A suggested Interpretation Note for
section 9D of the Income Tax Act

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ABSTRACT

Controlled foreign company (‘CFC’) legislation was introduced in phases to co-incide with South Africa’s move from a source based system to a residence based system. Initially with the introduction of the legislation it was directed at those foreign entities earning passive income. However, over the years the legislation has been amended to include active income of entities and additional aspects to the section have been inserted to provide clarity for taxpayers.

An increase in cross border transactions and offshore investment has necessitated the need to introduce CFC legislation into the revenue codes of many countries, South Africa being one of them.

In most revenue codes where CFC or similar legislation has been introduced it is one of the most complex areas in a country’s revenue code (Sandler, 1998:23). This mini-dissertation aims to interpret section 9D and also aims to provide guidance on its application in practice with the help of practical examples and reference to relevant international case law.

The end result of this research is a proposed interpretation note on section 9D which is attached as Appendix 1.
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1 CHAPTER ONE

1. INTRODUCTION TO THE STUDY

1.1 Scope of the study

In South Africa, controlled foreign company (‘CFC’) legislation is contained in the provisions of section 9D of the Income Tax Act no 58 of 1962 (the ‘Act’). As it stands currently the section is difficult to follow because of the number of exemptions, provisions and inclusions contained in the various subsections to section 9D. In addition, taxpayers find it difficult to interpret the key concepts underlying the legislation and are uncertain about the practical application of the sections.

There is uncertainty in the market amongst business and tax professionals alike, coupled with the fact that there is a lack of formal guidance from the South African Revenue Services (‘SARS’) on the application of the section. Many taxpayers interpret the section as they understand it, resulting in a wide variety of interpretations and therefore uncertainty.

Despite the lack of guidance section 82 remains applicable. The uncertainty is exacerbated for taxpayers as a result of the provisions of section 82 which requires the taxpayer to prove that an amount should not be included in a taxpayer’s net income in terms of section 9D. Section 82 of the Act, places the burden of proof on the taxpayer by stating that ‘the burden of proof that any amount is
(a) exempt from or not liable to any tax chargeable under this Act; or
(b) subject to any deduction, abatement or set-off in terms of this Act;
(c) to be disregarded or excluded in terms of the Eighth Schedule,
shall be upon the person claiming such exemption, non-liability, deduction, abatement or set-off, or that such amount must be disregarded or excluded, and upon the hearing of any appeal from any deduction of the Commissioner, the decision shall not be
reversed or altered unless it is shown by the appellant that the decision is wrong'  
(58/1962).

1.2 Purpose of the research

Section 9D was introduced into the Act with the introduction of a residence based taxation system (National Treasury, 2002a:9). This means that a South African resident will be taxed on their world wide income and a non resident will only be taxed on true or deemed sources of income (Stiglingh et al, 2010:49).

The purpose of the study is to provide guidance and insight into section 9D to form the basis of drafting a suggested Interpretation Note on section 9D.

It is clear from the guidance issued by National Treasury with the introduction of section 9D (2002b:1), that section 9D is an anti-avoidance provision designed to prevent deferral of income by residents through the use of foreign entities. Whilst an explanatory document was issued by National Treasury in 2002 with the introduction of the comprehensive section 9D (i.e. covering both passive and active income) there have been no updates to this document despite numerous changes made to the legislation around CFCs. Since that date even though there have been various amendments to section 9D, some of them significant, no subsequent updated guidance has been provided.

1.3 Background

CFC legislation was introduced in phases to coincide with South Africa’s move from a source based system to a residence based system (National Treasury, 2002a:9)

Initially only passive income was imputed (National Treasury, 2000a:12). In 2001, the scope of section 9D was increased to include active trading income of CFCs within its scope as well. (National Treasury, 2000a:7).

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1 This was confirmed in CIR v Goodrick 1942 OPD 1 at 20, 12 SATC 279 at 296, it has been held that what is required of the taxpayer to discharge this onus is affirmative evidence which satisfies a court upon a preponderance of probability that the amount is deductible or alternatively not taxable.
In many of the countries concerned, the CFC provisions probably form the most complex part of an already complex revenue code (Sandler, 1998:23). South Africa is no exception and reading the section as it currently stands, confirms this. Yet SARS has not issued an Interpretation Note to provide guidance on the application of the section. There is also no South African case law to provide guidance to taxpayers.

Tax authorities in most other countries with CFC legislation have provided some form of guidance as to the application of the legislation. The United States introduced CFC legislation in 1962 with the enactment of Passive Foreign Investment Company (‘PFIC’) rules in 1986. The Internal Revenue Service (‘IRS’) has issued guidance on PFIC rules through various Internal Revenue Bulletins and Guidance on PFIC which are ‘temporary regulations’ for taxpayers (IRS, 2010).

The United Kingdom has issued an ‘International Manual’ referenced with INTM numbers. The CFC’s reference of the International Manual commences at INTM200000 with an introduction to CFC legislation through to apportionment and examples, ending in INTM201000 with guidance relating to superseded legislation, documented in INTM217000 (HMRC, 2010).

In Canada, the CFC legislation which was initially introduced was referred to as the Foreign Accrual Property Income (‘FAPI’) provisions. Currently, there are Foreign Investment Fund (‘FIF’) rules that have been introduced into the Canadian legislation relating to CFCs but there appears to be no guidance provided in applying these rules correctly (Sandler, 1998:26).

CFC legislation has been enacted in both New Zealand (IRD, 2010) and Australia with detailed guidelines provided by both revenue agencies to taxpayers (ATO, 2009). Both countries have introduced FIF into their legislation which complements the CFC regime (Sandler, 1998:29).

Below is a table summarizing the developed countries which have enacted CFC or similar legislation (Olivier & Honiball, 2008:430).
Table 1.1: Introduction of CFC legislation in various countries
(Olivier & Honiball, 2008:430)

|---------------------------------|--------------|--------------|

The lack of formal guidance from SARS is even more problematic if one considers the fact that there is no South African case law on the subject. There is also a surprising lack of case law in the international arena.

In France, for example there have been few court decisions concerning the interpretation of the CFC legislation despite the fact that legislation has been in place for over 15 years. Canada, which has had CFC legislation for 25 years, has had relatively few cases regarding the interpretation of the provisions (Sandler, 1998:23).

One of the best known UK court cases on CFC legislation is the Bricom Holdings Ltd v IRC (1997) STC 1179 CA. In this case the courts found that in the circumstances the CFC legislation prevailed. In brief the facts of the case are that Bricom Holdings
Ltd was the sole shareholder of a Dutch subsidiary, Spinneys International BCV (‘Spinneys’). Bricom was potentially liable for a portion of the income of Spinneys a CFC in relation to Bricom. In this case, the income related to interest from a loan from Spinney’s to Bricom a resident in the UK. The issue in this case is that the treaty between the UK and the Netherlands was referred to relating to the interest income earned by Bricom and Spinney’s, however the Commissioner in the UK relied on the rules contained in the CFC legislation (Olivier & Honiball, 2008:472).

The Court of Appeal dismissed Bricom’s appeal and it was held that the treaty between the two countries did not apply as the interest had lost its character and what was actually taxed was a notional amount derived from a hypothetical determination of the CFC’s UK equivalent income tax. The following quote summarises the essence of this case: ‘The situation is analogous to that found in IRC v Willoughby (1995) STC 143. Income which was ‘industrial and commercial profits’ of one person was deemed by s 739 to be income of another person, but its character as industrial and commercial profits was not preserved as it was charged to tax in the hands of the deemed recipient under Case VI of Sch D. Mr David Shirley, the Special Commissioner, found (at 168) that the double taxation arrangement with the Isle of Man could no longer be applied to the income in the hands of the deemed recipient. This part of the decision was not appealed and we respectfully agree with his reasoning.’ (Olivier & Honiball, 2008:472.)

In another UK case, Cadbury Schweppes plc v Commissioner of Inland Revenue (Case C-196/04) the facts were as follows:
- Cadbury Schweppes a UK incorporated and resident company
- It established two subsidiaries in Ireland
- The tax rate in Ireland at the time was 10%

In order to avoid attribution of the income of these two subsidiaries, Cadbury Schweppes argued that it was exercising its rights to establish subsidiaries and they contended that the CFC legislation in the UK had assumed that this was to avoid tax due to both subsidiaries being established in low income tax jurisdictions. The UK Government in turn argued that this was a diversion of profits to low tax jurisdiction. It was held that the UK’s CFC legislation restricted the freedom of establishing
subsidiaries in other European Economic Area member states in terms of the European Community Constitution. Following this decision the UK Government only applies CFC legislation to low tax jurisdiction where there are ‘wholly artificial arrangements’ (Olivier & Honiball, 2008:481).

The issue in this case revolved around European Union issues and are not applicable in South Africa. In addition, South Africa’s legislation contains only an objective test and whether or not tax avoidance was the sole or even one of the purposes are completely irrelevant in the application of section 9D, despite the fact that section 9D is in essence anti-avoidance legislation.

An indication of the uncertainty experienced by taxpayers in South Africa is the number of advance tax rulings applied for on specific topics. Since the introduction of advance tax rulings into the Act with sections 76B to 76S (58/1962) there have been a total of 90 binding private rulings (‘BPR’) that have been issued in accordance with section 76Q of the Act (SARS, 2010b).

Section 76B defines a private binding ruling as ‘an advance tax ruling regarding the interpretation of the Act in respect of a proposed transaction that is issued in accordance with the requirements of section 76Q in response to an application by the applicant’ (58/1962). At the date of this study, six BPRs have been issued which relate directly to section 9D and two that relate indirectly to topics around residents and foreign investment. The table below lists the binding private rulings which have been issued relating to section 9D:

Table 1.2 (SARS, 2010b)

<table>
<thead>
<tr>
<th>Binding Private Ruling number</th>
<th>Section of the Act</th>
<th>Subject of the BPR</th>
</tr>
</thead>
<tbody>
<tr>
<td>BPR 003</td>
<td>Section 9D, paragraphs 1, 26 and 29 of the Eighth Schedule</td>
<td>Method for determination of the valuation date value of financial instruments listed</td>
</tr>
<tr>
<td>Binding Private Ruling number</td>
<td>Section of the Act</td>
<td>Subject of the BPR</td>
</tr>
<tr>
<td>------------------------------</td>
<td>--------------------</td>
<td>--------------------</td>
</tr>
<tr>
<td></td>
<td>on a recognised exchange to be used for capital gains tax purposes.</td>
<td></td>
</tr>
<tr>
<td>BPR 044</td>
<td>Section 9D(10)(a)(iv)</td>
<td>Foreign Business Establishment exclusion.</td>
</tr>
<tr>
<td>BPR 047</td>
<td>Section 9D(2A) read with (9)(b)(ii)(cc)(C)</td>
<td>Agency income earned by a Controlled Foreign Company to be excluded from its net income.</td>
</tr>
<tr>
<td>BPR 048</td>
<td>Section 9D(1) and (10)(a)(i)</td>
<td>Deeming a place of business to be a ‘foreign business establishment’ as envisaged in section 9D(1).</td>
</tr>
<tr>
<td>BPR 052</td>
<td>Section 10(1)(k)(ii)(dd)</td>
<td>Repatriation of profits in the form of foreign dividends paid by a foreign subsidiary to a resident company which was previously exempt from Income Tax.</td>
</tr>
<tr>
<td>BPR 0061</td>
<td>Section 1, definition of ‘company’ and Section 9D and 10</td>
<td>Application of the definition of ‘company’ and ‘controlled foreign company’ with regard to a foreign limited partnership.</td>
</tr>
<tr>
<td>BPR 0067</td>
<td>Section 9D(10)(a)(i)</td>
<td>Foreign business establishment: Sharing of employees, equipment and</td>
</tr>
<tr>
<td>Binding Private Ruling number</td>
<td>Section of the Act</td>
<td>Subject of the BPR</td>
</tr>
<tr>
<td>-------------------------------</td>
<td>---------------------</td>
<td>-------------------</td>
</tr>
<tr>
<td>BPR 082</td>
<td>Section 1 – definition of ‘gross income’; section 9(1)(b), 10(1)(h) and 108</td>
<td>facilities amongst controlled foreign companies which are part of the same group of companies.</td>
</tr>
<tr>
<td>BPR 090</td>
<td>Section 9D(10)(a)(iii)</td>
<td>Permanent establishment and royalty income attributable to a foreign business establishment of a controlled foreign company</td>
</tr>
</tbody>
</table>

Based on the number of BPRs dealing with section 9D which have been issued by SARS it is clear that this section of the Act is an area of uncertainty for many taxpayers: only where there is uncertainty on the correct application of the legislation would one apply for a ruling as the taxpayer would require certainty on what the tax consequences of the proposed transaction would be.

International tax is by its nature a very complex area of taxation (Olivier & Honiball, 2008:429). For many of the other sections in the Income Tax Act which deal with international tax aspects, SARS has issued either interpretation notes or practice notes, as can be seen from the table below:

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2 A ‘group of companies’ is defined in section 1 to the Act to mean two or more companies in which one company directly or indirectly holds shares in at least one other company to the extent that –
(a) at least 70 per cent of the equity shares of each controlled group company are directly held by the controlling group company, one or more other controlled group companies or any combination thereof; and
(b) the controlling group company directly holds at least 70 per cent of the equity shares in at least one controlled group company.
Table 1.3

<table>
<thead>
<tr>
<th>Section</th>
<th>Topic</th>
<th>Interpretation note/practice note</th>
</tr>
</thead>
<tbody>
<tr>
<td>Section 1</td>
<td>Definition of resident</td>
<td>Interpretation notes 3, 4, 6 and 25</td>
</tr>
<tr>
<td>Section 6quat</td>
<td>Relief from double taxation</td>
<td>Interpretation note 18</td>
</tr>
<tr>
<td>Section 10(1)(o)</td>
<td>Exemption in respect of remuneration earned for services rendered outside SA</td>
<td>Interpretation notes 16 and 34</td>
</tr>
<tr>
<td>Section 11C</td>
<td>Deductibility of interest: foreign dividends</td>
<td>Interpretation note 2</td>
</tr>
<tr>
<td>Section 31</td>
<td>Transfer pricing and thin capitalization</td>
<td>SARS Practice notes 2 and 7</td>
</tr>
</tbody>
</table>

The lack of an interpretation note on section 9D is a glaring omission.

1.4 Conclusion

As it currently stands, section 9D is difficult to read due to the number of exemptions, provisions and inclusions across the various subsections. In addition to the above, there are specific concepts that create ambiguity as to the exact requirements that are needed to meet the provisions. Based on the discussion above, it is clear that there is a need for guidance to taxpayers on the practical application of section 9D and the interpretation of the key concepts driving the legislation.

This mini-dissertation aims to interpret section 9D and also aims to provide guidance on its application in practice with the help of practical examples and reference to
relevant international case law, the end result being a proposed interpretation note on section 9D.

Subsequent to the finalisation of this mini-dissertation the Taxation Laws Amendments of 2010 came into effect. Where these changes have been made information has been provided thereon or a footnote has been inserted to describe the change that has been made and the effective date.

In interpreting legislation, the very important starting point is the definitions provided in the Act for that specific piece of legislation. The next chapter will consider the meaning of the key terms used in section 9D.
2 CHAPTER TWO

2.1 INTRODUCTION-THE DEFINITIONS AND KEY TERMS USED

2.1.1 The scope of this chapter

CFC legislation contained in section 9D is one of the most complex sections in South Africa’s tax legislation as well as those of most other countries which have enacted CFC legislation into their revenue codes (Olivier & Honiball, 2008:429).

Yet, as was illustrated in chapter 1, there is no formal guidance in South Africa as to the application of this complex section. The Little Oxford English Dictionary gives the meaning of the term definition as:
‘1. a statement of the exact meaning of a word or the nature or scope of something.
2. the degree of sharpness in outline of an object or image.’ (LOED. 195)

The purpose of this chapter is to consider the key definitions and terms used in section 9D and other directly relevant sections in the Act as these definitions and terms will be critical in providing insight and clarity to the terms used in the legislation.

The following terms are specifically defined in section 9D of the Act and will be considered in detail in this chapter:

- Controlled foreign company
- Country of residence
- Foreign business establishment
- Foreign company³
- Foreign financial instrument holding company
- Foreign tax year
- Participation rights

³ Subsequent to the completion of this dissertation the Taxation Laws Amendment Bill of 2010 was released resulting in the deletion of the definition of foreign company with effect from 1 January 2011 and applicable in respect of foreign tax years of controlled foreign companies ending during years of assessment commencing on or after that date.
In addition, there are a number of terms used, referred to or implied in section 9D that have not been specifically defined in section 9D even though they may have been defined elsewhere in the Act. The following terms will also be considered as clarification is required as to the meaning thereof to ensure that taxpayers apply section 9D correctly. These terms are:

- Voting rights
- Control in relation to voting rights
- Permanent establishment – this term is defined in section 1 of the Act
- Local currency – as defined in section 24I and referred to in section 9D(6)(c)
- Currency used for financial reporting
- Comparable prices (s9D(9)(b)(ii)(aa)(C))
- Dividends, interest, royalties, rental, annuities, insurance premiums and income of a similar nature (i.e. passive income) – these terms are not specifically defined in the Act but are referred to as ‘passive income’ a term which was previously defined in the now repealed section 9E

The reasons for selecting these terms will become clear in the discussion below.

It should be noted that if a word is not defined in the Act itself, one has to turn to other sources to find a definition such as the Interpretations Act no 33 of 1957, relevant case law or to the ordinary dictionary meaning of the word. As a general principle in the interpretation of statutes, the intention of the legislator is very important (De Koker, 2010). Even the definitions in section 1 of the Act only applies in context, i.e. if the context otherwise indicates, these definitions will not apply.

As the meaning of the terms needs to be seen in context, these terms cannot be considered in isolation. Therefore each definition will be examined and all component parts reviewed to assist to provide a clearer understanding.
2.1.1.1 The legislature’s intent

It may be helpful to first gain an understanding of the legislator’s overall intent with section 9D before undertaking a detailed analysis of individual terms. At the time of tabling the legislation, National Treasury’s view was that a two part test had to be applied in understanding the term ‘controlled foreign entity’ (which has since been replaced by the term controlled foreign company) (National Treasury, 2002a:14):

- Firstly, income must be generated by a ‘foreign entity’ and
- Secondly, that entity must be ‘controlled’ by South African shareholders (National Treasury, 2002b:3)

As was mentioned, section 9D is an anti-avoidance measure presumably based on the argument that if residents control a foreign company, the fact that the company is not a resident is driven by tax avoidance achieved by establishing the company outside the South African tax net.

The word ‘control’ is not defined in the Act. However there have been a number of cases where the term has been clarified in a court of law. In ITC 486 (1940) 12 SATC 584 it was stated that ‘it seems to us that Mr Rosenberg’s contention on behalf of the appellant is correct that control means the right to more than fifty percent of the voting power in that company’, ‘Control must mean actual de facto control’, ‘Control, furthermore means control of all the activities of the company’.

In ITC 412 (1938) 10 SATC 24I (U), ‘A company shall be deemed to be under the control of any persons where the control is by any means in their hands. This means by which that control is given may be ‘any means – be it by voting power, be it by shareholdings or be it by a control outside the Articles or by a fiduciary relationship. Control of a company inter alia includes control by means of an individual’.

From this it is clear that where a shareholder can exercise ‘control’ of a foreign company in any manner, it is possible that it may be a CFC.
2.2 The definition of a controlled foreign company

The term CFC is key to the understanding and practical application of section 9D of the Act as it will enable a resident shareholder to determine whether an investment in a foreign company would result in that company being classified as a CFC or not. Where the definition is met, the requirements and provisions of section 9D would then need to be adhered to in determining whether imputation by a resident shareholder into its taxable income is necessary after considering all provisions and exemptions.

The definition is complicated and in itself contains terms requiring clarification.

A CFC is defined in section 9D of the Act as (my emphasis),

‘any foreign company where more than 50 per cent of the total participation rights in that foreign company are held, or more than 50 per cent of the voting rights in that foreign company are directly or indirectly exercisable, by one or more residents: Provided that—

(a) no regard must be had to any voting rights in any foreign company—

(i) which is a listed company; or

(ii) if the voting rights in that foreign company are exercisable indirectly through a listed company;

(b) any voting rights in a foreign company which can be exercised directly by any other controlled foreign company in which that resident (together with any connected person in relation to that resident) can directly or indirectly exercise more than 50 per cent of the voting rights are deemed for purposes of this definition to be exercisable directly by that resident; and

(c) a person is deemed not to be a resident for purposes of determining whether residents directly or indirectly hold more than 50 per cent of the participation rights or voting rights in a foreign company, if—
(i) in the case of a listed company or a foreign company the participation rights of which are held by that person indirectly through a listed company, that person holds less than five per cent of the participation rights of that listed company; or

(ii) in the case of a scheme or arrangement contemplated in paragraph (e) (ii) of the definition of “company” in section 1 or a foreign company the participation rights of which are held and the voting rights of which may be exercised by that person indirectly through such a scheme or arrangement, that person—

(aa) holds less than five per cent of the participation rights of that scheme or arrangement; and

(bb) may not exercise at least five per cent of the voting rights in that scheme or arrangement,

unless more than 50 per cent of the participation rights or voting rights of that foreign company or other foreign company are held by persons who are connected persons in relation to each other; (58/1962).

It is clear that whether a foreign company will be a CFC is dependent on the voting rights and participation rights and it is therefore necessary to clarify the meaning of these two terms.

2.2.1 The meaning of “participation rights”

Participation rights are defined in section 9D to mean ‘in relation to a foreign company —

(a) the right to participate directly or indirectly in the share capital, share premium, current or accumulated profits or reserves of that company, whether or not of a capital nature; or

(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’ (58/1962).

It is National Treasury’s view that participation rights ‘include shares representing equity share capital as well as other forms of shares, such as non-participating preference shares. However, convertible debentures, options and similar interests do not qualify as participation rights because these instruments do not represent a participation interest until converted into shares’ (National Treasury, 2002b:3).

The term ‘participation rights’ referred to in the definition of a CFC includes within its ambit the right to participate directly or indirectly in the share capital, share premium, current or accumulated profits or reserves’ of the company. The term ‘participation rights’ is therefore very widely defined and requires careful consideration in determining whether ‘more than 50%’ of these rights are held in that foreign company are held by residents (De Koker, 2010).

The reference in (a) to the definition of participation rights, clearly points toward what is generally referred to as ‘owner’s equity’ (the use of the word ‘or’ simply suggests not an alternative ‘participation rights’, but a simple arithmetic total of share capital, premium, profits and reserves) (Clegg, 2010). It is submitted that, when one determines the participation rights held in a foreign company, all aspects of the owner’s equity should be taken into account not only share capital and this should be added together in order to determine the percentage of the participation rights held in a foreign company. However, in determining whether South African residents together hold more than 50% of the participation rights of a foreign company, a mere mathematical calculation may not suffice because the shareholders’ register may reflect a disguised holding by a resident (Olivier & Honiball, 2008:436).

Example: A resident holds 49% of the rights, and a third party is the holder of 2% of such voting rights. This interest is held in a trust for or as nominee of a number of residents (irrespective, it is submitted, of how the trust or nominator/nominee relationship arises), the foreign company is a CFC in relation to the residents because of the fact that if the 49% and the 2% are combined this results in more than 50% of the foreign company being held by residents.
A resident holds 49% and non-residents 51% of the participation rights. However, in terms of the rights of shareholders, the non-residents undertake to vote according to the wishes expressed by the residents. Therefore the residents are able to control more than 50% of the voting rights in the company as the non-residents will vote in accordance with the residents. This will mean that the residents hold more than 50% of the foreign company and will therefore qualify as a CFC (De Koker, 2010).

Where residents do not hold more than 50% of the participation rights, but are entitled to appoint the board of directors of the foreign company, it might very well constitute a CFC (De Koker, 2010). This again comes back to the ‘control’ that the resident shareholder has in the company i.e. the voting rights.

The word ‘jointly’ refers to the participation rights or voting rights of South African resident beneficiaries exceeding 50 percent, irrespective of whether they know each other or not. The word ‘jointly’ merely means ‘aggregate’ and not that the residents must have a ‘common purpose’ (Olivier & Honiball, 2008:436). Therefore it is not necessary that the residents be ‘connected’ but that they must merely hold the participation rights in the same foreign company.

**Example:** If a South African resident holds 15% in a foreign company and a Jersey company holds 40% of the shares in the same foreign company and unconnected South African residents hold the shares of this Jersey company, the foreign company will be a CFC.

I.e. the South African residents indirectly hold the participation rights in the foreign company. In the definition of participation rights this refers to both the direct and indirect interests of a resident which need to be taken into account in the determination of the ‘more than 50%’ shareholding.

The reference to ‘indirectly’ means that the interests needing to be taken into account to determine whether a foreign company is a CFC must consider both registered and beneficial shareholders (Olivier & Honiball, 2008:436).
Example: A South Africa resident (an individual) owns all the shares in a foreign company X, which in turn holds all the shares in another foreign company Y, both companies X and Y will be considered to be a CFC. However, a CFC will not exist where a foreign company X, has issued 100 ordinary shares, 50 to a South African company and 50 to a foreign individual and all the shares of the South African company are owned by a South African individual.

In the BPR 061, the issue brought before SARS was whether a business set up in a foreign jurisdiction through a limited partnership will result in the SARS applying the definition of ‘company’ and ‘controlled foreign company’ to the foreign limited partnership. The facts of the case are as follows:

- The partnership was an incorporated limited partnership and was established in terms of the foreign jurisdiction’s specific Partnership Act. The partnership would be managed by the Management Partnership which would then be managed by Foreign Company A and Foreign Company B.

- Foreign Company B would provide 99% of the capital necessary to set up the Partnership and Foreign Company B would be entitled to:
  - Distributions from the Partnership during and upon winding up of the Partnership;
  - To share in the proceeds realised on the assets upon liquidation;
  - Have limited liability (to the total amount of its capital contribution of the Partnership);
  - No liability to any other partner in the Partnership;
  - Have voting rights regarding major decisions affecting the Partnership for example, change of investment strategy, borrowings, and major investment decisions and so on.
  - The Partnership agreement quorum is reached when the limited partners represent more than 50% of the total capital of the Foreign Partnership is present.
• In terms of the Partnership Act in the foreign country, the partnership is viewed as a body corporate with a legal personality separate from its partners. This is different to the principles applied in South Africa relating to Partners.

• Based on the ruling, the Partnership was viewed as a ‘foreign company’ as defined in section 9D(1) as in terms of the foreign legislation it is seen to be a body corporate and in terms of South African tax legislation will meet the definition of a company.

• The Foreign Partnership is regarded as a CFC as defined in section 9D as Foreign Company B would indirectly hold 99% of the participation rights in the Foreign Partnership. Foreign Company B is indirectly a wholly owned subsidiary of the Applicant (i.e. a South African resident).

• Any distribution made by the Foreign Partnership to Foreign Company B would constitute a dividend as defined in section 1.

• The exemption contained in section 10(1)(k)(ii)(dd) would apply, as Foreign Company B would hold at least 20% of the equity share capital in the Foreign Partnership (SARS, 2009a:1-3).

The aim of section 9D, is to tax income where a South African resident has control, therefore the term should include all those who have control over the income of the foreign company in determining the rights of the resident shareholders (Olivier & Honiball, 2008:435, 436).

While it is arguably relatively certain as to whether a resident owns participation rights or not, the position is vague as far as the term ‘voting rights’ is concerned as the term is not defined in section 9D or anywhere else in the Income Tax Act.

2.2.2 The meaning of “voting rights”

The term ‘voting rights’, is not defined in the Act, and is relevant in circumstances where no person has any right in the foreign company, or no rights can be determined for any person, when the term ‘participation rights’ has not been met (Olivier & Honiball, 2008:435).
Voting rights is an alternative test to ‘participation rights’ in determining whether a foreign company is a CFC. The Act is clear that when more than 50 per cent of the voting rights in that foreign company are directly or indirectly exercisable by one or more residents, the foreign company will be a CFC (58/1962).

In Shears v Phosphate Co-operative Co of Australia Ltd 1988 14 ACLR 747 SC (Vic) 759 it was held that the Companies (Vic) Code made it clear that only members have the right to vote (i.e. voting rights). This principle held in this case holds true for the Companies Act 61 of 1973 i.e. a company’s constitution cannot extend the right to vote in a general meeting upon a person who is not a member of the company or, indeed, on a member in a capacity other than that of a member. In any event, because a company’s constitution cannot confer any binding rights on third parties or even on a member other than in his capacity as a member any provision purporting to confer a right to vote on such a person would not be enforceable against the company and its members (Blackman et al, 2009). In terms of section 195(2) of the Companies Act, it states that although the articles determine the voting rights each share must carry at least one vote (61/1973).

Therefore it is submitted that should one be unable to determine whether a resident has more than 50% of the participation rights, one should consult the constitution of the foreign company to determine whether any of the shareholders have additional rights in that foreign company. This would have an impact on whether the definition of a CFC is met or not, through its voting rights.

**Example:** Company A owns 40% of the share capital of Company B which is situated in a foreign country, Company A also owns 60% of the voting control of Company B. Therefore Company B will be a CFC as defined.

As section 9D is an anti-avoidance provision aimed at attributing income of a foreign company where a South African resident controls the income brought into the tax net, voting rights therefore arguably refer to any form of control over the distribution of profits or capital exercised by a South African resident (whether as shareholder, director or otherwise) (Olivier & Honiball, 2008:436).

