§ 3.1 Background to the controlled foreign company rules and their purpose

Controlled foreign company ('CFC') rules were first introduced into the Income Tax Act in 1997 but their scope was broadened considerably when South Africa moved from a pure source basis of taxation to the residence basis of taxation in 2001/2.

The rules are contained in s 9D of the Income Tax Act, 58 of 1962 ('the Act'). In Treasury's own words, 'Section 9D is an anti-avoidance provision that is generally aimed at preventing South African residents from shifting tainted forms of taxable income outside the South African taxing jurisdiction by investing through a CFC. The main targets of concern are mobile (passive and business) income as well as diversionary foreign business income (i.e. suspect structures that can easily lead to transfer pricing avoidance).'[1]

The mischief at which the CFC rules are targeted generally arises in situations where a local taxpayer sets up or acquires existing shares in a company located in a low tax jurisdiction outside his home country. The taxpayer then uses this company to conduct activities that could have been carried on from his home country i.e. the sole or primary reason for housing the activities in the foreign company is to avoid tax in the home country on the income they produce. Whereas most countries see these rules as measures to apply in situations where transfer pricing abuse is not taking place, and hence where transfer pricing rules cannot be used to have the effect of pulling some or all of the CFC's income back into the local tax net, South Africa goes further and attempts to use the South African CFC rules to supplement our local transfer pricing rules.

National Treasury has acknowledged that as a policy matter the rules should not result in the imputation to South Africa of income from countries where the tax rate is the same as, or even higher than, South Africa's. Prior to June 2004, the so called designated country exemption applied to protect most income derived by CFCs in countries specifically identified by the South African Revenue Service ('SARS') from being imputed to South Africa for tax purposes. However, for years of assessment commencing on or after 1 June 2004 and ending on or before 31 December 2007, the CFC legislation contained no specific relief for CFCs located in countries with relatively high tax rates. Relief has again been introduced with effect from years of assessment ending on or after 1 January 2008, in the form of the provisions discussed further in § 3.5.4.7.

CFC rules are found in the tax systems of many countries around the world. From a business economic point of view, they are controversial as it is argued that the existence of such rules makes multinational groups headquartered in countries that have these rules uncompetitive in relation to multinational groups headquartered in countries that do not have CFC rules. Tax authorities, however, argue that they are justifiable because they are preventing or neutralising structures and transactions that shift income out of the home country's tax net to a lower tax jurisdiction where the shift is not justified by a genuine commercial purpose unrelated to tax. Drafting CFC rules that achieve their intended purpose without impacting negatively on genuine commercial transactions that are not tax driven is, unfortunately, notoriously difficult.

The rules are potentially triggered the moment a South African taxpayer establishes a company in a foreign country. If the foreign company meets the definition of a CFC, then its income will be imputed to the South African taxpayer for local tax purposes as if that income had been derived directly by the South African taxpayer itself, unless the circumstances are such that one or more of the exemptions provided for in the CFC rules is available. Where the CFC clearly has to be based in the foreign country in order to carry on its business, for example, if the CFC is involved in farming or mining, or is manufacturing in order to sell to customers in its own country, it is relatively easy for the CFC's income to be kept out of the South African tax net. However, where the CFC engages in business transactions with connected parties in South Africa or where the business imperative for the CFC's choice of location is not immediately obvious because the geographical source of its income is not the foreign country where it is incorporated, it becomes harder for the CFC's income to escape the reach of the South African tax authorities.

Footnotes

1 Explanatory Memorandum to the 2009 Taxation Laws Amendment Bill.

Author: Various - See relevant chapter.

§ 3.2 Definition of a controlled foreign company

'Company' must be defined in accordance with the definition in s 1 of the Act. A foreign company is a company as defined that is not South African tax resident.

A controlled foreign company means any foreign company where more than 50% of the total participation rights in that foreign company are held by, or more than 50% of the voting rights in that foreign company are directly or indirectly exercisable by, one or more residents of South Africa.

The definition of 'participation rights' is discussed in § 3.3.

In performing the analysis of whether or not a company is a CFC, voting rights in a listed company can be disregarded, as can voting rights in any foreign company that are exercisable only indirectly through a listed company.

Where a chain of companies exists, any voting rights exercisable by a CFC in which a South African resident together with any connected person in relation to that South African resident can directly or indirectly exercise more than 50% of the voting rights are treated as being exercisable by the South African resident directly. Once the new headquarter company provisions are implemented, residents that are headquarter companies as defined in the Act will not be treated as residents for the purposes of analysing whether foreign companies held by them qualify as CFCs.

Example

Co A in South Africa holds 60% of the shares and voting rights in Co B in the UK. Co B in turn controls 25% of the voting rights in another UK company, Co C. In analysing whether or not Co C is a CFC, Co A is treated as being able to exercise 25% of the voting rights in Co C, even though in fact Co A only has an indirectly held 15% (60% × 25%) stake in Co C. However, if Co B is listed, A's voting rights in both Co B and Co C must be disregarded.

There are at present two situations in which South African taxpayers can be deemed not to be South African tax resident for the purposes of testing the extent of the participation rights held by South African residents in a foreign company. The first situation is where the resident holds less than 5% of the participation rights in a listed foreign company. The resident will not be counted as a South African resident shareholder either of that listed company or of any company held indirectly via the listed company. The second situation is where a resident holds less than 5% of the participation rights and voting rights in a foreign collective investment scheme. In this case the resident will not count as a resident either in regard to the direct shareholding in the foreign collective investment scheme or with regard to any shares held indirectly via the collective investment scheme, unless more than 50% of the participation rights or voting rights in the foreign collective investment scheme are held by persons who are connected persons in relation to each other.

Example

Mr and Mrs X and their 3 children each own 4% of the interests and voting rights in a foreign unit trust scheme, Hola Kola.

Because they are all related to each other, they qualify as connected persons as defined. Hence their shareholding in Hola Kola must be aggregated for the purposes of testing whether or not they qualify as South African resident shareholders for the purposes of the CFC rules. Their combined shareholding is 20%. Since it is not more than 50%, and since each of them in his or her own right holds only 4% of the interests and voting rights, they can be deemed not to be SA residents for the purposes of analysing whether or not the foreign unit trust scheme is a CFC.

For foreign tax years of CFCs ending in years of assessment commencing on or after 1 January 2011, headquarter companies will also not qualify as SA residents for purposes of testing whether or not a foreign company is a CFC.

Author: Various - See relevant chapter.

§ 3.3 Definition of 'participation rights'

The current definition of participation rights, introduced in respect of any foreign tax year commencing on or after 8 November 2005, reads as follows:

> ' **"Participation rights"** in relation to a foreign company means
>
> (*a*) the right to participate directly or indirectly in the share capital, share premium, current or accumulated profits or reserves of that foreign company, whether or not of a capital nature; or
>
> (*b*) in the case where no person has any right in that foreign company as contemplated in paragraph (*a*) or no such rights can be determined for any person, the right to exercise any voting rights in that company.'

Participation rights are a broad concept and this has given rise to some difficulties of interpretation. It seems that both a balance sheet approach and an income statement approach can be taken in determining which parties have participation rights in the foreign company. Under the balance sheet approach, regard needs to be had to who would be entitled to the share capital and share premium of the company on liquidation or on redemption or buy back of the shares. Similarly, regard is had to who would benefit from the reserves of the company should it declare a dividend or be liquidated.

The term 'accumulated profits' could be interpreted as relating to the total amount of accumulated earnings in the balance sheet, including any amount by which the most recent year's profits have increased the retained earnings. However, this is presumably not what was intended as the definition of participation rights refers to the 'current **or** accumulated profits' (our emphasis) of the foreign company. Hence 'current profits' must presumably be interpreted to mean the company's profits after tax derived in the current year as reflected in each year's income statement. The income statement approach therefore looks only at who is entitled to benefit each year from the current profits i.e. the profits derived by the CFC in that year. 'Accumulated profits' in the context of the balance sheet approach can then be interpreted to mean the accumulated retained earnings and reserves as reflected in the balance sheet but excluding any amount by which the retained earnings increased in the current year.

Complexities arise where the parties who are entitled to the lion's share of the foreign company's share capital and share premium are not necessarily the same parties who are entitled to share in profits on a year by year basis. For example, a foreign company may have one ordinary shareholder who is entitled to 100% of the ordinary share capital and retained earnings on a winding up of the company. However, the company has issued preference shares to another party and the preference shares carry a fixed dividend coupon that entitles them in practice to more than 50% of the after tax profits made by the company each year. If the preference shareholder is South African resident but the ordinary shareholder is not, the question will be whether or not the foreign company qualifies as a CFC. If both shareholders are South African resident, the foreign company will undoubtedly be a CFC and the question will then be what percentage of the participation rights each of the two shareholders holds.

An important question in addressing the first test (whether or not the foreign company is a CFC) is whether the participation rights have to be tested in the aggregate i.e. must South African residents hold more than 50% of all the participation rights, or can a company be a CFC if more than 50% of any particular class of participation rights (e.g. share capital) is held directly or indirectly by South African tax residents. The definition of 'controlled foreign entity' in the Act in 2001/2 read as follows:

> ' **"Controlled foreign entity"** means any foreign entity in which any resident or residents of the Republic whether individually or jointly and whether directly or indirectly hold more than 50% of the participation rights, or are entitled to exercise more than 50% of the votes or control of such entity.'

This definition did not specify whether, in applying the test, the percentage of participation rights held should be applied to all possible participation rights i.e. whether the test should be applied to participation rights in the aggregate or to each different class of participation rights.

In 2003, however, the definition was amended, with effect from years of assessment commencing on or after 1 June 2004, to provide that a controlled foreign company (no longer 'entity') meant:

> 'a foreign company where more than 50% of the **total** participation rights in that foreign company are held by one or more residents, whether directly or indirectly.' (emphasis added.)

This put beyond doubt the fact that the participation rights must be tested in the aggregate in order to determine whether or not a foreign company qualified as a CFC for South African tax purposes.

Although the definition of CFC has been amended again, by Act 31 of 2005 and by the Revenue Laws Amendment Act 2007, the concept of testing participation rights in the aggregate has been retained. The current definition (in force since 1 January 2007) opens with the provision that

> 'Controlled foreign company means any foreign company where more than 50% of the total participation rights in that foreign company are held or more than 50% of the voting rights in that foreign company are directly or indirectly exercisable by one or more residents: . . .'

The test at least since the 2005 tax year and arguably also prior to that, has therefore been whether, tested in the aggregate, South African tax residents hold directly or indirectly more than 50% of the total participation rights in the foreign company being tested to see whether or not it qualifies as a CFC.

