

An analysis of the South African tax treatment of interests in foreign companies held through foreign trusts

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ABSTRACT

South Africa is a high rate tax country and it is common for taxpayers to develop global avoidance strategies to reduce the amount of tax they are liable for. This pertains especially to taxpayers in the international trade sector since South Africa changed to a worldwide income-tax base. (Oguttu, 2007:10). One of the anti-avoidance provisions included in the Income Tax Act (58 of 1962) is the controlled foreign company regime.

Where a foreign discretionary trust controls a foreign company, as stated in the definition of a controlled foreign company and a resident is a beneficiary of the foreign trust, that resident is not necessarily subject to tax in accordance with the controlled foreign company rules. Whether or not they will be subject to tax will depend on the indirect participating rights the beneficiary may hold in the foreign company. The controlled foreign company rules do not include foreign trusts and certain foreign foundations, depending on how the structure is viewed by the resident country of the foreign foundation. Residents can thus possibly escape the controlled foreign company rules in the tax legislation by using a foreign trust or a foreign investment vehicle other than a company to directly hold the voting and participating rights in a controlled foreign company.

National Treasury has raised concerns that a foreign company held by a foreign trust is not included in the tax net of the controlled foreign company regime. In 2018, National Treasury addressed this concern by expanding the trust anti-avoidance rules to exclude the foreign dividend exemption for residents of South Africa if the dividends received by the resident arose as a result of a controlled foreign company held by the foreign trust (National Treasury: 2018:41). The question arises as to whether the attempt to exclude the foreign dividend exemption is sufficient to protect the tax net of South Africa.

Australia has two anti-avoidance measures that can address the taxation of foreign companies held by foreign trusts. Connected foreign trust rules, included as part of the controlled foreign company regime in the Income Tax Assessment Act (1936) and the Transferor Trust anti-avoidance measures, are intended to capture structures that do not adhere to the requirements of the connected foreign trust provisions.

The aim of this study was to analyse the connected foreign trust and transferor trust rules included in Australian legislation to include profits from foreign companies held by foreign trusts to determine what mechanism used by Australia, if any, can be considered to reduce the inconsistencies in the ITA of South Africa.

Based on the analysis performed on both South African and Australian legislation, it is determined that the control tracing interest principle included in the connected foreign trust rules in Australia should be considered by South Africa to address the inconsistency in the ITA as a primary mechanism. If it is determined that the control tracing interest principle is not an effective or appropriate mechanism to reduce the inconsistency in South Africa, it should be considered to amend section 7(8) of the ITA (58 of 1962) to include the transfer of property or services to a foreign company held by a foreign trust as an alternative. If the primary mechanism is used, it will eliminate the inconsistency between the CFC regime and the foreign trust provisions in the ITA. The alternative mechanism will not eliminate but reduce the inconsistency by imposing additional tax when a transfer is made by a beneficiary to a foreign company held by a foreign trust.

Key terms: International tax, anti-avoidance, controlled foreign company, foreign trust

OPSOMMING

Suid-Afrika is 'n hoë koers belasting land en dit is algemeen vir belastingbetalers om globale vermyding strategieë te gebruik om die bedrag van belasting waarvoor hulle aanspreeklik is te verminder. Sedert die verandering na 'n wêreldwye inkomste belastingbasis is dit meer algemeen vir belastingbetalers in die internasionale handelsektor (Oguttu, 2007:10). Een van die teenvermydingsbepalings in die Inkomstebelastingwet (58 van 1962) is die beheerde buitelandse maatskappy bepaling.

Waar 'n buitelandse diskresionêre trust 'n buitelandse maatskappy beheer soos uiteengesit in die definisie van 'n beheerde buitelandse maatskappy en 'n inwoner van Suid-Afrika is 'n begunstigde van die buitelandse trust, nie noodwendig onderworpe aan belasting in ooreenstemming met die beheerde buitelandse maatskappy bepaling nie. Dit sal afhang van die indirekte deelnemende belang wat die begunstigde in die buitelandse maatskappy hou. Die beheerde buitelandse maatskappy bepaling sluit nie buitelandse trusts in nie. Inwoners kan dus moontlik die beheerde buitelandse maatskappy reëls vermy deur die gebruik van 'n buitelandse trust of 'n buitelandse belegging wat die direkte belang hou in die buitelandse maatskappy.

Nasionale Tesourie het bekommernisse uitgespreek dat 'n buitelandse maatskappy wat deur 'n buitelandse trust gehou word nie in die beheerde buitelandse maatskappy reëls ingesluit nie. Nasionale Tesourie het in 2018 die buitelandse trust reëls uitgebrei om die bekommernis aan te spreek, die vrystelling vir buitelandse dividende aan inwoners van Suid-Afrika moet verontagsaam word, as die inwoner dividende ontvang as gevolg van 'n beheerde buitelandse maatskappy wat gehou word deur 'n buitelandse trust (Nasionale Tesourie: 2018:41). Die vraag ontstaan of die poging om die buitelandse dividend vrystelling te verontagsaam voldoende is om die belasting net van Suid-Afrika te beskerm.

Australië het twee stelle teenvermydingsmaatreëls wat belasting van buitelandse maatskappye wat deur buitelandse trusts gehou word kan aanspreek. Verbonde buitelandse trust reëls word ingesluit as deel van die beheerde buitelandse maatskappy reëls in die Inkomste belastingaanslag Wet (1936) en die oordraggewer trust teenvermydingsmaatreëls om strukture aan te spreek wat nie aan die verbonde buitelandse trust reëls voldoen nie.

Die doel van hierdie studie was om die verbonde buitelandse trust en oordraggewer trust teenvermydingsmaatreëls in Australiese wetgewing te ontleed, om te bepaal hoe winste van buitelandse maatskappye wat gehou word deur buitelandse trust in die omvang van die belasting wetgewing ingesluit is, indien dit wel ingesluit is. Dit sal bepaal watter meganisme wat deur Australia gebruik word in Suid-Afrika oorweeg kan word om die teenstryding in die huidige

teenvermydingsreëls te verminder, indien Australia teenvermydingsbepaalings het om dit in te sluit.

Gebaseer op die ontleding uitgevoer op beide Suid-Afrikaanse en Australiese wetgewing, kan die deurlopende beheerende belang beginsel in die beheerde buitelandse maatskappy bepaling in Australië deur Suid-Afrika oorweeg word as primêre meganisme om die teenstryding te verminder. Indien dit bepaal word dat die deurlopende beheerende belang beginsel nie 'n doeltreffende of toepaslike meganisme is nie, kan dit oorweeg word om artikel 7(8) in die Suid-Afrikaanse wetgewing uit te brei om die oordrag van eiendom of dienste aan 'n buitelandse maatskappy wat deur 'n buitelandse trust gehou word in te sluit as 'n alternatief. Indien die primêre meganisme oorweeg word, sal die teenstryding tussen die beheerde buitelandse maatskappy bepaling en die buitelandse trust bepaling uit geskakel word. Die alternatiewe meganisme sal nie die teenstryding uitskakel nie, maar sal dit belastingbepaling tussen beheerde buitelandse maatskappye en buitelandse trust verminder.

Sluuteltermes: Internasionale belasting, belasting vermyding, beheerde buitelandse maatskappye, buitelandse trusts

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CHAPTER 1 INTRODUCTION

1.1 Background to the study

South Africa is a high rate tax country and it is common for taxpayers to develop global avoidance strategies to reduce the amount of tax they are liable for. This is especially true for taxpayers in the international trade sector since the change to a worldwide income tax base in South Africa (Oguttu, 2007:10).

Previously, residents of South Africa were taxed on income that originated from any source in South Africa or income that was deemed to be from a source in South Africa. From 1 January 2001, however, the taxation system was amended for residents, changing from a source-based system to a worldwide income system. Residents are now taxed on all income received including foreign income (National Treasury, 2000:1). The change in the tax system was implemented to increase the competitiveness of the Republic of South Africa internationally and the residence tax system increases the effectiveness of e-commerce (National Treasury, 2000:4).

Controlled foreign entity rules were included in the scope of the taxation of residents on source income, as the rules were first introduced into the Income Tax Act (hereafter ITA) (58 of 1962) in 1997 to protect the South African tax base (De Koker, 2018). These rules captured any investment income that accrued to a foreign company or trust established by such a resident. Any company or trust that was not effectively managed or established in South Africa, where a resident held more than five per cent of the participating rights or where more than 50 per cent of the entity was controlled by the resident of South Africa was a controlled foreign entity. The investment income of the offshore establishment was deemed to be from a South African source that would be received by or accrue to the resident directly and thus form part of the tax net of South Africa (National Treasury, 1998:12).

The change in the South African tax system in 2001 enhanced the importance of implementing tax anti-avoidance rules for residents to include all income that accrues to residents in the South African tax net, whether domestic income or foreign income. According to De Koker (2018), if anti-avoidance provisions are not implemented in a tax system, taxpayers can easily shift the income to an offshore company and avoid any tax payable in South Africa by accumulating or capitalising such income (De Koker, 2018). After the amendments were made to the Revenue Laws Amendment Act 74 of 2002, the definition of a controlled foreign entity was replaced with the current definition of a controlled foreign company (hereafter CFC)(National Treasury, 2002:9).

A CFC can be defined in accordance with section 9D(1) of the ITA (58 of 1962) as a company that is non-resident where a resident jointly or separately, directly or indirectly holds more than 50 per cent of the participating and voting rights, or a foreign company that should be included in the consolidated financial statements in accordance with IFRS 10. The participating and voting rights can thus be held by more than one resident of the Republic and if their participating and voting rights exceed 50 per cent in aggregate the foreign company can still qualify as a CFC.

If CFC rules are not implemented in the South African ITA (58 of 1962) or if the rules are not correctly applied by South African residents, the fiscal shortages faced by South Africa could escalate. These shortages include the shortfall in income experienced by government as a result of income not being included in the tax net that should have been included. The absence of CFC rules will have an arbitrary taxation effect on income in comparison with residents who do not have an interest in foreign companies, as the former will not pay the full taxation that they are liable for, thus further increasing the gap between the wealthy and the poor, and ultimately having an adverse effect on the ongoing growth of South Africa (Kuzniacki, 2017).

Residents can use offshore companies to try and reduce their tax liability in South Africa. The income that may be distributed by foreign companies to residents will likely qualify for the foreign dividend exemption in section 10B(2) and thus the resident will not be liable for any tax in the South Africa. The CFC rules are set out in section 9D of the ITA (58 of 1962). Any net income, as defined in section 9D (1) of the ITA (58 of 1962), that is received by or accrues to the CFC will be deemed to be received by or accrued to the resident in the apportionment of the resident's participating and voting rights. The resident shall thus include the income in his taxable income in that year of assessment (National Treasury, 2013:103). CFC rules were implemented in the tax legislation to prevent residents from shifting passive income that includes, but is not limited to, interest, dividends, rentals and annuities to foreign companies (National Treasury, 2011:73).

If a trust is included in the holding company structure it will fall within the scope of CFC rules, but only if the trust is a resident of South Africa, bearing in mind that as defined in section 1 of the ITA (58 of 1962), a trust is a legal person for taxation purposes. If a foreign trust is used by residents of South Africa to indirectly hold more than 50 per cent in a foreign company, and the foreign company can be deemed to be a CFC for international tax purposes, it may be difficult to argue that the CFC is controlled by the resident, as the income received by the foreign trust will only accrue to the resident at the discretion of the trustees because there is no specific apportionment allocated to the beneficiaries by the trustees (Olivier & Honiball, 2009:6-7). Trusts can thus possibly be used by residents of the Republic to circumvent CFC taxation rules to reduce the amount of taxation they are liable for.

1.2 Motivation for the study

Where a foreign discretionary trust controls a foreign company, as stated in the definition of a CFC, and a resident is a beneficiary of the foreign trust, that resident is not necessarily subject to tax in accordance with the CFC rules. This will depend on the indirect participating rights the beneficiary may hold in the foreign company. This is because CFC rules do not include foreign trusts and certain foreign foundations, as this depends on how the structure is viewed by the resident country of the foreign foundation. Residents can thus possibly escape the CFC rules in the tax legislation by using a foreign trust or a foreign investment vehicle other than a company to directly hold the voting and participating rights in a CFC.

In the 2017 Draft Taxation Laws Amendment Bill (2017:46) it was proposed that section 25BC should be implemented in the ITA (58 of 1962) to take away the current loophole in the CFC rules when a foreign trust is used as intermediary between the South African resident and the foreign company (National Treasury, 2017b:37). This proposed amendment indicated that any amount received by or that accrued to the resident from the foreign trust must be included in the income of such resident as from the years of assessments commencing on or after 1 January 2018 (National Treasury, 2017a:46).

However, concerns were raised by the public over the proposed amendments of the CFC rules, for example about the various structures that would be caught up in the Section 9D rules, where the primary purpose of these structures was not to deliberately use them to avoid the CFC rules currently imposed by the South African tax legislation (Gilmour, 2018). Furthermore, the proposed legislation does not consider whether the foreign company that is held by a foreign trust is already caught in the scope of the CFC rules in section 9D of the ITA (58 of 1962). If the income of the foreign company is already taxed in South Africa this can result in double taxation on that income (Ntombela, 2017).

For the past few years, National Treasury has been revising the CFC rules to find a solution to the tax avoidance in South Africa involving the use of a foreign trust as intermediary between the resident and the CFC. Various interventions have been considered, but nothing was implemented prior to 2018 (National Treasury, 2017). This was because the proposed amendments were too broad and were not implemented in the ITA, as the level of interest held by a beneficiary in a trust could not be determined. Subsequently, it was indicated that the proposed amendment for foreign trusts to be included in the scope of CFC rules would be reconsidered (National Treasury, 2017b:37). In 2018, National Treasury expanded the trust anti-avoidance rules to exclude the foreign dividend exemption to residents of South Africa, if the dividends received by the resident

arose as a result of a CFC held by the foreign trust (National Treasury: 2018:41). The question then arises as whether the attempt to exclude the foreign dividend exemption is sufficient to protect the tax net of South Africa. When the response of South Africa is also considered, the need for this study increases and confirms that there is a possible gap in the literature. Previous studies conducted have confirmed that CFC rules are of the utmost importance to increase the tax net of any country and if a country does not apply the CFC tax rules in its legislation it may have far-reaching effects. Therefore, it has to be determined whether the current legislation on CFCs held by a foreign trust is in line with the legislation in a comparable country and, if not, how the tax legislation of CFCs held by a foreign trust can be amended to expand the tax net in South Africa.

Australia has two anti-avoidance measures that can address the taxation of foreign companies held by foreign trusts. Connected foreign trust rules are included as part of the CFC regime in the Income Tax Assessment Act (1936) and Transferor Trust anti-avoidance measures to capture structures that do not adhere to the requirements of the connected foreign trust provisions. The CFC regime identifies income that should be attributed to an Australian entity, where the transferor trust anti-avoidance provisions will apply to Australian residents who transferred property, directly or indirectly, to a discretionary trust (BOT, 2007).

In Australia, residents are taxed on worldwide income because income tax is imposed on a resident basis and not based on the source of the income earned by Australian residents. This is the same tax system imposed by South Africa. The Katz Commission, which was appointed by the South African Government to examine whether South Africa should move from a source-based system to a residence based system used the Australian income tax system as a basis for implementing the residence tax system in South Africa (Katz Commission, 1997).

The corporate tax rate implemented for companies in Australia is currently 30% (PwC, 2019), which is in line with the 28% corporate tax rate for companies in South Africa (SARS, 2020). The individual tax rates in Australia are based on a taxable income scale for natural persons (ATO, 2019c); this is also in line with the ITA (58 of 1962) of South Africa.

Australia is a member country of the Organisation for Economic Co-operation and Development (hereafter OECD). The OECD is an international organisation established to provide international evidence-based standards and policies (OECD, 2020). South Africa is currently a key partner of the OECD and the guidance issued by the OECD from an income tax perspective is used by applying the ITA, such as guidance on transfer pricing, and the place of effective management of control and CFC provisions (OECD, 2018b). The OECD issued guidance to determine the place

of effective management in terms of the Income Tax Assessment Act of Australia (OECD, 2019). The OECD further supports the Australian Government's multinational tax avoidance measures. A report by the OECD in 2015 mentioned that the anti-avoidance measures implemented by the Australian Government are consistent with OECD recommendations and reinstate fairness from an international tax perspective (Morrison, 2015).

As the tax base implemented by South Africa considered the income tax legislation in Australia and Australia has similar tax rates for individuals and companies in relation to South Africa, Australia is considered to be an appropriate benchmark against which to determine whether South Africa can implement other anti-avoidance provisions to address tax on CFCs held by a connected foreign trust in the income tax legislation. The 2015 OECD report in relation to the anti-avoidance measures implemented by Australia from an international tax perspective further substantiates why the income tax legislation of Australia will be investigated to determine whether the current legislation implemented in South Africa is adequate.

The connected foreign trust rules included in the CFC regime and the transferor trust anti-avoidance provisions in the Income Tax Assessment Act (1936) will be considered to determine what mechanism used by Australia, if any, to eliminate the inconsistency in the tax treatment to include profits of foreign companies held by foreign trusts can be considered by South Africa.

1.3 Problem statement and research question

Where a foreign discretionary trust controls a foreign company, as stated in the definition of a CFC, and the resident is a beneficiary of the foreign trust, that resident is not necessarily subject to tax in accordance with the CFC rules. The CFC may, however, be liable for tax in accordance with the foreign trust rules of the ITA (58 of 1962), although the timing and extent of taxation and the control over the taxable amount will just be different.

The current South African legislation for CFCs and foreign trust is inconsistent with one another. Australia has implemented anti-avoidance provisions to address the inconsistent tax treatment for a CFC held by a resident and a CFC held by a foreign trust to include profits of a CFC held by a foreign trust.

The research question for this study can thus be stated as the following:

What mechanisms, if any, used by Australia to eliminate the inconsistency in the tax treatment to include profits of foreign companies held by foreign trusts can be considered to reduce the inconsistencies in the ITA of South Africa?

1.4 Research aim and objectives

1.4.1 Research aim

The aim of this study is to analyse the connected foreign trust and transferor trust rules included in Australian legislation to include profits from foreign companies held by foreign trusts to determine what mechanism, if any, used by Australia can be considered to reduce the inconsistencies in the ITA of South Africa.

1.4.2 Research objectives

The primary objective of this study is to determine what mechanism, if any, used by Australia to eliminate the inconsistency in the tax treatment to include profits of foreign companies held by foreign trust can be considered to reduce the inconsistencies in the ITA of South Africa.

The following secondary objectives can be formulated to achieve the primary objective of the study:

1. To consider the CFC rules set out in section 9D of the ITA (58 of 1962) and the taxation of foreign trusts to determine what the legislation currently provides for including foreign income in the tax net of the Republic (Chapter 2).
2. To explore what the mechanism regarding the income earned by foreign companies held by foreign trusts in the CFC regime is in Australia (Chapter 3).
3. To determine what the mechanism regarding the income earned by foreign companies held by foreign trusts in the transferor trust anti-avoidance measures is in Australia (Chapter 4).

1.4.3 Research design

The research design comprises the data required for the study, the methods that will be used to collect and analyse the data and the way in which the research question will be answered (Van Wyk, 2015).

According to Saunders, Lewis and Thornhill (2007:133), an exploratory study is “a valuable means of finding out ‘what is happening; to seek new insights; to ask questions and to assess phenomena in a new light’”. This will be a useful research design when a high level of uncertainty exists about the research and little research is already conducted on the phenomenon (Van Wyk, 2015).

In this study, an answer must be obtained to make relevant recommendations, if necessary, on if the CFC rules can be amended to include the income of the CFC, if that company is held by residents through a foreign trust that indirectly holds more than 50 per cent of the participating rights. Therefore, this design may be applicable. There is currently scant research available that has been done on this topic and therefore the phenomena are assessed in a new light. Thus, an exploratory research design will be used based on the characteristics of this study.