However, as a result of the provisos to the definition of a CFC as per section 9D(1), voting rights are not in all cases available as an alternative to participation rights in
determining the CFC status of a foreign company. In addition, in certain cases, indirect voting rights are deemed to be exercisable directly.

2.2.3 **Provisos to the CFC definition**

Proviso (A) to the definition of a CFC in section 9D(1) determines that no regard must be had to any voting rights in a foreign company which is a listed company whether the interest is held directly or indirectly (De Koker, 2010). This does not mean that a foreign company that is a listed company cannot be a CFC. It merely means that in determining whether a listed foreign company and any foreign companies held by the listed foreign company are CFCs only the participation rights and not the voting rights, must be taken into account.

It is submitted that this proviso also means that paragraph (b) of the definition of participation rights cannot be applied in relation to foreign listed companies and foreign companies held by the foreign listed company. Therefore, in the highly unlikely situation that no person has the right to directly or indirectly participate in the share capital, share premium, profits or reserves of a foreign listed company or no such rights can be determined, the foreign listed company will not be a CFC despite the fact that South African residents may exercise more than 50% of the votes in the foreign company.

Proviso B introduces a special ‘look-through’ rule where a resident (either individually or together with connected persons) can directly or indirectly exercise more than 50% of the voting rights in a foreign company (FCo A), which in turn can directly exercise the voting rights in another foreign company (FCo B). If these conditions are met, the resident is deemed to directly exercise the voting rights in FCoB despite only being able to indirectly exercise those voting rights. This means that the voting rights in FCo B are not diluted by any voting rights held in FCoA by persons other than the resident in question. The effect of this proviso can best be illustrated by way of the following example:
Illustration of Proviso B

Due to Company A and Company B, who are connected persons, being able to exercise 80% (i.e. more than 50%) of the voting rights in Company C (the CFC), based on proviso B, Company A (resident) and Company B (connected person to Company A) would be able to exercise 60% of the voting rights in Company D making Company D a CFC as defined. In the absence of this proviso, Companies A and B collectively would have been able to indirectly exercise 80% of 60%, i.e. 48% of the voting rights in Company D and Company D would not have been a CFC.

Proviso C relates to the situation where a person would be deemed not to be a resident. This would be the case where:

- The resident indirectly holds the participation rights in a listed company or a foreign company through a listed company, which is less than 5% of the participation rights in the listed company; or
- The resident holds the participation rights or voting rights indirectly in a foreign collective investment scheme or foreign company – which is less than 5% of the participation rights or voting rights. This exclusion does not apply if connected persons hold more than 50% of the participation or voting rights of the foreign company or foreign collective investment scheme.

Example: South African residents in aggregate hold 52% of the participation and voting rights in a listed foreign company. One of the residents, Mr A, is not connected to the other South African residents holds 2% or more of the voting rights, Mr A will be deemed not to be a resident. The result is that the foreign company will not qualify as a CFC and the CFC rules would not apply to any of the residents.
2.3 **Country of residence**

The term ‘country of residence’ is defined ‘*in relation to a foreign company, as the country where that company has its place of effective management*’ (58/1962). The term ‘effective management’ is not defined in the Act, however the SARS has issued Interpretation Note 6 to provide guidance.

The place of effective management has different meanings for local and international tax purposes. In terms of Interpretation Note 6 to the Act for South African tax purposes, the meaning encompasses the following:

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

- The place of implementation of the entity’s overall group vision and objectives. (SARS, 2002:1-5)

Where there is a discrepancy between a taxpayer and the SARS regarding the meaning of ‘effective management’ SARS will rely on the contents of this interpretation note in defending its case and is a guide to understanding the legislator’s intention on the matter.

In terms of the Organisation for Economic Co-operation and Development (‘OECD’) commentary on Article 4 of the Model Tax Convention, the place of effective management is the place ‘where key management and commercial decisions which are necessary for the conduct of the enterprise’s business are in substance made’ (OECD, 2008:79). It is submitted that the interpretation by the OECD will not be applicable to the imputation of CFC income as it is not dealt with by the various double taxation agreements and the interpretation by SARS will be applied.

The country of residence is of importance due to the fact that if a foreign company has its place of effective management in South Africa, it will meet the definition of a resident as contained in section 1 to the Act for South African tax purposes.
This is reiterated in the Explanatory Memorandum on the Revenue Laws Amendment Bill 2006, relating to a country of residence where the definition was changed to refer to the place of effective management as opposed to where it is incorporated. It goes further to highlight that with the meaning of the term ‘place of effective management’, South African tax law interpretation prevails (National Treasury, 2006:55).

2.4 **Foreign business establishment**

A foreign business establishment in relation to a controlled foreign company, ‘means—

(a) a fixed place of business located in a country other than the Republic that is used or will continue to be used for the carrying on of the business of that controlled foreign company for a period of not less than one year, where—

(i) that business is conducted through one or more offices, shops, factories, warehouses or other structures;

(ii) that fixed place of business is suitably staffed with on-site managerial and operational employees of that controlled foreign company who conduct the primary operations of that business;

(iii) that fixed place of business is suitably equipped for conducting the primary operations of that business;

(iv) that fixed place of business has suitable facilities for conducting the primary operations of that business; and

(v) that fixed place of business is located outside the Republic solely or mainly for a purpose other than the postponement or reduction of any tax imposed by any sphere of government in the Republic:

Provided that for the purposes of determining whether there is a fixed place of business as contemplated in this definition, a controlled foreign company may take into account the utilisation of structures as contemplated in subparagraph (i), employees as contemplated in subparagraph (ii), equipment as contemplated in
subparagraph (iii), and facilities as contemplated in subparagraph (iv) of any other company—

(aa) if that other company is subject to tax in the country in which the fixed place of business of the controlled foreign company is located by virtue of residence, place of effective management or other criteria of a similar nature;

(bb) if that other company forms part of the same group of companies as the controlled foreign company; and

(cc) to the extent that the structures, employees, equipment and facilities are located in the same country as the fixed place of business of the controlled foreign company;

(b) any place outside the Republic where prospecting or exploration operations for natural resources are carried on, or any place outside the Republic where mining or production operations of natural resources are carried on, where that controlled foreign company carries on those prospecting, exploration, mining or production operations;

(c) a site outside the Republic for the construction or installation of buildings, bridges, roads, pipelines, heavy machinery or other projects of a comparable magnitude which lasts for a period of not less than six months, where that controlled foreign company carries on those construction or installation activities;

(d) agricultural land in any country other than the Republic used for bona fide farming activities directly carried on by that controlled foreign company; or

(e) a vessel, vehicle, rolling stock or aircraft used for purposes of transportation or fishing, or prospecting or exploration for natural resources, or mining or production of natural resources, where that vessel, vehicle, rolling stock or aircraft is used solely outside the Republic for such purposes and is operated directly by that controlled foreign company or by any other company that has the same country of
The income of a CFC which carries on active foreign business does not result in the imputation of income for South African tax purposes. The exception applies if the business is truly active, has some nexus to the country of residence and is used for bona fide non-tax business purposes. The legislation sets out several tests that are used in order to determine these features. Different sets of rules exist for ‘general’ places of business, places of extraction for natural resources, construction sites, farming, and international transport (National Treasury, 2006:53).

A foreign business establishment is defined in section 9D(1) and bears some relationship to the ‘permanent establishment’ definition used in most double taxation treaties and which forms an integral part of section 31 (Clegg, 2010). The term ‘permanent establishment’ as defined in Article 5 of the Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development (‘OECD’) includes, amongst others, ‘a fixed place of business through which the business of an enterprise is wholly or partly carried on’ (OECD, 2003:8). The OECD Commentary states that the term ‘fixed place of business’ distinguishes three pre-conditions:

- There must be a distinct place, such as premises, or in certain instances, machinery or equipment (the ‘place-of-business test’).
- It must be established with a certain degree of permanence (the ‘permanence test’).
- Business must be carried on through the place of business, usually by personnel of the enterprise (the ‘business-activities test’). The place of business is usually the location where the business activity of the foreign company occurs, but the necessity of satisfying all three requirements sometimes leads to different results. For most companies, finding a ‘place of business’ is the least controversial part of the test. Most have a physical location where management activities are conducted, goods are manufactured or sold, or personnel perform daily functions. But even businesses without conventional locations are covered. For example, a place of business may be constituted by a pitch in a market place or a permanently
used area in a customs depot (the storage of dutiable goods) or gaming and vending machines operated and maintained by the company or its agent for its own benefit (OECD, 2008:80-81).

To determine that a place of business is ‘fixed’ is more difficult. While the OECD Model Tax Convention does not require that the enterprise be ‘actually fixed to the soil on which it stands,’ it does mandate that it be situated at a distinct place with a certain measure of permanence (OECD, 2008:81-82). The ‘business-activities test’ requires that commercial activity be carried on and that it be done through some type of connection with the fixed place of business. The connection between the place of business and the business activity of the enterprise does not have to involve human beings or any decision-making activity, as long as an activity is performed there. But there is one condition: the enterprise must carry on a genuine business activity, such as maintenance and actual operation (Clegg, 2010).

Binding private ruling 048 was issued by the SARS relating to the ‘deeming a place of business to be a ‘foreign business establishment’ as envisaged in section 9D (1)’. The ruling deals with the question whether the place of business of a CFC would meet the requirements of subparagraphs (a)(i) and (ii) of the definition of ‘foreign business establishment’ when taking into account the CFC’s use of employees, equipment and facilities of any other CFC having the same country of residence and where that other CFC forms part of the same group of companies (SARS, 2009b:1-3).

It is submitted that the outcome of this ruling provides insight into the intentions of the legislator and the practical application of the definition of foreign business establishment. This is crucial when applying these definitions in practice for any taxpayer.

The transaction per BPR 048 has the following elements which resulted in the SARS deeming Company A to be a ‘foreign business establishment’ as defined in section 9D(1):

- Company A carries on a business as an investment holding company and financing company with its primary operations being conducted in a foreign country.
• Company A does not employ any permanent employees but relies on Company B’s employees.

• Company B has five permanent employees and a number of part time employees. There is a Shared Service Agreement between Company A and B.

• In terms of the Shared Service Agreement Company B’s employees will render the following services to Company A, administration, accounting, company secretarial, finance, foreign exchange, taxation, insurance, employment practices, public relations.

• The powers and authorities of Company B under the Agreement are subject to the overall discretion, supervision, strategy and policies of Company A’s board of directors.

• The board meetings of Company A and Company B are held in Country Z. There is an overlap between the directors of Company A and Company B, who also serve as board members of these respective companies. Company A’s board members also sit on the board of its other subsidiaries in Country Z (Z Group).

• The business premises of Company A and Company B are located in the capital of Country Z, in the building wholly owned by a subsidiary of Company A. Company B has entered into a lease agreement with the said subsidiary. Company A and Company B have occupied these premises since late 2004.

• Company A and Company B share, amongst other things, the following equipment and facilities: IT server, telephone exchange, facsimile machines, network printers, laptops, PCs, scanners, company vehicles, catering equipment, meeting facilities, kitchen reception area, scullery and bathrooms (SARS, 2009b:1-3).

The above factors have assisted in the determination by the SARS that Company A indeed meets the definition of a ‘foreign business establishment’ as defined in section 9D of the Act.

BPR 067 was issued by the SARS and relates to the definition of a ‘foreign business establishment’ dealing more specifically with the sharing of employees, equipment and facilities amongst CFCs which are part of the same group of companies (SARS, 2009c:1-3).

In terms of the binding private rulings the following are the details of the proposed transactions:
A Company acquired an interest of more than 50% in a foreign group of companies.

The foreign holding company and its subsidiaries (other principal CFCs and dependent CFCs) are all incorporated and effectively managed in one foreign country and are tax residents of the foreign country.

The foreign holding company (first principal CFC) is suitably equipped and has a permanent place of business in that foreign country. It also has 13 full time employees (8 on-site managerial employees and 5 on-site operational employees).

One of the subsidiaries of the foreign holding company (second principal CFC) is suitably equipped and has a permanent place of business in that foreign country. It also has 23 full time employees (5 on-site managerial employees and 18 on-site operational employees) and owns an office building and equipment.

Another subsidiary of the foreign holding company (third principal CFC) is suitably equipped and has a permanent place of business in that foreign country. It also has 23 full time employees (on site operational employees) and owns a building.

All employees are employed on a full-time basis by the three principal CFCs. The staff employed by the principal CFCs and made available to the other subsidiaries of the foreign holding company (dependent CFCs) has the necessary skills to carry out the business of the foreign group of companies. Furthermore, the staff used by the dependent CFCs has the necessary skills to perform the work required. In the aggregate, all employees of the foreign group of companies are the equivalent to full-time staff required to conduct the business of the foreign group of companies in that foreign country.

The buildings and equipment of the principal CFCs are shared with the dependent CFCs and the said buildings and equipment are adequate for the CFCs to conduct their business in that foreign country (SARS, 2009c:1-3).

Based on this ruling SARS concluded that the place of business of the respective dependent CFCs is deemed under the provisions of section 9D(10)(a)(i) to fulfill the requirements of paragraph (a)(i) and (ii) of the definition of ‘foreign business establishment’ in section 9D(1) in respect of the foreign tax years ending during the Applicant’s years of assessment ending after 1 January 2007 (SARS, 2009c:1-3)
Olivier and Honiball (2008:448) states that in order for a place of business to qualify as a business establishment under para (a) of the definition, it requires both an ‘economic substance’ and a ‘business purposes’ test before the definition can be met. The ‘economic substance’ requirement ensures that income will not be exempt if the foreign business exists merely on paper and not in substance (i.e. requires substance over form). It is not sufficient to have employees who take management decisions at the foreign business premises, if there are no persons available to take the day-to-day management decisions (operational). In addition, there needs to be full time employees present at the foreign company as independent agents will not qualify (see SIR v Downing 37 SATC 249).

The ‘business purpose’ requirement attempts to ensure that income derived by a CFC that complies with the necessary permanence and economic substance requirements will still not be exempt if the business activities are not conducted for bona fide business purposes, but to obtain a tax benefit. Where a business has been set up in a foreign company purely to obtain a tax benefit, this CFC will not qualify as a foreign business establishment in terms of section 9D (Olivier & Honiball, 2008:449).

In deciding whether the place of business is conducted outside the Republic for bona fide business purposes, the Commissioner does not need to rely on the requirements of the general anti-avoidance section, Part IIA of the Act including s80A to s80L. It is sufficient if, on the facts, the reason for conducting the business outside the borders of South Africa is to avoid, postpone or reduce tax (Olivier & Honiball, 2008:449).

It should be noted that mines, construction sites, farms and certain vessels and aircraft are all deemed to be business establishments without satisfying the additional economic substance and business purpose test, the reason being that by the nature of these activities it is virtually impossible to fabricate them for tax planning purposes. In addition it should also be remembered that where these activities are fabricated, no or little income will be derived which qualifies for the exemption (Olivier & Honiball, 2008:449).

The requirement that the office, shop or factory should be used for a minimum period of one year presupposes some activity and not merely holding rights as owner or
lessee (Olivier & Honiball, 2008:449). In my view, this provides clarity on the meaning of the term ‘fixed’ included in the Act and will enable a taxpayer to fulfill the ‘permanence test’ thus meeting the definition of foreign business establishment.

No minimum time limit is laid down for mining, farming and the operation of certain vessels and aircraft. The reason is that, owing to the relatively unusual nature of each of these types of activities, it is highly unlikely that there will be no permanency, economic substance or business purpose. However, from the wording of paras (b) and (e) it is clear that the CFC should conduct the preliminary/exploring or actual exploration/extraction activities itself and not merely have an interest in such activities. This presupposes that the CFC itself must have a business and that the relevant vessel, aircraft or mine on its own is not the business of the CFC (Olivier & Honiball, 2008:449).

2.5 Foreign company

A foreign company is defined in section 9D(1) and ‘means any association, corporation, company, arrangement or scheme contemplated in paragraph (a), (b), (c), (e) or (f) of the definition of “company” in section 1, which is not a resident’ (58/1962).

National Treasury states that a ‘foreign entity’ means any entity that does not qualify as a South African resident under South African Income Tax Act or as a result of the application of South African Income Tax Treaty. Foreign entities contemplated in section 9D mainly include foreign companies or foreign business organisations of a similar tax nature under foreign law. These foreign entities do not include foreign partnerships (however, refer to BPR 061 contained in paragraph 1.2.1 above) or similar flow-through regimes because income is deemed to have been immediately received by the South African owners of these entities in any event. Foreign entities under section 9D also do not include foreign trusts because foreign trust income is typically subject to immediate tax by its South African donors or beneficiaries under

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4 The Taxation Law Amendment Bill of 2010 has deleted the term ‘foreign company’ with effect from 1 January 2011 and applicable in respect of foreign tax years of controlled foreign companies ending during years of assessment commencing on or after that date.
the principles of section 7 and/or the beneficiaries in terms of section 25B(2A) (National Treasury, 2009b:3).

In terms of paragraphs (a), (b) and (e) of the definition of ‘company’ it encompasses those entities which are incorporated or deemed to be incorporated under South African or foreign law, bodies corporate incorporated under South African law and foreign collective investment schemes (mutual funds and unit trusts). The inclusion of South African incorporated entities makes it clear that a CFC may be a South African incorporated company which is ‘resident’ outside South Africa and, hence, subject to the attribution rules discussed in this paragraph. A trust cannot be a CFC’ (Clegg, 2010).

The definition identifies two issues: firstly, that the foreign entity must be a company as defined for South African tax purposes and, secondly that it must be a non-resident (Olivier & Honiball, 2008:431). The following companies will qualify as foreign companies provided they are not resident:

- Associations, corporations or companies incorporated or deemed to be incorporated in South Africa or a body corporate formed or establish or deemed to be formed or established under South African law (para (a) of the definition of company in section 1 of the Income Tax Act) (58/1962);
- Associations, corporations or companies incorporated under foreign law or a body corporate formed or established under foreign tax (para (b) of the definition of company in section 1 of the Income Tax Act) (58/1962);
- A co-operative as defined in section 1 of the Income Tax Act (58/1962);
- Certain local and offshore collective investment schemes in securities (previously known as unit trusts) (para (e) of the definition of company in s1 of the Income Tax Act) (58/1962) and

Co-operatives and close corporations were only relatively recently included in the definition of foreign company, by section 9 of the Taxation Laws Amendment Act No 8 of 2007 and promulgated on 8 August 2007. The effective date for the inclusion of co-operatives was backdated 1 January 2007, and the effective date for the inclusion of close corporations was 2 November 2007 (Olivier & Honiball, 2008:431). It is important to note that a foreign partnership was held to fall within the definition of a
‘company’ when referring to the requirements of section 9D. This was confirmed in the Binding Private Ruling 061 issued by the SARS.

2.6 **Foreign financial instrument holding company**

A ‘foreign financial instrument holding company’ means ‘a foreign financial instrument holding company as defined in section 41: Provided that in determining whether the prescribed proportion of all the assets of the company and all influenced companies consist of financial instruments, the following assets must be wholly disregarded—

(a) any share in any other company in the same associated group of companies; and

(b) any instrument as defined in section 24J(1) entered into between companies which form part of the same associated group of companies:

Provided further that in making any such determination, paragraph (i) of the proviso to the definition of ‘foreign financial instrument holding company’ in section 41 shall not apply;’ (‘FFIHC’) (58/1962)

Essentially a FFIHC is a foreign company as defined in section 9D, when more than the ‘prescribed proportion’ of all the assets of that company, together with the assets of all ‘influenced companies’ in relation to that foreign company, consist of financial instruments. The term ‘influenced company’ is defined within the definition of an ‘associated group of companies’ in section 41. In simple terms it is one in which at least 20% of the equity shares and voting rights are held by an influencing company. Also defined in section 41 is the term ‘prescribed proportion’. Again, in simple terms the prescribed proportion comprises

- Half of the market value, or
- Two-thirds of the actual cost

of all assets. But when shares are to be disposed of to members of the same group of companies, the prescribed proportion may alternatively be determined at half the
book value of the assets per the most recent set of audited financial statements, or two-thirds of the market value of all the assets (SARS, 2010a:381).

There are a number of exceptions such as the exclusion of certain trade debts and licensed financial institutions such as banks and insurance companies. (SARS, 2010a:379). The following assets are excluded from the determination of a financial instrument:

1. Debts due to the foreign company or influenced company relating to goods sold or services rendered. Where the debt has been included in the income of the foreign company or influenced company or would have been so included were that foreign company or influenced company a resident and it forms an integral part of the company’s business conducted as a going concern.

2. Financial instruments arising from the principal trading activities of the foreign company or influenced company as a bank or financier, insurer or broker which conducts more business in its country of residence or in the country of residence of that influenced company than in any other single country. It must regularly accept deposits or premiums or make loans, issue letters of credit, provide guarantees or effect similar transactions for the account of clients, or receive commissions from clients, who are not connected persons or it must derive more than 50% of its income or gains from principal trading activities with those clients. This exclusion will not apply to a foreign or influenced company which is potentially eligible for preferential tax treatment in its country of residence if the tax treatment is dependent upon it conducting business with non-resident clients or a prerequisite is that more than 50% of its ownership be held by non-residents (proviso (ii) to the definition of a FFIHC contained in section 41).

3. Financial instruments held by any influenced company in relation to it if the influenced company is one envisaged in para (b) of the definition of a ‘domestic financial instrument holding company’, namely, a local bank, authorised user, insurer or collective investment scheme (De Koker, 2010).

In determining whether more than the prescribed proportion of the assets of the company and influenced companies consist of financial instruments, the following assets must be wholly disregarded:
• Shares in any other company in the same associated group of companies
• ‘Instruments’ as defined in section 24J entered into between companies which form part of the same associated group of companies (proviso to FFIHC in section 9D(1))

It is provided that in making the determination, any share of an influenced company in relation to that company must be disregarded (De Koker, 2010).

For purposes other than section 9D, the following financial instruments can be wholly disregarded in terms of proviso (i) of the definition in section 41:

' (aa) any share in any other influenced company in the same associated group of companies;

(bb) any financial instrument which constitutes a loan, advance or debt entered into between—

(A) that company and any influenced company in relation to that company; or

(B) influenced companies in relation to that company;

(cc) any financial instrument with a market value equal to base cost other than a financial instrument contemplated in paragraphs (a), (b) and (c) of this definition; and

(dd) any instrument defined in section 24J with a term of less than 12 months other than a financial instrument contemplated in paragraphs (a), (b) and (c) of this definition’ (58/1962).

It is therefore clear that the definition of a FFIHC for purposes of section 9D is wider. The exclusion of paragraph (aa) of the proviso is not problematic as the section 9D(1) definition provides for a similar exclusion. The section 9D definition also provides for the disregarding of section 24J(1) instruments entered into between CFCs that are part of the same group of companies. Arguably some of the instruments contemplated in paragraphs (bb), (cc) and (dd) of the section 41 definition will fall within the scope of the section 9D(1) proviso. However, certain instruments will not fall within the scope
of this proviso such as for example cash and interest-free loans, which is common in group companies.

It could therefore mean that CFCs that are cash rich or that have made significant interest free loans to other CFCs will constitute foreign financial instrument companies as defined, which may in return result in an imputation of so called passive income or capital gains from the sale of assets that are capable of producing passive income.

2.7 Foreign tax year

A foreign tax year is defined in section 9D(1) and is said to be ‘in relation to a controlled foreign company means the year or period of reporting for foreign income tax purposes, or if that company is not subject to foreign income tax, the annual period of financial reporting by that company’ (58/1962).

It states that where a company does not have to submit a tax return nor has any official annual period to submit financial reporting information to government in terms of its country’s legislation. The foreign tax year is then said to be the annual period of financial reporting to shareholders (De Koker, 2010).

2.8 Local currency

The term ‘local currency’ is not defined in section 9D of the Act; however the term is defined in paragraph 43(7) of the Eighth Schedule of the Act. Local currency is defined as meaning ‘(a) in relation to a permanent establishment of a person, the currency used by that permanent establishment for purposes of financial reporting (other than the currency of any country in the common monetary area); (b) in any other case, the currency of the Republic’ (58/1962).

For an explanation of the meaning of ‘purposes of financial reporting’ refer to the explanation contained under the heading ‘currency used for financial reporting 2.10.2)

3 The Taxation Law Amendment Bill of 2010 has replaced the term ‘currency for financial reporting’ with ‘functional currency’ with effect from 1 January 2011 and applicable in respect of foreign tax years of controlled foreign companies ending during years of assessment commencing on or after that date.
2.9 **Taxation Law Amendment Act, 7 of 2010**

The following changes have been proposed relating to the definitions as contained in section 9D or in the Act, which will directly impact the provisions contained in section 9D.

2.9.1 **Company law reform**

With the enactment of the Companies Act, 2008 (Act no 71 of 2008) certain changes to the Income Tax Act were inevitable as many of the provisions contained in the Act are dependent on the principles and definitions contained in the Companies Act. It is said that the new Companies Act modernises company law in line with both economic and international trends (National Treasury, 2010:37). The changes include:

- The removal of capital maintenance rules for determining dividends in favour of market value solvency and liquidity tests
- Modernisation of reorganisation rules and
- The facilitation of business rescue procedures

The following are the proposed change:

- Dividend definition

  Under the new requirements of the Companies Act the revised rules and distributions are tested to ensure that the dividend being declared does not reduce the assets to below the liabilities (solvency test) and whether the declaration of the dividend will result in a deprivation of the cash holdings of the Company. (National Treasury, 2010:37).

  The new dividend definition will come into effect on 1 January 2011 and treats amounts transferred by a company as being a dividend unless the dividend is declared from contributed tax capital. Contributed tax capital is the amount
contributed to the company in exchange for shares (National Treasury, 2010:37-38).

2.9.2 Head-quarter Company

In terms of the Explanatory Memorandum on the Taxation Laws Amendment Bill 2010, included therein is the definition of a ‘head-quarter company’. The reason for the change is due to South Africa being an ideal location for entities to establish regional holdings by foreign multinationals. In order to meet the ideal location to establish holding companies in South Africa certain tax relief measures have been enacted to eliminate the tax burden relating to the CFC rules, the charge on outgoing dividends and the thin capitalisation rules. The following relief has been provided in order to make South Africa a more attractive location for foreign multinationals to set up their holding companies, namely (National Treasury, 2010:77):

- Foreign subsidiaries of a qualifying holding company will not be treated as CFCs merely because the holding company has significant equity interests in those foreign subsidiaries;

- Dividends declared by a holding company will generally be exempt from secondary tax on companies (or the new Dividends Tax once the new Dividends Tax comes into effect);

- The holding company will not be deemed to violate the thin capitalisation rules merely because of the existence of back-to-back cross-border loans involving the holding company;

- Foreign creditors of the qualifying holding company will be exempt from the pending withholding tax on interest in respect to back-to-back loans

In order to determine whether the relief can be utilised, a company needs to meet the definition now contained in the Income Tax Act where certain criteria have to be met, namely (National Treasury, 2010:78):

- Minimum participation by shareholders: each shareholder of the holding company must hold at least 20% of the equity shares in that holding company. This
requirement must be satisfied throughout the tax year (National Treasury, 2010:78)

- **80-20 tax value**: 80% of the tax value (i.e. cost) of the holding company must represent equity, debt or intellectual property investments in foreign subsidiaries in which the holding company holds at least 20% of the equity shares. Compliance with this requirement will be measured at the end of each tax year. The status of a foreign subsidiary is measured at the end of a tax year without taking into consideration previous tax years (National Treasury, 2010:78).

- **80-20 receipts and accruals**: 80% of the total receipts and accruals of a holding company should be derived from foreign companies in which the holding company has an interest of at least 20%. The receipts received by the holding company can include fees, interest, royalties, dividends and sale proceeds derived from those foreign companies. This again is measured at the end of the tax year (National Treasury, 2010:79).

- **Uninterrupted compliance**: a holding company is assessed regularly to determine whether it is complying with the following:
  
  - Minimum participation shareholding
  - 80-20 tax value

These requirements need to be met in each year of assessment from the date of the company’s inception. This requirement will apply to existing companies who seek to become a holding company as at the effective date of this regime and to new companies established after the effective date. The 80-20 receipts and accruals test is not monitored in determining compliance with this test (National Treasury, 2010:79).

An anti-avoidance mechanism has been added where qualifying holding companies will be deemed to be foreign residents in terms of the reorganisation rollover rules (i.e. eliminating any benefit of the roll over relief) (National Treasury, 2010:79).

The explanatory memorandum goes further to provide an explanation on the following:
2.9.2.1 CFC’s impact on foreign subsidiaries of a qualifying holding company

In order to determine whether a foreign company will qualify as a CFC in relation to a holding company, the proposal is that the qualifying holding company is deemed to be a foreign resident. Therefore, a foreign subsidiary will not automatically be a CFC where there is a direct ownership from the qualifying holding company. However, it may be a CFC when one takes into account the indirect ownership in the foreign subsidiary (National Treasury, 2010:78).

Example:

Company A (non SA resident) holds 70% in a qualifying holding company situated in South Africa. The remaining 30% is held by Company B a resident of South Africa. The qualifying holding company has 100% interest in a foreign subsidiary.

As the qualifying holding company is deemed to be a foreign resident, based on the direct ownership, the foreign subsidiary is not a CFC, however, one needs to look to the shareholders of the qualifying holding company in order to ensure that there is no indirect interest in the foreign subsidiary. In this case Company B only has a 30% indirect interest in the foreign subsidiary.