In the example given above, therefore, the fact that a South African resident preference shareholder derives substantial amounts of income from the foreign company every year would only cause the foreign company to

qualify as a CFC in any financial year in which the amounts derived by the South African resident exceeded the amounts of share capital, share premium and retained earnings to which the non resident ordinary shareholder would be entitled were the company to be liquidated.

If both the ordinary and preference shareholders were South African resident, the question would be how much of the CFC's income each of them would need to impute into their own income for South African tax purposes each year. The Act provides that net income of a CFC must be imputed to a South African resident 'in the same ratio as the percentage of the participation rights of that resident in relation to that company bears to the total participation rights in relation to that company' as measured on the last day of the CFC's financial year (s 9D(2)(*a*)(i)). This can give rise to some very inequitable results. For example, if shareholder A holds all the ordinary share capital which is a significant amount, and is entitled to all the retained earnings of the company on winding up but each year shareholder B (who holds preference shares only) in practice receives all or most of the CFC's after tax income in the form of preference share dividends, it would seem very unfair to impute to A for South African tax purposes a significant portion of the CFC's income every year (which in practice will be paid to B and never to A) simply because the aggregate value of A's entitlement to participate in the ordinary share capital, share premium and accumulated profits of the company in a particular year may be greater than the dividend amount factually derived by B from the CFC in that year.

Although there is no legislative basis for this, the equitable approach in these circumstances would seem to be to adopt the income statement rather than the balance sheet approach and impute to the preference shareholder an amount equal to the amount actually derived by that shareholder in the form of his annual preference share dividend, since any remaining income of the CFC will then become part of the retained earnings to which the ordinary shareholder is entitled. In practice, as long as the approach taken in determining how much to impute is logical and consistent, it seems unlikely that SARS would contest it.

Where an entity is classified as a company for purposes of South African tax but factually does not have share capital or retained earnings (for example, a mutual fund), and for this or other reasons it is just not possible to test who has the participation rights in that entity having regard to share capital, premium, reserves or accumulated profits, then participation rights will be tested solely with regard to voting rights, and who is entitled to exercise these rights.

With effect from 1 January 2011, sub-s 1(*a*) of the definition of 'participation rights' is to be changed to define these as 'the right to participate in all or part of the benefits of the rights (other than voting rights) attaching to a share or any interest of a similar nature in that company'.

The discussion above in regard to the application of the definition is unlikely to be materially affected by this change.

Author: Various - See relevant chapter.

§ 3.4 Consequences of classification as a CFC

§ 3.4.1 General principle

The fundamental principle underlying the CFC rules is that the income (including capital gains) of a CFC must, under certain circumstances, be imputed to one or more South African tax residents holding participation rights in the CFC and taxed in the residents' hands (s 9D(2)).

Two main questions arise when applying the CFC rules:

- ☐ When does a resident have to impute?
- ☐ What does a resident have to impute?

§ 3.4.2 When does a resident have to impute?

The general rule is that an obligation to impute arises when a resident (together with any connected person in relation to it) holds at least 10% of the participation rights or voting rights in the CFC.

Here one must distinguish between a foreign company which qualified as a CFC at the end of its foreign tax year and one which ceased to be a CFC during its foreign tax year. In the first scenario, the 10% test is applied at the end of the last day of the CFC's foreign tax year. In the second scenario, the 10% test is applied immediately before the foreign company ceased to be a CFC. (Section 9D(2).)

It must be noted that a CFC is not defined in relation to a resident, but is tested independently. Thus, a change in shareholding in a CFC from one resident to another has no effect on the foreign company's CFC status, although its shareholders have changed.

Example

Resident X owns all the shares in a foreign company. The foreign company is therefore a CFC. Resident X sells its interest in the CFC to resident Y. The foreign company remains a CFC, albeit no longer in relation to resident X (the seller). If the shareholding in the CFC thereafter remains unchanged until the end of the CFC's foreign tax year, an obligation to impute all of the income derived by the CFC during its entire foreign tax year (subject to any exemptions available) will rest on resident Y (the purchaser). This is so even if resident Y has acquired the shares one day before the end of the CFC's foreign tax year.

The calculation of the proportional amount to be imputed is a function of the net income of the CFC for the foreign tax year, the percentage of the participation rights held by the resident in the CFC during the foreign tax year, and the period during the foreign tax year when the foreign company qualified as a CFC.

If the foreign company was a CFC for the entire foreign tax year, the proportional amount is equal to the net income of the CFC for the foreign tax year multiplied by the resident's percentage participation rights in the CFC on the last day of the foreign tax year.

If the foreign company became a CFC during the foreign tax year, the resident can elect one of two options:

(*a*) it can calculate the net income for the relevant year and then multiply that by the number of the days that the foreign company was a CFC during the foreign tax year divided by the total number of days in the foreign tax year; or

(*b*) it can treat the CFC's foreign tax year as having commenced on the day that it became a CFC and determine its net income for that shortened foreign tax year, and impute that amount.

If the foreign company ceased to be a CFC during the foreign tax year, the resident again has one of two options:

(*a*) it can calculate the net income in accordance with (*a*) above; or

(*b*) it can treat the CFC's foreign tax year as having ended on the day that it ceased to be a CFC and determine its net income for that shortened foreign tax year, and impute that amount.

Example

Scenario 1

Foreign Co X was a CFC for its entire foreign tax year and had net income of £2,000,000. Resident A holds 25% of the participation rights in X on the last day of X's foreign tax year. A must therefore impute an amount equal to £500,000, being 25% of X's net income for its foreign tax year.

Scenario 2

Foreign Co Y has a December year end. On 1 October 2009, resident B buys all the shares in Y from Y's non-resident shareholder and continues to hold the shares in Y until 31 December 2009. Y therefore becomes a CFC on 1 October 2009. Y's net income for its 2009 year is £10 million, £7 million of which was earned in the period up to 1 October 2009.

B has an option to impute either £10m x 92/365 = £2.5m or £3m.

§ 3.4.3 CFC ceasing to be a CFC

A net income calculation is required upon a CFC ceasing to be a CFC, for example, if a resident sells his foreign subsidiary to a non-resident. Although the resident may be exempt from CGT on the share disposal (in terms of the participation exemption contained in para 64B of the Eighth Schedule), para 12 of the Eighth Schedule deems the CFC to be disposing of all of its assets at their fair market value, immediately before it ceases to be a CFC. This may give rise to notional income or capital gains in the CFC which must then be included in the resident's proportionate share of the CFC's net income and imputed to South Africa for local tax purposes, unless an appropriate exemption applies.

§ 3.4.4 Circumstances under which no obligation to impute arises

The following provisos operate to the general rule contained in s 9D (2), i.e. no obligation to impute arises:

- To the extent a resident (together with any connected person in relation to that resident) holds at least 10% of the participation rights or voting rights in the CFC. This is also discussed in para 3.4.2.
- To the extent that the participation rights are held by the resident indirectly through another company which is a resident (the definition of participation rights currently includes an indirect right to participate in profits and share capital of a company). This exception avoids the imputation of income at multiple shareholder levels.
- To the extent that the participation rights are held by a South African registered long-term insurance company in any policyholder fund and are directly attributable to a linked policy (as defined in section 1 of the Long-Term Insurance Act No. 52 of 1998) or to a non-linked policy, the policy benefits of which are not guaranteed by the insurer and are determined wholly by reference to the value of particular assets or categories of assets. In addition, the insurer should not hold the participation rights as part of a transaction, operation or scheme entered into or effected solely or mainly for purposes of using this proviso to exclude an amount from imputation.

  The rationale underpinning the proviso flows from the application of the four funds principle to the taxation of South African long-term insurers. These four funds comprise three policyholder funds holding the assets of, and acting as trustees for, policyholders and a corporate fund representing the interests of shareholders. The different funds are taxed separately, although the insurance company is one resident. It is recognised that it would be inequitable to aggregate the foreign participation rights of the policyholders, as no aggregation would be required if they were to invest individually and so escape imputation because their individual interests would then be less than 10 per cent.

Example

SA Life Company, a registered insurer, holds 20% of the shares (participation rights) in a CFC. 15% of the shares are held in the insurer's individual policyholder fund and 5% in its corporate fund. The holding is not linked to any tax avoidance scheme.

An obligation to impute arises only in respect of the 5% holding in the corporate fund. Note that although the corporate fund's holding is less than 10 per cent, it still has an obligation to impute, because the resident (the insurer) holds at least 10% of the participation rights (the corporate fund is not a separate resident).

- To the extent that the provisions of s 9A of the Act do not apply. If some or all of the net income of a CFC cannot be remitted to South Africa, as a result of currency or other restrictions or limitations imposed in terms of the laws of the country where the amount arose, the net income concerned does not have to be imputed to South Africa. The Act provides for a deemed deduction in the calculation of the net income equal to the restricted amount. This amount is then included in the CFC's net income the following year (but can again be deducted if the restrictions on remittance still apply in that year).

§ 3.4.5 Section 9D(13) election

As stated above, the obligation to impute under s 9D only potentially arises if the foreign company is a CFC. To this there is one exception: s 9D(13) permits a resident who together with any connected person in relation to itself holds at least 10% but less than 20% of the participation rights and voting rights in a foreign company that is not a CFC to elect that the foreign company be deemed to be a CFC. The election may be made annually in respect of the foreign company's foreign tax year.

In the past, a resident may have had good reason to treat the foreign company as a CFC. This could be, for example, because any dividends received from the foreign company would be subject to South African tax in the resident's hands as foreign dividends and the foreign company may also be located in a high tax jurisdiction and pay substantial taxes. By making the election, the resident has been able in practice to minimise or eliminate any South African tax arising under the CFC rules by claiming a foreign tax credit in respect of the foreign taxes paid by the CFC. Because the foreign company's net income has been included in the resident's income as a result of the election (even though in practice no South African tax may have been payable because of foreign tax credit relief) the resident could then claim a tax exemption in respect of the foreign dividend received.

Example

SA Co holds 15% of the shares in X Co, incorporated and tax resident in India. X Co pays tax at an effective rate of 40% in India. By making a s 9D(13) election to treat X Co as a CFC, SA Co is required to include 15% of X Co's net income in its own taxable income. However, the Indian tax suffered on these profits is creditable in South Africa and reduces the South African

tax due under the CFC rules to nil. When X Co in due course pays a dividend to SA Co the dividend will qualify for tax exempt treatment in South Africa in terms of s 10(1)(*k*)(ii)(*cc*) of the Act to the extent it does not exceed the amount of the net income (less the Indian tax paid on that income) imputed to South Africa under the CFC rules.