1.5 Research methodology

1.5.1 Study context

This study will include research on both an international level and a national level. Legislation of Australia will be analysed and interpreted to explore relevant legislation included in the Income Tax Assessment Act (1936) to include profits of foreign companies held by foreign trusts. The international research will be used to determine what mechanisms used by Australia, if any, to eliminate the inconsistency in the tax treatment to include profits of foreign companies held by foreign trusts can be considered to reduce the inconsistencies in the ITA of South Africa.

1.5.2 Paradigmatic perspective

1.5.2.1 Meta-theoretic assumptions

Guba and Lincoln (1994:105) indicate that “a paradigm represents a world view that defines, for its holder, the nature of the “world”, the individual’s place in it, and the range of possible relationships to that world and parts”. Smith (2014) describes meta-theories as the dynamic lenses society uses to understand the world. Meta-theory can be used to set out the objectives, expectations and actions of researchers (Smith, 2014). According to Creswell (2005:15), there are five assumptions a researcher can use to conduct research, namely, axiology, rhetorical, ontology, epistemology and methodological assumptions. Only the assumptions that will be considered in this study will be discussed in detail.

Axiology relates to judgements about values. The researcher’s values, including the values of aesthetics and ethics, are of the utmost importance in all the different stages of the research proses (Saunders *et al.*, 2007:110). When making a conclusion based on his/her values, the researcher may have a different perspective from other researchers (Saunders *et al.*, 2007:111).

Rhetorical assumptions relate to the language of the researcher. These become personal based on the definitions that are used in the study rather than as defined by the researcher (Creswell,

2005:19). According to Creswell (2005:18), researchers adopt the rhetorical assumptions as the research being performed should be personal and literary in form.

Ontology relates to the nature of reality. A distinction has to be made between two aspects of ontology: objectivism and subjectivism. An objectivist view can be explained as the researcher and research being two parties separate from one another and which do not influence one another (Saunders *et al.*, 2007:108). A subjectivist view holds that it is possible for more than one reality to exist and perspectives can differ between individuals, therefore evidence is gathered from different perspectives (Creswell, 2005:18).

In this study a subjective approach will be followed, as a detailed understanding of current laws and legislation such as the CFC regime and foreign trust rules in the Republic has to be understood to be able to do relevant research on the rules of Australia. If the current legislation is not understood, it will not be possible to understand the rules of Australia and how these are implemented to address the phenomenon. Australia may have a different perspective on CFCs and foreign trusts.

Epistemology relates to the nature of the relationship between the researcher and what is researched (Guba & Lincoln, 1994:108) and the researcher may attempt to narrow the distance in the relationship or the complexity the relationship (Creswell, 2005:18). Epistemology relates to what the researcher considers as important in a study (Saunders *et al.*, 2007:102). A researcher can adopt one of two perspectives on epistemology, namely, positivism or interpretivism.

According to the Cambridge dictionary (2018), positivism can be defined as “the belief that knowledge comes from things that can be experienced with the senses or proved by logic”. The positivist perspective indicates that the researcher will likely use resources that are observable when obtaining credible data; furthermore, an existing theory will be used to set a hypothesis to be tested and confirmed in the current study (Saunders *et al.*, 2007:103).

Interpretivism takes the individual’s perspective into consideration in the process of understanding the research results obtained. the researcher will then form subjective opinions of their experience (Creswell, 2005: 20). The researcher will then develop various opinions on the research results which will lead to a complexity of views (Creswell, 2005:20). According to Saunders *et al.* (2007:107), generalisability is not important when using an interpretivist perspective because circumstances that may be currently applicable may differ in the short-term future and then the value of generalisability is lost. Using this perspective, a researcher works towards receiving an answer to a question stated instead of to prove or disapprove a hypothesis on research that already exists (Mckerchar, 2009).

The positivist perspective will not be relevant to this study as the research does not seek to have a hypothesis that will be disapproved, but rather to obtain an answer regarding the phenomenon. Therefore, an interpretivist perspective will be used because the research entails a study of legislation in Australia to include the profits of foreign entities held by foreign trusts. The evidence gathered from the study will be interpreted and recommendations will be formed, if necessary, based on the interpretations. This study therefore consists of a qualitative study and a qualitative research method has been used as a quantitative study was not relevant.

Research sets out a different view of the world for every researcher; there will always be a new discovery to be made. The above concepts have been used in this study to conduct the research which may have different outcomes depending on various researchers' perspective. In this study, the conclusions have been based on my personal views and values.

1.5.2.2 Methodological assumptions

Cotty (2003:3) defines methodology as “the strategy, plan of action, process or design lying behind the choice and use of particular methods and linking the choice and use of the methods to the desired outcomes. Methodology is thus the approach or paradigm a researcher will use to conduct research. There are two methods that may be used, namely quantitative techniques and the qualitative techniques.

A simple difference between the two techniques is that the one focuses on numeric (quantitative) and that other on non-numeric (qualitative) data (Saunders *et al.*, 2007:145). Qualitative technique can be summarised as any data collecting technique or analysis procedure, such as interviews or surveys, which is used to obtain non-numeric data (Saunders *et al.*, 2007:145). Qualitative techniques will therefore be research methods that do not involve statistics or surveys but rather methods such as document review.

As mentioned previously, this study will not be based on quantitative techniques owing to the nature of the research and therefore qualitative techniques have been used to conduct the study.

1.5.2.3 Population and sampling

In this study, population and sampling were not relevant as it was a qualitative study and document review was applied to obtain the relevant information for answering the research question and for making recommendations.

1.6 Data collection

1.6.1 Data collection tool

1.6.1.1 Development of the data collection tool

Document analysis and review is a systematic data collecting technique for reviewing or evaluating both hard-copy and electronic material to examine and interpret information to obtain a better understanding on a specific area of study (Corbin & Strauss, 2008). The documents that can be used in a study include journals, legislation, books, brochures, letters, memorandums, press releases, proposals and the like (Bowen, 2009:27). According to Bowen (2009), “the analytical procedure entails findings, selecting, appraising, and synthesising data contained in documents”.

The advantages and disadvantages of document analysis can be set out as follows (Evaluation Briefs, 2009):

Table 1-1: Advantages and disadvantages of document review (Adapted from Evaluation Briefs, 2009)

Advantages	Disadvantages
Cost effective as information is easily available.	Information obtained from documents may be irrelevant, disorganised, protected or already updated.
Wide range of background information can be obtained.	Documents could be biased due to the selective availability of information.
Documents can be reviewed without any obstructions.	Information obtained from documents may be inadequate and contain errors.
Documents can provide insights that are not directly observable.	Obtaining documents can be time consuming.

Documents were obtained from various sources, online and libraries, in order to obtain a wide range of interpretations of how the CFC rules were incorporated in the legislation in the specific country and whether the data obtained will be relevant to the South African legislation. Documents

were only analysed if they were relevant to the phenomenon and were subsequently used if applicable to the study.

Doctrinal research is, according to Chynoweth (2008), “the formulation of legal ‘doctrines’ through the analysis of legal rules”. The question that has to be asked in doctrinal research is “what is the law?” in a specific scenario, considering all relevant facts and circumstances (Chenoweth, 2008). Doctrinal research has thus be used, as different countries will have different laws relating to interest in foreign companies held through foreign trusts. In addition, a detailed analysis of the legal rules should be done in order to obtain a thorough understanding on what the legal rules provide for together with the reasons why the legal rules was implemented by the country, to understand the context in which the countries intended to implement the relevant legal rules.

Normative doctrinal research includes the study of principles of law as well as the law of comparative research (Christiani, 2015:202). This is applicable to the study as the tax law of Australia has been studied and compared with the tax law of the Republic of South Africa to determine whether the tax net should be amended to expand the taxation on income earned by CFCs held by foreign trusts. This will only be possible by doing an in-depth study on the relevant laws of Australia.

1.7 Validity and reliability

Validity relates to whether the information obtained, and the conclusion made based on the information from the documents, accords with what the information appears to be (Saunders *et al.*, 2007:150).

Reliability relates to the results of your data collecting tool and whether consistent findings will be obtained (Saunders *et al.*, 2007:149).

Data source triangulation refers to doing qualitative research by using various data sources to test the validity of data and to develop a detailed understanding of the phenomena (Patton, 1999). As this study requires the analysis of international taxation laws, data source triangulation will be used to interpret the different views to develop subjective opinions on these views. The information gathered from Australia will be cross verified with the South African ITA (58 of 1962) together with the different international tax laws. Data source triangulation will therefore increase the validity and credibility of the study (Anon., 2018).

The information obtained from this study has been analysed thoroughly to enable a clear understanding that has been formed of what is implied by the information. The documents have

been obtained from trusted sources such as the North West University's library online catalogue and published hard-copy sources.

1.8 Chapter overview

Chapter 2 South African CFC and foreign trust tax legislation

This chapter will consist of a detailed explanation on why a foreign company held by a foreign trust with beneficiaries who are residents of the Republic is a resident connected foreign trust. The chapter will further include a detailed analysis of the way in which foreign trusts are taxed in the Republic in accordance with section 25B of the ITA (58 of 1962) and the current CFC legislation as set out in section 9D of the ITA (58 of 1962). Areas that will be focused on in this chapter include the definition of a trust, how the income of a trust is taxed, the definition of a CFC and how the net income of a CFC is taxed (Objective 1).

Chapter 3 Taxation of a CFC held by a resident-connected trust – Australia

This chapter will include a detailed analysis of connected foreign trust legislation to determine the ambit of this legislation in Australia. The findings of this chapter will determine what mechanism used by Australia in the connected foreign trust rules can be considered in South Africa to reduce the inconsistency between the foreign trust and CFC legislation to include profits of a foreign company held by a foreign trust (Objective 2).

Chapter 4 Taxation of a resident connected trust not included in the ambit of the CFC regime – Australia

This chapter will include a detailed analysis of transferor trust legislation to determine the ambit of this legislation in Australia. The findings of this chapter will determine what mechanism used by Australia in the transferor trust rules can be considered in South Africa to reduce the inconsistency between the foreign trust and CFC legislation to include profits of a foreign company held by a foreign trust (Objective 3).

Chapter 5 Conclusion

This chapter will conclude the findings of the study on what mechanisms used by Australia, if any, to eliminate the inconsistency in the tax treatment to include profits of foreign companies held by foreign trusts can be considered to reduce the inconsistencies in the ITA of South Africa.

CHAPTER 2 SOUTH AFRICAN CONTROLLED FOREIGN COMPANY AND FOREIGN TRUST TAX LEGISLATION

2.1 Introduction

The current fiscal shortages faced by South Africa increase the importance of enhancing the anti-avoidance rules from an international perspective. If the anti-avoidance rules are not implemented or revised on an ongoing basis to adapt to new structures used by residents to exclude their income from the South African tax net, the shortfall in government income will escalate (Kuzniacki, 2017). It has, however, been acknowledged that anti-avoidance rules played an important role when the South African tax base changed from a source-based tax system to a residence-based tax system (Oguttu, 2007:10).

When the issue arose as to whether South Africa should shift from a source-based system to a residence-based system, the Katz Commission was appointed by the government to investigate and examine both of these systems. The Katz Commission was led by the chairman, Professor Michael Katz (Aanon & Slemrod, 1999). The Katz Commission recommended that the South African capital base needed protection, as a higher tax rate could encourage residents to relocate the income of holding companies through the use of international tax structures (Katz Commission, 1997:para 3.1.3.1).

As a result of the presence of international tax systems, the implementation of a residence-based tax system enhanced the danger for the South Africa tax net (Katz Commission, 1997:para 3.1.3.2). The Commission therefore recommended that passive income should be taxed on a worldwide residence-based system and active income should remain in the source-based system to mitigate this risk (Katz Commission, 1997:para 3.2.3). Anti-avoidance rules, such as on the taxation of income earned by foreign companies and foreign trusts, were implemented as a method to protect the tax net of the Republic.

This chapter will focus on the content and intent of the current South African legislation with regard to foreign trusts and CFCs to understand the tax consequences resulting from the two possible structures. This will provide clarity on the differences between the two anti-avoidance rules. The chapter will further include an explanation regarding why a foreign trust held as an intermediary between a resident and a CFC can be classified as a CFC held by a resident connected foreign trust.

2.2 Trusts

In South Africa, a trust is often used by residents to plan their future financially, as over the years a perception has been created that by using a trust, any legal or other barrier can be overcome (Olivier & Honiball, 2011:114). Benson and Poutasse (2018) state that trusts are not just created for tax benefits but for family wealth, restricting access to certain assets and to give direction to future individuals on the usage of certain assets.

Trusts entered the legislation of South Africa in 1988 when the Trust Property Control Act 57 of 1988 was introduced. A trust is defined in accordance with this Act as:

“the arrangement through which the ownership in property of one person is by virtue of a trust instrument made over or bequeathed –

- a) To another person, the trustee, in whole or in part, to be administered or disposed of according to the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument; or
- b) To the beneficiaries designated in the trust instrument, which property is placed under the control of another person, the trustee, to be administered or disposed of according to the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument.

But does not include the case where the property of another is to be administered by any person as executor, tutor or curator in terms of the provisions of the Administration of Estates Act 66 of 1965.”

This definition of a trust is closely linked to the ownership trust and the bewind trust developed under common law of South Africa. An ownership trust is where the founder of the trust transfers ownership of assets to trustees for the benefit of the beneficiaries of that trust. A bewind trust is where the founder of a trust transfers ownership to the beneficiaries of that trust, but the trustees have control over that asset (SARS, 2018).

Trusts can be further distinguished by when the trust is created. If the trust is created during the lifetime of the founder and all relevant documentation that clarifies the different parties to the trust, together with their rights and obligations, is available in the trust deed, that trust will be an *inter vivos* trust (Moore Stephens, 2018). In contrast to the *inter vivos* trust, a *mortis causa* trust will be created as soon as the founder of the trust is dead, therefore only after the lifetime of the founder (Olivier & Honiball, 2009:4). The founder of the *mortis causa* trust will include a clause in his will that certain assets should be allocated to the trust and will also stipulate the terms and conditions that will apply to the trust (Moore Stephens, 2018).

The last method for categorising different types of trust is to determine the rights of the beneficiaries; this will determine whether the trust is a discretionary trust or a vesting trust. From

an income tax perspective this is the most important difference that has to be ascertained in order to determine whether the beneficiaries will be taxed on the income received from an asset not (Olivier & Honiball, 2009:4).

A vested trust is a trust where the trustees have no discretion to decide what beneficiary will receive income or capital from an asset in the trust. A beneficiary will have a predetermined vested right in the capital and income from a certain asset, but even if they have a vested right, it does not mean that they will obtain ownership of that asset, as ownership remains in the trust (Olivier & Honiball, 2011:119).

A discretionary trust is where the trustees have the power to use their discretion to decide when and what capital or income will be distributed to the beneficiaries. The trustees will be able to act in certain and uncertain circumstances based on discretion (Endacott, 1967). The beneficiary will obtain a vested right to the capital or income of an asset only after the trustee has used their discretion to determine that the benefit will be paid over to the beneficiary; therefore the beneficiary has no certainty as to whether he will obtain any rights to benefit from the trust (Moore Stephens, 2018).

The ITA (58 of 1962) also has its own definition of a trust. If a trust adheres to the definition, it will be liable for income tax in accordance with the provisions set out in the Act. A trust is a person other than a natural person, and therefore a trust will be taxed in its own capacity, and possibly together with the beneficiaries.

A trust is defined in the ITA(58 of 1962) as:

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

In this definition it is clear that the ITA (58 of 1962) acknowledges both an *inter vivos* and a *mortis causa* trust, as discussed above. This definition is closely linked to the definition in the Trust Property Act (57 of 1988) and the definitions under the common law. Any income received by a resident trust will be included in the tax net of South Africa, either as a tax liability for the trust or as a tax liability directly to the beneficiary.

The principle contained in section 25B, generally known as the “conduit pipe principle”, is used as the basis for taxation on resident trusts (Karriem, 2014:58). According to Olivier and Honiball (2009:84), this principle was introduced by the *Commissioner of Inland Revenue v Polonsky* where it was determined by the court that the trustees of a trust are nothing more than a conduit pipe and that they do not have any material interest in the income of the beneficiaries. *Estate*

Dempers v SIR (1977) also embodied the conduit pipe principle, where the court established that any income distributed to a beneficiary will retain its initial identity regardless of any provision in the trust deed that the income will be part of the capital in the trust.

The conduit pipe principle overall determines that any income that is distributed to a beneficiary of a trust in the same year of assessment that the income was received by that trust, will be taxed in the hands of the beneficiary as if the income were received directly by them. The expenses that were incurred by that trust to obtain the income that was distributed to the beneficiary in that same year of assessment would also be deemed to have been incurred by them (Stiglingh *et al.*, 2019: 901). If a trust incurs a loss, that loss cannot be distributed to the beneficiaries of the trust but would be retained within the trust to utilise in the following year of assessment as an assessed loss (Musviba, 2019:1). If the income is not distributed to the beneficiary within the same year the income was received by the trust, the resident trust will be taxed on the income received or accrued to the trust directly. The trust will also receive a deduction for the expenses incurred in order to receive the income (Moodley, 2014:38).

Section 7 of the ITA (58 of 1962) contains tax provisions that will generally apply when any income is received by virtue of a “donation, settlement or gratuities disposition” by any person to a trust. That person will be taxed on the “donation, settlement or gratuities disposition” in his personal capacity. Section 7(8) thus taxes the founder, beneficiaries or any other person who makes a “donation, settlement or gratuities disposition” to a resident or foreign trust and the trust will not be taxed on these amounts in the Republic. A similar principal for capital gains tax purposes is included in the ITA (58 of 1962), where a capital gain is vested in a beneficiary of a resident trust; the capital gains tax should be included in the beneficiary’s income tax. Accordingly, the trust will not be liable for the capital gains tax in its own capacity (Sevenster, 2013).

In section 7C, the ITA (58 of 1962) includes deemed donations tax on interest-free or low-interest loans by a taxpayer to a trust (Stiglingh *et al.*, 2019:906). When a taxpayer, who is a connected person in relation to the trust, provides a loan to the trust at an interest rate below the official interest rate, the difference between the interest actually charged on the loan and the official interest rate will be a deemed donation by the taxpayer to the trust (Bain, 2018). The taxpayer will be subject to donations tax at a rate of 20% on the deemed donation to the trust (Stiglingh *et al.*, 2019:908).

These sections are therefore not applicable to the taxation of trusts but rather to the taxation of a resident who gratuitously disinvests themselves of an asset to the trust (Karriem, 2014:62). If any of that income is distributed to the resident in the future, that resident will not be taxed on the

amount again in accordance with the trust anti-avoidance provisions (Stiglingh *et al.*, 2019:920). The income of a trust will therefore be taxed either in the capacity of the trust, as it is a natural person, or directly in the hands of the beneficiaries of the trust.

2.2.1 Definition of a foreign trust

The problem statement identified in this study is applicable to a foreign trust. A foreign or offshore trust is commonly referred to in an international perspective as a trust set up in a tax haven or a low tax jurisdiction. In South African tax legislation, however, a foreign trust is a trust that is not a resident of the Republic (Olivier & Honiball, 2009:28).

As defined in section 1 of the ITA (58 of 1962), a trust is a person, therefore a trust will be a resident of the Republic of South Africa if the trust is incorporated, established or formed in South Africa or if the trust is effectively managed in South Africa. The first provision of the definition of a resident is in many cases overruled and the place of effective management will be the ruling factor to determine the residency of a trust. This is due to double tax agreements between South Africa and another country. If a double tax agreement is applicable between South Africa and a foreign country, the double tax agreement should be considered before the provisions of the ITA (Stiglingh *et al.*, 2019:33). Internationally, a common test used to determine the residency of a trust is where the trust is established and administered, the present location of the assets of the trust or where the founders, trustees, beneficiaries or protector is resident (Olivier & Honiball, 2009:67).

If the trustees of the trust are residents of the Republic and the trust is administered from South Africa, the trust will not be a foreign trust, as the trustees will be seen as the management of the trust (Stiglingh *et al.*, 2019:35). The trustee of a trust may not be the same person as the founder or a beneficiary of the trust, as a separation of ownership should take place when assets are transferred from the founder to the trust (Olivier & Honiball, 2011:235). The relationship between the trustee, founder and beneficiaries should therefore be distinct. Further, the place where the trustee determines which rights, assets or enjoyment of assets will be distributed to the beneficiaries will have an impact on whether the trust is a foreign trust.

