AN EVALUATION OF CONSEQUENCES OF THE CONTROLLED FOREIGN COMPANY PROVISIONS OF THE SOUTH AFRICAN INCOME TAX ACT

by

ROBERT POTGIETER

MINOR DISSERTATION

submitted in the fulfilment of the requirements for the degree

MAGISTER COMMERCII

in

SOUTH AFRICAN AND INTERNATIONAL TAXATION

in the

FACULTY OF ECONOMIC AND FINANCIAL SCIENCES

at the

UNIVERSITY OF JOHANNESBURG

SUPERVISOR: Prof. Lynette Olivier

MAY, 2012

SUMMARY

In the Introduction to this study, two potential measures of effectiveness of controlled foreign company (hereinafter "CFC") rules (as anti-avoidance legislation) are identified, namely the extent to which tax avoidance or deferral is prevented, and the extent to which those business undertakings and investments for which tax avoidance or deferral is not the sole or main purpose or effect are complicated or subjected to disincentives, with the focus of the study being on the latter.

Section 9D of the Income Tax Act 58 of 1962 (South Africa: 2012a), (hereinafter "the Act", to which all otherwise un-referenced section references also refer) operates within the context of the worldwide basis of taxation adopted by South Africa and its related provisions. The study of the fundamentals of section 9D demonstrates that residents who, alone or together with one or more "connected persons", invest in "foreign companies" which meet the definition of a "controlled foreign company" in section 9D(1), and who meet the minimum holding requirement of at least 10% of either participation rights or voting rights (proviso (A) to section 9D(2)), are subjected to the inclusion in their income for tax purposes of a notional amount equal to their proportion of participation rights in the CFC applied to the CFC's net income (section 9D(2)), unless any exemption or exclusion from the provisions of section 9D of the Act applies.

A foreign company meets the CFC definition (subject to provisos) if residents "directly or indirectly" hold over 50% of participation rights or voting rights. The legislature is understood to have intended this section as both an anti-deferral and anti-avoidance measure regarding income tax, within the context of the intention of the legislature to tax South African residents on a worldwide basis. Relief is provided where limitations in the jurisdiction of residence of a CFC would inhibit the funding of a resident's tax liability by way of CFC dividends (section 9A), however not when such dividends are not forthcoming for other reasons.

The study highlights in a number of areas that when section 9D of the Act is measured against the extent to which business is complicated or subjected to disincentives, it may fall short in that the section is found to both introduce considerable complexity, and to contain a number of uncertainties and potential pitfalls which may introduce risk and compliance cost for resident investors in CFCs. The section appears however to be effective in its prevention of avoidance or deferral of tax, which is its main purpose, although it is submitted that the section does have wider implications for resident taxpayers. Further legislative focus appears to be warranted with a view to alleviating those impacts which may be undesirable from a policy point of view.

Negative impacts may include potential reduced after-tax investment returns; increased taxation uncertainty; increased administrative costs; and increased requirements for scarce business resources.

The impact of uncertainty or ignorance of CFC status or of a qualifying participation in a CFC by a resident may be severe, given the penalty provisions of the Act and the anticipated Tax Administration Bill (South Africa, 2011b). Residents however have limited, if not no recourse at all, to rulings in relation to the operation of section 9D.

Alternative bases for apportionment of net income in years where CFC status changes, may potentially have a significant bearing on the calculation of CFC net income. Restrictions apply in regard to deductibility of certain expenses in relation to other CFCs and transfer pricing requirements may also introduce considerable uncertainty. The foreign business establishment (hereinafter "FBE") exemption (section 9D(9)(b) read with section 9D(9A)) additionally introduces both complexity and risk (consequent upon uncertainty arising from among others, the arm's length requirement for amounts attributable to an FBE) to resident investors in a CFC. Where specific exemptions do not cover active business income, such income continues to fall within the ambit of section 9D. Resident taxpayers are however not assisted by the fact that official publications and guidance on section 9D (apart from the Act itself) are lacking in that these are found to be either out of date or excessively brief. The provision of up-to-date guidance would therefore appear to be warranted.

South African taxable income of a CFC is excluded from its net income (section 9D(9)(e)), so avoiding economic double taxation on such income. Economic double taxation is also averted through the exclusion of dividends received by a CFC from another CFC (section 9D(9)(f)) and the foreign tax credit (section 6*quat*(1)(b), 6*quat*(1A)(b) and section 72A(3)). The act has been simplified through the elimination of elections in regard to the exclusion from net income of certain passive amounts transacted with another CFC, however the elimination of provisions for specific rulings has eliminated a mechanism for residents to pursue in order to deal with uncertainty (and consequently risk).

Where the FBE exemption applies, amounts attributable to an FBE are excluded from CFC net income (section 9D(9)(b) read with section 9D(9A)). The narrow scope of the exemption, as well as its excessive associated peremptory requirements may result in active business income falling within the ambit of section 9D of the act, however with differing tax consequences to those which may apply to the contrasted case of a permanent establishment ("PE") under a double taxation agreement ("DTA"). Residents may therefore benefit if the concept of an FBE were to be further aligned with the internationally accepted concept of a PE under a DTA. Further the "arm's length" and independence requirements contained in the section 9D(9)(b) from 1 April 2012 may create considerable uncertainty for a resident investor in a CFC which has a FBE, which uncertainty may be reduced, but by no means eliminated, by means of a sound and objectively justifiable transfer-pricing policy. Also, transfer pricing requirements of section 31 of the Act may apply between two CFCs that are not even part of the same group of companies.

Complexity or compliance cost concerns in relation to CFC legislation may not be entirely unique to South Africa given that a number of advanced countries have similar legislation (Olivier and Honiball, 2011: 561). The breadth of exemptions in respect of legitimate active business income available under the Act may nevertheless not be sufficient to avoid the inclusion of such income within section 9D of the Act.

Over the longer term, tax considerations, including CFC laws, can be expected to form part of location decisions in order to optimise multinational businesses (Wilson, 1993:228/229). Corporate tax competition can further be expected to lead to pressures for corporate tax rate reductions. Internationally, corporate tax rates have been on a reducing trend, and South Africa's corporate tax rate is above the international norm and its VAT rate is below the international norm, as published by KPMG International (2010: 14). McKinsey's statistics set out in Table 5.1 (Chapter 5: 5.2) indicate the potential existence of a strong case for the domestic benefits of outbound multinational investment and of containing the burdens of both taxation and government regulation. The headquarter regime may to an extent compensate by seeking to attract inbound multinational investment in holding companies (as opposed to a company to house the majority of centralised headquarter activities), however the CFC regime offered by section 9D may in other cases result in both residents and non-residents choosing to steer clear from its provisions wherever possible. Nevertheless, where the requirements of the FBE exemption can be met, resident investors in a CFC possessing such a FBE might derive a deferral benefit to the extent that the CFC is resident in a lower tax jurisdiction.

If implemented in future, a simpler and more efficient CFC system could benefit potential and current investors. The requirement imposing a South African taxation calculation on the results of a foreign entity can be expected to impose an additional administrative load, both on resident taxpayers and on SARS. The example of the Office of Tax Simplification within HM Treasury department in the United Kingdom as well as the approach in that jurisdiction of a principle of "all out unless in" (HM Treasury, 2012b: 2) and "gateway" approach (HM Treasury, 2012b: 3) in their CFC rules, are pointed to as an admirable example which may benefit from further consideration. Arguably investments in active international businesses of substance should be more widely excluded from attribution, as the intention behind such income is arguably less likely to be avoidance

The current 75% high taxed exemption provides no relief from the considerable determinations which are required to arrive at the point of exemption, which is found to contrast poorly with the United Kingdom's "excluded territories exemption" (which is a simple test based on the headline income tax rate) (HM Treasury, 2012a: 5 and 2012b: 18). Limitations exist on setting off of CFC losses, without relief for subsidiaries in the loss-generating developmental phase of their business lifecycle, and unlike the comparable position in the United Kingdom (HM Treasury, 2012a: 5) no grace period is provided to fulfil the FBE exemption following a corporate acquisition. The other United Kingdom exemptions targeted at simplification and narrowing of scope of its CFC rules may also be worthy of further consideration in the domestic South African context.

The arm's length principle applicable to an FBE appears to increase uncertainties. Given these uncertainties and those introduced by the application of transfer pricing concepts in relation to section 9D, as well as the fact that peremptory diversionary transactions rules may not always accurately distinguish between diversionary income and legitimate active business income, it is recommended that the internationally established practice of pro-active Advance Pricing Agreements should be further explored by the legislature, leveraging existing international experience with a view to provide taxpayers a mechanism for both acquiring greater certainty in relation to their investments in CFCs, as well as to avoid potential later disputes and potential penalties.

TABLE OF CONTENTS

LIST OF TABLES **Page**

CHAPTER 1 – INTRODUCTION

1.1 Background

With reference to foreign dividends in particular, a partial residence-based system of tax was introduced by the South African legislature as early as 1997, effective as of 1998. Readers may wish to refer to Olivier & Honiball (2011: 108) who present, for example, a succinct summary of the historical foreign dividend exemptions. In 2001 South Africa implemented a residence-based tax system whereby South African resident taxpayers are taxed on their worldwide income, having migrated from a previous source-based tax system, the legislature at that time having accordingly amended the gross income definition in section 1 of the Income Tax Act, No 58 of 1962 (South Africa, 2012a) (which is simply referred to in this study as "the Act", to which all otherwise-unreferenced legislative section references in the study also refer). The South African Controlled foreign company (hereinafter "CFC") legislation therefore operates as an integral part of this worldwide taxation system.

A number of commentators cast light on the intent of Section 9D of the Act. For instance, it has been said that it is primarily an anti-avoidance measure aimed at investments of capital through foreign companies by South African residents (Meyerowitz, 2007:9.114). De Koker (2011:§1.10) has pointed out that "In the absence of specific anti-avoidance provisions, it would be a simple matter for taxpayers to avoid tax on foreign income by re-routing the income through an offshore company and by accumulating or capitalizing such income in the company." Olivier & Honiball (2011: 559) note that "in the absence of remedial legislation, significant tax benefits may flow from earning foreign income in the name of a separate taxpayer, especially if the taxpayer is situated in a tax haven", and observe that in order "to counter the avoidance or deferral of tax, countries attempt to draw within their tax nets income accrued to or received by foreign corporations over which their residents have a degree of control".

Section 9D has been explained by the South African National Treasury department ("National Treasury") as being "designed to prevent deferral [of taxation liabilities] through South African owned foreign entities", which they consider to be very important because "taxpayers often delay repatriation for years or never repatriate funds at all" (own insertion) (National Treasury, 2002:1). Olivier and Honiball (2011: 558) further observe that "it is in the context of direct investments"… "where the investor has a large enough interest to influence the operations of the company" that CFC rules are relevant, contrasting such investments with "portfolio investment" (where the investor has little or no influence). The CFC regime is therefore a continuation in a long-standing on-going effort by the legislature to ensure that the foreign income of residents is effectively taxed.

National Treasury's initial solution to this problem in tax collection was, *via* section 9D, to tax "South

African owners on the foreign income earned by their controlled foreign entities as if those foreign entities immediately repatriated their foreign income when earned", explaining further that "International Law does not allow South Africa to directly tax foreign entities on their foreign source income, even if those entities are completely owned by South African residents" (National Treasury, 2002:1). Subsequently section 9D was refined to apply to companies only, therefore the above reference to controlled foreign entities now applies only to a "Controlled Foreign Company" as defined in section 9D(1). Olivier and Honiball (2011: 559) note that such rules are generally referred to as "controlled foreign corporation" rules internationally.

More recently, National Treasury has stated that the "main purpose of controlled foreign company rules is to prevent South African residents from shifting passive income offshore" (National Treasury, 2011a:73). It has clarified that "the CFC regime taxes certain income generated by South African controlled foreign companies on an accrual basis. More specifically, the CFC rules impose tax on South African residents in respect of their proportionate share of CFC tainted income" (National Treasury, 2012:103). It is further explained that "Tainted income consists of passive (or highly mobile) income as well as diversionary income. Passive income includes interest, dividends, royalties, rentals, annuities, exchange differences, insurance premiums, similar income and associated capital gains. Diversionary income generally includes income derived from suspect transactions between a CFC and a resident that will likely lead to transfer pricing concerns. Tainted (passive or diversionary) income is fully taxable in South Africa because CFC ownership of this income poses a high risk to the tax base" (National Treasury, 2012:103).

The Act indicates in section 9D(2) that the actual mechanism is for those residents having qualifying direct or indirect participation rights in foreign companies falling within its provisions, to include a notional amount of the income of such companies, referring to "on the last day of the foreign tax year" including in income "an amount equal to" a portion of such companies' foreign "net income" (as defined in section 9D), calculated with reference to the percentage of participation rights of the resident, modified by certain refinements for any change in status to or from being a controlled foreign company during the relevant foreign tax year. Residents' indirect participation rights *via* local companies other than headquarter companies (as defined in section 1) are however ignored (proviso (B) to section 9D(2)), in order to prevent a potential cascading effect of duplicated tax charges. Sections 6*quat*(1)(b), 6*quat*(1A)(b) and section72A(3) then provide for a potential rebate (unilateral tax credit) for the foreign taxes of residents through the deduction of a rebate from the income tax payable where such resident's taxable income includes a proportionally attributed amount in regard to the net income of a CFC. The latter provisions therefore seek to avoid effective economic double taxation from prevailing upon CFC income, by preventing that income from effectively being taxed *via* both the company and the shareholder in economic terms (even though such taxation may not constitute double taxation in legal terms as the two are separate legal persons and the income involved may also not even be considered to be the same in legal terms).

Various exemptions apply to the CFC attribution rules, “such as the foreign business establishment (hereinafter “FBE”) exemption, a *de minimis* exemption, a high-foreign tax exemption and related party exemptions” forming part of a “framework that seeks to strike a fair balance between protecting the tax base and the need for South African multinationals to be internationally competitive” (National Treasury, 2012: 103).

1.2 Research Problem

It is submitted that the potential measures of the effectiveness of tax anti-avoidance legislation in the wider sense (including the general anti-avoidance measures contained in sections 80A to 80T and 103(2) as well as specific anti-avoidance measures such as section 9D and any other specific anti-avoidance measures) includes both the extent to which:

- tax avoidance or deferral is prevented; and
- those business undertakings and investments for which tax avoidance or deferral is not the sole or main purpose or effect, are complicated or subjected to disincentives.

In cases where investments in foreign companies may appear (from either a policy perspective or an administrative perspective) to compromise the public interest because of the problem of taxation deferral raised by National Treasury (2002:1), the provisions of section 9D can be expected to be justified by the benefits to the *fiscus* of countering the potential deferral or avoidance (as described by Meyerowitz, 2007:9.114) of income tax in cases where South African residents invest internationally through foreign companies, as well as potential benefits to the economy of preventing potential taxation motives from skewing investment flows by residents to international companies rather than to domestic companies by approximating a situation of capital export neutrality.

According to Greenleaf (2003: 590-592) capital export neutrality “is achieved when tax rates play no part in a MNE’s [multi-national entity’s] decision to invest in its home country or abroad” (own insertion). This would logically be the case where an investor experiences the same after-tax return domestically or abroad for the same investment risk and return such as would *prima facie* be the case with the imputation of tainted income as outlined above. It is nevertheless submitted that international CFC legislation can potentially have considerable impact on decisions regarding the choice of one or more holding structures for foreign companies, including which country or countries are chosen for the residence of such structures, should the legislation impact upon the costs and degree of risk (uncertainty of outcome) undertaken by investors.

National Treasury has recently acknowledged considerable success in this regard in that “the CFC regime has largely closed the straight-forward movement of passive income offshore and the comparable use of shell companies to divert income offshore through unsustainable transfer pricing" (National Treasury, 2012: 103). National Treasury has acknowledged that problems remain and has characterised the 2011 amendments (e.g. South Africa, 2011a: section 25) in relation to section 9D of the Act as "reform" with the rationale including for instance that "the tainted income calculation is overly complex and creates uncertainties" (National Treasury, 2012: 103), and has further provided the following examples of specific problems targeted *via* the 2011 amendments:

"The overly rigid nature of the regime":-

- "triggers tainted income for non-tax driven commercial income";
- "often allows taxpayers to artificially manipulate problematic income so as to avoid tainted treatment, especially in the case of diversionary-type transactions";
- "allow taxpayers to create a marginal nexus in respect of employment or activity to tax havens so as to claim exemption" whereas income so exempted "lacks any meaningful economic substance"; and
- "Elections and ruling mechanisms that add complexity with little benefit for the tax system" (National Treasury, 2012: 103).

The literature on Section 9D includes various indications that the section has consequences for taxpayers which extend beyond the taxation incurred. Jooste (2005:88) has argued that, at the time of his news article, previous amendments to the CFC provisions of the Act had imposed a time-consuming, costly and heavy compliance load on South African resident taxpayers having multi-national group interests. Olivier and Honiball (2011:618) have more contemporarily acknowledged (notably, prior to the 2011 amendments) the impact of "the additional cost of compliance arising as a result of the new FBE exemption requirements in the South African CFC legislation" and indicate that this burden, together with tax considerations, is a factor to consider when choosing a jurisdiction to house a CFC. In this regard Clegg and Stretch (2012: Vol 1, 8-53 footnote 293) note further that the "arm's length" wording is not simple to construe, and that it therefore should be carefully studied".

National Treasury acknowledges, in relation to CFCs that "some provisions are overly complex and can interfere with normal business conduct, while others create unintended loopholes", and indicated that CFC rules will be "made more targeted" (South African National Treasury, 2011a:73). The South African legislature consequently appears historically to have faced difficulty in its various attempts to alleviate certain of the consequences of section 9D.

For instance, National Treasury noted in 2009 that "Section 9D(10) was added to provide relief if SARS provides a ruling that the transaction does not represent an erosion of the tax base. However, this relief measure is proving difficult to administer because the issues raised are typically of a policy nature as opposed to administrative interpretation” (National Treasury, 2009:20). With effect from 1 April 2010, the section 9D(10) provision for specific rulings has since been removed in its totality (South Africa, 2011a: 66). The ruling system was previously initially partially replaced with a high-taxed net income exemption, whereby in concept the proviso to section 9D(2A) provides for an exemption to “disregard CFC income if little or no South African tax is at stake once South African tax credits in section 6*quat* of the Act are taken into account” (Mendes, 2011:1). While application of the proviso may appear simple in concept, Mendes (2011:1) has observed that “a deeper examination of the proviso reveals that its application is very complex and gives rise to a number of unanswered questions”.

1.3 Research Question(s)

Given problems such as those prefaced above, this study proposes to address the question: “What are the main consequences of section 9D which can be expected by (existing and potential South African-resident investors) in controlled foreign companies?”

Given the successes acknowledged by National Treasury (2012: 103) in addressing its concerns regarding the taxation of foreign passive income, the question arises whether section 9D might in fact extend too far, to the extent that business is complicated or subjected to disincentives. This study, as a secondary focus, considers the extent to which the 2011 amendments address problems, and highlights selected areas of possible refinement of the legislation to achieve substantially the same ends with less impact to taxpayers.

The study considers primarily the consequences to a South African resident investor in regard to its investments in controlled foreign companies, and peripherally also considers the controlled foreign companies themselves and also the South African *fiscus*.

1.4 Motivation

It is expected that the proposed study will find resonance with South African-resident individuals or companies holding or intending to establish CFCs or multi-national groups of companies. Such investors can be expected to have keen interest in an issue which has bearing on their profitability and international competitiveness.

This appears to be supported in the literature by both Greenleaf (2003:601) who indicates that research subsequent to her own may potentially seek to identify whether section 9D “achieves an optimum fulcrum point”, which it is submitted refers in context to whether section 9D carries appropriate balance between competing objectives such as competitiveness and anti-avoidance objectives (Greenleaf, 2003:580), and capital export neutrality versus capital import neutrality

(Greenleaf, 2003: 590-592). This view appears to be borne out by Jooste (2005:88) who raised various serious practical concerns regarding the administrative requirements of section 9D in his article. The comments mentioned further above by National Treasury (2011a:73), Olivier and Honiball (2011:618) and Clegg and Stretch (2011, 8-53) all provide some level of support for the view that there remains a need to improve section 9D.

Informal interaction with an executive tax manager of a major South African-listed multi-national group of companies has further preliminarily confirmed that the adequacy of the CFC rules is worthy of consideration in the international context (Gericke, 25 February 2009). Such a study could therefore reasonably be expected to have resonance with other multi-national groups as well.

Reasons (other than tax avoidance or deferral) for conducting business activities outside South Africa through foreign companies may be numerous. In light of the potential strategic importance of such foreign investment to the country, it follows that it would possibly be in the national interest to limit the negative impact of anti-deferral and anti-avoidance provisions relating to such investment in those cases where such investment is undertaken to the benefit of the country.

Findings in regard to the research question are expected to be immediately useful, through effectively identifying important matters that a South African-resident investor facing significant investment in one or more foreign companies would need to consider (in conjunction with others outside the scope of the study, e.g. exchange control compliance, funding, resourcing etc).

It is therefore submitted that it will be of value to identify and better understand the consequences of section 9D in order to consider the extent to which business conducted *via* investments in controlled foreign companies are complicated or subjected to disincentives where tax avoidance or deferral may not be the sole or main purpose or effect of such structures. An understanding of such consequences of particular anti-avoidance legislation surrounding investments in controlled foreign companies is essential when making investment decisions regarding such companies, in determining optimal corporate structures, as well as in considering how this legislation might in future be improved upon.

1.5 Aims, objectives and purpose of the study

The study plans to cast light on the relationship between section 9D and corporate behaviour, by identifying, considering and evaluating the consequences of section 9D of the Act.

The objective of the analysis includes, however a secondary intent of identifying potential solution areas, possibly for investigation in further studies, and not mere negative criticism of the legislation. It is submitted that the identification of problem areas can provide focal points for identifying and motivating potential improvements to the legislation.

The intention is therefore to bring a useful addition to the debate surrounding section 9D. The study can be expected to identify focus areas which might be further considered to assist in determining what may in particular circumstances constitute an appropriate balance between measures to protect the domestic tax base from deferral of taxation through controlled foreign companies, and competitiveness considerations of "the relative ease with which resident MNEs [multi-national enterprises] can relocate in response to tax rates" and the "desire to attract non-resident MNEs to their jurisdictions" as contemplated by Greenleaf (2003:580) (own insertion).

The purpose of the study is to focus the section 9D debate on the consequences to the "engine room" of the *fiscus*, namely the taxpayer, without whom there would, it is trite to state, by definition be no tax.

1.6 Research design (including discussion of design logic and research methodology)

The research is an applied cross-sectional study, in that it considers the current provisions of the Act at a point in time, and the consequences thereof.

The study is primarily descriptive of the legislation and related regulatory requirements at the time of the study and touches upon recent changes, but also seeks to identify areas of potential improvements in legislation whereby consequences of the legislation might be reduced by further consideration of possible changes to the legislation and its regulations.

Because of the sizable number of various historic changes to the wording of the Act in relation to section 9D, for which one might refer for instance to Clegg and Stretch (2012: Vol 1A Appendix A) for further detail, apart from its consideration of recent amendments at the time of the study, this study generally does not seek to highlight the position regarding specific historic periods of time in which different provisions applied, as such aspects are adequately covered elsewhere. It should however be noted that constantly changing taxation rules can be expected to add to the compliance cost of taxpayers (through updating and applying their understanding of such rules on their investments and business practices), and may even to some extent distract management focus from business objectives, which distractions might potentially manifest themselves in lower returns to investors.

1.6.1 Research method and logic

Available academic literature was considered regarding the operation of section 9D, where necessary in context with related provisions of the Act, in order to identify and document in a structured way the key expected consequences of this section.

Without exploring potential changes to the legislation in detail, consideration has been given to identifying whether any potential improvements to the legislation are apparent and which might be possible in a manner that balances the stated interests of National Treasury, and those of taxpayers.

Because of the historic extensive changes to section 9D, and the potential for lingering after-effects of its initial years (Clegg and Stretch, 2012: 8-46) care has been taken during the study in interpreting and eliminating or discounting observations which relate to older provisions to the extent that these are no longer applicable.

While certain aspects of the study involve quantitative elements (e.g. the tax rate), the study is primarily qualitative in nature.

1.6.2 Study variables

In this study, the current section 9D rules and related provisions of the Act are the primary independent variable of the study, and the consequences of the provisions of section 9D the main dependent variable, with potential legislative and associated regulatory improvement areas being secondary dependent variables.

1.6.3 Limitations

The answers to the research questions can be expected to lead to potential further studies of areas in which the legislation could be improved to reduce or eliminate particular impacts of section 9D, or otherwise improved to appropriately balance the interests of the *fiscus* and taxpayers. Such studies are outside the scope of the research conducted, and it has not been the primary focus of the study to explore all areas in which the legislation might be improved. The study has nevertheless sought to, where possible, at least identify certain such areas, which may potentially benefit thereafter from further studies.

The study does not explore in detail the considerations of international law or of the applicability of double tax agreements to section 9D, or other anti-avoidance provisions in the Act (such as sections 80A to 80T), although such considerations may of necessity be touched upon. The study also does not seek to comprehensively explore transfer pricing issues in relation to section 9D, however as transfer pricing issues and concepts appear to be of increasing importance, particularly but not exclusively in relation to the foreign business establishment exemption, the consequences of such issues are explored to a degree.

The study is premised on *bona fide* business intentions for structuring international business through controlled foreign companies, i.e. those situations where the deferral or avoidance of taxation is not the sole or main motivating factor for the investment in international corporate structures. Such valid non-tax reasons for conducting business *via* a foreign company could, for instance, conceivably include managing overall financial risk within a group of companies *via* the separate limited liability of each legal entity; seeking to strategically contain country-specific financial risks to in-country entities; or even to manage potential acquisitions and disposals of individual business operations.

Given the nature of section 9D as anti-avoidance legislation, secondary consideration has also been maintained of the position with regard to those who might seek advantage through an international company *via*, as referred to by Meyerowitz (2007:9.114), the re-characterisation or conversion of taxable income into non-taxable income, or the deferral or avoidance of taxation by accumulating or capitalizing such income in such a company. Regard has therefore also been given to a consideration of the public interest.

The study does not evaluate in detail the special corporate restructuring rules regarding CFCs, contained within sections 42, 44, 46 and 47. It should however be noted that the 2011 amendments to the Act have extended taxation relief to certain corporate restructuring transactions involving CFCs, which transactions were previously totally excluded from such relief. Readers may wish to refer to National Treasury (2012: 110-113) for further detail in this regard.

The study endeavours to exclude the impacts of any extraneous variables (e.g. exchange controls, wider anti-avoidance measures or other elements of the South African armoury against potential capital flight, tax avoidance or evasion). As legislation operates at a point in time in a particular socio-political context, socio-political considerations have, where possible, similarly been excluded.

1.7 Envisaged contribution of the study to scholarship and policy or practice

It is envisaged that the study will contribute to the body of knowledge regarding South Africa's CFC legislation by reviewing the legislation, its practical operation and the academic literature. The study may reasonably be expected to bring additional value to bear by documenting potentially neglected, previously inadequately documented or undocumented aspects of the impact of South Africa's CFC laws.

It is further envisaged to endeavour to identify areas for consideration of potential refinement of the legislation which may stimulate further thought among academics, professional specialists and potential legislators regarding the appropriate balance to be struck in future between the competing objectives of taxation and competitiveness.

1.8 Compliance with ethical standards

Care has been taken to acknowledge all sources, to seek to avoid plagiarism and acknowledge all contributions and quotations. Further, while it is impossible to absolutely avoid bias, apart from seeking to adhere to the specific focus of the study, care has been taken to avoid or minimise bias and to acknowledge the interests of parties affected by CFC provisions of the Act.

1.9 Broad plan and order of the study

The study commences in Chapter 2 with an overview of the intent and context of section 9D as part of a system of world-wide taxation, and the anti-avoidance and anti-deferral intention behind section 9D.

In Chapter 3 the fundamentals and the various specific provisions of section 9D are considered, as an understanding of the basic operation of the section is expected to be central to evaluating its consequences.

In Chapter 4 the FBE exemption is considered and evaluated in more detail. A comparison of the 2011 amendments (South Africa, 2011a) to the Act in regard to the FBE exemption, *versus* the position up to 31 March 2012 is further presented in Appendix A.

As international competitiveness considerations can be expected to constitute a matter of considerable concern for a multi-national group of companies, a study of such considerations follows in Chapter 5, including brief consideration of the headquarter company regime (which has some bearing on South Africa's competitiveness as a holding company jurisdiction), as well as efficiency considerations, the example of the United Kingdom's focus on taxation simplification, and the potential to benefit from the international experiences with advance pricing agreements.