It is submitted that Company A is a South African resident and Company B is a non resident. In this case, the foreign subsidiary will be a CFC as defined, as Company A has a 70% indirect interest in the foreign subsidiary which is more than 50%.
2.9.2.2 Taxation of dividends distributed by qualifying holding company

Where dividends are distributed by a qualifying holding company to its shareholders, it will be seen to be a foreign resident, i.e. this means that where the qualifying holding companies distributing dividends will not be subject to STC. This will also be the case when the new Dividends Tax is introduced. Further to the above, the dividend distributed may qualify for the participation exemption (National Treasury, 2010:80).

2.9.2.3 Transfer pricing in respect of qualifying holding company loans

In terms of this amendment, a qualifying holding company will not need to take into consideration any foreign loans obtained where:

- The loan proceeds are on-loaned to foreign companies and
- The equity shares of those foreign companies are at least 20% held by the qualifying holding company.

However, there is an anti-avoidance mechanism that has been put in place in relation to these loans relating to the interest deductions. These are ring fenced against the interest earned on the proceeds on-lent to the 20% or more foreign companies. Where there are any unused losses from the excess interest incurred these are deemed to be incurred in the following year (National Treasury, 2010:80).

2.10 Terms referred to in section 9D but not defined in the Act

The following terms are not specifically defined in section 9D nor in the Income Tax Act itself. However, in order to understand these terms further, a brief understanding is required. Where a term is not specifically defined in the Act, one should refer to its normal dictionary meaning of the word or to guidance which has been issued (either by SARS or by principles laid down in court cases).
2.10.1 **Comparable prices (s9D(9)(b)(ii)(aa)(C))**

The meaning of ‘comparable’ in the Little Oxford English Dictionary is ‘similar to someone or something else and able to be compared’. ‘The meaning of compare is to estimate or measure the ways in which one person or thing is similar to or unlike another’ (LOED, 2006:130).

In terms of Practice Note 7 to the Income Tax Act relating to the Determination of the Taxable Income of Certain Persons from International Transactions: Transfer Pricing, paragraph 8 refers to the Principles of Comparability. In terms of this paragraph comparability is fundamental to the application of the arm’s length principle. The preferred arm’s length methods are based on the concept of comparing the prices/margins achieved by connected persons in their dealings to those achieved by independent entities for the same or similar dealings. In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be highly comparable (Lexis Nexis, 2009:1472). To be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the method (e.g. price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences. If suitable adjustments cannot be made, then the dealings cannot be considered comparable (Lexis Nexis, 2009: 1472).

2.10.2 **Currency used for financial reporting**

In terms of IAS 21 – The effects of changes in foreign exchange rates, paragraph 8 defines the following terms:

- Functional currency – is the currency of the primary economic environment in which the entity operates
- Presentation currency – is the currency in which the financial statements are presented (IFRS, 2011:A654).

The meaning of the expression ‘currency used for the purposes of financial reporting’ is obscure. If the intention of the legislature is to indicate a reference to the legally required presentation currency in the relevant country for financial reporting
purposes, this is not evident. It would appear that the relevant currency should be determined having regard to the currency actually used by the company for reporting purposes, which is the basis for the preparation of the accounts of the CFC, as opposed to the currency required for statutory compliance purposes within the foreign country (De Koker, 2010).

It would appear then that the legislature intended the expression ‘currency used for purposes of financial reporting’ as a reference to functional currency rather than presentation currency of the CFC. Support for this submission lies in the fact that a CFC can have different presentation currencies, but only one functional currency (De Koker, 2010).

In terms of IAS 21 – The effects of changes in foreign exchange rates describes further how an entity would determine its functional currency. Paragraph 9 ‘the primary economic environment in which an entity operates is normally the one in which it primarily generates and expends cash. An entity considers the following factors in determining its functional currency:

(a) the currency

   (i) that mainly influences sales prices for goods and services (this will often be the currency in which sales prices for its goods and services are denominated and settled); and

   (ii) of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services.

(b) the currency that mainly influences labour, material and other costs of providing goods or services (this will often be the currency in which such costs are denominated and settled)’ (IFRS, 2011:A654).

Paragraph 10 of IAS 21 goes further to describe additional factors that will provide evidence on the functional currency, namely:

(a) the currency in which funds from financing activities (i.e. issuing debt and equity instruments) are generated.

(b) The currency in which receipts from operating activities are usually retained (IFRS, 2011:A655).
Paragraph 11 lists the following additional factors which should be considered in determining the functional currency of a foreign operation, and whether its functional currency is the same as that of the reporting entity, namely:

(a) ‘whether the activities of the foreign operations are carried out as an extension of the reporting entity, rather than being carried out with a significant degree of autonomy. An example of the former is when the foreign operation only sells goods imported from the reporting entity and remits the proceeds to it. An example of the latter is when the operation accumulates cash and other monetary items, incurs expenses, generates income and arranges borrowings, all substantially in its local currency.

(b) Whether transactions with the reporting entity are a high or a low proportion of the foreign operation’s activities.

(c) Whether cash flows from the activities of the foreign operations directly affect the cash flows of the reporting entity and are readily available for remittance to it.

(d) Whether cash flows from the activities of the foreign operation are sufficient to service existing and normally expected debt obligation without funds being made available by the reporting entity’ (IFRS, 2011:A655).

In terms of the Explanatory Memorandum of the Taxation Laws Amendment Bill of 2010, clarity is provided relating to companies with multiple reporting currencies, in particular relating to currency for financial reporting. Currently the Act does not cater for the following situations:

- Report in various currencies for various purposes
- Report in one currency with significant part of the underlying economic activities being conducted in another foreign currency (National Treasury, 2010:87).

Taxpayers are now afforded flexibility allowing taxpayers to use their functional currencies as the base currency for translating foreign currency for tax purposes. The meaning of functional currency is said to be determined with reference to the currency of the primary economic environment in which the business operations are conducted (National Treasury, 2010:87).
The term ‘functional currency’ described in the Explanatory Memorandum on the Revenue Laws Amendment Bill for 2010 is therefore similar to that used for accounting purposes in terms of IAS21, as described above. In the Explanatory Memorandum on the Taxation Laws Amendment Bill of 2010, the tax functional currency used by the entity should be effective for a full tax year. The ‘significance’ of activities can be based on the relationship of activities throughout the year or on the basis that a particular currency is the most significant throughout most of the year (National Treasury, 2010:87).

The Explanatory Memorandum goes further that the headquarter company regime being enacted, can determine its taxable income with reference to its functional currency as opposed to the Rand. The dollar based headquarter companies can rely on the dollar as their base currency for tax purposes. The taxable income must then be translated into Rands using the average exchange rate for the year of assessment (National Treasury, 2010:87).

2.10.3 Passive income (Dividends, interest, royalties, rentals, insurance, annuities and income of a similar nature)

In the now repealed section 9E, the term passive income was defined as ‘gross income derived from financial instruments’ (National Treasury. 2008:39). Therefore passive income encompasses, in general terms, all income that is not generated by an economic activity exercised by the recipient. Such definition formulated usually includes interest, dividends, royalties and gains. In any case, the definition of passive income excludes financial income derived by banking, insurance or financial businesses; to the extent it represents the income from the characteristic activity (Maisto and Parolini, 2010:27).

2.11 Conclusion

The aim of the discussion above was to provide insight into the meaning of a number of significant terms used in section 9D and the manner in which to apply them in practice including all the terms that are vital in determining whether a foreign company will be a CFC and when it will not.
In practice, once it has been determined that a foreign company meets the definition of a CFC, residents owning participation rights in these CFC’s will need to determine whether any amounts will be imputed or not. While the proviso to section 9D(2A) may deem the net income to be Rnil if the CFC was subject to sufficient tax in spheres other than South Africa, the application of this proviso requires one to do a detailed South African tax computation for each CFC in which participation rights are held and this is suggested in the IT10 form as well. However, in practice, it is often easier to consider whether the amounts of income earned by a CFC does not qualify for specific exemption as provided for in section 9D(9).

This next chapter follows this reasoning and will therefore consider these exemptions.
3.1 Introduction to section 9D(9)

Section 9D(9) provides for certain exemptions to the imputation of the net income of a CFC into the resident shareholder’s net income. The primary exemptions are aimed at providing relief for taxpayers where bona fide business or commercial activities are taking place in foreign companies controlled by residents (foreign business establishment exemption) or where income has already been included in the South African income tax net due to the true or deemed source rules (refer section 9 of the Act).

Where a resident shareholder can prove (the onus is on the taxpayer in terms of section 82 of the Act) that any of the exemptions apply, the income earned on these transactions will not be included in the determination of net income and attributed to the resident shareholder’s taxable income.

The purpose of this chapter is to review the various exemptions available to resident shareholders who hold more than 50% of the participation rights or voting rights in a foreign company:

3.2 Summary of exemptions – the provisions of section 9D will not apply

<table>
<thead>
<tr>
<th>S9D(9)(b) – amounts attributable to any foreign business establishment of the controlled foreign company</th>
<th>Provided that this exemption will not apply</th>
</tr>
</thead>
<tbody>
<tr>
<td>(i) where transactions are not in line with section 31 of the Act (i.e. thin capitalisation or financial assistance);</td>
<td></td>
</tr>
<tr>
<td>(ii) where certain transactions fall into any of the so-called diversionary rules;</td>
<td></td>
</tr>
<tr>
<td>S9D(9)(c) – policyholder</td>
<td>Attributable to any policyholder who is not a resident or a CFC in relation to a resident in respect of any</td>
</tr>
<tr>
<td>--------------------------</td>
<td>--------------------------------------------------------------------------------------------------</td>
</tr>
</tbody>
</table>

(aa) Sale of goods by a CFC to a connected resident;
(bb) sale of goods by a CFC to an unconnected resident but where the CFC purchased the goods from a connected resident
(cc) Service performed by a CFC to a connected resident;
(dd) granting by that CFC the right of use or permission to use an intangible asset to a connected resident.

(iii) To any amounts in the form of dividends, interest, royalties, rental, annuities, insurance premiums or similar income or any capital gain or foreign currency gain, unless

(aa) to the extent that the income and capital gains attributable to those amounts do not in total exceed 10%
(b) arise from the principal trading activities of any banking, financial services, insurance or rental business taking into account exclusions contained in A, B and C
(cc) where the amounts arise from the disposal or deemed disposal of any intangible assets
(dd) in the case of royalties received by or accrued to the CFC, if the company directly and regularly creates, develops or substantially upgrades any intellectual property.
<table>
<thead>
<tr>
<th>Exemption</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>S9D(9)(e) – South African source</td>
<td>Any amounts included in the taxable income of the company and has not been or will not be exempt at a reduced rate in the Republic as a result of the application of any agreement for the avoidance of double taxation.</td>
</tr>
<tr>
<td>S9D(9)(f) – foreign dividends</td>
<td>Attributable to any foreign dividend declared to the CFC by any other CFC in relation to the resident, and the foreign dividend does not exceed the aggregate of all amounts which have or will be included in the income of the resident in terms of section 9D in any year of assessment.</td>
</tr>
<tr>
<td>S9D(9)(fA) – Interest, royalties, rental, exchange differences</td>
<td>Is attributable to any interest, royalties, rent or similar income, exchange differences in terms of section 24I or in terms of any forward exchange contract or reduction or discharge of any other CFC of a debt owed by that company to any other CFC for no consideration where both CFCs form part of the same group of companies.</td>
</tr>
<tr>
<td>S9D(9)(fB) – disposal of asset in terms of Eighth Schedule</td>
<td>Is attributable to the disposal of any asset, where the asset was attributable to any foreign business establishment of any other CFC, where the company and that other CFC form part of the same group of companies. (58/1962)</td>
</tr>
</tbody>
</table>

Each exemption will now be discussed in detail including illustrative examples to demonstrate the practical application of the exemptions contained in 9D:
3.3 Foreign business establishment exemption

The foreign business establishment exemption is one of the most significant exemptions contained in section 9D(9) (National Treasury, 2009b:7). Section 9D(9)(b) provides that any income attributable to a foreign business establishment is exempt including any capital gain on the disposal or deemed disposal of any assets of the foreign business establishment in terms of the Eighth Schedule. However, the exemption contained in this section excludes income resulting from certain transactions, referred to as diversionary rules (National Treasury, 2006:55).

Where diversionary type transactions are being concluded by a CFC which meets the definition of a foreign business establishment, the income earned on these transactions will no longer be exempt and will be included in the net income of the resident shareholder. There are two types of transactions falling within the scope of the diversionary rules, i.e. those not in compliance with section 31 (transfer pricing) and secondly, those transactions which do comply with section 31, but are nevertheless capable of manipulation (Olivier & Honiball, 2008:449). These diversionary rules will now be discussed in more detail:

3.3.1 Transfer pricing

Section 9D(9)(b)(i) excludes from the foreign business establishment exemption (my emphasis) ‘(i) any amounts derived from any transaction relating to the supply of goods or services by or to that controlled foreign company with any connected person (in relation to that controlled foreign company), who is a resident unless the consideration in respect of that transaction reflects an arm’s length price that is consistent with the provisions of section 31’ (58/1962).

Section 31 of the Act includes anti-avoidance provisions relating to international transactions involving transfer pricing and thin capitalisation. The transfer pricing provisions give the Commissioner the authority to adjust any artificial prices (i.e. not at arm’s length) to that price which the Commissioner believes is a better reflection of
an arm’s length price. Section 31(3)\(^6\) relates to thin capitalisation which will occur where financing is obtained by a resident company from a foreign connected person and it results in a disproportionate debt to equity ratio (Stiglingh et al, 2010:583). Guidance as to the meaning of an arm’s length consideration as contemplated in section 31 is provided in Practice Note 7 to the Act, which provides an understanding as to the determination of a price which will be considered to be at arm’s length by SARS (Lexis Nexis, 2009:1472). In summary, Practice Note 7 states that the ‘arm’s length principle’ means that a transaction should have the financial characteristics of a transaction which would have been concluded between independent parties, where each party will aim to achieve the best possible benefit from the transaction. No individual entity will benefit from the transaction and it makes commercial sense (Lexis Nexis, 2009:1472).

### 3.3.2 Diversionary rules

The following types of transactions concluded between a CFC and connected persons who are residents of South Africa for tax purposes are also excluded from benefiting from the foreign business establishment exemption, despite the fact that the transactions might comply with the ‘arm’s length principle’ as contemplated in section 31. The diversionary rules relate to the following types of transactions, namely:

1. Sale of goods by the CFC to a South African resident who is a connected person, (s9D(9)(b)(ii)(aa));
2. Sale of goods by a CFC which were bought from SA resident who is a connected person, and sold to persons other than connected South African residents, (s9D(9)(b)(ii)(bb)); and
3. Services performed by the CFC to South African resident connected persons (s9D(9)(b)(cc)) (58/1962).

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\(^6\) With effect from years of assessment beginning on and after 1 October 2011, section 31 has been amended by inter alia removing the so called thin capitalisation provisions.
3.3.2.1 CFC sales to connected SA residents (i.e. sale of goods by the CFC to a South African resident connected persons)

The foreign business establishment exemption does not apply where the CFC sells goods to a SA resident who is a connected person unless any of the four following situations occur:

1. ‘(A) that controlled foreign company purchased those goods within the country of residence of that controlled foreign company from any person who is not a connected person in relation to that controlled foreign company’ (58/1962).

In the above, the CFC would need to purchase the goods in the same country in which it resides (i.e. country of residence) from unconnected persons. In order to determine the ‘country of residence’ of a person, one should refer to the definition contained in section 9D (refer to Chapter 2). If the CFC then sells those goods to a connected person who is a resident, the foreign business establishment exemption will still apply. There might be a commercial reason for setting up a company outside of South Africa besides obtaining a tax benefit, in this scenario; it might make sense for the CFC to then sell the products it manufactures in the foreign country to its resident shareholder. Where SARS is satisfied that there is not only a tax benefit from setting up a company outside South Africa the foreign business establishment exemption would still apply.

Diagrammatic illustration:

<table>
<thead>
<tr>
<th>Unconnected person (UK)</th>
<th>→</th>
<th>CFC (UK)</th>
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<tr>
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<tr>
<td>Unconnected person</td>
<td>→</td>
<td>CFC (UK) then sells to a</td>
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<tr>
<td>sells goods or services</td>
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<td>SA connected resident</td>
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<tr>
<td></td>
<td></td>
<td>SA Resident who is connected to CFC (UK)</td>
</tr>
</tbody>
</table>
**Example 1:** Company A, resident in South Africa, owns 100% of the shares in Company B, a company resident in the UK. Company B purchases radios from an unconnected person which has its operations based in the UK. Company B resells the radios at a profit to Company A (connected person). The income of Company B will **not be** imputed into the taxable income of Company A as the exemption in terms of section 9D(9)(b)(ii)(aa)(A) will apply, provided that the consideration paid by Company A for the radios constitutes an arm’s length consideration.

**Example 2:** Company A, a resident in South Africa, owns 100% of Company B which is situated in the United Kingdom. Company B purchases radios from Company C (a company resident in the United Kingdom which meets the definition of a connected person). The radios are then sold to Company A in South Africa at a market related price. The net income of Company B will be imputed into the taxable income of Company A as the exemption contained in section 9D(9)(b)(ii)(aa)(A) does not apply, as Company B is purchasing its stock from a **connected person Company C** even though Company C is a **non resident**.

In order for the foreign business establishment exemption to apply the CFC should purchase its stock from an unconnected person resident in the same country as the CFC.

2 ‘(B) the creation, extraction, production, assembly, repair or improvement of goods undertaken by that controlled foreign company amount to **more than minor** assembly or adjustment, packaging, repackaging and labelling; or’(58/1962)

The CFC will be a foreign business establishment where the activities being performed by the CFC before the goods are sold to a South African resident if the product is a result of a process of creation, extraction, production, assembly, repair or an improvement and that which the CFC performs on the products before the sale is considered to be ‘more than minor’. The term ‘more than minor’ needs to be explained in order to apply the exemption above. The meaning of ‘more than’ in terms of the Little Oxford Dictionary is ‘very’ (LOED, 2006:447) and ‘minor’ means
‘not important or serious’ (LOED, 2006:438). It is submitted that in order for the activities to result in a CFC being a foreign business establishment, the activities should result in changing the product quite significantly before being sold to a South African resident hence referring back to the fact that there needs to be a form of creating, extracting, and producing.

*Diagrammatic illustration:*

CFC (USA) purchases Product X

Individual units (different to unit purchased as they are put through a process)

To create a new, different, better Product which is then sold to the SA connected resident

Sold to SA resident

*Example:* where the CFC purchases wine from an unconnected person, places labels on the wine bottles with the name of the South African resident and places the wine in cases and exports them, this is a minor activity as it does not result in something new (significant change) being created, extracted, produced or assembled and therefore the foreign business establishment exemption will not apply.

*Example: Company* A owns all the shares in Company X, a company resident in a foreign country Y. Company X assembles machinery in a labour intensive factory located in Y. The assembly requires that various parts are screwed or welded together and the machines are then painted after which the machines are sold to Company A the South African Company for R2000 per machine. The parts required to assemble the machinery were acquired from various distributors located outside Y at a cost of R800 per unit. Each machine has numerous parts which have to be assembled. The physical factory overhead, equipment and
labour costs to produce the machinery amount to R300 per machine. The management, accounting and administrative fees amount to R80 per machine. As the activities of the CFC amount to more than minor assembly or adjustment, the income derived from the sales will be exempt in terms of the foreign business establishment exemption.

3 ‘(C) that controlled foreign company sells a significant quantity of goods of the same or a similar nature to persons who are not connected persons in relation to that controlled foreign company, at comparable prices (after accounting for the level of the market, volume discounts and costs of delivery).’(58/1962)

Where a CFC sells a significant portion of its stock on hand to unconnected persons at prices which reflect an arm’s length price (i.e. comparable prices) the foreign business establishment exemption will apply. In order to apply this exemption the following terms require clarification, namely, the term ‘significant’ and ‘comparable prices’.

The term ‘significant’ is not defined in the Act. The Little Oxford English Dictionary (2006:647) states the word means ‘important, large enough, to have an effect or be noticed’. As the term is before the word quantity this would indicate that the sales made to unconnected persons in terms of volume or quantity must be large in comparison to the sales made to connected persons.

The term ‘same’ per the Little Oxford English Dictionary (2006:613) means ‘exactly alike’, ‘identical people or things’ and ‘similar’ means ‘like something but not exactly the same’(LOED, 2006:648). From the above it can be seen that the goods being sold should be exactly alike or can differ slightly but possibly form part of the same type of industry or objective of the company. For example: A CFC that sells car batteries and car tyres can be said to sell goods of the same or similar nature however, if the CFC sells canned food and car batteries these goods would not be of a similar nature.

The term ‘comparable prices’ would indicate a price that is considered to be ‘at arm’s length’. Refer to chapter 2 where a discussion on the meaning and
determination of comparable prices in relation to Practice Note 7 is discussed. This gives a taxpayer an indication as to the legislator’s intention regarding how one is expected to determine a ‘comparable price’. Under the comparable uncontrolled price method (‘CUP’) method it states that the basic understanding is that it results in a direct comparison between the price charged for a specific product in a controlled transaction and the price charged for a closely comparable product in an uncontrolled transaction. Where a difference between the two prices arises this will provide evidence or give an indication that the existence of a non arm’s length condition might be present and that the price in the controlled transaction might need to be substituted for the price in the uncontrolled transaction (Lexis Nexis, 2009:1476-1477).

Diagrammatic illustration:

<table>
<thead>
<tr>
<th>Company (USA)</th>
<th>CFC (UK)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchases stock from unconnected person</td>
<td>80% Sales at R10</td>
</tr>
<tr>
<td>In another country (i.e. CFC (UK) purchases From Company in the USA)</td>
<td>20% Sales at R10</td>
</tr>
<tr>
<td></td>
<td>Unconnected third parties (in any country of residence)</td>
</tr>
<tr>
<td></td>
<td>SA resident</td>
</tr>
</tbody>
</table>

Example: Company A owns all the shares in Company X, a company resident in country Y. Company X does not engage in any production activities, but maintains a purchasing and sales office and a warehouse in Y which qualifies as a business establishment. Company X purchases desks from an unrelated distributor, a company with its full physical location in D. Company X sells 30 000 of these desks to various retailers located within Y at R4500 and 20 000 desks to Company A at R5000 each (the price difference is entirely due to higher
transportation and delivery costs). Although Company X is not engaged in local purchases (since none of the goods were ever located within Y) or any production activities, the income derived from the sale to Company A is still exempt on the basis that Company X sells a significant number of desks to unconnected persons at comparable prices after taking into account differences in the cost of delivery.

‘(D) that controlled foreign company purchases the same or similar goods mainly within the country of residence of that controlled foreign company from persons who are not connected persons in relation to that controlled foreign company.’ (58/1962)

The term ‘mainly’ is not defined in the Act, and therefore one can turn to case law in order to assist in understanding the meaning thereof, in SBI v Lourens Erasmus (Edms) Bpk 1966 (4) SA 434 (A) 28 SATC 233, the terms ‘solely or mainly’ were reviewed extensively. The conclusion was that the term ‘mainly’ established a purely quantitative measure of ‘more than 50%’. In CIR v King 1947 (2) SA 196 (A) 14 SATC 184, the word ‘mainly’ for the purposes of tax avoidance was said to convey the idea of dominance. Therefore foreign business establishment exemption would apply where the CFC purchases more than 50% of its goods within its country of residence from unconnected persons.

In terms of the Explanatory Memorandum on the Revenue Laws Amendment Bill issued by National Treasury (2003:43) the introduction of the two additional situations (C) and (D) was to narrow the diversionary transactions. The two situations introduced were;

1. Purchases the same or similar goods mainly within the country of residence
2. Mostly sells to local customers but sells lesser amounts to customers from nearby countries.

However, it is submitted that paragraph (A) and (D) are similar in nature, the one referring to ‘those goods’ and the other to ‘same or similar goods’. The implication here is that (D) seems to have a much wider interpretation than that provided for in (A). The question arises as to whether (A) is superfluous since the introduction of (D) which provides exemption to a much wider range of transactions and is arguably easier to apply in practice.
**Diagrammatic illustration:**

Any Company (situated in any Country)  

- Sells products to CFC (40%)  
  
  Sells products to CFC (60%)  
  
  CFC (UK)  
  
  Sells to connected SA resident  
  
  SA resident

**Example:** Company C, resident of the UK is a controlled foreign company of Company A. Company C sells fridges to Company A, which is a resident in South Africa. Company C purchases 90% of its stock from a supplier which is resident in the UK. Therefore there will be no imputation of the consideration from this transaction into the taxable income of Company A.

**3.3.2.2  CFC purchases goods from SA resident who is a connected person**

Where a CFC sells good to an unconnected person but initially purchased the goods from a connected person who is a resident, the foreign business establishment exemption does not apply unless any one of the following four scenarios apply.

1. ‘(A) those goods or tangible intermediary inputs thereof purchased from connected persons (in relation to such controlled foreign company) who are residents amount to an insignificant portion of the total goods or tangible intermediary inputs of those goods’ (58/1962)

   The foreign business establishment exemption will still apply provided the goods purchased are from connected persons who are residents but amount to an insignificant portion of all goods and these are then on sold to unconnected persons.
Diagrammatic illustration

Connected SA Resident  Unconnected Persons (any country)
Sells 5% of goods Sells 95% of goods

CFC (UK)

Unconnected third person (any country)

2 ‘(B) the creation, extraction, production, assembly, repair or improvement of goods undertaken by that controlled foreign company amount to more than minor assembly or adjustment, packaging, repackaging and labelling’ (58/1962)

This requirement is similar to that referred to above relating to sales made to South African connected persons. In that the product being purchased needs to be changed through creation, extraction, production and assembly in order to obtain the exemption and not merely by a minor (insignificant) change to the product being sold.

Example: Company A, a resident in South Africa, owns 100% of the shares in Company B, a company resident in the UK. Company B assembles machinery from various component parts purchased from a number of suppliers. Each machine is custom made based on the specifications of customers and takes up to 2 months to build. Company B purchases one component part from Company A at a market related price. Once the machinery is assembled these are on sold to unconnected persons in the UK.

Due to the fact that Company B assembles the machinery which takes a considerable amount of time and is customer specific, the foreign business establishment exemption will still apply as only a component part of the entire machine is purchased from Company A.
3 ‘(C) the products are sold by that controlled foreign company to a person who is not a connected person in relation to that controlled foreign company, for physical delivery to a customer’s premises situated within the country of residence of that controlled foreign company’ (58/1962)

The foreign business establishment exemption will still apply where goods are sold by the CFC to an unconnected person where physical delivery is expected within the country of residence of that CFC.

The term ‘delivery’ is said to have a more physical focus (i.e. this means that the CFC cannot deliver the goods hypothetically but that goods must be delivered to a physical address of the recipient in the same country of residence as the CFC). Physical delivery need not be undertaken directly by the CFC but could be by a customer or other parties. The CFC’s operations have to have an appropriate nexus to the physical business needs of genuine local customers (National Treasury, 2006:56).

**Example:** Company B, a CFC incorporated in the UK, purchases goods from Company A (SA Resident connected person). Company B sells the goods to an unconnected person situated in the UK. In terms of the sales agreement with its customers, Company B is required to deliver the goods to the physical address of the customer to assist in the installation of the product. From the above, because Company B has to deliver the product to the customer’s premises located in its country of residence, the foreign business establishment exemption still applies.

4 ‘(D) products of the same or similar nature are sold by that controlled foreign company mainly to persons who are not connected persons in relation to that controlled foreign company for physical delivery to customer’s premises situated within the country of residence of that controlled foreign company’ (58/1962)

This exemption is similar to that described above relating to sales made to South African residents that are connected persons. Refer above for commentary.
Diagrammatic illustration:

```
Connected SA resident
   ↓
CFC (UK)
   ↓
Connected SA residents Unconnected persons (UK)
(20%) For delivery in the UK (80%)
```

3.3.2.3  **CFC South African connected services**

Where any services are performed by a CFC to a connected person who is a resident, the foreign business establishment exemption will not apply. However where the services are performed outside the Republic and any four of the following scenarios occur, the foreign business establishment exemption will still apply.

1  ‘(A) such service relates directly to the creation, extraction, production, assembly, repair or improvement of goods utilised within one or more countries outside the Republic’ (58/1962)

The term ‘directly’ was used in SIR v Consolidated Citrus Estates Ltd (1998) 4 All SA 269 (A), 60 SATC 449 where the court was called upon to consider the requirements of ‘directness’ in the now repealed section 11bis(4)(f) of the Income Tax Act.

Galgut JA said:

‘The section is concerned to aid the taxpayer who has incurred market development expenditure. If expenditure has not been incurred by a taxpayer, he will not normally be given the benefit of a deduction for such expenditure or
part thereof. It would thus seem that ‘directly’ refers to and qualifies the act of incurring the expenditure. Obviously the expenditure must have been incurred by the taxpayer, i.e. he must have incurred the liability or made the payment. “Directly” appears to have been deliberately added in order to serve some purpose that the Legislature had in mind. The purpose, I think, was to postulate that the connection between the taxpayer’s incurring the expenditure and the object for which it was incurred . . . should be direct, i.e. straight and close, not devious and remote (cf The Concise Oxford English Dictionary vs. “direct”)’ (De Koker, 2010).