The above requirements are in line with article 4 the Organisation of Economic Co-Operation and Development's Model Convention. This model states that the place of effective management is the place where the trust is managed on a day-to-day basis by the trustee of the trust in making strategy decisions or where the overriding control is exercised (OECD, 2003).

According to Karriem (2014), most offshore jurisdictions require a protector to be appointed to act in a fiduciary capacity for the offshore trust. This can have a material impact on the decision as to whether the trust is a resident or not. A protector is a third party who is appointed over the trustees of a trust. The trustees will in some cases have to obtain the approval of the protector to distribute any rights or assets to beneficiaries (Oguttu, 2007:327). In some cases, the protector has the ability to replace a trustee with another trustee and, thus, an increased risk of tax avoidance occurs, as this may have a direct impact on the discretion of the trustees and where decisions are made. If a protector is appointed for the trust, the place where the protector approves or meets with the trustees may have an impact on the place of effective management of the trust.

If the founder of the trust wants to appoint a protector, it is mentioned in the letter of wishes and accompanied by the reason for the protector, the rights of the protector and when the rights should be executed (Oguttu, 2007:328). The letter of wishes is a separate document that is drawn up by the founder of the trust and to which no beneficiary may have access (Olivier & Honiball, 2009:67). The letter of wishes includes additional documentation on the beliefs, facts, concerns and other characteristics of the trust's founder. It can therefore be used to manipulate the discretion of the trustees in distributing rights and assets to beneficiaries (Karriem, 2014). Letters of wishes can therefore encourage tax avoidance in offshore trusts by residents of the Republic.

If the trustees are located in multiple locations, it may be difficult to determine where the trustees or protector uses their discretion to give a vested right to a beneficiary. In such cases, the place of effective management should be determined by taking into account all facts and circumstances in establishing the dominant place. This may lead to the trust having more than one place of effective management, but only one at a given time (SARS, 2018). When seeking to determine where the place of effective management of the trust is, the letter of wishes and whether a protector exists will be taken into account in the facts and circumstances.

If it is concluded that the trust is established outside the Republic and that the trust has a place of effective management in an offshore location, that trust will be a foreign trust. Accordingly, South Africa will not have any right to the tax income of such a trust as non-residents are taxed on source income. If the beneficiary of a foreign trust is a resident of South Africa, the income distributed to that beneficiary may be taxable in the Republic, as residents are taxed on worldwide income (Stiglingh *et al.*, 2019:905).

The onus to prove a person's place of effective management lies with the trust in accordance with section 102 of the Tax Administration Act (28 of 2011) and all evidence to prove the place of

effective management must be kept by the trust to support where the place of effective management of a person is, as stated in section 29 of the Tax Administration Act (28 of 2011).

2.2.2 Taxation of foreign trusts

Taxation of foreign trusts is also included in section 25B of the ITA (58 of 1962), more specifically section 25B(2A). The structural features of a trust and a low tax jurisdiction make it easy to prompt anti-avoidance, therefore the anti-avoidance provisions to specifically curb avoidance through offshore trusts were implemented in the South African tax legislation (Karriem, 2014:37). In general, the income of a foreign trust will only be included in the tax net of the Republic if it originates from a South African source (Olivier & Honiball, 2011:564).

The anti-avoidance measures implemented for foreign trusts are specifically aimed at discretionary foreign trusts which accumulate income until the following year of assessment commences for the beneficiaries. The income will then be seen as a capital distribution to the beneficiary as the foreign trust received the income in the previous year of assessment. This will result in a no tax liability for the beneficiary as a resident is only liable for taxation that is income in nature (Stiglingh *et al.*, 2019:919).

These anti-avoidance measures are therefore not aimed at taxing the income of foreign trusts, but rather are aimed at taxing the resident on any income received or accrued from a foreign trust. Section 25B(2A) dominates all provisions in the ITA(58 of 1962), thus implying that a resident is not taxed on capital amounts but will be taxed on any foreign amounts received from the foreign trust that should be classified as capital (Stiglingh *et al.*, 2019:920).

The beneficiary of a foreign trust will, however, only be taxed on income or capital from the foreign trust if that beneficiary acquired a contingent right to receive the income or asset and the trust or beneficiary has not been taxed on the same amount by any other provision of the ITA (Olivier & Honiball, 2009:77). A tax liability will be diverted to the beneficiary once the vested right is granted to any income or assets at the discretion of the trustees. The beneficiary will be required to include the income of the foreign trust in his taxable income in the current year of assessment if the capital amount received from an offshore trust would have been income if that trust were deemed to be a resident of the Republic and the amount received by the beneficiary was not formerly taxed in South Africa (Stiglingh *et al.*, 2019:920).

The beneficiary should have a contingent right to the distribution by the trust. This should be included in the taxable income of the beneficiary as determined by the anti-avoidance measures for income from foreign trusts. In the court case *Durban City Council v Association of Building*

Societies (1942), it was determined that a contingent right refers to “the conditional nature of someone’s title to a right” by judge Watermeyer JA. The beneficiary could have had the contingent right to the income in any prior year even though the beneficiary was not a resident of South Africa at that time, as the requirement only states that the beneficiary should have had the contingent right in one or more of the previous years of assessment.

The taxation requirements set out above are currently the only anti-avoidance rules in the ITA (58 of 1962) for resident beneficiaries of a foreign trust and the foreign trust itself. The income of a foreign trust will therefore not be included in the taxable income for South African tax purposes as with a resident trust, unless the income is from a South African source. The anti-avoidance provisions for foreign trusts are intended to include income from foreign trusts in the beneficiary’s taxable income regardless of the nature of the income received.

2.3 Controlled foreign companies

In the Republic of South Africa, taxpayers can use various methods to plan the income tax that they will be liable for. Establishing a foreign structure in a jurisdiction that has little to no taxation is a common method used to transfer income received by a taxpayer before it is taxed in South Africa (Kuzniacki, 2017). Prior to the implementation of anti-avoidance rules, international tax planning could have been seen as tax avoidance. Anti-avoidance rules will not necessarily capture all the structures used for income tax planning as the anti-avoidance rules is not clear in every situation. International tax structures can therefore still be used by taxpayers for tax avoidance. Tax avoidance is a lawful act by a taxpayer to adjust his financial position thus reducing their tax liability. This is in contrast to tax evasion, which is an unlawful act by the taxpayer to lower his tax liability (OECD, 2018).

Section 9D of the ITA (58 of 1962) was introduced in 1997 as an anti-avoidance rule to prevent South African-owned foreign companies and entities from going untaxed when a resident defers the income of that foreign company that accrues them (Van Heerden, 2009). The immediate tax on the income of that South African-owned foreign company is of the utmost importance, as the resident can delay the tax payable for many years or until the end of time (National Treasury, 2002). When the CFC rules were initially implemented in the South African tax legislation, they were only applicable to passive income received by the South African-owned foreign entity. In 2001, the anti-avoidance rules were extended to include certain active income of the CFC in the calculation of the net income for that CFC and the limitation on the inclusion of certain passive income was amended (National Treasury, 2000a). The intent was then changed such that all

foreign income should be included in the tax net of South Africa in order to prevent avoidance through a foreign company (Olivier & Honiball, 2011:561).

2.3.1 Definition of a CFC

The nature of the CFC regime was set to prevent circumstances where a resident of the Republic can make capital investments offshore that will not form part of the tax net, as the investments are not directly in the resident's name but in a foreign entity (Van Heerden, 2009). The income received from the foreign entity will be received as foreign dividends and the resident taxpayer will receive an exemption for foreign dividends and thus the income is reclassified as exempt or partially exempt income (Stiglingh *et al.*, 2019:829).

In 2002, the definition of a controlled foreign entity, as discussed in 2.3, was replaced with the definition of a CFC. The CFC definition had the same elements as the definition of a controlled foreign entity, except that trusts have been removed from the scope of section 9D. National Treasury indicated that this change was made in line with anti-avoidance tax techniques, through which foreign trusts have been addressed in a different way on their own in the ITA (National Treasury, 2002).

A CFC can be defined in accordance with section 9D(1) of the ITA (58 of 1962) as a company that is a non-resident where a resident jointly or separately, directly or indirectly holds more than 50 per cent of the participating and voting rights. The participating and voting rights can thus be held by more than one resident in the Republic and if their participating and voting rights exceed 50 per cent in aggregate, the foreign company may still qualify as a CFC. These residents who will hold more than 50 per cent of the participating or voting rights in aggregate do not have to be connected persons in relation to each other for the CFC rules to be applicable; the participating and voting rights may also be held by unconnected residents of the Republic (Van Heerden, 2009). The purpose of the CFC regime was to prevent residents reclassifying the income of the CFC as exempt income in the hands of the residents.

A company situated in a foreign country where residents, directly or indirectly, control the company will not form part of the CFC legislation of South Africa if that company is effectively managed in South Africa, as the company will be a resident of South Africa no matter where the company is situated (Olivier & Honiball, 2011:562). A company can therefore only be classified as a CFC if the company is a foreign company. A foreign company is defined in section 1 of the ITA (58 of 1962) as "any company that is not a resident".

The residency of a person other than a natural person can be determined in accordance with the definition of a resident in section 1 of the ITA (58 of 1962). Such a person will be a resident of the Republic if that person is incorporated, established or formed in South Africa or if such person has its place of effective management in the Republic of South Africa as discussed under foreign trusts in this study.

The place of effective management is not defined in the South African tax legislation to determine whether a company is a resident of the Republic. Interpretation Note 6 issued by SARS gives guidance on determining a company's place of effective management. This can be determined by establishing where the core decisions are made by senior management in order to achieve the business objectives and to steer the company in its operations (SARS, 2015:4). This principle was interpreted from international court cases, such as *Wensleydale's Settlement Trustees v Inland Revenue Services* (1996), where the commissioner D. A. Shirley made a statement that the place of effective management is not where some sort of management takes place, but realistically where the big shots are called.

This interpretation is in line with the OECD principle in the Model Tax Convention that the place of effective management is where the company is managed on a day-to-day basis by the directors or senior managers of the company, in order to implement policies and strategy decisions and the entity's overall group vision and objectives, irrespective of where the overriding control is exercised, or where the board of directors meets (OECD, 2003). All the facts and circumstances of the company should be taken into account when determining whether it is a foreign company.

The second part of the CFC definition refers to participating rights in relation to the foreign company. Participating rights refer to the ability and right of the taxpayer to participate in all or parts of the distributions made by a company and any right to benefits that the taxpayer will be entitled to because of his shareholding in that foreign company. The definition further makes provision for instances where no person has a right in the foreign company or if the right cannot be determined. In such a case the participating rights will be the voting rights that the taxpayer has in the foreign company.

Participating rights are broadly defined and include share capital in a company and non-participating shares. According to National Treasury (2002), the reason for the broad definition is to ensure that residents do not enter into convoluted share arrangements to avoid tax in terms of the CFC regime. It is therefore important to determine the percentage of participating rights held by the resident to determine whether the foreign company can be classified as a CFC.

If a foreign company adheres of the definition of a CFC in relation to the resident, the CFC regime will only be applicable when a foreign company is involved in a structure between a resident and a foreign company. If the foreign company adheres to the definition of a CFC, that CFC should be taxed in the hands of the resident of the Republic in accordance with the rules set out in section 9D of the ITA (58 of 1962).

2.3.2 How the income of a CFC is taxed in South Africa

CFC rules were implemented with the objective that a taxpayer that diverts income through a foreign company will be left in the same position as if that income had accrued directly to the taxpayer (Stiglingh *et al.*, 2019:827). The net income of a foreign company will only be included in the taxable income of a taxpayer that is a resident of South Africa, if it is concluded that the foreign company relating to that taxpayer is a CFC (Olivier & Honiball, 2011:572). CFC rules are therefore aimed at structures that are deliberate avoidance schemes used to reduce the taxable income of a taxpayer. The CFC regime is not intended to capture income of a foreign company in the tax net of South Africa when the income arises from pure business activities between a resident and a foreign company (Stiglingh *et al.*, 2019:828).

Olivier and Honiball (2011:562) state that CFC regimes are generally based on three concepts:

“The income is available for distribution by the CFC;

To its resident shareholders; and

The income contributes to the resident shareholders’ ability to pay as it is at their disposal, even if not distributed.”

This statement highlights the fact that the income does not have to be distributed to the resident of the Republic; the CFC regime will be triggered when the income is capitalised by the foreign company or distributed to the resident.

Section 9D(2) of the ITA (58 of 1962) determines the time and apportionment of the foreign company’s income that has to be included in the taxpayer’s taxable income. If a foreign company was a CFC in relation to a resident taxpayer for the full year of assessment, the net income of the CFC shall be included on the last day of that foreign company’s year of assessment. The percentage of participating or voting rights held by the resident will be used as an apportionment mechanism to determine the amount that should be included in the resident’s taxable income (Stiglingh *et al.*, 2019:828).

When the net income of a CFC is determined, it has to be deemed as if that foreign company was a resident of the Republic and the income should adhere to the provisions of the ITA in

accordance with section 9(2A). The CFC will be taxed on all income, as South African residents are taxed on worldwide income. Two sets of financial records should be kept by the CFC, one for South African tax purposes and another for the country of residence of the CFC (Olivier & Honiball, 2011:575). The net income of the CFC should be calculated using the functional currency pertaining to the CFC, only after calculating the tax payable. The amount will be converted to rand using the average exchange rate for the relevant year. The CFC regime further limits the deductions that a CFC can make from the income calculated within the tax scope of South Africa. These limitations are as follows (Section 9D(2A)(c)):

- i. Any interest, royalties, rental, insurance premium or any income with a similar nature that are payable from one CFC to another CFC;
- ii. Any exchange gains or losses determined in section 24I where the CFC and another CFC are parties and any exchange differences arising from the aforementioned as part of a forward exchange contract or foreign currency option to hedge the item; and
- iii. Any reduction of debt between the CFC and another CFC.

Where the two CFC's form part of the same group of companies as defined in section 1 of the ITA (58 of 1962). Two CFCs will form part of the same group of companies if one of the CFCs holds more than 70 per cent of the equity shares of the other CFC (Section 1).

The CFC will therefore not be entitled to the deductions, as indicated above to determine its taxable income, as if it was the income that the resident taxpayer would have received if the CFC was a resident of the Republic.

The net income of the CFC can be deemed to be zero if the CFC adheres to the two possible exemptions in the CFC regime. The high-tax exemption and the foreign business establishment exemption are usually considered prior to calculating the net income of the CFC. If the CFC qualifies for both the exemptions it will result in a decision having to be made by the resident to determine which exemption to apply (Stiglingh *et al.*, 2019:835).

The first exemption in the ITA (58 of 1962) states that if the CFC is liable for taxation in its local jurisdiction or any jurisdiction other than the Republic that would amount to at least 75 per cent of the taxation that the CFC would have been liable for if it was a resident company of the Republic, that CFC's net income will be deemed to be zero. This exemption was implemented as the risk of tax payable in South Africa being reduced to a lower level as a result of the section 6quat rebate that will be granted to the CFC for the tax paid in the foreign country (Stiglingh *et al.*, 2019:835).

Olivier and Honiball (2011:581) state that the second exemption is one of the most complex provisions in the ITA. Any income linked to a foreign business establishment of a CFC in a foreign

jurisdiction will be deemed to be zero. The primary purpose of the CFC regime is to capture anti-avoidance schemes and not income from normal business activities across the border. This exemption was therefore implemented to find a balance between legitimate and illusive business activities (Olivier & Honiball, 2011:581).

If a foreign company adheres to the definition of a CFC for South African income tax purposes and the CFC were not taxed in terms of the anti-avoidance rules, the tax net of South Africa would have been diluted significantly. The South African resident will qualify for a full exemption on any foreign dividends received in terms of section 10B(2) if the taxpayer has a 10 per cent equity share and voting right participation or if the dividends arose from a listed foreign company. All other foreign dividends will qualify for the partial foreign dividend exemption in section 10B(3); the dividends received will be exempt in the ratio 25/45 if the resident is a natural person or 8/28 if the resident is a company (Stiglingh *et al.*, 2019:90). The resident thus uses a foreign company or entity to shift taxable income in the Republic to another tax jurisdiction to earn passive income that is not taxable, or the income is capitalised in that foreign entity to avoid the tax liability (National Treasury, 1997). This emphasises the importance of the CFC regime for South African income tax purposes.

The above rules are currently the only CFC rules set out in the South African ITA (58 of 1962). The rules were implemented in order to prevent residents from reducing their tax liability by using offshore structures and thus protecting the South African tax net. The CFC rules should be revised on a regular basis to minimise the available loopholes and new mechanisms that can be used by residents to reduce their tax liability.

2.4 Comparison between the taxation of CFC and foreign trusts

The tax treatment for a foreign trust and a CFC, as discussed above, differs in the sense that a resident will be taxed on the entire income of the CFC in apportionment of the participation and voting rights held by the resident and a foreign trust will only be taxed when the resident obtains a vested right in the income from the foreign trust.

The vested right received by the resident from the foreign trust will be taxed when the resident receives the vested right in the capital or income from that vested right in terms of section 25B(2A) of the ITA (58 of 1962). The taxation of the income from the CFC held by the connected foreign trust therefore differs and does not fall within the tax net of the Republic in the year that the CFC earned the income in apportionment that the foreign trust has participating and voting rights in the CFC (Stiglingh *et al.*, 2019:832).

The tax treatment for the two different anti-avoidance rules is not consistent and therefore a foreign trust used as an intermediary between a CFC and a resident can be used to avoid South African CFC legislation and receive a tax benefit. This is due to the fact that the resident would not be in the same tax position if the CFC held by the foreign trust was deemed to be a resident of the Republic of South Africa.

2.5 Resident connected foreign trust

The problem statement identified in this study involves a foreign trust that is established as an intermediary between a resident that is a beneficiary of the foreign trust and a foreign company. The income of the foreign company is not taxed in the hands of the resident of the Republic. This foreign trust will be referenced as a resident connected foreign trust further on in this study.

The reason why the problem statement can be referenced as a resident connected foreign trust is because the three parties involved in this structure are connected persons in accordance with the definition of a connected person in section 1 of the ITA (58 of 1962). This definition, which is relevant to this study, states that:

““Connected person” means

(a) in relation to a natural person

- i. any relative; and
- ii. any trust (other than a portfolio of a collective investment scheme) of which such natural person or such relative is a beneficiary;

(b) in relation to a trust (other than a portfolio of a collective investment scheme)

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

(bA) in relation to a connected person in relation to a trust (other than a portfolio of a collective investment scheme), any other person who is a connected person in relation to such trust;

(c) in relation to a company

- i. any person, other than a company as defined in section 1 of the Companies Act that individually or jointly with any connected person in relation to that person, holds, directly or indirectly, at least 20 percent of the equity shares in the company; or
- ii. the voting rights in the company; and

in relation to any person who is a connected person in relation to any other person in terms of the foregoing provisions of this definition, such other person”.