While the principal consideration is the provisions of the Act itself, consideration has also been given to opinions and observations from existing available literature on the section, and this is threaded throughout the study.

Ultimately, conclusions are drawn regarding the research question in the light of the aims, objectives and purpose of the study.

CHAPTER 2 – THE FOREIGN INCOME TARGETED BY SECTION 9D

2.1 Introduction

This chapter considers the context and intent of section 9D within the Act by expanding on the foreign income targeted by the legislature. It is submitted that an understanding of the section's context and rationale can be expected to cast light on its consequences. In particular such an understanding might help to distinguish between the intended and unintended consequences.

2.2 The context within which section 9D operates

South Africa has in relation to the "connecting factor" necessary to establish jurisdiction to tax, in the context of its sovereignty "legislated that the connecting factor is taxing residents on their world-wide income, and non-residents on income sourced within the particular state" (Olivier & Honiball, 2011:560). Income arising from South African resident shareholdings in foreign companies is dealt with for income tax purposes *via* one of three mechanisms, described in further detail below.

2.2.1 Taxation of foreign dividends

Dividends paid by resident companies or foreign companies listed in the Republic are from 1 April 2012 subject to a withholding tax known as the "dividends tax", as provided in Part VIII of Chapter II of the Act (sections 64D to 64N), levied at the rate of 15% (South Africa, 2012b: section 6(1)). It should be noted that the dividends tax is a separate tax (section 64E).

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

An exemption of 75% of foreign dividends received or accrued is provided in respect of natural persons, deceased or insolvent estates and special trusts, and 18/28ths (approximately 64.3%) for other persons (section 10B(3)). This exemption aligns the effective rate of tax payable upon foreign dividends with that on local dividends (Clegg & Stretch, 2012: Vol 1A, 12-23).

Other exemptions in relation to foreign dividends include those received or accrued to a person:

- who holds a minimum of 10% of the equity shares and voting rights in the foreign company or foreign co-operative (section 10B(1)(2)(a)). This exemption is also known as the "participation exemption" (Olivier & Honiball, 2011: 107), and in the former section 10(1)(k)(ii)(dd), required a minimum of 20% of such shares or rights to be held. In the case of a person who is a company, the percentage holding is calculated by combining the company's owned shares or rights with those owned by any other company or companies within the same "group of companies" as defined in section 1. It should be noted, however that this exemption will not apply *inter alia* if the amount is deductible for South African income tax in the hands of the payer of the dividend but is not subject to tax in the hands of the recipient, or if the recipient is a CFC, the amount is not included in that CFC's net income (section 10B(4));

- that is a company, which in context is understood to mean a CFC (Clegg & Stretch, 2012: Vol 1, 12-24), where the foreign dividend is paid by a person resident in the same country as that company (section 10B(2)(b)). The same potential exclusions from exemption apply as those mentioned in the previous point (section 10B(4));
- who is a resident receiving a foreign dividend from a CFC to the extent that the dividend does not exceed all amounts included in the resident's income *via* section 9D in respect of that CFC and any other company held indirectly through the CFC, reduced by any foreign taxes on the amounts as well as the sum of all dividends received or accrued at any time from the CFC or such other company as was exempted on the basis of the section 10B(2)(a) participation exemption; the section 10B(2)(b) exemption mentioned above; or the section 10B(2)(d) exemption below, or which was previously not included in the income of the resident by virtue of a prior inclusion in terms of section 9D (section 10B(2)(c)); or
- to the extent that the foreign dividends are in respect of a listed share as defined in section 1 of the Act (excluding a distribution *in specie*) (section 10B(2)(d)).

2.2.2 Taxation of capital gains from the disposal of shares in a foreign company

Where income earned by a foreign company in consequence of a shareholding by a South African resident has remained undistributed by that company, upon disposal of the shares any increase in the value of the shares which may (in economic terms) be attributable to such undistributed income will, to the extent that any such increase in value constitutes part of the proceeds received or accrued to the resident upon disposal of the shares, effectively be partially included in taxable income *via* the taxation of net capital gains (Section 26A, read together with Schedule 8 of the Act). Certain exceptions and refinements do however apply to, for instance, holdings which immediately prior to disposal exceeded 10 *per cent* of the equity shares and voting rights in the company (paragraph 64B of Schedule 8 of the Act). It should also be noted with regard to capital gains within any CFC in which a resident holds qualifying participation rights, that the exemptions contained in section 9D(9) potentially apply in regard to including an amount in the income of the resident in relation to the capital gains of that CFC.

2.2.3 Taxation of CFC deemed income attributed in terms of Section 9D

The fundamentals of section 9D are discussed in more detail in Chapter 3 of this study. By way of overview, where a resident holds qualifying participation rights in a foreign company which is a controlled foreign company as defined in section 9D, the resident is deemed to receive income in their own right. The amount of income so deemed is derived by calculating a portion of the "net income" (as defined in section 9D(2A)) of the foreign company, which is calculated largely as if the company was a South African resident but with notable exceptions e.g. for income which is not considered "tainted" as referred to by National Treasury (2012: 103), and attributing the resulting notional amount as income of the resident themselves (section 9D(2)). In general terms, the amount so imputed to the resident is derived by first calculating the proportion of the resident's participation rights in company to the total participation rights in the company, and then applying that proportion to the total net income of the CFC. Where dividends are paid out of the profits so imputed to the resident, the dividends will not be taxed in the hands of the resident, being exempted from 1 April 2012 by section 10B(2)(c) (described further above). Prior to 1 April 2012 section 10(1)(k)(ii)(cc) provided for a similar exemption of CFC dividends.

It should be remembered that the Act additionally provides (section 6*quat*(1)(b)) for a potential proportional rebate of the taxes on income paid by the CFC to "any sphere of government of any country other than the Republic" (section 6*quat*(1A)(b)) provided that the investor has available (for submission when requested) financial statements of the CFC (section 72A(3)) and that there is no right of recovery of the taxes save "any entitlement to carry back losses" (section 6*quat*(1A)). The rebate is however limited to the "amount of normal tax which is attributable" (proviso (iA) to section 6*quat*(1B)(a)) to the resident's proportional amount in relation to the CFC's net income. Consequently the intention is evidently not to introduce economic double taxation (nor to inadvertently create any effective reduction in taxes) but to effectively tax such foreign income at parity with domestic income.

De Koker (2011: §5.43) has observed that "The main category of income falling outside the 'tainted' category is that of amounts attributable to a foreign business establishment of the CFC." Pursuant to the above, SA National Treasury (2002:8) originally referred to providing an exemption from attribution of all income attributable to a "business establishment" of a CFC. In this regard a "foreign business establishment" (hereinafter "FBE") is currently defined within section 9D(1), with associated provisions in section 9D(9)(b) and 9D(9A), as discussed in more detail in chapter 4 below. FBE income was generally intended to be excluded from attribution, unless it falls within one of three categories as follows, as described by National Treasury (2002:8).

- “Mobile Foreign Business Income”
- “Diversionary Foreign Business Income”
- “Mobile Foreign Passive Income”

SA National Treasury (2012:103) consequently contemporaneously continues to refer to such income as “tainted income”, contemplating “passive (or highly mobile) income as well as diversionary income” and specifically states that “the CFC rules impose tax on South African residents in respect of their proportionate share of CFC tainted income”.

It is submitted that the word “foreign” (as opposed to “local”) simply refines the terms “mobile business income”, “diversionary business income” and “mobile passive income” respectively, and for this reason these terms might equally validly be referred to as e.g. “foreign mobile business income”, “foreign diversionary business income” and “foreign mobile passive income”. It is the latter form which is preferred in the text which follows.

It is therefore useful to consider what is meant by the above terms. Such analysis therefore follows further below, preceded by a positioning of the meaning of passive income and active income.

2.3 Passive income

Olivier & Honiball (2011, 581) argues that passive income “is usually the target income for CFC regimes, since such income typically arises from structures set up to avoid tax” further noting that “the general rule is that income derived from mobile business activies, so-called passive income does not qualify for exemption from attribution”.

Reference to the term “passive income” can be found in section 9E, which is expected to come into effect on 1 April 2013 (South Africa, 2011a: section 155(1)), dealing with passive holding companies, wherein it is defined for the purpose of that section to mean “in relation to a company”… “an amount equal to so much of the gross income of the company for a year of assessment as is derived from financial instruments”. While the definition in Section 9E is limited to that section, it is submitted that it does cast light on what is generally meant, in that once such instruments are owned, any income arising therefrom is usually earned without any significant degree of activity on the part of the person earning the income.

The Act, without directly using the term “passive income” in relation to section 9D, as an exception to the general FBE exemption consequently for instance specifically includes in CFC net income amounts attributable to certain FBEs of a CFC, that arise “in respect of a financial instrument” (Section 9D(9A)(iii), from 1 April 2012). (Readers may refer in more detail to the FBE exemption described in Chapter 4 and its various exceptions highlighted in Appendix A). The term “financial instrument is widely defined in section 1 to include a broad range of instruments including loans, advances, debts, bonds, debentures, bills, shares, promissory notes, banker's acceptances, negotiable certificates of deposit, deposits with financial institutions, participatory interests in collective investment schemes, or a "similar instrument", as well as agreements for repurchase or resale, as well as a wide range of derivative contracts and arrangements. Section 9D(9)(b)(iii) (up to 31 March 2012) previously similarly specifically included (without, it should be noted, ever using the term "passive income") the following categories of passive income: "dividends, interest, royalties, rental, annuities, insurance premiums or income of a similar nature" as well as capital gains from the disposal or deemed disposal of assets which can generate such amounts, foreign currency gains in respect of any foreign equity instrument or determined in terms of section 24I (other than foreign currency gains which arise in the normal course of business of the CFC, if the CFC was not a foreign financial instrument holding company) (Section 9D(9)(b)(iii)).

The Act also includes in CFC net income amounts arising from the use of, and capital gains in respect of, intellectual property as defined in section 23I of the Act (sections 9D(9A)(v) and 9D(9A)(vi) from 1 April 2012). Section 23I refers, with reference to the relevant laws of the Republic, to patents, patent applications, designs, trade marks and copyrights, as well as patents, designs, trade marks and copyrights defined or described in any "similar law" of a country other than the Republic, as well as property or rights "of a similar nature" as well as knowledge "connected to the use" of such patents, designs, trade marks, copyrights, property or rights (Definition of "intellectual property" in Section 23I of the Act). With regard to the the term "similar nature" cognisance should be made of precedent when interpreting what is meant. For instance in *Income Tax Case 1735* (2002: 64 SATC 455), payments in respect of the use of the name, likeness, biographical details, etc of a taxpayer were held not to result from any creative effort by the taxpayer and were accordingly of an entirely different nature from a royalty, the rights of use granted in respect thereof were not rights in respect of "property of a similar nature" to patents, designs, trademarks and copyright then listed in section 9(1)(b)(i) in relation to the particular case.

2.4 Active income

The concept "passive income" can be contrasted with the concept of "active income", which is not defined in the Act. While not of application to section 9D but perhaps illuminative by way of its contrast to passive income, the word "active" is used in section 80E, dealing with "accommodating or tax indifferent parties" in relation to tax avoidance arrangements, in the phrase to "engage directly in substantive active trading activities" (in section 80E(3)(b)). It is submitted that the word "active" in contrast to "passive" can be expected to connote a degree of effort and application of wit, which might for instance be expected to be the position in the conduct of a trade.

2.5 Foreign mobile business income

South African National Treasury (2002: 8) refers to foreign mobile business income as income involving "paper shell businesses without economic substance" whose "sole economic activity is maintaining a post office address or a website". For this reason it is considered that in such cases "no real non-tax business reason exists for maintaining income offshore versus generating that income within South Africa". While it may be argued that certain valid business reasons may well exist for such entities, e.g. perceived security of wealth reasons or for operating in a particular currency environment, it is clear that National Treasury intends to prevent a situation where such entities might be used to defer or avoid South African taxation. There is however arguably an international competitiveness perspective which might reveal that all business income is potentially mobile in the longer run as a company could migrate its country of residence, even if it is involved in highly substantial physical activities such as manufacture. Naturally in the case of heavy industries the relocation of physical infrasture may not be practical or even possible, but in such cases alternative sources of similar capacity can arguably be procured in a number of ways and all that may potentially be required is one or more contractual arrangements with sub-contracted providers of manufacturing capacity.

2.6 Foreign diversionary business income

South African National Treasury (2002: 8) refers to foreign diversionary business income as being generated from sale and service transactions conducted with related South African residents, and clarifies that it intends for such income to fall within the attribution rules of section 9D as a "proxy for the transfer pricing regime under section 31". It considers that such income arises "when a CFC engages in transactions with a related South African resident in a manner that will most likely lead to transfer pricing tax avoidance". De Koker (2011: §1.10 & §5.43) similarly identifies "diversionary foreign business income" as being "suspect business structures that can easily lead to transfer pricing".

The Act consequently contains a number of rules relating to circumstances in which such transactions are considered to arise and which should therefore not benefit from exemption or exclusion from the provisions of section 9D, particularly with reference to the FBE exemption contained in section 9D(9)(b), read with section 9D(9)(A) from 1 April 2012.

2.7 Foreign mobile passive income

South African National Treasury (2002: 8) referred to foreign mobile passive income as being included within the attribution rules of section 9D because they "do not involve any direct international competitiveness concerns because no business is directly involved" and the "mobile nature of the income potentially means that South African residents could otherwise avoid the ambit of worldwide taxation merely by shifting these mobile passive assets to a controlled foreign company".

More recently, the South African National Treasury (2011a: 73) has said "The main purpose of controlled foreign company rules is to prevent South African residents from shifting passive income offshore." It is submitted that the section operates as part of a policy armoury which includes both the foreign exchange controls imposed by the South African Reserve Bank (which to an extent limit foreign investment and other capital outflows), as well as the transfer-pricing requirements of section 31, and also other taxation anti-avoidance measures such as those set out in sections 80A to 80T and section 103.

It is noted that section 9D does not directly prevent a resident from investing in companies outside the Republic. Owing to the potential for administrative impact on investors and CFCs themselves, controlled foreign company rules however carry some risk of being an inefficient choice of device for preventing residents from shifting passive income offshore as compared, for instance to the alternative means of both legislatively and administratively (e.g. through efficient and reliable governance, public infrastructure and public services) providing an environment in which returns on particular domestic investments are enabled to outstrip returns on comparable foreign investments, and in which domestic investment risks can consequently also compete favourably with foreign investment risks.

2.8 Potential impact

It is submitted that CFC rules at least carry the potential to have a negative impact on investors, such as: reduced after-tax investment returns; increased taxation uncertainty; increased administrative costs; and increased requirements for scarce resources such as management time, skilled administrative or taxation professional staff. For potential domestic investors in foreign companies such considerations may indeed well influence such investors not to make particular foreign investments. It is further submitted that should legislation be found to increase risks to investors or put administrative hurdles in their path, this may arguably not be as strongly in the public interest as legislation which encourages economic activity and incentivizes domestic passive savings and investment through enabling lower domestic risk and higher domestic investment returns. It is also submitted that legislation which would achieve the latter may be expected to potentially not only retain domestic savings and investment but to potentially attract increased foreign savings and investment in the domestic economy, all of which can be expected to encourage domestic employment and growth. For the above reasons, critical consideration is required of any negative consequences of the CFC provisions.

Because the exemptions in section 9D for active business income are arguably constrained by the definition of an FBE (please refer to Chapter 4 and Appendix A of this study for further detail in regard to the FBE exemption), certain business income can be expected to be included in CFC calculations and attribution. The statistics provided by Mc Kinsey & Company (see Table 5.1 in Chapter 5: 5.2) highlight the potential economic benefits of such investment, which arguably may be lost or at least disincentivised (so that such benefits may not arise), and may lend some credence to an argument that section 9D should ideally only include in its ambit passive income which has been diverted from South Africa through a separate legal persona, and structures which more clearly seek to defer income from South African taxation.

Arguably, owing to the current wording of section 9D, in particular the constraints of the Foreign Business Establishment definition and related exemption, much active business income potentially stands to be caught in the net of section 9D. There has been a stated intent to address certain deficiencies in section 9D. National Treasury (2011a: 73) has noted that "Some provisions are overly complex and can interfere with normal business conduct, while others create unintended loopholes. Adjustments will focus the rules without compromising their purpose."

The uncertainties which may surround the ultimate taxation outcome of a foreign investment can arguably be expected to form a part of the general management of financial risks faced by a multi-national company. Unless section 9D is properly understood and applied correctly in practice, unforeseen taxation (e.g so-called "treble-tax" provided for within section 76), taxation penalties (e.g. the "penalty on default" of not providing certain information on time contained in section 75, or an "administrative penalty in respect of non-compliance" according to section 75B) or taxation-related interest (as provided in Part IV of the Act, i.e. sections 89 to 94) may conceivably be incurred. It should further be noted that once the Tax Administration Bill (South Africa, 2011b) introduced in Parliament during 2011 has been signed into law by the President, penalties can further be expected to be defined and regulated under that legislation, with similar dire consequences, including the "understatement penalty" in its Chapter 16 and potential criminal offences in certain circumstances as set out in its Chapter 17.

2.9 Conclusion

Section 9D seeks to address the deferral or avoidance of taxation which might otherwise arise *via* investment through foreign companies by creating a situation of capital export neutrality. In particular, the section targets the effective taxation of foreign mobile passive income, as well as foreign mobile business income and foreign diversionary business income at parity with domestic income. Section 9D operates in the context of the South African world-wide taxation of residents, complementing the other means of taxing resident shareholders in foreign companies, namely foreign dividends and capital gains on disposal of foreign shareholdings.

Section 9D may potentially be an inefficient device for preventing residents from shifting passive income offshore; although it may nevertheless be effective in achieving the objective of subjecting much of such income to taxation, thereby protecting the domestic tax base. Furthermore, much active business income may stand to be caught in the net of section 9D; and considerable penalties, as well as potential disallowance of the section *6quat* rebate for foreign taxes of the CFC, can conceivably be incurred in the event of non-compliance (even if non-compliance is inadvertent). Other potential areas of negative impact to investors may include reduced after-tax investment returns; increased taxation uncertainty; increased administrative costs; and increased requirements for scarce business resources.

CHAPTER 3 - THE FUNDAMENTALS OF SECTION 9D

3.1 Introduction

This chapter seeks to identify the fundamental aspects of section 9D, as well as its specific provisions, and to evaluate their consequences.

At the outset it is considered to be of value to further highlight some of the potential financial consequences of non-compliance with the section. As mentioned under 2.8 in the previous chapter, failure to comply with the section has the potential of attracting administrative penalties and interest under Chapter III of the Act in regard to any non-disclosures of information and any late-payment or non-payment of tax. It should in this regard be noted that SARS has standardised a form styled IT10, requiring the submission of information in relation to the participation rights held in each CFC (SARS, 2010). Further, in the event of non-retention of CFC financial statements by a holder of at least 10% of participation rights in a CFC, the amount attributed under section 9D is also based only on the receipts and accruals of a CFC, and no section 6*quat* rebate is available in respect of the foreign taxes incurred by the CFC (section 72A(3)). Potential financial implications would consequently include making adequate financial arrangements to fund any resulting taxation, and any potential financial consequences of non-declaration or non-payment of tax, including the abovementioned dire consequences of any failure to retain annual financial statements, as required by section 72A(3).

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

Section 9D(2) requires for a given year of assessment the inclusion in the income of a resident investor in a CFC (other than a "headquarter company" as defined in section 1) of a notional amount calculated in the relative proportion of the participation rights of the resident to the total participation rights in a CFC. The amount is determined by applying the proportion of participation rights to the "net income" (discussed in more detail in 3.1.4 below) of the CFC, which in respect of the CFC's foreign tax year is determined as "an amount equal to the taxable income of that company as if that CFC had been a taxpayer, and as if that company had been a resident" for the purposes of various sections as outlined in section 9D(2A). The inclusion applies where such participation rights are held either on the last day of the foreign tax year (section 9D(2)(a)) or on the day before a foreign company ceased to be a CFC (section 9D(2)(b)) (hereafter "the trigger dates").

Three provisos define circumstances in which no such amount relating to the net income of a CFC is to be included in a resident's income (lettering corresponds with the lettering of provisos in section 9D(2)):

(A) where the resident (together with any connected person in relation to them) at the trigger dates "in aggregate holds less than 10 *per cent* of the participation rights and may not exercise at least 10 *per cent* of the voting rights in that CFC"; or

(B) in the case of a resident's participation rights in a CFC being held indirectly by them *via* a company (other than a headquarter company) ; or

(C) where a long-term insurer holds participation rights in a CFC *via* any policyholder fund in relation to certain linked policies or non-guaranteed policies (as specified in the proviso) where benefits are determined wholly by reference to underlying asset values and such holding did not arise "solely or mainly"… "to avoid the inclusion of an amount in the income of a resident as contemplated in this subsection"

Clearly the inclusion in a resident's income could have potential financial implications should a South African resident unwittingly possess participation or voting rights in a CFC at or beyond the threshold of 10%, either at its financial year-end or on the day before it ceases to be a controlled foreign company (Proviso (A)(i) and A(ii) to section 9D(2)).

It may be argued that at a level of at least 10% of participation rights or voting rights the resident is likely to be aware of their participation rights. Nevertheless, such a situation could arguably easily arise for instance where such a resident has limited access to the necessary information to determine whether or not the particular company falls within the CFC definition in section 9D read with section 1; or where the resident has little or no knowledge of their interest in the foreign company (e.g. such a possibility could arise for uninformed vested major beneficiaries of a foreign trust set up by a third party such as an aged parent); or where the resident is unaware of the holdings of connected persons in relation to themselves. Such circumstances could be made considerably worse if the Controlled Foreign Company has not declared dividends or is not in a position to declare dividends to fund the income tax as well as any penalties which may arise for such a resident as a consequence.

Proviso (B) to section 9D(2) prevents a cascading effect whereby resident shareholders may hold an otherwise-qualifying level of at least 10% of either indirect participation rights or voting rights in a Controlled Foreign Company through one or more resident companies. Only the first resident company needs to include an amount in relation to its participating rights in CFC net income in its tax return. Caution nevertheless needs to be exercised by any resident investors in a headquarter company (as defined in section 1), as they would be taxable on an amount in relation to their indirect participation rights in the net income of an underlying CFC, provided their own indirect participation rights or voting rights in the CFC are at least 10%.

The section 9D(2) exclusion of headquarter company from attribution of CFC net income and the provision regarding a headquarter company in proviso B to section 9D(2) complements the exclusion of the participation rights of headquarter companies (as defined) *via* the 2010 amendment of section 9D(1) when determining the CFC status of a company with effect from 1 January 2011 (South Africa, 2010: Section 16(1)(a)). A headquarter company as defined in section 1 of the Act, while included in the definition of a "resident" in section 1 of the Act is consequently itself effectively excluded from the CFC provisions and is effectively transparent to resident investors with regard to CFC net income.

3.2.1 Controlled foreign company

The impact of uncertainty or ignorance regarding the controlled foreign company status of a particular foreign company, which may potentially result in the inadvertent non-payment of tax, is potentially severe, as outlined at the beginning of this chapter.

The term "controlled foreign company" (hereafter "CFC") is defined in section 1 read with section 9D(1). A foreign company (as defined, see discussion in 3.1.2) meets the definition (subject to three provisos, see further below, which may exclude it from the definition) if "one or more persons that are residents" "directly or indirectly" hold over 50% of participation rights (see discussion in 3.1.3) or voting rights in that company.

For the purposes of the CFC definition both voting rights in any foreign company which is a listed company as well as voting rights in a foreign company which rights are exercisable "indirectly through a listed company" must be disregarded (Proviso (a) to section 9D(1) definition of "controlled foreign company").

The term "indirectly" requires interpretation. Olivier and Honiball (2011, 569) consider that "both registered and beneficial shareholders have to be taken into account" and that it may therefore be practically problematic to apply the provisions of section 9D to indirect interests, with the onus of proof being on the taxpayer. Jooste (2001, 476) notes that "indirectly" may include a voting agreement. Jooste (2001, 477) further expresses support for the view that indirect holdings through a company (more contemporarily expressed, a company such as a foreign company or a headquarter company) are included, submitting that the contrary interpretation is "too narrow and unlikely to be accepted by the courts". Other resident parties may therefore be difficult or even impossible for a resident taxpayer to identify. Consequently, residents should take great care in ensuring the obtainability of such information when investing in unlisted foreign companies. De Koker (2011: §5.44) warns that "a mere mathematical calculation may not suffice because *ex facie* the shareholders' register may reflect a holding of a resident's *alter ego*", suggesting that such an *alter ego* might, for example, manifest in the form of a nominee shareholder, a voting agreement or an entitlement to appoint the board of the company.

The term "listed company" is defined in section 1 of the Act to include variously companies which have listings of shares or depository receipts for their shares on an exchange as defined in section 1 of the Securities Services Act, No. 36 of 2004 and licensed under section 10 of that Act, or on a stock exchange (outside the Republic) recognized by the Minister as foreseen by paragraph (c) of the definition of a ‘recognised exchange’ in paragraph 1 of the Eighth Schedule of the Income Tax Act (South Africa, 2012). Naturally, it is important that the stock exchange in question has been recognized by the Minister in the manner required, otherwise a particular company may fall outside the definition of a ‘listed company’, which would therefore have implications for voting rights to be taken into account for the purpose of determining CFC status, as well as the 5% *de minimis* holding exclusion (Proviso (c) to the CFC definition in section 9D(1)).

It is clear from the current wording of the CFC definition, which simply refers to “one or more persons that are residents other than headquarter companies” (CFC definition in section 9D(1)) that the residents do not need to have a “common purpose” or be “acting in concert” for a company to meet the CFC definition. Jooste (2001, 476) highlighted the uncertainty created by earlier wording of the CFC definition (use of the word “jointly”), which has since been addressed. Nevertheless, it is not impossible (if perhaps unlikely) that connected persons may be unaware of each others’ participation rights or voting rights, although it may be argued that the risk of this is minimised by the exclusion from attribution of CFC net income, to residents having participation rights and voting rights below 10% (Proviso A to section 9D(2)), and also the exclusion of residents holding participation rights below 5% in listed companies and below 5% of participation rights and voting rights in a collective investment scheme (paragraph (c) of the proviso to the definition of “controlled foreign company” in section 9D(1)), as discussed more fully further below, when calculating the extent of resident participation rights and voting rights in a foreign company.

Based on the manner of the inclusion of voting rights in the CFC definition, the extent of voting rights held by residents is an alternative test to the extent of participation rights and the two would need to be separately evaluated. If either test is met, the company would be a CFC. It may be simpler for a resident to establish first whether the participation rights test is met. If this is clearly so, there may in practical terms be no need to establish whether the voting rights test is also met. Voting rights were presumably included in the definition by the legislature to address the situation where a resident has control of a foreign company *via* voting rights rather than *via* their shareholding, and where the participation rights in the foreign company are structured in such a manner that the resident would otherwise not be taxed on the pro-rata net income of the company as a CFC. Consequently, residents need to ensure that they understand the applicable shareholdings and any other relevant participation rights, as well as the voting rights in the foreign company properly to avoid potential penalties and interest from inadvertent non-inclusion of the relevant portion of net income in a CFC.

Proviso (a) to the CFC definition (Section 9D(1)) excludes consideration of voting rights in a foreign company which falls within the definition of a listed company (in section 1) or where voting rights in a foreign company are indirectly exercisable *via* a listed company. It is submitted that this proviso simplifies the determination of the status of a foreign listed company, however it should be noted that a listed company could nevertheless still fall within the definition of a CFC by virtue of its resident shareholders exceeding 50% of shareholdings in aggregate. Obtaining the share register and details of percentage shareholdings in the register of a foreign listed company, as well as those of all companies underlying a foreign listed company, could prove to be a very onerous, if not sometimes totally impractical, process. However, this proviso should also be considered in the context of proviso (A) to section 9D(2) whereby a threshold (of 10% of either participation rights or voting rights) is set for the inclusion in income of the relevant proportional amount of the net income of such a CFC. For residents who meet this threshold, the information requirements implied by section 9D apply, and may prove onerous to satisfy.

Proviso (b) to the CFC definition (section 9D(1)) deems the indirect voting rights in a foreign company which are exercisable by a CFC to be exercisable directly by a resident in circumstances where the resident (together with connected persons in relation to them) directly or indirectly control over 50% of the voting rights of the CFC. While this rule appears to seek to unravel the true extent of control exercisable over underlying foreign companies, it does complicate the evaluation. A resident may need to take care to ensure that their voting rights in underlying foreign companies are properly understood for the purpose of evaluating the CFC status of each underlying foreign company. Similar care is required to determine their participation rights in regard to those (possibly unusual) cases where paragraph (b) of the definition of "participation rights" applies e.g. in the case of the existence of a company limited by guarantee, in which a CFC may possibly have voting rights but hold no shares as such.)