Going forward, the s 9D(13) election may be of less practical benefit than has been the case previously. This is because a recently added proviso to the determination of net income deems the net income to be nil if the foreign tax payable equates to at least 75% of the South African tax that would have been payable had the foreign company been a resident. This puts in doubt the resident's ability to access the foreign tax credit and appears to deny the resident an exemption on the foreign dividend received (cf. the discussion in respect of deemed nil income in § 3.5.4.7).

Author: Various - See relevant chapter.

§ 3.5 Net income

§ 3.5.1 Interaction with tax treaties

A resident must impute an amount equal to the proportional amount of the net income of the CFC for its foreign tax year which ends during the year of assessment of the resident (s 9D(2)).

It is important to note that it is not the net income that is imputed but an amount equal to the proportional amount of the net income of the CFC. It is therefore argued that s 9D does not override South Africa's double taxation agreements, because no juridical double taxation results. In 'National Treasury's Detailed Explanation to s 9D of the Income Tax Act', issued in June 2002, at 2, the argument is stated as follows:

> 'The purpose of tax treaties is to avoid double taxation and determine the taxing rights between treaty parties. The purpose of tax treaties is not to prevent treaty partners from protecting their tax base. The OECD, in its publication "International Tax Avoidance and Evasion, Four Related Studies" (Paris: OECD, 1987), concludes that CFC legislation. . . is not inconsistent with the spirit of tax treaties.'

It is submitted that the issue is not settled law. However, it is acknowledged by the authorities that economic double taxation may result and a unilateral foreign tax credit in terms of s 6*quat* of the Act is therefore provided to the extent of any foreign tax suffered by the CFC on income which is imputed to the resident.

§ 3.5.2 Impact of imputation of net income on base cost of the shares in a CFC

A resident's base cost (for CGT purposes) in the shares of a CFC whose net income is imputed to it will be increased by the amount imputed and decreased by any dividends distributed to the resident to the extent of the amounts imputed (para 20(1)(*h*)(iii) of the Eighth Schedule). If the amount imputed includes a capital gain, it is the gain and not the taxable gain that is added to base cost.

Example

CFC P is wholly-owned by resident Q. Its net income for the year is 100, comprising trading income of 80 and a taxable capital gain of 20 (capital gain of 40 multiplied by the inclusion rate of 50%). The amount to be added to Q's base cost in P's shares is 120 (80 + 40), i.e. the trading income plus the net capital gain.

§ 3.5.3 What does a resident have to impute — the determination of net income

Central to the application of s 9D is the determination of a CFC's net income. In essence, the net income of a CFC is determined in accordance with the Act as if that CFC had been a taxpayer and as if it had been a resident for the following purposes:

- The definition of 'gross income'.
- Section 7(8) (the attribution of income derived by a non-resident to a resident by reason of or in consequence any donation, settlement or disposition made by the resident).
- Section 10(1)(*h*) (interest exemption for non-residents).
- Section 25B (income of trusts and beneficiaries of trusts).
- Paragraph 2(1)(*a*) of the Eighth Schedule (ambit of the application of CGT legislation).
- Paragraph 24 of the Eighth Schedule (rules determining the base cost of an asset of a person who becomes a resident on or after the valuation date).
- Paragraphs 70, 71 and 72 of the Eighth Schedule (CGT attribution rules).
- Paragraph 80 of the Eighth Schedule (attribution of capital gains to trust beneficiaries).

(Section 9D(2A).)

The net income of a CFC, therefore, largely equates to what would have been its taxable income had it been a resident. Thus, whilst the CFC is subject to income tax and CGT on its worldwide income and capital gains, it remains a non-resident and, other than for the purposes of the sections of the Act listed above and certain transfer pricing provisions, its net income is determined on this basis and it cannot access tax relief available only to residents. For example, a CFC will generally not be able to access the corporate rollover reliefs contained in ss 41 to 47 of the Act.

§ 3.5.4 Provisos to the calculation of net income

Numerous provisos operate to the determination of net income:

§ 3.5.4.1 *Deductions may not exceed income*

The deductions or allowances allowable against the income of the CFC may not exceed the CFC's income. It is

accordingly not possible to impute a net loss to the resident shareholder. The loss is, however, not lost to the resident, as it is allowed to be carried forward to the immediately succeeding foreign tax year of the CFC where it will be deemed to be a balance of assessed loss for set off against the CFC's income for the purposes of s 20.

May the CFC carry forward a loss relating to years prior to it becoming a CFC? The Act does not explicitly deal with this question. The answer is probably not. A 'foreign tax year' is defined in s 9D(1) in relation to a CFC. It would seem, therefore, that prior to a foreign company becoming a CFC it would not have a 'foreign tax year' as contemplated in s 9D in respect of which a net income calculation can be made. In addition, the valuation date value for CGT purposes of a foreign company which becomes a CFC after 1 October 2001 is the day before the company becomes a CFC. This provision does not make much sense unless a net income calculation only becomes relevant upon a foreign company becoming a CFC.

§ 3.5.4.2 *Inter-CFC passive income flows, debt forgiveness and certain foreign exchange hedging losses*

No deduction is allowed for the following amounts paid from one CFC to another CFC, or arising between two CFCs, which form part of the same group of companies:

(i) Interest, royalties, rental or income of a similar nature (including any transfer pricing adjustment in terms of s 31).

(ii) Any exchange loss (determined in terms of s 24I) in respect of any exchange item entered into between the CFCs.

(iii) any foreign exchange loss suffered by a CFC in respect of a forward exchange contract or foreign currency option contract concluded to hedge the exchange item referred to in (ii).

(iv) The reduction or discharge by one CFC of a debt owed to it by the other CFC at less than face value.

These non-deduction rules are not inviolate. A deduction will be allowed if the resident, to whom the net income of that other CFC is imputed, has elected in terms of s 9D(12) that s 9D(9), which contains numerous exemptions from imputation, should not apply to that other CFC or if the disallowed amount is taken into account to determine the net income of that other CFC. The disallowed amount will be so taken into account if the resident to whom the net income of that other CFC must be imputed has elected that the income be imputed. In other words, a deduction will be allowed in the determination of the net income of the one CFC where a corresponding amount of income will be taken into account in determining the net income of the other CFC.

§ 3.5.4.3 *Valuation date value rules for CGT purposes*

As mentioned above, the valuation date value for CGT purposes of a foreign company that becomes a CFC on or after 1 October 2001 is the day before such company becomes a CFC.

Example

US Company X buys property in the US as a capital asset in 2002 for $1,000,000. It becomes a CFC on 1 January 2006. The asset had a market value of $1,200,000 on 31 December 2005. Company X sells the property in June 2008 for $1,500,000.

The property is regarded as a pre-valuation date asset for purposes of determining the capital gain or loss on a subsequent disposal of the asset. Consequently, the base cost of the asset may be determined with reference to original cost by applying the time-apportionment base cost formula or with reference to the 31 December 2005 market value, subject to the various loss limitation rules that apply to the disposal of pre-valuation date assets.

§ 3.5.4.4 *CGT inclusion rate*

The Act includes capital gains in taxable income where they are taxed at the relevant tax rate (e.g. 28% for companies, 18% to 40% for natural persons). However, the amount of the capital gain so included varies depending on the profile of the taxpayer. Thus, only 25% of a capital gain is included in the taxable income of natural persons, special trusts and the individual policyholder fund of long-term insurers, whilst 50% is included in the taxable income of companies and trusts. This principle is followed in the determination of the net income of a CFC. Hence, only 25% of capital gains will be included in the net income of a CFC to the extent that the imputation is to a natural person, special trust or the individual policyholder fund of a long-term insurer.

§ 3.5.4.5 *Transfer pricing and thin capitalisation*

The thin capitalisation rules (contained in s 31 of the Act) apply to the determination of the net income of a CFC as if the CFC were a resident taxpayer. The CFC will also be treated as if it were a resident taxpayer for transfer pricing purposes in the context of cross border transactions entered into between the CFC and any connected person in relation to that CFC.

§ 3.5.4.6 *Paragraph 43 of the Eighth Schedule*

The 'local currency' of a CFC for purposes of determining capital gains and losses on the disposal of capital assets (in terms of para 43 of the Eighth Schedule) not related to a permanent establishment of the CFC, is the currency used by the CFC for purposes of financial reporting with regard to foreign tax years ending in years of assessment commencing on or after 1 January 2011, this is to be changed to the functional currency of the CFC.

§ 3.5.4.7 *75 per cent foreign tax threshold — net income deemed to be nil*

A recent amendment has inserted a proviso to the effect that the CFC's net income in respect of a foreign tax year shall be deemed to be nil if the CFC has paid a certain amount of foreign tax (second proviso to s 9D(2A)). The aggregate amount of tax payable by the CFC to all spheres of government of any foreign country on its income must be at least 75% of the South African tax that the CFC would have paid had it been a resident (the Act currently refers to 'net income' but this is obviously an oversight as the application of the proviso has the effect of deeming the net income to be nil, this is to be changed with retrospective effect once the Taxation Laws Amendment Act of 2010 comes into force). The foreign tax payable must be determined after taking into account any applicable double taxation agreement and any credit, rebate or any right of recovery of the foreign tax from any sphere of foreign government. One must also disregard any balance of assessed loss brought forward from earlier tax years or any losses taken into account from other companies.

Example

CFC K, a UK tax resident, is wholly-owned by resident S. K would have paid South African tax of R20,000,000 had it been a resident. It did pay an equivalent of R18,000,000 tax in the UK on its income. As it has paid tax in the UK of at least 75% of its notional SA tax liability, its net income is deemed to be nil.

The broad principle is simple: if the foreign tax payable by the CFC is at least equal to 75% of the South African tax that would have been payable had the CFC been a resident, the net income of the CFC will be deemed to be nil. That said, a number of questions of interpretation have already been raised and amendments to the provision as well as the publication of an Interpretation Note are expected. For present purposes, the following comments are apposite:

1. The proviso does not operate to exempt the net income from imputation, as is the case with the exemptions provided for in s 9D(9); it merely deems the net income to be nil. This raises two questions. Firstly, given that the income is not exempt (albeit that it may have that practical effect), would any foreign tax paid by the CFC still qualify as a foreign tax credit in terms of s 6*quat*? It is considered that it might. The question is not academic, as the resident shareholder may have other sources of foreign income which suffer tax at a low rate of foreign tax; it could therefore use the foreign tax paid by the CFC as a rebate against its South African tax liability on its other foreign income. Secondly, what is the relationship between the exemptions provided in s 9D(9) and deeming the net income to be nil because of the 75% foreign tax paid? For example, what is the position if a CFC has paid tax equal to 75% of the potential South African tax, but also qualifies for an exemption from imputation on the basis that the income is attributable to a foreign business establishment? Is the net income deemed to be nil and the exemption ignored or does the exemption take precedence and the amounts are not taken into account in determining the net income? It is considered that the exemption should take precedence, but it is not clear.