If the structure can be identified as a resident of the Republic of South Africa, that is, a beneficiary of a foreign trust, and that trust holds more than 50 per cent of the participating rights in the foreign company, the beneficiary indirectly, jointly or separately holds more than 50 per cent of the foreign company. The structure can be illustrated as (own compilation) as indicated in Figure 2-1:

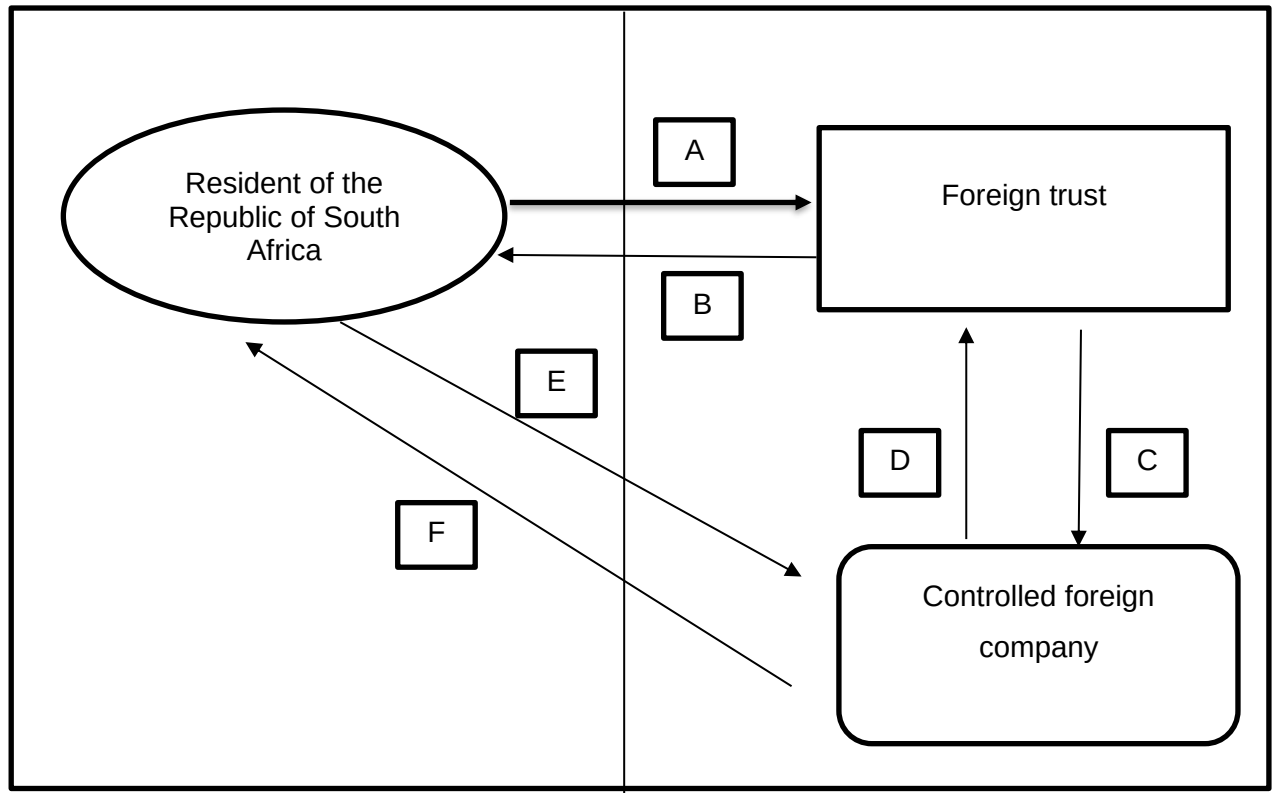


Figure 2-1: A resident connected foreign trust

A: If the resident of the Republic of South Africa is a natural person, that natural person will be a connected person in relation to the trust (par a(ii)).

B: The foreign trust will be a connected person in relation to the beneficiary (par b(ii)).

C: The foreign trust should hold more than 50 per cent, jointly or separately, of the participating or voting rights in accordance with the definition of a CFC in section 9D(1) of the ITA, and the trust is a person other than a company, as defined in the Companies Act. If the foreign trust, individually or jointly, holds more than 20 per cent of the participating or voting rights of the CFC, the trust is a connected person in relation to the foreign company (par d(iv)).

D: As the foreign trust is a connected person to the foreign company, the foreign company will be a connected person in relation to that foreign trust (par e).

E: The resident of the Republic of South Africa is a connected person in relation to the foreign trust and the foreign trust is a connected person in relation to the foreign company, therefore the resident will be a connected person in relation to the foreign company (par bA).

F: As the foreign company (CFC) is a connected person to the foreign trust and the resident is a connected person in relation to the foreign trust, the foreign company will be a connected person in relation to the resident of the Republic of South Africa (par bA).

All parties are connected to one another, the resident beneficiary, the foreign trust and the foreign company. A resident connected trust will be used to reference the foreign trust where a resident of the Republic is a beneficiary of that trust.

2.6 Amendments to the ITA to address the taxation of CFCs held by a connected resident trust

The government of South Africa became concerned about the CFC regime as early as 2008. It was noted that the current CFC legislation did not capture taxation on CFCs held by a connected foreign trust (Kotze, 2017:33). In 2015, it was announced in the budget speech that the CFC income tax legislation would be revised to include the taxation of CFCs held by a resident connected foreign trust. However, National Treasury did not propose any amendments to the CFC regime or the foreign trust anti-avoidance measures at that stage (Warneke, 2017).

The issue that government wanted to address was that where residents of South Africa had an indirect interest in a CFC through a resident connected foreign trust and held CFC participation or voting rights indirectly through the foreign trust, the income from the CFC did not fall within the CFC regime (Treurnicht, 2018). According to Warneke (2017), the implication of a CFC held by a resident connected foreign trust is that residents would possibly be taxed on the net income of the CFC, but the circumstances in which the deemed participation or voting rights would be determined were unclear.

2.6.1 Proposed section 25BC

National Treasury raised its concerns over CFCs held by a connected foreign trust in the 2017 Draft Taxation Laws Amendment Bill (2017:46), proposing that a new section 25BC should be implemented in the ITA. The purpose of section 25BC was to tax any resident who used a foreign trust as intermediary between that resident and the foreign company, for any income received or accruing to the resident from that foreign trust (National Treasury, 2017b:37).

The proposed section 25BC determined that when any person, other than a company, is a beneficiary to a foreign trust and the foreign trust holds participating or voting rights of more than 50 per cent in a foreign company, will be taxed on any amount from the resident connected foreign trust (National Treasury, 2017a:46). The person will have to include any income received or accrued to the person, because the person is a beneficiary of the foreign trust, in the taxable income of that person (National Treasury, 2017a:46). National Treasury did not want to extend the CFC regime to close this loophole, but rather wanted to implement a new section in the ITA (58 of 1962), that is, section 25BC. The new section was proposed to discourage the use of trusts to re-characterise income and defer the income tax residents would be liable for in South Africa (National Treasury, 2018b:39).

Comments from the public included that the words “any amount” from the connected foreign trust in the new proposed section should be included in the person’s taxable income. The section therefore did not only capture income from the CFC held through the resident connected trust, but also any amount from the resident connected foreign trust. The person would therefore be in a worse position than if the indirect participation rights had been held directly in the CFC, as the CFC regime further has exemptions to the net income that should be included in the South African resident’s taxable income (Dennehy *et al.*, 2017:8).

The Law Society of South Africa (2017:6) commented that the proposed section 25BC should be revised to ensure that the tax imposed on the income of the resident connected trust will not be triggered twice, as the trust anti-avoidance provisions in section 25B(2A) in the ITA (58 of 1962) already impose tax on the amounts that vest in a resident of South Africa. It was further outlined that there was no direct link between the CFC regime and the proposed section 25BC. The proposed section 25BC therefore does not address the primary purpose of National Treasury to impose tax on the net income from a CFC held by a connected resident foreign trust.

As a consequence, section 25BC was not implemented due to the public criticism. The primary reason was that structures would be caught in this section even if the structure were established for legitimate cross-border activities. The response document from the public for the 2017 Draft Taxation Law Amendment Bill included that there was no threshold for determining the interest residents should have in the foreign trust that holds the CFC and this would result in structures being caught where the purpose of the foreign trust was not to prevent taxation in terms of the CFC regime (National Treasury, 2017b:40). This would have been in direct contrast to the aim of the CFC legislation, which was implemented to impose structure that deliberately sought to reduce the tax consequences of the CFC. The suggestion to implement the section 25BC was therefore rejected.

2.6.2 Legislation included in the ITA in 2018

In the 2018 Draft Taxation Law Amendment Bill, National Treasury (2018:47) proposed new amendments to the ITA (58 of 1962) to address CFCs held through a connected foreign trust. The proposed amendments included new subsections in the trust anti-avoidance rules, section 25B and section 7(8). It was further also proposed that paragraphs 72 and 80 of the Eighth Schedule should be amended to include profits from foreign companies held by foreign trusts.

It was further proposed that section 25B should be amended to include subsection 25B(2B). This new subsection determined that where any amount derived from a CFC emanates from a foreign trust, section 10B(2)(a) pertaining to foreign dividend exemption should be disregarded. This indicates that although the resident will not qualify for exemption of foreign dividends, the resident will not be taxed on the foreign company's net income in terms of the CFC regime (National Treasury, 2018).

Similar to the subsection in section 25B, it was proposed that section 7(8) of the ITA (58 of 1962) also be amended such that when a resident includes income from a foreign trust arising from a donation, settlement or other dispositions to that foreign trust, the foreign dividend exemption should also be disregarded. The resident will therefore be taxed on the dividends received by the foreign trust resulting from the donation, settlement or other disposition by the resident to the foreign trust (National Treasury, 2018b:39).

In order to address capital gains tax on CFCs held through a resident connected foreign trust, the participation exemption in respect of the sale of foreign shares should be disregarded by South African residents if the sale is attributable to a donation to a foreign trust. However, the capital gain on the foreign shares will not be disregarded in terms of paragraph 64B of the Eighth Schedule. The resident will therefore be taxed on the capital gain resulting from the donation (National Treasury, 2018b:39). The participation exemption in terms of paragraph 64B should be disregarded for both paragraph 72 and paragraph 80 in the Eighth Schedule.

Public comments on the proposed amendments to include CFCs held by connected foreign trusts included that if the high tax exemption or foreign business establishment exemption applies to the CFC held through the connected foreign trust, the foreign dividend exemption should not be disregarded (National Treasury, 2018c:33). However, this comment was rejected by National Treasury as the purpose of removing the participation exemption on the foreign dividends was not to tax the income of the CFC, but rather to remove the participation exemption on foreign dividends (National Treasury, 2018c:34). This exemption was removed on foreign dividends from

a connected foreign trust irrespective of whether the foreign company that would have been a CFC adhered to the exemptions in the CFC regime.

The amendments in the 2018 Taxation Law Amendment Bill were therefore implemented in the ITA (58 of 1962) to include CFCs held through a connected foreign trust in the tax net of South Africa. The new subsections make no provision for accumulating income in the foreign company involved that will have a direct influence on the shares of that foreign company. These new subsections include the taxation on foreign dividends from the foreign company held by the foreign trust, but the tax treatment of the CFC regime and the trust anti-avoidance provisions are still inconsistent regardless of National Treasury's attempt to narrow it down to a single tax treatment.

2.7 Conclusion

The tax treatment of a CFC and a foreign trust are not consistent. When a CFC is held by a South African resident connected trust, the resident will not be taxed to the same extent as in the normal CFC regime. The CFC rules require that the resident include the total apportionment of the net income of that CFC in his taxable income, whereas a resident who is a beneficiary of a foreign trust will only be taxed on the income of the trust if he has received a contingent or vested right to the income from the trust, even if the amount received by the resident is capital in nature.

The newly implemented subsections in the ITA (58 of 1962) during 2018 includes the foreign dividends received by a beneficiary of the foreign trust, from a CFC, in the taxable income of that resident. However, the tax treatment of a CFC and a foreign trust are still not consistent. When a CFC is held by a resident connected trust, the South African resident will not be taxed on the comprehensive income of the CFC held by the foreign trust as in the normal CFC regime. The tax treatment stated in the ITA (58 of 1962) that includes profits from a CFC held by a connected foreign trust will, therefore, be compared to the mechanisms used by Australia to include profits from a CFC held by a connected foreign trust in the Income Tax Assessment Act (1936).

CHAPTER 3 THE TAXATION OF A CFC HELD BY A RESIDENT CONNECTED TRUST – AUSTRALIA

3.1 Introduction

As chapter 2 indicated, the current anti-avoidance measures and the attempt by South Africa to include a CFC held by a resident connected foreign trust in the tax net did not align with the tax treatment of a CFC directly held by a resident. In this chapter, the tax treatment of CFCs held by connected foreign trusts in Australia will be explored to determine whether South Africa can implement other anti-avoidance provisions to impose tax on CFCs held through a connected foreign trust.

Australia introduced its CFC regime in the Income Tax Assessment Act (hereafter ITAA) during December 1989 to prevent Australian residents from deferring income tax by accumulating income in offshore entities (Azzi, 1994). The anti-tax deferral regimes have been amended on an ongoing basis to ensure that Australia stays competitive in the global environment (The Board of Taxation, 2008:v). The purpose of the CFC regime in the ITAA is to prevent bias between domestic investments and foreign investments that creates a tax deferral benefit. This tax deferral benefit arises as a result of time value of money principles. In addition, the effective tax rate will be closely linked to the foreign tax rate, especially if the foreign investment is located in a tax haven (Burns, 2006:152).

Investments in closely linked foreign trusts held by Australian residents were initially taxed through an anti-deferral regime for foreign investment funds. The foreign investment fund rules were introduced to the ITAA together with the CFC regime, which became effective in July 1990 (Burns, 2006:163). The foreign investment fund regime was applied when Australian residents contributed to foreign trusts that would result in a benefit for beneficiaries and applied to closely linked trusts where an Australian resident had an interest (directly or indirectly) in an offshore trust (Cooper, 2013:230). These two sections of the foreign investment fund regime were referred to as the Grantor Trust regime and the Deemed Present Entitlement regime, respectively.

The anti-deferral regimes in Australia were placed under review in 2006 and the final review document was released in September 2008. These regimes were reviewed because of their complexity and the cost associated with compliance for Australian residents (The Board of Taxation, 2008:1). The final review document determined that the CFC regime will be the primary anti-deferral rules for deemed foreign income earned by Australian residents (Cooper, 2013:231). It was recommended that the foreign investment fund regime be repealed and that the taxation

of closely linked foreign trusts should be included in the CFC regime in the ITAA 1997 (The Board of Taxation, 2008:2).

This chapter will focus on what the content of the current legislation of Australia entails for closely linked foreign trusts to understand the tax consequences of a CFC held by a resident connected foreign trust (hereafter CFT). The chapter will consider the tax consequences of the CFC regime as the primary anti-deferral regime.

3.2 CFT rules included in the CFC Regime

In terms of the ITAA, the CFC regime applies to investments held by Australian residents in listed and unlisted foreign entities controlled by Australian residents. A listed foreign entity will be considered to be a foreign entity with a comparable income tax rate to the Australian income tax rate of 30 per cent (Burns, 2006:157). If the foreign investment does not adhere to the definition of a listed foreign entity, the investment will be treated as a resident of an unlisted foreign company (Burns, 2006:157). Therefore, the tax treatment will depend on whether the investment is in a listed foreign entity or an unlisted foreign entity, as relief will be applicable to the taxation in the listed foreign entity (Burns, 2006:160).

The ITAA (1936) includes three control tests for ascertaining whether the CFC provisions apply to an Australian resident who holds an interest in a foreign company. The strict control test states that a foreign company will be a CFC if a group of five or less Australian entities, each holding a minimum of one per cent, collectively holds an interest of 50 per cent or more (ATO, 2019c). The remaining two control tests are based on economic control (Burns, 2002:339). The assumed control interest test will apply when one Australian entity, together with its associates, holds an interest of at least 40 per cent in the foreign entity and the foreign entity is not controlled by any other entity (ATO, 2019c). The final CFC control test is the de facto control test and will apply if five or less Australian entities effectively control the foreign entity (Burns, 2002:339). The de facto control test will consider the ability of the Australian entities to appoint and remove the directors of the foreign entity (ATO, 2019c).

If the interest held by the Australian entity in the foreign entity satisfies one of these control tests, the Australian entity will be taxed on the portion of the tainted income in the foreign entity as if the foreign entity was a resident of Australia (Burns, 2006:155). The total attribution of the income of the CFC, based on the direct and indirect control tracing interest of the Australian entity, will be included in the Australian entity's assessable income for every tax year where one of the control tests are satisfied. This results in the income of the CFC being taxed in Australia and prevents the deferral of taxation until the income is distributed to the Australian entity.

The Australian entity will not have to include the portion of the income in relation to the Australian entity's direct and indirect control tracing interest in the foreign entity if the foreign entity satisfies the active income test. The active income test is determined by the following five factors (ATO, 2019c):

- The entity is a resident of foreign country.
- The entity carries on a business through a permanent establishment.
- The entity has kept proper records of financial reporting.
- The entity can substantiate why it met the active income test.
- The tainted income ratio is less than five per cent of the total turnover of the entity.

The CFC needs to adhere to all of the above factors to pass the active income test. If one or more of the factors are not applicable to it, the Australian entity will include the attributable income of the CFC in its income tax for a tax period in proportion to the associated inclusive control the Australian entity has in the CFC as a result of the eligible transfer to the CFT (ATO, 2007b).

The CFC regime further determines that a foreign trust will be taxed in Australia if the trust is not a resident of Australia and if the control test applicable to CFTs applies to the trust (Waterhouse, 2015). This control test stipulates that if there is a group of five or less Australian one per cent entities and the total aggregated associate-inclusive control interest in the trust is equal to 50 per cent or more, the foreign trust will be a CFT (Waterhouse, 2015). Two factors have to be considered to determine whether the Australia legislation will apply to CFTs. These factors are the trust residency rules and the control test in the CFT regulations.

3.2.1 Australia trust residency test

The residency of a trust is primarily determined by the residency of the trustee and the centre management of control (Brydges, 2019a). If a trustee is a resident of Australia, the trust will be a resident of Australia. If there are multiple trustees, only one of the trustees of the trust has to be a resident of Australia to be classified as an Australian resident trust (Brydges, 2019b:90).

A trustee of a trust in Australia can be a company or a natural person. The residency test will have to be considered for both to determine whether the trustee of the CFT will be a resident to comply with the definition of a CFT.

3.2.1.1 Residence test – natural persons

The OECD has issued guidance on determining the residence of a natural person in terms of the ITAA 1936, whereby statutory requirements and common law principles should be considered for (OECD, 2019).

The statutory requirements include four different assessments to determine the residency of a natural person in Australia. If the natural person resides in Australia, has a domicile in Australia, was present in Australia for a period exceeding 183 days continued or intermittently or is a natural person, or spouse, or child of the natural person or is a member or eligible employee of certain Commonwealth superannuation funds (Brydges, 2019a).

The common law test considers the facts and circumstances of an individual during any income year. Each assessment of residency will differ in terms of the common law test as facts and circumstances can differ from one case to another (Brydges *et al.*, 2019:5). According to the OECD (2019), the general factors that are considered under the common law test include:

- “the intention or purpose of the individual’s presence in Australia;
- the extent of the individual’s family or business and employment ties within Australia;
- the maintenance and location of the individual’s business; and
- the individual’s social and living arrangements.”

The common law test can determine that a natural person is a resident of more than one country, double tax agreements will be considered as the deciding factor of the residency (Brydges, 2019a). If the trustee adheres to the statutory or common law requirements for residency in Australia, the trust will not be a foreign trust and therefore the CFT rules do not apply.

3.2.1.2 Residence test – company

If the trustee of the trust is a company and it is incorporated in Australia, the company will be an Australian resident. If the company is not incorporated in Australia, but its centre of management and control is in Australia or the voting power of the company is controlled by shareholders who are residents of Australia, it will also be an Australian resident (Burrows, 2018).

3.2.1.3 Centre of management and control

The centre of management and control (hereafter COMC) test is subjective and therefore can cause confusion when determining the tax residency of a company and trust in terms of Australian tax legislation. The Australian Tax Office (hereafter ATO) has released a tax ruling and practical

guidance to assist with determining the place of residency in terms of the COMC test (ATO, 2018/5).

The tax ruling and practical guidance only refer to the considerations for a company, even though there has been no set guidance specifically applicable to a trust. In the decision of *Fundy Settlement v. Canada*, the Canadian Supreme Court determined that the considerations for a trust and a company are based on the same principles and therefore can be applied to both persons (Brydges, 2019c).