**Diagrammatic illustration:**

```
CFC (UK)
Performs services in the UK for the connected SA resident
The services result in the creation, extraction
Production, assembly etc

Connected SA resident

Utilisation of those goods within one or more countries outside the Republic
```

2 ‘(B) such service relates directly to the sale or marketing of goods of a connected person (in relation to that controlled foreign company) who is a resident and those goods are sold to persons who are not connected persons in relation to that controlled foreign company for physical delivery to customers’ premises situated within the country of residence of that controlled foreign company’ (58/1962)

For an explanation on the term ‘physical delivery’ refer to the commentary included above regarding sales by a CFC to South African residents who are connected persons.
For (A) and (B) above it is clear that income derived from services of a general nature, such as management fees, internal accounting fees and fees to guarantee loans never qualify for exemption. The legislator is of the view that the possibility of manipulating prices is high and no business reason other than tax exists for these services to be rendered outside South Africa (Olivier & Honiball, 2008:454).

Diagrammatic illustration:

<table>
<thead>
<tr>
<th>CFC (UK)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market and sale services of connected Persons goods</td>
</tr>
<tr>
<td>Connected SA resident</td>
</tr>
<tr>
<td>Sold and physically delivered</td>
</tr>
<tr>
<td>Unconnected person (UK)</td>
</tr>
</tbody>
</table>

3 ‘(C) such service is rendered mainly in the country of residence of the controlled foreign company for the benefit of customers that have premises situated in that country’ (58/1962)

The Explanatory Memorandum on the Revenue Laws Amendment Bill issued by National Treasury (2006:56), the proposed changes to this section of the Act, where the change was made to ensure that no tax be levied on services rendered to legitimate clients in the same country of residence as the CFC.

Included in this requirement is the term ‘mainly’ which as discussed previously indicates more than 50%. Therefore in order for this exemption to apply, the majority of the CFC’s total services need to be performed for customers situated in its country of residence.
**Example:** Company A (CFC situated in Dubai) assists customers with IT related services in Dubai, however, Company B (a SA resident who is a connected person) requires IT assistance on an ad hoc basis during the year. Company A performs these services on behalf of Company B. During the 2009 year of assessment, Company A provided services to Company B which resulted in a 60% of its time being spent providing services solely to Company A. During the 2010 year of assessment, Company A only spent 20% of its time providing services to Company B.

Therefore in 2009, the foreign business establishment exemption will not apply as more than 50% of its services were rendered to a connected resident whereas in 2010, the foreign business establishment exemption will apply as less than 50% of its services were rendered to a connected resident.

4 ‘(D) to the extent, no deduction is allowed of any amount paid by that connected person to that controlled foreign company in respect of that service’ (58/1962)

CFC services will no longer be subject to diversionary treatment if they do not give rise to South African deductions by a South African party holding a participation interest in that CFC. No potential for avoidance exists without a corresponding South African deduction which directly erodes the tax base.

The reason for this exemption from attribution is that no potential for avoidance exists without a corresponding deduction in South Africa which directly erodes the tax base (Olivier & Honiball, 2008:455).

**Example,** assume a South African company makes payment to fund R&D performed by its CFC outside the Republic, and this payment is not allowable as a deduction. In this instance, the South African company is ineligible for deductions so no need exists to trigger CFC income (i.e. the denial of deductions can be matched against by the non-inclusion of income) (National Treasury, 2006:56).
3.3.2.4 **Intangible asset**

Where the controlled foreign company receives any amount for the granting of the right to use or permission to use an intangible asset to a connected person who is a resident, the foreign business establishment exemption will not apply.

An intangible asset is defined in paragraph 16 to the Eighth Schedule to the Act and is said to ‘mean –

(a) goodwill;

(b) any patent as defined in the Patents Act, 1978 (Act No. 57 of 1978), or any design as defined in the Designs Act, 1993 (Act No. 195 of 1993), or any trade mark as defined in the Trade Marks Act, 1993 (Act No. 194 of 1993), or any copyright as defined in the Copyright Act, 1978 (Act No. 98 of 1978), any rights recognised under the Plant Breeders’ Rights Act, 1996, (Act No. 15 of 1996), or any model, pattern, plan, formula or process or any other property or right of a similar nature;

(c) any intellectual property right or property or right of a similar nature in respect of which a proprietary interest may be established in terms of the common law of the Republic of South Africa; or

(d) any other intangible property except any financial instrument.’ (58/1962)

**Example:** Company A owns 100% of Company B (Company B meets the definition of a foreign business establishment). Company A is a resident of the Republic whereas Company B is incorporated and effectively managed in Dubai. Company B has an intangible asset (trademark) which they have granted the use to Company A at a market related price. During the 2010 year of assessment, Company A pays royalties to Company B amounting to R1million (this is considered to be an arm’s length price). The following tax considerations need to be taken into consideration, namely:

- Company B is a controlled foreign company as defined in section 9D(1) and meets the definition of a foreign business establishment and therefore the exemptions as contemplated in section 9D(9)(b) and 9D(9)(e) will apply. However, in terms of South Africa’s residence based taxation, non residents are taxed on income where the source or deemed source is within the Republic of South Africa.
Therefore the income earned by Company B will be taxed in South Africa in terms of section 9(b) or 9(bA). In terms of both these sections, the income will be taxed in terms of section 35 as a withholding tax.

In terms of section 35, where a resident pays an amount over to a non resident for the use or right of use of a trade mark, the non resident is liable to pay tax, known as a withholding tax at a rate of 12%. Therefore Company A will be required to withhold R120 000 from the total payment of R1 million to be paid to the SARS on behalf of Company B. The net amount of R880 000 will ultimately be paid over to Company B. This is assuming that no double taxation agreement reduces the withholding tax rate.

Therefore the foreign business establishment exemption will not apply as the intangible asset is used within the Republic and in terms of section 9, the source of the income is in the Republic and will be taxed.

3.3.3 Mobile passive income

Where income is derived from mobile business activities, so called passive income, this income does not qualify for exemption under section 9D(9)(b)(iii). Passive income includes the following:

- Dividends
- Interest
- Royalties
- Rentals
- Annuities
- Insurance premiums
- Income of a similar nature
- Capital gains derived from the disposal or deemed disposal of an asset from which dividends, interest, royalties, rentals, annuities, insurance premiums and income of a similar nature was or could be earned; and
- Foreign currency gains determined under section 24I (other than those arising in the normal course of business of the CFC which is not a foreign financial instrument holding company) (58/1962).
It is submitted that the term ‘could be earned’ relates to the fact that the asset does not necessarily have to be earning passive income, but that the asset has the potential to produce passive income. Where an asset has the potential to produce passive income it will fall within the scope of this provision.

Included in section 9D(9)(b)(iii) the term ‘income of a similar nature’ is used, this term is not defined in the Act and is extremely wide and therefore provides ambiguity as to the types of income that qualify as ‘passive income’ and hence will not qualify for an exemption. The following discussion is to provide clarity as to what types of income would be considered ‘income of a similar nature’ in terms of this section.

A ‘passive’ asset is an asset from which dividends, interest, royalties, rentals, annuities, insurance premiums or income of a similar nature could be earned for example, a dividend yielding share, a rent producing property or an interest bearing security. This is a general statement (Wilson, 2004).

Section 9D(9) does not define the term ‘passive income’ and this term is not defined anywhere else in the Act, however there are other definitions in the Act that could influence the meaning and understanding of the term as well as terms described in accounting standards. These have been discussed below.

Investment income is defined in section 12E as ‘(i) any income in the form of dividends, royalties, rental derived in respect of immovable property, annuities or income of a similar nature; (ii) any interest as contemplated in section 24J (other than any interest received by or accrued to any co-operative bank as contemplated in paragraph (a)(ii)(ff), any amount contemplated in section 24K and any other income which, by the laws of the Republic administered by the Commissioner, is subject to the same treatment as income from money lent; and (iii) any proceeds derived from investment or trading in financial instruments (including futures, options and other derivatives), marketable securities or immovable property’ (58/1962).

It has been said that the word ‘income’ as used in the definition of ‘investment income’ in all three places where it appears is not used in its defined meaning of ‘gross income’ less ‘exempt income’ but rather to describe the inflow of earnings
from an investment; in other words, the receipts and accruals that result from an income earning asset. (Mitchell, 1998)

In IAS 40, *investment property* is defined, yet the part of the definition that is of interest is that an investment property is one where a person will earn rentals or for capital appreciation and excludes an asset that is used in the production or supply of goods or services or for administrative purpose or for sale in the ordinary course of business (IFRS, 2011: A1010). In my view, this indicates that passive income is earned on assets or investments where the intention of the taxpayer is to earn rentals, interest, dividends or for capital appreciation (for the value to increase and to be sold at a later date for an amount higher than what was paid for the asset). This is confirmed with the exclusion of assets that produce goods (products manufactured for resale, i.e. inventory).

The term ‘passive’ as defined in the Little Oxford English Dictionary means ‘accepting what happens without resisting or trying to change anything’ (LOED. 2006:498), therefore the term ‘income of a similar nature’ would include income earned on investments or assets where the taxpayer has to do almost nothing and earns some kind of return on their investment. Therefore from the above, it is submitted that this subsection would include income earned on lease premiums, licensing and technical fees, know how payments and guarantee fees despite these not being mentioned specifically.

**Example:** Company A has a trade mark which it recognises as an asset in its accounting records. No royalty income is earned by Company A on this trade mark However, as Company A could give the right to another company to use in exchange for a royalty or license fee, the trade mark is capable of producing passive income. Therefore the capital gain on the trade mark will fall into this provision if sold as relates to an asset on which royalty income ‘could be earned’.

There is a provision to this subsection where in certain circumstances the passive income will be exempt. These will be discussed below and can be summarised as follows:
1. The 10% rule
2 Principal trading activities
3 Sale of intangible assets
4 Royalties received and accrued

3.3.3.1 10% rule

Where the passive income does not in total exceed 10% of the income plus capital gains of the CFC attributable to a foreign business establishment but excluding income or capital gains attributable to those amounts or in respect of which any of the provisions contained in paragraphs (e) to (fB) apply. Paragraph (e) relates to income received by the CFC from a South African source which will be taxed in terms of section 9 of the Act. This will be automatically included in the South African income tax net due to its source being in South Africa. Paragraph (f) applies to the following types of income, any foreign dividend declared by any other CFC in relation to a resident to the extent that such dividend does not exceed the aggregate of all amounts which have been or will be included in the income of the resident in terms of section 9D which relate to the company declaring the dividend. Paragraph (fA) relates to net income of a CFC that is attributable to interest, royalties, rentals or income of a similar nature or certain exchange differences or debt reductions received from another CFC where those CFCs form part of the same group of companies unless they elect that it should apply to them. Paragraph (fB) relates to where capital gains arising from the disposal of a capital asset which is attributable to the foreign business establishment of either the CFC or another company within the same group of companies (58/1962). In essence this exemption means that passive income is exempt to the extent that it is equal to or below 10% of active trading income, i.e. income derived from selling goods or services.

For example: A South African resident company owns all the shares of a CFC. The CFC generates gross income amounting to R400 000 from its active trading activities of its business establishment. However, the CFC also generates passive income. The total passive income earned amounts to R47 000. Due to the above 10% rule, the passive income that is excluded from inclusion in terms of section 9D amounts to 10% of R400 000 = R40 000. The excess passive
income amounts to R7 000 (R47 000 less R40 000), which is deemed to be income in the hands of the South African resident.

As was mentioned already, in applying the 10% rule, passive income or capital gains attributable to those amounts or in respect of which any of the provisions contained in paragraphs (e) to (fB) apply are to be excluded. However, no mention is made to section 10(1)(k)(ii) which will exclude certain foreign dividends from being income and therefore from imputation.

It is submitted that dividends that are excluded in terms of section 10(1)(k)(ii) will also be excluded from amounts used to apply the 10% rule as section 9D(9)(b)(iii)(aa) reads as follows (emphasis added):

‘to the extent that any income and capital gains attributable to those amounts (other than income or capital gains in respect of which any of the provisions contained in paragraphs (e) to (fB) apply) do not in total exceed ten per cent of the income and capital gains of the controlled foreign company attributable to that foreign business establishment other than…’ (58/1962).

As ‘income’ refers to gross income less exempt income, foreign dividends exempted by section 10(1)(k)(ii) will fall outside the scope of the 10% rule.

3.3.3.2 Principal trading activities

Where the passive income arises from the following trading activities the foreign business establishment exemption will still apply:

- Banking or financial services
- Insurance
- Rental business

However, excluded from these trading activities are any amounts derived from:

- A company that is a foreign financial instrument holding company at the time the amount is derived;
- Any connected person in relation to the CFC who is a resident and where the resident directly or indirectly holds at least 5% of the participation rights in that CFC or any other company in the same group of companies which holds shares in that CFC;
• Amounts derived which form part of a transaction, operation or scheme where any amount received or accrued to any person is exempt from tax and the corresponding expenditure is deductible by that person or any connected person in determining the liability for tax of that person or connected person (58/1962).

The question arises as to the scope of passive income that ‘arises’ from a trading activity like insurance or rental. Insurance and rental companies deposit money received in the form of rental or insurance premiums with financial institutions and therefore receive interest on these deposits. Can the interest received be said to arise from the trading activity of insurance or rental or does the interest have to be evaluated in terms of other provisions in this subsection?

It is submitted that the answer would lie in the activities undertaken by the CFC in earning the interest. In Western Platinum Ltd v C: SARS the court held that for income to constitute ‘mining income’, its source must be minerals taken from the earth, and that ‘income derived from mining operations’ means income derived from the business of extracting minerals from the soil. An intermediate investment of such income, by putting it to work as capital, however, generally breaks the requisite direct connection. Thus, interest derived by a mining company from a cash management scheme involving moneys placed on overnight call is not mining income; nor is interest earned on foreign bank accounts. But interest on late payments by customers and so-called escrow bank accounts as well as interest on the payment of export incentives, intended to compensate exporters for deferred payment, constitutes mining income.

Therefore it is submitted that the interest received by rental and insurance companies, merely from depositing their receipts in a bank account, can be said to arise from the trading activity of insurance or rental. However, when the CFC undertakes activities to actively increase the interest by actively managing the deposits, the interest can no longer be said to arise from the rental or insurance activities.
The application of the diversionary rule applicable to passive income can be illustrated by way of the following comprehensive example:

**Example (Obtained from the North West University):**

**Group Structure for Example**

- SA Paper Co owns 100% of the share in Botswana Hold Co, which in turn owns 51% of the shares in Botswana Pulp Co, both companies having been incorporated and effectively managed in Botswana.
- The tax rate in Botswana is 25%. However, since Botswana Pulp Co is a manufacturing company, it only pays tax at a rate of 20%.
- Botswana Pulp Co distributes the paper into Botswana as well as into South Africa via SA Paper Co. Botswana Pulp Co employs 25 employees and owns premises in Gaborone.

- Since it does not use all the office space, it lets office space to Botswana Transport a company in which it holds 60% interest in the participation rights of the company. It also lets a portion of the office space to CNA Botswana, which does not form part of the group.

- Botswana Holdco does not have any employees or offices. It pays Botswana Pulp Co a fee of 2500 Pula per month for administration and finance work undertaken on its behalf. It receives dividends from Botswana Pulp Co and also receives interest income from informal loans it makes to Botswana Pulp Co and other independent businesses operating in Botswana.

**Summarised Income Statement of Botswana Holdco and Botswana Pulp Co:**

<table>
<thead>
<tr>
<th></th>
<th>31 Dec 2010</th>
<th>31 Dec 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Botswana Pulp Co</strong></td>
<td>Pula</td>
<td>Botswana Holdco</td>
</tr>
<tr>
<td>Sales</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Botswana customers</td>
<td>100 000</td>
<td>- Botswana Pulp Co</td>
</tr>
<tr>
<td>- SA Paper Co</td>
<td>30 000</td>
<td>- Other</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>130 000</strong></td>
<td></td>
</tr>
<tr>
<td>COS</td>
<td>(45 000)</td>
<td>Dividend: Botswana Pulp Co</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>85 000</td>
<td>Admin fee</td>
</tr>
<tr>
<td>Operating and other expenses</td>
<td>(42 000)</td>
<td><strong>Net income before tax</strong></td>
</tr>
<tr>
<td>Rental income</td>
<td></td>
<td>Tax</td>
</tr>
<tr>
<td>- Botswana Transport</td>
<td>20 000</td>
<td><strong>Net income after tax</strong></td>
</tr>
<tr>
<td>- CNA Botswana</td>
<td>20 000</td>
<td><strong>Effective tax rate</strong></td>
</tr>
<tr>
<td>Fee from Botswana</td>
<td>30 000</td>
<td></td>
</tr>
</tbody>
</table>
The tax implications for Botswana Pulp Co are as follows:

**Botswana Pulp Co:**

- Botswana Pulp Co meets the definition of a foreign company as defined in section 9D(1).
- As SA Paper Co holds more than 50% (actually has 100%) of the participation rights in Botswana Pulp Co, it’s a CFC as defined.
- Botswana Pulp Co has a foreign business establishment as defined as it has an office situated in a foreign company and employs a number of employees.
- Botswana Pulp Co and SA Paper Co are connected persons and form part of a group of companies as defined as more than 70% of the shares in Botswana Pulp Co are held by SA Paper Co.
- Based on the information provided a company could rely on the high taxed exemption contained in section 9D(2A). In order to qualify for the high taxed exemption, one should compare the tax actually paid in Botswana to tax that would be paid in SA. If Botswana tax is at least 75% of tax that would be paid in SA – net income deemed to be R nil and no imputation.
- Even though Botswana Pulp Co meets the definition of a foreign business establishment as defined, Botswana Pulp Co sells paper to SA Paper Co a resident connected person. One therefore needs to consider the diversionary rules in order to determine whether the foreign business establishment exemption will not apply.
Sales to SA Paper Co - due to the lack of information provided the following should be considered before one can rely on the section 9D(9)(b) exemption.

- Where the sales between the two connected persons are not at arm’s length – the net income of Botswana Pulp Co will be imputed into the taxable income of SA Paper Co.
- However, where the transactions are taking place at arm’s length and they are made mainly to customers in Botswana then the foreign business establishment exemption would apply.
- Based on the above, 30 000 Pula of a total 130 000 Pula are made to SA Paper Co, this amounts to 23% of Botswana Pulp Co’s total sales. The remaining 77% of sales are made to customers situated in Botswana. Therefore the exemption will apply resulting in no imputation required.

Botswana Pulp Co also earns rental income. Rental income is seen to be passive income earned by the company in terms of section 9D(9)(b)(iii).

- The rental income earned from Botswana Transport Co does not require imputation due to the exemption contained in section 9D(9)(fA).
- The rental income earned from CNA Botswana will not be exempt due to the principal trading activities of Botswana Pulp Co not being a rental business. This is confirmed by the amount of rental income earned versus sale of products made. 24% of total income relates to the rental business. This would indicate that this is not the principal activity of Botswana Pulp Co. However, the 10% exemption rule could apply where a company earns passive income.
- Below is an analysis of the income of Botswana Pulp Co into income that is active versus that which is passive in order to determine whether the passive income earned is in excess of the 10% threshold.
Analysis of Passive versus Active income – Botswana Pulp Company

<table>
<thead>
<tr>
<th></th>
<th>31 Dec 2010 Pula</th>
<th>31 Dec 2010 Pula</th>
<th>31 Dec 2010 Pula</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Amount</strong></td>
<td><strong>Passive income</strong></td>
<td><strong>Active Income</strong></td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Botswana Customers</td>
<td>100 000</td>
<td>100 000</td>
<td></td>
</tr>
<tr>
<td>- SA Paper Co</td>
<td>30 000</td>
<td>30 000</td>
<td></td>
</tr>
<tr>
<td><strong>Rental income</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Botswana Transport</td>
<td>20 000</td>
<td>S9D(9)(fA) applies</td>
<td></td>
</tr>
<tr>
<td>- CNA Botswana</td>
<td>20 000</td>
<td>20 000</td>
<td></td>
</tr>
<tr>
<td>Fee from Botswana Holdco</td>
<td>30 000</td>
<td></td>
<td>30 000</td>
</tr>
<tr>
<td><strong>Total income</strong></td>
<td><strong>200 000</strong></td>
<td><strong>20 000</strong></td>
<td><strong>160 000</strong></td>
</tr>
</tbody>
</table>

**Passive income : Active income**

\[
\frac{20 000}{160 000} = 12.5\%
\]

This is in excess of the 10% rule, therefore imputation is required and is determined as follows:

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total passive income</td>
<td>20 000</td>
<td></td>
</tr>
<tr>
<td>Active income at 10%</td>
<td>16 000</td>
<td>(160 000x 10%)</td>
</tr>
<tr>
<td>Excess</td>
<td>4 000</td>
<td></td>
</tr>
<tr>
<td>Amount to be imputed</td>
<td><strong>4 000</strong></td>
<td></td>
</tr>
</tbody>
</table>

- The fee earned from Botswana Hold Co does not constitute passive income and will form part of the income attributable to a foreign business establishment, this will be exempt and no imputation is required.
The dividend received will be exempt in terms of the participation exemption contained in section 10(1)(k)(ii)(dd).

**Botswana Holdco**

- Botswana Holdco meets the definition of a controlled foreign company as more than 50% of the participation rights are held by SA Paper Co a South African resident.
- The operations of Botswana Holdco does not meet the requirements of a foreign business establishment as it:
  - Does not employ any employees
  - Does not have a permanent or formal office or premises from which it operates
- Therefore the following income will be imputed into SA Paper Co from Botswana Hold Co (in pula)
  - Interest received 12 000
  - Other 40 000
  - Dividend (s10(1)(k)(ii)(dd) -
  - Admin fee expense (30 000)
  - **Net Income to be imputed** 22 000
- The net income is then translated into South African Rands (ZAR) at the average exchange rate for that year of assessment.
- However, as Botswana Holdco has paid tax in Botswana, therefore SA Paper Co should determine whether the 75% rule would not apply and no imputation necessary.

### 3.3.3.3 Sale of intangible assets

Where an amount is received or accrued by a CFC from the disposal or deemed disposal of any intangible asset as defined in paragraph 16(2) of the Eighth Schedule (other than an intangible asset created, devised or developed in the Republic), if that intangible asset:

1. Forms an integral part of any business conducted by that CFC; and
Was so disposed of as part of the disposal of that business and where all the assets which are necessary for carrying on that business are disposed of as a going concern (58/1962).

Where these requirements have been met, the foreign business establishment exemption will apply.

The reason for the exclusion of intangible assets ‘created, devised or developed in the Republic’ is due to the deemed source rules. The source of income is based on its ‘originating cause’, there are two questions that need to be asked:

1. What is the originating cause of the income?
2. Where is the originating cause located? (CIR v Lever Brothers & Unilever Ltd (1946))

In Millin v CIR (1928 AD) it was held that the originating cause of royalties accruing to a novelist was her wits, labour and intellect. Therefore if these faculties are utilised in South Africa, the source of the income is South Africa. Further, where an intangible asset is created, devised or developed in South Africa, the deemed source of the income accruing on this intangible asset will be South Africa and it will be taxed in the South African tax net (Stiglingh et al, 2010:58).

Based on section 9, it is submitted that where the right of use of an intangible asset is in South Africa, the source of the income is South Africa and hence the income earned therefrom will fall within the tax net. Therefore the income will already be taxed in the South African tax net even when it is earned by a foreign company. Therefore the exemption above applies, as if imputation is required on this income it will result in the income earned being taxed twice. Firstly in the hands of the foreign company, usually by way of a withholding tax at 12% in terms of section 35 to the Act and then secondly, when the income earned by the CFC requires imputation into the resident shareholders taxable income.

**Example:** SA Paper Co owns 35% of the shares in Dubai Co 1 and 100% of the Shares in SA Pulp Co. SA Pulp Co in turn owns 35% of the shares in Dubai Co 1. Dubai Co 1 owns 51% of the shares in Dubai Co 2. The rest of the shares in Dubai Co 2 are held by a natural person who is a resident of Dubai. None of the companies are listed companies.
Dubai Co 1 is a holding company incorporated in Dubai. Dubai Co 2 is a company that owns 5 car dealerships in Dubai. The assets of the company consist of trading stock, debtors, fixed assets and goodwill.

What would the tax implications in terms of section 9D only be if the group decides to sell the business of Dubai 2 Co to Dubai 1 Co followed by the liquidation of Dubai 2 Co?

- SA Paper Co and SA Pulp Co are both residents as they are incorporated in South Africa
- Assume Dubai Co 1 and Dubai Co 2 are all effectively managed in their country of incorporation, and are therefore not residents of South Africa and are therefore foreign companies (i.e. meet the definition of foreign company as contained in section 9D(1)).
- Together SA Paper Co and SA Pulp Co hold more than 50% of the participation rights in Dubai Co 1, therefore they are deemed to exercise 51% of the voting rights directly in Dubai Co 2, therefore:
  - Dubai Co 1 meets the definition of a CFC as more than 50% of the participation rights are held by a South African resident that are connected persons.
  - Dubai Co 2 meets the definition of a CFC as more than 50% of the voting rights are held indirectly by South African residents.
- Sale of business:
  - Dubai 2 Co is an operating company which owns a number of car dealerships situated in Dubai (its country of residence). Based on the above no mention is made that Dubai 2 Co makes any sales to connected persons. Operating and management decisions are made in Dubai and therefore the requirements of the foreign business establishment as defined are met.
  - The sale of the business will also be exempt in terms of section 9D(9)(b) which excludes from imputation in SA any amount attributable to any foreign business establishment, including the disposal or deemed disposal of any assets forming part of that foreign business establishment.
The exemption does not apply to amounts which arise from the disposal or deemed disposal of any intangible assets (as defined in paragraph 16(2) of the Eighth Schedule) such as goodwill unless:

- The intangible asset formed an integral part of any business conducted by the CFC, which is the case; and
- the asset was so disposed of as part of the disposal of that business and where all the assets which are necessary for carrying on that business is disposed of as a going concern, which again, is the case.

3.3.3.4 **Royalties received or accrued**

Where a CFC receives or accrues an amount relating to royalties, if that company directly and regularly creates, develops or substantially upgrades any intellectual property as defined in section 23I which gives rise to those royalties, then the foreign business establishment exemption will still apply (58/1962).

Section 23I of the Act deals with the prohibition of deductions in respect of certain intellectual property. Intellectual property is defined in section 23I as ‘any—

(a) patent as defined in the Patents Act, 1978 (Act No. 57 of 1978), including any application for a patent in terms of that Act;

(b) design as defined in the Designs Act, 1993 (Act No. 195 of 1993);

(c) trade mark as defined in the Trade Marks Act, 1993 (Act No. 194 of 1993);

(d) copyright as defined in the Copyright Act, 1978 (Act No. 98 of 1978);

(e) patent, design, trade mark or copyright defined or described in any similar law to that in paragraph (a), (b), (c) or (d) of a country other than the Republic;

(f) property or right of a similar nature to that in paragraph (a), (b), (c), (d) or (e); and
(g) knowledge connected to the use of such patent, design, trade mark, copyright, property or right;’ (58/1962)

Tainted intellectual property is defined as ‘intellectual property—

(a) which was the property of the end user or of a taxable person that is or was a connected person, as defined in section 31 (1A), in relation to the end user

(b) which is the property of a taxable person;

(c) a material part of which was used by a taxable person in carrying on a business while that property was the property of a taxable person and the end user of that property acquired that business or a material part thereof as a going concern; or

(d) which was discovered, devised, developed, created or produced by the end user of that property, or by a taxable person that is a connected person, as defined in section 31 (1A), in relation to the end user, if that end user, together with any taxable person that is a connected person in relation to that end user, holds at least 20 per cent of the participation rights, as defined in section 9D, in a person by or to whom an amount is received or accrues—

(i) by virtue of the grant of use, right of use or permission to use that property; or

(ii) where that receipt, accrual or amount is determined directly or indirectly with reference to expenditure incurred for the use, right of use or permission to use that property;‘ (58/1962)

Subsection (2) of section 23I states that ‘a deduction is not allowed in respect of;

(a) any amount of expenditure incurred for the use, right of use or permission to use tainted intellectual property, or

(b) expenditure the incurral or amount of which is determined directly or indirectly with reference to expenditure incurred for the use, right of use or permission to use tainted intellectual property;
to the extent that the amount of expenditure does not constitute income received by or accrued to any other person or to the extent that the amount of expenditure does not constitute a proportional amount of net income of a controlled foreign company an amount equal to which is included in the income of any resident in terms of section 9D.

(3) Notwithstanding any provision of subsection (2) to the contrary, an amount equal to one third of any expenditure contemplated in subsection (2) shall be allowed to be deducted if tax contemplated in section 35 is payable in respect of that amount at a rate of at least 10 per cent.’ (58/1962)

In terms of the Explanatory Memorandum on the Revenue Laws Amendment Bill issued by National Treasury (2008:55), royalty income earned by a CFC is seen to be tainted (per section 23I). However, there are two exceptions to this general view:

1 Intra-group royalty receipts or accruals are exempt with a matching denial of any deduction for intra-group royalties incurred (s9D(2A)(c) and s9D(9)(fA))

2 CFC royalty income may receive relief from section 9D inclusion via SARS’ ruling request under section 9D(10)(a)(iii).

Although one relief exists if SARS is convinced that the royalties earned are associated with intellectual property which is regularly created, developed or upgraded.

The term ‘regularly’ as defined from the Little Oxford English Dictionary, means ‘done or happening frequently, doing the same thing often, usual’ (LOED, 2006:581).

Originally this was viewed as ‘overly narrow’ and therefore it was included as a proposal under the Explanatory Memorandum on the Revenue Laws Amendment Bill, issued by National Treasury (2008:55), that CFC royalties would be placed in line with other CFC activities. Passive royalties would however, still be seen to be tainted and fall outside the section 9D(9) exemptions. Where the royalty ‘directly and regularly create, develops and substantially upgrades the intellectual property’ the foreign business establishment exemption will still apply.
The term ‘substantially’ according to the Little Oxford English Dictionary means ‘to a great extent, for the most part, mainly’ (LOED, 2006:698).