2. It is understood that in practice it is not Treasury's intention to require taxpayers first to perform detailed South African tax calculations for each of their CFCs to determine whether or not these CFCs are deemed to have net income of nil under this proviso. If it is clear that s 9D(9) exemptions can apply to shield the CFC's income from imputation, these may be claimed by the resident taxpayer when completing the relevant IT 10 without first having to complete the notional South African tax calculation

3. It is the aggregate amount of tax payable to all spheres of government of any foreign country which must be aggregated to test the 75% threshold. The foreign income is therefore not limited to income from the CFC's country of residence. This allows the CFC to mix income streams from high tax jurisdictions with those of lower tax jurisdictions; the only requirement is that the foreign tax must amount overall to 75% or more of the notional South African tax due.

4. The amount of foreign tax payable must be determined after taking into account any applicable double taxation agreement. Thus, if a double taxation agreement permits a lower rate of tax or exempts certain income streams, one must have regard to such lower tax rates. The amount of foreign tax payable must be determined after taking into account any balance of assessed loss brought forward and any losses suffered by other companies. This makes it clear that the CFC can be in an overall loss position due to losses suffered in earlier years with no actual tax to pay, yet still meet the 75% threshold. It also makes it clear that the CFC can utilise losses of other group companies to reduce its actual foreign tax payable (for example, under a system of group taxation) and still meet the 75% threshold.

5. Because tax systems in foreign countries often differ from the tax system in South Africa in certain material respects, the amount on which the foreign tax is paid and on which the notional South African tax is payable will clearly not be the same and anomalies may arise. To give an example, assume that a South African company holds a number of Dutch companies which form a tax group for Dutch tax purposes. One of these companies makes significant interest payments to another of the Dutch companies in the same group. For Dutch tax purposes, these interest payments are ignored because they are within the fiscal group. Hence no deduction is allowed for the interest and no tax is leviable on the interest in the hands of the recipient company. When the CFC that receives the interest has its net income calculated under the new proviso, its interest income will have to be included because South Africa does not have group relief and hence would not ignore this income. (This is the case even though the income might well qualify for relief under s 9D(9)(*f*A)). This could push the foreign tax paid below the 75% threshold relative to the South African tax notionally payable and is inequitable to the taxpayer, given that the taxpayer is tax neutral on this interest in the Netherlands. If the 75% threshold is not met, the taxpayer in South Africa will then potentially have to pay South African tax on some of the CFC's income (possibly excluding the problematic interest income which may be exempt under s 9D(9)(*f*A), even though in substance Dutch tax is suffered on the CFC's other income at a high rate. Conversely, a situation unfavourable to SARS would arise when the income of the debtor CFC is calculated under South African tax rules because South Africa would allow a deduction whereas the Netherlands does not.

6. The provision will no doubt be welcomed by many taxpayers. It is still new and will have to be refined over the course of time.

§ 3.5.5 Currency rules applicable to the determination of net income

The net income of a CFC must be determined in the currency used by the CFC for purposes of financial reporting. (This is to be changed to the CFC's functional currency for foreign tax years ending in years of assessment commencing on or after 1 January 2011.) The amount to be imputed to the resident in a particular year of assessment is then calculated by translating the net income of the CFC to South African rand at the average exchange rate for the resident's year of assessment. (Section 9D(6).)

Example

CFC A is tax resident in Mauritius and is a wholly-owned subsidiary of resident D. A has a June year-end and D a December year-end. A's reporting currency is US dollars. To determine the amount to be imputed to D, A must first calculate its net income in US Dollars. Assume its net income for its June 2009 year is $1,000,000 and the average Rand/Dollar exchange rate for D's 2009 tax year is R8.45:$1. The amount to be imputed is therefore $1,000,000 × 8.45 = R8,450,000.

This reasonably straight-forward calculation is rendered more complex in a number of instances. It is evident that the calculation of the imputed amount does not take into account any fluctuations in the exchange rate between South African rand and other foreign currencies in which the CFC may have transacted during the year. This runs counter to the legislature's general intent to capture currency gains and losses derived by residents in respect of transactions concluded in foreign currency.

For the sake of simplicity, it was apparently decided not to require such a capturing of currency gains and losses in the determination of a CFC's net income to the extent that the relevant transaction is attributable to a permanent establishment of the CFC outside South Africa. Hence, the following exceptions to the general rule exist:

(*a*) The capital gain or loss resulting from the disposal of an asset contemplated in para 43(4) of the Eighth Schedule which is not attributable to a permanent establishment of the CFC outside South Africa must first be determined in South African rand and then translated to the currency used by the CFC for purposes of financial reporting at the average exchange rate used to translate the net income into South African rand for imputation to the South African resident shareholder.

Example

CFC A bought a foreign equity instrument for 100 Euro in its 2006 tax year and sold it for 120 Euro in its 2009 tax year. The disposal of the asset is not attributable to a foreign permanent establishment. The average Euro:Rand exchange rate for the 2006 foreign tax year was 1:9, and for the 2009 foreign tax year, 1:11. The CFC's reporting currency is the British Pound and the average Pound:Rand exchange rate for the resident shareholder's 2009 tax year was 1:12.50.

The capital gain must first be determined in Rand and equates to R420 ((120*11) – (100*9)). This amount must then be translated to Pounds (for inclusion in the CFC's net income) thereby giving a Pound gain of 33.6 Pounds (420/12.5).

(*b*) The same translation rule applies to the determination of a profit or loss on the disposal of a foreign equity instrument which constitutes trading stock and which is not attributable to a permanent establishment of the CFC outside South Africa.

(*c*) For purposes of s 24I, 'local currency' of a CFC, in relation to an exchange item which is not attributable to a permanent establishment of the CFC outside South Africa, is South African rand. Any exchange difference determined must be translated to the currency used by the CFC for purposes of financial reporting at the average exchange rate used to translate the net income into South African rand for imputation to the South African resident shareholder. Where a CFC's functional currency is different from its presentation currency, the functional currency may be used if the taxpayer so wishes as the currency for purposes of financial reporting in the context of the CFC rules. In future, as mentioned above, it will be the functional currency and not the currency used for purposes of financial reporting that must be used in terms of the legislation.

A specific currency rule also deals with the determination of net income in a hyper-inflationary environment to avoid an artificial increase in the CFC's net income. In term of this rule, if a country has an inflation rate of 100% or more throughout a CFC's foreign tax year, then any asset or foreign equity instrument disposed of, and any exchange item denominated, in any currency other than the currency used by the CFC for purposes of financial reporting is deemed not to be attributable to any permanent establishment of the CFC. This ensures that any net income triggered by such foreign currency assets is calculated with reference to The South African rand as opposed to the local hyper-inflationary currency. (Paragraph (*d*) of the first proviso to s 9D(6).)

§ 3.5.6 Foreign tax credits

A resident in whose income is included a proportional amount contemplated in s 9D can claim a deduction against its tax liability of foreign tax paid by the CFC in respect of the imputed amount (s 6*quat*). The rules governing the granting of foreign tax credits are beyond the scope of this chapter, but one important question needs to be raised: is a foreign tax credit available in South Africa in respect of foreign tax imposed on a CFC under a different foreign country's CFC rules?

Example

Foreign Company L, a UK tax resident, is a subsidiary of resident P. L is the parent of a number of foreign subsidiaries. Under

the UK CFC rules, the income of L's foreign subsidiaries is imputed to L and taxed in the UK. However, L's foreign subsidiaries are also CFCs in relation to P and their income must be imputed to P under the South African CFC rules. The CFCs themselves may not have suffered any foreign tax, but their UK holding company, L, suffered UK tax on the subsidiaries' income as a result of the UK CFC rules.

Is a foreign tax credit available in South Africa for the UK CFC tax suffered? The Act states that a credit is available for foreign tax proved to be payable by *any* CFC (our emphasis) in respect of a proportional amount included in a resident's taxable income under section 9D. The use of the word 'any' implies that a credit is available and it is submitted that, as a matter of equity and principle, a credit should be available and that s 6*quat* should be read to give effect to such an interpretation. It is understood that Treasury and SARS officials have in the past also expressed the view that a credit should be available, although recent opinions given by SARS officials have been less certain.

Author: Various - See relevant chapter.

§ 3.6 Exemptions

Section 9D(9) of the Act provides that certain amounts must not be taken into account in calculating the net income of the CFC. The taxpayer normally has no choice in this regard – if the CFC derives income or losses that fall within the scope of the exclusion provisions in s 9D(9), these amounts have to be ignored for South African tax purposes. However a taxpayer that holds (together with any connected person in relation to itself) between 10% and 20% of the participation rights and voting rights in a CFC may elect that the exemptions in s 9D(9) of the Act will not apply. Such an election is not often exercised but theoretically could be, where doing so would be beneficial.

§ 3.6.1 Foreign business establishment exemption

The exemption most frequently relied upon to prevent the income of a CFC from being imputed to one or more South African taxpayers is the so called foreign business establishment exemption provided for in s 9D(9)(*b*) of the Act. As a general rule (although subject to certain exclusions which are discussed further below) amounts attributable to a foreign business establishment as defined, including amounts resulting from either an actual or deemed disposal of assets forming part of the foreign business establishment, must not be taken into account in calculating the net income of the CFC. Such amounts are simply ignored for South African tax purposes.

'Foreign business establishment' is a defined term which has been the subject of frequent amendments over the years. The current definition is arguably relatively clear compared with certain prior versions.

§ 3.6.1.1 *Fixed place of business*

In general, a foreign business establishment will exist where the CFC conducts its activities from a fixed place of business located in a country other than South Africa that has already been in use, or that will be in use, for a period of at least a year. In this context, fixed place of business should probably be interpreted in accordance with OECD principles applicable when determining whether or not a 'fixed place of business' exists in a country for the purposes of establishing in accordance with relevant treaty principles whether or not a permanent establishment has been created there.

The OECD Model Commentary provides that the use of the word 'fixed' in the term 'fixed place of business' means that in the normal course, there has to be a link between the place of business and a specific geographical point. It states that it is immaterial how long a company which is tax resident in one treaty state may operate in the other treaty state if it does not do so 'at a distinct place, but this does not mean that the equipment constituting the place of business has to be actually fixed to the soil on which it stands. It is enough that the equipment remains on a particular site.'2

Further guidance is given in the definition of foreign business establishment. In addition to the need for – or perhaps as evidence of – a fixed place of business, there must be:

- one or more offices, shops, factories, warehouses or other structures through which the CFC's business is carried on;
- on-site managerial and operational employees and those employees must be conducting the 'primary operations' of the business;
- suitable equipment and suitable facilities for conducting the primary operations of the business; and
- bringing in a subjective test, the place of business must have been located outside South Africa solely or mainly for a purpose other than the postponement or reduction of any tax imposed by any sphere of government in South Africa.