Proviso (c) to the CFC definition (section 9D(1)) provides a 5% threshold whereby a person is deemed not to be a resident (for the determination of whether participation rights or voting rights held by residents exceed 50% of a foreign company) if the person holds less than 5% of participation rights in a foreign company which is either a listed company; a foreign company the participation rights in which are held indirectly by a listed company; a foreign collective investment scheme in which the person may also not exercise at least 5% of voting rights; or a foreign company in which the participation rights and voting rights of which are indirectly exercisable through such a foreign collective investment scheme. This proviso does not apply however if connected persons hold in excess of 50% of the participation rights or voting rights of the foreign company.

Where a company therefore only meets the 50% threshold by virtue of residents who are not connected parties holding less than 5% in qualifying listed companies or collective investment schemes "the effective consequence would be that the foreign company will not qualify as a CFC and the CFC rules would not be applicable to any of the residents" De Koker (2011: §5.44).

It is of course also conceivable (even if perhaps reasonably unlikely) that connected persons who together hold in excess of 50% of a qualifying listed company or foreign collective investment scheme or company held through such companies or schemes may be totally oblivious to the existence of one another's holdings. It is also possible that a person seeking to determine the CFC status of a company in order to alert shareholders may not be aware of which particular persons are connected persons in relation to other persons in connection with the determination.

3.2.2 Definitions of "company" and "foreign company"

In order to fall within the definition of a CFC, an entity must first be a company as defined in section 1. The view has been expressed that for the purpose of determining whether an entity is a company or not, Olivier and Honiball (2011: 565) are of the opinion that "the legal status of the foreign entity has to be determined according to foreign law" in its own jurisdiction. A resident investing in such an entity will therefore need to determine how the entity is treated in its home jurisdiction and cannot therefore simply assume, for example, that a foreign partnership will automatically fall outside the ambit of section 9D. The company must also be a foreign company in order to meet the definition. It should be noted that a company incorporated and registered in a foreign country, but which is effectively managed in South Africa would not fall within the definition of a CFC at any point as it would be a resident company for South African taxation purposes and "therefore by definition would not be a foreign company" (Olivier & Honiball, 2011:561).

Before a company can meet the definition of being a "controlled foreign company", it must also first meet the requirement of being a "foreign company", as this term is used in the CFC definition. The term "foreign company" is primarily defined in section 1, and includes any 'company' (as also defined in section 1) which is not resident. If a company is resident in South Africa, it therefore cannot fall within the definition of a controlled foreign company in section 9D(1), even if it was incorporated in another country.

A company is resident in the Republic, according to paragraph (b) of the definition of "resident" in section 1, if "incorporated, established or formed in the Republic or which has its place of effective management in the Republic", unless deemed exclusively a resident of another country in terms of a double taxation agreement. Section 9D(1) further defines the "country of residence" of a foreign company as being where its place of effective management is. These definitions of residence are consistent with the definition in Article 4 of the OECD Model Tax Convention on Income and on Capital (OECD, 2010:24) (hereafter "OECD MTC"), and are therefore in alignment with customary international law and the OECD's model wording for double taxation agreements, which alignment arguably therefore facilitates some degree of common understanding by taxpayers.

The current version of the definition of 'company' in section 1 excludes a foreign partnership, even "if the foreign jurisdiction accorded the partnership juristic personality" (De Koker, 2011: §5.44). This would result in such an entity being taxed in terms of normal partnership provisions rather than under section 9D. A participating resident would need to be astute to this consideration. The taxation implications in the event of changes in partnership interests, for instance, can be expected to be the same as for any other partnership. There is additionally possibly some risk for the *fiscus* that tax avoidance might conceivably arise from the hybrid nature of the entity, arising from differences in tax treatment between the countries involved depending on the classification of the entity by the domestic law in each country (Oguttu, 2009b: 58), or even from differing tax treaty interpretations in each country associated with such domestic classification.

The potential for uncertainty is highlighted by the fact that SARS (2009: 3) has in the past given a Binding Private Ruling in terms of section 76Q that a foreign limited partnership (having the requisite level of South African participation rights or voting rights) would be considered to be a controlled foreign company. It should also be noted that the specific historic provisions for rulings formerly contained in section 9D(10) have been totally removed as of 1 April 2012 (South Africa, 2011a: section 25(1)(l)), although the general advance tax ruling procedures provided by 76P, 76Q and 76R potentially remain available.

From 1 January 2012, the definition of a 'foreign company' is expanded for the purposes of section 9D by the inclusion of protected cell companies (hereinafter "PCC") and their individual 'cells' or segregated accounts as contemplated in the definition of a PCC (South Africa, 2011a: section 25(1)(a)). A definition of a PCC is introduced which targets only insurance PCCs. It should however be noted that a foreign mutual fund (collective investment) which is structured as a cell of a protected cell company (as defined under the laws of another jurisdiction) would also still be a foreign company by virtue of the definition of such funds as a company via paragraph (e) of the definition of 'company' in section 1.

3.2.3 Participation rights

The definition of "participation rights" in section 9D(1) is important to establishing both whether a company is a "controlled foreign company" (section 1 read with section 9D(1) as discussed in 3.1.1 above) and, for a resident investor in a company which meets the definition of a controlled foreign company, to establish the portion of the net income of the controlled foreign company to include in the resident's income for tax purposes (section 9D(2)).

The definition of "participation rights" has been updated with effect from 1 April 2012 (South Africa, 2011a: section 25(1)(b)), however there is expected to be "no essential change in meaning" (Clegg & Stretch: 2012, Vol 1, 8-46[2] footnote 274) for most practical purposes. The latest definition refers to “the right to participate directly or indirectly in the share capital, share premium, current or accumulated profits or reserves of that company, whether or not of a capital nature” or where no such rights are held by any person, or where none can be determined, “the right to exercise any voting rights in that company” (“participation rights” definition in section 9D(1)). Voting rights are therefore only taken into account in determining “participation rights” in those cases where either no person actually has such rights or where “no such rights can be determined for any person”. Consequently, there is only a need to consider voting rights for the purposes of the definition of “participation rights” if no person has other rights attaching to “share capital, share premium, current or accumulated profits or reserves of the company” (para (a) of “participation rights” definition in section 9D(1)). “Voting rights” are not defined in the Act, consequently the term has the common meaning.

Voting rights are therefore potentially considered at least twice for CFC purposes: once (as an alternative to participation rights) in the determination of whether the company is a controlled foreign company (section 9D(1) and section 1 CFC definitions), and again potentially in the determination of participation rights (section 9D(1)) for the purpose of the imputation of income *via* section 9D(2) of the Act.

It is conceivable that a company having share capital may fall within the definition of a controlled foreign company by virtue of the voting rights of residents exceeding 50%, however by virtue of the extent of the residents’ participation rights the total participation rights of residents may actually be equal to or less than 50%. Further, no imputation of income may be required at all if no resident, or collection of resident connected persons in relation to each other, have participation rights or voting rights totalling at least 10% of total participation rights in the CFC (proviso (A) to section 9D(2)). Nevertheless, if there is any uncertainty regarding the CFC status of a foreign company or the extent of participating rights held by a resident investor, it would arguably be advisable for the investor to retain annual financial statements of the CFC for submission to SARS in terms of section 72A(2) when requested, for the reasons given in the introduction to this chapter (3.1 above).

Some uncertainty regarding the calculation of total participation rights, and the percentage of participation rights held, may arise in a foreign company in which different classes of shares exist, including preference shares with the various possible attributes such shares may have. Practical interpretation issues may well arise in such circumstances.

It is possible that varying levels of participation may arise by virtue of varying rights attaching to various classes of shares, and which might shift a particular company into or out of CFC status at various times. Depending on the circumstances in a particular case, it is quite possible that the variation in rights has no tax avoidance objective, but is designed to serve real commercial requirements in line with agreements in regard to extent of funding, return and contribution of particular shareholders. Such circumstances could arguably be expected to trigger CGT to the detriment of resident shareholders, even when no actual disposals have taken place (PricewaterhouseCoopers, 2010:2). Further, in the event that additional equity funding for a CFC is secured from non-residents, a foreign company may cease to be a CFC because of the dilution effect. In addition, the participation exemption provided in paragraph 64B of the Eighth Schedule to the Act may not exempt resulting capital gains within the CFC because the fact that CFC status is lost was not as a result of an actual disposal of shares by the resident shareholders (PricewaterhouseCoopers, 2010).

Olivier and Honiball (2011: 571) have expressed the opinion that the legislature should clarify the reference to "indirect" holdings to clearly refer to "holding through another company" rather than "conditional holdings" such as might arise in the case of holding convertible instruments such as debentures or certain derivatives, also however pointing out that National Treasury has in the past expressed a narrower interpretation. The notion that such uncertainty should ideally be eliminated is supported owing to the potentially negative financial consequences to a resident investor which might result should an incorrect interpretation result in an understatement of their participation rights.

Arguably the definition would include the rights of a vested capital beneficiary of a foreign trust which holds shares in a foreign company, but it is uncertain that it would include the rights of an unvested capital beneficiary of such a foreign trust (this is perhaps unlikely as such beneficiaries have no rights to the income of the trust). It is submitted that it would be far better for the legislature to be explicit regarding the position of the unvested beneficiaries of a trust, in order to eliminate such uncertainty, which it is submitted is onerous to trustees and beneficiaries alike, as an incorrect interpretation could have far-reaching financial consequences for the beneficiaries.

3.2.4 Net income

A resident who holds a qualifying participation in a CFC needs to determine the CFC's net income for the purposes of proportional inclusion in their own income (section 9D(2) read with section 9D(2A)). This involves largely performing a full South African taxable income calculation. Such a resident should have cognisance of the specific sections for which the company is treated as a resident for the purposes of determining the CFC's net income ("net income" definition in section 9D(2A)).

Additional consideration needs to be given by such a resident to the various provisos of section 9D(2A) which limit deductions; ring-fence assessed losses; prohibit certain deductions in relation to transactions with other CFCs unless (prior to 31 March 2012) an election has been made in terms of section 9D(12) that the exemption provisions of section 9D(9) should not apply for the particular foreign tax year of a CFC; define the valuation date upon becoming a CFC for the purposes of Schedule 8 of the Act for the determination of taxable capital gains and losses; set the inclusion rate for resident participation holders' capital gains where the resident is an individual, special trust or insurer regarding their individual policyholder fund; prior to 31 March 2012 reinforce transfer pricing requirements regarding transactions with connected persons of the CFC (which subsequently deleted); and specify certain currency-related matters.

Section 9D(2A) defines "net income" for the purposes of the section as "an amount equal to the taxable income of that company determined in accordance" with the manner set out therein. What is included is therefore not actually a direct part of the net income of a CFC but an amount "equal to" an amount derived in terms of the provisions of the section. The reason such a notional amount is included in the South African CFC rules relates to the potential problems highlighted by the United Kingdom case of *Bricom Holdings Ltd v IRC* (1997) STC 1179 CA, in which case the United Kingdom CFC legislation was successfully defended against the application of a double taxation agreement as the underlying income was held to have lost its original character.

South African National Treasury (2002:2) states that the original intention of the legislature was to avoid any possibility of an allegation of Double Tax Agreement override. A full discussion of the arguments for and against the existence of such override is however outside the scope of this study, although it is clear that CFC rules have the potential to at least effectively bypass the provisions of a double tax agreement through the attribution to a resident of an amount corresponding to the income of separate person who is a non-resident, even if such an effect may be entirely legitimate in terms of domestic law. The operation of section 9D together with the unilateral credit for foreign taxes paid by a CFC in terms of section 6*quat* aims to prevent effective economic double taxation, while ensuring that the resident incurs in economic terms a similar amount of tax to that which might be incurred if no CFC was involved in the foreign income-earning activities but that the resident conducted such activities directly. Oguttu (2009a: 73 – 114) considers the potential conflict between double tax treaties and CFC legislation in some detail and concludes that because CFC laws and tax treaties enjoy equal status under South African domestic law, potential conflicts could be resolved by means of including a CFC clause in revised or new tax treaties, as recommended by the OECD (Oguttu, 2009a: 114).

One consequence of the manner of inclusion of an amount in respect of CFC income in the income of a resident taxpayer is that no deduction of expenses (paid e.g. by a holding company of a CFC to provide income-earning funding in its subsidiary) may be available against income so included by section 9D, as such expenditure may arguably be considered not to be expended in production of the notional amount included in the income of the taxpayer, consequently excluding the possibility of a deduction by the taxpayer in terms of section 11(a).

The formula specified for the determination of the amount to be equated to is "taxable income of that company determined in accordance with the provisions of this Act as if that controlled foreign company had been a taxpayer, and as if that company had been a resident. The effect is that the CFC is fictionally treated as if it were “chargeable with any tax leviable” under the Act (definition of “taxpayer” in section 1) notwithstanding its factual lack of residence and any consequent lack of jurisdiction, and because the CFC is treated as if it were resident the determination of the notional taxable income is on a worldwide basis, rather than on the source basis usually applicable to non-residents (definition of “gross income” in section 1). A CFC is accordingly explicitly treated as a “resident” for purposes of the gross income definition and the various other specific sections as listed in section 9D(2A), resulting in the CFC effectively requiring a taxable income calculation which is substantially similar to other resident taxpayers, however also with several differences. For instance, several provisos within section 9D(2A) qualify and refine the “net income” definition and consequently the notional taxable income calculation in respect of the CFC.

It could perhaps be argued that, given the complexities, information requirements and compliance costs involved in applying a full South African tax calculation based on the net income (as defined in section 9D(2A)) of a foreign company, it may help to simplify matters considerably if the legislature permitted more generally an alternative concept of net income better aligned to the records of a foreign company, to whom a South African taxation calculation can be expected to be alien in many cases.

Such an approach could arguably have the potential of reducing the impact of maintaining South African taxation records for a foreign company, which Olivier & Honiball (2011: 575) characterize as “two sets of books” having to be kept. In addition, such an approach could be expected to have a benefit in addressing the problem identified by Thuronyi, V. (2003: 295) that “To the extent that developing and transition countries want to tax non-residents, the main difficulties lie in untangling the accounting of multinationals, a task that tax administration officials are not up to”. Thuronyi’s comment appears to apply equally to the difficulties of taxing a resident on a notional portion of a non-resident’s net income.

Naturally, any alternative basis would also need to be measured against and cater adequately for the anti-avoidance and anti-deferral objectives of CFC legislation, but the economic benefits of such alignment may well be worthy of pursuit by the legislature. It is submitted that the International Financial Reporting Standards incorporating International Accounting Standards and Interpretations (hereafter all three of which are collectively referred to as “IFRS”) (SAICA, 2011:Preface to IFRS 2010, paragraph 12) and which are prescribed domestically in terms of the Companies Act (South Africa, 2008: section 29(4)) for various categories of companies by regulation 27(4) of the Companies Regulations, 2011 (South African Department of Trade & Industry, 2011:31) could potentially be a starting point for a basis which might be worthy of consideration by National Treasury and the legislature. International precedent for such an approach is evident to some degree in the United Kingdom, where for instance the test of "control" is now determined in certain circumstances with reference to the applicable accounting standards (HM Treasury, 2012a: 6).

3.2.5 Restrictions regarding losses

For a resident holding company having multiple foreign subsidiaries, some of which may have net income and some of which may have losses, no set-off of such losses against net income of other CFCs or other income of the resident is provided for, and any excess of deductions over gross income is carried forward to the succeeding foreign tax year as a deemed assessed loss which may only be set off the income of that CFC (provisos (a) and (b) to section 9D(2A)). This is arguably overly prejudicial to the resident, as world-wide income is taxed, however no relief is given for subsidiaries in a loss-generating developmental phase of their business lifecycle. It should however be noted that in the event of ring-fencing of assessed losses, no limitation on the carry-forward of any excess deductions or allowances) is evident in section 9D(2A)(b) (Olivier & Honiball, 2011: 576).

3.2.6 Restrictions regarding transactions with other CFCs

A number of restrictions are also imposed in regard to transactions with other CFCs (proviso (c) to section 9D(2A)) which are summarised as follows:

(c) "no deduction shall be allowed"… for -

- (i) "interest, royalties, rental or income of a similar nature which is paid or payable"… "to any other CFC" (including any similar amount adjusted in terms of section 31"[the transfer pricing section of the Act]);
- (ii) "exchange difference"… "in terms of section 24I in respect of any exchange item to which that company and any other CFC are parties";
- (iii) "exchange difference"… "in respect of any forward exchange"… "or foreign currency option contract entered into to hedge"… "item referred to in subparagraph (i)"; or
- (iv) "reduction or discharge by that company of a debt"… receivable from "by any other CFC for no consideration or"… "less than the amount by which the face value"… "has been so reduced or discharged";

"where that CFC and that other CFC form part of the same group of companies, unless that interest, rental, royalty, other income, adjusted income, exchange difference, reduction or discharge is taken into account to determine the net income of that other foreign company." (Section 9D(2A)(c), from 1 April 2012)

The resident taxpayer therefore needs both to maintain an awareness of other CFCs with which a CFC had dealings, and to obtain all the required financial and other information which is relevant to apply the above requirements when determining CFC net income.

With regard to the deduction limitations regarding transactions with other CFCs it should be noted that section 9D(9)(fA) correspondingly exempts from the net income of a CFC the income items disallowed by proviso (c) to section 9D(2A) above, ensuring symmetry in the treatment between the two CFCs. Up to 31 March 2012, in the event of an election in terms of section 9D(12) by a resident (holding at least 10% but not more than 20% in a CFC) that the provisions of section 9D(9) are not to apply in a particular tax year, such income would not be exempted, however because the deduction prohibitions in section 9D(2)(c) did not apply if such an election had been made, symmetry was maintained between the treatment of the two CFCs. From 1 April 2012 the aforementioned election is no longer available (South Africa, 2011a: section 25(1)(l)).

3.2.7 Capital gains valuation date

For the purposes of determining capital gains within net income, paragraph (e) of the proviso to section 9D(2A) specifies that the valuation date "shall be the day before such company becomes a CFC". This has the effect of excluding capital gains or losses which occured prior to such date from any inclusion in CFC net income. Paragraph (f) specifies the CFC capital gains inclusion rate for the purposes of section 26A for residents which are not companies. As a CFC is a company the company rate would otherwise apply. CFC investors should therefore expect the inclusion rates specified in paragraph 10 of the Eighth Schedule of the Act to increase for the 2013 year of assessment in line with the Minister's announcement in the 2012 budget speech (Gordhan, 2012: 14).

3.2.8 Connected Persons

The term "connected person" as defined in section 1 is particularly important in the following contexts regarding section 9D:

- In establishing the status of a foreign company as either being a CFC or not, the participation rights and voting rights of any connected persons in relation to a resident holder of participation rights or voting rights are respectively combined with those of the resident for the purpose of determining whether residents hold greater than 50% of the voting rights or participation rights in a foreign company (definition of "controlled foreign company" in section 9D(1));
- In determining the percentage of voting rights which may be exercised directly or indirectly in a foreign company, the voting rights of connected persons in relation to a resident are combined with their voting rights (definition of "controlled foreign company" in section 9D(1));
- In evaluating the 5% de minimis exclusions from residence in relation to listed companies and foreign collective investment schemes (para (c) of the definition of "controlled foreign company" in section 9D(1));
- In establishing whether a resident who has a participatory interest in a CFC of less than 10% is required to include any amount relating to the net income of the CFC in his income or not, such a resident will not be so required if "that resident (together with any connected person in relation to that resident)"… "in aggregate holds less than 10 per cent of the participation rights and may not

exercise at least 10 per cent of the voting rights" of the CFC (proviso (A) to section 9D(2));

- In establishing whether the transfer pricing provisions of section 31(2) apply to any "transaction, operation, scheme, agreement or understanding" between a CFC and any other person, this will be the case if the other person is a connected person in relation to the CFC (section 9D(2A)(i) up to 31 March 2012 – subsequently deleted). Regarding the position from 1 April 2012, note however the continuing uncertainties as described in 3.1.8 above;
- In establishing with reference to an FBE or a CFC whether any exclusions should be made from the calculation of CFC net income, extensive reference is made in section 9D(9A) (from 1 April 2012 – also in the former version of section 9D(9)(b) up to 31 March 2012) to connected persons in relation to the CFC, primarily with a view to providing that there should be no such exclusion in regard to CFC transactions with such persons except in very specific circumstances as set out therein; and
- Up to 31 March 2012, in determining eligibility for the elections set out in section 9D(12) and (13). From 1 April 2012 these elections are however deleted (South Africa, 2011a: 66).

It is submitted that the "connected person" definition is arguably not a definition that is likely to be fully understood by many residents, and yet it is of absolute importance that a resident invested in a foreign company understands the importance of connected persons both in relation to themselves and in relation to the foreign company, because a failure to identify the participation rights and voting rights of connected persons or CFC transactions with connected persons as described therein may well result in considerable additional unforeseen financial cost in the form of the taxation and/or penalties and interest thereon.

The term connected person is defined in section 1 of the Act with reference to various types of "person" as follows (lettering corresponds to lettering within the definition in the Act), in relation to a:

(a) **natural person** – any relative of the person and any trust (excluding a portfolio of an investment scheme in securities) of which the person or their relative is a beneficiary;

(b) **trust –** any beneficiary of the trust, as well as "any connected person in relation to such a beneficiary";

(bA) **connected person in relation to a trust** (excluding a collective investment scheme in property shares in terms of the Collective Investment Schemes Control Act, 2002) **–** "includes any other person who is a connected person in relation to such trust";

(c) **partnership – "**any other member; and any connected person in relation to any member";

(d) **company –** the following persons:

- a "company which would be part of the same group of companies" if the percentage in the definition of "group of companies" were reduced to 50% (it is 70% in that definition – refer also to the discussion of "group of companies") ;

- a person "other than a company" as defined in section 1 of the Companies Act (South Africa, 2008) who (either "individually or jointly with any connected person in relation to himself") "holds directly or indirectly, at least 20 *per cent*" of either the equity shares or the voting rights in the company;
- another company "if at least 20 *per cent* of the equity shares in the company are held by that other company, and no shareholder holds the majority voting rights in the company"; and
- another company which is "managed or controlled" by a person "who or which" is either "a connected person in relation to such company" or a connected person in relation to such a connected person;
- where the "company" as defined in section 1 is a close corporation, any member of the close corporation; any "relative of such member"; any trust which is a connected person in relation to such member ("other than a portfolio of a collective investment scheme in securities"); and "any other close corporation or company which is a connected person" regarding any member of the close corporation; any relative of such a member; or a relative or trust which is a connected person of such a member; and

(e) a person who is a connected person in relation to any other person – "such other person"

The word "**relative**", which is frequently referred to in the definition of a connected person, is itself defined in section 1 to mean the spouse of a natural person; "anybody related to him or his spouse within the third degree of consanguinity"; or "any spouse of any person so related". An adopted child is for this purpose "deemed to be related to its adoptive parent within the first degree of consanguinity".

3.2.9 Transfer-pricing and general anti-avoidance provisions

Because a "transaction, operation, scheme, agreement or understanding between a CFC and any connected person in relation to it" is subject to the requirement for arm's length transfer pricing, it will be very important for a resident to evaluate which parties are such connected persons (as defined in section 1) of the CFC and to ensure that such transactions are either at arm's length or that appropriate adjustments have been made (section 31 and section 9D(9)(b) read with section 9D(9A)).

A full discussion of transfer pricing principles and methodology and methods to determine an arm's length price acceptably is beyond the scope of this document. Readers may wish to refer, for instance to Olivier & Honiball (2011: 631), for further information in this regard. It is however noteworthy that a CFC was previously deemed through proviso (i) to section 9D(2A), for the purposes of the arms-length transfer-pricing requirements of section 31(2) of the Act, to be a resident regarding a wide range of transactions, agreements or other understandings "between that CFC and any connected person in relation to that CFC" (proviso (i) to section 9D(2A) up to 31 March 2012). From 1 April 2012 this provision is deleted (South Africa, 2011a: section 25(1)(e)). It would appear that its deletion has the effect that the application of section 31 transfer pricing provisions from 1 April 2012 to transaction amounts of the CFC will initially therefore depend on whether the CFC is treated as a resident, or remains a non-resident, in particular circumstances.

Olivier and Honiball (2011: 658) have explained that while the net income of a CFC is subject to section 31, through the reference in section 9D(2A) to "taxable income", which includes section 31 as it falls within Part I of Chapter II of the Act (definition of "taxable income" in section 1), the CFC is treated as a non-resident only for the purpose of calculating its net income, and therefore remains non-resident (for instance, in relation to another CFC). For instance, for the purposes of calculating CFC net income in terms of section 9D(2A), a CFC is consequently treated as if it is a resident for the purposes of the definition of "gross income" in section 1, and it is clear from the wording of section 11(a) that expenses actually incurred in the production of income arising from a trade of the CFC would be allowable in determining CFC net income. It is perhaps to be expected that the courts might conclude that, being treated as a resident in relation to gross income, it would require an impossible dual personality for a CFC to be treated as a non-resident in relation to the deduction of expenses in the production of such income.

Paragraph (a)(iv) of the definition of "affected transaction" in section 31(1) specifically includes the position where a non-resident person deals with a connected person that is a CFC in relation to any resident. Therefore, in respect of any transaction between a CFC and a non-resident who is a connected person with regard to the CFC which "results or will result in any tax benefit" to one of the parties thereto, the "taxable income or tax payable" by that party must be calculated as if "entered into on the terms and conditions that would have existed had those persons been independent persons dealing at arm's length" (section 31(2)). In addition, as a CFC is not a resident, paragraphs (a)(i) and (a)(ii) of section 31(1) will apply in the relevant circumstances.

Further, the transfer pricing requirements of section 31 may apply between two CFCs where these are not part of the same group of companies (as defined). It is however arguably unlikely that transfer pricing manipulation will occur in a circumstance where only a partial ownership of the other party to a transaction is in place, and therefore it is submitted that it would also help to reduce the burden of compliance if such transactions were removed from the ambit of the transfer pricing rules in relation to CFCs.

It should also not be forgotten that the general anti-avoidance provisions contained in sections 80A to

80T and section 103 are of potential application by the Commissioner to seek to ensure that the effect of transfer pricing arrangements is not to reduce the South African tax-base. In addition, residents should be aware of the courts' ability to entirely disregard simulated transactions under the common law. For example in the case of *C:SARS v NWK Ltd* (2010), the Supreme Court of Appeal has extended its enquiry beyond the form and tenor of agreements entered into, to their commercial substance, resulting in contractual transactions being entirely disregarded. Resident taxpayers would undoubtedly generally prefer to eliminate uncertainty regarding their transactions and pricing arrangements, given the dire potential financial consequences described at the beginning of this chapter, and should therefore seek to ensure that real commercial substance underlies the transactions of a CFC or its FBE as well.

Resident taxpayers accordingly need to be well versed in transfer pricing principles, anti-avoidance requirements and relevant common law, and should ensure that the transfer pricing matters in relation to CFCs have been well thought through, documented and operationally implemented, in order to minimise the possibility of unexpected adverse transfer pricing adjustments being imposed upon assessment, which would potentially be accompanied by the consequence of the late payment or non payment of taxation, or of non-disclosure of all relevant matters.

It is submitted that the area of Transfer Pricing can be one of great uncertainty to a resident who is invested in a CFC, and consequently this area potentially carries considerable risk for such a resident. The legislature could help to remove the negative effects of such uncertainty by, for instance, introducing appropriate legislative provisions for Advance Pricing Agreements, whereby the pricing arrangements in relation to a CFC could be endorsed by a suitable organ of South Africa's National Treasury department such as SARS, perhaps in conjunction with representatives of the Department of Trade and Industry (in order to counter-balance the potentially opposed policy interests of taxation and trade), following an application and associated activities to agree such arrangements. Readers may wish to refer for additional detail in this regard to Chapter 5 regarding International Competitiveness considerations.

In the case of amounts attributable to an FBE of the CFC, specific arm's length provisions apply (see discussion in Chapter 4). It might be argued that the position is however not simplified, and it is submitted that complexity itself in the arena of transfer pricing can be a considerable source of uncertainty (and consequently risk) to resident taxpayers.

3.2.10 Foreign tax year

"Foreign tax year" in relation to a CFC means the year or period of reporting for foreign income tax purposes or, if that company is not subject to foreign income tax, the annual period of financial reporting of that company;" (s 9D(1) of the Act). De Koker (2011: §5.44) notes that there may be some uncertainty as to the 'foreign tax year' of a CFC if it is not required to report for foreign income tax purposes "and is not subject to an official annual period for financial reporting to the government of its country of incorporation". He considers that in such a case the meaning will presumably be "the annual period of financial reporting to the shareholders concerned." It is submitted that De Koker's view is probably correct, as the definition in section 9D(1) does not explicitly mention to whom the annual reporting need be made.