Further to the above, it should be noted that royalties will still be seen to be tainted under the diversionary rules if the CFC generates royalty income from a connected person who is a South African resident. However, this rule too can also be overcome with a ruling from SARS in terms of section 9D(10).

3.3.4 Long term insurers (s9D(9)(e))

The net income of a CFC will be exempt when it is attributable to any non-resident policyholder or a CFC in relation to a resident of any policy issued by a company licensed to issue any long term policy in its country of residence (58/1962).

The Explanatory Memorandum on the Revenue Laws Amendment Bill 2005 states that certain CFCs of South African insurance companies earn profits which would eventually be paid to policyholders who do not fall within the South African tax net at all. In order that these profits are untaxed under the CFC regime, there is an exemption for the net income of the CFC which is attributed to non-resident policyholders who are not CFCs. An additional requirement for the exemption to apply is that the policy should have been issued by a company which is licensed to issue any long-term policy as defined in the Long-term Insurance Act in its country of residence (National Treasury, 2005:13).

The issue here is that an insurance company is viewed as the owner of all policyholder funds. The insurer is taxed on these policyholder funds under the trustee principle as a proxy for the policyholders. The tax on the insurer is designed to approximate in full the tax that would have fallen on the policy holders as a collective. All policy holders’ assets are held in the name of a long-term insurer and are accordingly regarded as the long-term insurer’s participation rights in the foreign company for section 9D purposes. The net result is that foreign entities held in the name of local long term insurer are often classified as a CFC subject to the various section 9D inclusions, even though the bulk of the underlying interests are held in the
name of policyholders (none of whom would have triggered any section 9D inclusions had they invested in the CFC directly) (National Treasury, 2007:35-36).

Based on the above it is clear that long term insurers which would be classified as CFCs will be exempt from imputation.

3.3.5 South African taxable income (s9D(9)(e)

In terms of section 9D(9)(e) which states that where net income of a CFC is included in the taxable income of the company and has not been or will not be exempt or taxed at a reduced rate in the Republic, as a result of the application of any agreement for the avoidance of double taxation (58/1962).

In simple terms, this means that where the CFC has already been taxed in terms of any of the source rules contained in section 9 (actual) to the Act or deemed sources, this income cannot be taxed again in determining the net income to be included in the resident shareholders taxable income (De Koker, 2010)

Example: A CFC has rent producing property situated in South Africa. In terms of the true source rules, the rental income earned is from a South African source. This income earned by the CFC will be taxed in South Africa. Therefore this rental income will be excluded from the net income of the CFC to be imputed into the resident shareholder’s taxable income as it has already been taxed in South Africa. This ensures that the same income is not taxed twice.

Example (North West University): SA Paper Co acquired 70% of the shares in Irish Plc on 1 April 2009. SA Paper Co decided to invest in Irish Plc because they use both the patents owned by Irish Plc, a company incorporated in Ireland (see below). The balance of the shares is held by an unconnected company situated in the Isle of Man. Irish Plc is not listed.

The financial year end of SA Paper Co is 30 June. The financial year of Irish Plc is 1 January to 31 December. Irish Plc has an office and fully equipped laboratory in Wimbledon and employs a general manager, development manager, financial
manager, three researchers and two sales representatives as well as three administrative staff.

Irish Plc is the owner and sometimes developer of patents used in the manufacturing of paper related products (nappies, toilet paper, kitchen towels etc). Currently, only two patents are active, i.e.:

- **Patent A**: Irish Plc acquired patent A five years ago from an ex employee. There is no competitive patent available and therefore Irish Plc does not do any research or further development in relation to Patent A.

- **Patent B**: Irish Plc developed patent B during 2003 and 2004. The patent relates to the manufacture of super absorbent baby nappies. Due to the competition in the market, Irish Plc constantly works on the improvement of this patent.

Irish Plc’s income statement for the 2009 and 2010 financial years can be summarised as follows:

**Financial results in Irish Plc**

<table>
<thead>
<tr>
<th></th>
<th>31 Dec 2009</th>
<th>31 Dec 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Rands</td>
<td>Rands</td>
</tr>
<tr>
<td>Patent A</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Customers in the UK market</td>
<td>100 000</td>
<td>105 000</td>
</tr>
<tr>
<td>- SA Paper Co</td>
<td>95 000</td>
<td>97 000</td>
</tr>
<tr>
<td>Patent B</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Customers in the UK market</td>
<td>69 000</td>
<td>72 000</td>
</tr>
<tr>
<td>- SA Paper Co</td>
<td>21 000</td>
<td>27 800</td>
</tr>
<tr>
<td><strong>Total Income</strong></td>
<td><strong>285 000</strong></td>
<td><strong>301 000</strong></td>
</tr>
<tr>
<td>- Admin expenses</td>
<td>15 000</td>
<td>17 000</td>
</tr>
<tr>
<td>- Research expenses</td>
<td>45 000</td>
<td>54 000</td>
</tr>
<tr>
<td><strong>Income before tax</strong></td>
<td><strong>225 000</strong></td>
<td><strong>230 000</strong></td>
</tr>
</tbody>
</table>
- Ireland Tax 22 500 23 000
Income after tax 202 500 207 000

- What are the tax implications in terms of section 9D relating to the above transaction in both the 2009 and 2010 years of assessment?
- Irish Plc is a foreign business establishment as it has a fixed place of business located outside of South Africa (regardless of the fact that the operations are conducted in Wimbledon England and not in Ireland). Irish Plc’s business is suitably staffed with facilities located at a fixed place. Therefore Irish Plc is a foreign business establishment as defined.
- Royalties from patent A:
  - Despite the fact that the foreign business establishment definition has been met, the royalties income is not exempt in terms of S9D(9)(b) as diversionary rule applies to passive income and no development takes place in respect of patent A (even if the royalty charge is at arm’s length).
  - Royalties from Patent A used by SA Paper Co however, is deemed to be from a SA source in terms of section 9(1)(b) of the Act. The right of use of the patent is in South Africa and therefore the source is South African. Even if they are at arm’s length, the foreign business establishment exemption will not apply to the royalties received from SA Paper Co due to the provisions contained in section 9D(9)(b)(ii)(dd).
  - But section 9D(9)(e) will exempt the royalties from SA Paper Co from imputation as the royalties are subject to tax at the full rate in SA:
  - Irish Plc a non-resident will be subject to tax on income from a SA source.
  - S35 does not apply to CFC’s and as a result the exemption provided for in s10(1)(l) will not apply.
  - The royalties will therefore be taxed in full in SA (however one should refer to the Ireland/ South Africa DTA).
  - Irish Plc will have to register for tax and complete a tax return.
- Royalties that are received from the UK customer, the 10% rule may apply, but Irish Plc does not receive active trading income but receives mainly passive income.

- Therefore income in relation to Patent A from customers in the UK market may be subject to imputation (reduced by the income per the 10% rule as contained in section 9D(9)(b)(dd)(iii)(aa)) after claiming allowable deductions unless the proviso to section 9D(2A) applies, i.e. tax paid by Irish Plc to all spheres if government other than SA is at least 75% of the tax that would have been paid in SA. The tax in Ireland is 10%, therefore this does not appear to be the case.

- However, Irish Plc seem to have a permanent establishment in the UK (Wimbledon), the profits of which would be subject to tax in the UK, which has a comparable rate to the 28% charged in SA.

- Patent B: provided the royalty is an arm’s length royalty, since Irish Plc directly and regularly creates, develops or substantially upgrades patent B, the royalties received from third party customers in relation to patent B will be exempt in terms of section 9D(9)(iii)(dd). In relation to royalties received from SA Paper Co, refer discussion above as the same principles will apply.

- Irish Plc's foreign tax year is 1 January to 31 December. Shares bought on 1 April 2009. First imputation in SA Paper Co’s hands: Income actually earned/apportioned from 1 April 2009 to 31 December 2009 during SA Paper Co’s year of assessment ending 30 June 2010. No imputation in relation to SA Paper Co’s 2009 year of assessment as foreign tax year of Irish Plc ends after 30 June 2009.

### 3.3.6 Foreign dividends received (s9D(9)(f))

Section 9D(9)(f) relates to net income earned by a CFC that is attributable to any foreign dividend declared to a CFC by another CFC in relation to the same resident. However the foreign dividend should not exceed the amounts which have been or will be included in the income of the resident in any year of assessment which relates to:
The net income of the company declaring the dividend or

Any other company which has been included in the income of that resident by
virtue of that resident’s participation rights in that other company held indirectly
through the company declaring the dividend:

**LESS:** the amount of any foreign tax payable in respect of the amount included in
that resident’s income

**LESS:** so much of all foreign dividends received by or accrued to that controlled
foreign company as was –

(i) excluded from the application of this section in terms of this paragraph or
s10(1)(k)(ii)(dd)

(ii) previously not included in the income of that resident by virtue of any
prior inclusion in terms of section 9D. (58/1962)

This means that where a resident holding participation rights in a CFC who in turn
derives a foreign dividend from another CFC, this foreign dividend will not be
taxed on the proportional amount of that foreign dividend.

**Example:** H Ltd owns 100% of the share capital of CFC 1 and 60% of CFC 2. The
following is the income earned and distributed of the various CFCs.

**CFC 1**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividend income</td>
<td>R600</td>
</tr>
<tr>
<td>Other income</td>
<td>R300</td>
</tr>
<tr>
<td><strong>Total income</strong></td>
<td><strong>R900</strong></td>
</tr>
<tr>
<td>Dividend distributed to H Ltd</td>
<td>(R900)</td>
</tr>
<tr>
<td><strong>Profit retained</strong></td>
<td><strong>R0</strong></td>
</tr>
</tbody>
</table>

**CFC 2**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>R1000</td>
</tr>
<tr>
<td>Dividend Distributed</td>
<td>(R1000)</td>
</tr>
<tr>
<td><strong>Profit retained</strong></td>
<td><strong>R0</strong></td>
</tr>
</tbody>
</table>
Therefore the following:

**Net income of CFC 2 to be included in H Ltd’s taxable income in terms of section 9D:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total income</td>
<td>R1000</td>
</tr>
<tr>
<td>H Ltd’s share in CFC 2</td>
<td>x 60%</td>
</tr>
<tr>
<td>Net income to be imputed</td>
<td>R600</td>
</tr>
</tbody>
</table>

**Net income of CFC 1 to be included in H Ltd’s taxable income in terms of section 9D:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>R900</td>
</tr>
<tr>
<td>Less:</td>
<td></td>
</tr>
<tr>
<td>Section 10(1)(k)(ii)(dd)</td>
<td>(R600)</td>
</tr>
<tr>
<td>Section 9D(9)(f) foreign dividend</td>
<td>R600</td>
</tr>
<tr>
<td>Reduced by section 9D(9)(f)(ii)</td>
<td>(R600)</td>
</tr>
<tr>
<td>Net income of CFC 2 to be imputed</td>
<td>R300</td>
</tr>
</tbody>
</table>

Total net income of CFC 1 and CFC 2 to be imputed into the taxable income of H Ltd is R600 + R300 = R900.

### 3.3.7 Interest, royalties, rental, annuities and insurance premiums (s9D(9)(fA))

Where net income earned by a CFC is attributable to the following types of income:

- Any interest, royalties, rental or income of a similar nature including any amount adjusted in terms of section 31;
- Any exchange differences determined in terms of section 24I;
- Any exchange differences in respect of any forward exchange contract entered into to hedge an exchange item;
- The reduction or discharge by any other CFC of a debt owed by the company to that other CFC for no consideration of for consideration less than the amount by which the face value of the debt has been so reduced or discharged where that CFC and that other CFC form part of the same group of companies.

Provided that any such amount may at the election of any resident be so taken into account as contemplated in subsection 2 (58/1962).
From the above it is submitted that the exemption in terms of section 9D(9)(fA) should be read together with the proviso (c) to section 9D(2A) which expressly prohibits the deduction of interest, royalties, rental or amounts of a similar nature paid or payable or deemed to be paid or payable by one CFC to another in determining its ‘net income’.

**Example:** A resident company owns 100% in two wholly owned subsidiaries, E and F. E and F are non residents and there income and expenses converted to rands, is as follows:

<table>
<thead>
<tr>
<th></th>
<th>Company E</th>
<th>Company F</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Income</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue</td>
<td>R200 000</td>
<td>R150 000</td>
</tr>
<tr>
<td>Rent from E</td>
<td></td>
<td>R60 000</td>
</tr>
<tr>
<td><strong>Expenses</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rent paid to F</td>
<td>R60 000</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>R140 000</strong></td>
<td><strong>R210 000</strong></td>
</tr>
</tbody>
</table>

Therefore included in the taxable income of Company A the resident shareholder of E and F:

Company E – The full revenue of R200 000 is included as the expense relating to rent paid to fellow subsidiary amounting to R60 000 will not be deducted in terms of section 9D(2A).

Company F – the revenue of R150 000 is included in the taxable income of Company A as the rental received by E is excluded due to the exemption contained in section 9D(9)(fA).

Therefore Company A will include in its taxable income a total of R350 000 (R200 000 plus R150 000).
However, the above exemption might not be applicable where a taxpayer has elected the provisions contained in section 9D(12) (See Chapter 5) and it will not apply to a resident who fails to comply with the disclosure requirements of section 72A (See Chapter 7).

3.3.8 **Disposal of assets (s9D(9)(fB))**

Net income received by a CFC which is attributable to a disposal of an asset in terms of the Eighth Schedule to the Act, provided that the asset that was disposed of formed part of the assets of a foreign business establishment as defined in section 9D(1) to the Act of any other CFC where that company and that other CFC form part of the same group of companies (58/1962).

The reason for this exclusion is that it ensures that the qualifying exclusion remains available when foreign business assets are disposed of by companies within the same group (Stiglingh et al, 2010:577).

An asset in this part of the Act excludes a ‘financial instrument’ as defined in section 1 of the Act or ‘intangible asset’ as defined in paragraph 16 to the Eighth Schedule to the Act (De Koker, 2010).

A financial instrument is defined in section 1 of the Act as, ‘includes –

a) a loan, advance, debt, stock, bond, debenture, bill, share, promissory note, banker’s acceptance, negotiable certificate of deposit, deposit with a financial institution, a participatory interest in a portfolio of a collective investment scheme or similar instrument;

b) any repurchase or resale agreement, forward purchase arrangement, forward sale arrangement, futures contract, option contract or swap contract;

c) any other contractual right or obligation the value of which is determined directly or indirectly with reference to –

(i) a debt security or equity;

(ii) any commodity as quoted on an exchange; or

(iii) a rate index or a specified index;

d) any interest bearing arrangement; and
e) any financial arrangement based on or determined with reference to the time value of money or cash flow or the exchange or transfer of an asset’ (58/1962).

As the above exemption is only available to capital assets on which a capital gain has arisen on its disposal and that it is attributed to a foreign business establishment, it by implication requires that at least of one of the CFCs in the group of companies qualifies as a foreign business establishment as defined in section 9D(1). It is not required that the CFC disposing of the capital asset meets the foreign business establishment test (Olivier & Honiball, 2008:463).

Example: Company A holds 100% of the shares in Company B and both companies are incorporated in the Isle of Man. Company A is held 100% by SA residents. Company A is a property company but does not have any employees. Company B is a bona fide insurance company with several employees and rents a fully equipped building from Company A. Neither Company A nor Company B pay tax in the Isle of Man.

It is clear that Company B has a foreign business establishment as defined. Company A in turn does not. Should Company A dispose of fixed property, the capital gain will be subject to imputation in the hands of Company A unless it is the building occupied by Company B as the building is attributable to the foreign business establishment of Company B, which are part of the same group of companies as Company A.

3.3.9 High-taxed CFC net income exemption (s9D(2A))

The proviso to section 9D(2A) effectively provides an exemption from imputation despite not being grouped with the other exemptions included in section 9D(9). The proviso states that the net income of a CFC shall be nil where the aggregate amount of tax payable to all spheres of government of any country other than the Republic is at least 75% of the amount of normal tax which would have been payable had the CFC been a resident for that foreign tax year (58/1962).
This means that in order to comply with this proviso to the Act, one would need to perform a taxable income calculation for the CFC in terms of the requirements of the South African Income Tax Act (Stiglingh et al, 2010:568).

In terms of the proviso to section 9D(2A) the following should be taken into account in determining the taxable income of the CFC:

- After taking into account any double taxation agreements and any credit, rebate or other right of recovery of tax from these foreign governments; and
- Disregarding any loss in respect of a year other than the current foreign tax year or any loss from a company other than the CFC (Stiglingh et al, 2010:568).

National Treasury aimed, with the introduction of the high-taxed CFC income exemption, to disregard tainted CFC income where little or no South African tax is at stake once South African tax rebates are taken into account (National Treasury: 2009:76).

The 75% threshold matches that which is used in the United Kingdom in their CFC legislation (National Treasury, 2009:76). In the United Kingdom, the purpose of CFC legislation is to prevent UK companies from avoiding UK tax by diverting income to subsidiaries in low tax countries. A low tax country is one where that company is subject to tax at a level of taxation which is less than three quarters of what it would have paid had it been a resident in the UK (HMRC, 2010).

Previously included under section 9D(9) was a section dealing with a designated country exemption. This section was deleted by section 22(1)(g) of the Revenue Laws Amendment Act 45 of 2003 with effect from 1 June 2004. Under this section, income from a CFC that was situated in a foreign country identified on the list was exempt. The countries identified on the list in most cases had similar tax systems to South Africa and were subject to tax at a statutory rate of at least 27% (SARS, 2010a:630).

The exemption was removed as the list of designated countries as it was incorrectly perceived as an incentive system for investing in these countries. The list consisted of
OECD and wealth countries and not developing countries and the exemption did not take into account hidden incentives (National Treasury, 2003:43).

There are many views in practice as to how this proviso should be treated: some tax experts are of the view that the 75% should be determined on an effective tax rate basis and others to compare the statutory tax rate at 75% of the country of residence of the controlled foreign company to 28% (South Africa’s statutory income tax rate). It is submitted that both these views are incorrect as the Act is clear that it requires the resident to undertake a tax computation and to compare the tax paid to the result of the tax computation. The amount of tax is therefore compared and not the rate of tax.

It would seem that in order to determine the taxable income calculation, the CFC is required to maintain two sets of accounting records, one to adhere to its country of residence’s tax legislation and the other to adhere to South African tax legislation (Olivier & Honiball, 2008:444).

It is submitted that this proviso places a sometimes undue administrative burden on residents that wish to rely on this exemption. It is trite that extremely detailed information is required to prepare an accurate tax computation. Where the resident is a minority shareholder, the resident may not have access to a significant amount of information in relation to the foreign company in order to correctly determine and perform a taxable income calculation in terms of the Income Tax Act no 58 of 1962. Therefore it is submitted that this provision is not easily applied in practice and therefore it is easier to determine whether another exemption as contained in section 9D(9) will apply in order to reduce the administrative burden. However, because of this exemption being placed under section 9D(2A) it appears that a taxpayer has to perform this calculation first before being able to consider the exemptions contained in section 9D(9). Having said that, in practice, there would not be any adverse implications if one does not perform this calculation and instead relies on any of the exemptions contained in section 9D(9).
The following examples have been taken from the Explanatory Memorandum to the Taxation Laws Amendment Bill of 2009:

**Example 1:** South African Company owns all the shares of CFC. CFC is a tax resident of Country X. CFC generates income of R800 000 as determined under Country X tax law. The actual foreign tax imposed is at a rate of 25 per cent. In terms of South African tax law, the CFC income (both tainted and untainted) would be translated into R600 000.

The comparison is made as follows:

<table>
<thead>
<tr>
<th>Country X income</th>
<th>Country X tax</th>
<th>Country Y tax</th>
<th>Hypothetical South African tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>R800 000 at 25%</td>
<td>R200 000</td>
<td>R200 000</td>
<td>R168 000</td>
</tr>
<tr>
<td>R600 000 at 28%</td>
<td></td>
<td></td>
<td>Hypothetical</td>
</tr>
</tbody>
</table>

**Result:** Because the foreign tax paid in country of the CFC is more than 75% of the tax paid in South Africa. CFC will be deemed to have a net income of zero by virtue of the high-tax exemption.

**Example 2:** South African Company owns all the shares of CFC. CFC is a tax resident in Country X and has most of its operations located in the same country. CFC also operates a branch located in Country Y. CFC generates income of R900 000 as defined under Country X and Y tax law (R600 000 is sourced in Country X and R300 000 is sourced in Country Y). In terms of South African tax law, the amount of income (both tainted and untainted) of CFC would be translated into R1 million. CFC pays Country X tax at a rate of 25% and Country Y tax at a rate of 30%. All Country X credits for Country Y taxes are limited to 25%.

The comparison is made as follows:

<table>
<thead>
<tr>
<th>Country X income</th>
<th>Country X tax</th>
<th>Country Y tax</th>
<th>Country X credits for Country Y taxes</th>
<th>Hypothetical South African tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>R900 000 at 25%</td>
<td>R225 000</td>
<td>R60 000</td>
<td>R50 000</td>
<td>R235 000</td>
</tr>
</tbody>
</table>

**Result:** The hypothetical South African tax is R280 000 (28% of R1 million) because the R235 000 amount exceeds 75% of the R280 000 hypothetical South African tax, CFC will be deemed to have a net income of zero by virtue of the high-tax exemption.
Example 3: South African company owns all the shares of CFC 1 and CFC 1 owns all the shares of CFC 2. Both CFCs are located in Country X. CFC 1 generates income of R800 000 as defined under Country X tax law, and CFC 2 generates a net loss of R300 000. By virtue of the system of group taxation in Country X, the losses of CFC 2 can be offset against the CFC 1 income. In terms of South African tax law, the income amount for CFC 1 (both tainted and untainted) would be translated into an amount of R700 000 with CFC 2 generating a net loss. The actual foreign tax imposed on CFC 1 is at a rate of 25%.

The comparison is made as follows:
- R800 000 (ignoring the R300 000 loss\(^7\)) at 25% = R200 000
- R700 000 at 28% in South Africa = R196 000

Because the R200 000 hypothetical foreign tax amount exceeds 75% of the R196 000 hypothetical South African tax, CFC will be deemed to have a net income of zero by virtue of the high-tax exemption.

3.4 Rulings

In terms of the Act, subsection (10) states that the Commissioner may issue a ruling that disregards the application of paragraph (i) of the proviso to subsection 9(b) in respect of the sale of goods or performance of services by a CFC where the foreign business establishment of that CFC situated in that company’s country of residence mainly serves in at least two countries contiguous to the country of residence of that company (58/1962).

The section goes further to provide that the Commissioner must take into account that the activities and transactions carried out or to be carried out by the persons involved and must not issue any ruling in terms of this section if the application for the ruling relates to the determination of the net income of a CFC in respect of a foreign tax year and that application is submitted after the end of the year of assessment in which that foreign tax year ends (58/1962).

\(^7\) The R300 000 is not taken into account in terms of section 9D(2A)(a) as the losses incurred by a CFC are ring fenced in terms of the Act.
Where any ruling is issued in terms of paragraph (a) will be subject to the same procedures, terms and conditions as a BPR as contemplated in Part IA of Chapter III but disregarding section 76G(1)(a)(ii) and the requirements that the transaction must be a proposed transaction. (58/1962) Therefore, section 9D(10) empowers the Commissioner to issue BPR granting an exemption from the normal CFC rules. However, this is only in certain circumstances and the ruling issued is subject to the same procedures as those documented in section 76G to the Act and the transaction must be proposed (De Koker, 2010).

The section enables the Commissioner to waive the rules contained in section 9D(9)(b)(ii) relating to the diversionary rules for the sale of goods and the performance of services by a CFC where it’s a foreign business establishment and where it serves as a central location for the sale or performance of services which are similar or identical and it takes place within two countries which are contiguous (De Koker, 2010).

If this waiver were not available it would result in the CFC being taxed unless the services or goods were being supplied to end users within the same country of residence. In order for the waiver to apply, the CFCs foreign business establishment serves as a central location for end-users in at least two neighbouring contiguous countries. Contiguous means by land, but not by sea (De Koker, 2010).

As discussed in Chapter 3 as an example, one could apply for a ruling under section 9D(10) regarding royalty income received by a CFC that should be exempt under the foreign business establishment exemption but due to the nature of royalty income is seen to be received from tainted intellectual property.

3.5 Conclusion

As can be seen from the discussion above section 9D(9) exemptions appear deceptively simple, however the correct application of the exemptions provided for in section 9D is of utmost importance as the consequences of incorrect application can be dire: additional tax, interest, penalties and reputational damage.
It is therefore vital that a resident availing him/herself of these exemptions has a thorough understanding of each exemption in order to correctly determine whether the net income of a controlled foreign company does indeed need to be included in the resident shareholder’s taxable income.

It is also clear that each exemption will have to be considered in detail and places a significant administrative burden on residents owning participation rights in CFC’s.

If none of the exemptions apply, a resident shareholder will be required to determine the net income of the CFC. The resident shareholder is required to determine when the net income of a CFC should be included, how much should be included and in which of its years of assessment. The next chapter in this study will be dedicated to the rules provided for determining the imputable net income.
4. SECTION 9D(2) – THE IMPLICATIONS FOR A RESIDENT HOLDING PARTICIPATION RIGHTS IN A CFC

4.1 Introduction: section 9D(2)

The effect of a resident holding, more than 50% of the participation rights or voting rights in a CFC is set out in Section 9D(2): the income of the CFC shall be included in the income of that resident who holds the participation rights. Section 9D(2) of the Act states that ‘there shall be included in the income for the year of assessment of any resident who holds any participation rights in a controlled foreign company –

(a) on the last day of the foreign tax year of that controlled foreign company which ends during that year of assessment, an amount equal to –

(i) where that foreign company was a controlled foreign company for the entire foreign tax year, the proportional amount of the net income of that controlled foreign company determined for that foreign tax year, which bears to the total net income of that company during that foreign tax year, 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 on that last day; or

(ii) where that foreign company became a controlled foreign company at any stage during that foreign tax year, at the option of the resident, either –

(aa) an amount which bears to the proportional amount determined in accordance with subparagraph (i), the same ratio as the number of days during that foreign tax year that the foreign company was a controlled
foreign company bears to the total number of
days in that foreign tax year; or

(bb) the proportional amount determined in the
manner contemplated in subparagraph (i) (as
if the day that foreign company commenced to
be a controlled foreign company was the first
day of its foreign tax year), of the net income
of that company for the period commencing on
the day that the foreign company commenced
to be a controlled foreign company and ending
on the last day of that foreign tax year; or

(b) immediately before that foreign company ceased to be a controlled
foreign company at any stage during that year of assessment before the
last day of the foreign tax year of that controlled foreign company, an
amount which shall be equal to, at the option of the resident, either –

(i) an amount determined in accordance with paragraph
(a)(ii)(aa); or

(ii) the proportional amount determined in the manner
contemplated in paragraph (a)(i) (as if the day that foreign
company ceased to be a controlled foreign company was the
last day of its foreign tax year), of the net income of that
company determined for the period commencing on the first
day of that foreign tax year and ending on the day before the
company so ceased to be a controlled foreign company

Provided that this subsection shall not apply –

(A) where that resident (together with any connected person in relation to
that resident) –

(i) at the end of the last day of the foreign tax year of the
controlled foreign company; or

(ii) in the case where that foreign company ceased to be a
controlled foreign company during the relevant foreign tax
year, immediately before that foreign company so ceased to be
a controlled foreign company,
in aggregate holds less than 10 per cent of the participation rights and may not exercise at least 10 per cent of the voting rights in that controlled foreign company; or

(B) to the extent that the participation rights are held by that resident indirectly through any company which is a resident; or

(C) to the extent that –

(i) the participation rights are held by an insurer as defined in section 29A in any policyholder fund as defined in terms of that section, and are directly attributable to –

(aa) a linked policy as defined in section 1 of the Long-Term Insurance Act, 1998 (Act No. 52 of 1998); or

(bb) a policy as defined in section 29A, other than a policy contemplated in item (aa), of which the amount of the policy benefits as defined in the Long-Term Insurance Act, 1998 (Act No. 52 of 1998), is not guaranteed by the insurer and is to be determined wholly by reference to the value of particular assets or categories of assets; and

ii. the holding of the participation rights by the insurer does not form part of any transaction, operation or scheme entered into or effected solely or mainly for purposes of utilising the provisions of this paragraph in order to avoid the inclusion of an amount in the income of a resident as contemplated in this subsection ’ (58/1962).

As with the other subsections of section 9D considered up to now, the operative subsection is a mouth full containing several detailed requirements and again, exemptions in the form of a proviso to the subsection. Each of these requirements and the proviso will be explained below with the aid of discussion and illustrative examples.
4.2 Controlled foreign company – for an entire foreign tax year

In terms of section 9D(2) of the Act, where a resident shareholder has an interest in the participation rights of a controlled foreign company (‘CFC’) on the last day of that CFC’s foreign tax year and that foreign tax year ends during that resident shareholder’s year of assessment, then the net income of the CFC will be imputed into the resident shareholder’s taxable income. However, the inclusion of the net income and method to determine the amount of net income depends on whether the CFC was one for an entire year of assessment or only commenced to be a CFC during the year. The determination is governed by section 9D(2)(a) either in terms of subsection (i) or (ii) (58/1962).

4.2.1 Entire foreign tax year

Where for the entire foreign tax year a foreign company is a CFC then the net income is determined based on the total net income of that CFC by the percentage of the participation rights that the resident shareholder has in that CFC (Section 9D(2)(a)(i)) (58/1962).