With regard to tax years of CFCs ending on or after 1 January 2008, a CFC has been able to take into account, in analysing whether it meets all or any of the first three tests listed above, the utilisation by that CFC of structures, employees, equipment and facilities belonging to one or more other companies provided that the other company or companies are subject to tax in the country in which the fixed place of business of the CFC is located by virtue of residence, place of effective management or other criteria of a similar nature. It is noted that the legislation does not simply provide that the other company must be 'tax resident' in the country where the CFC has its fixed place of business, and neither does it provide that the CFC and the other company concerned must be tax resident in the same jurisdiction (although this will generally be the case). The wording used mirrors the wording generally found in the residence Article of tax treaties based on the OECD Model Convention. In this context, however, the treaties normally go on to state explicitly that a person will not be regarded as qualifying for benefits as a treaty resident (i.e. as being subject to tax in the treaty country) if that person is only subject to tax on income derived from sources in that treaty state.

In terms of s 9D, an explicit carve out of this nature has not been included. Consequently it seems feasible to argue that if a CFC shares resources with a company that has a taxable branch in the same country in which the CFC carries on business, those shared resources may count towards the CFC's foreign business establishment even if the other company concerned is incorporated and/or even tax resident in a different jurisdiction. It would arguably be fair to allow the relief in this situation, given that what is being tested is the commercial rationale for the CFC being located in a particular jurisdiction. If a CFC is genuinely carrying on business there and making use of resources that are in close geographical proximity, it should not matter whether or not the owner or employer of those resources is itself incorporated in the same country, so long as that owner is subject to some form of tax in

the country where those shared resources are physically located.

The question of what constitutes 'subject to tax' is an interesting one. In general, this requires that the other company fall within the scope of the taxing rules of the relevant country and is not exempt from tax. The OECD Model Commentary in discussing the treaty concept of 'liable to tax' (a requirement for a taxpayer to benefit from a treaty is generally that he is liable to tax in the treaty country) notes that the term can be interpreted differently in different countries.[3]

Where a country's local tax law provides for certain companies based there to be subject to tax but at a rate of zero per cent, it is considered that the companies concerned should qualify as being 'subject to tax' for the purposes of the foreign business establishment definition provided that the local law in the CFC's country of tax residence makes it very clear that the CFC is within the scope of that company's taxing laws, albeit that for a particular period of time the relevant rate applicable is 0%.CFCs that are outside the scope of, or simply exempt from, that country's taxing laws would almost certainly not qualify as being 'subject to tax' there.

It is submitted that if companies elect to pay some tax in a particular jurisdiction where this is not strictly obligatory, this will also not allow them to qualify as being subject to tax in that jurisdiction.

The other company with which the CFC is sharing resources must form part of the same group of companies as the CFC. For these purposes, a group will exist where there is a common direct or indirect holding company that holds directly or indirectly at least 70% of the shares in the CFC and also in the company that is sharing resources with the CFC. In addition, the structures, employees, equipment and/or facilities shared must be located in the same country as the fixed place of business of the CFC.

§ 3.6.1.2 *Other forms of foreign business establishment*

It is recognised in the legislation that circumstances may exist where business activities are legitimately conducted in one or more locations for reasons wholly unrelated to South African tax, but the nature of those activities may be such that the criteria for a foreign business establishment discussed above may not necessarily be met. Specific examples of where a foreign business establishment is recognised as existing, without any other criteria having to be met are where a CFC makes use of:

- A place outside South Africa where the CFC carries on prospecting or exploration operations for natural resources.
- A place outside South Africa where the CFC carries on mining or production operations in regard to natural resources.
- A site outside South Africa where the CFC carries on construction or installation activities relating to buildings, bridges, roads, pipelines, heavy machinery or other projects of a comparable magnitude where the relevant activities last for a period of not less than six months.
- Agricultural land outside South Africa used for *bona fide* farming activities directly carried on by the CFC. The use of the word 'directly' in this context is interesting and implies that in the examples immediately above (since the word 'directly' is not used there) the CFC could be carrying on the activities in question indirectly, for example through sub-contractors or agents.
- A vessel, vehicle, rolling stock or aircraft used for purposes of transportation, fishing, prospecting or exploring for natural resources or mining or production of natural resources. In this case, the vessel, vehicle, rolling stock or aircraft must be used solely outside South Africa for such purposes and must be operated directly by the CFC, or by any other company that has the same country of residence as, and that forms part of the same group of companies as, that CFC. Again, the use of the word 'directly' suggests that the CFC must not be making use of agents or subcontractors.

  The requirement in this context that the vessel, vehicle, rolling stock or aircraft must be used solely outside South Africa will preclude a CFC that operates ships anywhere in South African waters, or aircraft anywhere in South African airspace or rolling stock or vehicles that ever travel on terrain belonging to South Africa from qualifying as having a foreign business establishment under this particular section of the definition.

  If the vessel, vehicle rolling stock or aircraft is being operated by another company in the same group of companies as the CFC that wishes to qualify as having a foreign business establishment, both companies must have the same country of residence i.e. must be effectively managed in the same country. In this context, therefore, it is not sufficient for the other company only to have a taxable branch in the country in which the CFC is tax resident.

The reason given by National Treasury for allowing mines, construction sites, farms and fishing operations to qualify automatically as foreign business establishments is that 'fixed businesses of this kind are virtually impossible to fabricate for tax planning purposes.'[4]

§ 3.6.2 Exclusions from the foreign business establishment exemption

Even though a CFC may have a foreign business establishment as defined, this will not automatically protect all of the CFC's income from potential inclusion in the taxable income of the CFC's South African shareholder or shareholders. Certain types of income require further analysis. These are:

- Income derived from transactions between CFCs and connected persons who are South African tax resident relating to the supply of goods or services;

- income derived by CFCs that fall within the scope of the so-called diversionary transaction rules; and
- income derived by CFCs that is characterised as passive income for the purposes of the provisions in s 9D(9)(*b*)(iii).

Each of these categories is discussed in more detail below.

§ 3.6.2.1 *Non arm's length transactions with connected persons who are South African tax resident*

If a CFC supplies goods or services to a connected person (as defined in s 1 of the Act) who is South African tax resident, the income derived from those supplies by the CFC must be analysed to determine whether or not it reflects an arm's length price consistent with the transfer pricing provisions in s 31 of the Act. For example, if the application of transfer pricing principles (a discussion of which is beyond the scope of this chapter) evidences that the CFC is being overpaid for goods or services supplied to the South African resident connected person, then none of the income derived by the CFC from the transaction in question will be sheltered from the application of the CFC rules by the foreign business establishment exemption.

There is debate as to whether a similar result can also be triggered if goods or services are supplied by a connected person that is South African tax resident to a CFC for a price below market value. When the CFC then on sells the goods at a profit, it is likely that SARS would wish to use s 9D(9)(*b*)(i) to prevent the foreign business establishment exemption being used to shelter the profit concerned from South African tax. However it is difficult to see how this approach could succeed, given that the wording in s 9D(9)(*b*)(i) refers to 'any amounts derived from any transaction. . .with a connected person. . .who is a resident'. In the scenario outlined above, the amount derived by the CFC would result not from the CFC's transaction with the South African resident but rather from a transaction with a third party when the goods are on-sold to that third party.

The co-existence of s 9D(9)(*b*)(i) and the transfer pricing rules in s 31 could result in double taxation of the same amount in the same SA tax resident's hands. For example, if a South African resident is charged an excessive amount by its wholly owned CFC in exchange for goods supplied by the CFC to the South African resident, then under s 31, SARS may deny the SA resident a tax deduction for the non arm's length portion of the purchase consideration paid. In addition, s 9D(9)(*b*)(i) could be invoked, with the result that the CFC's income from the transaction is imputed to the SA resident shareholder for SA tax purposes. In practice, it would not be equitable for SARS to create effective double taxation in this manner and it is hard to imagine a court sanctioning this. Unfortunately, the Act gives no guidance in situations which could potentially result in double taxation as to which of s 9D and s 31 should take precedence.

§ 3.6.2.2 *Diversionary transaction rules*

These rules, which are essentially provisions targeted at tax avoidance, are aimed at deterring South African taxpayers from entering into transactions aimed at shifting income that otherwise would have been taxable in South Africa, out of the South African tax net and into a taxing regime that is more beneficial. It is openly acknowledged by National Treasury that the rules are in place as a supplement to transfer pricing rules that have the same objective.

The relevant provisions are, however, very broad in their scope and can unfortunately often catch transactions entered into on an arm's length basis and which would not be considered problematic from a transfer pricing point of view.

The rules are potentially triggered in situations where:

- a CFC sells goods to a connected person who is South African tax resident; or
- a CFC sells goods that it has acquired from a connected person who is South African tax resident; or
- a CFC supplies services to a connected person who is South African tax resident; or
- a CFC grants the right of use of certain intellectual property to a connected person who is a South African tax resident.

The relevant income derived by the CFC from these transactions is at risk of being imputed to its South African shareholder(s) even if the CFC has a foreign business establishment. In each of these situations, however, the impact of the rules can be avoided if the CFC meets certain specific criteria provided for in the Act.

§ 3.6.2.2.1 Sale of goods to connected South African resident

Any amount derived from a sale of goods by a CFC to a connected person who is South African resident will be excluded from the foreign business establishment exemption unless:

(i) The goods were purchased within the CFC's country of residence from an unconnected person. The rationale behind this exclusion is that it is logical for businesses to establish foreign subsidiaries as buying entities in the countries in which the relevant buying activities will be conducted and this should not be assumed to constitute tax avoidance. In this context, the country of residence of the CFC is defined as the country where the CFC has its place of effective management. This may be different from the country where the CFC is incorporated.

(ii) The CFC purchases the same or similar goods 'mainly' within the country of residence of the CFC from persons who are not connected persons. No guidance is given as to how widely 'similar' is to be construed. It can be argued that as long as the goods purchased by the CFC within its country of residence have the same nature

and uses as the goods it acquires from elsewhere, they can be considered similar even if their appearance or even material components may not be the same. For example, if a CFC buys wooden dolls within its own country, but also buys and on-sells porcelain dolls from other countries, as long as in aggregate the CFC's sales are primarily to customers in its own country, all of the CFC's sales income should be able to be sheltered under the foreign business establishment exemption.