The first step to determine whether a company or trust adheres to the subjective test for the COMC is to understand the meaning of COMC (ATO, 2020a). The ATO has compiled a definition in the tax ruling (2018/5:4) that is based on various case law such as the *Bywater case*, *Fundy Settlement*, *De Beers* and the *John Hood & Company Ltd v. Magee (1912-1921) 7 TC 327* (ATO, 2018/5:10) as:

“Central management and control refers to the control and direction of a company's operations. It does not refer to a physical location in which the control and direction of a company is located, and may ultimately be exercised in more than one location.”

The definition clearly states that the physical location of a company or trust is not a key deciding factor when determining the COMC. The definition will however be slightly different in terms of a trust, as in order to be an Australian resident a trust cannot have more than one location. The COMC should be in Australia or predominately in Australia but this does not have to be predominately so for a company (Brydges, 2019c).

The direction of a company's or trust's operations will be determined based on the decisions of the board or the trustees of the company or trust. The factors for determining the COMC, based on the tax ruling of the ATO, are summarised in Table 3.1 below:

Table 3-1: Factors that will influence the decision of the court when determining residency (Adapted from Gouveia, 2018)

Key factors that will influence the decision of the court	Other factors that will, to an extent, influence the decision of the court
Where the decisions of the board of directors or trustees are made, irrespective of where they reside	Where the directors or trustees who control the operations reside

Key factors that will influence the decision of the court	Other factors that will, to an extent, influence the decision of the court
Where those charged with governance meets to make the decisions (the trustees or the board of directors)	Where the accounting records are kept
Where a trust declares a right to a beneficiary, or a company declares and pays dividends to shareholders	Where the registered office is located
The nature of the operations of the trust or company and where the decisions are clearly made in practice	Where the register of shareholders or beneficiaries is kept
Documents, including minutes, in which decisions made by the directors or trustees are recorded	Where the shareholder meetings for a company are held
	Where the shareholders or beneficiaries reside

All the considerations to determine the residency of a trust and its trustees, explained in 3.2.1, should be considered to determine whether the trust is a foreign trust in terms of the ITAA (1936). If the trust is a foreign trust, the control test for the CFC regime should be considered to determine whether the foreign trust will be taxed in Australia.

3.2.2 CFT – control tests

A foreign trust can only be taxed in terms of the CFT rules if it adheres to the control test as per the definition of a CFT (Waterhouse, 2015). This test differs from the three control tests applicable to CFCs in terms of the ITAA (1936) but is closely linked to the principles of the strict control test applicable to CFCs.

The control test for CFTs determines that if there is a group of five or less Australian one per cent entities and the total aggregated associate-inclusive control interest in the trust is equal to 50 per cent or more, the foreign trust will be a CFT (Waterhouse, 2015). There are two factors to consider when determining whether the foreign trust would adhere to the control test: the meaning of a one

per cent Australian entity and the associated-inclusive control interest. The two factors for the CFT control test are discussed below.

3.2.2.1 One per cent Australian entity

An entity and a one per cent Australian entity are defined in section 317 of the ITAA (1936). A one per cent Australian entity, as per the control test, is an entity with an associated-inclusive control interest (discussed in 3.2.2.2) of at least one per cent in the foreign trust. An entity includes a company, partnership, a person in the capacity of a trustee or any other person. For tax purposes, an Australian entity therefore includes an individual and the reference in the control test to an entity relates to Australian beneficiaries of the foreign trust (ATO, 2020b).

The definition of an entity further specifically includes that a trustee of a trust forms part of an entity. The trustee will therefore have to be considered together with the beneficiaries when determining what the tax consequences of the foreign trust will be in relation to the ITAA in Australia.

3.2.2.2 Associated-inclusive control interest

Associated-inclusive control interest in a company or a trust is defined in section 349 of the ITAA (1936). According to CCH Australia Limited (2011:1187) associated-inclusive control is the accumulated direct and indirect control interest held by a taxpayer together with the direct and indirect control interest of the associates of the taxpayer.

Direct control interest in a trust refers to the share of income an Australian beneficiary is entitled to or entitled to acquire from a foreign trust (section 351, 1936). A beneficiary of a discretionary trust does not have a vested right in any income or capital of a trust until the trustee distributes the income or capital to the trustee (Pinto & Karlinsky, 2007:254). Direct control interest will therefore not be applicable to the beneficiaries of a discretionary trust as the entitlement requirement does not apply.

An indirect control interest in a trust or a company is defined in section 352 of the ITAA (1936) and determines the interest that an Australian entity holds in a foreign company or foreign trust through an interposed entity or multiple interposed entities. The indirect control interest will be equal to the control tracing interest held by the Australian entity in the interposed entity, or multiple interposed entities, multiplied by the control tracing interest that the interposed entity, or multiple interposed entities, has in the foreign trust. An Australian entity will have a control tracing interest of 100 per cent if the entity is an eligible transferor at any point in time in relation to the CFT (ATO, 1990).

An Australian entity will be an eligible transferor in relation to a discretionary trust at any point in time if all the requirements in section 347 of the ITAA (1936) are met by the Australian entity (ATO, 1992). The following summarises the requirements for an Australian entity to be an eligible transferor in terms of section 347 of the ITAA (1936):

- the Australian entity transferred the property or services to the discretionary trust at any given time
- the transfer made by the Australian entity was not transferred in the normal course of business as a business transaction, or
- the transfer was an arm's lengths business transaction, but the Australian entity was in a position to control the trust.

An Australian entity will be in a position to control a trust if the entity, together with its associates or on its own, can obtain the beneficial enjoyment of the transfer without the consent of any other entity. The Australian entity directly or indirectly controls the income of the trust if the trustee of the trust is expected to act in terms of directions, formally or informally, from the Australian entity on its own or together with its associates, or they have the power to remove or appoint the trustee in relation to the trust (section 347(2), 1936).

The transfer of property will further be deemed to be transferred to the discretionary trust if the Australian entity is an eligible transferor in respect of the property or services to any other entity for the benefit of the discretionary trust, or on the direction of the discretionary trust (section 344(3), 1936). The transfer to any other entity for the benefit of or on the direction of the discretionary trust will be a transfer in terms of the CFT provisions.

If the Australian entity is an eligible transferor in terms of the CFT provisions in relation to another entity, the entity will be taxed on the income of the foreign entity if the associated inclusive control of the Australian entity is more than 50 per cent in terms of the CFC provisions (ATO, 2019c). The attributable income that will be included in the income tax assessment of the Australian entity will only be applicable if the other foreign entity fails the active income test in the CFC provisions (ATO, 2019c).

3.2.3 Structure captured by the CFC regime for CFT

The structure that will be captured in terms of the CFT regime in the ITAA is illustrated in Figure 3.1 (own compilation):

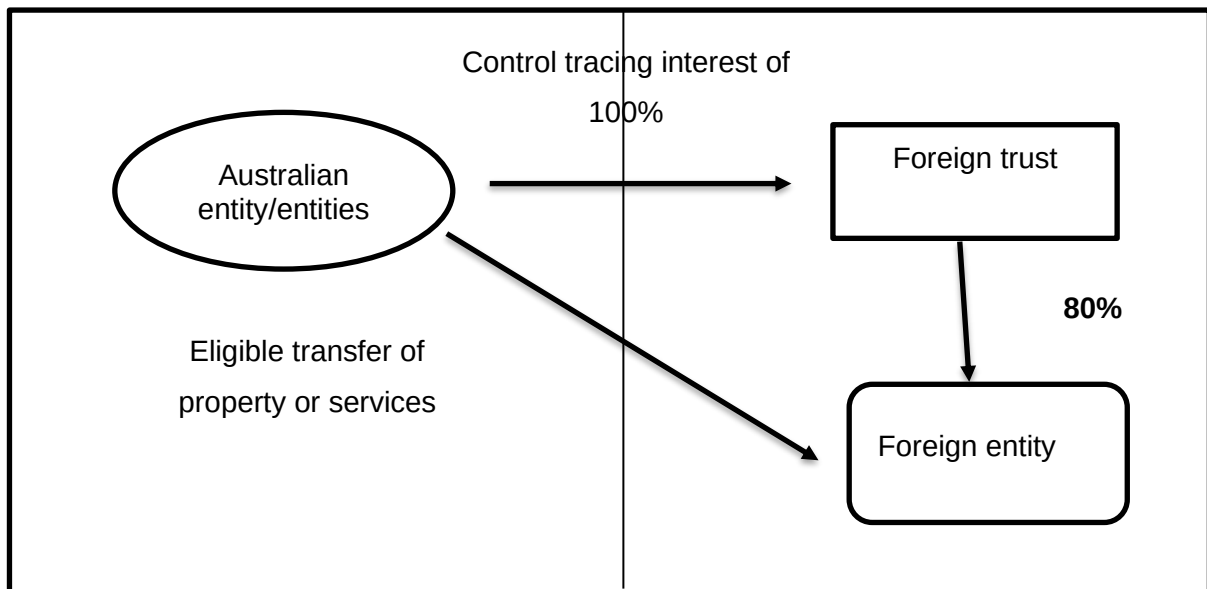


Figure 3-1: Structure captured by the CFT rules in the ITAA

If the Australian entity is an eligible transferor of property or services to the foreign entity held by the foreign trust, it will be deemed that the Australian entity made an eligible transfer to the foreign trust as the former has a control tracing interest of 100 per cent in the latter. The total associated inclusive control of the Australian entity as a result of the transfer of property or services to the foreign entity will be equal to the control tracing interest in the CFT multiplied by the control of the foreign trust in the foreign entity. The total associated inclusive control interest will be 80 per cent for the Australian entity which is more than the 50 per cent required by the CFC provisions and the Australian entity will be taxed on the attributable income of the CFC.

The total attributable income of the CFC will be included in the transferor's taxable income unless there is more than one transferor in an income year. The portion of the net income that will be included in the transferor's taxable income will be calculated based on the attributable income of the foreign trust relating to the property or services transferred by the transferor (ATO, 2019a). If there is more than one transferor in the same income year, transferor will have to apply to the Australian Taxation Office (hereafter ATO) for the reduction in the net income included in the taxable income in the income year (ATO, 2019a).

If the Australian entity is an eligible transferor in terms of the CFT provisions and more than one foreign entity is included in the structure, it is less likely that the foreign company will be taxed on the taxable income of the transferor, as the associated inclusive control is diluted by the interposed entities. This is illustrated in the structure presented in Figure 3.2 below (own compilation):

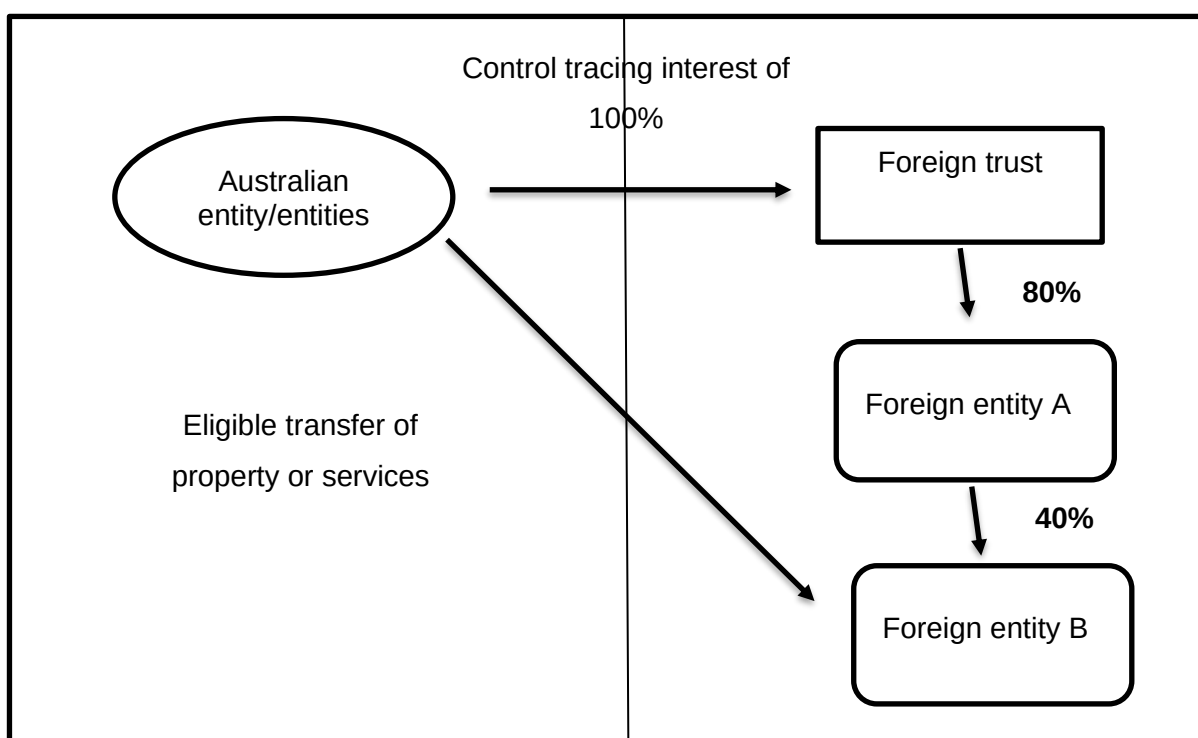


Figure 3-2: Structure not captured by the CFT rules in the ITAA

If the Australian entity is an eligible transferor of property or services to the foreign entity held by the foreign trust, it will be deemed that the Australian entity made the eligible transfer to the foreign trust because it has a control tracing interest of 100 per cent in the foreign trust. The total associated inclusive control of the Australian entity resulting from the transfer of property or services to foreign entity B will be equal to the control tracing interest in the CFT multiplied by the control of the foreign trust in foreign entity B. The total associated inclusive control interest will be 32 per cent ($100\% \times 80\% \times 40\%$) for the Australian entity, which is less than the 50 per cent requirement of the CFC provisions. The Australian entity will therefore not be taxed on the transfer in terms of the CFC provisions, but the transferor trust provisions should be considered on the transfer to foreign entity B.

The CFT provisions in the ITAA therefore include the profits of a foreign entity held by a resident CFT but, as identified above, the CFT provisions will not include the profits of a foreign company that is not a CFC. The ITAA includes transferor trust provisions that have to be considered if the CFT provisions in the CFC regime do not apply. The transferor trust provisions will therefore be

explored in chapter 4 to determine whether the anti-avoidance measures included in the ITAA will impose tax if a deemed eligible transfer is made where more than one interposed entity is held by the CFT and the associated inclusive control is less than 50 per cent.

3.2.4 Comparison of the tax treatment in South Africa and Australia

A comparison of the tax treatment of a foreign company held by a resident CFT in the CFT provisions in Australia and in South Africa will be performed by considering the tax consequences from the following scenario in the ATO (2007a:6) Taxation Ruling 2007/13 Application of the transferor trust and controlled foreign company measures, where property or services are transferred to a non-resident company in which a non-resident trustee has a direct or indirect ownership interest:

“Blue, an Australian resident taxpayer establishes a non-resident discretionary trust, “SwissTrust”, in Switzerland, on 1 January 2005. The terms of the trust deed have the effect that, apart from a named charitable institution, only members of Blue's family can be added as beneficiaries. SwissTrust owns 100% of the shares in “ACo” which owns 100% of the shares in “GCo”, both companies being incorporated in Guernsey. SwissTrust does not have any other assets. On 1 April 2005, Blue gives \$10 million to GCo for nil consideration.”

The scenario above can be illustrated as follows (adapted from ATO (2007a:6):

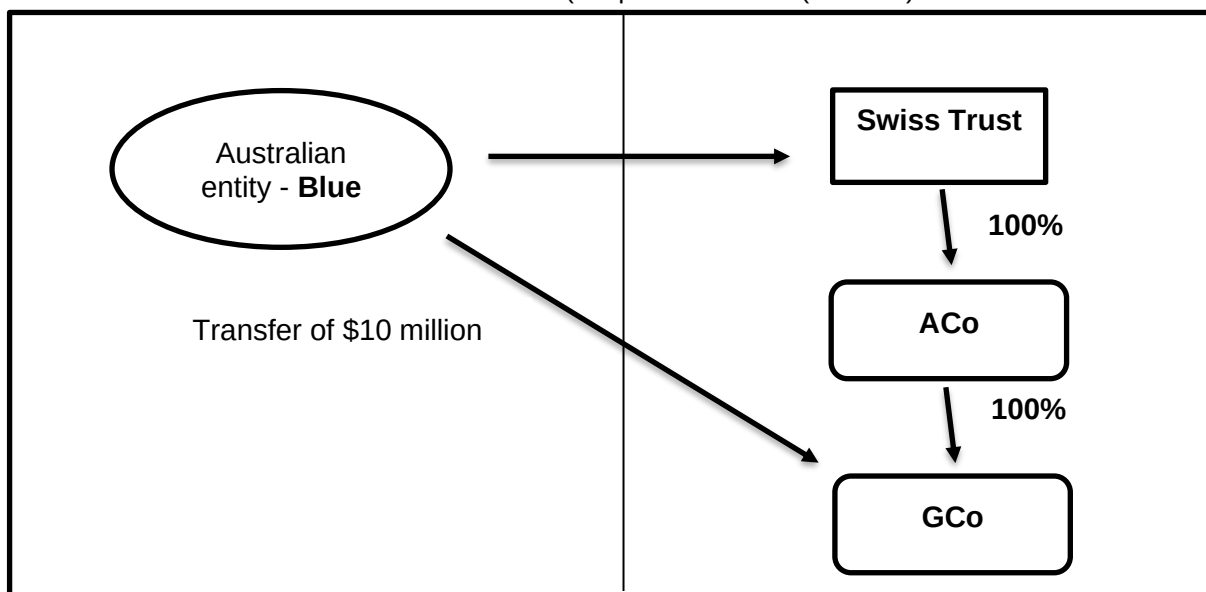


Figure 3-3: Taxation Ruling 2007/13 CFT structure

3.2.4.1 Tax consequences in Australia

The CFT rules included in the CFC regime in the Australian ITAA (1936) will apply to a resident CFT if the Australian beneficiary made an eligible transfer of property or services to the CFC held by the foreign trust (section 347, 1936). A transfer of property or services will be an eligible transfer if the transfer was not transferred in the normal course of business or is not an arm's lengths

business transaction. The Australian beneficiary will include the income of the CFC held by the foreign trust in his/her income tax for the tax year in proportion to the associated inclusive control as a result of the transfer (CCH Australia Limited, 2011:1187).

The Australian entity, Blue, is an eligible transferor of property or services to the foreign entity, GCo, indirectly held by the foreign trust through the 100 per cent direct interest in ACo. The transfer of \$10 million adheres to the requirements of an eligible transfer in section 347 of the ITAA (1936), as the transfer was made for nil consideration and it was not made in the normal course of business nor was it at arm's length. As a result of the eligible transfer of \$10 million, Blue will have a control tracing interest of 100 per cent in the Swizz Trust (ATO, 2019c).

The \$10 million transferred from Blue to GCo will be deemed an eligible transfer by Blue made to the foreign trust, Swiss Trust, as Blue has a control tracing interest of 100 per cent in the Swiss Trust. The total associated inclusive control of the Australian entity, Blue, as a result of the transfer of the \$10 million to GCo will be equal to the control tracing interest (100 per cent) in the Swizz Trust multiplied by the indirect control (100 per cent) of the Swizz trust in GCo. The total associated inclusive control interest will be equal to 100 per cent for Blue, which is more than the 50 per cent requirement in the CFC provisions and Blue will be taxed on the attributable income of GCo.

The total attributable income of GCo will be included in Blue's taxable income unless there is more than one transferor in an income year. The portion of the net income that will be included in Blue's taxable income will be calculated based on the attributable income of the Swizz Trust relating to the \$10 million transferred by Blue (ATO, 2019c). Blue will, however, have to apply to the ATO for the reduction of net income included in the taxable income in the income year (ATO, 2019c).

3.2.4.2 Tax consequences in South Africa

The ITA (58 of 1962) in South Africa does not include specific anti-avoidance provisions to include the income of the CFC held by the resident CFT. The tax treatment of the transfer of property or services to the CFC held by the resident CFT will therefore have to be considered when comparing the legislation in South Africa to the legislation in Australia.