Example: Company A (a South African resident) owns 80% of Company B (a company incorporated and effectively managed in Dubai). Company A has held the participation rights in Company B for the entire foreign tax year. Company B has a net income as determined in terms of section 9D(2A) for the 2010 foreign tax year amounting to R500 000.

In terms of section 9D(2)(a)(i) the determination of the amount of net income is determined as follows due to the foreign company being a CFC for the entire year:

\[
\text{Net income of CFC} \times \frac{\text{ratio of participation rights}}{\text{Total participation rights}}
\]

\[
R500\ 000 \times \frac{80}{100} = R400\ 000
\]

is the net income to be included in the taxable income of Company A in terms of section 9D(2)(a)(i).
4.2.2 **Commences to be a CFC during the foreign tax year**

In terms of the Act, where a foreign company becomes a CFC during the foreign tax year there are two elective options available to the resident shareholder in determining the net income, i.e.:

- The proportional approach (s9D(2)(b)(i)), or
- Determining the actual amount (s9D(2)(b)(ii)) of net income that relates to the part of the foreign tax year (from the date that the foreign company commences to be a CFC to the end of that CFC’s foreign tax year) (58/1962).

4.2.2.1 **Proportional approach (s9D(2)(a)(ii)(aa))**

The proportional amount of net income multiplied by the number of days during which the company was a CFC divided by the total number of days in the tax year (Stiglingh *et al*, 2010:571).

\[
Y = \frac{A \times B}{C}
\]

- $Y =$ the proportional amount of the net income to be included in the resident shareholder’s taxable income
- $A =$ the total net income of the CFC as determined under section 9D(2A)
- $B =$ the number of days from the date on which the CFC became one to the end of the foreign tax year
- $C =$ total number of days in the foreign tax year.

4.2.2.2 **Actual Amount (s9D(2)(a)(ii)(bb))**

The actual amount approach is determined by taking the proportional amount of the net income of the foreign company from the day on which it becomes a CFC until the end of the foreign tax year (Stiglingh *et al*, 2010:571).

**Example:** Company A (a South African resident) owns 80% of Company B (a company incorporated and effectively managed in Dubai). Company A has held the participation rights in Company B since 1 May 2010. Company A has a 31 December
year end whereas Company B has a 31 July year end. Company B has a net income for the 2010 foreign tax year amounting to R500,000. Neither the proviso to subsection 2A nor the exemptions provided for in subsection 9 apply to the net income. From the date on which Company B became a CFC the following net income was earned in each month to the end of the foreign tax year:

<table>
<thead>
<tr>
<th>Month</th>
<th>Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>August 2009</td>
<td>R20,000</td>
</tr>
<tr>
<td>September 2009</td>
<td>R15,000</td>
</tr>
<tr>
<td>October 2009</td>
<td>(R40,000)</td>
</tr>
<tr>
<td>November 2009</td>
<td>(R35,000)</td>
</tr>
<tr>
<td>December 2009</td>
<td>R10,000</td>
</tr>
<tr>
<td>January 2010</td>
<td>(R20,000)</td>
</tr>
<tr>
<td>February 2010</td>
<td>R30,000</td>
</tr>
<tr>
<td>March 2010</td>
<td>R40,000</td>
</tr>
<tr>
<td>April 2010</td>
<td>R90,000</td>
</tr>
<tr>
<td>May 2010</td>
<td>R100,000</td>
</tr>
<tr>
<td>June 2010</td>
<td>R150,000</td>
</tr>
<tr>
<td>July 2010</td>
<td>R140,000</td>
</tr>
<tr>
<td><strong>Total Income</strong></td>
<td><strong>R500,000</strong></td>
</tr>
</tbody>
</table>

**Solution based on the Proportional approach:**

<table>
<thead>
<tr>
<th>January 2010</th>
<th>July 2010 (YE of CFC)</th>
<th>December 2010 (YE of Co A)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1 May 2010 (Acq of Co B) by Co A</td>
<td></td>
</tr>
</tbody>
</table>

The foreign tax year of Company B that ends during the year of assessment of Company A is the year from 1 August 2009 to 31 July 2010. However, company B was not a CFC in relation to Company A during this entire period and company A can therefore elect to apportion the net income of R500,000 based on the period that company was in fact a CFC in relation to Company A.
<table>
<thead>
<tr>
<th>500000</th>
<th>X</th>
<th>80%</th>
<th>X</th>
<th>92</th>
<th>/</th>
<th>365</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>R 100 821.92</strong></td>
<td>Amount to be included in the taxable income of Company A</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Solution based on the Actual approach**

<table>
<thead>
<tr>
<th>January 2010</th>
<th>July 2010 (YE of CFC)</th>
<th>December 2010 (YE of Co A)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1 May 2010 (Acq of Co B) by Co A</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Net income of the CFC from the 1st day that it commences to be a CFC to the last day of the foreign tax year</th>
<th>X</th>
<th>Percentage of participation rights</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income of CFC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>May 2010</td>
<td>R100 000.00</td>
<td></td>
</tr>
<tr>
<td>June 2010</td>
<td>R150 000.00</td>
<td></td>
</tr>
<tr>
<td>July 2010</td>
<td>R140 000.00</td>
<td></td>
</tr>
<tr>
<td>R390 000.00</td>
<td>= Net income to be included in the taxable income of Co A.</td>
<td></td>
</tr>
</tbody>
</table>

From the above example it is clear that the proportional approach results in a lower net income that needs to be included in the taxable income of the resident shareholder. The Act is silent on which approach needs to be followed and therefore, the taxpayer has the option to elect either approach. The Act does not insist that the approach followed for one foreign company be the same each time a foreign company becomes a CFC.
4.2.3 A foreign company ceases to be a controlled foreign company during a foreign tax year (s9D(2)(b))

In terms of the Act, where a foreign company ceases to be a CFC the net income is determined on the day immediately before the foreign company ceases to be a CFC. The net income to be included in the taxable income of the resident shareholder shall be equal to either of the following; again this is at the option of the resident shareholder:

- An amount determined in accordance with paragraph (a)(ii)(aa) – the proportional approach as determined in section 9D(2)(b)(i)
- The proportional amount as determined in paragraph (a)(i) – as if the day that the foreign company ceased to be a controlled foreign company was the last day of its foreign tax year – actual approach (s9D(2)(b)(ii)) (58/1962).

**Example:** Company A (resident) holds 60% in Company B (non resident). Company B ceases to be a controlled foreign company in May 2010. The total net income of Company B for the year August 2009 to July 2010 amounts to R880 000. For the period June 2009 to May 2010 the net income amounts to R600 000. To determine the net income to be included in Company A’s taxable income in terms of:

1. Proportional approach (s9D(2)(b)(i))

**Solution based on the Proportional approach**

<table>
<thead>
<tr>
<th>Net income</th>
<th>X</th>
<th>% Participation rights</th>
<th>X</th>
<th># of days foreign company is a CFC</th>
<th>Divided by</th>
<th>Total number of days in foreign tax year</th>
</tr>
</thead>
<tbody>
<tr>
<td>R880000</td>
<td>X</td>
<td>60%</td>
<td>X</td>
<td>304</td>
<td>Divided by</td>
<td>365</td>
</tr>
</tbody>
</table>
Solution based on Actual approach

Net income is determined based on the actual amounts for each month from the beginning of the tax year to the day before which the foreign company ceases to be a CFC. Net income therefore amounts to

\[
\text{Net income} \times \text{60\%} = 360,000
\]

The above again demonstrates that one option is more beneficial for the resident shareholder than the other. In the Act it states that the resident has the option to elect either method of inclusion in its taxable income.

4.3 **Provisos**

There are three provisos to section 9D(2) which result in no imputation in the hands of the resident shareholder owning the participation rights in a CFC.

4.3.1 **Proviso (A)**

There are two aspects to proviso (A) to section 9D(2), namely:

1. If the resident and any of its connected persons in aggregate hold less than 10% of the participation rights of the CFC at the end of the CFC’s tax year and are not
allowed to exercise more than 10% of the voting rights of the CFC, the resident will not have to account for their portion of the net income of the CFC. (Proviso A(i)) or

2 If the resident and any of its connected persons hold in aggregate less than 10% of the participation rights in the CFC immediately before it ceases to be a CFC during its tax year and are not allowed to exercise more than 10% of the voting rights, the resident will not have to account for their portion of the net income of the CFC (Proviso (A) (ii)) (58/1962).

Example: The following South African residents hold participation and voting rights in Company D, a company incorporated and effectively managed in the UK.

- Company A has participation rights and voting rights amounting to 5%
- Company B has participation rights and voting rights amounting to 9%
- Company C has participation rights and voting rights amounting to 6%
- Company A and C are connected persons
- Company B is not connected to any other company
Company A – Company A has participation rights and voting rights less than 10% however, Company C is a connected person in relation to Company A and therefore the participation rights and voting rights need to be taken into account. Therefore based on the participation rights and voting rights of Company A and C in aggregate a total of 11% is held, which is more than 10%. Therefore there will be imputation into the taxable income of Company A and C as together they hold more than 10% of the participation and voting rights in Company D. The imputation will still be in the ratio of the participation rights of Company A and Company C respectively, i.e. 5% of the net income of Company D will be imputed in Company A’s hands and 6% in Company C’s hands.

Company B – has participation rights and voting rights amounting to 9%, there is no other company that is connected to it and therefore Proviso A to section 9D(2) will apply, i.e. there will be no imputation into the taxable income of Company B as it holds less than 10% of the participation and voting rights in Company D.

4.3.2 Proviso (B)

Proviso (B) of section 9D(2) states that a resident will not have to account for its portion of the net income where the participation rights are held by the resident indirectly through another resident company. The resident company will most probably be subject to the provisions of section 9D (Stiglingh et al, 2010:571). This is to ensure that there is no double imputation where a resident holds shares in a resident company who in turn directly holds participation rights in a CFC. In the absence of this proviso, both residents would have had an obligation to include the net income of the CFC as the definition of participation rights refer to the right to directly or indirectly share in the share capital, share premium or profits and reserves of a company.
**Example:** Company A (SA resident) owns 100% in Company B (SA Resident) who then owns 100% in Company C (Dubai resident).

Therefore the net income of Company C will be included in Company B’s taxable income in terms of section 9D and in terms of the proviso to section 9D(2), no net income of Company C will be included in the taxable income of Company A.

4.3.3 **Proviso (C)**

In proviso (C), a resident will not have to account for his portion of the net income of a CFC if the participation rights are held by an insurer as defined in section 29A in any policy holder fund as defined in that section and

- The participation rights can be directly attributable to a linked policy as defined in section 1 of the Long – term Insurance Act, 1998
- Or the participation rights are directly attributed to a policy as defined in section 29A, other than a linked policy, of which the amount of the policy benefits is not guaranteed by the insurer and is to be determined solely by reference to the value of the particular assets or categories of assets.
The participation rights in this case may only be excluded if it does not form part of a transaction, operation or scheme which was entered into solely for the purposes of avoiding the inclusion of the amount in the income of a resident in terms of section 9D(2). If the insurer holds other participation rights of at least 10% in the CFC, the net income will still be deemed to be income of the insurer in terms of section 9D (Stiglingh et al, 2010:571).

4.4 CFC income and double taxation

There is an international debate on the issue of whether a country can tax income under CFC legislation despite that under a treaty provision, the other contracting state is granted the sole right to tax the income derived by the CFC (Olivier & Honiball, 2008:471).

One of the international cases dealing with the issue (Bricom Holdings Ltd v IRC (1997) STC 1179 CA) was discussed in chapter 1. It is submitted that the outcome would probably have been the same had the case been heard in South Africa as the CFC legislation in South Africa is similar to that in the UK and therefore reliance would be placed on conclusions reached in the UK on CFC issues raised there.

The provisions of the tax treaty are incorporated into and enjoy the binding force of law in South Africa in terms of section 108(2) of the Income Tax Act read with section 23I(4) of the South African Constitution. The result is that the treaty provisions and section 9D will have equal status in South African law.

A court is therefore set the task of establishing which legislation will then apply where a conflict is noted. A court cannot automatically conclude that a treaty overrides domestic legislation. The following should be considered before a decision is made, namely, the object and purpose of the provisions contained in the treaty and South African law, South African common law rules of interpretation and foreign precedents (Olivier & Honiball, 2008:479).

Olivier & Honiball (2008:481) go further to explain that certain countries have dealt with this issue by enacting in their CFC legislation that a treaty will not override
domestic legislation. This has been the case in both the United States and in Australia. France on the other hand has decided to amend treaties both existing and future by renegotiating these to provide for suitable clauses to take into account the CFC legislation in that country.

They recommend that South Africa should follow either of the above practices, in order to provide certainty regarding whether a treaty will override the provisions of section 9D (Olivier & Honiball, 2008:481).

4.5 Conclusion

Whilst section 9D(2) is the operative subsection of section 9D, it provides mostly apportioning rules for net income and also describes the circumstances where section 9D would not apply at all, i.e. where the net income of a CFC is not imputed in the hands of specific residents. It does however not provide guidance as to how the net income that may be subject to imputation needs to be determined. For this, the resident has to turn to subsection (2A), which is the focus area of the next chapter.
5  

CHAPTER FIVE  

5.  SECTION 9D – NET INCOME OF A CONTROLLED FOREIGN COMPANY  

5.1  Introduction to section 9D(2A)  

Section 9D is designed as an anti-avoidance measure, to prevent the avoidance of tax through the use of foreign companies by South African residents. Where a foreign company meets the definition of a CFC, this has the effect of including as income in the hands of the South African resident, who holds more than 50% of the ‘participation rights’ or ‘voting rights’ in a that CFC a notional amount, being the South African resident’s proportional amount of the CFC’s ‘net income’ (De Koker, 2010).  

Section 9D(2A) contains a set of specific rules to assist in the determination of the net income of CFC. The most important rule contained in this section is that the net income of the CFC must be calculated as if the CFC is a taxpayer for South African tax purposes and as if the CFC is a resident in terms of the ‘gross income’ definition, sections 7(8), 10(1)(h), 25B and paragraphs 2(1)(a), 24, 70, 71, 72 and 80 of the Eighth Schedule (Olivier & Honiball, 2008:443) (emphasis added).  

A taxpayer is defined in section 1 of the Act as ‘any person chargeable with any tax leviable under this Act and includes every person required by this Act to furnish any return’ (58/1962).  

In turn, the concept of ‘resident’ for South African tax purposes is fundamental to the worldwide or residence-based system of taxation (De Koker, 2010). A person who qualifies as a ‘resident’ as defined in section 1 is subject to tax in South Africa on their receipts and accruals from all sources subject to certain exceptions (De Koker, 2010).
5.2 **Preamble to section 9D(2A)**

The preamble to section 9D(2A) reiterates that the entire Income Tax Act no 58 of 1962 will apply to CFCs where the net income is to be determined for imputation into the taxable income of the resident shareholder (Olivier & Honiball, 2008:443). The opening words go on to specifically state that certain sections in the Act will apply to CFCs as if they are residents for South African tax purposes. In these specific circumstances, since the CFC is seen to be a resident, it results in the imputation of the CFC’s world-wide income into the South African tax net. In the absence of these provisions, it is submitted that section 9D would have been ineffective as only South African sourced income earned by the CFC would have been subject to imputation. This income would then have had to be excluded as already being subject to tax based on the existing source rule applied to non-residents.

The provisions of section 9D(2A) are therefore key to the effectiveness of section 9D in ensuring that there is no deferral of income to low tax jurisdictions by residents to obtain a tax benefit.

In terms of section 9D(2), a CFC is deemed to be a resident in relation to the following sections in the Act:

- Section 1 which relates to the gross income definition
- Section 7(8) relating to donations (broadly) made by a resident to a non-resident
- Section 10(1)(h) the exemption of interest accrued to or received by a non-resident
- Section 25B, the income of trusts and beneficiaries of trusts
- Paragraph 2(1)(a) of the Eighth Schedule which deals with capital gains tax on worldwide gains
- Paragraph 12 of the Eighth Schedule which relates to events treated as disposals and acquisitions for capital gains tax purposes
- Paragraph 24 of the Eighth Schedule which clarifies the determination of the base cost an asset of a person who becomes a resident after 1 October 2001
• Paragraph 70 of the Eighth Schedule deals with the attribution rules for capital gains that are subject to conditional vesting
• Paragraph 72 of the Eighth Schedule deals with attribution of capital gains vesting in non-residents
• Paragraph 80 of the Eighth Schedule deals with capital gains attributed to a beneficiary (Olivier & Honiball, 2008:443).

5.2.1 Requirements to section 9D(2A)

There are a number of requirements that should be taken into consideration in the determination of the net income per section 9D(2A) (Stiglingh et al, 2010:567). Each requirement will be discussed together with illustrative examples to provide a better understanding in determining the net income of a CFC:

5.2.1.1 Limiting deductions and allowances to income earned

In terms of section 9D(2A) of the Act, the deductions and allowances that the CFC is entitled to in terms of South African tax legislation is limited to the income earned by that CFC. The section goes further to state that no loss is allowed to be imputed into the resident shareholder’s taxable income. Due to the limitation provided in section 9D(2A)(a), where a CFC is in a net loss position, a net income of zero will be included in the resident shareholder’s taxable income (58/1962).

Example: Company B is a wholly owned subsidiary of Company A. Company B is situated in the UK and is a controlled foreign company in terms of section 9D to the Act (none of the exemptions apply). Company B has the following income and expenses in terms of South African tax legislation:

- Gross Income $\text{R200 000}$
- Deductions $\text{R120 000}$
- Wear and tear allowance $\text{R100 000}$

Total expenses amount to R220 000 and exceeds total income of R200 000 by R20 000. Therefore no income is imputed into the taxable income of Company A, as the expenses exceed the income for the foreign tax year.
5.2.1.2 Ring fencing of assessed losses

In terms of section 9D(2A)(b) of the Act, where the deductions and allowances granted to a CFC result in a net loss position (i.e. the deductions and allowances exceed the income earned) the loss can be carried forward to the succeeding year of assessment. This assessed loss can then be set off against income earned in the succeeding year of assessment in terms of section 20 (58/1962).

Based on the above, it is clear that the provision of section 20 needs to be adhered to in determining the net income of a CFC. However, this begs the question as to whether all the provisions of section 20 would be applied to assessed losses carried forward by a CFC. As stated above, the CFC is seen to be a taxpayer and therefore the requirements of section 20 would apply to the CFC as well.

The general viewpoint followed in the Act is that each year of assessment is a closed compartment and that the taxpayer’s taxable income is determined anew in each year of assessment by taking account of the taxpayer’s income and deductions in respect of that year only, i.e. a taxpayer resident cannot decide in which year of assessment to incur expenses and recognise income. An important qualification to this principle is laid down in section 20(1)(a) which provides that, subject to certain requirements, an assessed loss in one year of assessment can be carried forward into the following year of assessment and set off against the income of that year for the purposes of determining the taxable income of that year (Williams, 2005:447).

Section 20(1)(a) of the Act states that for the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be set off against the income so derived by such person, any balance of assessed loss incurred by the taxpayer in any previous year which has been carried forward from the preceding year of assessment (58/1962).

In terms of Interpretation Note 33 to the Act relating to assessed losses, the meaning of assessed losses is defined in section 20(2) and is said to refer to the tax loss that
arises in the current year after deducting the admissible deductions in sections 11 to 19. From the above it is clear that the term ‘trade’ is not included in the definition of ‘assessed losses’, however, the carrying on of a trade is a general requirement in terms of the deductibility under sections 11 to 19 (Lexis Nexis, 2009:1058).

The Interpretation Note goes further to discuss the ‘trade requirement’ and it states that before a taxpayer can carry forward an assessed loss to the succeeding year of assessment, it must have carried on a trade during that year of assessment during which it requires the deduction of the carry forward of assessed losses. Where a taxpayer fails to carry on a trade, the right to carry forward the assessed loss is forfeited. This was firmly entrenched by a landmark case SA Bazaars (Pty) Ltd v CIR 1952 (4) SA 505 (A) (Lexis Nexis, 2009:1058).

In SA Bazaars (Pty) Ltd v CIR 1952 (4) SA 505 (A) the appellant closed the company but for a period kept itself alive by maintaining a bank account, paying its annual duty and complying with the Companies Act and Income Tax Act requirements. Seven years later it resumed trading and sought to set off the assessed loss from prior years. Although the ‘trade’ requirement may have been firmly established, difficulties arise in determining whether a company’s activities constitute the carrying on of a trade. This can happen where-

- The nature of the activity itself does not fall within the meaning of the word ‘trade’ as defined in section 1; or
- The company’s activities have taken place prior to commencement of trade; or
- The company conducts non-trade activities after it has ceased trading; or
- The anti-avoidance provisions of section 103(2) of the Act apply.

It is SARS’ view that section 20 contains firstly, a trade requirement and secondly, an income from trade requirement. Both requirements are required to be satisfied before an assessed loss may be carried forward (Lexis Nexis, 2009:1058-1059, 1066). Therefore, it is submitted that where a CFC has an assessed loss carried forward to the succeeding year of assessment and that CFC has ceased to trade, that assessed loss
will be lost and cannot be set off against future net income determined for inclusion in the resident shareholder’s taxable income.

**Example:** Company B is a wholly owned subsidiary of Company A. Company B is situated in the UK and is a controlled foreign company in terms of section 9D to the Act (none of the exemptions apply). Company B has the following income and expenses in terms of South African tax legislation:

- **Gross Income**  
  R200 000

- **Deductions**  
  R120 000

- **Wear and tear allowance**  
  R100 000

Total expenses amount to R220 000 and exceeds total income of R200 000 by R20 000. Therefore no income is imputed into the taxable income of Company A, as the expenses exceed the income for the foreign tax year. The R20 000 calculates loss is therefore carried forward in terms of section 9D(2A)(b) to the succeeding year of assessment and can be set off against future taxable income. However, in the following year Company B, ceases to trade for the entire year of assessment, this calculated loss in terms of the principles laid down in SA Bazaars is lost.

### 5.2.1.3 Disallowable expenses

In terms of section 9D(2A)(c), there are certain expenses that are not available for deduction from income in determining the net income of the CFC. This provision is a mirror of the exemptions from imputation provided for in section 9D(9)(fA) (refer to Chapter 3 for a discussion on the exemptions). Subsection (2A)(c) describes how the following expense items are disallowed in the determination of the net income of a CFC, where this CFC and that other CFC form part of the same ‘group of companies’:

- Interest, royalties, rental or income of a similar nature which is paid/payable or deemed to be paid or payable by that company to any other controlled foreign company (including any similar amount adjusted in terms of section 31);

- Exchange difference determined in terms of section 24I in respect of any exchange item to which that company and any other controlled foreign company are parties;
• Exchange differences in respect of any forward exchange contract or foreign currency option contract entered into to hedge the exchange item referred to in subparagraph (ii); or

• Reduction or discharge by that company of a debt owed to that company by any other controlled foreign company for no consideration or for consideration less than the amount by which the face value of the debt has been so reduced or discharged (58/1962).

This rule effectively ensures that parity exists between the two CFCs. For example, if CFC A receives royalty income from CFC B, in terms of this subsection, CFC A does not include the income in its net income determination and CFC B is unable to obtain the royalty paid deduction. However, where an election is made in terms of section 9D(12), which determines that the resident shareholder can elect to include the royalty income of CFC A and then CFC B will be able to obtain the deduction (De Koker, 2010).

5.2.1.4 Valuation date of Controlled Foreign Company

Where a foreign company becomes a CFC after the date on which capital gains tax (“CGT”) was introduced (i.e. 1 October 2001) the valuation date for CGT purposes is the date on which it became a CFC (s9D(2A)(e)) (Olivier & Honiball, 2008:445).

For the CGT consequences and illustrative examples relating to CFCs, refer to 5.5.

5.2.1.5 Capital gains tax for natural persons, special trusts and insurers

Where the controlling resident is a natural person, special trust, or an insurer in respect of its individual policyholder fund, the inclusion rate for CGT purposes in determining the inclusion of the capital gain in terms of section 26A is at a rate of 25% (s9D(2A)(f)) (Olivier & Honiball, 2008:445).

For the CGT consequences and illustrative examples relating to CFCs, refer to 5.5.
Section 31

Section 9D(2A)(h)(i) states that section 31(2) of the Act will apply in relation to any transaction, operation or scheme between the CFC and any connected person in relation to that CFC (58/1962). This means that the Commissioner is entitled to adjust the consideration in relation to said transactions if the consideration is not at an arm’s length.

For purposes of applying the thin capitalisation provisions contained in section 31(3)(a)(i) and (ii)\(^8\), the CFC will be deemed to be a resident for South African income tax purposes (Stiglingh et al, 2010:584).

In terms of Practice Note 7 to the Act which states that section 31 enables the Commissioner to adjust the consideration in respect of a supply or acquisition of goods or services in terms of an international agreement between connected persons. The Commissioner may adjust the consideration, for tax purposes, if the actual price charged by or to the resident is either less or greater than the price that would have been set if the supply or acquisition of goods or services had occurred between independent parties on an arm’s length basis. The Commissioner may then use the amount so determined, for inclusion in the taxable income of either of the parties to the transaction (Lexis Nexis, 2009:1470).

In terms of Practice Note 2 of the Act, section 31 also refers to transactions where financial assistance is granted by a foreign connected person to a South African resident. Financial assistance in terms of section 31 includes both interest-bearing financial assistance and interest-free financial assistance. As the purpose of subsection (3) is in essence to enable the Commissioner to determine an acceptable debt/equity ratio (3:1) in order to disallow a deduction in respect of interest relating to the excessive portion of loan capital, the application of subsection (3) will be limited to interest-bearing financial assistance. This will, however, not have the effect that

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\(^8\) With effect from years of assessment beginning on and after 1 October 2011, section 31 has been amended by inter alia removing the so called thin capitalisation provisions.
financial assistance which is not interest bearing will be regarded as permanent owner’s capital (Lexis Nexis, 2009:1408).

The Practice Note goes further to state that on the same basis, interest-bearing financial assistance will be taken into account in the application of the transfer pricing provisions of subsection (2) in cases where it is applied in conjunction with the provisions of subsection (3) to determine whether the interest calculated on the portion of the financial assistance falling within the 3:1 guideline, is based on an arm’s length price (interest rate). However, where the application of the thin capitalisation provisions are not necessary because the financial assistance granted falls within the prescribed guidelines, financial assistance may include financial assistance which is not interest bearing in the application of the provision of subsection (2) (Lexis Nexis, 2009:1408).

Section 9D(2A)(h)(i) read with section 31 means that the Commissioner may make adjustments if the transactions between two CFCs who are connected persons in relation to each other are not arm’s length. This may for example apply where the income of CFC A is imputable but the income in CFC B qualifies for exemption in terms of section 9D. If CFC A and CFC B transact with each other, the parties may be influenced by the resident to manipulate the pricing policy to ensure that the majority of the income ends up in CFC B so as to limit the amount that can be imputed in the hands of the resident holding the participation rights.

It is submitted that in practice there are a number of transactions where an adjustment in terms of section 31(2) would be pointless. An example would be financial assistance provided by CFC A to CFC B as the interest paid by CFC B would not be deductible in determining the net income of CFC B and similarly the same amount of interest earned by CFC A would not be included in the net income of CFC B.

The same would apply to thin capitalisation provisions: if none of the interest paid by the CFC to another CFC is allowed in determining the net income of the first mentioned CFC, it is pointless to determine which portion of the interest relates to excessive financial assistance, i.e. to financial assistance which exceeds the 3:1 ratio.
In terms of the Explanatory Memorandum on the Taxation Laws Amendment Bill of 2010, certain amendments have been made relating to section 31 relating to transfer pricing. The amendments to section 31 were made to be in line with the guidance provided by the OECD with the focus being on cross border transactions, operations, schemes, agreements or understandings that have been effected between or undertaken for the benefit of connected persons. The new rules are now aligned with the provisions contained in the OECD and UN Model Tax Convention and are now also in line with tax treaties and related international tax principles. South Africa will therefore be following the OECD Transfer Pricing Guidelines and to re-characterise transactions and the application of the transfer pricing rules thereon (National Treasury, 2010:75-76).

In relation to the rules relating to thin capitalisation, these will now be combined with the transfer pricing rules. This will result in the transfer pricing rules now being used to deny the deductions relating to interest where a South African entity is thinly capitalised with excessive debt (National Treasury, 2010:75-76).

5.2.1.7 Paragraph 43 of the Eighth Schedule

For purposes of the application of paragraph 43 of the Eighth Schedule, CFC’s local currency refers to the currency used by it for purposes of financial reporting (s9D(2A)(k)) (Olivier & Honiball, 2008:445).

For the CGT consequences and illustrative examples relating to controlled foreign companies, refer to 5.5.

5.3 Translation of net income

Section 9D(6) clarifies the approach that should be followed in translating the net income of a CFC, from the foreign currency used by the CFC for reporting purposes\(^9\) in its country of residence to the local currency of the resident shareholder, i.e. South

\(^9\) The Taxation Law Amendment Bill of 2010 has replaced the term ‘currency for financial reporting’ with ‘functional currency’ with effect from 1 January 2011 and applicable in respect of foreign tax years of controlled foreign companies ending during years of assessment commencing on or after that date.
African Rands (58/1962). Included in this section to the Act, is certain provisos relating to specific transactions that may take place in the CFCs business for the foreign tax year. The section describes the different translation rules that will apply other than that disclosed in the preamble to the section.

