 October 2018.

Viviers, JA. 2014. An analysis of the South African controlled foreign company regime in light of amendments in the United Kingdom. North-West. NWU. (Dissertation – Mcom).

Vlahos, L. 2018. U.S. Taxation of Foreign Income After Tax Reform. https://www.taxlawforchb.com/2018/01/u-s-taxation-of-foreign-income-after-tax-reform/ Date access: 10 September 2018.

Walker, A. 2016. The South African tax implication of ceasing to be a resident. Port Elizabeth. Rhodes University. (Dissertation – Mcom).

Zalta, E. 2004. Stanford Encyclopedia of Philosophy . https://plato.stanford.edu/entries/thomas-kuhn/ Date of access: 18 October 2018.