It is also not clear how 'mainly' should be interpreted. It seems equitable that this should be able to be calculated with reference to either volumes or values and that 'mainly' should be interpreted as meaning 'more than 50%'. It could be argued also that 'mainly' can be tested with regard to numbers of customers, although this could be challenged by SARS if the values and volumes of the CFC's sales to the SA resident are consistently greater than the amounts it derives from sales to a greater number of smaller customers in its own country.

The legislation does not require a strictly arithmetical test to be passed or failed each year. For example, assume that for two years, a CFC has acquired well over 50% every year of the goods its sells from third parties in its country of residence. In year 3, however, due to unforeseen circumstances, it buys only 47% of its goods from its own country. This does not mean that in year three the CFC is automatically outside of the scope of this particular exemption. Assuming that in future years it is anticipated that the CFC will again acquire goods predominantly from sources in its own country, it can be argued that the amounts derived in year three can still be sheltered under the foreign business establishment exemption.

(iii) The CFC undertakes some processing activity which adds value to the goods it has acquired prior to on-selling them. This could be a fully fledged manufacturing process or a process of extraction, production, assembly, repair or improvement of the goods. However it must amount to more than minor assembly or adjustment, packaging, repackaging and labelling.

(iv) The CFC sells a 'significant quantity' (again an undefined term) of goods of the same or a similar nature to persons who are not connected persons, at comparable prices to the prices paid by the connected South African buyers, after accounting for the level of the market, volume discounts and costs of delivery.

§ 3.6.2.2.2 Sale of goods acquired by CFC from connected South African residents

Any amount derived from a sale of goods by a CFC, where those goods or any tangible intermediary inputs into the goods were purchased by the CFC from a connected person who is South African resident will be excluded from the foreign business establishment exemption unless:

(i) The goods or tangible intermediary inputs in question amount to an insignificant portion of the total goods sold or tangible intermediary inputs acquired by the CFC overall.

(ii) The CFC undertakes some processing activity which adds value to the goods it has acquired prior to on-selling them. This could be a fully fledged manufacturing process or a process of extraction, production, assembly, repair or improvement of the goods. However, it must amount to more than minor assembly or adjustment, packaging, repackaging and labelling.

(iii) The CFC is selling the goods to a person who is not connected to it for physical delivery to a customer's premises situated within the country of residence of the CFC. If the customer's buying agent operates in the CFC's country of residence and the sales contracts are concluded there but the goods are shipped to a destination outside that country, this exemption can not apply. Country of residence of the CFC means the country in which the CFC is effectively managed, which may or may not be the same country as the country in which the CFC is incorporated.

(iv) Products of the same or similar nature are sold by the CFC mainly to persons who are not connected persons in relation to that CFC for physical delivery to customers' premises situated within the country of residence of the CFC. Two tests need to be passed in this regard. Firstly, the CFC's sales need to be predominantly to unconnected persons. Secondly, the goods sold need to be physically delivered (constructive delivery is not relevant) within the CFC's country of residence. It seems equitable that 'mainly' should be able to be calculated with reference to either volumes or values and should be interpreted to mean 'more than 50%' (the discussion of this concept in § 3.6.2.2.1 refers.) The legislation does not require a strictly arithmetical test to be passed or failed each year. For example, assume that for five years, well over 50% of the goods sold by a CFC each year has been for physical delivery to third parties in its country of residence. In year six, however, due to unforeseen circumstances, only 40% of its sales are for local delivery. This does not mean that in year six, the CFC is automatically outside of the scope of this particular exemption, assuming that in future years it is anticipated that the CFC will again sell goods predominantly to third parties for physical delivery within its own country.

§ 3.6.2.2.3 Services performed by CFC for connected South African resident

Amounts derived by a CFC from services performed for a connected person who is South African tax resident will not benefit from the foreign establishment exemption unless the service is performed outside South Africa and

(i) such service relates directly to the creation, extraction, production, assembly, repair or improvement of goods utilised within one or more countries outside South Africa; or

(ii) such service relates directly to the sale or marketing of goods of a connected person who is a resident and the goods are sold to persons who are not connected persons in relation to the CFC for physical delivery to customers' premises situated within the country of residence of the CFC. This exclusion recognises the commercial need for sales representatives in countries to which South African taxpayers are selling goods; or

(iii) such service is rendered mainly in the country of residence of the CFC for the benefit of customers that have premises situated within that country. This could include, for example, the situation where a CFC provides support services or after sales services to customers located in its own country in respect of goods acquired by those customers from a South African tax resident that is connected to the CFC; or

(iv) the circumstances are such that no deduction is available to the connected South African resident for the relevant amount paid by it to the CFC in respect of that service. For example, Company A in South Africa pays amounts to its CFC to enable the CFC to undertake certain research activities outside SA on the South African company's behalf. The South African company does not qualify for a deduction in South Africa because the research and development activity is not taking place in South Africa. Because the payment is not tax deductible in South Africa, the income derived by the CFC (assuming the CFC has a foreign business establishment) will not be imputed back to South Africa for tax purposes under the diversionary transaction rules.

§ 3.6.2.2.4 Grant of the use of intellectual property by the CFC to connected South African resident

Prior to 2008, there was uncertainty as to whether the licensing of intellectual property by a CFC to a connected South African tax resident fell within the scope of s 9D(9)(*b*)(*cc*) i.e. was a service performed by a CFC. In 2008, legislation was introduced, which took effect from 1 January 2009, specifically providing that amounts derived by a CFC from the granting by that CFC of the use, right of use or permission to use an intangible asset as defined in para 16(2) of the Eighth Schedule to a connected person who is South African tax resident are caught by the diversionary transaction rules despite the fact that the CFC has a foreign business establishment.

An intangible asset as defined in para 16(2) of the Eighth Schedule includes goodwill, trademarks, designs, patents, copyright, rights recognised under the Plant Breeders Act 1996 and any model, pattern, plan, formula or process.

§ 3.6.2.2.5 Avoidance measures

It may seem relatively easy to escape the ambit of these rules by interposing a third party (related or unrelated, but if related, not South African resident) between the CFC and the connected South African resident with whom the CFC is transacting. Taxpayers should however be cautioned that if, for example, a South African resident sells to a third party (whether related or unrelated) outside South Africa that in turn sells goods to the CFC, and no compelling commercial reason unrelated to tax exists for the interposition of the third party in the chain, then any income derived by the CFC from on-selling the goods concerned will be extremely vulnerable to a challenge from SARS under the general anti avoidance provisions in the Act.

§ 3.6.2.3 *Income derived by CFCs that is characterised as passive income for the purposes of the provisions in s 9D(9)(b)(iii).*

The fact that a CFC has a foreign business establishment as defined should be sufficient to prevent most active income derived by the CFC (excluding diversionary transaction income) from being included in the taxable income of the CFC's South African tax resident shareholder or shareholders under the CFC rules. However, insofar as passive income is concerned, additional tests must be applied to see whether the income concerned can escape South African taxation.

The CFC rules do not use the term 'passive income'. However any of the following amounts (whether derived by the taxpayer as investment income or in the course of its trade) will potentially be taxable in South Africa unless an exemption other than the foreign business establishment exemption can be found:

- Dividends.
- Interest.
- Royalties.
- Rental.
- Annuities.
- Insurance premiums.
- Income 'of a similar nature' to any of the above.
- Any capital gain determined in respect of either an actual disposal or a deemed disposal of any asset from which any of the above amounts either factually are, or theoretically could be, earned by the CFC. For example, a gain arising on the sale of shares or of intellectual property would fall into this category irrespective of whether in fact the CFC had ever derived dividend or royalty income respectively from these assets.
- Any foreign currency gains which arise in respect of any foreign equity instrument.
- Any foreign currency gain determined in terms of s 24I, but excluding foreign currency gains arising in the normal course of business of any CFC which is not a foreign financial instrument holding company as defined for the purposes of section 9D (see 3.6.2.3.3 for a discussion of the concept of foreign financial instrument holding company for the purposes of s 9D).

Where a CFC derives any of these amounts, and they are attributable to a foreign business establishment, there

are four possible options that can be explored to prevent the income from being pulled into the South African tax net.

§ 3.6.2.3.1 De minimis rule

Treasury and SARS acknowledge that in the carrying on of any active business or trade, a certain amount of passive income is likely to be generated, for example interest on bank accounts. Hence, they have acknowledged that to the extent that the total passive income (i.e. aggregate amounts in all of the categories above derived by the CFC in any particular year but excluding any such income and/or capital gains that is or are specifically exempted under any of the provisions discussed in §§ 3.6.3.2–3.6.3.5.) does not exceed 10% of the CFC's active income, those passive amounts can be sheltered by the foreign business establishment exemption.

The wording of this provision is complicated and its application is best illustrated by way of some examples.

Example 1

Company A, a CFC that manufactures and sells children's toys, derives the following amounts in a particular financial year.

Sales income	$20,000,000
Cost of sales	($15,000,000)
Bank interest	$1,500,000
Interest on a loan to another CFC in the same group	$500,000
Dividend income from a wholly owned subsidiary out of profits not previously imputed to SA under the CFC rules	$2,000,000
Capital gain on sale of manufacturing equipment (as calculated under SA tax rules)	$600,000

The interest from the loan to another CFC in the group is excluded from the passive income taken into account for the calculation because it qualifies for exemption under s 9D(9)(*f*A) (see **§** 3.6.3.4).

The capital gain is not included in the passive income taken into account for the calculation because it relates to the sale of an asset that generated active and not passive income.

The dividend amount does not need to be included in the calculation, assuming it qualifies for exemption under s 10(1)(*k*)(ii)(*dd*) of the Act and therefore is not 'income' as defined in the Act.

The calculation is as follows:

$$\frac{\text{Bank interest (\$1,500,000)}}{\text{Sales income (\$20,000,000) + capital gain (\$600,000)}} = \frac{\$1,500,000}{\$20,600,000} \times 100 = 7.28\%$$

The amount of passive income that can be excluded under the *de minimis* exemption is 10% × $20 600 000 i.e. $2 060 000. This more than covers the full bank interest of $ 1 500 000.

Example 2

Co B, a holding company that is a CFC that provides group management services, and also makes loans, to its subsidiaries, derives the following amounts of income in a particular financial year. It should be assumed that Co B is not a foreign financial instrument holding company.

Services income	$12,000,000
Cost of performing services	($5,000,000)
Interest accruing on loan to connected SA resident	$1,500,000
Foreign exchange gain arising on a loan to another CFC in the same group	$500,000
Foreign exchange gain arising on a loan to a company not in the same group	$600,000
Capital gain on sale of shares (as calculated under SA tax rules)	$400,000

Both foreign exchange gains arguably qualify as active and not passive income for these purposes because they have arisen in the normal course of Co B's business and Co B is not a foreign financial instrument holding company. Alternatively, the gain on the loan to a CFC in the same group can be excluded under s 9D(9)(*f*A), but the gain on the loan to the company outside the group cannot qualify for this exemption. Because the gain on the loan to another CFC falls within the provisions of s 9D(9)(*f*A), even though this exemption may not necessarily be claimed by the taxpayer to shield the gain from imputation, it cannot be included as part of the denominator in the calculation.