It should perhaps be noted that jurisdictions do exist where the period of reporting for tax purposes and the period of annual reporting to shareholders are not necessarily the same e.g. in the Bailiwick of Guernsey (States of Guernsey, 2011:1). Any such anomaly should perhaps in future be addressed in the Act e.g. for the foreign tax year to be nominated by the resident investor in any instance where the position is not clear.

Section 9D also deals with changes in the status of a company to or from falling within the definition of a CFC during the foreign tax year, which are interpreted in summary as follows:

In the case where a foreign company became or ceased to be a CFC during its foreign tax year (including arguably any sequence of such changes), the resident is afforded an option to either apportion the net income of the CFC based on the portion of its foreign tax year for which it was a CFC (calculated based on the number of days as a ratio of total days in that foreign tax year); or based on the actual net income for the period or periods from when the foreign company became a CFC until the sooner of either the end of its foreign tax year or the day before it ceased to be a CFC (section 9D(2)(a)(ii)). It may be in the interest of a resident affected by such a partial CFC tax year to take the trouble to calculate and compare the taxation outcome of the alternate bases, as prior studies have shown that the difference can be significant (Olivier & Honiball, 2011:573 refer to an example by Burt "Apportionment under section 9D: the two methods" 2004 Tax Planning 110). Olivier & Honiball (2011: 573) have identified that because the last day of a CFC's foreign tax year is decisive, the legislation is susceptible to abuse through income shifting between CFCs. Residents should however note that such shifting for tax purposes might be disallowed in terms of the general anti-avoidance provisions (sections 80A to 80T and section 103(2)).

3.2.11 Currency matters in relation to CFCs

Section 9D(6) sets out the main rules with regard to currencies, and the conversion thereof, for both determining and converting the "net income of a CFC in respect of a foreign tax year" for the purposes of including the relevant portion in the income of a resident. The general rules are spelled out in the initial part of section 9D(6), followed by certain specific refinements which are set out in the proviso.

The first such general rule is that the net income of a CFC is to be determined in its own functional currency as defined in section 1 of the Act (section 9D(6)). The term "functional currency" is defined in section 1 of the Act to mean in relation to a person "the currency of the primary economic environment in which the business operations of that person are conducted"; or where a person has a permanent establishment in a country outside the country of its residence the term means "the currency of the primary economic environment in which the business operations of that permanent establishment are conducted" (paragraphs (a) & (b) of "functional currency" definition in Section 1).

Consequently, the functional currency of a CFC would be the currency of its country of residence, provided that country is where most of its business is conducted. In the event of the CFC operating primarily outside its country of residence, or of it having a permanent establishment outside its country of residence, its functional currency or that of its permanent establishment may not actually be the currency of its country of residence. Paragraphs (k) of the proviso to section 9D(2A) additionally specifies that the CFC's functional currency is to be the "local currency" for the purposes of paragraph 43 of the Eighth schedule of the Act, dealing with the acquisition or disposal of assets in foreign currency of a CFC.

Paragraph (l) of the proviso to section 9D(2A) deals with an abandoned functional currency in a country where inflation was at least 100%, such as in the case of Zimbabwe, deeming a CFCs existing assets to have been acquired for market value on the first day of the foreign tax year for an amount equal to the market value on the date on which a new currency was adopted by the CFC. This provision would seem to be aimed at reducing the impact of the base cost of CFC assets being denominated in a severely depreciated, abandoned currency, resulting in excessive capital gains upon their disposal.

The second general rule is that for the purposes of including the amount (with reference to the relevant calculated portion of CFC net income) to include in the income of any resident, the average exchange rate for that currency (relative to the currency of the Republic) for the company's foreign tax year is to be used (section 9D(6), from 1 January 2012) previously the average for the resident's year of assessment applied, which was arguably less appropriate where this differed considerably from the foreign tax year should a significantly different rate have resulted. Van Heerden (2009: 159/160) has provided worked examples to illustrate the potential impact of such a mismatch where the average for the resident's year of assessment was used prior to 1 January 2012.). Because of the effect of averaging, in the event of significant foreign currency exchange rate fluctuations, the conversion rate and method specified by the Act may not accord with a currency conversion method designed to match the specific timing considerations with respect to the underlying transactions.

It is submitted that it would therefore be preferable for the legislature to provide more choice with regard to the method of currency conversion (e.g. the use of spot rates or of monthly average rates), although it is appreciated that should such greater choice be made available by the legislature, consistency of application by taxpayers may be a desirable concomitant in order to prevent regular switching of method in order to secure the most favourable rate, simply in order to minimise any resulting taxation. The use of spot rates or monthly average rates could also be expected to make checks by SARS more difficult, although a more accurate economic result might result in cases of exchange rate volatility.

The more specific rules, all of which clarify the first general rule, i.e. the calculation of the net income of a CFC, are as follows (lettering matches the lettering within the proviso to section 9D(6)), providing special cases where the relevant part of CFC net income must be calculated in the currency of the Republic (South African Rands) and thereafter translated to the functional currency of the CFC by applying the average exchange rate for the year of assessment of the resident within which the foreign tax year of the CFC ends:

(a) The CFC's capital gains or capital losses from disposals of foreign equity instruments or from any asset "the capital gain or capital loss from the disposal of which is deemed to have been derived from a source in the Republic" (as per paragraph 43(4) of the Eighth Schedule to the Act) and which are not attributable to any permanent establishment outside the Republic (proviso (a) to section 9D(6));
(b) Disposals of foreign equity instruments (as defined in section 1) which constitute trading stock, and which are not attributable to a permanent establishment of the CFC outside the Republic (proviso (b) to section 9D(6)); and
(c) When calculating gains or losses on foreign exchange transactions in accordance with section 24I, "local currency" as referred to in that section is deemed to mean the currency of the Republic (proviso (c) to section 9D(6));
(d) The following are deemed not to be attributable to any permanent establishment of the CFC in any case where the relevant functional currency is that of a country with an official inflation rate exceeding 100% for the foreign tax year of the CFC:
    (i) any asset or foreign equity instrument disposed of in a currency other than the CFC's functional currency; and
    (ii) any exchange item which is denominated in a currency other than the CFC's functional currency

It should be noted with regard to the FBE exemption (discussed further in Chapter 4 and Appendix A) under section 9D(9A)(iii)(bb) the foreign currency gains or losses on financial instruments are excluded from CFC net income if these arise "in the ordinary course of business of the principal trading activities" of the FBE, not being the activities of a "treasury operation or a captive insurer". In addition, the 5 *per cent de-minimis* provision of section 9D(9A)(iii)(cc) could also apply to exclude such gains or losses from the CFC net income calculation.

3.3 Specific provisions of section 9D

Section 9D(9) specifies various circumstances where amounts must not be taken into account when determining the net income of a CFC. These circumstances as well as other selected provisions in relation to section 9D are highlighted and evaluated below. Exemptions may serve to reduce the amount to be included in the income of a resident who holds qualifying participation rights in the CFC. By virtue of section 23(f), in such circumstances residents will also need to remember that where income is exempted under such provisions, no deduction will be allowed for related expenses, as no income (as defined in section 1) will have been produced.

3.3.1 Exemption regarding high taxed net income

Two further provisos exist within section 9D(2A), firstly in the form of a nullification of the net income if foreign taxes payable at least match 75% of the normal tax which would have been payable "to all spheres of government of any country other than the Republic by the CFC" had the CFC been a resident for the particular foreign tax year, and secondly instructions for the calculation of the aggregate foreign tax for the purpose of the determination of the percentage for the first further proviso (further proviso (ii) to section 9D(2A)). The words "any sphere of government" could be construed to include even regional or local taxes and even indirect taxes such as VAT or similar taxes, and not merely national income taxes. The aggregate foreign tax must be determined "after taking into account any applicable agreement for the prevention of double taxation and any credit, rebate or other right of recovery of tax from any sphere of government of any country other than the Republic" and "after disregarding any loss" in respect of any other year, or from another company. Consequently, for the determination no prior assessed loss is considered, and losses in respect of other CFCs are also ignored.

Mendes (2011:1) has highlighted several complexities and uncertainties involved in properly evaluating a CFC's net income with regard to the so-called "high taxed net income exemption" within the further provisos to section 9D(2A), noting that "at first sight the proviso seems simple to apply: if the CFC is subject to a minimum level of tax, there is no CFC net income. However, a deeper examination of the proviso reveals that its application is very complex and gives rise to a number of unanswered questions". She points to the complexity of the rules regarding the calculation of net income and the "circumstances in which amounts are included or excluded", as well as the determination of foreign taxes in respect of "all spheres of government".

Mendes (2011:1) has also provided by way of example the introduction of the proviso by promulgation on 30 September 2009 with retrospective application to foreign tax years of a CFC "after 1 January 2008", which might have resulted in taxpayers including CFC income which should in fact have been excluded, and the apparent lack of a specific mechanism to correct this.

In addition Mendes (2011:1) has pointed to the difficulties which may arise in regard to the allowances provided for in section 12C which arise when plant or equipment is "brought into use for the first time" (section 12C) may not be available in regard to a CFC where in consequence of timing differences with the CFC's foreign tax year, such plant or equipment may have been brought into use during the year of assessment where the provision is first applied. Consequently, she notes that "it is possible that the 75% test would not be met" should a similar provision apply in the CFC's own tax jurisdiction.

Mendes (2011:1) has further identified a similar challenge should an income tax deduction be sought for a CFC in terms of the allowance for bad debts (section 11(i)). Such an allowance is only permitted if the amount previously formed part of the CFC's income, and may therefore not arise should the original amount have accrued prior to the effective date of the proviso to section 9D(2A) and have proved to be a bad debt subsequent to the effective date of the proviso.

It is submitted that Mendes' arguments carries merit, and it is agreed that many other such issues can be expected to face residents both in applying this proviso following its implementation and potentially in circumstances where the proviso is applied in one year, not applied in the next and again applied in a subsequent year.

These further provisos warrant careful consideration because if, after performing the determination of net income (which in essence requires a full South African taxable income computation together with any CFC-related adjustments), it transpires that the foreign taxes payable (to all spheres of government) at least match 75% of the normal tax which would have been payable had the CFC been a resident for the particular foreign tax year, the CFCs net income is deemed to be nil. The rationale for this provision appears to be that in such circumstances, little South African normal tax would be payable after the section 6*quat* rebate is taken into account. It should be noted that relief should be claimed under section 6*quat*, and not relief under an application double taxation agreement, because the inclusion of CFC income is "an amount equal to" the proportional amount of the net income of the CFC for the applicable foreign tax year (section 9D(2) of the Act). This notional amount of income is arguably not the same as the income of the CFC itself, following the logic of the aforementioned *Bricom* case (1997). It should however be noted that nevertheless another argument does exist that such a notional amount would fall within the business profits provision of a double taxation agreement (Olivier & Honiball, 2011: 613). It is therefore submitted that a South African resident should rather follow the certainty of section 6 *quat* in this regard.

It is submitted that the calculation and associated complexity required to arrive at this particular relief is overly onerous to arise at a conclusion of nullification of net income, and therefore compares poorly in this regard with, for instance the United Kingdom “excluded territories” exemption which requires simply a headline tax rate which exceeds 75% of the United Kingdom rate (HM Treasury, 2012a: 5 and 2012b: 18).

It would potentially lighten resident taxpayers taxation compliance efforts (and the administrative burden placed on certain CFCs) considerably if the legislature would ease the burden by providing an exemption similar to the United Kingdom “excluded territories” exemption, or (at least as an alternative) a simpler mechanism for the high taxed exemption test, for instance based on the current taxation charge as a percentage of the net income disclosed in the audited annual financial statements of the CFC, provided that these are prepared based on international accounting standards accepted by the Commissioner for this purpose, together with a certificate from the auditors that there is not expected to be a “credit, rebate or other right of recovery” that might reasonably be expected to reduce the percentage below the threshold. It is submitted that such an alternative would be in keeping with the spirit of the exemption and could be expected to eliminate considerable effort and expense for a number of residents.

3.3.2 Postponement of inclusion of CFC net income

While not a provision of section 9D itself, section 9A operates to provide relief if an amount included in the income of a resident “may not be remitted to the Republic during that year as a result of currency or other restrictions or limitations imposed in terms of the laws of the country where the amount arose” (Section 9A(1)). In regard to the calculation of net income of a CFC, section 9A(3) provides such relief by way of a deduction “equal to so much of the amount or portion which may not be remitted” if a CFC is subject to such restrictions or limitations. Section 9A(4) then provides that the amount of such a deduction is deemed to be an amount received by or accrued to the CFC in the following foreign tax year of the CFC. In effect the accumulation of such amounts would be repeatedly postponed until such time as the restrictions or limitations referred to were no longer applicable, and consequently this section serves to reduce the potentially onerous impact of section 9D in such circumstances.

This provision is considered fair to the taxpayer involved, as it would be onerous to the taxpayer to incur a taxation liability on income which is subject to such limitations or restrictions in the jurisdiction of residence of a CFC, where no possibility would exist of funding the resulting tax liability by way of dividends declared by the CFC.

It should however be noted that no such relief is available to a taxpayer when the management and controlling shareholders of a CFC refuse to declare dividends, which could of course put a minority shareholder in a similar position to the abovementioned limitations and restrictions. Consequently residents having or contemplating securing minority holdings in a CFC above the 10% exemption threshold (as provided within proviso (A) to section 9D(2)) either on their own or together with their connected persons, would arguably be well advised to ensure in advance that they understand and are satisfied with the prospects of earning sufficient dividends in relation to the company or alternatively that they expect to have an adequate independent ability to fund the normal tax resulting in relation to the section 9D inclusions in their income.

3.3.3 Foreign business establishment exemption

As mentioned in Chapter 2 above, the FBE exemption is considered to be the main exemption from section 9D. The exemption seeks to exclude the active business income attributable to an FBE of a CFC. Up until 31 March 2012, the full FBE exemption was contained in section 9D(9)(b) and included a number of exclusions, the intricate nature of which have doubtlessly led to commentators such as Olivier and Honiball (2011:581) referring to the FBE exemption as "one of the most complicated provisions in the South African Income Tax Act". Section 9D(9)(b)'s shorter successor from 1 April 2012, continues to contain a more generalised FBE exemption and some new instructions for its application, and is complemented by the diversionary rules contained in section 9D(9A). This exemption is discussed in more detail in Chapter 4 and Appendix A.

3.3.4 Insurance policies held by non-residents

Where any amounts received by or accrued to a CFC are attributable to a long term insurance policy held by a non-resident policyholder (who is also not a CFC in relation to a resident), such amounts will be excluded from the net income of the CFC. For the exclusion to apply the policy would need to have been issued by a company licensed in its country of residence to issue "any long term policy as defined in the Long Term Insurance Act, 1998 (Act No. 53 of 1998)" (Section 9D(9)(c)).

It is submitted that this provision is appropriate, as a premium received by a CFC from a non-resident policyholder is likely to be active business income of the CFC, rather than diversionary passive income.

3.3.5 Previous inclusions of income in CFC Taxable Income

Where a CFC has taxable income in South Africa, an amount which is already taxable in South Africa is excluded by section 9D(9)(e) when calculating the CFC's net income, in order to avoid the economic double taxation of a resident investor by way of inclusion *via* section 9D(2). It is submitted that this measure is self-evidently reasonable. Such amounts could for instance be earned from a source within the Republic, and therefore included in gross income as defined in section 1. The gross income would form part of a South African calculation of taxable income for income tax purposes. By excluding that income from the net income calculation in regard to the CFC as provided in section 9D(9)(e), the *fiscus* is effectively prevented from taxing the same income twice, once in the hands of the CFC and again in the hands of the resident.

For example, interest which has a South African or deemed South African source (e.g. by virtue of section 9(2)(b)) and is earned by a CFC will therefore be excluded from its net income as defined, but will be taxed in the CFC's hands directly as South African source income.

3.3.6 Foreign dividends earned by a CFC from another CFC in relation to a resident

If there were no exclusion of foreign dividends received by a CFC from another CFC, juridical double taxation would arise because the resident would be taxed both on the amount of the dividend (as a foreign dividend) and on the amount imputed to the resident in relation to the net income of the CFC declaring the dividend.

Consequently, section 9D(9)(f) excludes a foreign dividend declared to a CFC by another CFC (in relation to the resident taxpayer) from the net income of the former CFC which receives the dividend. The exclusion only applies to the extent that the foreign dividend does not exceed an amount calculated as follows (based on a decomposition and interpretation of the section):

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

plus

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

less

The aggregate of the proportional amounts of any foreign tax payable in respect of the amounts so included above *via* sections9D(9)(f)(i) and (ii) (section 9D(9)(f)(aa)).

less

The sum of all foreign dividends or portions thereof which have been excluded from CFC net income because of either: section 9D(9)(f); or (from 1 April 2012) section 10B(2)(a),(b) or (c) (or section 10(1)(k)(ii)(dd) on or before 31 March 2012), which provisions exempt from tax dividends from any foreign companies in which the so-called "participation exemption" are held, as referred to by for instance Clegg & Stretch (2012: Vol 1A, 12-24) and others, being from 1 April 2012 greater than 10% (previously 20%) of equity shares and voting rights; or by virtue of prior inclusion by section 9D itself

(Section 9D(9)(f)(bb)).

The above limitation on the exclusion of foreign dividends has the effect of containing the exclusion to an amount which is or has previously been included in the income of the resident taxpayer by virtue of section 9D's attribution of amounts corresponding to the proportional share of the CFC's net income. The limitation therefore seeks to eliminate the possibility of avoiding taxation on foreign dividends through the exclusion contained in section 9D(f). Clegg and Stretch (2012: Vol 1A, 12 – 24) however characterises the section 10B exemptions as "an extremely confusing provision" and is of the opinion that the "practical application of the provision is likely to cause immense difficulties".

It is submitted that the exclusion within section 9D(9)(f) is in the interests of taxpayers as it avoids double taxation that would otherwise arise. In addition, the limitation would appear to be an effective method of preventing abuse of the section 9D(9)(f) exclusion. It is however submitted that the wording and mechanism of the limitation does add to the complexity of the administration requirements to support section 9D, and it can therefore be expected to contribute to the compliance effort (and therefore cost) for an affected resident taxpayer as well as the risk of taxpayer error.

3.3.7 Interest, royalties, rentals, similar income and exchange differences between two CFCs

In addition to dividends earned by a CFC from another CFC (see above), the Act provides for various further exclusions from CFC net income in regard to certain passive amounts transacted between two CFCs forming part of the same group of companies. The following such amounts are so excluded:

(i) "interest, royalties, rental or income of a similar nature" (including any section 31 transfer pricing adjustment of such income to reflect arms-length pricing);
(ii) exchange differences (in terms of section 24I) where both CFCs are parties to an exchange item;
(iii) "exchange differences in respect of any forward exchange contract or forward currency option contract" used to hedge exchange items between CFCs; and
(iv) the amount of a "reduction or discharge" of a CFC's debt to another CFC by that other CFC "for no consideration or for consideration less" than the amount thereby reduced or discharged.
(section 9D(9)(fA))

Notwithstanding the exclusion, section 9D(fA) contained up to 31 March 2012 a proviso that allowed a resident contemplated by section 9D(2) of the Act to elect to include such an amount in the net income of a CFC. In this case, whereas proviso (c) to section 9D(2A) disallowed a deduction for a corresponding list of items, it expressly provided that this is "unless"… the particular item in question "is taken into account to determine the net income of that other CFC". Balance was therefore maintained by matching the inclusion of income in one CFC's net income with a corresponding deduction in the other CFC, or alternatively the exclusion of income from one CFC's net income with a corresponding prohibition on deduction in the other. From 1 April 2012 the election has been removed (South Africa, 2011a: section 25(1)(j)) and the requirement has therefore been correspondingly simplified.

To the extent that the former proviso to section 9D(fA) offered a taxpayer some degree of choice (which may allow the CFC calculation to be more closely mapped to a suitable group-internal accounting or reporting practice), the former election would arguably have been welcomed by those charged with performing CFC net income calculations. To the extent that this proviso however complicated CFC net income computations and introduced further risk of error the simplification could perhaps alternatively be justified.

3.3.8 Capital gains i.r.o. an FBE of another CFC in the same group of companies

The Act provides in section 9D(9)(fB) for the exclusion from a CFC's net income calculation of amounts attributable to the disposal of any asset (including for this purpose the definition of 'asset' in the Eighth Schedule of the Act, but excluding any "financial instrument or intangible asset" as defined in paragraph 16 therein) attributable to any FBE of another CFC within the same group of companies.

3.3.9 Discretion for exemption from section 9D: rulings

From 1 April 2012 all specific provisions within section 9D for rulings by the Commissioner have been removed (South Africa, 2011a: section 25(1)(l)). Up to 31 March 2012, section 9D(10) had granted the Commissioner the power to issue rulings in particular cases on very specific matters to "grant waivers from tainted treatment" to achieve balance between "acceptable commercial practice and anti-avoidance rules" (De Koker, 2011: §5.43).

The only ruling mechanisms subsequently remaining available in respect of CFCs are the Advance Tax Rulings provided for in sections 76B through 76S which are intended to "promote clarity, consistency and certainty regarding the interpretation or application of the Act" (section 76C read with the definition of "Advance Tax Ruling" in section 76B). Consequently, while such rulings cannot amend the Act they may at least potentially provide a degree of certainty to taxpayers. Such rulings would however not in theory be able to provide any discretionary exemptions from attribution of section 9D, unless this was the effect of interpretation or application of the wording of the Act. As both a binding private ruling and a binding class ruling are by definition in respect of a "proposed transaction" it is probably only potentially possible to secure a binding general ruling should a transaction already have taken place, as may often be the case in applications regarding CFCs (definitions of "binding private ruling", "binding class ruling" and "binding general ruling" in section 76B). In practice it may prove difficult or impossible to secure desired rulings.

One problem with a potential rulings mechanism within section 9D itself is that it is the Commissioner's mandate in section 2 to "be responsible for carrying out the provisions of this Act", a key object of which Act is stated in its preamble as "to provide for the recovery of taxes on persons" (preamble to the Act), the Commissioner may therefore arguably be expected to exercise bias towards the "recovery of taxes", and therefore protection of the tax base of the Republic may arguably be considered paramount rather than the extent of balance with commercial considerations. This was acknowledged in National Treasury's statement that rulings are "proving difficult to administer because the issues raised are typically of a policy nature as opposed to administrative interpretation." (National Treasury, 2009:20)

3.3.10 Elections

Up to 31 March 2012, the Act provided for certain elections in connection with section 9D regarding the inclusion of certain foreign companies as a CFC and/or the applicability of various exclusions from a CFC's net income. In particular sections 9D(12) and 9D(13) to 31 March 2012, either or both of which were available to a resident in each year where the participation rights and voting rights held by the resident (alone or together with their connected persons) in a foreign company are at least 10% and are less than 20% of such rights. The connected persons were taken into account for the purpose of determining whether or not such an election might be possible for a particular resident, and such connected persons were not bound to follow the same election (section 9D(12) and 9D(13) to 31 March 2012. From 1 April 2012 these election provisions have been deleted (South Africa, 2011a: section 25(1)(l)), consequently less choice is available to the affected resident taxpayers, although arguably section 9D has been simplified to some extent.

Up to 31 March 2012, if either or both of these elections were made, the resident could benefit from the section 6*quat* rebate in regard to their portion of any foreign income taxes paid by the CFC in relation to the amount included in their income, provided this rebate did not create a surplus of foreign

3.4 Conclusion

A CFC must first meet the definitions of "company" and "foreign company" and participating residents may need to be astute to these definitions, particularly in relation to hybrid entities. A notional amount is included in the income of a qualifying resident investor in a CFC, consequently potentially excluding section 9D from the scope of international double taxation agreements as well as potentially excluding the deduction of certain expenses in relation thereto. The notional amount is based on the net income of the CFC on a world-wide basis, in proportion to the resident's direct or indirect participation rights, in relation to all participation rights in the CFC.

The proviso to section 9D(2) excludes certain resident investors from the application of the section, including a 10% participation exemption, and exemption of indirect holdings *via* a resident company or long-term insurance policy. A headquarter company is exempt in consequence of section 9D(2), but not a resident investor in such a company. A 75% high taxed exemption provides exemption from section 9D in defined circumstances, however no relief exists from the considerable determinations required to arrive at the point of exemption, and this is identified as an area which might benefit from legislative attention, together with the potential for an alternative concept of "net income". Alternative bases for apportionment of net income in years where CFC status changes, may potentially have a significant bearing on the calculation of CFC net income. Residents have limited, if not no recourse to rulings in relation to the operation of section 9D.

The impact of uncertainty or ignorance of CFC status may be severe. The availability of information to understand participation rights and voting rights and to make a determination of CFC status is important but may not be automatic, and residents do not need to "act in concert" for a company to meet the CFC definition. A 5% *de minimis* exemption is in place for participation rights or voting rights in listed companies and foreign collective investment schemes. The definition of connected persons however has relevance in determining whether any particular resident falls within or outside the various participation thresholds, and connected person relationships warrant careful examination both when determining CFC status and also whether or not a resident meets the participation thresholds. Resident investors in CFCs further need to understand the rights attaching to the various classes of shares and any potential variations in such rights.

Limitations exist for setting off CFC losses, with no relief given for subsidiaries in the loss-generating developmental phase of their business lifecycle. Restrictions apply to deductibility of certain expenses in relation to other CFCs, and transfer pricing requirements may introduce considerable uncertainty. Relief is however provided where limitations in the jurisdiction of residence of a CFC would inhibit the funding of a resident's tax liability by way of CFC dividends, but not when such dividends are not forthcoming for other reasons.

The FBE exemption introduces both complexity and risk (consequent upon uncertainty arising from among others, the arm's length requirement for amounts attributable to an FBE) to resident investors in a CFC. Where the specific exemptions do not cover active business income, such income continues to fall within the ambit of section 9D.

South African taxable income of a CFC is excluded from its net income, so avoiding economic double taxation on such income. Economic double taxation is also averted through the exclusion of dividends received by a CFC from another CFC. The act has been simplified through the elimination of elections in regard to the exclusion from net income of certain passive amounts transacted with another CFC, however the elimination of provisions for specific rulings has eliminated a mechanism for residents to pursue in order to deal with uncertainty (and consequently risk).

CHAPTER 4 – THE FOREIGN BUSINESS ESTABLISHMENT EXEMPTION

4.1 Introduction

This chapter seeks to evaluate the consequences of the foreign business establishment exemption by means of closer examination. While the FBE exemption is considered in this chapter, certain detailed exceptions and refinements are only described in Appendix A to this study, which compares provisions pertaining up to 31 March 2012 with those applicable from 1 April 2012.

When determining the net income of a CFC, an amount which is attributable to a ‘foreign business establishment’ (hereinafter “FBE”) is not taken into account (unless, prior to 1 April 2012, the proviso to section 9D(9)(b) or, from 1 April 2012, section 9D(9A), requires otherwise). A disposal or deemed disposal of assets forming part of a CFC’s FBE is treated similarly (Section 9D(2A)). To the extent that the FBE exemption is available in a particular case, the resident investors in a CFC may be exempted from the application of section 9D imputation of the net income attributable to such an FBE, and a deferral benefit might therefore be available to that extent should the company be resident in a lower tax jurisdiction (Olivier & Honiball, 2011:699).

4.2 Categories of FBE

One criticism that may arguably be levelled at section 9D in its present form is that it in certain circumstances continues to tax active business income falling outside its specific exemptions (e.g. those in section 9D(9) of the Act) even though the asset giving rise to it may potentially originate from a qualifying FBE.