The opening words to the section of the Act, explain that the net income of a CFC is to be determined in the currency used by that CFC for purposes of financial reporting and to be translated into the currency of the Republic at an average exchange rate for that year of assessment. The year of assessment is in relation to the resident shareholder’s year of assessment. The term ‘currency used for financial reporting’ is not defined in the Act, however an explanation of the meaning of the word is contained in Chapter 2 (58/1962).

The provisos to the section are described below and are as follows:

- Subsection (a) to the Act states that where the CFC disposes of any asset in terms of paragraph 43(4) of the Eighth Schedule which is not attributable to a permanent establishment of the CFC outside the Republic, any capital gain or loss of that CFC, when applying this paragraph shall be determined in the currency of the Republic and translated to the currency used by that CFC by applying the average exchange rate (58/1962).

- Subsection (b) states that in respect of a disposal of any foreign equity instrument which is treated as trading stock and which is not attributable to a permanent establishment of that CFC outside the Republic, the amount taken into account in determining the net income of that CFC is determined in the currency of the Republic and that amount shall be translated to the currency used by that CFC by applying the average exchange rate (58/1962).

- Subsection (c) states that for the purposes of section 24I, ‘local currency’ in relation to an exchange item of a CFC which is not attributable to a permanent establishment of that company outside the Republic, means the currency of the Republic and any exchange difference determined must be translated to the currency so used by that CFC by applying that average exchange rate (58/1962). The provisos to this section, refer to the ‘average exchange rate’ but do not say in
relation to what period, the year of assessment of the resident shareholder or the foreign tax year of the CFC. In my view, clarity by the legislator is required. Currently, it can be assumed based on the preamble to the section that the ‘average exchange rate’ should be in relation to the year of assessment of the resident shareholder. However, this assumption might be incorrect and therefore further guidance is required from the legislator.

- Subsection (d)(i) states that any asset or foreign equity instrument which is disposed of and any exchange item denominated in any currency other than the currency used by that CFC for purposes of financial reporting shall be deemed not to be attributable to any permanent establishment of the CFC if the currency used for financial reporting is the currency of the country which has an official rate of inflation of 100% or more throughout the foreign tax year (58/1962).

In terms of section 9D(6)(d)(i), the Explanatory Memorandum of the Taxation Laws Amendment Bill of 2010, provides for the fact where a foreign country abandons its currency as legal tender due to unfavourable circumstances, for example Zimbabwe, where they have changed their legal tender from Zimbabwe dollars to US dollars. This takes place after a period of hyperinflation which results in a lack of reliable exchange rate information. In the view of the above, a special rule has been proposed in respect of the tax cost of the foreign assets before the abandonment of the hyper-inflationary currency. The tax treatment of these assets will be that they are deemed to be restated at the market value at the time the abandonment of the hyper-inflationary currency takes place. The new starting date is said to be the date on which the new currency is adopted and the tax cost will apply if the assets were acquired for the first time. The amendment is aimed at alleviating the burden of determining the tax cost of assets after a period of hyperinflation experienced by a country (National Treasury, 2010:88-89).

The term ‘average exchange rate’ is defined in section 1 of the Act to mean ‘in relation to a year of assessment the average determined by using the closing spot rates at the end of daily or monthly intervals during that year of assessment which must be consistently applied within that year of assessment’ (58/1962).
It is submitted that the exchange rate required to be used in section 9D(6) when translating the net income of the CFC to the currency of the resident shareholder will be misstated. The average exchange rate used is based on the year of assessment of the resident shareholder, but the net income that is being translated relates to the foreign tax year of the CFC. There is disparity between the exchange rate being applied and the period to which the income relates. However, as the Act specifically refers to the “year of assessment” this is the basis used in this study in the interpretation note to Section 9D.

5.4 Elections

Included in section 9D are two elections available to resident shareholders for CFCs provided that the resident together with a connected person in aggregate holds at least 10% but not more than 20% of the participation rights and voting rights of a CFC. The resident shareholder may elect section 9D(12) and/or section 9D(13) (58/1962). The election of section 9D(12) impacts directly upon the amount of net income of a CFC that is subject to imputation.

Section 9D(12), if elected will result in all the provisions of subsection 9 (i.e. the exemptions available to resident shareholders to not impute the net income of a CFC) not applying in respect of the net income in relation to a foreign tax year of a CFC in which that resident holds any participation rights. Therefore, where a CFC is a foreign business establishment and the exemption in terms of section 9D(9) could apply and the net income not imputed, where a resident shareholder has elected subsection (12) to apply, the net income regardless of the definition of foreign business establishment being met, the net income of the entity will still be imputed into the resident shareholder’s taxable income (De Koker, 2010). At the same time, the corresponding deductions denied in terms of subsection (2A) become available again.

The elections that can be used by a resident shareholder are mechanisms with an ‘all or nothing approach’. The resident shareholder cannot choose to bring only certain portions of otherwise exempt income into the tax net. The elections may be made on a year by year basis. Where the election is made it effectively permits a resident
shareholder to be taxed on foreign income so as to receive the benefit of the rebate contained in section 6quat (De Koker, 2010).

**Example:** A South African company owns 25% of the ordinary shares of a Swedish-based CFC. In its 2005 year of assessment, this CFC earns E600 000 (E = Euro) of active income attributable to a business establishment and E40 000 of passive income from related working capital. All the income of the CFC is subject to a 30% company rate of tax.

In its 2006 year of assessment, this CFC distributes its after-tax income of E448 000 (E600 000 plus E40 000 less E192 000 tax) from its previous year of assessment to its shareholders as a dividend.

In its 2005 year of assessment, the South African company may elect to treat an amount equal to its portion of the CFC income as imputed amounts despite the exclusion in section 9D(9)(b). Its South African tax liability may then be reduced by the section 6quat rebate. The South African company can disregard the dividend in its 2006 year of assessment because this dividend represents previously taxed income.

In addition to the section 9D(12) election, the resident is also afforded an election in terms of section 9D(13) to treat a foreign company which is not a CFC as if it were a CFC for the relevant foreign tax year. This election effectively permits him to be taxed on his share of the CFC’s profits and as a consequence to receive the benefit of the section 6quat rebate. It also means that any subsequent dividend declared by the CFC will be exempt from tax, since dividends from CFC’s whose profits have been subject to tax in South Africa are exempt, with the result that the foreign dividend remains exempt even though the shareholding is below 20%. However, the election does not allow for the excess foreign tax credits to be utilised against the South African tax liability (De Koker, 2010).

**Example:** A South African company owns 20% of the ordinary shares of a Swedish-based company. An unconnected foreign individual who is not resident in South Africa owns the remainder of its shares.
In its 2005 year of assessment, the Swedish-based company earns E70 000 (E=Euro) of passive net income subject to a 30% rate of tax.

In its 2006 year of assessment, the Swedish-based company distributes its after-tax income of E49 000 (E70 000 – E21 000) from its previous year of assessment to its shareholders as a dividend on a pro rata basis.

The South African company can elect to be subjected to tax on its pro rata share of the E70 000 earned by the Swedish-based company as if it [the Swedish-based company] were a CFC. If the South African company makes the election, it is deemed to receive E14 000 (20% of E70 000) of income along with E4 200 (20% of (E21 000) towards a section 6quat rebate (resulting in no South African taxes being payable E70 000 × 30% – E21 000).

The South African company can disregard the E9 800 (20% of E49 000) of dividends received in the following year of assessment because all these dividends represent previously taxed income (see s 10(1)(k)(ii)(cc)).

Both elections contained in 9D(12) and (13) can be made on a year by year basis by the resident shareholder, regardless of whether an election has been made by any other resident shareholder. The election contained in section 9D(12) can be combined with the election in section 9D(13). Both sections gives access to the rebate provided for in section 6quat as the net income of the CFC is imputed into the taxable income of the resident, which in turn means that any dividend distributed by the CFC from the same profits will be exempt (De Koker, 2010).
5.5 **Capital gains tax implications**

The following provisions in section 9D relates specifically to CGT:
1. Section 9D(2A)(e) – When a capital gain of a CFC will be included in net income
2. Section 9D(2A)(f) – Rate to be used for CGT purposes for CFC’s
3. Section 9D(2A)(k) – Meaning of ‘local currency’ in terms of paragraph 43 of the Eighth Schedule
4. Section 9D(6)(a) – Translation of capital gain or loss on disposal of assets (58/1962).

The following paragraphs of the Eighth Schedule are relevant specifically to CFC’s:
1. Paragraph 12(2) – deemed disposal rules for the purposes of determining the base cost of assets owned by a foreign entity when that foreign entity becomes a CFC and deemed disposal rules for the purposes of determining a notional capital gain or loss in respect of assets being removed from the CGT net when a CFC ceases to be a CFC
2. Paragraph 12(4) – deemed disposal rules when a CFC ceases to be CFC as a result of becoming a resident for CGT purposes
3. Paragraph 13(g) – Setting the time of disposal for the deemed disposals mentioned above
4. Paragraph 20(1)(h)(iii) – determining the base cost of a right held directly by a resident in a CFC as well as the base cost of a right held indirectly in a CFC through another CFC by a resident
5. Paragraph 24 – Base cost of asset of a person who becomes a resident on or after valuation date

As was already mentioned above, a CFC is deemed to be a resident for purposes of inter alia, paragraph 2(1)(a), 24, 70, 71, 72 and 80 of the Eighth Schedule:
- The result of deeming a CFC to be a resident for purposes of paragraph 2(1)(a), is that all the assets of a CFC will fall within the scope of the Eighth Schedule.
Had it not been for this provision, only immovable property situated in South Africa and assets attributable to a permanent establishment of the CFC in South Africa would have fallen within the scope of South Africa’s CGT legislation.

- Paragraph 24 read with paragraph 12(2) is the sole method prescribed for the purpose of determining the base cost of a CFC’s assets upon becoming a CFC (SARS, 2010b:158).
- Paragraphs 70, 71 and 72 are anti-avoidance measures dealing with the attribution of capital gains where the disposal of the asset is subject to conditional or revocable vesting or results in a capital gain vesting in a non-resident.
- Paragraph 80 deals with the attribution of capital gains arising in a trust or resulting from the vesting of an asset in a beneficiary of a trust (58/1962).

As section 9D in some instances refers specifically to certain paragraphs in the Eighth Schedule, in order to clarify the position relating to controlled foreign companies, the sections in 9D will be discussed together with the provisions in the Eighth Schedule, where necessary.

### 5.5.1 Imputation of foreign capital gain of a CFC to SA resident

In terms of section 9D(2A) to the Act, the taxable income of the CFC is determined in accordance with the provisions of the Act and this includes any taxable capital gains made by the CFC for the year of assessment (De Koker, 2010). Therefore the capital gains have to be apportioned to the resident in accordance with participation rights in that CFC. The net income of the CFC must be determined as if it were a taxpayer for South African tax purposes, but a resident for purposes of the Eighth Schedule (see discussion above) and therefore gains and losses resulting from the disposal of its worldwide assets will be taken into account in determining its net income even though the Eighth Schedule limits capital gains of certain assets owned by non-residents (De Koker, 2010).

The valuation date of a CFC is determined in section 9D(2A)(e), to be the day before the foreign company becomes a CFC. This is mirrored in the Eighth Schedule in paragraph 13(g)(i) which states that when a CFC commences or ceases to be a
resident the time of disposal is the date immediately before the day that the event occurs.

Example: Company A bought 100% of the share capital of Company B on the 1 January 2010. Therefore company B is a controlled foreign company and its valuation date for capital gains tax purposes is the day before it becomes a controlled foreign company, i.e. 31 December 2009.

5.5.2 Determination of the base cost of pre-1 October 2001 assets

As already stated, CFCs are deemed to be residents for purposes of paragraph 2(1)(a). Therefore by implication, the determination of the valuation date value of pre-valuation date assets applicable to CFCs (those include paragraphs 20, 25, 26, 27, 28, 29, 30, 31 and 32). Therefore where a CFC existed before 1 October 2001, the pre valuation date rules per the Eighth Schedule will apply to them i.e. when determining any capital gain or loss in respect of the disposal of its pre-valuation date asset. A CFC will have to determine the base cost in the same manner as a resident. For example, where a CFC has elected to use the market value valuation date, it would need to have valued its assets by 30 September 2004 except for those assets held by the CFC which consist of South African listed shares or South African participatory interests in collective investment schemes whose prices were published in the Gazette (SARS, 2010b:624).

5.5.3 Base cost adjustments (para 20(1)(h)(iii))

Paragraph 20 of the Eighth Schedule specifies the expenses and amounts allowed in determining the base cost of an asset as well as the amounts which are specifically excluded. The paragraph deals with qualifying expenditure to determine the cost of an asset for both pre and post valuation date assets (SARS, 2010b:624).

For CFCs, paragraph 20(1)(h)(iii) describes the base cost adjustment that is required. In terms of the Act, where there is a right in a CFC which is held directly by a resident, the amount must be equal to the proportional amount of net income of that company and of any other CFC in which that CFC and that resident directly or
indirectly have an interest, which was included in the income of that resident in terms of section 9D during any year of assessment less the amount of any foreign dividend distributed by that company to that resident during any year of assessment which was exempt from tax in terms of section 10(1)(k)(ii)(cc) (58/1962).

In terms of the detailed explanation on Section 9D issued by National Treasury, the base cost adjustment in terms of paragraph 20(1)(h)(iii) is described as an adjustment which is required where South African residents have an interest in a CFC. In summary, the base cost adjustment is made for the net income amount included and certain dividends. To the extent that the South African resident receives net income to be included in its taxable income this results in an upward adjustment. Residents also receive a full upward base cost adjustment for their net capital gains (even though those gains are only partially included in income). In essence, the base cost of an interest in a CFC is increased by amounts included in the taxable income of the resident (SARS, 2002b:7).

<table>
<thead>
<tr>
<th>Therefore:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of shares in CFC</td>
</tr>
<tr>
<td>Plus: Net income included in SA resident taxable income</td>
</tr>
<tr>
<td>Less: Net taxable capital gain included in net income above</td>
</tr>
<tr>
<td>Plus: Capital gain at full value</td>
</tr>
<tr>
<td>Less: Dividends received from CFC from income previously included in net income and taxed</td>
</tr>
</tbody>
</table>

= Base cost adjustment for CFC’s

However, residents must reduce the base cost of their CFC shares to the extent they receive a tax-free dividend distribution which represents previously taxed section 9D income, CFC dividends are exempt under section 10(1)(k)(ii)(cc) (SARS, 2010b:624).
Example 1
South African Company owns all the shares of a CFC with a R700 base cost. In 2001, CFC generates R300 of active income, R70 of passive interest income, and R50 of passive capital gains. The latter two items are included in South African Company’s income by virtue of section 9D. In 2002, CFC distributes all R120 of the previously described profits.

The base cost of the shares in the CFC is determined as follows:

<table>
<thead>
<tr>
<th></th>
<th>R</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening base cost of shares in CFC</td>
<td>700</td>
</tr>
<tr>
<td><strong>2001</strong></td>
<td></td>
</tr>
<tr>
<td>Active income (no adjustment)</td>
<td>-</td>
</tr>
<tr>
<td>Passive interest income</td>
<td>70</td>
</tr>
<tr>
<td>Passive capital gains</td>
<td>50</td>
</tr>
<tr>
<td>Revised base cost</td>
<td>820</td>
</tr>
<tr>
<td><strong>2002</strong></td>
<td></td>
</tr>
<tr>
<td>Less: Exempt foreign dividend</td>
<td>(120)</td>
</tr>
<tr>
<td>Closing base cost</td>
<td>700</td>
</tr>
</tbody>
</table>

Note the full credit for the passive capital gains despite the 50% inclusion rate.

The passive income will be included in the CFC’s taxable income in terms of section 9D before the reduction of the base cost by that which has been distributed via a dividend which is exempt in terms of section 10(1)(k)(ii)(cc).

Example 2
A South African resident individual owns all the shares in a foreign company, which qualifies as a CFC. The shares were acquired for R600 000 on 19 December 2001. The receipts and accruals of the foreign company consist of the following:

<table>
<thead>
<tr>
<th></th>
<th>R</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign dividends</td>
<td>300 000</td>
</tr>
<tr>
<td>Capital gain on disposal of shares</td>
<td>500 000</td>
</tr>
</tbody>
</table>
Capital loss on disposal of shares  (200 000)

The net income of the CFC (disregarding the inclusion rate applicable to individuals) as contemplated in section 9D is R300 000 + R500 000 – R200 000 = R600 000. The base cost of the shares is determined as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of shares (para 20(1)(a))</td>
<td>600 000</td>
</tr>
<tr>
<td>Net income as above (para 20(1)(h)(ii)(aa))</td>
<td>600 000</td>
</tr>
<tr>
<td>Base cost</td>
<td>1 200 000</td>
</tr>
</tbody>
</table>

**Example 3**

Joe, a resident is the sole shareholder of Company A, a controlled foreign company. Joe paid R350 000 for the shares in Company A. During the current year of assessment, Company A made had the following receipts and accruals:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign dividends</td>
<td>R150 000</td>
</tr>
<tr>
<td>Capital gain</td>
<td>R200 000</td>
</tr>
<tr>
<td>Capital loss</td>
<td>R90 000</td>
</tr>
</tbody>
</table>

Joe will include in his determination of the net income of Company A for inclusion in his taxable income the following:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proportional amount of the foreign dividends</td>
<td>R150 000</td>
</tr>
<tr>
<td>Proportional amount of the capital gain</td>
<td></td>
</tr>
<tr>
<td>- Capital gain</td>
<td>R200 000</td>
</tr>
<tr>
<td>- Capital loss</td>
<td>(R90 000)</td>
</tr>
<tr>
<td>Net capital gain</td>
<td>R110 000</td>
</tr>
<tr>
<td>At 25%</td>
<td>R27 500</td>
</tr>
<tr>
<td>Net income of Company A included in Joe’s income</td>
<td>R177 500</td>
</tr>
</tbody>
</table>

During the year of assessment, Company A declared a dividend to Joe amounting to R100 000 which was exempt from tax in terms of section 10(1)(k)(ii)(cc). After receiving the dividend from Company A, Joe decided to sell the CFC for R600 000.

The base cost is determined as follows:
Original cost of the shares in the CFC  
Plus: net income included  
Less: taxable capital gain  
Plus: Full Capital gain  
Less: Dividends received that were previously included  
Base cost of shares  
Proceeds  
Capital gain  
Net capital gain at 25%  

R350 000  
R177 500  
(R27 500)  
R110 000  
(R100 000)  
R510 000  
R600 000  
R90 000  
R22 500  

In terms of the Act, section 10(1)(k)(ii)(cc) states that ‘where a resident to the extent that the foreign dividend does not exceed the aggregate of all amounts which have been or will be included in the income of that resident in terms of section 9D in any year of assessment, which relate to the net income of:

- The company declaring the dividend or
- Any other company which has been included in the income of that resident in terms of section 9D by virtue of that resident’s participation rights in that other company held indirectly through the company declaring the dividend

Reduced by –

- The amount of any foreign tax payable in respect of the amounts so included in that resident’s income and
- So much of all foreign dividends received by or accrued to that resident at any time from any company contemplated above as was
  - Exempt from tax in terms of this item or item (dd) or
  - Was previously not included in the income of that resident by virtue of any prior inclusion in terms of section 9D’ (58/1962).

A foreign company in which a resident has an indirect qualifying interest will also constitute a CFC in relation to that resident. In other words, not only is the proportional amount of the net income of the holding company imputed to the resident shareholder, but also the proportional amount of the net income of any CFC subsidiaries in which the resident has an indirect qualifying interest. A special rule is
contained in paragraph 20(1)(h)(iii)(bb) to deal with the determination of the base cost of an interest in a subsidiary CFC by a holding company CFC. (SARS, 2010b:625).

Paragraph 20(1)(h)(iii)(bb) per the Act, states that where a right in a CFC is held directly by another CFC, an amount equal to the proportional amount of the net income (without having regard to the percentage adjustments contemplated in paragraph 10) of that first-mentioned CFC and of any other CFC in which both the first and second mentioned CFC directly or indirectly have an interest, which during any year of assessment would have been included in the income of that second-mentioned CFC in terms of section 9D had it been a resident, less the amount of any foreign dividend distributed by that first-mentioned CFC to the second-mentioned CFC if that dividend would have been exempt from tax in terms of section 10(1)(k)(ii)(cc) had that second-mentioned CFC been a resident (58/1962).

Example 1
Michelle, a resident, owns all the shares in CFC 1 which owns all the shares in CFC 2 which owns all the shares in CFC 3. Michelle acquired all the shares in CFC 1 at a cost of R400 000 on 1 March 2008. At that date each CFC owned a portfolio of foreign listed shares valued at R150 000. On 29 February 2009 CFC 3 sold its portfolio of shares for R200 000 and reinvested the proceeds in other foreign listed shares. On 30 June 2009 CFC 3 declared a dividend of R70 000 to CFC 2 which on declared it to CFC 1 which on-declared it to Michelle. On 31 December 2009, CFC 1 disposed of its interest in CFC 2 for R450 000.
The disposal of listed shares by CFC 3 gives rise to a capital gain of R50 000 (R200 000 less R150 000) which is taxed in Michelle’s hands under section 9D (that is, R50 000 x 25% - R12 500). The base cost of CFC 1’s shares in CFC 2 is determined as follows:

\[
\begin{align*}
\text{Market value of shares on date CFC 2 became a CFC (para 12(2))} & \quad R 200 000 \\
\text{Net income of CFC 3 (disregarding inclusion rate)} & \quad 50 000 \\
\text{Less: Exempt dividend (s10(1)(k)(ii)(cc))} & \quad (70 000) \\
\end{align*}
\]

\[180 000\]

Disposal of CFC 2 by CFC 1

Capital gain = Proceeds less base cost

\[
R 450 000 - R 180 000 = R 270 000
\]

5.5.4 Section 9D(2A)(f) – Rate to be used for CGT purposes for CFCs

Section 9D(2A)(f) of the Act goes further to explain that where the resident shareholder is a natural person, special trust or insurer in respect of its individual policyholder fund, the taxable capital gain of the CFC shall be at 25% of that company’s net capital gain for the relevant foreign tax year. This is determined in line with paragraph 10 of the Eighth Schedule (58/1962).
**Example:** Mr A owns 60% of the shares in Company B. Company B is a controlled foreign company in terms of section 9D. Company B has made the following capital gains and losses during the foreign tax year to be included in its net income for the year.

<table>
<thead>
<tr>
<th>Disposal of</th>
<th>Gain/ (loss) in ZAR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property</td>
<td>100 000</td>
</tr>
<tr>
<td>Assets</td>
<td>20 000</td>
</tr>
<tr>
<td>Shares</td>
<td>(30 000)</td>
</tr>
<tr>
<td>Net Capital gain</td>
<td>R90 000</td>
</tr>
</tbody>
</table>

The taxable income of Company B before inclusion of the net capital gain amounts to R50 000.

As the resident which is a natural person owns 60% of the participation rights in Company B and therefore the inclusion rate in terms of paragraph 10 is 25%.

Therefore included in the net income of Company B to determine its taxable income, the net capital gain of R22 500 (R90 000 at 25%). Therefore the net income of Company B amounts to R72 500 (R50 000 plus R22 500). An amount of R43 500 (R72 500 x 60%) is included in the taxable income of the resident shareholder in terms of section 9D.

### 5.5.5 Section 9D(2A)(k) – Meaning of ‘local currency’ in terms of paragraph 43 of the Eighth Schedule

Paragraph 43 of the Eighth Schedule deals with conversion rules for capital gains or capital losses in respect of transactions in foreign currency. The term ‘local currency’ of a CFC is said to mean the currency used for purposes of its financial reporting (De Koker, 2010). Chapter 2 of this study deals with definitions and explains the term ‘currency used for purposes of financial reporting’, and in short is the currency used by the CFC for reporting purposes, i.e. its presentation currency.

The Comprehensive Guide to Capital Gains Tax (Issue 3) states that the term ‘local currency’ as used in paragraph 43 means in relation to:
• A permanent establishment (PE) of a CFC the currency used by that PE for purposes of financial reporting (other than the currency of any country in the common monetary area) and
• The CFC itself, the currency used by the CFC for purposes of financial reporting (SARS, 2010b:628).

**Example:**
Company A is the sole shareholder of Company B, a company incorporated in the United Kingdom. Company B reports its financial results in Sterling. Company B has a branch situated in Dubai that operates a retail business. The branch reports its financial results in US dollars. In applying paragraph 43, the local currency of Company B is said to be Sterling and for the branch it is US dollars.

In terms of section 9D(6) to the Act, there are certain specific translation rules needing to be taken into account, one of which relates to paragraph 43(4) assets. The Act states that in respect of the disposal of any asset contemplated in paragraph 43(4) of the Eighth Schedule which is not attributable to any permanent establishment of that CFC outside the Republic, any capital gain or capital loss of that CFC shall, where applying paragraph 43(4) of the Eighth Schedule, be determined in the currency of the Republic and that capital gain or capital loss shall be translated to the currency used by that CFC for purposes of financial reporting by applying that average exchange rate (58/1962).

Paragraph 43(4) of the Eighth Schedule relates to the following assets:
• Foreign equity instrument
• Assets, the capital gain or capital loss from the disposal of which is derived or deemed to have been derived from a source in the Republic, in terms of section 9 excluding a foreign currency asset in terms of paragraph 84(b) of the Eighth Schedule (58/1962).
  • This includes deemed South African source assets
    • Immovable property in South Africa
    • Any interest or right in or to immovable property in South Africa
Assets of a permanent establishment in South Africa (SARS, 2010b:628)

The capital gains and losses in respect of a disposal of assets in terms of paragraph 43(4) assets must be translated as follows:

- Determined in the currency of the Republic, and;
- Translated into the currency used by the CFC for the purposes of financial reporting at the average exchange rate (SARS, 2010b:628).

The Comprehensive guide on CGT provides insight into the reason why one would determine the capital gain and loss in the currency of the Republic only to then translate it back into the reporting currency of the CFC. It states that it is necessary if the CFC has an assessed loss before taking into account any capital gain determined under paragraph 43(4). In terms of section 9D(2A)(b) where a CFC has incurred an assessed loss in previous years of assessment, these can be carried forward to succeeding years of assessment and set off against the taxable income earned by that CFC in future years. However, this assessed loss cannot be imputed into the taxable income of the resident shareholder. Therefore the provisions of paragraph 43(4) of the Eighth Schedule ensure that the capital gain of the CFC is set off against its own assessed loss first before determining the value of its net income to be imputed into the taxable income of the South African resident (SARS, 2010b:629).

**Example:**

A South African resident holding company owns all the shares of a foreign subsidiary (CFC) incorporated and based in a tax haven in the Isle of Man. The CFC uses Sterling for the purposes of financial reporting. The CFC sells a share listed on the NYSE during its financial year ended 30 June 2004 for proceeds of $300. The share was purchased on 1 October 2001 for $100. The relevant exchange rates are as follows:

- On 1 October 2001  R10= $1 (ruling exchange rate)
- Year ended 30 June 2004  R17= 1GBP  R9=$1 (average exchange rate)

The taxable income (all of a passive nature) of the CFC before inclusion of any capital gains is 1500GBP.
**Result**

*Step 1 - Determine capital gain in rands under para 43(4)*

<table>
<thead>
<tr>
<th>Proceeds ($300x R9)</th>
<th>R2 700</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: Base cost ($100 x R10)</td>
<td>(R1 000)</td>
</tr>
<tr>
<td>Capital gain</td>
<td>R1 700</td>
</tr>
<tr>
<td>Inclusion rate</td>
<td>50%</td>
</tr>
<tr>
<td>Taxable capital gain</td>
<td>R850</td>
</tr>
</tbody>
</table>

*Step 2 – Determine amount to be included in net income in currency used by CFC for financial reporting*

Translate into GBP using average exchange rate during the year ending 30 June 2004 = R850/17GBP = 50GBP

*Step 3 – Determine amount to be included in income of resident company*

Net Income = 1500GBP + 50GBP = 1550GBP x R17 = R26 350

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**5.5.6 Paragraph 12(2) – when a CFC or resident ceases or commences to be a resident for CGT purposes**

The Eighth Schedule to the Act includes certain occurrences which are treated as a disposal and the provisions of the schedule would apply. In terms of paragraph 12(2) to the Eighth Schedule it describes certain events which may take place and where these would be treated as a disposal and immediate reacquisition and then the provisions contained in paragraph 12(1) would apply. Paragraph 12(2) states that a disposal will take place where a person commences or ceases to be a resident or controlled foreign company for South African Income Tax purposes (SARS, 2010b:78). However, there are certain exceptions, this is due to the fact that regardless of whether a person or company is a resident or controlled foreign company, the source of the income still remains within South Africa, and this includes the following assets, namely:
1 Immovable property – where this immovable property is situated in South Africa or any right to immovable property situated in South Africa.

2 Asset of a permanent establishment – any asset that is attributable to a permanent establishment in South Africa.

3 Assets held by the CFC (before it ceased to be a CFC) if any amount received or accrued from their disposal of those assets would have been taken into account for purposes of determining the net income of the CFC in terms of section 9D (De Koker, 2010).