The capital gain qualifies as passive because it relates to a sale of shares from which dividend income was or might have been earned.

The calculation is as follows:

$$\frac{\text{Interest from SA resident (\$1,500,000) + capital gain (\$400,000)}}{\text{Services income (\$12,000,000) + foreign exchange gains (\$600,000)}} = \frac{\$1,900,000}{\$12,600,000} \times 100 = 15,079\%$$

The amount of passive income that can be excluded under the *de minimis* exemption is 10% × $12 600 000 i.e. $1 260 000.

Assuming this is pro-rated between the interest income and capital gain, R994 737 of interest income and R265 263 of capital gain is protected.

§ 3.6.2.3.2 Principal activities of banking, financial services, insurance or rental business

If a CFC's main or principal trade consists of banking, financial services, insurance or rentals, then passive amounts arising directly from these activities will qualify for exemption, provided that the CFC is not a foreign financial instrument holding company as defined at the time the amounts arise.

§ 3.6.2.3.3 Foreign financial instrument holding company

A foreign financial instrument holding company ('FFIHC') is a company the assets of which are largely comprised of certain financial instruments. In testing whether or not a company is a FFIHC, the company's own assets are taken into account as well as a proportionate share of the assets of any other company in which the CFC holds directly or indirectly at least 20% of the equity shares.

The test will be met if at least half of the market value or two thirds of the cost of the assets tested consists of qualifying financial instruments. Both calculations must be performed as a company can qualify as a FFIHC under either test. Since it is practically difficult and potentially expensive to obtain market valuations for all of the company's assets (including those such as goodwill that may not be reflected on the balance sheet) in practice, companies often substitute book values for market values in performing the calculation. This can be useful as a guide to potential FFIHC status, but it should be noted that the legislation does require a market value calculation. Hence, if the test using book values indicates any risk that the company may potentially be a FFIHC, market valuations should certainly be obtained in respect of any assets that could potentially change the outcome of the calculation from non FFIHC to FFIHC.

In calculating whether or not a CFC is a FFIHC the formula to be followed = A–B–C–D/A–C.

A = total assets, B = assets that are not financial instruments, C = disregarded financial instruments and 'D' = 'good' financial instruments.

The starting point is to identify which assets must be tested and then to identify which of these assets are financial instruments as defined. (The liabilities side of the CFC's and the relevant influenced companies' balance sheets is ignored).

The next step is to exclude altogether:

- Any share in any other company in the same associated group of companies. This is partly to avoid double counting, since the assets of any influenced company in relation to the CFC must be taken into account in the calculation. However by allowing any share in any other company in the same associated group to be excluded, the rules for s 9D purposes go beyond just elimination of double counting. Even shares in group companies that are not influenced companies in relation to the CFC can be disregarded. An associated group of companies is defined in s 41 of the Act and comprises two or more companies in which one company (the 'influencing company') directly or indirectly holds shares in at least one other company (the 'influenced company') with the result that at least 20% of the equity shares and voting rights of each influenced company are directly held by the influencing company, one or more influenced companies or any combination thereof as assets of a capital nature. The influencing company must hold directly at least 20% of the equity shares and voting rights in at least one influenced company as assets of a capital nature.

  This is more generous than the FFIHC calculation required for the purposes of the corporate rules which only allows shares in influenced companies in relation to the CFC being tested to be disregarded and hence is not as beneficial to the taxpayer.

- Any instrument as defined in s 24J(1) entered into between companies that form part of the same associated group of companies. Again this is more generous than the s 41 calculation rules which require that for such debts to be disregarded altogether, they must be entered into between the CFC and any influenced company in the same associated group of companies i.e. for s 41 purposes but not for s 9D purposes the CFC must actually own directly or indirectly at least 20% of the equity shares and voting rights in the debtor company.

The next step is to identify which of the remaining financial instruments qualify as 'good' financial instruments. These would be:

- Trade debts in respect of goods sold or services rendered. The debts in question must be or have been included in the income of the CFC or influenced company in relation to the CFC (or at least would have been so included had the CFC or influenced company been SA tax resident). In addition, the debt must be an integral part of a business conducted as a going concern. If the trade debts are with any company in the same associated group of companies they fall into the category of related party debtors discussed above and must be wholly disregarded.

- Financial instruments attributable to the principal trading activities of a bank, financier, insurer or broker that

  - conducts more business in the country of residence of the CFC or influenced company as the case may be than in any other single country; and

  - regularly accepts deposits or premiums or makes loans, issues letters of credit, provides guarantees or effects similar transactions for the account of clients or receives commissions from clients who are not connected persons; and

  - derives more than 50% of its income and gains from principal trading activities with regard to those

clients.

Even if these tests are met, however, the relevant financial instruments will still not qualify as good financial instruments for the purposes of the calculation if the CFC or influenced company is eligible for preferential tax treatment in its country of residence and the tax treatment is dependent upon the company conducting business with clients who are not residents of that country or a prerequisite of that tax treatment is that more than 50% of the ownership of that company must be held by persons who are not residents of that country.

- Financial instruments held by an influenced company that qualifies as a bank regulated in terms of the Banks Act, or an authorised user regulated in terms of the Securities Services Act or an insurer regulated in terms of either the Long-Term Insurance Act or the Short-Term Insurance Act or a collective investment scheme.

Example: FFIHC calculation

Co A which is a wholly owned CFC in relation to SA Co has made a foreign exchange gain on a loan owed by it to an unrelated bank and hopes to be able to ignore this gain for SA CFC purposes on the basis that it arose in the normal course of Company A's business. To be successful, Co A must be able to evidence that it is not a FFIHC. Co A which is a CFC has the following assets on its balance sheet:

	Cost	Market
	$	$
☐ Shares in Co B which is in the USA	1 300 000	2 500 000
☐ Co A holds 18% of Co B and SA Co holds 72% of Co B Shares in Co C which is in the USA	1 000 000	5 000 000
☐ Co A holds 100% of Co C		
☐ Land	275 000	1 500 000
☐ Buildings	1 250 000	2 000 000
☐ Debt owed by Co B	60 000	60 000
☐ Debt owed by Co C	750 000	750 000
☐ Cash in bank	650 000	650 000
Total assets	5 285 000	2 460 000

Co C owns the following assets:

	Cost	Market
☐ Cash in bank	65 000	65 000
☐ Inter group debtors	1 750 000	1 750 000
☐ Office buildings and equipment	900 000	1 400 000
Total assets	2 715 000	3 215 000

Co C wishes to be able to claim the foreign business establishment exemption for the bank interest it earns on the basis that its principal business is that of providing financial services. To be successful, Co C must not qualify as a FFIHC.

The relevant assets to be included in the s 9D FFIHC calculation in regard to Co A will include all of Co A's assets other than its shares in and loans to Co B and in Co C which must be disregarded. Although Co A owns only 18% of Co B, Co B and Co A are members of the same associated group of companies because SA Co holds the other 72% stake in Co B. Hence Co A's shares in, and loan to, Co B qualify as disregarded assets for the FFIHC calculation. Since Co A owns 100% of Co C, Co C is clearly also in the same associated group of companies as Co A. Hence the shares in and loan to Co C also qualify as disregarded assets.

The calculation for Co A using cost values and applying the formula referred to above will then look as follows:

$$\frac{\text{Total assets-non financial assets-disregarded assets-good financial instruments}}{\text{Total assets – disregarded assets}}$$

Translated into numbers, this will look as follows:

$$\frac{8\ 000\ 000 - 2\ 425\ 000 - 4\ 860\ 000 - 0}{8\ 000\ 000 - 4\ 860\ 000} = \frac{715\ 000}{3\ 140\ 000} \times 100 = 22{,}77\%$$

Hence Co A is not a FFIHC under the cost value test. It is also not a FFIHC applying the market value test:

$$\frac{15\ 675\ 000 - 4\ 900\ 000 - 10\ 060\ 000 - 0}{15\ 675\ 000 - 7\ 560\ 000} = \frac{715\ 000}{8\ 115\ 000} \times 100 = 8{,}8\%$$

Co C's FFIHC calculation using cost values looks as follows:

$$\frac{2\ 715\ 000 - 900\ 000 - 1750\ 000}{2\ 715\ 000 - 1\ 750\ 000} = \frac{65\ 000}{965\ 000} \times 100 = 6{,}7\%$$

Co C's FFIHC calculation using market values looks as follows:

$$\frac{3\ 215\ 000 - 1\ 400\ 000 - 1750\ 000}{3\ 215\ 000 - 1\ 750\ 000} = \frac{65\ 000}{1\ 465\ 000} \times 100 = 4{,}436\%$$

Consequently Co C is also not a FFIHC.

§ 3.6.2.3.4 Amounts not derived from connected South African resident

Even if the CFC is not a FFIHC, a further test applies before the CFC can claim exemption on the grounds that its principal activities consist of banking, financial services, insurance or rental business. The amounts must not be derived from any connected person that is South African resident, nor from any resident who directly or indirectly holds at least 5% of the participation rights in

- the relevant CFC; or
- any other company in the same group of companies which holds shares in the CFC.

Example:

Co A, a South African resident is the head of a group of companies. Co B is a South African subsidiary of Co A. Co B holds 70% of the shares in Co C, which is incorporated and tax resident in Switzerland. Both Co A and Co B pay insurance premiums to Co C which carries on insurance business and does not qualify as a FFIHC. Although other premiums derived by Co C may qualify for exemption, the amounts derived from Co A are excluded (and hence taxable in South Africa) because Co A holds shares in Co B which holds into Co C and the premiums derived from Co B are similarly potentially taxable in SA because Co B directly holds more than 5% of the participation rights in Co C.

The amounts must also pass a specific anti avoidance test aimed at countering round tripping. The amounts cannot be protected by the exemption in s 9D(9)(*b*)(iii)(*bb*) if they are seen as forming part of any transaction, operation or scheme in terms of which any amount received by or accrued to any person is exempt from South African tax while any corresponding expenditure is deductible for South African tax purposes either by the same person or by any connected person in relation to that person.