Five different alternative categories of ‘foreign business establishment’ (hereafter “FBE”) are discernible from its definition, which is set out in section 9D(1), briefly listed herein as follows and further detail of which is thereafter clarified and discussed thereafter, including selected comparisons to the position which would potentially apply to the alternative structure of a foreign permanent establishment (branch) covered by a Double Taxation Agreement (“DTA”) based on the OECD Model Tax Convention (OECD, 2010) while noting that a DTA and that OECD model convention are not of direct application to section 9D itself:

> Para. (a) of the definition: (hereafter a “foreign fixed place of business”) “A fixed place of business in a country other than the Republic”… “used”… “for a period of not less than one year”…;
>
> Para. (b) of the definition: (hereafter a “foreign mining or natural resource operation”) “Any place outside the Republic where prospecting or exploration operations for natural resources” or “where mining or production operations of natural resources are carried on”… “where that

controlled foreign company carries on those"… "operations";

Para (c) of the definition: (hereafter a "foreign construction project") "A site outside the Republic for the construction or installation of"… "projects of a"… (large) "comparable magnitude which lasts for a period of not less than six months, where that controlled foreign company carries on those"… "activities";

Para. (d) of the definition: (hereafter "foreign farming") "agricultural land"… located "other than the Republic"… "used for bona fide farming activities"… "directly carried on by that controlled foreign company"; or

Para. (e) of the definition: (hereafter "foreign transport") "a vessel, vehicle, rolling stock or aircraft used for"… "transportion or fishing, or prospecting or exploration for natural resources, or mining or production of natural resources, where that"… [transportation] "is used solely outside the Republic for such purposes and is operated directly by that controlled foreign company or by any other company that has the same country of residence"… "and that forms part of the same group of companies"…

4.2.1 Foreign fixed place of business

In addition to the above summary of para (a) of the FBE definition in section 9D(1), the act further constrains a foreign fixed place of business with a further list of peremptory requirements all of which are required to be met in order to qualify for the FBE definition (references below refer to sub-paragraphs of para. (a) of the FBE definition:

(i) …"conducted through one or more offices, shops, factories, warehouses or other structures";
(ii) … "suitably staffed with on-site managerial and operational employees of that controlled foreign company who conduct the primary operations of that business";
(iii) … "suitably equipped for conducting the primary operations of that business";
(iv) … "has suitable facilities for conducting the primary operations of that business"; and
(v) … "is located outside the Republic solely or mainly for a purpose other than the postponement or reduction of any tax imposed by any sphere of government in the Republic"

Sub-paragraphs (i) – (iv) referred to above have been characterized as requirements relating to the nature of the business and sub-paragraph (v) has been characterized as relating to the purpose of the business (De Koker, 2011: §5.44).

The proviso to para (a) of the FBE definition in the Act then provides some flexibility for a CFC to utilize the resources (mentioned in sub-paragraphs (i) to (iv) referred to above) of another company which is "subject to tax in the country in which the fixed place of business is located by virtue of residence, place of effective management or other criteria of a similar nature" ; "part of the same group of companies" as the CFC; and "to the extent" that the abovementioned resources are located in the same country as the fixed place of business of the CFC.

The Organisation for Economic Co-operation and Development (hereafter “OECD”) includes the same words “fixed place of business”, found within para. (a) of the FBE definition in the Act, as part of their definition of a “Permanent Establishment” in Article 5 of their Model Tax Convention on Income and on Capital (OECD, 2010:24) which in comparison to the FBE definition refers to “a fixed place of business through which the business of an enterprise is wholly or partly carried on.” This on the face of it would appear to indicate some degree of effort to align the FBE definition with international practice, and the OECD model commentary (OECD, 2010:92) may consequently arguably cast some light on the usage of the term domestically in both paragraph (a) of the FBE definition (section 9D(1)) and South African double taxation agreements which have been incorporated into South African domestic law through the procedure defined in section 108(2).

The OECD commentary (OECD, 2010:92) refers to a “fixed *situs*”, clarifying a “place of business” as meaning “a facility such as premises or, in certain instances, machinery or equipment.” and clarifying “fixed” as meaning “established at a distinct place with a certain degree of permanence”. At this point the similarity of the FBE definition however diverges somewhat from the OECD “Permanent Establishment” definition in the Model Tax Convention and its commentary (OECD, 2010: 24 and 92), and while these as well as any existing double taxation agreements may arguably serve to confuse rather than clarify the position for a South African resident taxpayer and the international management of a potential CFC, it is however submitted that a comparison is illustrative of the degree of (mis-)alignment of the Act with international concepts, comprehension and practices.

It is arguably not an unreasonable requirement of the fiscus to require some sort of fixed presence in a particular country, for the purposes of determining whether or not section 9D should apply in a particular instance, with a view to including as CFC income the net income of “brass plate” companies which the *fiscus* may view as having little substance other than to achieve tax avoidance or deferral. The narrow definition of the requirements for a fixed place of business to constitute an FBE can however be contrasted with the much wider understanding underlying the OECD’s Permanent Establishment definition. (OECD, 2010:92). Readers may wish to refer also to Olivier and Honiball (2002: 881) in this regard. Furthermore, it may be argued that even a ‘fixed place of business’ test is a rather ‘old world’ test in an era of virtual business models, where a business may largely not consist of actual infrastructure but rather a network of agreements, contractual undertakings, corporate entities and electronic commerce, all of which may well be managed and situated outside the Republic for a bona fide active income-generating purpose.

The timing requirement of a minimum of a year warrants some consideration. This requirement can similarly be contrasted with the more flexible understanding underlying the OECD’s Permanent

Establishment definition (OECD, 2010:92), where no definitive concept of permanence is specified, although a period of six months is mentioned as a more common international requirement. The minimum of one year as specified in the Act imposes a requirement which it is submitted may be overly onerous for a dynamic business which is forced to move premises or which validly requires to operate at various international locations at various times. De Koker (2011: §5.44) considers that the one year requirement however "allows for a one-year back or forward determination" and contrasts this mode of operating with "occasional sales or other intermittent transactions". It is submitted that a case could be made why even certain such transactions could be considered valid candidates for an alternative definition of an FBE. It is however accepted that the legislature does need to define clear guidelines in this regard, although greater consideration arguably does need to be given to accommodating valid non-tax business considerations.

The constraints and requirements within the sub-paragraphs and proviso to para. (a) of the FBE definition in section 9D(1) require close analysis, as these are peremptory and meeting the requirements described above may prove quite onerous if these differ from the operational plan of the CFC. It is submitted that the provision in sub-paragraph (v) speaks to the real intent and purpose of section 9D, and is therefore supported. In this regard, De Koker (2011: §5.44) argues that "the provision does not say that the sole or main purpose in this regard must be a business purpose (as distinct from a personal or perhaps ideological reason) but this will usually be so; thus, a *de minimis* tax avoidance purpose for locating the business outside the Republic will not be a disqualifying factor".

A CFC may however conceivably find the other peremptory requirements and the supposed flexibility of the proviso to para (a) of the FBE definition in section 9D(1) quite constraining where meeting these requirements involves additional cost and devotion of management time simply to comply with the view of the South African legislature of how an FBE should operate, in many cases in circumstances where the reasons for requiring an FBE constitute non-tax-driven business motives.

It might also be argued that in addition to a fixed place of business, the requirements for managerial and operational staffing, equipment and facilities are unsuitable 'old world' requirements to define an FBE or indeed a permanent establishment. It is questionable, for instance, why one form of contract (i.e. employment) should be favoured over others which are equally binding and valid means of resourcing a business undertaking. A similar observation can be applied to the requirement to 'suitably equip' the place of business. Staff, premises and equipment are simply inputs to a business process, which can validly be procured in a number of ways, including by way of contractual arrangement with a third party. In many business models, the subject of the business can conceivably be non-tangible in a number of respects, and it is submitted with respect that the legislature has overemphasized the physical and tangible aspects of a business operation, in a way which exceeds the intended purpose of the section, and which in many cases can be expected to frustrate and overly constrain legitimate business plans, even if it does potentially also achieve the stated objectives of the legislature. In the case of an FBE, it would arguably be preferable if the legislature were to place increased reliance on transfer-pricing rules supported by practical Advance pricing agreements ("APA") in order to regulate the situation. Additionally, it is submitted that ideally as common an approach as possible would ideally be adopted to both permanent establishments and FBEs to avoid any potential arbitrage opportunities, while ensuring that "brass plate" activities are taxed effectively. It is submitted that government's reluctance, as mentioned by Olivier (2002: 882) to fully align these two concepts may unduly complicate the situation for many taxpayers.

It is therefore submitted that the criteria are collectively overly-prescriptive regarding the manner in which the business is resourced. In the modern world, a company can conceivably outsource almost any aspect of the execution of its business model. It is submitted that the strategic core revenue-generating activity of a business is arguably the only part of a business model which in the modern world might (generally speaking) not be outsourced, however arguably an unlimited number of specific inputs to achieve a particular core business might conceivably be outsourced, which traditionally may have been resourced by a company itself directly procuring labour and other inputs. If it is accepted that each core business is central, the execution of operational plans can generally be expected to revolve around this central feature rather than the notion of physical premises, staff, equipment and facilities, which could collectively be considered to simply be a means to an end. What the legislature is achieving by setting such requirements as primary requirements for a 'foreign business establishment' for the purposes of the section 9D(9)(b) FBE exemption, is effectively compelling a group of companies which desires such an establishment to either fit in with the legislature's view of what should comprise such an establishment, or to forego the possible benefits of the exemption.

Considerable risk additionally accrues to the qualifying resident investors in such a CFC as the full weight of the CFC rules and the administrative and penalty provisions of the Act may be brought to bear on the net income of the CFC to be included proportionally if any of the FBE requirements are for any reason inadvertently not met, potentially resulting in considerable unforeseen expense for the resident shareholders. The legislature would therefore arguably provide a better match to modern commercial considerations if less emphasis were placed on the means of sourcing a company's factors of production, or at least if outsourced and sub-contracting models were accommodated, together with the effective application and enforcement of transfer-pricing principles.

4.2.2 Foreign mining or natural resource operation

It is notable in regard to foreign mining or natural resource operations as referred to in the FBE definition (section 9D(1)) that no minimum time period is specified in order for such operations to qualify as an FBE. While this aspect provides greater flexibility to CFCs involved in such operations, it is likely to exclude CFCs undertaking only e.g. oversight or short-term support activities, owing to the requirement that the CFC itself "carries on" the operations. It is noteworthy, with regard to the comparable international position under a DTA that the OECD MTC includes within its definition of the term "immovable property", "rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources" under Article 6 "Income from immovable property" (OECD 2011, 26) which it permits to be taxed in the state in which the activities are conducted, regardless of whether activities are conducted directly by the entity itself or not, referring only to "income derived by a resident" from such activities. Paragraph (d) of the FBE exemption within section 9D(1) however makes it clear that the exemption will only be available in respect of foreign mining or natural resource operations carried on directly by the CFC itself, meaning that a CFC having such rights may potentially be prejudiced when compared to a permanent establishment under such a DTA.

4.2.3 Foreign construction project

The minimum duration of six months which is specified in regard to foreign construction projects appears on the face of it to be more favourable than that set out in paragraph (3) of Article (5) of the OECD MTC as clarified by its commentary (OECD, 2011:25 & 99) which (by way of comparison) mentions a minimum duration of one year for the purpose of double tax agreements. The OECD commentary however, clarifies that such a project the nature of which requires activity to relocate continuously or from time to time, but which as a whole lasts longer than a year, "must be regarded as a permanent establishment if, as a whole, it lasts more than twelve months" (OECD, 2011:101). It is submitted that the wording in section 9D does not include such a project as it is unlikely to meet the requirement of constituting "a site". Furthermore, the CFC itself would be required to "carry on" the activities. It is submitted that if the activities are outsourced to a third party, the CFC may not meet that specific requirement, and the full force of section 9D would apply to its activities.

4.2.4 Foreign farming

Similarly to the position in regard to a foreign mining or natural resource operation, the foreign farming requirement of the FBE definition in section 9D(1) makes no reference to a minimum duration, however because the farming activities are required to be "directly carried on" by the CFC, it is unlikely that such activities would have a short duration. It is noteworthy in comparison, with regard to the international position under a DTA that the OECD MTC includes "income from agriculture and forestry" under Article 6 "Income from immovable property" (OECD 2011, 26) which it permits to be taxed in the state in which the activities are conducted, regardless of whether activities are conducted directly by the entity itself or not. Paragraph (d) of the FBE definition within section 9D(1) however makes it clear that such an exemption will only be available in respect of foreign farming carried on directly by the CFC itself. Consequently, resident investors in a CFC may find themselves subject to section 9D in respect of such income, simply by virtue of the CFC's preferred resourcing model.

4.2.5 Foreign transport

Paragraph (e) of the FBE definition in section 9D(1) of the Act requires that to meet the definition the foreign transport "is used solely outside the republic for such purposes" and "is operated directly" by the CFC or another company within the same "group of companies" as defined in section (1) of the Act. The FBE definition would therefore appear to exclude outsourced operation by a third party. In comparison in this regard, Article 6 of the OECD MTC (OECD, 2011:26) in the context of a DTA specifically excludes "ships, boats and aircraft" from its definition of "immovable property" and in Article 8 (OECD, 2011:27) provides for taxation exclusively in the state "in which the place of effective management of the enterprise is situated", further clarifying that if effective management is located aboard a ship or boat, the "home harbour", or if none such exists, the state "of which the operator of the ship or boat is resident".

The FBE definition therefore differs in that in order to qualify as an FBE use of such foreign transportation is required to be "solely outside the Republic for such purposes" and further requires that the CFC itself or another company within the same "group of companies" as defined in section (1) operates the foreign transport directly itself. In the FBE definition, the place of effective management is not explicitly mentioned, presumably because if this were within the Republic the foreign company would in any event not fall within the definition of a CFC in section 9D(1), but would rather be taxable in the Republic as a resident, on its world-wide income (definitions of "resident" and "gross income" in section 1). A resident operating such foreign transportation would accordingly need to take care to use such transportation "solely outside the Republic" or the income generated thereby would be subject to section 9D attribution.

4.3 The FBE "arm's length" requirement

Deanehan, Kühnlein, Skretkowicz, Swenson, Veli-Matti, Vollebregt and Mashlab Gutierrez (2008: 65) have observed that "The arm's-length principle is easy to state conceptually but extremely difficult to apply in practice" and that "as tax administrations have increased their focus on transfer pricing, different interpretations of the term 'arm's-length principle' have driven disputes" (Deanehan *et al*., 2008: 55). It is accordingly submitted that the "arm's length" criterion in both section 31(1)(b) and the new section 9D(9)(b) has the potential to create considerable uncertainty for a taxpayer when seeking to apply the FBE exemption.

The new FBE exemption contained in section 9D(9)(b) of the Act from 1 April 2012 imposes arms-length requirements consistent with transfer pricing principles whereby an FBE is to be treated as if it were a "distinct and separate enterprise" which is "dealing wholly independently" with the CFC of which it is a part (section 9D(9)(b)(i)). When determining both the *quantum* attributable to an FBE and whether an amount is indeed attributable to the FBE the determination is required to be made as if the amount resulted from terms and conditions that would have existed between "independent persons dealing at arm's length" (section 9D(9)(b)(ii)).

The revised FBE exemption is further subject to (and accordingly therefore needs to be read together with) the exceptions and refinements which are from 1 April 2012 set out in the new section 9D(9A) (South Africa, 2011a: 60). It should be noted that the opinion has been expressed that the revision of the FBE exemption rules, while "said to be a simplification" are "with respect, considerably more complex than the previous rules" (Guzman-Martinez, Pilodia, Manning & Wilson, 2012: 1).

There is no definition of "arm's length" in the Act, although this term is also used in section 31 in relation to transfer pricing requirements. SARS advises that "the transaction should have the substantive financial characteristics of a transaction between independent parties, where each party will strive to get the utmost benefit from the transaction" (SARS, 1999: 572(139)). Residents would consequently be well advised to both consider formulating and implementing their own transfer pricing policy with regard to transactions with non-resident connected persons (SARS 1999: 572(159)-572(164)), and to encourage CFCs in which they have invested to themselves adopt a suitable transfer pricing policy with regard to both resident and non-resident connected persons as well as in accounting for the interaction between any FBE and the CFC of which it is a part. Such a policy should provide substantiated practices for establishing arm's length prices. Such policies are needed both to ensure that the resident can meet SARS disclosure requirements and to simplify their discharging of the onus to prove that the prices used were established at arm's length (SARS, 2005: 572(188)). Residents should ideally also consider following domestic guidance to define their policy for establishing arm's length transfer prices, such as that contained in SARS Practice Note 7 (SARS, 1999: 572(145)-572(159)).

The term "arms-length" is well established internationally and is, for instance, referred to in the first paragraph of the OECD's commentary to Article 9 of the OECD model tax convention (OECD, 2010: 181). Article 9 of that model convention refers to "commercial or financial relations" between "associated enterprises" having conditions "which differ from those which would be made between independent enterprises" (OECD, 2010: 27). Residents investing in CFCs may therefore also wish to refer further in this regard to the related OECD commentary, as well as the OECD transfer pricing guidelines referred to therein, to consider the international guidance on establishing arm's length commercial arrangements.

The “arm’s-length principle” has been described as requiring “that transfer prices charged between related parties are equivalent to those that would have been charged between independent parties in the same circumstances” (PWC International Limited “PWCIL” and Member firms of the PWCIL network, 2010: 9) and it is submitted that the South African courts would apply a similar meaning. The Oxford English Dictionary, in support includes the following references in relation to the phrase “at arm’s length”: “as far out or away from one as one can reach with the arm; *hence*, away from close contact or familiarity, at a distance; *spec.* in Law, without fiduciary relations, as those of trustee or solicitor to a client; at arm('s) length : *Comm*., designating a sale or transaction in which neither party controls the other” (University of Oxford, 1989: meaning of phrase “at arm’s length”). It is therefore believed that the concept whereby “neither party controls the other” has relevance, but it is submitted that the requirement in section 9D(9)(b) to treat an FBE as if it were dealing “wholly independently” extends well beyond “control” to potentially exclude almost any form of influence on the other party which might inhibit total independence.

Section 9D(9)(b)(i) and (ii) (from 1 April 2012) therefore aligns strongly with the objectives of transfer pricing rules, which rules seek to address the situation where profits are shifted by means of transactions between related parties to the most favourable jurisdiction from a tax point of view (Olivier & Honiball: 2011, 620). The requirements resonate with section 31, the general international transfer pricing provision, which in its definition of “affected transaction” specifies that an affected transaction exists where a “transaction, operation, scheme, agreement or understanding” between the various combinations of connected persons (in relation to one another) as specified therein has terms and conditions which differ “from any term or condition that would have existed had those persons been independent persons dealing at arm’s length” (section 31(1)).

Because section 9D(9)(b) exempts from CFC net income an amount that “is attributable” to an FBE (section 9D(9)(b) from 1 April 2012) it cannot automatically be assumed when determining an amount which is not to be so exempted, that the same tests would apply. Nevertheless section 31(2) applies a broad brush to any dealings of the CFC with connected persons, regardless of the existence of any FBE.

The effect of the paragraphs within section 9D(9)(b) might perhaps be simply illustrated by comparing an amount of gross income received by a FBE versus that received by a CFC outside of an FBE. In the case of the FBE, the gross income “must not be taken into account” for the purposes of the section 9D(2A) determination of CFC net income (section 9D(9)(b)). Consequently, the CFC would not be treated “as if that company had been a resident” in relation to the FBE’s gross income, for purposes of section 9D(2A). Therefore, in relation to the transfer pricing provisions of the Act, the CFC would be treated as a non-resident in relation to such gross income, which would be the usual position for a foreign company. By contrast, in the case of non-exempted CFC gross income, not being attributable to an FBE and which is taken into account for the purposes of section 9D(2A), the CFC the gross income is treated "as if that company had been a resident" (section 9D(2A)). Consequently, in relation to the transfer pricing provisions of the act, in this case the CFC would be treated as a resident. In each case, it is submitted that for the purposes of the transfer pricing determinations of section 31 and section 9D(9)(b) the treatment of residence of the CFC with regard to allowable deductions in relation thereto would follow suit.

The requirement in section 9D(9)(b) that an FBE must be treated as a "distinct and separate enterprise" could have considerable implications for the records to be kept by a CFC, as the financial records of the CFC would not only need to be split between those transactions and amounts which are attributable to the FBE, and those transactions and amounts which are not, but the amounts themselves need to be evaluated against the "distinct and separate enterprise" test as between the FBE and the rest of the CFC which, it is submitted is potentially subjective and should therefore ideally be done within the framework of a sound and objectively justifiable transfer-pricing policy . While the existence of such a policy may potentially to a degree shift the burden of proof away from the resident taxpayer (Olivier and Honiball, 2011: 641) and enable the resident to service a request for documentation (e.g. in terms of section 65, failure to comply with which could even result in conviction or imprisonment), it is submitted that it would by no means remove all uncertainty.

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

It is further noteworthy that because the sub-paragraphs also apply to the determination of whether an amount is "attributable to" the FBE of a CFC, it would appear that the legislature opens up scope for a finding on assessment, by virtue of the requirements of independence and of arms-length relationship, that an amount is "attributable to" the CFC itself, but not to the FBE of the CFC. The effect of such a determination would be to exclude the amount in relation to such transactions from the FBE exemption, meaning that these would be included in the net income calculation of the CFC.

4.4 The significance of the term "Attributable to"

The term "attributable to" is used several times in section 9D. There is no definition in the Act of the meaning of "attributable to". One of the uses of the term which can be expected to be of importance is in section 9D(9)(b) in which the foreign business establishment exclusion applies only to the extent that an amount is "attributable to any foreign business establishment" of the CFC. In this context, the meaning of the term is critical to determining whether or not a particular amount forms part of CFC net income or not, as if the amount is attributable to an FBE it is exempted from section 9D.

The term is used by the Organisation for Economic Co-operation and Development (hereafter "OECD") in their Model Tax Convention (hereafter "MTC") and commentary in a somewhat similar context: Article 7, which deals with business profits, uses the term to indicate that where an enterprise carries on business in another contracting state which is subject to a double tax agreement following the OECD MTC, "the profits that are attributable to the permanent establishment"... "may be taxed in that other state". In that specific context the term is clarified as meaning "the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise" (OECD 2011: 26). The term is then however also used fairly extensively in other contexts in both the OECD MTC and its commentary. It should however be noted that the meaning adopted within the OECD MTC is however not necessarily of direct application in interpreting the meaning within the abovementioned context within section 9D.

The Oxford English Dictionary (University of Oxford, 1989: meaning of "attributable") provides the following meaning "Capable of being attributed or ascribed, esp. as owing to, produced by" and it is likely that the meaning of being "produced by" or "ascribed as owing to" would be of influence to a court in interpreting its meaning. Nevertheless, for a taxpayer performing the calculation, some uncertainty can expect to remain in particular circumstances regarding whether amounts are attributable to an FBE, particularly in light of the requirement for the FBE to be treated for the purpose of the determination as a "distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently" with the CFC (section 9D(9)(b)(i)).

4.5 Diversionary transactions Provisions

The legislature has targeted certain circumstances and transactions related to an FBE for inclusion in section 9D, notwithstanding the FBE exclusion from net income. Such transactions have been referred to as being "diversionary" (National Treasury, 2002:11). These so-called diversionary transactions of a CFC are therefore subject to the provisions of s 9D." The related rules have also been referred to as "reversionary rules" (Olivier and Honiball, 2011: 586).

Up until 31 March 2012, the proviso to section 9D(9)(b), and from 1 April 2012, section 9D(9A), set out specific requirements included by the legislature in this regard. It is submitted that the provisions relating to diversionary transactions introduce considerable complexity in obtaining a full appreciation of section 9D(9)(b), and therefore these are analysed in more detail below and in Appendix A to this study. It should be noted that the tables presented therein are not intended to represent a strict interpretation of the wording used in the Act itself, and while these may be useful to navigate the provisions, the wording of the Act at all times remains paramount.

As mentioned earlier in this chapter, the FBE exemption contained in section 9D(9)(b) read with section 9D(9A) (from 1 April 2012) is narrower in application than the arguably more widely understood concept of the residence of a Permanent Establishment, as referred to in double tax agreements - refer for instance to the OECD model tax convention definition and commentary in this regard (OECD, 2010: 24). It is submitted that resident investors in CFCs having FBEs would consequently need to study its provisions carefully.

In order to facilitate understanding, a table structured similarly to Table 4.1 below (as relevant in each case) is presented in Appendix A to this study to clarify each of the re-inclusions and re-exclusions from the net income of a CFC to be found in (to 31 March 2012) the proviso to section 9D(9)(b) and (from 1 April 2012) section 9D(9A).

The proviso to Section 9D(9A) can be broken down into a number of parts which are generically classified in Appendix A as depicted in Table 4.1 below. The indent level and the number of prefixed dashes indicates subordinate wording which clarifies or modifies preceding higher-order wording:

General FBE exemption from net income of a CFC (the purpose of sections 9D(9)(b) and 9D(9A)). This exemption or exclusion is subject to the provisions of section 9D(9A), which consist of one or more of the various components in the hierarchy set out below.
- re-inclusions These are circumstances which will result in the inclusion of an amount in CFC net income in spite of the general FBE exclusion, provided no re-exclusion is applicable.
-- triggers for re-inclusion These are circumstances which will confirm a particular re-inclusion of an amount in CFC net income.
-- re-exclusions In spite of a particular re-inclusion provision, these circumstances will result in an amount being excluded from CFC net income, in line with the general FBE exclusion.
--- further re-inclusions These are specific circumstances in which an amount will be included in CFC net income, in spite of a more general re-exclusion.

Table 4.1 - Hierarchy of components of the section 9D(9A) exclusions from the FBE exemption

The 5% passive income exemption threshold for an FBE provided for in section 9D(9A)(iii) from 1 April 2012 (formerly 10% as specified in section 9D(9)(b)(iii)(aa) prior to 1 April 2012) currently applies per CFC. It is submitted that it would benefit multinational groups of companies if this were to be extended by the legislature to be performed on a group-of-CFCs basis, rather than a per-CFC basis, which may provide the contemplated exemption in a simple group structure but may potentially not correspond with the operational requirements of a more complex group of companies. The legislature's justification could perhaps be expected to be that the section primarily targets the deferral or avoidance of tax on passive income earned *via* CFCs, however it is submitted that such an accommodation carries the merit of even-handed treatment for more complex groups of companies.

Section 9D(9A) (from 1 April 2012), and also the proviso to section 9D(9)(b) (prior to 1 April 2012), is fairly lengthy and complex. It is submitted that the structure and organization may arguably pose many readers some challenge in gaining a thorough appreciation. The multiple levels of logical exclusions, re-inclusions, re-exclusions and further re-inclusions, the combinations and format of which vary to a degree between parts of the proviso, arguably complicate its interpretation. Readers of the wording in the Act may therefore perhaps find it both time consuming and difficult to properly understand its flow and the relationship and meaning of the various sub-texts.

The same could arguably naturally be said of much legislation. Should investors in CFCs however find the structure and complexity overly challenging this can however be expected to increase their compliance costs and uncertainty (and introduce a degree of risk of inadvertent non-compliance or misinterpretation) and its daunting nature and the associated risks to affected taxpayers may arguably even perhaps introduce at least some level of deterrence to investors who for non-tax reasons validly require or desire an international corporate structure. Some degree of attention appears to have been paid to this problem by the legislature in the form of the exclusion of the applicability of section 9D to resident "headquarter companies" (as defined in section 1) *via* the CFC definition in section 9D(1) however it is submitted that as it is probable that many South African holding companies will not qualify as such headquarter companies, the concern remains.

Assuming that the legislators intended the consequences of their actions, difficulty that may be experienced in following the section could arguably perhaps even potentially be suspected to form an active part of a policy armoury against outbound investment in favour of inbound investment. It is submitted, however that it would be ill-advised for the legislature to seek to incentivize investor behavior through unnecessarily complex legislation, and infinitely preferable to keep the law as simple and easily understandable as possible. The potential domestic benefits of legislators facilitating multi-national investment by way of policy are highlighted in the McKinsey statistics presented in Table 5.1 (Chapter 5: 5.2), with reference to the experience in the United States. It is therefore submitted that it would be preferable for the legislature to simplify the structure of the provisions, and to provide easily accessible mechanisms to restore taxpayer certainty (e.g. through providing a taxpayer-friendly process to implement Advance Pricing Agreements to establish greater transfer-pricing certainty – refer to chapter 5 for more detail in this regard). If simplification is attempted, the legislature might also wish to consider whether managing such requirements by way of regulation, rather than in the main body of the act itself, might help it to structure and manage the requirements in an adaptive manner to the needs of taxpayers.

4.6 Conclusion

Where the FBE exemption applies, amounts attributable to an FBE are excluded from CFC net income. Inappropriate "old world" peremptory requirements may result in active business income falling within the ambit of section 9D. Further the "arm's length" and independence requirements contained in the section 9D(9)(b) from 1 April 2012 may create considerable uncertainty for a resident investor in a CFC which has a FBE, which uncertainty may be reduced, but by no means eliminated, by means of a sound and objectively justifiable transfer-pricing policy. Further, transfer pricing requirements of section 31 may even apply between CFCs within different groups of companies.

CHAPTER 5 - INTERNATIONAL COMPETITIVENESS

5.1 Introduction

This chapter aims to evaluate the consequences of section 9D given the considerations of international competitiveness.

5.2 The international trend regarding corporate taxation

Several countries internationally have some form of CFC regime. Olivier & Honiball (2011:561) indicate that the number of such countries may however be as low as 30. The United States of America, for instance has long-standing CFC provisions which seek “to attribute both business and passive income to its domestic owners” and “are designed to curb the meld of tax haven and deferral abuses” (Postlewaite, 1999: 279). It is clear that complexity or compliance cost concerns which may arise in South Africa in relation to its CFC regime may therefore not be entirely unique to South Africa.