Based on the scenario, the transfer of \$10 million to GCo will be considered to be a donation by Blue in the year of assessment in terms of section 54 of the ITA (58 of 1962). A donation is defined as any gratuitous disposal of property by a South African resident and is levied at 20 per cent on the value of the property disposed, if the value is less than R30 million (Stiglingh *et al.*, 2019:931).

If the value of the property exceeds R30 million, the donations tax will be levied at 25 per cent of the value exceeding the R30 million threshold¹ (SARS, 2019). Blue will therefore be liable for donations tax of \$2 million as a result of the transfer of \$10 million for nil consideration to GCo. No other tax consequences will apply to the scenario presented above in South Africa. The resident of South Africa will only be taxed on the profit made by GCo, if GCo declares a dividend to ACo and ACo declares the dividend to Swiss Trust and Blue obtains a vested right to the dividends in the same year of assessment. Blue will not obtain the foreign dividend exception in section 10B(2)(a) and will be liable for income tax on the foreign dividend received from ACo.

Based on the comparison performed between the legislation in Australia and the legislation in South Africa in the scenario above, it is clear that the CFT legislation in Australia is more comprehensive than in South Africa. The CFT legislation in the CFC regime determines that the Australian resident will include the attributable income of the CFC held by the resident CFT in the taxable income of the resident for the income tax year. South Africa does not have income tax legislation to assess whether the attributable income of the CFC held by the resident CFT should be included in the resident beneficiary's taxable income.

The principles in the CFC regime in the ITAA (1936) have been compared with the tax consequences in South Africa to include profits of a foreign company held by a resident CFT. The impact of the differences noted above has been considered as part of the comparison performed in the table below (own compilation):

¹ The exchange rate for purposes of this study was deemed to be ZAR: AUD of 1:1 in order prevent unnecessary complexity when comparing the income tax consequences between the two countries.

Table 3-2: Principles contained in the CFT provisions in Australia compared to the principles in South Africa

Australia	South Africa	Mechanism employed by Australia to achieve CFC treatment
The CFC regime will be applicable to foreign entities where five or less Australian entities collectively hold an interest of 50 per cent or more.	The CFC regime will be applicable when South African residents collectively hold 50 per cent or more of the voting and participation rights in the foreign entity.	The percentage of interest for a foreign company to be a CFC in both countries is 50 per cent or more; however, in Australia the Australian entities are limited to five while in South Africa the number of residents who collectively hold 50 per cent is not restricted.
The CFC regime includes CFT provisions, where five or less Australian entities collectively hold an associated control interest of 50 per cent or more.	The CFC regime does not make any provision for CFTs in the ITA (58 of 1962).	The ITAA (1936) includes CFT provisions in the CFC regime compared to the ITA (58 of 1962) that do not include any provisions to impose tax on a foreign trust. The CFC provisions in South Africa are only applicable to foreign companies.
The CFT provisions will be triggered when an Australian entity makes an eligible transfer of property or services to or for the benefit of the foreign trust. A transfer will be an eligible transfer if the property or services were not transferred in the normal course of business	If a South African resident transfers property or services directly to a foreign trust for a consideration of less than the market value, it will be deemed to be a donation. The resident will be taxed on the income that the foreign trust generates from the portion of the property	The CFT legislation in Australia will be triggered if an eligible transfer is made for the benefit of the trust, therefore the property or services can be transferred to a foreign company held by the foreign trust. The legislation in South Africa will only tax a South African resident on the portion of

Australia	South Africa	Mechanism employed by Australia to achieve CFC treatment
or were not an arm's length business transaction.	or services transferred as a result of the deemed donation.	income generated as a result of the deemed donation directly to the foreign trust. The resident will not include any portion of income generated by a foreign company held by the foreign trust if the transfer is made directly to the foreign trust. The legislation in Australia will therefore include a transfer of property or services to a foreign company held by a foreign trust. The legislation in section 7(8) does not include transfers to foreign companies held by foreign trusts.
The CFT provisions will apply to a CFC held by a resident CFT when property or services are transferred to the CFC. The eligible transfer of property or services to the CFC held by the foreign trust will result in the Australian resident being deemed to have a control tracing interest of 100 per cent in the trust.	The South African legislation does not include control tracing interest rules to determine the indirect participation rights that the beneficiary may hold in a CFC held by a resident CFT. An eligible transfer to a CFC held by the resident CFT will only trigger the donations tax of 20 to 25 per cent on the difference between the actual consideration and the market value	Australia has included the deemed control tracing interest rules to determine the indirect interest that the Australian resident has in the foreign trust. The deemed control tracing interest rules enable Australia to determine the associated inclusive control that a resident holds in a foreign trust. If the Australian resident holds an associated inclusive control of 50 per cent or more, he/she will

Australia	South Africa	Mechanism employed by Australia to achieve CFC treatment
	of the property or services transferred, depending on the value of the donation.	be subject to the CFT provisions in terms of the CFC regime in the ITAA (1936). South Africa does not have deemed control tracing interest rules to include the profits of a CFC held by a resident CFT.
The Australian resident will include the profits of the CFC held by the resident CFT to whom the eligible transfer was made, if the total associated inclusive control as a result of the transfer is more than 50 per cent. The total associated inclusive control in the CFC held by the resident CFT is determined by multiplying the deemed control tracing interest as a result of the eligible transfer by the direct or indirect interest of the foreign trust in the CFC.	The ITA (58 of 1962) does not provide in the CFC regime to include the profits of a CFC held by a resident CFT. South African CFC legislation stipulates that a resident should determine the direct or indirect participation or voting rights in the CFC. If the total of these is more than 50 per cent, the profits of the CFC in relation to the attributable income should be included in the taxpayer's taxable income.	The Australian resident will include the profits of the CFC held by the resident CFT on the same principle as determined by the CFC legislation. The total profit of the CFC held by the resident CFT will be included in the Australian resident's income for the tax year on the same basis as if the Australian resident held the interest in the CFC directly and not through the CFT.

Australia	South Africa	Mechanism employed by Australia to achieve CFC treatment
If there are more than one eligible transfer in one income tax year, the Australian resident will have to apply to the ATO to reduce the profits in relation to the trust to be included in the resident's income for the income tax year.	South Africa does not have similar provisions, as the CFC regime only applies to companies. The South African resident will therefore only include income attributable to direct or indirect participation or voting rights.	As the control tracing interest is deemed to be 100% when an Australian resident makes an eligible transfer to the CFC for the benefit of the trust, the control tracing interest will be 100% for more than one Australian resident if more than one eligible transfer was made to the CFC held by the CFT. Australia has therefore determined in the ITAA (1936) that the Australian resident should apply to the ATO to reduce the control tracing interest as a result of the transfer to avoid double taxation on the profits of the CFC held by the CFT. If the control tracing interest is reduced, the associated inclusive control for the Australian resident will be reduced and, as a result, the profits of the CFC that will be included in the Australian resident's income will be reduced as determined by the ATO.

It should therefore be considered whether the mechanisms used in Australia to include connected foreign trust principles in the CFC regime can be used to reduce the inconsistency in the South African legislation.

3.3 Conclusion

The CFT income tax provisions included in the ITAA (1936) determines that the attributable income of a CFC held by a resident CFT will be included in the Australian entity's income for the tax period but not in the South African resident's taxable income. The attributable income of the CFC held by the resident CFT will only be included if the Australian entity made an eligible transfer of property or services to the CFC held by the resident CFT. The attributable income that will be included in the Australian resident's income will be calculated by multiplying the control tracing interest, which is deemed to be 100 per cent, multiplied by the direct and indirect interest of the foreign trust in the CFC.

In South Africa, the ITA (58 of 1962) does not include specific anti-avoidance provisions for a CFC held by a resident CFT. If a South African beneficiary transfers property or services to a CFC held by a resident CFT, the transfer will be considered to be a donation and the resident will be liable for donations tax at 20 to 25 per cent, depending on the value of the donation, in the year of assessment. Moreover, the resident will not include a portion of the income of the CFC held by the CFT in his/her taxable income. The South African resident will only be taxed on the dividends distributed from the CFC to the foreign trust that are distributed to the South African resident in the same year of assessment. It should therefore be considered whether the current anti-avoidance provisions in the South African CFC regime should be amended to include specific provisions for CFCs held by resident CFTs. This can be achieved by including the deemed control tracing interest principle when property or services are transferred to a CFC held by a resident CFT as part of the indirect participation rights of the resident in the profits of the foreign company.

CHAPTER 4 TAXATION OF A RESIDENT CONNECTED TRUST NOT INCLUDED IN THE AMBIT OF THE CFC REGIME – AUSTRALIA

4.1 Introduction

The Australian ITAA (1936) includes transferor trust provisions for instances where investments in closely linked foreign trusts do not adhere to the CFT provisions included in the CFC regime. The transferor trust provisions in the ITTA (1936) aim to remove opportunities for Australian residents to defer taxation through foreign trusts (Lamb, 2013). Investments in closely linked foreign trusts held by Australian residents were initially taxed through the anti-deferral regime for foreign investment funds.

The foreign investment fund rules were introduced to the ITAA together with the CFC regime that became effective in July 1990 (Burns, 2006:163). The foreign investment fund regime was applied when Australian residents contributed to foreign trusts that would result in a benefit for Australian beneficiaries. This regime applied to closely linked trusts where Australian residents had an interest, whether directly or indirectly, in offshore trusts (Cooper, 2013:230).

The anti-deferral regimes in Australia were placed under review in 2006 and the final review document was released in September 2008. The reason for reviewing the anti-deferral regimes was as a result of their complexity and the cost associated with compliance for Australian residents (The Board of Taxation, 2008:1). The anti-deferral regime in Australia includes specific roll-up-fund measures, the transferor trust provisions, where the closely linked foreign trust does not adhere to the requirements of the CFC regime. The taxation of closely linked foreign trusts can therefore further be captured in the Australian ITAA through the transferor trust rules if they do not adhere to the CFC regime (Cooper, 2013:232).

This chapter will focus on what the content of the current Australian legislation entails for closely linked foreign trusts, other than the CFC regime, to understand the tax consequences of a foreign company held by a resident CFT. The tax consequences in terms of the transferor trust provisions will be considered in this chapter to determine the tax consequences if the CFC regime for closely linked trusts does not apply.

4.2 Transferor trust rules

Foreign trusts are only taxable in Australia if the income of the foreign trust is from an Australian source, unless the income of the foreign trust has another basis that will be subject to income tax in Australia. The transferor trust rules included in the ITAA (1937) are, in fact, anti-deferral

measures aimed at preventing Australian residents from accumulating income in a low-tax jurisdiction that will not ordinarily be taxed in Australia (Brydges, 2019b:15).

A foreign trust will be subject to the transferor trust rules if an Australian resident transfers property or services to a foreign trust and the income of the foreign trust is not included in the taxable income of one or more Australian residents (ATO, 2019a). The Taxation Institute of Australia (2007) argues that the Australian resident that transfers property or services to a non-resident trust is likely to benefit as a result of the transfer to the non-resident trust.

4.2.1 Transferor trust requirements

An Australian resident will be subject to transferor trust measures if the resident transferred property or services to a non-resident trust and no exemptions are applicable to that transfer (ATO, 2019a). The transferor trust rules therefore comprise three factors that must be considered when determining whether the anti-avoidance measures apply: firstly, whether there was a transfer of property and services by an Australian resident; secondly, whether the transfer was made to a foreign/non-resident trust, and lastly, whether the exemptions will apply. These factors will be discussed separately in this chapter.

4.2.1.1 Transfer of property or services by an Australian resident

The transfer of property or services by an Australian resident is defined in section 102AAJ of the ITAA (1936). The transfer includes any transfer of property or services by means of the creation of a foreign trust, by transferring property or services that did not previously exist, by creating property or services and then transferring them to the trust, transferring property or services to discharge debt, and transferring property or services for the benefit of the foreign trust (Thompson, 2007).

The transfer of property and services by an Australian resident may be deemed to be transferred to a foreign trust. This will occur when an Australian entity transfers the property or services to an interposed entity on the condition that the interposed entity transfers the property or services to the trust. The transfer of the property will be deemed to be transferred directly from the initial Australian entity to the foreign trust (ATO, 2019a).

Property and services applicable to the transferring of property and services in terms of section 102AAJ of the ITAA (1936) are defined in section 102AAB of the ITAA (1936). The ITAA (1936) states that money is specifically included when referring to the transfer of property. The transfer of services includes any benefit, right or privilege that is not limited or provided for under an

arrangement for the performance of work, use of facilities, a contract of insurance or an arrangement for lending money.

The residency of an income taxpayer in Australia has been discussed as part of the CFT considerations in section 3.2.1 Australian residency. The same principles will apply to determine whether an Australian resident transfers property or services and therefore this is not discussed as part of this chapter.

The transfer of property or services by an Australian resident is broadly defined in the ITAA and therefore all property and services that are transferred or deemed to be transferred should be considered separately to determine whether they adhere to the requirements for transferring property or services.

4.2.1.2 To a foreign trust

The residency of a trust is primarily determined by the residency of the trustees and the COMC of the trust (Brydges, 2019c). If a trustee is a resident of Australia, the trust will be a resident of Australia. In the case of multiple trustees, to be classified as an Australian resident trust only one of the trustees has to be a resident of Australia (Brydges, 2019b:90).

The residency rules of Australia have been discussed as part of the CFT considerations in section 3.2.1 Australian residency and the same principles will apply to determine whether a trust will be classified as an Australian resident trust or a foreign trust.

4.2.1.3 Transferor trust exemptions

The transferor trust rules include various circumstances in which the anti-deferral rules do not apply for the transfer of property or services by an Australian resident to a foreign trust. The exemptions are categorised according to the nature of the trust to which the transfer is made and include the following categories, as included in the list of exemptions by the ATO (2019):

- public unit trusts
- deceased estates
- non-resident family trusts
- post-marital family trusts
- family relief trusts
- contingent beneficiaries
- migrant transferors
- discretionary trusts, and

- non-discretionary trusts.

The exemption applicable to a discretionary trust will be discussed as part of the study, because the problem statement is applicable to a discretionary trust. The remaining exemptions in the Australian transferor trust regime do not fall within the scope of the study.

4.2.1.3.1 Transferor trust exemption: discretionary trust

The transferor trust exemption for discretionary trusts includes two requirements when property or services are transferred to a foreign trust (Thompson, 2007): firstly, that the transfer was made in the course of carrying on a business and, secondly, the transfer was made at arm's length by the transferor to the foreign trust (ATO, 2019a).

In order to adhere to the exemption of the transferor trust rules for a discretionary trust, the transfer of property or services has to be done in the course of carrying on a business. The term "in the course of carrying on a business" is not defined in the ITAA; hence, the ATO released a tax ruling, TR 2019/01, to provide guidance on determining when a company carries on a business (ATO, 2019b).

In the court case *Federal Commissioner of Taxation v Murray* (1998), judges Gaudron, McHugh, Gummow and Hayne JJ determined that, "[a] business is not a thing or things. It is a course of conduct carried on for the purpose of profit and involves notions of continuity and repetition of actions". Every case will have to be considered separately to determine whether, based on the facts and circumstances of the transactions, the trust is indeed conducting business (ATO, 2019b).

The tax ruling provided that the following facts and circumstances should be considered to determine whether a transaction was initiated in the course of carrying on a business (ATO, 2019b):

- whether the person intends to carry on a business
- whether the nature of activities involves a profit-making purpose
- whether the activities are repeated and regular
- whether accounting records are kept, and an accounting system is used
- the size and scale of the activities, and
- that the activities are not considered to be a hobby or recreation.

If the above facts and circumstances are considered and it is determined that the transfer will be in the course of carrying on a business, the transfer should further also be at arm's length in terms

of the requirements of the exemption of the transferor trust rules. The transfer will be at arm's length if the transfer is made on the same terms as a transfer in the ordinary course of business to any other third party (ATO, 2019a).

The transferor trust provisions will still be applicable if the transfer was not made in the course of carrying on a business but was at arm's length and the transferor is in a position to control the foreign trust (ATO, 2019a). The transferor is deemed to control the foreign trust if he/she has the power to obtain the beneficial enjoyment or income of the foreign trust or the application of the income of the foreign trust, he/she can reasonably expect the trustee to follow his/her directions or he/she has the ability to remove or appoint the trustee (section 102AAT, 1936).

If the transferor trust regime applies to the transferor of property or services by an Australian resident to a foreign trust, the Australian resident will be an attributable taxpayer in relation to the foreign trust and the attributable income of the transferor will have to be determined in relation to the foreign trust.

4.2.2 Transferor trust – attributable income

The attributable income of a discretionary non-resident trust is determined by section 102AAU of the ITAA (1936). The attributable income of the trust should be determined before the portion that will be included in the Australian resident's taxable income can be determined. The rules contain two sections for determining the income that will be included: one if the Australian resident can obtain the information needed to determine the attributable income of the non-resident trust and another if the Australian resident cannot obtain the information (ATO, 2019a).

4.2.2.1 Information is available to calculate attributable income

The attributable income of the foreign trust will be determined by calculating the net income of the trust as if the foreign trust is a resident trust of Australia (ATO, 2019a). The net income of a resident trust is determined by section 95 of the ITAA (1936). The net income of the trust will be equal to the total income calculated as if the trustee were the taxpayer in relation to the resident trust (section 95, 1936). The income of the trust will therefore be assessed based on the nature of the trustee.

If a beneficiary of a trust has a present entitlement to a portion of the net income of the trust, he/she will be taxed on this net income and it will be reduced by the portion that will be taxed in the hands of the beneficiary (Adams, 2017). The total amount of net income of the trust that will be included in the income tax payable by the trustee will be the net income that was not distributed to any beneficiary during the current income year of the trust (section 95, 1936).

When an Australian resident is a transferor in relation to the trust, the net income of the trust will be determined as if the foreign trust were a resident trust, but it should be considered whether the foreign trust is a resident trust of a listed or unlisted country (ATO, 2019a). A listed country will be a foreign entity with an income tax rate comparable to the Australian income tax rate of 30 per cent, any other country will be an unlisted country (Burns, 2006:157).

If the trust is a resident of an unlisted country the net income will be reduced by any amount of income subject to income tax payable in a listed country or in Australia (Thompson, 2007:11). If the trust is a resident of a listed country, the net income of the trust will be reduced by the income subject to the full amount that will be taxed in the listed country or that will be subject to taxation in Australia.

The amount of the net income of the foreign trust that will be reduced because the income that is taxable in a listed country or in Australia is calculated on the total amount that is taxed in the listed country or in Australia multiplied by the listed country tax amount divided by the net income of the trust in relation to the ITAA (Section 102AAU, 1936). The transferor of property or services to a foreign trust in a listed country will not be subject to tax in Australia if the transfer made by the Australian resident does not attribute to at least 10 per cent of the net income of the foreign trust, provided that the 10 per cent does not exceed \$20 000 (Thompson, 2007:11).

The total net income of the trust will be included in the transferor's taxable income unless there is more than one Australian transferor in an income year. The portion of the net income that will be included in the transferor's taxable income will be calculated on the basis of the attributable income of the foreign trust relating to the property or services transferred by the transferor (ATO, 2019a). The transferor will, however, have to apply to the ATO for a reduction in the net income included in their taxable income for the income year (ATO, 2019a).

4.2.2.2 Information is not available to calculate the attributable income

If the information to calculate the attributable income as per 4.2.2.1 is not available, the transferor will apply the calculation of attributable income in section 102AAZD of the ITAA. The attributable income that will be included in the transferor's taxable income will be calculated by applying a deemed rate of return on the transfer. The deemed return will be calculated on the market value of the property or the services transferred (ATO, 2019a).

The deemed return on capital will be equal to the base interest rate determined for the period in question, in terms of section 8AAD(2) of the Taxation Administration Act 1953, and an additional return of five per cent will be added. If the interest rate for the period includes more than one rate,

the weighted average interest rate will be determined and adjusted for the additional five per cent (section 102AAZD, 1936). The base rate in terms of the Taxation Administration Act 1953 for the 2019/2020 income year was as follows (for illustration purposes):

Table 4-1: Base interest rates 2019/2020 income year (ATO, 2020c)

Quarter	Annual base rate %
April – June 2020	7.89
January – March 2020	7.91
October – December 2019	7.98
July – September 2019	8.54
Weighted-average	8.08

The total deemed return on capital on the transfer of property or services for the 2019/2020 income year will be equal to 8.08 per cent plus the additional 5 per cent, as determined by section 102AAZD(4) of the ITAA (1936), therefore 13.08 per cent.