§ 3.6.2.3.5 Amounts arising from the disposal or deemed disposal of certain intangible assets

Amounts can be classified as active rather than passive for CFC purposes where they arise from the disposal or deemed disposal (e.g. if the taxpayer ceases to be South African resident) of any intangible asset as defined in para 16(2) of the Eighth Schedule to the Act. However, intangible assets that were created or developed in South Africa are excluded, as are financial instruments. This definition includes goodwill, trademarks, designs, patents, copyright, rights recognised under the Plant Breeders Act 1996 and any model, pattern, plan, formula or process. In addition, the intangible asset concerned must have formed an integral part of the CFC's business and must have been disposed of in the context of the disposal by the CFC of its business as a going concern. Isolated disposals of intellectual property where the CFC otherwise continues to trade as before will not qualify.

§ 3.6.2.3.6 Royalty income where CFC directly and regularly creates, develops or substantially upgrades intellectual property

Royalty income can be sheltered by the foreign business establishment exemption to the extent that the CFC is engaged in a business where it directly (i.e. not through an agent or sub-contractor) develops or substantially upgrades intellectual property that gives rise to the royalty income. Intellectual property for these purposes must be interpreted as defined in s 23I of the Act.

§ 3.6.3 Other exemptions

If a CFC does not qualify as having a foreign business establishment, or if it does but not all of its income can be protected in terms of the foreign business establishment exemption, relief may still be available in terms of one or more of the other specific exemptions provided in s 9D(9).

§ 3.6.3.1 *Long-term insurance policies — s 9D(9)(c)*

A CFC that issues long-term insurance policies can exclude from its net income calculation for s 9D purposes any amounts that it derives that relate to policyholders that are neither South African tax resident nor CFCs.

§ 3.6.3.2 *Amounts taxable in SA in the hands of the CFC itself — s 9D(9)(e)*

A CFC may earn income from a South African source that is taxable in South Africa under provisions of the Act other than the CFC rules. In this case, the income concerned can be excluded from the CFC's net income calculation provided that it is not exempt from tax or liable to a reduced rate of tax in South Africa as a result of the application of tax treaty provisions. From years of assessment commencing on or after 1 January 2011, this exemption will apply where the income has been 'included in the taxable income of the company'.

Example

A CFC in a country that does not have a tax treaty with South Africa derives royalty income from third parties in South Africa. The royalties are subject to a 12% withholding tax in South Africa. The royalty income must be excluded from the CFC's net income calculation for purposes of the CFC rules.

A CFC in a country that does have a tax treaty with South Africa makes use of a sales agent in South Africa to conclude sales agreements with third parties for goods supplied by the CFC. Because the sales agent conducts similar activities for other companies, the tax treaty prevents South Africa from being able to tax the CFC on its South African sourced income on the grounds that a permanent establishment as defined in the treaty has not been created in South Africa. In this case, even though the CFC earns income that is sourced in South Africa, it cannot exclude the sales income from its net income calculation under the s 9D(9)(*e*) exemption because South Africa is precluded from taxing the income directly as a result of the application

of tax treaty provisions.

§ 3.6.3.3 *Foreign dividends — s 9D(9)(f)*

Where profits of a CFC have been imputed to South Africa for tax purposes under the CFC rules, it is not the intention of National Treasury that these profits should again be subject to South African tax under the CFC rules when distributed to another CFC in the form of a foreign dividend. Consequently, s 9D(9)(*f*) provides that any foreign dividend derived by a CFC must be excluded from the net income calculation to the extent that the foreign dividend amount does not exceed an amount calculated as follows:

All net income of

(i) the CFC declaring the dividend; or

(ii) any CFC held via the CFC declaring the dividend;

(iii) previously imputed to the same SA resident under the CFC rules.

Less

Foreign tax payable in respect of those amounts included in the resident's income plus foreign dividend amounts received by or accrued to the CFC that were exempt from South African tax under the CFC rules.

§ 3.6.3.4 *Intra group interest, royalties, rentals, or income of a similar nature — s 9D(9)(fA)*

An exemption that is often used relates to interest, royalties, rentals 'or income of a similar nature' paid or payable to the CFC by any other CFC in the same group of companies. This also applies to amounts of this nature that are not actually paid or payable but are only deemed to be paid or payable, for example under SA's transfer pricing rules. The rationale behind this exemption is that the CFC paying the amounts is not allowed a tax deduction under the CFC rules for the expenditure incurred.

The exemption also applies to foreign exchange differences determined under s 24I in respect of an exchange item to which two CFCs in the same group of companies are parties. If a CFC has entered into a forward exchange contract or other hedging arrangement to hedge against exchange movements arising in respect of a loan, advance or debt entered into with another CFC in the same group of companies, then any exchange gain arising as a result of the hedging arrangement may also be sheltered under this provision even though the hedge is likely to be with a party outside the group.

Example

Co A in Belgium takes up a loan in Euro and on-lends the funds in dollars to its wholly owned US subsidiary, Co B. Both A and B are CFCs in the same group of companies. Co A enters into a forward exchange contract with a bank in terms of which it is guaranteed a certain US $:Euro exchange rate from the bank in regard to the principal amount of the loan. In a particular tax year, the dollar strengthens against the Euro and Co A makes an (unrealised) loss on its dollar loan to Co B. Simultaneously, a gain arises under the hedging arrangement with the bank. In terms of s 9D(9)(*f*A), the gain must be ignored for SA tax purposes. In terms of s 9D(2A), the loss must also be ignored, thus resulting in tax neutrality.

Section 9D(9)(*f*A) also applies relief in the case where a debt owed by one CFC to another CFC in the same group of companies is reduced or discharged for no consideration or for a consideration which is less than the amount by which the face value of the debt has been reduced or discharged. For example, if a loan is waived or it is agreed that the loan can be discharged at a discount, this provision will apply to prevent a tax liability arising in the debtor company. This measure was introduced into s 9D at the same time that para 12(5) of the Eighth Schedule was amended to limit the application of that sub-paragraph to SA tax residents. However, the wording in s 9D(9)(*f*A) is very broad and arguably encompasses any gain, whether income or capital in nature, arising on the reduction or discharge for a non arm's length consideration of a debt owed by one CFC to another CFC in the same group.

It is possible for a South African taxpayer to elect to ignore the provisions of s 9D(9)(*f*A) i.e. to elect to include in the net income of its CFC any amount that would otherwise qualify for exclusion from the calculation as a result of s 9D(9)(*f*A). Such an election might be made, for example, if a CFC that has a brought forward tax loss for section 9D purposes derives interest income from another CFC in the same group of companies that has positive net income under s 9D. In this case, making the election would allow the CFC paying the interest to claim a deduction for it. The CFC receiving the interest would have to take it into account in calculating its net income and will reduce its tax loss as a result, but cash tax on the interest income could be avoided.

§ 3.6.3.5 *Amounts attributable to the disposal of certain capital assets attributable to the foreign business establishment of another CFC in the same group of companies — s 9D(9)(fB)*

A CFC may dispose of an asset that is used by another CFC in the same group of companies. For example, a South African headquartered group with business operations in Sweden decides to house its immovable property including the manufacturing plant on the property there in a separate subsidiary from the one that conducts the manufacturing and sales operations. In due course, the entire business is sold. When the land and plant is sold a gain arises. If the company owning the immovable property does not itself qualify as having a foreign business establishment, the gain can nevertheless be sheltered from tax under the CFC rules on the basis that it is attributable to the foreign business establishment of the subsidiary that actually conducted the manufacturing activities on those premises.

It should be noted that this will not apply if the asset disposed of is either a financial instrument or an intangible

asset as defined in para 16 of the Eighth Schedule. This definition includes goodwill, trademarks, designs, patents, copyright, rights recognised under the Plant Breeders Act 1996 and any model, pattern, plan, formula or process.

Footnotes

2 OECD Model Commentary 2008, Article 5, para 5.

3 'In many States, a person is considered liable to comprehensive taxation even if the Contracting State does not in fact impose tax. For example, pension funds, charities, and other organisations may be exempt from tax but they are exempt only if they meet all of the requirements for exemption specified in the tax laws. They are thus subject to the laws of a Contracting State. Furthermore, if they do not meet the standards specified, they are also required to pay tax. . .In some States however these entities are not considered liable to tax if they are exempt from tax under domestic laws.' OECD Model Commentary on art 4, paras 8.5–8.6.

4 Explanatory Memorandum on the Revenue Laws Amendment Act (2002).

Author: Various - See relevant chapter.

§ 3.7 Rulings

With effect from 1 September 2009, there is now only one set of circumstances under which in terms of a specific provision in s 9D(10), a ruling can be sought from the tax authorities in the context of section 9D. This relates to the situation in which exemption is sought from the scope of the diversionary transaction rules. It will potentially be relevant where a CFC buys goods from South Africa and on-sells them, or supplies services for the benefit of a connected South African resident. The CFC must be deriving income as a result of the sale of goods or the performance of services outside South Africa. It must also be able to show that its foreign business establishment is located in its country of residence and that the foreign business establishment primarily serves as a central location for the sale or performance of identical or similar goods or services to those falling within the scope of the diversionary transaction rules, in at least two countries that are contiguous to the country of residence of the CFC.

'Contiguous' in the view of National Treasury means contiguous by land and not by sea.

The rulings process involved and the terms and conditions applying to both SARS and the taxpayer are the same as those for obtaining a binding private ruling other than that the transaction need not be proposed (as opposed to having already taken place).

Example

Co X, a South African resident, establishes a sales subsidiary in Switzerland. The company buys goods from its South African parent and on-sells them to customers in Germany, Austria, France and Italy. Its income is caught by the diversionary transaction rules and potentially taxable in Co X's hands. It is possible for Co X to go to SARS for a ruling that the diversionary transaction rules should not apply on the grounds that the Swiss company's offices serve as a central location for sales activities that take place in at least 2 countries that physically border on Switzerland.

No ruling will be issued in regard to any foreign tax year of the CFC that has already ended prior to the ruling application being submitted.

Author: Various - See relevant chapter.

§ 3.8 Administrative aspects: s 72A

Section 72A of the Act places certain administrative obligations on a resident who, together with any connected person, holds at least 10% of the participation rights in a CFC on the last day of the CFC's foreign tax year or immediately before the CFC ceased to be a CFC. The resident must submit to the Commissioner a return (known as an IT 10) as prescribed by the Commissioner. A resident who holds his participation rights indirectly through a company which is a resident is exempted from the obligation to submit such return.

The resident is also obliged to have available for submission, on request by the Commissioner, a copy of the CFC's financial statements for its relevant foreign tax year. Failure to comply with this requirement in the absence of reasonable grounds for the failure which was outside the control of the person or for that person to believe that he was not subject to the requirement will result in the CFC's gross receipts and accruals being imputed and foreign tax relief (in terms of s 6*quat*) being denied.

Author: Various - See relevant chapter.