Nevertheless, when South Africa implemented its CFC regime it became at the time “one of only four regimes globally which” at the time did not “distinguish between active and other income within the scope of their CFC attribution rules” (Greenleaf, 2003:581). While section 9D of the Act has changed considerably since Greenleaf’s study, and for instance section 9D(9A) (from 1 April 2012), and its predecessor section 9D(9)(b) prior to 1 April 2012, does to an extent seek to exclude active business income in relation to a FBE, such exclusions of active business income may not be as wide in scope as might otherwise indicate competitiveness with its peers, some of whom have no CFC regimes whatsoever (for example many other African countries), or may for simplicity’s sake extend their CFC regimes largely to passive income only. Indeed, Olivier and Honiball (2011: 560) express the opinion that “the impression is gained that South Africa’s CFC legislation is not part of a well-thought-through policy but rather a piecemeal effort to close loopholes”, noting also that “constant legislative amendments undisputedly discourage foreign investments”.

Taxation may in many cases not be the primary decision factor in companies’ location and sourcing decisions, particularly where non-tax considerations such as for instance the location of existing manufacturing plant, even marketing considerations or global strategic considerations may have a heavier weighting in such decisions (Wilson, 1993:228/229). Wilson has observed, however that taxation does have an impact, particularly where the “frictions” of non-tax considerations are small, such as administrative and distribution centres. It is also perhaps likely that in the longer-run, where new opportunities arise for major direct investment decisions to be made in any given country of the world, tax considerations might logically be expected to form part of such decisions.

Hines (2007: 292) has observed that “the evidence points to a systematic change in the pattern of international tax rate setting during the period in which international capital mobility greatly increased", noting that "tax competition stiffened substantially since the early 1980s". He further observes that tax rates on mobile income declined, although "countries maintained their (higher) rates of tax on less mobile domestic investment" opining that this "evolution of corporate tax policy is the logical outcome of greater competition between countries to attract investment and, if anything, intensified corporate tax competition can be expected to lead to further pressures for corporate tax rate reductions".

On global trends in corporate income tax, KPMG (2010:3) appears to support Hines' observations, observing that "The typical global action taken to compete for investment is to reduce the headline corporate tax", cautioning that it is becoming evident to national revenue bodies that as a consequence of increasing globalisation "corporate income tax is a mobile and volatile source of income". This therefore appears to explain why corporate tax rates are declining. KPMG note that they observe "a combination of reduced corporate tax reliefs, strengthened transfer pricing regulations, and, importantly, a shift to indirect taxes and transfer pricing measures as "real-time transaction taxes" to create a more stable source of tax revenues (as consumption taxes are less mobile)". It is further observed by KPMG that tax authorities are also globalizing, increasingly collaborating and sharing information with one another, as well as more effectively engaging with corporate taxpayers through so-called "enhanced relationships".

KPMG further opine (2010:7) that "Global companies require global tax planning. It is not enough for a multinational company to adapt separately to each of its local operating environments." It is noteworthy that South Africa's effective tax rate of 34.55% as depicted in the KPMG International survey (KPMG International, 2010:24) (which figure includes both the corporate income tax rate of 28% defined in Appendix I.4 of the Taxation Laws Amendment Act, 2010 (South Africa, 2010) and an adjustment by KPMG International for the effect of STC, as this is a tax at the corporate level rather than on shareholders. STC has subsequently been replaced as of 1 April 2012 by a dividend tax at the level of the shareholder *via* sections 64D to 64N (SA National Treasury, 2011b: 2). The corporate income tax rate of 28% is itself above the global average of 24.99% depicted in that survey (KPMG International, 2010: 14). It is perhaps also noteworthy from the KPMG survey that South Africa's Value Added Tax rate (an indirect tax) is at 14% below the international average published by KPMG, of 15.61% (KPMG International, 2010: 38).

This seems to indicate that South Africa's fiscal regime may currently be out of step with the international trend. It is within contemplation that political considerations may currently inhibit the potential for an increase of the VAT rate because of the perceived immediate impact on the poor, and this may therefore arguably sustain some inertia against a more internationally competitive lower corporate tax rate. Nevertheless, a counter-argument certainly exists in favour of broadening the tax base as well as the potential creation of employment opportunities through attracting foreign direct investment by lowering the company tax rate.

The above therefore indicates the possibility that an aggressive and onerous controlled foreign company regime would potentially be a misplaced strategic focus by the legislature. It is submitted that direct investment in foreign companies can be of strategic importance and even of disproportionate benefit to a country. A commercial study of the role of multinational companies to growth and competitiveness in the United States appears to support a view that investment in foreign companies is not only a tax avoidance issue but a strategic policy issue (McKinsey & Company, Mc Kinsey Global Institute, 2010: iv –v). The authors of the study follow for this purpose the United States Direct Investment Abroad (USDIA) survey (as conducted by the United States Bureau of Economic Analysis) definition of a United States multinational company as being a company maintaining its headquarter in the United States and holding at least a 10 percent equity interest in a foreign affiliate. The McKinsey & Company’s McKinsey Global Instititute, (a commercial research instititution represented in 95 offices in 50 countries) accordingly published the following indicators of the disproportional benefit and importance of such investment to the United States economy.

<1%	the share of the total number of US companies accounted for by US multinationals
11%	the share of private sector employment growth generated by US multinationals since 1990
19%	the share of the private sector work force employed by US multinationals in 2007
25%	the share of private sector wages paid by US multinationals in 2007
25%	the share of total US private sector gross profits earned by US multinationals in 2007
31%	the share of growth in real private sector GDP accounted for by US multinationals since 1990
37%	multinationals’ share of total US goods imports in 2007
41%	the gains in labour productivity accounted for by US multinationals since 1990
48%	multinationals’ share of total US goods exports in 2007
53%	the gains in labour productivity accounted for by US multinationals during periods of economic expansion since 1990
74%	The share of the [US] nation’s private sector R&D [research and development] spending made by US multinationals
90%	the share of US multinationals’ intermediate inputs purchased from other US-based firms

Table 5.1 - Indicators of the disproportional benefit and importance of investment in at least a 10 percent equity interest in a foreign affiliate to the United States economy (McKinsey & Company, Mc Kinsey Global Institute, 2010: iv – v).

In contrast to the abovementioned 10% threshold (the statistics in relation to which clearly elucidate expected benefits to an economy of direct foreign investment by its residents) one should nevertheless bear in mind that the extent of South African residents' participation rights required (i.e. in excess of 50%) for the qualification of a foreign company as a CFC is substantially higher than the above 10% threshold (definition of CFC in section 9D(1)), although it is noteworthy that 10% is the level at or above which the exemption provided by proviso (A) to section 9D(2) no longer applies.

It is also noteworthy that McKinsey & Company et al. (2010:43) include "burden of government regulation", "extent and effect of taxation" and "total tax rate" as three of twenty key indicators of business climate considered by investors, and also make reference to the World Economic Forum (WEF) Global Competitiveness Index which ranks countries based on among other key "business climate favourability" factors, "the burden of regulation and taxation". Taxes are included among the "significant factors when making a new investment" and it is further noted that "tax rates, by affecting companies' cost of capital, rate of return, and relative competitive position are among the factors that influence executives' decisions about where to retain or expand operations" (McKinsey & Company et al. (2010:44). The above terms are not defined in that article, however "burden of government regulation" upon a business can be expected to include all forms of non-tax government regulations such as exchange controls, customs regulations, visa and work-permit regulations, industry-specific regulations, labour regulations (including affirmative action), black empowerment requirements, occupational health and safety regulations, building regulations *etc*. The "extent and effect of taxation" similarly extends more widely than the mere income taxation rate. The word "extent" refers to scope, including such considerations as the range of national, regional and local taxation measures and government revenues, the basis of income tax (e.g. worldwide *versus* source basis, including extensions thereof such as CFC rules), the double tax treaty network (and the degree of override thereof by CFC rules), taxation of capital gains, and additionally the variety of bases of other forms of taxation e.g. wealth taxes, transfer and other duties. The "effect of taxation" can be expected to include both the direct financial effects of taxation (such as the amount of tax payable) and the non-financial or indirect financial effects and business risks of supporting and complying with rules such as CFC rules. It is submitted that the costs associated with these two factors mentioned above, namely "burden of government regulation" and "extent and effect of taxation" have a similar effect in deciding the future location of both new and existing business operations.

Section 9D can therefore be expected to have impact in the many circumstances where the avoidance or deferral of taxation is not the primary motive for investing through foreign companies, and where taxation simply forms one of the legislative and regulatory factors to be considered and managed in order to achieve a given business objective. Section 9D imposes taxation consequences (National Treasury, 2002:1) which necessarily implies a requirement for related operational compliance by affected South African residents and the controlled foreign companies in which they invest. The section may therefore introduce complexity, uncertainty and risk to international investment decisions.

It is therefore submitted that section 9D potentially has impact on South African residents' decisions on how to optimally structure and operate international investments, part of which may comprise decisions on whether to invest through foreign companies. Further, in the light of the introduction of the "headquarter company" regime *via* the Taxation Laws Amendment Act, No 7 of 2010 (South Africa, 2010), the extent of exemption of a South Africa-based "headquarter company" as consequently currently defined in section 1 of the Income Tax Act (South Africa, 2012) from the provisions of section 9D may have some degree of bearing on the extent to which foreign investors might consider making use of South Africa as a jurisdiction to house either a regional holding company or a headquarter company. The interaction of section 9D with this new regime therefore warrants special consideration and evaluation in context with the other competitive considerations of the new regime, particularly in view of the fact that National Treasury elevated section 9D as one of "three sets of South African tax rules" which it "identified as significant barriers" to enabling South Africa to operate as "an ideal holding company jurisdiction" (National Treasury, 2010a: 77). The differences between a "headquarter company" and a "holding company", and the relevance of section 9D to the so-called "headquarter company regime" are explored in more detail below.

Section 9D forms an integral part of the wider collection of taxation and other considerations which a South African resident investor needs to take account of in determining expected financial outcomes and the inherent risks (which would include taxation risk) which apply when making international investment decisions. Section 9D has relevance in conducting international business undertakings optimally. In addition, section 9D can be expected to form part of the environmental factors which both resident and non-resident investors need to take into account when considering South Africa as a potential future place of residence, either for themselves or as a holding company jurisdiction.

Olivier and Honiball (2011: 559) note that "global competitiveness is often in direct conflict with domestic tax policies". The possibility is that investors (both residents and non-residents) faced with a global choice of jurisdictions, can potentially structure their affairs or even change their tax residence so as not to fall within the South African controlled foreign company regime (among other considerations), while potentially incorporating holding companies and headquarter companies in other countries. Entrepreneurs may seek other jurisdictions from which to launch their multinational business plans. This could to a degree constrain the growth of the economy and tax base of the country.

South Africa consequently risks some degree of international reputation as a tax environment which is unfriendly to multinational groups of companies. Arguably, such a reputation may however not be worse than those of other countries having CFC rules, and non-residents may even wish to consider use of the headquarter company regime discussed below. Given the evident potential benefits to the economy from the presence of multinational groups of companies, as outlined in McKinsey's report as highlighted by Table 5.1 (Chapter 5: 5.2) it would seem that the potentially negative impact of CFC rules should however not be overlooked by policymakers, who should actively seek to remain competitive in order to attract future investment.

5.3 Interaction with the headquarter company regime

The South African government has prioritised the opportunity in regard to foreign inbound investment as a Gateway into Africa, and has targeted tax (National Treasury, 2010a: 77) and exchange control aspects (National Treasury, 2010b: 1) which inhibit international headquarter companies from leveraging South Africa as a means of investing in the rest of the African continent. In this regard the Act was previously amended to exempt a "headquarter company" as defined in section 1, from the CFC rules *via* section 9D(2), presumably as a consequence of having identified the CFC rules as an inhibitor to such investment. A resident company that meets the requirements set out in section 9I(2) may elect to be a headquarter company for a year of assessment (section 9I(1)), and the election will then be effective from the beginning of the year of assessment in respect of that election (section 9I(3)). It should however be noted that the requirements to qualify as such a company are very tightly defined, both regarding shareholdings and the composition of its assets and gross income, as described below.

For every year of assessment since its inception:

(a) Its equity shareholdings and voting rights need to consist and have consisted in all prior years of assessment solely of shareholdings in excess of 10% per shareholder (either alone or combined with any other company in the same group of companies as defined in section 1) (paragraph (a) of the definition of "headquarter company" in section 1);
(b) At least 80% of the cost of its assets (apart from bank demand deposits and cash) at the end of the year of assessment and all previous years be attributable to any combination of any:
    (i) interest in equity shares in;
    (ii) amount loaned or advanced to; or
    (iii) intellectual property (as defined in section 23I(1)) licensed to:

    any foreign company in which it (possibly together with other companies within the same group of companies) held at least 10% of the equity shares and voting rights (paragraph (b) of the definition of "headquarter company" in section 1); and
(c) in cases where the company's gross income exceeds R5 million, at least half of its gross income (excluding any exchange difference determined under section 24I) must have consisted of any rental, dividend, interest, royalty or service fee derived from such foreign companies as are

referred to in (b) above; or any proceeds from disposing of any interest in equity shares in such foreign companies contemplated in (b)(i) above or from intellectual property contemplated in (b)(iii) above (paragraph (c) of the definition of "headquarter company" in section 1).

Because only a resident company can apply to be a headquarter company (section 9I(a)), a headquarter company is a resident as defined in section 1 of the Act and would therefore be taxed as a resident on its worldwide income unless any exemption applies in a particular instance. As a resident, it may also consequently benefit, in regard to any foreign income, from South Africa's double tax agreement network.

With regard to any foreign company in which a headquarter company holds an interest, its participation rights and voting rights in a foreign company are not counted as those of a resident for the purposes of determining the company's CFC status (CFC definition in section 9D(1)). A headquarter company is further exempted from including in its income the notional amount of CFC net income which other residents in similar circumstances would need to include (section 9D(2)).

A resident investor in a headquarter company nevertheless has an indirect interest in any subsidiary foreign company of the headquarter company, to which normal CFC rules would apply if the company falls within the CFC definition (e.g. if more than 50% of participation rights are held indirectly by resident shareholders of the headquarter company), and in such a case resident investors in the headquarter company would not escape the application of the CFC rules, by virtue of the wording "directly or indirectly" in section 9D(2) read together with proviso (B) of that sub-section, unless any other exemption or exception applied (e.g. if the investor held less than 10% of participation rights and voting rights in the CFC as contemplated by proviso (A) of section 9D(2)).

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

While the special corporate rules set out in Part III of the Act (sections 41 to 47) are beyond the scope of this study, it is noteworthy given the recent extension of those rules to CFCs in certain respects, that a headquarter company is (from 1 January 2012) excluded from the definition of a “company” in section 41(1), having the effect that a headquarter company is largely excluded from the application of the unbundling rules, which fact may consequently have impact upon any CFC unbundling plans. Previously a headquarter company was excluded from the definition of a “resident” for the purpose of the aforementioned rules for similar reasons (section 41(1) prior to 1 April 2012).

A headquarter company is treated similarly to a non-resident in that its own dividends are not exempt in the hands of residents, being specifically excluded from the exemption in section 10(1)(k)(i), consequently residents need to include headquarter company dividends in their gross income, subject to the various exemptions contained in section 10B, for which purpose a dividend paid or declared by a headquarter company is included in the definition of “foreign dividend” within section 10B(1).

A “holding company” (whereby subsidiary and associated companies or intellectual property are held as passive investments) should be distinguished from a “headquarter company” (which term implies a more active role in the form of shared central group support services and economies of scale, or as Olivier and Honiball (2011: 690) state, to “share costs”. Such services or costs could, for instance comprise financial, treasury, funding, legal, marketing or other scarce professional or technical expertise, procurement of goods or services, co-ordinating utilization of a common group brand and public image or other forms of commonly utilized intellectual property and expertise), or co-ordinating regionalized services which may even be provided within or out of multiple global geographic locations. Olivier and Honiball (2011:692) confirm that this separate concept of a headquarter company has been well established for some time.

Anti-avoidance rules such as CFC rules, together with transfer pricing rules, are counted among the most relevant taxation considerations for the location of a holding company. Olivier & Honiball (2011: 693) express the opinion that given anti-avoidance laws, setting up an intermediary holding company mainly to avoid taxes “is often extremely complicated and may not be possible at all”. Section 9D serves to ensure that substantial South African resident investors will effectively be taxed on their portion of the net income of such a company, largely neutrally to the position which would apply if they earned such portion of net income directly themselves.

Olivier and Honiball (2011, 569) further point out that “multi-national corporations which conduct business in multiple jurisdictions are often faced with multiple layers of CFC legislation” and therefore identify the lack of CFC rules as “one of the requirements of the ideal holding company regime”. A holding company could be located “within or outside the country of its controlling shareholder" (Olivier & Honiball, 2011:689/690), the latter case being referred to as an "intermediary holding company". It is also possible that a holding company is additionally utilized, e.g. for commercial expedience or to facilitate exchange control approvals as a company to house centralized activities as a headquarter company as a "mixed" intermediate holding company (Olivier and Honiball, 2011:690).

Because exchange controls "apply to the payment of management and administration fees between companies in a South African-based multinational group" (Olivier & Honiball, 2011: 692), in addition to CFC rules a key consideration for a proposed headquarter company and its shared central services may therefore be to locate such in the absence of restrictions such as exchange controls. In addition to the exemption of a "headquarter company" itself from CFC rules in regard to its foreign investments (section 9D(2)), there has been some relaxation of exchange controls in relation to such companies, but given the applicability of exchange control circulars to South African-incorporated companies, it has been observed that the best way to obtain full exemption from exchange controls may still be to use a foreign-incorporated company which is South African resident for taxation purposes (*via* effective management in South Africa, and therefore not a CFC as mentioned above) which is also a headquarter company as defined in section 1 of the Act (Olivier & Honiball, 2011:709). It is submitted that while the various on-going concessions in respect of headquarter companies are likely to impact positively on the adoption of the headquarter regime, investors may also be impacted by uncertainty regarding future exchange controls, from which they might well be expected to shy away when considering the location of either a holding company or headquarter company, unless exchange controls are ultimately removed totally.

While in many respects the new headquarter company meets many criteria for an ideal intermediary holding company regime and appears to benefit from on-going legislative attention to deficiencies, it has in the past gained a reputation as being "not at all tax-efficient when used as an international headquarter regime" Olivier & Honiball (2011: 711). Given the restrictive definition, it is possible that the headquarter regime may continue to find limited support, although it may be of some benefit in particular circumstances. The extent of its adoption and benefit to the South African economy remains yet to be seen. The so-called "headquarter company" regime would therefore perhaps be better characterized as a holding company regime unless or until the tax-efficiency and exchange control aspects are fully addressed.

Given the international trend towards lower corporate taxation generally as observed by Hines (2007: 292) and KPMG (2010: 3) and favourable international tax rates for mobile income, an effective alternative approach available to legislators may arguably be to target a competitive lower rate of taxation of mobile passive income generally, and to offer a more competitive corporate tax rate. In such circumstances, arguably a CFC regime or headquarter regime may not even be required except possibly to defend mobile income against extremely low tax jurisdictions such as tax havens. The Act might therefore be simplified and the competitive attractiveness of South Africa tax-wise arguably considerably enhanced. Any such plan would ideally be carefully considered in terms of the cost to the national budget and may possibly require for instance an increase in the rate of indirect taxes such as VAT, which may have unpopular political ramifications. Nevertheless, it is submitted that such options should continue to receive serious consideration given the international trend towards lower corporate income taxes.

5.4 Official publications on section 9D

SARS' own "Tax Guide for Share Owners" merely contains reference to the exemption of dividends from a CFC (to the extent of cumulative included CFC income less previous exempt CFC dividends) (SARS, 2008:7) plus a brief paragraph (SARS, 2008: 8) containing three sentences on CFCs, noting that "these rules, which are contained in section 9D, are outside the scope of this Guide."

The legalistic wording of the Act arguably draws attention to a requirement for additional simple, accessible official literature for those who may wish to themselves better understand the rationale and operation of Section 9D.

It is also noteworthy that National Treasury first issued its only published comprehensive guidance document on section 9D as far back as June 2002 (National Treasury, 2002). It is submitted that given the extensive changes to section 9D since that time, it would have assisted taxpayers considerably if the detailed explanation were kept up to date in line with the changes in the legislation.

5.5 Efficiency and scope

Lymer & Hasseldine (2002: 13) have identified that "one of the key features of an effective tax system design is efficiency" which implies that "a tax system should aim to have a neutral impact on the economic decisions of its taxpayers (at least to limiting their effects on wider decisions than those that the tax system was designed to specifically influence". Balancing the challenges posed by three perspectives of neutrality as identified by Lymer & Hasseldine (2002: 13-14), namely "capital export neutrality", "capital import neutrality" and "national neutrality" are arguably therefore in the national interest. In this regard, for instance, an overly complex, cumbersome or otherwise burdensome CFC system in a particular country might perhaps be expected to exert some influence on the multi-national business plans of investors, whether initiated from within or outside that country, by introducing questions as to whether alternatives exist that might remove the need to satisfy such rules.

In contrast a simple and efficient CFC system, with well defined boundaries for achieving its intent with the minimum impact possible, might be expected to be viewed in a more positive light by potential and current investors in such a country. Lymer & Hasseldine (2002: 253/254) however identifies certain biases (e.g. a bias to the retention of profits; a bias to the use of debt funding; and a bias between the use of corporate and non-corporate forms) which might be addressed by a system of full imputation of profits of a company. They do however acknowledge (2002:268) that complexity arises in even a system of partial imputation (whereby for instance dividends are taxed in the hands of shareholders and part of the company tax paid is allowed for through some form of credit or relief to the shareholder to reduce any double economic taxation).

Complexity in tax compliance can also naturally be expected to result in cost for taxpayers, both at the level of discharging their responsibilities as taxpayers correctly and in terms of introducing some risk and uncertainty. Lymer & Hasseldine (2002: 273) acknowledge the “increasing public and political recognition in many countries in the world” of tax compliance costs. Indeed Scholes, Wolfson, Erickson, Maydew & Shevlin (2002: 3) contemplate the “taxing authority as an uninvited party to all contracts” which “announces a set of terms taxpayers must accept”. It is noted, additionally that “tax rules are pervasive in their effect on the investment and financing decisions of business” (Scholes *et al.*, 2002: 12).

Viewed from a high-level perspective, the concept underlying the imputation of an amount corresponding to a portion of the net income of a CFC to a resident taxpayer is arguably relatively straightforward. Calculating such an amount in proportion to the resident’s holding in the CFC, adding such amount to the taxpayer’s income for the calculation of income tax, and then allowing a tax credit in relation to the relevant proportion of the foreign taxes incurred by the CFC (without permitting the creation of excess foreign tax credits) at that level arguably poses little conceptual difficulty. The concept arguably becomes more complex and less certain for resident taxpayers, however, when once considers transfer pricing requirements, both for the CFC itself (section 31) and in relation to the FBE exemption and diversionary rules (section 9D(9)(b) read with section 9D(9A)). Many taxpayers may arguably find these requirements problematic to deal with satisfactorily.

In addition, the multiple considerations in regard to connected person relationships, the interaction of participation rights and voting rights (in regard to the definitions of “controlled foreign company” and “participation rights” (section 9D(1)), the *de-minimis* exclusion from imputation (proviso (A) to section 9D(2)), the diversionary rules (section 9D(9A)) and the various other exemptions, all introduce a degree of risk and complexity for taxpayers, their taxation personnel and their professional service providers. Performing a South African tax calculation on financial information prepared in accordance with the requirements and norms of a foreign jurisdiction, in addition to that required by its own jurisdiction, naturally imposes an additional administrative load as well.

That the associated administrative and compliance load which attaches to section 9D is onerous has been borne out by comments published in the financial press. For instance, Jooste (2005:88) and

Mendes (2011:1) both support this view. Given the six year period between the two articles, it would appear that this is a long-standing and on-going concern. The author of this study is also aware that certain of the largest accounting firms have seen the need to develop entire software tools to assist them in dealing with the complexities of section 9D, for example, PricewaterhouseCoopers' ECDC tool, the abbreviation of which apparently stands for "Electronic CFC Data Collector", as mentioned to the author by a tax consultant from PricewaterhouseCoopers Johannesburg office (2011). The impact of the uncertainty introduced by section 9D should also not be overlooked, as these may arguably make planning of residents difficult owing to the lack of certainty about ultimate tax outcomes.

Regular historic changes and refinements have occurred, which are evident for instance in the historic materials provided by Clegg and Stretch (2012: Vol 1A, Appendix A). Such regular changes can also be expected to complicate and increase the cost of taxpayer compliance efforts.

A consequence which should arguably also not be overlooked is the burden which is placed on the South African Revenue Services (hereafter "SARS") by section 9D. While little public empirical evidence is available, it is foreseeable that monitoring and enforcing compliance with section 9D may be quite burdensome on SARS. It may be worthy of at least an internal study within SARS to consider to what extent SARS has the necessary capacity to enforce such a complex regime. Should section 9D pose SARS itself considerable difficulty, it is submitted that some degree of further simplification may be warranted for this reason alone.

One approach to seek to address complexity without giving up the benefits to the *fiscus* of the worldwide system of taxation of which section 9D is part, and of addressing the abuses that might otherwise arise in respect of the deferral or avoidance of taxation, could therefore be for the legislature or National Treasury department to specifically mandate a sub-committee or other arm to propose simpler legislation and supporting regulations and even practical support (e.g. within the South African Revenue Services) as well as up-to-date, well structured and easily understood literature on topics such as section 9D. Such efforts are evident internationally, where similar issues are faced, for example in the form of the recently established "Office of Tax Simplification" (hereafter "OTS") within HM Treasury department in the United Kingdom (http://www.hm-treasury.gov.uk/ots.htm). OTS describes its object on its world-wide web home-page as being "to provide the Government with independent advice on simplifying the UK tax system".

HM Treasury in the United Kingdom have additionally broadened their own exemptions generally. In 2010 it was stated that "A full exemption will be available for a CFC, if it meets certain conditions in relation to: business establishment business activities; amount of finance income and income arising from IP; and extent of connection with the UK." (HM Treasury, 2010:70) as part of a "Package of

Interim CFC Improvements".

The 2010 UK interim measures (HM Treasury, 2010:69) comprised:

- "an exemption for a CFC carrying on intra-group trading activities where there is minimal connection with the UK and little risk that UK profits have been artificially diverted;
- an exemption for a CFC with a main business of IP" [intellectual property] "exploitation where the IP and the CFC have minimal connection with the UK;
- an exemption which runs for three years for foreign subsidiaries that, as a consequence of a re-organisation or change to UK ownership, come within the scope of the CFC regime for the first time; and improve the *de minimis* exemption and deferral of the withdrawal of the exemption for certain holding companies".

Subsequently, for instance HM Treasury has advised that the UK's Finance Bill, 2012 was published on 29 March 2012 (HM Treasury, 2012a: 1) and has provided *inter alia* the following insights into its operation, which includes:

- a targeted "all out unless in" approach (HM Treasury, 2012b: 2), whereby the concept of a "gateway" of rules (HM Treasury, 2012b: 3) is used to identify circumstances that fall within the UK CFC rules, which seek to "target artificially diverted UK profits" while "keeping the compliance burden to a minimum" (HM Treasury, 2012b: 2);
- no separate "local management" condition in order for income of a company to fall outside the rules (HM Treasury, 2012b: 3) although the "trading income exclusion" requires that the CFC has business premises and spends less than 50% of its management expenditure in the United Kingdom (HM Treasury, 2012b: 10);
- the inclusion of business profits within the scope of the UK CFC rules only where such profits derive from UK operations (HM Treasury, 2012b: 5);
- a 12 month initial period of exemption (which can be extended under certain circumstances) following a corporate acquisition, provided any required restructuring is undertaken to ensure that the company remains exempt in the following 12 months thereafter (HM Treasury, 2012a: 5);
- an "excluded territories" exemption, for which it is noteworthy that the exemption test is based on the headline income tax rate exceeding 75% of the UK rate and, in contrast to the "high taxed exemption" contained domestically in further proviso (i) to section 9D(9)(2A), consequently does not require a full CFC computation to arrive at the conclusion that the net income of the particular CFC is exempted from imputation (HM Treasury, 2012a: 5 and 2012b: 18);
- a "low profits" exemption, which provides a "simple exemption for companies making a small profit or a loss" (HM Treasury, 2012a: 5 and 2012b: 18);
- a "low profit margin" exemption, which is an "accounts based exemption" i.e. is based on the

entity's financial records, for cases where the profit margin above operating expenditure is less than 10% (HM Treasury, 2012a: 5 and 2012b: 17);

- an exemption for the "seeding" (initial funding) of offshore investment funds (HM Treasury, 2012a: 1);
- alignment of the UK domestic permanent establishment exemption legislation with the UK CFC rules (HM Treasury, 2012b: 11); and
- application of transfer pricing rules to intra-group arrangements (HM Treasury, 2012b: 9)

It is evident from the above that the United Kingdom is actively seeking to minimise the impact of its CFC rules on its residents who have interests in CFCs by focussing its rules in a targeted manner while providing a range of exemptions, several of which would appear to have the effect of eliminating the need for a high level of compliance activity in the circumstances associated with each exemption. It would therefore appear that South Africa may benefit from a similar focus by legislators.