The market value of the property or services transferred to the foreign trust will be adjusted for each income year and will be equal to the market value immediately before the transfer, adding the deemed return on capital included in the taxable income of the transferor in prior years (ATO, 2019a). In the first year that the transfer occurs, the deemed return on capital for the trust will be adjusted for the days in the income year that the property or services were transferred to the foreign trust in relation to the total days in the income year (Section 102AAZD, 1936). The calculation will be performed for each transfer of property or services by the transferor (ATO, 2019a).

The net income to include in the transferor's taxable income in an income year will be determined by whether the transferor has the necessary information to calculate the net income of the foreign trust in terms of Australian income tax legislation or not. The calculation of the attributable income to be included in the taxable income of the transferor will have to be considered on a case-by-case basis.

4.2.3 Structure captured by the transferor trust provisions

The structure that will be captured in terms of the transferor trust provisions in the ITAA can be illustrated as follows (own compilation):

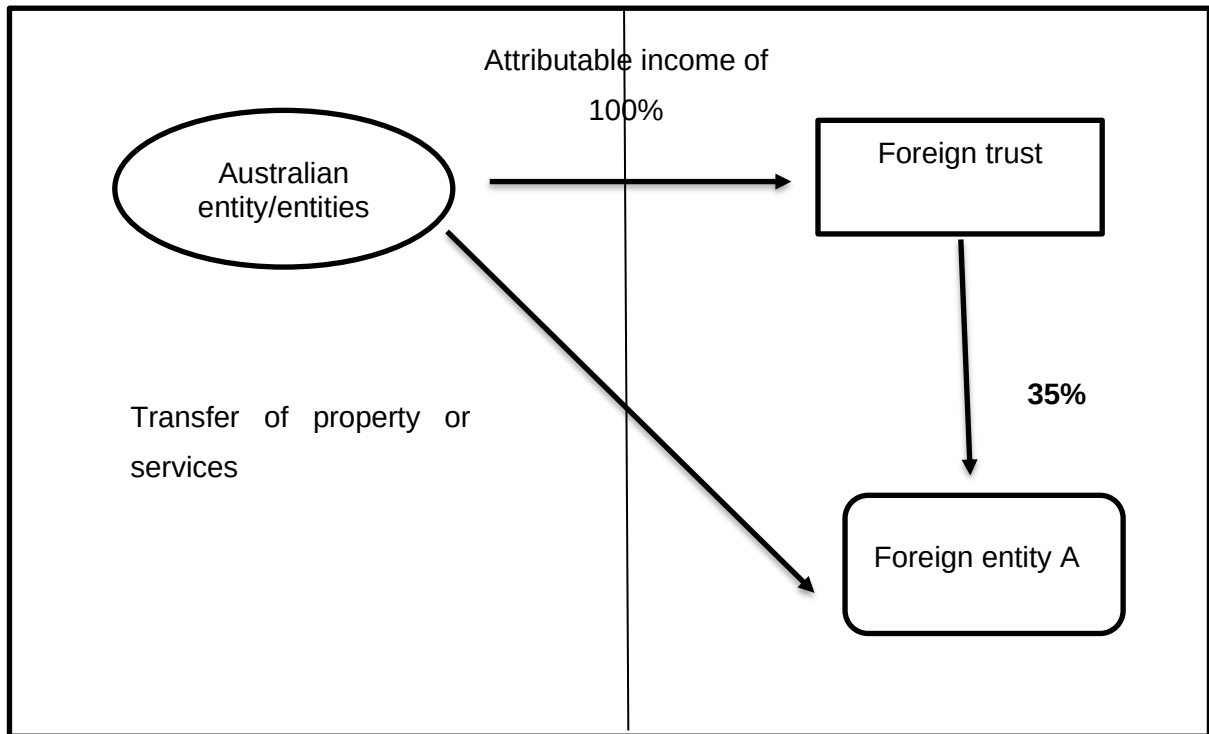


Figure 4-1: Structure captured by the transferor trust provisions in the ITAA

In terms of the transferor trust provisions, the Australian entity transferring the property or services to the foreign trust or for the benefit of the foreign trust, will be taxed on the transfer in Australia. The total amount included in the Australian resident's income will depend on whether the information for calculating the income of the foreign trust as if the trust were a resident of Australia is available or not.

If the information is available to the Australian entity, the total income of the foreign trust calculated as if the trust were an Australian entity will be included in the Australian resident's taxable income. If there was more than one transferor in the income year, the Australian resident will have to apply for a reduction in the foreign trust's income included in the resident's taxable income. If the information is not available to the Australian resident, the amount to be included in his/her taxable income will be calculated using the market value of the property transferred, immediately before the transfer, multiplied by the deemed return on capital. As a result of the transfer of property or services to the foreign trust or for the benefit of the foreign trust, the Australian entity will have an attributable income of 100 per cent in both instances.

4.2.4 Comparison of the tax treatment in South Africa and Australia

A comparison of the tax treatment in Australia and South Africa will be performed by considering the tax consequences of the following scenario in the ATO (2007b:18) Taxation Ruling 2007/D8 Income tax: application of the transferor trust and controlled foreign company measures where property or services are transferred to a non-resident company owned by a non-resident trustee:

“Blue, an Australian resident taxpayer establishes a non-resident discretionary trust, “SwissTrust”, in Switzerland, on 1 January 2005. The terms of the trust deed have the effect that, apart from a named charitable institution, only members of Blue's family can be added as beneficiaries. SwissTrust owns 100% of the shares in “ACo” which owns 100% of the shares in “GCo”, both companies being incorporated in Guernsey. SwissTrust does not have any other assets. On 1 April 2005, Blue gives \$10 million to GCo for nil consideration.”

“... except that ACo only owns 30% of GCo's shares and does not hold any indirect interest, nor are there associates or any other Australian resident entities with direct or indirect interests in GCo.”

The scenario above can be illustrated as follows (adapted from ATO (2007b:18):

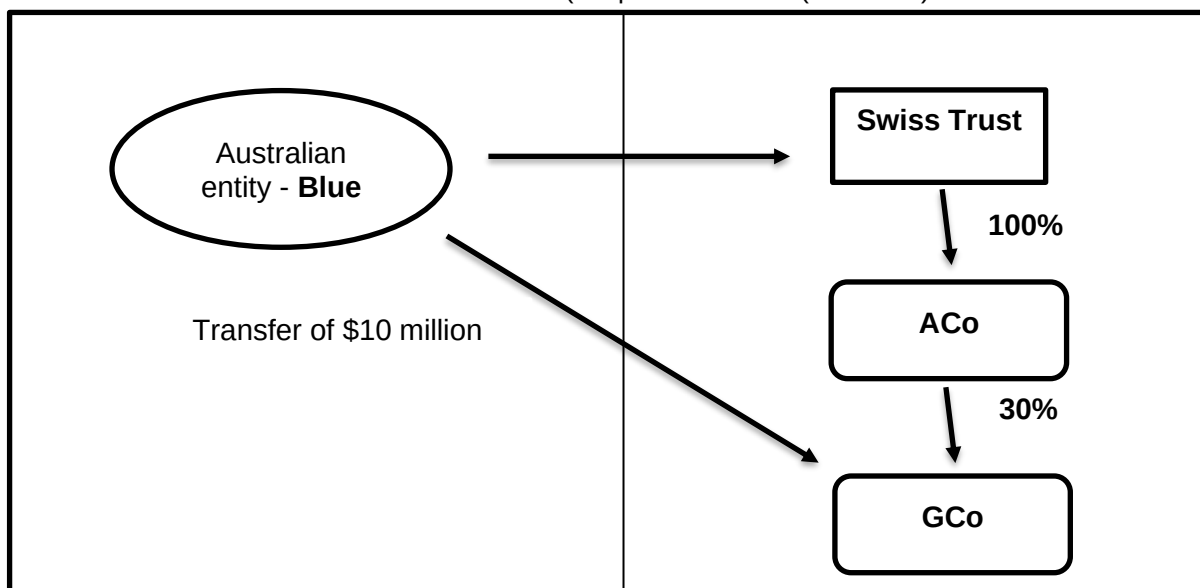


Figure 4-2: Taxation Ruling 2007/D8 Transferor trust structure

4.2.4.1 Tax consequences in Australia

In terms of the transferor trust provisions, an Australian entity transferring property or services to a foreign trust or for the benefit of a foreign trust will be taxed in Australia as a result of the transfer. The total amount included in the Australian resident's income will depend on whether the information for calculating the income of the foreign trust as if it were a resident of Australia is available or not.

The Australian entity, Blue, transfers \$10 million to GCo and SwissTrust holds an indirect interest of 30 per cent in GCo through ACo. The transfer of \$10 million will be a transfer of property or services, as money is specifically included in the definition of transfer of property (section 102AAB, 1936). The transfer of property to GCo will be for the benefit of SwissTrust as a result of the indirect interest in GCo. SwissTrust can therefore obtain a benefit from the transfer of \$10 million made to GCo by Blue. The transfer of \$10 million for nil consideration by Blue to GCo will not be in the course of carrying on a business, as the nature of the transfer does not involve a profit-making purpose and the transfer is not at arm's length. This is because the transfer will not be made on the same terms in the ordinary course of business to any other third party (ATO, 2019a). The exceptions included in the transferor trust provisions will therefore not apply to the transfer of \$10 million made by Blue to GCo for the benefit of SwissTrust and thus this transfer will fall within the ambit of the transferor trust provisions.

If the information for calculating the total income of SwissTrust as if it were a resident of Australia is available to Blue, 100 per cent of SwissTrust's income will be included in Blue's income for the income year. If the information is not available to Blue for calculating the income of SwissTrust, Blue will include the deemed return on capital for the transfer of the \$10 million to GCo for the benefit of SwissTrust. For purposes of this case study it is determined that Blue does not have sufficient information to calculate the income of SwissTrust as if it were a resident of Australia.

Accordingly, Blue will include the deemed return on capital resulting from the transfer of \$10 million to GCo for the benefit of SwissTrust for the income tax year. This return will be equal to the base interest rate determined for the period in question in terms of section 8AAD(2) of the Taxation Administration Act 1953 and an additional return of five per cent. If the interest rate for the period includes more than one rate, the weighted average interest rate will be determined and adjusted for the additional five per cent of return (Section 102AAZD, 1936). The base rate in terms of the Taxation Administration Act 1953 for quarter 4 of the 2004/2005 income year was as follows:

Table 4-2: Base interest rates 2004/2005 income year quarter 4 (ATO, 2020c)

Quarter	Annual base rate
April – June 2005	12.63%

The deemed return on capital that will be included in the income for the income year will be calculated by using the market value of the property transferred to GCo immediately before the transfer, i.e. \$10 million, multiplied by the deemed return on capital of 17.63 per cent (12.63% plus 5%) (section 102AAZD, 1936). The deemed return on capital should be calculated for the period in which Blue made the transfer to GCo, therefore for the period April 2005 to June 2005 in the current income year. The total deemed return on capital to be included in the income of Blue will be the return on capital for the full income year apportioned for the three-month period, April 2005 to June 2005. The deemed return on capital for the full income year will be equal to \$1.763 million (\$10 million x 17.63%) and the portion relating to the period that the property was transferred to GCo \$439,542 (\$1.763 million x 91/365).

The deemed return on capital will be included in the income of Blue in the following income year as a result of the transfer in the current income year, by calculating the deemed return on capital on the market value of the property immediately before the \$10 million transfer, and adding the deemed return on capital of the prior income year, \$10.4 million (\$10 million plus \$439,542). The deemed return on capital will be calculated on the basis of the weighted average base interest rate for the income year plus 5 per cent (Section 102AAZD, 1936). Blue will include the deemed return on capital as a result of the \$10 million transfer to GCo in every income year following the income year in which the transfer was made to GCo.

4.2.4.2 Tax consequences in South Africa

In South Africa, specific anti-avoidance provisions in the ITA (58 of 1962) do not include the income of a foreign trust resulting from a transfer by a resident for the benefit of the foreign trust. In addition, the ITA (58 of 1962) does not include anti-avoidance provisions for a transfer to an interposed entity where the trust will benefit from the transfer. This will result in a deemed return on capital to be included in the resident's taxable income in a year of assessment. The tax treatment of the transfer of property or services to the interposed entity for the benefit of the foreign trust will therefore have to be considered in order to compare the legislation in South Africa to the legislation in Australia.

Based on the scenario, in terms of section 54 of the ITA (58 of 1962), the transfer of \$10 million to GCo will be considered to be a donation by Blue in the year of assessment. A donation is defined as any gratuitous disposal of property by a South African resident and is levied at 20 per cent on the value of the property disposed, if the value is less than R30 million (Stiglingh *et al.*, 2019:931). If the value of the property exceeds R30 million, the donations tax will be levied at 25

per cent of the value exceeding the R30 million threshold² (SARS, 2019). Blue will therefore be liable for donations tax of \$2 million as a result of the \$10 million transfer for nil consideration to GCo. In terms of section 7(8) of the ITA (58 of 1962), the South African resident will be taxed on the income of the foreign trust resulting from the donation. No other tax consequences will apply to the scenario presented above in South Africa. The South African resident will only be taxed on the profit of GCo, if GCo declares a dividend to ACo and ACo declares the dividend to SwissTrust and Blue obtains a vested right to the dividends in the same year of assessment. Blue will not obtain the foreign dividend exception in section 10B(2)(a) and will therefore be liable for income tax on the foreign dividend received from ACo.

Based on the comparison of the legislation in Australia and the legislation in South Africa, it is clear that, in South Africa, Blue would be liable for more taxation in the year the transfer was made to GCo. This is as a result of the transfer made in quarter 4 in terms of the ITAA (1936). In Australia, however, Blue would be liable for income tax in the year subsequent to the initial transfer to GCo, while the donations tax in South Africa would be a once-off amount on the gratuitous disposal of \$10 million. Accordingly, the tax consequences in Australia for the transfer to an interposed entity for the benefit of a foreign trust are more aggressive than those provided by the current South African legislation. It should therefore be considered whether the current anti-avoidance provisions in the South African legislation should be amended to address the deferral of income tax through the use of closely linked foreign trusts, even if the interposed entity is not a CFC.

The principles of the transferor trust provisions in the ITAA (1936) have been compared with the tax consequences in South Africa to include the profits of foreign entities held by a resident CFT. The impact of the differences has been considered as part of the comparison performed in Table 4.3 (own compilation):

² The exchange rate for purposes of this study was deemed to be ZAR: AUD of 1:1 in order prevent unnecessary complexity when comparing the income tax consequences between the two countries.

Table 4-3: Principles contained in the transferor trust provisions in Australia compared to the principles in South Africa

Australia	South Africa	Mechanism used by Australia to achieve taxation of transfer to a foreign company held by a CFT
In terms of the transferor trust provisions, if an Australian entity transfers property or services to a foreign trust or for the benefit of a foreign trust, the resident will be taxed as a result of the transfer of property or services.	In terms of the ITA (58 of 1962) the resident will be liable for donations tax if he/she transfers property or services to a foreign trust for a consideration of less than market value. The resident will further be taxed on the income that the foreign trust generates from the portion of the property or services transferred as a result of the deemed donation.	Both Australian and South African residents will be liable for tax as a result of the transfer of property or services to a foreign trust. However, the Australian resident will be taxed if the transfer of property or services is made for the benefit of a foreign trust and will therefore be liable for tax if the transfer is made to a foreign company held by the CFT. South African legislation does not make provision for donations made for the benefit of a foreign trust and therefore a foreign company held by the resident CFT.
If the transfer of property or services is made to a foreign company held by a foreign trust,	South African legislation does not make provision for imposing tax on a resident if	The Australian transferor trust provisions enable taxation of the profits of foreign companies held by foreign trusts by including

Australia	South Africa	Mechanism used by Australia to achieve taxation of transfer to a foreign company held by a CFT
the transfer will be made for the benefit of the CFT.	property or services were transferred for the benefit of the foreign trust. The South African resident will be liable for donations tax only in South Africa and will not be taxed on the income generated by the foreign trust as a result of the donation to the foreign company held by the foreign trust.	the transfer of property or services for the benefit of a foreign trust. If a foreign trust holds an interest in a foreign company, it will be deemed that the foreign trust will benefit from the transfer by the Australian resident.
An Australian resident will be subject to income tax as if the foreign trust were a resident of Australia. The total income of the trust, calculated as if the trust were a resident, will be included in the resident's income in the tax year if information is available to calculate the taxable income of the trust in terms of the ITAA. If no information is available for the resident to calculate the income of the foreign trust as if it	The South African legislation does not include provisions for imposing tax on a resident if a transfer of property or services was made to the benefit of a foreign trust.	Australian legislation contains two sections for the taxation of a transfer of property or services to a foreign company held by a foreign trust: a) If information is available to calculate the income tax of the trust as if the trust were a resident of Australia; and b) If information is not available to calculate the income tax of the trust as if it were a resident of Australia.

Australia	South Africa	Mechanism used by Australia to achieve taxation of transfer to a foreign company held by a CFT
were a resident of Australia, the resident will be taxed on the transfer of property or services to the foreign company based on the deemed return on capital. The deemed return on capital will be calculated on the market value of the property or services transferred multiplied by the official interest rate plus 5 per cent.		If the information is available to the Australian resident, he/she will be taxed on the total income of the foreign trust as a result of the transfer of property or services to the foreign company held by the foreign trust. This will include a CFC held by the foreign trust, because if the foreign trust is a resident of Australia it will be required to include the profits of the CFC in its income. If information is not available, the Australian resident will be taxed on the deemed return on capital as a result of the transfer, calculated by using the market value of the property or services transferred multiplied by the official interest plus an additional 5%.

The transferor trust provisions in Australia includes the transfer of property or services by a resident, to a foreign company held by a foreign trust. It should be considered whether the anti-avoidance provisions in South Africa should be amended to include specific legislation on the transfer of property or services on behalf of or for the benefit of a foreign trust.

4.3 Conclusion

The Australian ITAA (1936) includes transferor trust provisions for instances where investments in closely linked foreign trusts do not adhere to the CFT provisions included in the CFC regime. The transferor trust provisions will be triggered if a transfer of property or services is made to a foreign trust, or for the benefit of a foreign trust. The total income of the foreign trust will be included in an Australian resident's income as if the trust were a resident of Australia, if the information is available to the Australian resident. If the information is not available then the deemed return on capital will be included in the income of the resident. Both instances will result in the Australian resident including additional income for tax purposes as a result of a foreign company held by a resident CFT.

In South Africa, the ITA (58 of 1962) does not include specific anti-avoidance provisions for the income of a foreign trust or the deemed return on capital as a result of a transfer by the resident for the benefit of the foreign trust. The ITA (58 of 1962) further does not include anti-avoidance provisions where a transfer of property or services is made to a foreign company held by a foreign trust.

If a South African beneficiary transfers property or services to a foreign company held by a foreign trust, the transfer will be considered to be a donation and the resident will be liable for donations tax at 20 to 25 per cent, depending on the value of the donation, in the year of assessment. The resident will not include the income of the foreign trust in their taxable income but will only be taxed on the dividends distributed by the foreign company to the foreign trust that are in turn distributed to the South African resident in the same year of assessment.

If the anti-avoidance provisions in South Africa are amended to include the mechanism used for closely linked foreign trusts in terms of the transferor trust provision, the ambit of the South African legislation will not only include the taxation of a CFC held by a resident CFT but also any transfer of property or services where a relationship exists between a South African resident, a foreign trust and a foreign company.

CHAPTER 5 CONCLUSION

5.1 Introduction

The aim of this study was to analyse the connected foreign trust and transferor trust rules included in Australian legislation to include profits from foreign companies held by foreign trusts to determine what mechanism, if any, used by Australia can be considered to reduce the inconsistencies in the ITA of South Africa.

Where a foreign discretionary trust controls a foreign company, as stated in the definition of a CFC, and the resident is a beneficiary of the foreign trust, that resident is not necessarily subject to tax in accordance with the CFC rules. The CFC may, however, be liable for tax in accordance with the foreign trust rules of the ITA (58 of 1962), although the timing and extent of taxation and the control over the taxable amount will just be different.

The current South African legislation for CFCs and foreign trust is inconsistent with one another. Australia has implemented anti-avoidance provisions to address the inconsistent tax treatment for a CFC held by a resident and a CFC held by a foreign trust to include profits of a CFC held by a foreign trust.

The problem statement of the study (paragraph 1.3, page 4) was to determine whether mechanisms used by Australia, if any, to eliminate the inconsistency in the tax treatment to include profits of foreign companies held by foreign trusts can be considered to reduce the inconsistencies in the ITA of South Africa. The problem statement of the study was the primary objective of the study.

In order to achieve the problem statement and the primary objective, the following secondary objectives were formulated (paragraph 1.4.2, page 4):

- To consider the CFC rules set out in section 9D of the ITA (58 of 1962) and the taxation of foreign trusts to determine what the legislation currently provides in terms of including foreign income in the tax net of the Republic (Chapter 2)
- To explore the mechanism regarding the income earned by foreign companies held by foreign trusts in the CFC regime in Australia (Chapter 3)
- To determine the mechanism regarding the income earned by foreign companies held by foreign trusts in the transferor trust anti-avoidance measures in Australia (Chapter 4)

5.2 Current foreign trust and CFC regime legislation of South Africa

The first secondary objective, which was addressed in chapter 2 of the study, considered the current foreign trust and CFC regime tax legislation to determine the current provisions of legislation for including foreign income in the tax net of the Republic.

5.2.1 Current foreign trust tax legislation of South Africa

In South Africa, a trust is commonly used by residents to plan their financial future, as over the years the perception has developed that by using a trust, any legal or other barrier can be overcome (Olivier & Honiball, 2011:114). Benson and Poutasse (2018) state that trusts are not just created for tax benefits but also for family wealth, restricting access to certain assets and to give direction to individuals for the use of certain assets in the future.

The principle contained in section 25B of the ITA (58 of 1962) is generally known as the conduit pipe principle and is used as the basis for taxing resident trusts (Karriem, 2014:58). The taxation of foreign trusts is included in section 25B(2A) of the ITA (58 of 1962). Accordingly, the income of a foreign trust will only be included in the South Africa tax net if it originates from a South African source (Olivier & Honiball, 2011:564). These anti-avoidance measures are therefore not aimed at taxing the income of a foreign trust, but rather are aimed at taxing the resident on any income received or accrued from a foreign trust. Section 25B(2A) dominates all provisions in the ITA(58 of 1962), implying that a resident will not be taxed on capital amounts, only on any foreign amounts received from the foreign trust that should be classified as capital (Stiglingh *et al.*, 2019: 920).

Section 7 of the ITA (58 of 1962) contains tax provisions that will generally apply when any income is received by a trust by virtue of a “donation, settlement or gratuities disposition” by any person. That person will then be taxed on the “donation, settlement or gratuities disposition” in his personal capacity. Section 7(8) thus taxes the founder, beneficiaries or any other person who made a “donation, settlement or gratuities disposition” to a resident or foreign trust and, thus, the trust will not be taxed on these amounts in the Republic. A similar principle for capital gains tax purposes is included in the ITA (58 of 1962), where a capital gain is vested in a beneficiary of a resident trust. In that case, the capital gains tax should be included in the beneficiary’s income tax and the trust will not be liable for the capital gains tax in its own capacity (Sevenster, 2013).

5.2.2 Current CFC tax legislation in South Africa

The CFC regime in section 9D was introduced in 1997 as an anti-avoidance rule to prevent South African owned foreign companies and entities from going untaxed when a resident taxpayer

defers the income of that foreign company that accrues to the him/her (Van Heerden, 2009). When the CFC rules were initially introduced into the South African tax legislation, they were only applicable to passive income received by the South African owned foreign entity. In 2001, the anti-avoidance rules were extended to include certain active income of the CFC in the calculation of its net income and the limitation on the inclusion of certain passive income was amended (National Treasury, 2000a). The intention was to include all foreign income in the South African tax net in order to prevent avoidance through a foreign company (Olivier & Honiball, 2011:561).

A CFC can be defined in accordance with section 9D (1) of the ITA (58 of 1962) as a company that is a non-resident in which a resident jointly or separately, directly or indirectly holds more than 50 per cent of the participating and voting rights. CFC rules were implemented with the objective that a taxpayer that diverted income through a foreign company would be left in the same position as if that income had accrued directly to the taxpayer (Stiglingh *et al.*, 2019:827).

Section 9D(2) of the ITA (58 of 1962) determines the time and apportionment of the foreign company's income that has to be included in the taxpayer's taxable income. When a CFC's net income is determined it has to be deemed as if that foreign company were a resident of the Republic and therefore the income should adhere to the provisions of section 9(2A) of the ITA. The CFC will be taxed on all income as South African residents are taxed on worldwide income. The South African resident will include the income of the CFC in his/her taxable income for the year of assessment in apportionment to the interest held by the resident.

5.2.3 Amendments to the ITA to address the taxation of CFCs held by a connected resident trust

The government of South Africa was concerned about the CFC regime as early as 2008. It was noted that the current CFC legislation did not capture taxation on CFCs held by a CFT (Kotze, 2017:33). In the 2018 Draft Taxation Law Amendment Bill, National Treasury (2018:47) proposed new amendments to the ITA (58 of 1962) to address such CFCs. The proposed amendments included new subsections in the trust anti-avoidance rules, section 25B and section 7(8). It was further proposed that paragraphs 72 and 80 of the Eighth Schedule be amended to include the profits of a CFC held through a resident CFT.

It was also proposed that section 25B should be amended to include subsection 25B(2B). This new subsection determines that for any amount received from a foreign trust, where that amount is derived from a CFC, the section 10B(2)(a) foreign dividend exemption should be disregarded. This indicates that the resident will not qualify for the exemption of foreign dividends, but the resident will not be taxed on the foreign company's net income in terms of the CFC regime

(National Treasury, 2018). An amendment to section 7(8) in the ITA (58 of 1962) was also proposed such that when a resident includes income resulting from a donation from a foreign trust, settlement or other dispositions to that foreign trust, the foreign dividend exemption should also be disregarded.

The amendments in the 2018 Taxation Law Amendment Bill were implemented in the ITA (58 of 1962) to include CFCs held through a CFT in the South African tax net. The new subsections do not make any provision for accumulating income in the foreign company that will have a direct influence on the shares of that foreign company. These new subsections will include a portion of the profits of a CFC held through a resident CFT when the CFC declares dividends to the South African resident, but the tax treatment between the CFC regime and the trust anti-avoidance provisions is still inconsistent, regardless of National Treasury's attempt to narrow them down to a single tax treatment.

The study showed that the tax treatment of a CFC and a foreign trust is not consistent, therefore when a CFC is held by a resident CFT, the South African resident will not be taxed so aggressively as in the normal CFC regime. The CFC rules require that the resident include the total apportionment of the net income of that CFC in his/her taxable income, thus a resident who is a beneficiary of a foreign trust will only be taxed on the income of the trust if he/she received a contingent or vested right to the income from the trust, even if the amount received by him/her is capital in nature.

The newly implemented subsections in the ITA (58 of 1962) include foreign dividends from a resident CFT resulting from a CFC in relation to the foreign trust. The tax treatment of a CFC and a foreign trust is still not consistent, therefore when a CFC is held by a resident CFT, the resident will not be taxed on the comprehensive income of the foreign trust as in the normal CFC regime.

5.3 Mechanism used by Australia to impose income tax on CFCs held by a foreign trust in Australia

The second secondary objective to explore the mechanism regarding the income earned by foreign companies held by foreign trusts in the CFC regime in Australia, was addressed in chapter 3 of the study.

Australia introduced the CFC regime in the Income Tax Assessment Act (hereafter ITAA) in December 1989 to combat the deferral of income tax by Australian by means of accumulating income in offshore entities (Azzi, 1994). A CFC held by a resident CFT will be taxed in terms of the CFC regime in Australia if the control test for a CFT is satisfied. This control test determines

that if there is a group of five or less Australian one per cent entities and the total aggregated associated inclusive control interest in the trust is equal to 50 per cent or more, the CFT provisions should be applied (Waterhouse, 2015). A one per cent Australian entity, as per the control test, is an entity with an associated inclusive control interest of at least one per cent in the foreign trust.

According to CCH Australia Limited (2011:1187), associated inclusive control is the accumulated direct and indirect control interest held by a taxpayer together with the direct and indirect control interest of the associates of the taxpayer. Direct control interest will not be applicable to the beneficiaries of a discretionary trust, as the beneficiaries will not be entitled to income from the foreign trust unless they obtain a vested right in the income. The indirect control interest will be the control tracing interest of the Australian beneficiary in the foreign trust. An Australian entity will have a control tracing interest of 100 per cent if the entity is an eligible transferor at any point in time in relation to the CFT (ATO, 1990).

An Australian entity will be an eligible transferor in relation to a discretionary trust at any point in time if it adheres to all the requirements of section 347 of the ITAA (1936) (ATO, 1992). The following summarises the requirements for an Australian entity to be an eligible transferor in terms of section 347 of the ITAA (1936):

- the Australian entity transferred property or services to the discretionary trust at any given time
- the transfer made by the Australian entity was not transferred in the normal course of business as a business transaction, or
- the transfer was an arm's lengths business transaction, but the Australian entity was in a position to control the trust.

An Australian entity will be in a position to control a trust if the entity, together with its associates or on its own, can obtain the beneficial enjoyment of the transfer without the consent of any other entity. The Australian entity directly or indirectly controls the income of the trust if the trustee of the trust is expected to act in terms of directions, formally or informally, from the Australian entity on its own or together with its associates, or it has the power to remove or appoint trustees in relation to the trust (section 347(2), 1936). If the associated inclusive control of the Australian entity is more than 50 per cent in terms of the CFC provisions and the Australian entity is an eligible transferor in terms of the CFT provisions in relation to another entity, it will be taxed on the income of the foreign entity (ATO, 2007).

The study determined that the CFT income tax provisions included in the ITAA (1936) determines that the attributable income of a CFC held by a resident CFT will be included in the Australian

entity's income for the tax period but not in the South African resident's taxable income. The attributable income of the CFC held by the resident CFT will only be included if the Australian entity made an eligible transfer of property or services to the CFC held by the resident CFT. The attributable income that will be included in the Australian resident's income will be calculated by multiplying the control tracing interest, which is deemed to be 100 per cent, multiplied by the direct and indirect interest of the foreign trust in the CFC.

In South Africa, the ITA (58 of 1962) does not include specific anti-avoidance provisions for a CFC held by a resident CFT. If a South African beneficiary transfers property or services to a CFC held by a resident CFT, the transfer will be considered to be a donation and the resident will be liable for donations tax at 20 to 25 per cent, depending on the value of the donation, in the year of assessment. Moreover, the resident will not include a portion of the income of the CFC held by the CFT in his/her taxable income. The South African resident will only be taxed on the dividends distributed from the CFC to the foreign trust that are distributed to the South African resident in the same year of assessment. It should therefore be considered whether the current anti-avoidance provisions in the South African CFC regime should be amended to include specific provisions for CFCs held by resident CFTs. This can be achieved by including the deemed control tracing interest principle when property or services are transferred to a CFC held by a resident CFT as part of the indirect participation rights of the resident in the profits of the foreign company.

5.4 Mechanism used by Australia to impose tax on the income earned by foreign companies held by foreign trusts in the transferor trust anti-avoidance measures

The third secondary objective was to determine the mechanism for the income earned by foreign companies held by foreign trusts in the transferor trust anti-avoidance measures in Australia. This was addressed in chapter 4 of the study.

The Australian ITAA (1936) includes transferor trust provisions in instances where investments in closely linked foreign trusts do not adhere to the CFT provisions included in the CFC regime. The transferor trust provisions in the ITTA (1936) aim to remove opportunities for Australian residents to defer taxation through foreign trusts (Lamb, 2013). Investments in closely linked foreign trusts held by Australian residents were initially taxed through the anti-deferral regime for foreign investment funds.

A foreign trust will be subject to the transferor trust rules if an Australian resident transfers property or services to a foreign trust and the income of that trust is not included in the taxable income of one or more Australian residents (ATO, 2019a). The Taxation Institute of Australia (2007) argues

in this regard that the Australian resident who transfers property or services to a non-resident trust is likely to benefit as a result of the transfer to the non-resident trust.

An Australian resident will be subject to the transferor trust measures if he/she transferred property or services to a non-resident trust and no exemptions are applicable to this transfer (ATO, 2019a). The transfer of property or services includes transfer of any property or services by the creation of the foreign trust, by transferring property or services that did not previously exist, by creating property or services and then transferring them to the trust, by transferring property or services to discharge debt and by transferring property or services for the benefit of the foreign trust (Thompson, 2007).

The transferor trust exemption for discretionary trusts includes two requirements that have to apply to the transfer of property or services to a foreign trust (Thompson, 2007). The two requirements include that the transfer was made in the course of carrying on a business and the transfer was made at arm's length to the foreign trust by the transferor (ATO, 2019a). If the transferor trust regime applies to the transferor of property or services to a foreign trust by an Australian resident, he/she will be an attributable taxpayer in relation to the foreign trust and the attributable income of the transferor will have to be determined in relation to the foreign trust.

The attributable income of the trust should be determined before the portion that will be included in the Australian resident's taxable income can be determined. The rules contain two sections to determine the income that will be included: one if the Australian resident can obtain the necessary information and the other if the Australian resident cannot obtain the necessary information to determine the attributable income of the non-resident trust (ATO, 2019a).

The study determined that the total income of the foreign trust will be included in the Australian resident's income, as if the foreign trust were a resident of Australia, if the information is available to determine the attributable income of the non-resident trust. If the information is not available to the Australian entity, the deemed return on capital will be included in his/her income. The deemed return on capital will be equal to the market value of the transfer of property or services multiplied by the base interest rate determined for the period in question and adding an additional return of five per cent. Both instances will result in the Australian entity including additional income for tax purposes.

In South Africa, the ITA (58 of 1962) does not include specific anti-avoidance provisions for the income of a foreign trust or the deemed return on capital as a result of a transfer by the resident for the benefit of the foreign trust. The ITA (58 of 1962) further does not include anti-avoidance

provisions where a transfer of property or services is made to a foreign company held by a foreign trust.

If a South African beneficiary transfers property or services to a foreign company held by a foreign trust, the transfer will be considered to be a donation and the resident will be liable for donations tax at 20 to 25 per cent, depending on the value of the donation, in the year of assessment. The resident will not include the income of the foreign trust in their taxable income but will only be taxed on the dividends distributed by the foreign company to the foreign trust that are in turn distributed to the South African resident in the same year of assessment.

If the anti-avoidance provisions in South Africa are amended to include the mechanism used for closely linked foreign trusts in terms of the transferor trust provision, the ambit of the South African legislation will not only include the taxation of a CFC held by a resident CFT but also any transfer of property or services where a relationship exists between a South African resident, a foreign trust and a foreign company.

5.5 Recommendations

The findings of the study indicate that the mechanism used in the CFT provisions, included in the CFC regime in Australia as the primary anti-avoidance measures, and the mechanism used in the transferor trust provision can be considered to reduce the inconsistent tax treatment of a CFC held by a resident CFT. If the treasurer deems it necessary to reduce the inconsistent tax treatment in South Africa, the following recommendations are made in terms of the mechanisms used in Australia:

5.5.1 Recommendation to amend the CFC regime to include CFT anti-avoidance provisions

It should be considered to include CFT anti-avoidance measures in the CFC regime as the primary anti-avoidance measure for including the profits of foreign companies held by resident CFTs. Similar measures, as included in the ITAA (1936), could be considered to expand the South African tax net when a resident beneficiary makes an eligible transfer to a CFC held by a resident CFT. This can be achieved by considering the following principles from the ITAA (1936):

- It should be considered to amend the CFC regime to include deemed control tracing interest rules for an eligible transfer of property or services from a resident to a CFC held by a resident CFT.

- Participating rights in the ITA (58 of 1962) refers to the ability and right of the taxpayer to participate in all or parts of the distributions made by a company and any right to benefits that the taxpayer will be entitled to because of his shareholding in that foreign company.
- It is therefore recommended, if necessary, that the CFC legislation be amended to include the deemed control tracing interest principle as part of the definition of participation rights, if the resident made an eligible transfer to the CFC held by the CFT.
- If the participation right definition is amended to include deemed control tracing interest and if more than one eligible transfer is made, provision should be made for a resident to apply to reduce the control tracing interest in the year of assessment. This will prevent double taxation on the profits of the CFC held by the resident CFT.

If the South African legislation were amended to include the deemed control tracing interest rules, the inconsistent tax treatment will be eliminated when a CFC is directly held by a resident and when a foreign trust as intermediary between the resident and the CFC. The control tracing interest principle will further prevent that structures are caught when the intent is not to defer taxation, as the resident has to make an eligible transfer on behalf of the trust to the CFC for it to apply.

5.5.2 Recommendation to amend foreign trust rules to include transfers of property or services to a foreign company held by a CFT

If it is deemed inappropriate to include the CFT provisions in the South African CFC regime, it should be considered to amend the current foreign trust anti-avoidance provisions to expand the tax net of foreign companies held by CFTs as an alternative. This can be achieved by considering the following principles of the ITAA (1936):

- It should be considered to amend Section 7(8) to include a “donation, settlement or gratuities disposition” to a foreign entity held by the resident CFT. The resident would then be taxed on the income of the trust resulting from the deemed donation to the foreign entity held by the resident CFT.
- If section 7(8) were amended to include a deemed donation to a foreign company held by a foreign trust, it should be considered whether the taxation on the “donation, settlement or gratuities disposition” to a foreign company held by a CFT should be based on the deemed return on capital principle in the ITAA (1936). This principle is similar to the deemed donation provisions included in section 7C for low-interest or interest-free loans to trusts.

The above amendment would not eliminate the inconsistency but will reduce the inconsistency between the tax treatment of a CFC held directly by a South African resident and when a foreign trust is held as an intermediary between the resident and the CFC.

5.6 Conclusion

The current provisions of the CFC regime regarding the imposition of tax on a foreign company directly held by a resident and the anti-avoidance measures for foreign trusts to impose tax on a CFC held by a resident CFT, are not consistent. The CFC regime determines that a resident should include the attributable income of the CFC in his/her taxable income, whereas a beneficiary of a foreign trust will only include the income from the CFC held by the resident connected trust if the beneficiary has a vested right in the income.

The anti-avoidance measures included in the Australian ITAA (1936) include CFT provisions as part of the CFC regime and transferor trust provisions for including income emanating from a company held by a resident CFT. The CFT provisions in the CFC regime in Australia determine that an Australian resident will include the income of the CFC held by the CFT, if he/she made an eligible transfer to the CFC. The transfer trust provisions further determine that an Australian resident should include income for tax purposes as a result of a transfer made to an entity where the trust has an interest in that entity, even if the entity is not a CFC.

The analysis carried out to compare the current South African tax legislation and the Australian legislation on tax of residents with an interest in a foreign entity through a CFT has shown that it should be considered to amend the provisions of the South African ITA (58 of 1962), if the treasurer deems it necessary to reduce the inconsistent tax treatment. This can be achieved by introducing control tracing interest rules in the CFC regime as a primary mechanism for including foreign entities held by a resident CFT or by including transfers to foreign companies held by a resident CFT within the ambit of section 7(8) of the ITA (58 of 1962).

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To whom it may concern

This is to certify that I, Alexa Kirsten Barnby, an English editor accredited by the South African Translators' Institute, have edited the master's mini-dissertation titled "An analysis of the South African tax treatment of interests in foreign companies held through foreign trusts" by Melishe Swart.

The onus is on the author, however, to make the changes and address the comments made.