By comparison to the United Kingdom example, the South African CFC rules could therefore arguably benefit from similar exemptions or exclusions to narrow the scope to more precisely address the intent of ensuring the tax-neutrality of foreign mobile passive income with domestic passive income, and to more tightly re-focus on cases where a corporate persona is used to defer the incurral of taxation. The focus of such changes would arguably be best targeted at removing from the scope of the CFC rules those foreign companies which have primarily an active business intent, and to promote the use of South Africa as a headquarter jurisdiction, with the many economic benefits such as those highlighted by McKinsey *et al*. in Table 5.1 (Chapter 5: 5.2). Arguably outbound investments in active international businesses of substance should therefore be more widely excluded from attribution, on the basis that the intention behind such income is unlikely to be avoidance.

5.6 Advance Pricing Agreements

While it has been observed that while a full investigation of transfer pricing issues is beyond the scope of this study (Chapter 1: 1.6.3), and consequently also Advance Pricing Agreement ("APA") programs, it is clear that transfer pricing issues in relation to CFCs have potential to create considerable uncertainty for its resident investors (Chapter 3: 3.2.9 and Chapter 4: 4.3). APAs are currently being used by over 20 countries as a means of regulating their transfer-pricing regimes (Deanehan *et al*., 2008:62). One definition of an APA is "Binding advance agreements between the tax authorities and the taxpayer, which set out the method for determining transfer pricing for inter-company transactions" (Raby, Tran, Pedevilla, An, Van der Rest, Plannthin and Hart, 2010:9).

There is currently no APA mechanism in place in South Africa, nor has there ever been (Olivier & Honiball, 2011: 629). In fact SARS has (albeit several years ago) stated that no APA process will in the foreseeable future be made available to South African taxpayers (SARS, 1999: 572(177)). Olivier and Honiball (2011: 638) speculate that the reason for a lack of an APA process stems from a lack of capacity within SARS, and point additionally to the prohibition on advance tax rulings on pricing matters set out in section 76G(1)(a)(iii).

It is submitted that taxpayers can currently face considerable uncertainty when seeking to comply with the provisions of section 9D, even if they go to considerable lengths to comply with section 31 transfer pricing requirements and the arms-length requirements of sections 9D(9)(b) and 9D(9A) from 1 April 2012. Taxpayers however have limited means at their disposal to secure greater certainty and so reduce their risk. It is therefore submitted that the current lack of provision for transfer pricing rulings and APAs can adversely impact a multinational business owing to the increased risk and cost of compliance.

Internationally, APAs "once thought to be solely the realm of the biggest and most sophisticated taxpayers, are increasingly being seen as an everyday defensive tool" in regard to securing greater transfer pricing certainty (Raby *et al*, 2010:15). Where an APA involves the competent authority of a treaty partner in terms of a DTA the APA should be considered under its mutual agreement procedure ("MAP"), for example where such a procedure is similar to that provided by Article 25 of the OECD's Model Tax Convention (OECD, 2010: 36). Such an APA is sometimes referred to as a bi-lateral APA (Raby *et al*, 2010: 47). Uni-lateral APAs, being a binding agreement between the taxpayer and only one tax authority, are also theoretically possible, if provided for by domestic law.

As section 9D does not directly tax foreign income, but rather taxes a resident taxpayer on the notional amount referred to in section 9D(2), a narrow view may exist that section 9D falls outside the realm of international double taxation agreements and international agreement procedures. While section 9D itself does not seek to impose double taxation, it may however well result in additional taxation on active business income earned through a CFC, when compared to, for instance a foreign branch which constitutes a permanent establishment in terms of a DTA, and may potentially result in economic double taxation in particular circumstances. Consequently it is submitted that the government should seek to extend its DTAs wherever possible to cover CFCs as well.

Olivier and Honiball (2011: 639) are of the view that SARS can "override" transfer pricing adjustments required by other jurisdictions. Further, because a broad "arm's length" transfer-pricing requirement can create considerable uncertainty for taxpayers, it is therefore further submitted that a negotiated approach such as that offered by an APA program could potentially offer a pragmatic complementary approach to an "arm's length" requirement, while also potentially providing scope for the legislature to in future provide for a less "rules-based" approach or to provide an alternative to such an approach.

In relation to section 9D, should the legislature desire in future to implement such a program, it would probably need to be specifically provided for in the Act, in which case specific provision should also be made for bilateral APAs which extend to matters involving CFCs. It is submitted that a more creative solution to SARS capacity problems is in theory possible, for instance by offering taxpayers an option of paying for third party professional consultants appointed by SARS for this purpose. In particular, given that a number of countries have already implemented APA programs, much ground-work can be expected to already have been done by such countries, and considerations derived from international experience are likely to be worthy of further consideration.

Examples of international recommendations for a robust APA program, as identified by Deanehan *et al*. include:

- "Pro-active use of pre-filing conferences" (Deanehan *et al*., 2008:62): here it is suggested that pre-filing meetings should be held in all but the simplest cases, with provision by the taxpayer of a complete set of materials identifying all critical facts, in order to ensure early understanding of the issues and to identify all contentious issues. It is also suggested that a similar meeting should be encouraged with the revenue authority of the other country. The objective is to facilitate "filing a more 'agreeable' APA submission" later;
- "Comprehensive APA requests and simultaneous filings in BAPA [bi-lateral APA] cases" (own insertion) (Deanehan *et al*., 2008:62): here the objective is to contain the potentially lengthy timeframe for APA negotiations, and it is proposed that taxpayers be required to file as comprehensive an APA request at the beginning of the process, to include all relevant "facts, issues, methods, critical assumptions, economic analyses and other critical data completed and filed from the first day" (Deanehan *et al*., 2008:63). In the case of bi-lateral APAs, it is suggested that taxpayers should simultaneously file such information with the other country involved;
- "Early agreement to case plans and adherence to deadlines" (Deanehan *et al*., 2008:63): here it is suggested that project management techniques are used to expedite proceedings;
- "Industry specialization" (Deanehan *et al*., 2008:64): here the importance of the revenue authority's team having relevant industry experience is emphasised. It is submitted that this may be of particular relevance in a smaller economy such as South Africa's, where the revenue authority may even need to engage outside professional assistance in order to complement its internal team and its other limited resources;
- "Proactive use of subgroups in large APA cases" (Deanehan *et al*., 2008:64): here it is suggested that smaller working committees are used on large cases, dealing with aspects such as "comparable company identification and selection, critical assumptions, asset intensity adjustments, economics, accounting methods, and analysis of written agreements" (Deanehan *et al*., 2008:64) in order to promote understanding, reduce conflict and expedite timely completion.

- “Taxpayer participation” (Deanehan *et al*., 2008:65): here it is not suggested that taxpayers should actually participate in the competent authority negotiations, but it is acknowledged that it is likely that “no party to the negotiations is as well informed as the taxpayer and its advisors” (Deanehan *et al*., 2008:65) and that the taxpayer’s knowledge and understanding should be used to inform the authorities of both countries and to facilitate cohesion around a settlement;
- “Striking a balance between ‘perfect’ transfer pricing and ‘objective practicality’” (Deanehan *et al*., 2008:65): here a pragmatic approach is recommended, given that by seeking to negotiate a workable solution in preference to the alternative of later confrontation and litigation, both the taxpayer and the revenue authorities should enter into discussions in a spirit of flexibility and creativity in order to reach agreement;
- “Use of mediation” (Deanehan *et al*., 2008: 66): in order to seek to ensure agreement between the taxpayer and the revenue authority without excessively protracted negotiations or stalemates developing, a non-binding neutral mediator should be agreed to help resolve differences where needed;
- “Limitations on the use of certain taxpayer information in subsequent litigation” (Deanehan *et al*., 2008: 66): here taxpayers are encouraged to participate in the APA process without fear that information shared with the revenue authority through the process might have negative consequences in areas outside the process. The suggestion is a clear policy by the revenue authority not to use information obtained via an APA process outside that process, unless the information is obtained through normal information gathering means in any subsequent litigation; and
- “Periodic reports on the state of the APA program” (Deanehan *et al*., 2008: 67): here it is recommended that despite the fact that APAs are confidential documents, no “secret body of law” should be created. To achieve this, it is recommended that periodic reports be issued on the state of the country’s APA program, including statistics, “types of transactions covered, the countries involved, the transfer pricing methods accepted, the profit level indicators used” (Deanehan *et al*., 2008: 67) and other useful information such as practical guidance and interpretations to promote public information availability, without disclosing confidential trade secrets and confidential financial information.

It is submitted that in smaller economies such as that of South Africa, a full-blown APA program may potentially only be suitable for (and indeed affordable to) large taxpayers. Nevertheless, owing to the benefits of offering a mechanism to pro-actively address taxpayer uncertainty given the “arm’s length” requirement, it is submitted that provision for an APA program is an area that is worthy of further attention by the legislature. In addition, in order not to exclude smaller taxpayers and in order to reduce costs in simpler cases, some form of future scaled down, simpler “APA-like” mechanism could also be provided for in order to help secure certainty for taxpayers, thereby reducing their financial risk and consequently promoting trade and growth without unnecessarily compromising the tax base. Again, given the abovementioned potential SARS capacity issue, such a mechanism might need to be resourced by consultants appointed by SARS and funded by the applicant. Ideally, a range of options could be made available, including possible provision for unilateral APAs between the taxpayer and SARS alone.

It is submitted that such a potential program would ideally include other government policy interests than simply the South African Revenue Services, for instance the Department of Trade and Industry, the wider National Treasury Department and the Department of Foreign Affairs should also be involved, as the policy issues are perhaps likely to extend beyond the narrow interests of protection of the tax base to such areas as economic growth, job creation and international diplomatic relations and foreign policy. This view is potentially supported by National Treasury's past acknowledgement that the former rulings provisions in relation to section 9D were "proving difficult to administer because the issues raised are typically of a policy nature as opposed to administrative interpretation." (National Treasury, 2009:20)

5.7 Conclusion

Complexity or compliance cost concerns in relation to CFC legislation may not be entirely unique to South Africa given that a number of advanced countries have similar legislation. The breadth of exemptions in respect of legitimate active business income available under the Act may nevertheless not be sufficient to avoid the inclusion of such income within section 9D.

Over the longer term, tax considerations, including CFC laws, can be expected to form part of location decisions in order to optimise multinational businesses. Corporate tax competition can further be expected to lead to pressures for corporate tax rate reductions. Internationally, corporate tax rates have been on a reducing trend, and South Africa's corporate tax rate is above the international norm and its VAT rate is below the international norm, as published by KPMG International (2010: 14). McKinsey's statistics in Table 5.1 (Chapter 5: 5.2) indicate the potential existence of a strong case for the domestic benefits of outbound multinational investment and of containing the burdens of both taxation and government regulation. The headquarter regime may to an extent compensate by seeking to attract inbound multinational investment in holding companies (as opposed to a company to house the majority of centralised headquarter activities), however the CFC regime offered by section 9D may in other cases result in both residents and non-residents choosing to steer clear from its provisions wherever possible. Nevertheless, where the requirements of the FBE exemption can be met, resident investors in a CFC possessing such a FBE might derive a deferral benefit to the extent that the CFC is resident in a lower tax jurisdiction.

Official publications on section 9D (apart from the Act itself) are found to be lacking in that these are either out of date or excessively brief. The provision of up-to-date guidance would therefore appear to be warranted.

Given the uncertainties introduced by the "arm's length" principle and the application of transfer pricing concepts in relation to section 9D, as well as the fact that peremptory diversionary transactions rules may not always accurately distinguish between diversionary income and legitimate active business income, it is recommended that the internationally established practice of pro-active Advance Pricing Agreements could be further explored by the legislature with a view to providing taxpayers a mechanism for both acquiring greater certainty in relation to their investments in CFCs, as well as avoiding potential later disputes and potential penalties to taxpayers.

A future simple and efficient CFC system might be viewed in a positive light by potential and current investors. Many taxpayers may find the requirements of the current FBE exemption complex to deal with to at least some degree, and the requirement imposing a South African taxation calculation on the results of a foreign entity can be expected to impose an additional administrative load, both on resident taxpayers and on SARS. The example of the Office of Tax Simplification within HM Treasury department in the United Kingdom is pointed to as an admirable example of a focal point for seeking to reduce such impact. Arguably investments in active international businesses of substance should therefore be more widely excluded from attribution, on the basis that the intention behind such income is unlikely to be avoidance

CHAPTER 6 – CONCLUSION

Section 9D seeks to address the deferral or avoidance of taxation which might otherwise arise *via* investment through foreign companies, and appears to be successful in this regard.

The intent of the section is primarily to target passive income and tax avoidance through including foreign mobile passive income, foreign mobile business income and foreign diversionary business income in its ambit. Much legitimate active business income may nevertheless still be included *via* its provisions. Other potential areas of negative impact to investors may include reduced after-tax investment returns; increased taxation uncertainty; increased administrative costs; and increased requirements for scarce business resources. Furthermore, the provision of up-to-date official guidance and publications appears to be warranted, with the only such material having been published in 2002, since which considerable legislative changes have been made.

Some uncertainty remains for residents with interests in foreign companies where connected party relationships or other residents' direct or indirect participation rights may be unclear or unknown to them, or in cases or conditional holdings where the total participation rights may vary without the knowledge of the investor, or where a resident is an unvested capital beneficiary of a trust. The impact of uncertainty or ignorance of CFC status or of a qualifying participation by a resident may be severe owing to the potentially applicable penalties, which upon signature of the Tax Administration Bill (South Africa, 2011b) may even potentially include criminalisation in certain circumstances. This situation is exacerbated by the fact that residents appear to have limited, if not no recourse at all, to rulings in relation to the operation of section 9D.

The 75% high taxed exemption provides no relief from the considerable determinations required to arrive at the point of exemption. This compares poorly with the United Kingdom "excluded territories" exemption which simply requires a headline tax rate which exceeds 75% of the United Kingdom rate. Alternative bases for apportionment of net income in years where CFC status changes, may potentially have a significant bearing on the calculation of CFC net income.

Limitations exist on setting off of CFC losses, with no relief given for subsidiaries in the loss-generating developmental phase of their business lifecycle or following a corporate acquisition, in which case, in contrast to the position in the United Kingdom, no grace period exists to meet exemption requirements. Restrictions apply in regard to deductibility of certain expenses in relation to other CFCs and transfer pricing requirements may also introduce considerable uncertainty, with no current advance pricing agreement mechanism existing under South African law to help residents achieve a higher level of certainty.

Relief is provided where limitations in the jurisdiction of residence of a CFC would inhibit the funding of a resident's tax liability by way of CFC dividends, but not when such dividends are not forthcoming for other reasons. South African taxable income of a CFC is excluded from its net income, so avoiding potential economic double taxation on such income. Economic double taxation is also averted through the exclusion of dividends received by a CFC from another CFC. The act has been simplified through the elimination of elections in regard to the exclusion from net income of certain passive amounts transacted with another CFC, however it is considered unfortunate that the elimination of provisions for specific rulings has eliminated a mechanism for residents to pursue in order to deal with uncertainty (and consequently risk).

The FBE exemption introduces both complexity and risk (consequent upon uncertainty arising from among others, the arm's length requirement for amounts attributable to an FBE) to resident investors in a CFC as well as regarding whether income is "attributable" to the FBE or not. Where the specific exemptions do not cover active business income, such income continues to fall within the ambit of section 9D. Where the FBE exemption applies, amounts attributable to an FBE are excluded from CFC net income.

The provisions in relation to FBEs can be compared to those applicable to a permanent establishment ("PE") under a DTA. Inappropriate "old world" peremptory requirements may result in active business income falling within the ambit of section 9D of the act in a manner which may differ from what might apply under a DTA, and while some such requirements also exist in regard to a PE, the taxation outcomes in relation to an FBE may well differ from those which may apply to the alternative case of a PE under a DTA because the FBE exemption is considerably narrower in scope than the OECD model tax agreement's concept of a permanent establishment, potentially therefore distorting the comparable tax outcomes. Residents may benefit should the two concepts be further aligned to be decision-neutral both under South African domestic law and through South Africa's DTAs. The diversionary transactions provisions are complex, potentially increasing both uncertainty and compliance costs for taxpayers. In the light of international experience such as that in the United Kingdom, it appears that scope remains for the legislature to simplify the provisions while continuing to minimise any impact to the tax base. Official publications on section 9D (apart from the Act itself) are found to be lacking in that these are either out of date or excessively brief. The provision of up-to-date guidance would therefore appear to be warranted.

It is submitted that the "arm's length" and independence requirements contained in section 9D(9)(b) from 1 April 2012 increase complexity, and may create considerable uncertainty for a resident investor in a CFC which has a FBE, which uncertainty may be reduced, but by no means eliminated, by means of a sound and objectively justifiable transfer-pricing policy. Further, transfer pricing requirements of section 31 may apply between two CFCs that are not even part of the same group of companies.

Complexity or compliance cost concerns in relation to CFC legislation may not be entirely unique to South Africa given that a number of advanced countries have similar legislation. The breadth of exemptions in respect of legitimate active business income available under the Act may nevertheless not be sufficient to avoid the inclusion of such income within section 9D.

Over the longer term, tax considerations, including CFC laws, can be expected to form part of location decisions in order to optimise multinational businesses. Corporate tax competition can further be expected to lead to pressures for corporate tax rate reductions. Internationally, corporate tax rates have been on a reducing trend, and South Africa's corporate tax rate is above the international norm and its VAT rate is below the international norm, as published by KPMG International (2010: 14). McKinsey's statistics in Table 5.1 (Chapter 5: 5.2) indicate the potential existence of a strong case for the domestic benefits of outbound multinational investment and of containing the burdens of both taxation and government regulation.

The headquarter regime may to an extent compensate for competitiveness concerns by seeking to attract inbound multinational investment in holding companies (as opposed to a company to house the majority of centralised headquarter activities), however the CFC regime offered by section 9D may in other cases result in both residents and non-residents choosing to steer clear from its provisions wherever possible. Nevertheless, where the requirements of the FBE exemption can be met, resident investors in a CFC possessing such a FBE might derive a deferral benefit to the extent that the CFC is resident in a lower tax jurisdiction.

A simpler and more efficient CFC system might, if implemented in future, be viewed in a more positive light by potential and current investors. Many taxpayers may find the requirements of the current FBE exemption complex to deal with to at least some degree, and the requirement imposing a South African taxation calculation on the results of a foreign entity can be expected to impose an additional administrative load, both on resident taxpayers and on SARS. The example of the Office of Tax Simplification within HM Treasury department in the United Kingdom, as well as the "gateway" concept and principal of "all out unless in" in relation to CFC rules, can be considered an admirable example of a focal point for seeking to reduce the negative impact of such rules. Arguably investments in active international businesses of substance should therefore be more widely excluded from attribution, on the basis that the intention behind such income is arguably less likely to be avoidance.

Given the uncertainties introduced by the "arm's length" principle and the application of transfer pricing concepts in relation to section 9D, as well as the fact that peremptory diversionary transactions rules may not always accurately distinguish between diversionary income and legitimate active business income, it is recommended that the internationally established practice of pro-active

Advance Pricing Agreements should be further explored by the legislature with a view to providing taxpayers a mechanism for both acquiring greater certainty in relation to their investments in CFCs, as well as avoiding potential later disputes and potential penalties to taxpayers. It is submitted that the existing international experience of taxation authorities, taxpayers and taxation professionals could be leveraged in order to successfully tailor an APA program which is suitable to South African requirements and capacity constraints, and could even include the potential funding and resourcing of such a process by taxpayers and the private sector.

REFERENCES

Clegg, D., Stretch, R. (2012). *Income Tax in South Africa*. Vols 1 (Updated to March 2012 by Service Issue 40), 2, 2A, 2B and 2C (Updated to March 2012 by Service Issue 60). Durban: LexisNexis.

De Koker, A. (2011). *Silke on South African income tax*. (Updated). Durban:Butterworths. Available from http://butterworths.wits.ac.za/nxt/gateway.dll?f=templates$fn=default.htm$vid=mylnb:10.1048.enu (Accessed 16 May 2011).

Deanehan, R., Kühnleing, C., Skretkowicz, M., Swenson, D., Veli-Matti, T., Vollebregt, H., Mashlab Gutierrez, N. 2008. *Advance Pricing Agreements and Mutual Agreement Procedures – Steps businesses and governments can take to improve the systems*. In Transfer Pricing Perspectives – The Emerging Perfect Storm of Transfer Pricing Audits and Disputes. Thought Leadership Journal. (Electronic publication). United States of America: PricewaterhouseCoopers LLP. Hanumantha Rao, G. (geetha.hanumantha.rao@nl.pwc.com). 26 January 2012. RE: *APA program*. E-mail to Potgieter, R. (potgie_r@mtn.co.za).

Emslie, T.S., Davis, D.M. (2011). *Cumulative Supplement to Income Tax Cases & Materials*. 3rd edition February 2011. Cape Town: The Taxpayer.

Gericke, C. (25 February 2009). Unpublished informal discussion with Group Executive: Tax, MTN Limited group of companies. MTN Innovation Centre, Fairlands, Johannesburg.

Gordhan, P. (2011). *2011 Budget Speech.* Speech of the Minister of Finance, delivered in the Parliament of the Republic of South Africa. Cape Town. Communications Unit, National Treasury. Available from http://www.treasury.gov.za/documents/national%20budget/2011/speech/speech2011.pdf (Accessed: 29/05/2011).

Gordhan, P. (2012). *2012 Budget Speech.* Speech of the Minister of Finance, delivered in the Parliament of the Republic of South Africa. Cape Town. Communications Unit, National Treasury. Available from http://www.treasury.gov.za/documents/national%20budget/2012/speech/speech.pdf (Accessed: 28/03/2012).

Greenleaf, L. (2003). Catch-22: the deferral dilemma. *South African Law Journal*. 120:580-601. Available from SAePublications database *via* UJLink: http://0-www.journals.co.za.ujlink.uj.ac.za (Accessed 03/05/2009).

Guzmán-Martinez, Z., Pilodia A., Manning S., Wilson M. (Editors). Tax Publishing News (Leaflet). *Income Tax in South Africa - Service Issue 40, March 2012*. LexisNexis: Durban.

Hines, J. (2007). Corporate Taxation and International Competition. In *Taxing Corporate Income in* *the 21st Century*. New York: Cambridge University Press.

HM Treasury. (2010). Part IIIA: Controlled Foreign Company (CFC) Interim Improvements. In *Corporate Tax Reform: delivering a more competitive system.* November 2010. London: HM Revenue & Customs department of HM Treasury. Available from *http://www.hm-treasury.gov.uk/d/corporate_tax_reform_complete_document.pdf (*Accessed 29 May 2011).

HM Treasury. (2011). *Office of Tax Simplification.* Available from http://www.hm-treasury.gov.uk/ots.htm (Accessed 29 May 2011).

HM Treasury. (2012a). *Controlled Foreign Companies (CFC) reform- further changes*. In Changes to the CFC legislation since February 2012. United Kingdom: HM Treasury - Office of Tax Simplification. Available from: http://www.hm-treasury.gov.uk/d/cfc_further_changes.pdf (Accessed: 22 April 2012).

HM Treasury. (2012b). *Presentation slides for CFC reform open event*. Slideshow. United Kingdom: HM Treasury – Office of tax simplification. Available from: http://www.hm-treasury.gov.uk/d/cfc_jan_open_event_slides.ppt (Accessed 22 April 2012).

Jooste, Richard. (2001). The imputation of income of controlled foreign entities. *South African Law Journal*. 118:473-502. Available from HeinOnline database *via* UJLink: http://0-www.journals.co.za.ujlink.uj.ac.za (Accessed 03 May 2009).

Jooste, Ruan. (2005). Multi-national muddle – a heavier compliance load time-consuming and costly. *Finance Week*. 23/02/2005. Johannesburg: Media 24. Available from EBSCO Business Source Complete database *via* UJLink: http://0-web.ebscohost.com.ujlink.uj.ac.za/ehost/ (Accessed: 24 May 2012).

KPMG International Co-operative ("KPMG International"). (2010). *KPMG's Corporate and Indirect Tax Survey 2010*. Switzerland: KPMG International. Available from http://www.kpmg.com/BB/en/IssuesAndInsights/ArticlesPublications/Documents/Corp-and-Indirect-Tax-Oct12-2010.pdf (Accessed 18 May 2011).

Lymer, A., Hasseldine, J. (2002). *The International Taxation System.* Boston: Kluwer Academic Publishers.

McKinsey & Company, Mc Kinsey Global Institute. (2010). *Growth and competitiveness in the United States: The role of its multinational companies*. Seoul, San Francisco, London & Washington DC: McKinsey & Company and McKinsey Global Institute. Available from http://www.mckinsey.com/mgi/publications/role_of_us_multinational_companies/index.asp (Accessed 24/06/2010).

Mendes, A. (2011). Simplifying the controlled foreign company legislation. *tax enSight.* (electronic newsletter). March 2011. Johannesburg: Edward Nathan Sonnenbergs. Available from http://www.ens.co.za/newsletter/briefs/taxMar11legislation.html (Accessed 13 March 2011).

Meyerowitz, D. (2007). *Meyerowitz on income tax*. Cape Town: The Taxpayer.

Oguttu, A.W. (2009a). Resolving the conflict between 'controlled foreign company' legislation and tax treaties: a South African perspective. *Comparative and International Law Journal of South Africa*. 42(1):73-114. Available from SAePublications database *via* UJLink: http://0-www.journals.co.za.ujlink.uj.ac.za (Accessed 20/10/2009).

Oguttu, A.W. (2009b). The challenges of taxing investments in offshore hybrid entities: A South African perspective. *SA Mercantile Law Journal*. 21:51-73.

Olivier, L. (2002). The 'permanent establishment' requirement in an international and domestic taxation context: an overview. *South African Law Journal*. June 2002. 119(4):866-833. Available from HeinOnline database via UJLink: http://0-www.journals.co.za.ujlink.uj.ac.za (Accessed 24/05/2012).

Olivier, L., Honiball, M. (2011). *International Tax – a South African Perspective*. 5th edition. Cape Town: Siberink.

Organisation for Economic Co-operation and Development (OECD). (2010). *Model Tax Convention on Income and on Capital*. Condensed Version: 22 July 2010. http://0-www.oecd-ilibrary.org.ujlink.uj.ac.za/model-tax-convention-on-income-and-on-capital-condensed-version-2010_5kmd1qqtnfq4.pdf?contentType=/ns/Book&itemId=/content/book/mtc_cond-2010-en&containerItemId=/content/serial/20745419&accessItemIds=&mimeType=application/pdf (Accessed 18 May 2011).

Postlewaite, P.F., (1999). Controlled Foreign Corporations. Chapter 14 in *International Taxation – Cases, Materials and Problems.* Cincinnati, Ohio: Anderson Publishing Co.

PricewaterhouseCoopers. (2010). Excerpts of submissions to National Treasury on inter-alia aspects of section 9D. Made available by PricewaterhouseCoopers's Sunninghill, Johannesburg office (Obtained: 4 March 2011).

Raby, N., Tran V., Pedevilla M., An H., Van der Rest, A., Plannthin M., Hart D. (editors). 2010. *International Transfer Pricing 2011*. (Electronic publication). PricewaterhouseCoopers International Limited ("PWCIL") and Member firms of the PWCIL network. Hanumantha Rao, G. (geetha.hanumantha.rao@nl.pwc.com). 26 January 2012. RE: *APA program*. E-mail to Potgieter, R. (potgie_r@mtn.co.za).

Scholes, M.S., Wolfson, M.A., Erickson, M., Maydew, E.L., Shevlin, T. (1992). *Taxes and Business*

Strategy – A Planning Approach. 2nd Edition. New Jersey: Prentice-Hall Inc.

South Africa (Republic). (2008). Acts, statutes etc. *Companies Act, 2008.* (No. 71 of 2008). Pretoria: Government Printer. Available from http://www.acts.co.za/companies_act_2008/index.htm (Accessed: 26/06/2011).

South Africa (Republic). (2010). Acts, statutes etc.: *Taxation Laws Amendment Act, 2010.* (No. 7 of 2010). In Government Gazette Vol. 545 No. 33726 (2 November 2010). Cape Town: Government Printing Works. Available from South African National Treasury website: http://www.treasury.gov.za/legislation/acts/2010/Act07-2010.pdf (Accessed: 13 March 2011).

South Africa (Republic). (2011a). Acts, statutes etc.: *Taxation Laws Amendment Act, 2011.* (No. 24 of 2011). In Government Gazette Vol. 559 No. 34927 (10 January 2012). Cape Town: Government Printing Works. Available from South African National Treasury website: http://www.treasury.gov.za/legislation/acts/2011/act24-2011.pdf (Accessed: 15 April 2012).

South Africa (Republic). (2011b). Acts, statutes etc.: *Tax Administration Bill.* (B11- 2011). Cape Town: Creda Communications. Available from South African Parliament website: http://www.parliament.gov.za/live/commonrepository/Processed/20120313/355160_1.pdf (Accessed: 24 May 2012).

South Africa (Republic). (2012a). Acts, statutes, etc. *Income Tax Act*. (No. 58 of 1962, as amended). Reproduced op. cit. Clegg, D and Stretch, R. (Vol 2, updated March 2012 by Service Issue No. 60).

South Africa (Republic). (2012b). Acts, statutes, etc. *Rates and Monetary Amounts and Amendment of Revenue Laws Bill.* B10-2012 (13 March 2012). Cape Town: Creda Communications. Available from http://www.sars.gov.za/Tools/Documents/DocumentDownload.asp?FileID=76093 (Accessed: 25 May 2012).

South African Department of Trade and Industry ("DTI"). (2011). *Companies Regulations, 2011.* In Government Gazette No. 34239. South African Government Printer. Available from http://www.info.gov.za/view/DownloadFileAction?id=145907 (Accessed: 26/06/2011).

South African Institute of Chartered Accountants ("SAICA"). (2011). International Financial Reporting Standards (IFRSs) 2011 incorporating International Accounting Standards (IASs) and Interpretations as at May 2011. In SAICA Handbook (CD ROM). Durban: LexisNexis.

South African National Treasury. (2002). *National treasury's detailed explanation to section 9D of the Income Tax Act* (Brochure). Pretoria: National Treasury. Available from National Treasury Department (Republic of South Africa) website: http://www.treasury.gov.za/divisions/tfsie/tax/legislation/default.aspx (Accessed:

24/05/2012).

South African National Treasury. (2009). *Budget Tax Proposals 2009/10*. Pretoria: National Treasury. Available from National Treasury (Republic of South Africa) website: http://www.treasury.gov.za/documents/national%20budget%/2009/guides/Budget%20Proposals%202009.pdf (Accessed: 07 January 2010).

South African National Treasury. (2010a). *Draft Explanatory Memorandum on the Taxation Laws Amendment Bill, 2010*. National Treasury. Available from National Treasury (Republic of South Africa) website: http://www.treasury.gov.za/legislation/bills/2010/Explanatory%20Memorandum%20TLAB%2020%20October%202010.pdf (Accessed 13/03/2011).

South African National Treasury. (2010b). Further steps on exchange control reform – supporting investment and competitiveness. In *Documents – Medium Term Budget Policy Statements – 2010*. Available from National Treasury (Republic of South Africa) website: http://www.treasury.gov.za/documents/mtbps/2010/Excon.pdf (Accessed 13 March 2011).

South African National Treasury. (2011a). *Budget Review 2011.* Pretoria: National Treasury. Available from National Treasury (Republic of South Africa) website: http://www.treasury.gov.za/documents/national%20budget/2011/review/Budget%20Review.pdf (Accessed: 13 March 2011).

South African National Treasury. (2011b). *Government Notice No. 1073.* In Government Gazette No. 34873. 20 December 2011. Reproduced by Sabinet Online in terms of Government Printer's Copyright Authority No. 10505 dated 02 February 1998. Available from http://www.sars.gov.za/Tools/Documents/DocumentDownload.asp?FileID=74078 (Accessed: 21 April 2012).

South African National Treasury. (2012). *Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011.* 27 January 2012. Pretoria: National Treasury. Available from National Treasury (Republic of South Africa) website: http://www.treasury.gov.za/legislation/acts/2011/EM%20for%20Taxation%20Laws%202011%20dated%2030%20Jan%202012.pdf (Accessed: 15 April 2012).

South African Revenue Service ("SARS"). (1999). *Practice Note No. 7 – Section 31 of the Income Tax Act, 1962 (the Act) : Determination of the Taxable Income of Certain Persons from International Transactions : Transfer Pricing.* 6 August 1999. Reproduced op. cit. Clegg, D and Stretch, R. (Vol 2A, updated by Service Issue No. 60: 572(130) – 572(186)).

South African Revenue Service ("SARS"). (2005). *Transfer Pricing: Addendum to SARS Practice Note 7 dated 6 August 1999: Submission of Transfer Pricing Policy Document.* 29 September 2005. Reproduced op. cit. Clegg, D and Stretch, R. (Vol 2A, updated by Service Issue No. 60: 572(186) – 572(188)).

South African Revenue Service ("SARS"). (2008). *Tax Guide for Share Owners* (Brochure). 2nd issue: May 2008. Legal and Policy Division, SARS. Available from http://www.sars.gov.za/Tools/Documents/DocumentDownload.asp?FileID=4671 (Accessed 17 May 2011).

South African Revenue Service ("SARS"). (2009). *BINDING PRIVATE RULING: BPR 061* (Binding Private Ruling in terms of section 76Q of the Income Tax Act, No 58 of 1962). 30 October 2009. SARS. Available from http://www.sars.gov.za/Tools/Documents/DocumentDownload.asp?FileID=63227 (Accessed 17 May 2011).

South African Revenue Service ("SARS"). (2010). *INCOME TAX - IT10 - Controlled Foreign Company (CFC) Return* (Tax Form). Effective date: 26/03/2010. SARS. Available from http://www.sars.gov.za/home.asp?pid=4153&tid=60&s=form&show=1297#IT10 - Controlled Foreign Company (CFC) Return (Accessed 17 May 2011).

South African Revenue Service ("SARS"). (2011). *Tax Proposals – Budget 2011* (Brochure). SARS. Available from http://www.sars.gov.za/Tools/Documents/DocumentDownload.asp?FileID=66401 (Accessed 17 May 2011).

States of Guernsey. (2011). *Guernsey Income Tax* (brochure). Form 42 (06/06). Guernsey Income Tax Office. Available from http://www.gov.gg/ccm/cms-service/download/asset/?asset_id=9854078 (Accessed 18 May 2011).

Thuronyi, V. (2003). *Comparative tax law.* The Hague: Kluwer Law International.

University of Oxford. (1989). *Oxford English Dictionary.* Second edition, 1989; online version March 2011. Oxford. Oxford University Press, University of Oxford. Available from http://0-www.oed.com.ujlink.uj.ac.za (Accessed 30 May 2011).

Van Heerden, M. (2009). CFC translation rules : is the taxpayer currently getting the short end of the stick ?. *Meditari*. 2009.17(2). Available from Sabinet epublications database *via* UJLink : http://0-www.journals.co.za/ujlink.uj.ac.za (Accessed: 24/05/2012).

Wilson, G.P. (1993). The Role of Taxes in Location and Sourcing Decisions. In *Studies in International Taxation*. Edited by Giovannini, A., Glenn Hubbard, R., Slemrod, J. Chicago and

London: The University of Chicago Press.

Court cases referred to:

Bricom Holdings Ltd v IRC. (1997). STC 1179 CA. (United Kingdom).

Commissioner, SARS v NWK Ltd. (2010). SCA. (South Africa)

Income Tax Case 1735. (2002). 64 SATC 455. (South Africa).

APPENDIX A – COMPARISON OF FBE DIVERSIONARY TRANSACTIONS PROVISIONS PRE/POST 1 APRIL 2012

FBE Exemption: To 31 March 2012	**FBE Exemption: From 1 April 2012**
In determining the net income of a CFC in terms of section 9D(2A), an exemption is provided for any amount which is “attributable to any foreign business establishment” (including in relation to its disposals or deemed disposals of assets) (section 9D(9)(b), prior to 1 April 2012).	Section 9D(9)(b) now adds to a similarly worded exemption, further key requirements along the lines of transfer-pricing tests, as described in more detail in Chapter 4.
The FBE exemption is however subject to regulations regarding diversionary transactions, which were defined by the statutory provisos to section 9D(9)(b), and which are illuminated below:	The regulations regarding diversionary transactions have been removed from the proviso to section 9D(9)(b) and are now contained separately in section 9D(9A).
Diversionary transactions by an FBE of a CFC:	**Diversionary transactions by an FBE of a CFC:**
Non-arms’-length Sale or Service transactions with resident connected persons **- re-inclusion in net income** Amounts derived from sales of goods or service transactions attributable to an FBE of the CFC to or from resident connected persons of that CFC are included in the CFC’s net income (with the exception of the re-exclusion condition below) (Section 9D(9)(b)(i), up to 31 March 2012) **-- re-exclusion from net income** Where the transaction consideration “reflects an arms length price that is consistent with the provisions of section 31” (i.e. the transfer pricing provision) such amounts are excluded from CFC net income. (Section 9D(9)(b)(i)) **Table A.1 – Components of section 9D(9)(b)(i) (to 31 March 2012)**	**Non-arms’-length Sale or Service transactions with resident connected persons** The updated diversionary rules within section 9D(9A) from 1 April 2012 no longer refer to “non-arms’ length” sale or service transactions. Instead, section 9D(9)(b)(i) and (ii) (from 1 April 2012) accord with the objectives of transfer pricing rules as discussed in Chapter 4, requiring amounts to be determined as if the parties thereto had “been independent persons dealing at arms’ length” and as though the FBE were a “distinct and separate enterprise” with similar activities and conditions and “dealing wholly independently with the CFC of which it is an FBE” (section 9D(9)(b)(i) and (ii) from 1 April 2012). By virtue of the additional requirements included in section 9D(9)(b)(i) and (ii), it is now therefore peremptory that in determining the amount attaching to the sale or service transactions of a CFC, both the financial amount of the transaction as well as whether the amount is attributable to a FBE from 1 April 2012 have to be determined by treating the FBE fictionally as if it were in fact separate from the CFC of which it is a FBE, dealing “wholly independently”, and as if the amount was determined on an arm’s length basis. (section 9D(9)(b), from 1 April 2012).
Sales of goods to resident connected persons **- re-inclusion in net income** Amounts derived from any sale of goods by a CFC to any resident connected person (in relation to that CFC) are included in the CFC’s net income (with the exception of any one of the four alternative re-exclusion conditions below)	**Sales of goods to resident connected persons** **- re-inclusion in net income** Amounts derived from the disposal of goods, and which are attributable to an FBE of the CFC to resident connected persons of that CFC are included in the CFC’s net income (with the exception of the two alternative re-exclusion conditions below)

FBE Exemption: To 31 March 2012	FBE Exemption: From 1 April 2012
(Section 9D(9)(b)(ii)(aa), up to 31 March 2012) **-- re-exclusions from net income** Where the CFC either: purchased the goods within its country of residence from a person other than a connected person (in relation to that CFC); **or** (A) created, extracted, produced, assembled, repaired or improved the goods which activities “amount to more than minor assembly or adjustment, packaging, repackaging and labeling”; **or** (B) “sells a significant quantity of goods of the same or a similar nature” to persons other than a connected person (in relation to that CFC) “at comparable prices (after accounting for the level of the market, volume discounts and costs of delivery)”; **or** (C) “purchases the same or similar goods” mainly in the CFC’s country of residence “from persons other than a connected person (in relation to that CFC)” such amounts are excluded from CFC net income. (Section 9D(9)(b)(ii)(aa) up to 31 March 2012) **Table A.2 – Components of section 9D(9)(b)(ii)(aa) up to 31 March 2012**	(Section 9D(9A)(a)(i), from 1 April 2012) **-- re-exclusion from net income** Where either:- (aa) the “aggregate amount of tax payable to all spheres of government” of a foreign country, in respect of the CFC’s foreign tax year, “exceeds 50 *per cent* of the amount of normal tax” that the CFC would have been liable for had the CFC been a resident for that period (Section 9D(9A)(a)(i)(aa), from 1 April 2012). Note however that in calculating the foreign tax, any applicable double taxation agreement and any credit, rebate or right of recovery from any sphere of government of any foreign country must be taken into account, and losses in respect of any year other than the foreign tax year must be disregarded (Section 9D(9A)(b)(i)(aa) and (bb), from 1 April 2012); or (bb) the amount is “attributable to a permanent establishment” of the CFC (Section 9D(9A)(a)(i)(bb), from 1 April 2012). Section 9D(9A)(b)(ii) sets out the factors to be applied in determining for this purpose whether an amount is attributable to a permanent establishment (these factors are almost identical to those to be taken into account under section 9D(9)(b) when determining whether an amount is attributable to an FBE. amounts so derived from the disposal of goods and attributable to an FBE of the CFC are excluded from CFC net income. **Table A.3 – Components of section 9D(9A)(i) (from 1 April 2012)** This provision no longer specifically provides for re-exclusion from net income on the basis of an arms length price applying. The introduction from 1 April 2012 of both the specific “high tax exemption” in section 9D(9A)(a)(i)(aa), as well as alignment (in section 9D(9A)(a)(i)(bb)) with Article 7 of the OECD Model Tax Convention (OECD, 2010: Article 7) by virtue of allowing the active business income of a permanent establishment to be taxed in the jurisdiction in which it carries on business, is to be welcomed as these provisions can be expected to extend the FBE exemption to the operations of an increased number legitimate FBEs of CFCs. The reference in sub-paragraph (aa) to “tax payable to all spheres of government” would arguably include all forms of taxes e.g. including in addition to income taxes other forms of tax such as local government or regional taxes and even potentially non-

FBE Exemption: To 31 March 2012	FBE Exemption: From 1 April 2012
	income-based taxes such indirect taxes. Consequently a larger number of CFCs can be expected to benefit from the exemption than if the taxes contemplated included only income taxes. It is submitted that the legislature is to be commended for removing the overly complex rules which apply to 31 March 2012, in favour of a more principled approach.
Sales of goods purchased from resident connected persons **- re-inclusion in net income** Amounts derived from any sale of goods by a CFC to any person other than a resident connected person (in relation to that CFC), where the CFC initially bought the goods or any “tangible material inputs thereof” from one or more resident connected persons of the CFC, are included in the CFC’s net income (with the exception of any one of the four alternative re-exclusion conditions below) (Section 9D(9)(b)(ii)(bb), up to 31 March 2012) **-- re-exclusions from net income** Where the CFC either: (A) purchased no more than an insignificant portion of the “total goods” or their “tangible intermediate inputs” from resident connected persons of the CFC **or** (B) created, extracted, produced, assembled, repaired or improved the goods which activities “amount to more than minor assembly or adjustment, packaging, repackaging and labeling” **or** (C) sold the products to a person other than a connected person of the CFC for “physical delivery” to a customer’s premises situated in the CFC’s country of residence	**Sales of goods purchased from resident connected persons** The amended diversionary rules now contained in section 9D(9A) from 1 April 2012 no longer contain any specific provisions regarding the sale of goods which were purchased from resident connected persons. Consequently, it is to the extended wording of section 9D(9)(b) to which it is necessary to turn for comparison purposes. (The reader may wish to refer also to the discussion under section headed “Non-arms’-length Sale or Service transactions with resident connected persons” above.) Because of the arms’ length and independence requirements of section 9D(9)(b), it is possible that the net income of the CFC could potentially be adjusted where a non-arms’-length price has been charged by a resident connected person, or where the amount of the sale is found not to be “attributable to” the FBE. It is submitted that the legislature is to be commended for having chosen to move away from prescriptive rules (which may not factor in true business considerations, and therefore may distort business decisions) in regard to this class of transaction.

FBE Exemption: To 31 March 2012	FBE Exemption: From 1 April 2012
or (D) sells “products of the same or similar nature” mainly to persons who are not connected persons of the CFC for “physical delivery” to customers’ premises situated in the CFC’s country of residence then such amounts are excluded from CFC net income. (Section 9D(9)(b)(ii)(bb), up to 31 March 2012) **Table A.4 – Components of section 9D(9)(b)(ii)(bb), up to 31 March 2012**	
Services to resident connected persons **- re-inclusion in net income** Amounts derived from any service performed by a CFC to a resident connected person (in relation to that CFC) (with the exception of any one of the four alternative re-exclusion conditions below) (Section 9D(9)(b)(ii)(cc), up to 31 March 2012) **-- re-exclusions from net income** Where the CFC performs the service outside the Republic and either: (A) the service “relates directly to creation, extraction, production, assembly, repair or improvement of goods utilized within one or more countries outside the Republic” **or** (B) the service “relates directly to the sale or marketing of goods” of a resident connected person of the CFC and the goods are sold to persons who are not connected persons of the CFC for “physical delivery” to customers’ premises situated in the CFC’s country of residence **or** (C) “the service is rendered mainly in the country of residence of the CFC for the benefit of customers” having premises in that country **or** (D) to the extent that “no deduction is allowed of any amount paid by that connected person to the CFC in respect of that service”	**Services to resident connected persons** **- re-inclusion in net income** Amounts derived from any service performed by a CFC to a resident connected person (in relation to that CFC) (with the exception of any one of the four alternative re-exclusion conditions below) (Section 9D(9A)(a)(ii), from 1 April 2012) **-- re-exclusions from net income** Where the CFC performs the service outside the Republic and either: (aa) the service “relates directly to creation, extraction, production, assembly, repair or improvement of goods utilized within one or more countries other than the Republic” **or** (bb) the service “relates directly to the sale or marketing of goods” of a resident connected person of the CFC and the goods are sold to persons who are not connected persons of the CFC for “physical delivery” to customers’ premises situated in the CFC’s country of residence **or** (cc) “the service is rendered mainly in the country of residence of the CFC for the benefit of customers” having premises in that country **or** (dd) to the extent that “no deduction is allowed of any amount paid by that connected person to that CFC in respect of that service”

FBE Exemption: To 31 March 2012	FBE Exemption: From 1 April 2012
then such amounts are excluded from CFC net income. (Section 9D(9)(b)(ii)(cc), up to 31 March 2012) **Table A.5 – Components of section 9D(9)(b)(ii)(cc), up to 31 March 2012**	then such amounts are excluded from CFC net income. (Section 9D(9A)(a)(ii), from 1 April 2012) **Table A.6 – Components of section 9D(9A)(a)(ii), from 1 April 2012** It is considered to be unfortunate that the legislature has seen fit to retain the diversionary rules regarding services by a CFC to resident connected persons. It is submitted that it would be better to make use of a principle-based approach, such as effective transfer pricing rules, supported by an effective Advanced Pricing Agreement (APA) program.
Use of, and capital gains in respect of, intangible assets **Use of intangible assets** **- re-inclusion in net income** Where the CFC grants "the use, right of use or permission to use an intangible asset as defined in paragraph 16(2) of the Eighth Schedule" to a resident connected person of the CFC. (Section 9D(9)(b)(ii)(dd), up to 31 March 2012) *Note: Paragraph 16(2) of the Eighth Schedule contains a list of the intangible assets contemplated, which are quite widely defined therein. In the case of intangible assets there are no re-exclusions which modify the above re-inclusion in the Act.* **Table A.7 – Components of section 9D(9)(b)(ii)(dd), up to 31 March 2012**	**Use of, and capital gains in respect of, intellectual property** It is noteworthy that the updated act provides rules in respect of intellectual property as defined in section 23I rather than an intangible asset as defined in paragraph 16(2) of the eighth schedule. **Use of intellectual property** **- re-inclusion in net income** Where the amount arises in respect of "the use, right of use or permission to use any intellectual property as defined in section 23I" unless the CFC "directly and regularly creates, develops or substantially upgrades" any intellectual property which gives rise to the amount. (Section 9D(9A)(a)(v), from 1 April 2012) *Note: section 23I refers to patents, designs, trade marks, copyrights both in terms of specified South African legislation and the similar laws of other countries, as well as property or rights "of a similar nature" to the above, and knowledge connected to the use of such property or rights.* **Table A.8 – Components of section 9D(9A)(a)(v), from 1 April 2012**
Capital gains arising from disposal of intangible assets **- re-inclusion in net income** Amounts representing capital gains from disposals of assets from which passive income can be derived (with the exception of any of the re-exclusion conditions below, provided no further re-inclusion applies) (Section 9D(9)(b)(iii), up to 31 March 2012)	**Capital gains arising from disposal of intellectual property** **- re-inclusion in net income** Where the amount is a capital gain "in respect of the disposal or deemed disposal of any intellectual property as defined in section 23I", unless the CFC both "directly and regularly creates, develops or substantially upgrades" any intellectual property which gives rise to the amount, and the particular intellectual property would not be "tainted intellectual property"

FBE Exemption: To 31 March 2012	FBE Exemption: From 1 April 2012
-- re-exclusion from net income Refer to the list of re-exclusions from net income set out in Table A.11 below. **except for** **--- further re-inclusions** Refer to the list of cases resulting in such capital gain amounts being included in CFC net income in spite of the above exclusions, as set out in Table A.11 below. **Table A.9 – Relevant Components of section 9D(9)(b)(iii), up to 31 March 2012**	(as defined in section 23I) if the CFC were a resident. (Section 9D(9A)(a)(vi), from 1 April 2012) **Table A.10 – Components of section 9D(9A)(a)(vi), from 1 April 2012** It is submitted that the evident simplification and narrowing of scope of the provisions in relation to capital gains is to be welcomed.
Passive income **Passive income amounts** **- re-inclusion in net income** Amounts of passive income (it should be noted that the generic term "passive income" is not actually used in the Act, the section specifies "dividends, interest, royalties, rental, annuities, insurance premiums or income of a similar nature"; capital gains from disposals of assets from which such income can be derived; and foreign currency gains in respect of any foreign equity instrument or determined in terms of section 24I (with the exception of any of the re-exclusion conditions below, provided no	**CFC FBE: Passive income** In its updated form with effect from 1 April 2012, the Act deals separately with the following separate types of passive income (in addition to the abovementioned use of or capital gains arising from intellectual property): • Amounts that arise in respect of a financial instrument; • Amounts that arise by way of rental on movable property; and • Amounts in the form of an insurance premium. Consequently, it may be possible that other passive income earned by a FBE of a CFC could fall within the general FBE exemption contained in section 9D(9)(b), from 1 April 2012, however it would be necessary to demonstrate that such income is attributable to the FBE and the FBE would need to be treated as dealing with the rest of the CFC of which it is part on an arm's length basis, which may potentially prove problematic (section 9D(9)(b)). **Amounts that arise in respect of a financial instrument** **- re-inclusion in net income** Amounts that arise in respect of a financial instrument are included in CFC income (Section 9D(9A)(a)(iii), from 1 April 2012). In addition, amounts of rental in respect of movable property, unless the property is leased by the CFC in terms of an operating lease that constitutes a financial instrument. (Section 9D(9A)(a)(iv), from 1 April 2012). Further, insurance premium amounts are included in net income, unless the principal trading activities

FBE Exemption: To 31 March 2012	FBE Exemption: From 1 April 2012
further re-inclusion applies) (Section 9D(9)(b)(iii), to 31 March 2012)	of the FBE are that of an insurer, provided its activities are not those of a captive insurer (Section 9D(9A)(a)(vii), from 1 April 2012). Section 9D(9A)(b)(v), from 1 April 2012, defines an "operating lease" for this purpose as a lease of movable property in the ordinary course of business where the general public may hire the property for no more than five years and the cost or activities of maintenance are the responsibility of the lessor and, subject to any claim by the lessor against the lessee, the risk of destruction or loss of the property is not assumed by the lessee. (unless re-exclusion conditions below apply, provided that no further re-inclusion applies) (Section 9D(9A)(a)(iii), from 1 April 2012)
-- re-exclusion from net income - foreign currency gains which arise in the normal course of business, provided the CFC is not a foreign financial instrument holding company **or** (aa) "**to the extent** that any income or capital gains attributable to those amounts do not in total exceed 10 *per cent* of the amount in brackets below [the income and capital gains of the CFC attributable to that FBE other than income or capital gains attributable to (A) those amounts; or" (B) in respect of which any provision in section 9D(9)(e) to 9D(9)(fB) applies] (Please refer also to the discussion of this '**safe harbour threshold**' below) **or** (bb) "where those amounts arise from the principal trading activities of any banking or financial services, insurance or rental business"	**-- re-exclusion from net income** (bb) such amounts are excluded if they are attributable to an exchange difference interms of section 24I in respect of the financial instrument, and the difference arises in the "ordinary course of business of the principal trading activities" of the FBE, which activities do not constitute the activities of a treasury operation or captive insurer (section 9D(9A)(a)(iii)(bb), from 1 April 2012. (cc) to the extent that the sum total of such amounts and amounts arising from exchange gains determined under section 24I (attributable to the particular FBE) do not exceed 5 *per cent* of all amounts received by or accrued to the CFC and which are attributable to the particular FBE (Section 9D(9A)(a)(iii)(cc), from 1 April 2012). It is noteworthy that the above represents a considerable reduction in the so-called "safe harbour threshold". **or** (aa) where the financial instrument is attributable to the principal trading activities of the FBE, and which principle trading activities "constitute the activities of a bank, financial service provider or insurer" (Section 9D(9A)(a)(iii)(bb)(A), from 1

FBE Exemption: To 31 March 2012	**FBE Exemption: From 1 April 2012**
or (cc) amounts from the disposal or deemed disposal of any intangible asset defined in paragraph 16(2) of the Eighth Schedule if that intangible asset (A) formed an integral part of any business conducted by the CFC; **and”** (C) was disposed of as part of the disposal of that business and where all the assets necessary for carrying on that business are disposed of as a going concern **or** (dd) royalties received by or accrued to the CFC, provided the CFC “directly and regularly creates, develops or substantially upgrades any intellectual property as defined in section 23I which gives rise to those royalties” **except for**	April 2012). Note however that there is a further re-inclusion to CFC net income in regard to amounts received by or accrued to a treasury operation or captive insurer, as explained further below. **or** Kindly refer to the section further above titled “Capital gains arising from disposal of intellectual property” for re-inclusions in relations to amounts arising therefrom. **or** Kindly refer to the section further above titled “Use of intellectual property” for re-inclusions in relations to amounts arising from royalties received by or accrued to a CFC and attributable to an FBE of that CFC. **except for**
--- further re-inclusions The following cases result in amounts being included in CFC net income in spite of the above exclusions. (bb) In the case of “any banking or financial services, insurance or rental business” the following amounts will be included in CFC net income: (A) amounts derived by a foreign financial instrument holding company (B) amounts derived from a resident connected person of a CFC who directly or indirectly holds at least five *per cent* of either CFC participation rights or any other company (in the same group of companies) which holds shares in the CFC (C) to the extent that amounts derived form part of any “transaction, operation or scheme” whereby one	**--- further re-inclusions** The following cases result in amounts being included in CFC net income in spite of the above exclusions. Where the principal trading activities of the FBE constitute the activities of a treasury operation or captive insurer, amounts that arise in respect of a financial instrument, (Section 9D(9A)(a)(iii)(aa)(B), from 1 April 2012); or in such circumstances (i.e. for an FBE which is principally a treasury operation or a captive insurer), amounts attributable to an exchange difference determined in terms of section 24I. **or** To the extent that a deduction is allowed to a resident connected person (in relation to the CFC) in respect of another amount, to which the amount attributed to the FBE of

FBE Exemption: To 31 March 2012	**FBE Exemption: From 1 April 2012**
person is exempt from tax while any "corresponding expenditure (other than expenditure for the delivery of any goods including electricity) is deductible by that person or by any connected person"… "in determining the liability for tax of that person or connected person"…	the CFC is also attributable (Proviso to Section 9D(9A)(a), from 1 April 2012) **or** Section 9D(9A)(b)(iv) and (v) each provide three very similar conditions that will for the purposes of section 9D(9A)(a)(iii) (i.e. amounts arising in respect of financial instruments) and (vii) (i.e. amounts in the form of an insurance premium) deem the principal trading activities of the FBE to be those of a captive insurer or a treasury operation, namely if less of the principal trading activities are conducted in the country in which the FBE is located than in any other single country; or where its principal trading activities do not involve regular acceptance of deposits (in the case of the test for a treasury operation) or business transactions as an insurer (in the case of the test for a captive insurer) respectively with persons who are not connected persons to the CFC; or where less than 50 *per cent* of amounts attributable to business of the FBE are derived from clients who are not connected persons in relation to the CFC.
Table A.11 – Components of section 9D(9)(b)(iii), up to 31 March 2012	**Table A.12 – Components of section Section 9D(9A)(a)(iii), (iv), (v) and (vii) from 1 April 2012**