Two scenarios are possible under paragraph 12(2) of the Eighth Schedule, namely:

1 Where a CFC or person commences to be a resident for CGT purposes

2 Where a CFC or resident ceases to be a resident for CGT purposes

Under the first point above, when a CFC or person commences to be a resident in terms of the Eighth Schedule the requirements of paragraph 12(2) need to be adhered to. In summary, when one commences to be a resident it is deemed to have disposed of all its assets (except those identified above) on the date immediately before becoming a resident (paragraph 13(1)(g)) at a value equal to the market value and to have immediately reacquired these assets at the market value. This deeming provision does not result in an immediate capital gain or loss to be determined but ultimately sets a base cost value for these assets on the date it becomes a CFC. This ensures that when the asset is sold and capital gains tax imposed, it will only be on the value of the asset from the date of becoming a CFC to the date of disposal (De Koker, 2010).
Example: A resident acquires all the shares in Company A situated in Bermuda on 30 June 2009. At that date the cost of all qualifying assets under Company A’s control amount to R1 million, however the market value on the date before becoming a controlled foreign company amounted to R2 million.

Therefore in terms of paragraph 12(2), on the date that the Company A becomes a CFC it is deemed to have disposed of its assets at market value and immediately reacquired its assets at market value. Therefore the base cost of the assets held by Company A for CGT purposes going forward amount to R2 million.

Under the second scenario, where the CFC or resident ceases to be a resident for South African tax purposes (i.e. the resident is no longer effectively managed in South African or the participation rights in the CFC has decreased to less than 50%) there is a deemed disposal in terms of paragraph 12(2). When the CFC or resident ceases to be a resident, there is a disposal but there is no ‘real’ proceeds value and therefore the market value is used (De Koker, 2010).

Example: A resident acquires all the shares in Company A situated in Bermuda on 30 June 2009. At that date the cost of all qualifying assets under Company A’s control amount to R1 million, however the market value on the date before becoming a controlled foreign company amounted to R2 million. After two years the resident sells all its shares in Company A to a non resident. At this date the market value of its assets amount to R2.5 million.

<table>
<thead>
<tr>
<th>Proceeds – market value on date ceases to be a resident</th>
<th>R2.5 million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Base cost – on date becomes a CFC market value</td>
<td>R2 million</td>
</tr>
<tr>
<td><strong>Capital gain</strong></td>
<td><strong>R500 000</strong></td>
</tr>
</tbody>
</table>
5.5.7 Paragraph 12(4) – when a CFC becomes a resident

The requirements of paragraph 12(4) deal with the situation where a foreign company ceases to be a controlled foreign company because it becomes a resident (i.e. is now effectively managed in South Africa). It is treated as having disposed of each of its assets and having reacquired them at a cost equal to the market value. In essence, the company is permitted to disregard a portion of any capital gain or loss on these assets brought into the tax net as a result of it becoming a resident. The gain or loss which is disregarded relates to the period during which the assets were held before the CFC became a resident (De Koker, 2010). In this case the provisions of paragraph 24 also apply, and it is deemed that the CFC acquires each asset at an amount equal to the market value immediately before the disposal. Since paragraph 24 applies, the CFC cannot make an election to use the time apportionment base cost or the 20% of proceeds method to determine a pre-valuation date value (De Koker, 2010).

The same assets as described in 1.5 above are excluded from the application of the provisions of paragraph 12(4). Paragraph 12(4) is aimed at including within the CGT net, assets of a CFC which meet the foreign business establishment exemption contained in section 9D, i.e. assets that fall outside the South African CGT net while the company was a CFC (SARS, 2010b:83).

**Example**

Company H, a South African resident company owns all the shares of CFC 1. CFC 1 has active foreign business establishment assets falling outside a section 9D and portfolio passive assets falling within s9D, CFC 1 owns all the shares of CFC 2. CFC 1 shifts its effective management to South Africa, thereby triggering South African residence status (and the loss of section 9D CFC status).

The conversion of CFC 1 to South African residence status is a paragraph 12(4) event. Paragraph 12(4) triggers a deemed sale of the foreign business establishment assets, none of which is taxable by virtue of the foreign business establishment exemption in section 9D(9)(b). However, the deemed sale results in a market value base cost step
up of the foreign business establishment assets. The portfolio passive assets and the shares of CFC 2 are not subject to deemed sale treatment, meaning that those assets retain their historical base cost.

5.5.8 Relationship between paragraphs 12(2) and 12(4)

Paragraph 12(4) overrides the general rule contained in paragraph 12(2). The net effect is that when a CFC commences or ceases to be a resident, this triggers a deemed disposal and reacquisition at market value. An exception exists for CFC assets subject to tax on disposal in terms of section 9D. These assets will not be subject to taxable treatment nor will they be allowed to be valued at market value (i.e. these assets will have roll over treatment). The roll over treatment is that when the CFC commences to be a resident it is only taxed on the gains made from the date it commences to be a CFC to the date that the asset is either disposed of or the CFC ceases to be a CFC (National Treasury, 2008:22).

There are a number of paragraphs contained in the Eighth Schedule that deal with the tax treatment of CFCs in relation to capital gains, however, not all of these have been provided in this study as SARS has issued a Comprehensive Guide on Capital Gains Tax which deal with the consequences of these paragraphs in detail, namely paragraphs 24 and 64B of the Eighth Schedule.

5.6 Conclusion

Section 9D(2A) read with sections 9D(12) and (13) provide the “recipe” for determining the net income subject to imputation. Section 9D(2A) also provides the so-called high-taxed exemption discussed in detail in chapter 3, and specifically paragraph 3.3.9.

This subsection cannot be read in isolation as some of the amounts included in net income in terms of this subsection may qualify for exemption in terms of section 9D(9).
While capital gains resulting from the sale of assets fall within the scope of section 9D(2A), the determination of those gains rely heavily on the provisions of the Eighth Schedule. The majority of the CFC capital gains tax consequences have been explained in detail in the guidance issued by SARS, ‘Comprehensive Guide on Capital Gains Tax’, therefore in this chapter only the areas contained specifically within section 9D have been explained even where references have been made to the Eighth Schedule a brief outline of the consequences relating to a CFC have been explained together with examples.
6 CHAPTER SIX

6. SECTION 9D – ADMINISTRATION OF CONTROLLED FOREIGN COMPANIES ITO S72A

6.1 Introduction

Where a foreign company meets the definition of a CFC as contained in section 9D(1), the resident owning participation rights in the CFC is required to complete certain information and submit a return in order to comply with the administrative requirements of the Act. This chapter will focus on the administrative requirements that need to be adhered to when a foreign company is a CFC in terms of section 9D as contained under section 72A.

6.2 Provisions of section 72A

Section 72A to the Act, deals with the administration of section 9D relating to the returns of CFCs and states as follows:

‘(1) Every resident who on the last day of the foreign tax year of a controlled foreign company or immediately before a foreign company ceases to be a controlled foreign company directly or indirectly, together with any connected person in relation to that resident, holds at least 10% of the participation rights in any controlled foreign company (otherwise than indirectly through a company which is a resident), must submit to the Commissioner such return as may be prescribed by the Commissioner’ (58/1962).

The above section makes it clear as to what is required by SARS when it comes to CFC disclosure. Where any resident directly or indirectly holds 10% or more of the participation rights of a foreign company, that resident shareholder is obliged in terms of this section to submit a return. The return required for submission is an IT10 return.
‘(2) A resident must have available for submission to the Commissioner when so requested, a copy of the financial statements of the controlled foreign company for the relevant foreign tax year, as defined in section 9D of that controlled foreign company’ (58/1962).

It is submitted that in many instances, it is quite difficult to obtain a copy of the annual financial statements of a foreign company where one is considered to be a minority shareholder. In addition, certain companies may not have official annual financial statements available to be submitted to the SARS together with the relevant return at the date required. The legislation in relation to the requirement to prepare financial statements differs from country to country. If a company is not required by law to prepare financial statements, a resident requiring those financial statements as contemplated in section 72A(2) will find it difficult to compel the CFC to prepare such financial statements.

The Act is not clear as to the language in which the financial statements should be prepared. South African residents may own participation rights in companies located in Spain, Portugal, Japan, China or any other non-English speaking country. These CFCs are under no obligation to prepare financial statements in English. Since the Act does not have a language requirement, presumably the financial statements can be retained in their original language.

It is submitted that section 72A places a significant administrative burden on residents owning participation rights in CFCs.

Subsection (3) contains punitive provisions if a resident should fail to meet the requirements of subsection 2 (see below). Fortunately the problems mentioned above seem to have been recognised as subsection (3) acknowledges that there are factors which could have an impact on a resident’s ability to obtain financial statements.
‘(3) Where a person in respect of any year of assessment fails to comply with the provisions of –

(b) subsection (2) and no reasonable grounds exist either for that failure which is outside the control of the person or for that person to believe that such person was not subject to that requirement –

(i) the proportional amount which must be included in the income of that person in terms of section 9D for that year shall be determined with reference only to the receipts and accruals of the controlled foreign company; and

(ii) the provisions of section 6quat shall not apply in respect of any tax proved to be payable to the government of any other country with respect to the proportional amount of the net income of that controlled foreign company which is included in the income of that person in terms of section 9D’ (my emphasis) (58/1962).

Where a resident shareholder is unable to submit a copy of the annual financial statements of the foreign company and has no reasonable grounds for not submitting said financials, it will result in the inclusion of the net income of the CFC as the resident is prohibited from relying on the exemptions provided for in the Act. In addition, the resident can no longer apply the section 6quat rebate, resulting in double taxation (De Koker, 2010).

It is therefore important to establish what SARS considers to be reasonable grounds for failing to obtain and submit financial statements as and when requested. It is submitted that at least the following would constitute legal grounds:

- The CFC has not completed its audit and hence does not have signed annual financial statements by the time the submission of the tax return is required;

- Where the CFC in terms of the legislation in its country of residence is not required to submit annual financial statements.
6.3 IT10 returns

In terms of the administrative elements regarding controlled foreign companies, an IT10 return should be submitted. An IT10 return is required to be attached to the resident shareholder’s annual tax return (Ernst & Young, 2005).

The IT10 returns require disclosure relating to the following:

- The particulars of the resident
- **Part 1** - The particulars of the foreign company which is a controlled foreign company including the following:
  - The registered name of the CFC
  - Foreign tax reference number
  - Country of effective management – this is to ensure that the CFC is not effectively managed in South Africa which would result in the CFC being a South African resident for income tax purposes and not a controlled foreign company in terms of section 9D.
  - Country of incorporation
  - CFC’s financial year from and to date – this is to determine its foreign tax year in terms of section 9D
  - The registered and physical business address
  - The nature of the business – this will assist with whether the CFC is an investment holding company producing passive income or whether it is has active business income
- **Part 2** - Ownership information – which includes the types of participation rights by the taxpayer both directly and indirectly, as well as any connected person in relation to the taxpayer both directly and indirectly.
- **Part 3** - Elections – this section is where a taxpayer can choose whether to elect either section 9D(12) or 9D(13)
- **Part 4** – Determining whether proviso (i) contained in section 9D(2A) applies – included in this part of the IT10 is a number of columns of information required which then determines the 75% threshold and whether the exemption will apply or not.
• **Part 5** – Exclusions in terms of paragraph (C) of the proviso to section 9D(2) – in this part it asks whether the participation rights are excluded in terms of this proviso.

• **Part 6** – Exclusions in terms of section 9D(9) – where any of the exemptions contained in section 9D(9) apply the following additional information is then required:
  - Each of the exemptions is listed where the type of income is listed in the financial statements and the amount in foreign currency.

• **Part 7** - composition of the net income of the CFC. This part only needs to be completed if the exclusion contained under Part 4 does not apply. In terms of the guidance on the completion of the IT10 the following fields are required:
  - The type of income
  - The amount in reporting currency
  - Allowable deduction in reporting currency
  - Net amount in reporting currency
  - Proportional amount of net amount (C) attributable to SA resident

• **Part 8** – CFC foreign tax rebates – this is only completed if the exclusion under Part 4 does not apply.
  - The nature of foreign tax
  - Jurisdiction imposing foreign tax
  - Amount of foreign tax
  - Proportional tax attributable to SA resident
  - Average exchange rate
  - Amount converted to Rand

• **Part 9** – requires the following additional information
  - Whether there have been any changes in the participation rights and any connected person in relation to the resident CFC and to provide the full details if yes.

• **Part 10** – Requires the signature of the person completing the return (SARS, 2010c:1-5).

There are guidelines contained on the IT10 return. A separate IT10 return is to be completed and submitted for each controlled foreign company. The guidelines on completing the tax return includes a general note which states that a taxpayer must
take into consideration the provisions of section 72A (which has been described above) and section 75 (SARS, 2010c:1-5).

Section 75 of the Act relates to penalties on default by residents. Where a resident is guilty of any of the offences listed in section 75 they will be guilty of an offence and liable on conviction to a fine or to imprisonment for a period not exceeding 24 months (58/1962).

Based on the above it is imperative that resident shareholders ensure that the information disclosed in the IT10 return is correct and that the requirements of section 9D are adhered to in order to avoid financial penalties as well as imprisonment.

A further implication of the above administrative requirements is that where a resident shareholder is unable to provide the annual financial statements of the foreign company and no valid reason exists, the previously exempt income will now be taxable. However, the timing of this is after the end of the year of assessment and after the submission of the resident shareholder’s first and second provisional tax payments. The result is that the CFC’s net income will now be imputed into the resident shareholder’s taxable income thereby increasing the taxable income amount. This amount will now be higher than that which has been disclosed on the resident shareholders provisional tax returns.

In terms of the Fourth Schedule, interest penalties and additional taxes become payable, where estimates of taxable income or payments of provisional tax are incorrect or not made by the last day of the period prescribed for payment. On the first and second provisional payments there is the non compliance penalty as contained in section 75B, which allows the Commissioner to impose an administrative penalty in respect of non compliance with procedural action or duties imposed in terms of the Act. Section 75B contains two types of penalties; charge a penalty of up to 10% of the amount of provisional tax and a fixed amount penalty based on the amount of the assessed loss or taxable income, and interest in terms of s 89bis(2) will be levied at the prescribed rate on the portion which has been paid late. Coupled with an additional tax levied on the second provisional payment in terms of par 20(1)(b). Where the estimate at year end is inadequate, this will result in an automatic penalty
amounting to 20% of the difference between the normal tax on the estimate and the lesser of the 90% of actual taxable income or normal tax on the basic amount. There is an additional penalty in terms of paragraph 20A where the year end estimate is late i.e. not on or before the end of the year of assessment (Stiglingh et al, 2010:411, 414-415).

6.4 **Illustrative Example**

Company A, a resident shareholder owns 80% in a Company B situated in the United Kingdom. Company B has its own offices, employees and management in the UK. During the current year Company B has gross income amounting to R2 million and deductible expenses amounting to R 500,000. Company B paid foreign tax amounting to R 450,000. Company A decided that Company B has a foreign business establishment and that the exemption contained in section 9D(9) applies and has not imputed any of the net income for the foreign tax year into its taxable income. Company A has not recognised in any of its provisional payments made to SARS the net income of company B and has paid tax of R2.8 million (R10 million taxable income).

On completion of Company A’s tax return, management complete an IT10 form but are unable to obtain a copy of the annual financial statements of Company B. Company B is subsequently sold. Two years after the relevant year of assessment, SARS requests a copy of the financial statements of Company B. Company A are no longer able to obtain a copy of the financial statements from the new owners for Company B. Company A cannot provide a reason as to why Company A failed to obtain a copy of the annual financial statements of Company B at the time of submitting the IT10.

**Results**

In terms of administrative sections to the Act, the foreign business establishment exemption will not apply and the gross income of Company B will be imputed into the taxable income of Company A. Company A can also not rely on the proviso to section 9D(2A) even if Company B was highly taxed as section 72(3)(b)(i) states that
the imputable amount is now determined with reference only to the receipts and accruals of the CFC. No exemptions will apply and no deductions will be allowed.

Company A has paid tax amounting to R2.8 million based on a taxable income of R10 million.

Company A should have paid R3,360,000 on a taxable income of R12 million (R10 million plus Company B’s net income of R2 million).

Therefore Company A has underpaid tax on its second provisional payment by R560,000. This will result in administrative penalties imposed in terms of section 75B not based on the difference of R560,000 but on the taxable income of R12 million.

Interest at the prescribed rate on the R560,000 will be levied for the period that the tax remains unpaid.

The application of paragraph 20(1)(b) results in an automatic penalty of 20% on the difference between the R2,800,000 and R3,360,000, i.e. R560,000 x 20% = R112,000.

Company A will not be entitled to a section 6quat rebate in relation to the R450,000 foreign tax paid by Company B.

6.5 Conclusion

The IT10 return is required to be submitted in terms of the provisions of section 72A. Each controlled foreign company of a resident shareholder is required to complete and submit an IT10 form. This is quite a tedious process in order to meet the administrative requirements of the Act, but this is the only way in which SARS is able to monitor residents who have a foreign shareholding. Due to many multinationals that try and find any alternative to avoid the imputation of the net income of a controlled foreign company, the submission of these IT10 forms is a way in which the SARS is able to have some control. This control is also evident in the enactment of the provisions contained in section 72A(3) to ensure that if there is a valid exemption, a resident shareholder will ensure that the annual financial statements are submitted together with the IT10 return. The SARS has gone further to ensure compliance with the application of section 75 where it is thought that any defaults have been included in the submission of the return. Resident shareholders should ensure that the
disclosure on these returns is correct, should SARS attack the completion or disclosure of any of the information, in terms of section 82 to the Act, the onus is on the taxpayer to disprove the Commissioner.

As was illustrated with the example above, the consequences of non-compliance is dire.

As the purpose of the study is to suggest an interpretation note for section 9D, the study has up to now focussed largely on the legislation and CFC regime in South Africa. The concluding chapter to this study is therefore in essence the proposed interpretation note which is attached as Appendix 1.

However, during the course of the analysis resulting in the draft interpretation note, certain issues that require further consideration were identified and these issue are considered in the final chapter.
7 CHAPTER SEVEN

7. SECTION 9D – CONCLUSION

7.1 Introduction

The purpose of this study was to provide insight and understanding into the provisions contained in section 9D of the Act due to the lack of guidance provided by National Treasury and SARS. The objective of the study was to propose an interpretation for the various subsections included in the Act to provide certainty supplemented by practical examples and also to highlight certain shortcomings. Section 9D is and will remain a complicated section. However, where one has a better understanding of the basic provisions, the practical application will be easier.

An attempt was made to define the key terms and concepts used in section 9D. With a thorough understanding of the definitions contained in the section, one is able to determine whether an interest in a foreign company will result in a CFC and whether this interest will translate in an imputation.

While South Africa’s CFC legislation is admittedly complex, it is in line with international principles. Even though the CFC legislation enacted by different countries are different, the underlying principle is always the same, i.e. to ensure that there is no deferral of income to non-residents situated in low tax jurisdiction countries. Where it is considered that the entity is situated in a low tax jurisdiction the income would be attributed to the shareholder at their proportional interest in the entity and taxed. Many countries have gone further to introduce additional rules for portfolio investment funds where passive income is earned and on which attribution will apply.

A common principle also seems to be that the intention of the legislation is not to tax bona fide investments in active trading companies with companies earning passive income being placed under the microscope.
As in South Africa, the purpose of the United Kingdom (“UK”) CFC legislation is to prevent UK companies from avoiding tax by diverting income to subsidiaries in low tax countries. It will apply where the CFC (a non resident) is subject to tax in its incorporated country at a rate which is less than three quarters of what it would have paid had it been a resident in the UK. The difference between the tax that the CFC would have paid under UK tax legislation and that which it has paid is charged to the UK company with an interest of at least 10% in the profits. The UK CFC legislation also contains a number of exemptions (HMRC, 1998).

The exemptions used in the UK CFC legislation are to target transactions and companies whose existence is designed to reduce UK tax. One of the exemptions in the UK is referred to as the ‘motive test exemption’ which will apply where tax avoidance is not in point. There are further exemptions which are more objective and hence easier to apply (HMRC, 2003).

One of these exemptions is the ‘exempt activities test (EAT)’ which has several aspects to it and which will apply to all types of business. This test requires an assessment of the activities of the business in particular those that are inherently mobile where additional criteria need to be met. This would include companies engaged in wholesale, distribution, financial or service business. The EAT exemption is said only to apply where less than 50% of the gross trading receipts are derived from connected persons as defined in the UK legislation (HMRC, 2003). In my opinion this would be similar to South Africa’s ‘foreign business establishment’ exemption.

The United States (“US”) was one of the first countries to enact CFC legislation. The legislation originally adopted a transactional approach whereby mainly passive income and certain ‘base company’ income of the CFC would be attributed to the US shareholders. The US has also introduced additional anti-haven measures namely, passive foreign investment company (PFIC) rules. These rules are designed to eliminate the benefit of deferral of income to a low tax jurisdiction by US shareholders (Sandler, 1998:24).
Australia adopted CFC legislation after studying regimes adopted elsewhere. The CFC legislation was enacted in July 1990. This regime follows a transactional approach similar to that followed in the US, in that only tainted income of a CFC would be subject to tax in Australia. The Australian CFC legislation has a similar exemption to South Africa’s foreign business establishment exemption in that there is no attribution of income if a significant portion (i.e. more than 95 per cent) of the profits derived by the CFC is from active business activities. Australia has also enacted a FIF regime which is focused on offshore funds where Australian residents have an interest where that fund holds mainly passive assets. This passive income earned by the fund is attributed to the Australian resident in relation to its proportional interest (Sandler, 1998:31).

The Canadian’s introduced the foreign accrual property income (FAPI) provisions in 1972 but these only became effective in 1976. These provisions are similar to the US as they are transactional based. These provisions apply to passive income and certain base company income of the CFC regardless of where the CFC is located. The FAPI provisions were reviewed in 1994 and re-introduced in 1995 with the result that passive income was more clearly defined and the scope of the base company income was expanded. In 1984 Canada introduced the FIF rules, where a Canadian resident held an interest in a portfolio investment which is a non resident and if the main reason for the investment is seen to be to reduce the tax payable, the taxpayer is then subject to tax under a deemed rate of return method (Sandler, 1998:26).

In the United States, Australia and Canada cases have been heard that are similar to the Bricom case where a court is left to decide in which contracting state the income will be taxed. The United States has signed but not ratified the Vienna Convention on the Law of Treaties (VCLT). Double taxation conventions are international treaties and are governed by the provisions of the VCLT for countries that are parties to it. The United States has signed but not ratified the VCLT, yet the methods of interpretation utilised by courts in the United Sates are generally consistent with those contained in the VCLT. The VCLT has not been applied directly in any case heard in the United States involving the interpretation of a double tax convention, however, the principles adopted by the court have a lot in common with the rules contained in the VCLT. Australian courts apply the interpretation provisions contained in the VCLT.
as these provisions are deemed to form part of the customary international law. In Canada, the courts rely on the various intentions of the contracting states as contained by the words used in that treaty. The courts will also take into account the history and purpose as evidenced by the treaty’s preamble (Sandler, 1998:54, 59, 60, 78).

While South Africa’s legislation seems to be in line with international concepts and principles, it is as complex and can be improved upon.

7.2 Potential areas for improvement

During this study it was noted that there are a few areas which require further clarification from SARS as neither the Act nor any guidance or binding private rulings as yet have dealt with these issues. Some of these issues are:

- Section 9D(6) deals with the manner in which the net income of a CFC is translated into foreign currency providing that the net income be translated at the average exchange rate for the year of assessment, i.e. in relation to the resident shareholder’s year of assessment. The net income to be imputed is determined with reference to another period namely, the foreign tax year of the CFC. It is submitted that the translation should be done at the average exchange rate of the foreign tax year as it relates to the same period.

- Another criticism is the fact that the provisos to section 9D(6) refer to translation of gains or income at the average exchange rate, but does not refer to the period to which the average exchange rate relates.

- The ‘high taxed exemption’ which is contained in the proviso to section 9D(2A) is contained at the beginning of the section and it would seem that this exemption should be considered before any of the other exemptions can be utilised. This requires that a completed taxable income computation for each CFC is required to determine whether the tax payable in the foreign country is more than 75% of the tax payable in South Africa. However, this exemption is like any other contained in section 9D, and therefore it is submitted that this exemption be moved to section 9D(9) together with all the other exemptions. The ‘high taxed exemption’ is a very difficult exemption for resident shareholders to be able to meet due to the fact that one requires a large amount of information from the CFC in order to complete the computation.
• Taking into account the severe penalties if a resident is unable to submit the annual financial statements to SARS when required, guidance should be provided as to what constitute reasonable grounds for being unable to submit said financial statements.

• Confirmation is required that the financial statements need not be in one of South Africa’s official languages if the CFC is incorporated in a country where other languages are used.

7.3 Conclusion

While South Africa’s CFC legislation is arguably based on international best practice, there are areas that still need to be considered, as was highlighted above.

However, the principle objective of this study was to form the basis of a suggested interpretation note on section 9D based on existing legislation and therefore the areas for improvement were not analysed in detail.

A suggested interpretation note including illustrative examples based on the analysis undertaken in this study is attached as Appendix 1.
Appendix 1: Proposed Interpretation Note on Section 9D

Interpretation Note: No X: - 19 November 2010

ACT: INCOME TAX ACT, NO 58 OF 1962 (The Act)

SECTION: SECTION 9D

SUBJECT: CONTROLLED FOREIGN COMPANY LEGISLATION

Preamble

In this Note –

- “CFC” means a controlled foreign company as defined in section 9D

- South African-sourced amount” means an amount derived from a source located in South Africa as well as an amount derived from a source located outside South Africa that is deemed to be derived from a South African source under section 9

- The terms “South Africa” and the “Republic” are treated as having the same meaning

8.1 Purpose

This Interpretation Note explains the scope, interpretation and application of section 9D.

8.2 Background

CFC legislation was introduced in phases to co-incide with South Africa’s move from a source based system to a residence based system. Initially with the introduction of the legislation it was directed to those foreign entities that were earning passive income. However, over the years the legislation has been amended to include active income of entities.

Due to the increase in cross border transactions and offshore investment, this has necessitated the need to introduce CFC legislation into the revenue codes of many countries, South Africa being one of them.
8.3 The law and its application

8.3.1 Definitions contained in section 9D

The following terms are specifically defined in section 9D of the Act and will be explained further, namely:

- Controlled foreign company
- Country of residence
- Foreign business establishment
- Foreign company
- Foreign financial instrument holding company
- Foreign tax year
- Participation rights

Where a word is not defined in the Act itself, one has to turn to other sources to find a definition such as the Interpretations Act no 33 of 1957, relevant case law or to the ordinary dictionary meaning of the word. As a general principle in the interpretation of statutes, the intention of the legislator is very important (De Koker, 2010). The following terms are either contained or implied in the section 9D of the Act and therefore further clarification is required, either in relation to court cases to provide insight or these terms are defined in other sections to the Act, namely:

- Voting rights
- Control in relation to voting rights
- Permanent establishment – this term is defined in section 1 to the Act
- Local currency – as defined in section 24I and referred to in section 9D(6)(c)
- Currency used for financial reporting
- Comparable prices (s9D(9)(b)(ii)(aa)(C))
- Dividends, interest, royalties, rental, annuities, insurance premiums (i.e. passive income) – these terms are not specifically defined in the Act but are referred to as ‘passive income’ a term that was previously defined in the now repealed section 9E
At the time of tabling the legislation, National Treasury’s view was that a two part test had to be applied in understanding the term ‘controlled foreign entity’ (which has since been replaced by the term CFC) (National Treasury, 2002a:14):

- ‘Firstly, income must be generated by a ‘foreign entity’ and
- Secondly, that entity must be ‘controlled’ by South African shareholders (National Treasury, 2002b:3)

The term ‘control’ is not defined in the Act, however there have been a number of cases where the term has been clarified in a court of law. In ITC 486 (1940) 12 SATC 584 it was said that ‘it seems to us that Mr. Rosenberg’s contention on behalf of the appellant is correct that control means the right to more than fifty percent of the voting power in that company’, ‘control must mean actual de facto control’, ‘control, furthermore means control of all the activities of the company’. In ITC 412 (1938) 10 SATC 241 (U) ‘the relevant part of the sub-section reads in this way: A company shall be deemed to be under the control of any persons where the control is by any means in their hands. The means by which that control is given may be ‘any means – be it by voting power, be it by shareholdings or be it by a control outside the Articles or by a fiduciary relationship. Control of a company inter alia includes control by means of an individual’.

From the above it is clear that where a shareholder can exercise ‘control’ of a foreign company in any way it is possible that it may be a CFC.

8.3.2 The definition of controlled foreign company

A CFC is defined in section 9D of the Act as (emphasis added),

‘any foreign company where more than 50 per cent of the total participation rights in that foreign company are held, or more than 50 per cent of the voting rights in that foreign company are directly or indirectly exercisable, by one or more residents: Provided that—

(a) no regard must be had to any voting rights in any foreign company—

(i) which is a listed company; or
(ii) if the voting rights in that foreign company are exercisable indirectly through a listed company;

(b) any voting rights in a foreign company which can be exercised directly by any other controlled foreign company in which that resident (together with any connected person in relation to that resident) can directly or indirectly exercise more than 50 per cent of the voting rights are deemed for purposes of this definition to be exercisable directly by that resident; and

(c) a person is deemed not to be a resident for purposes of determining whether residents directly or indirectly hold more than 50 per cent of the participation rights or voting rights in a foreign company, if—

(i) in the case of a listed company or a foreign company the participation rights of which are held by that person indirectly through a listed company, that person holds less than five per cent of the participation rights of that listed company; or

(ii) in the case of a scheme or arrangement contemplated in paragraph (e) (ii) of the definition of “company” in section 1 or a foreign company the participation rights of which are held and the voting rights of which may be exercised by that person indirectly through such a scheme or arrangement, that person—(aa) holds less than five per cent of the participation rights of that scheme or arrangement; and

(bb) may not exercise at least five per cent of the voting rights in that scheme or arrangement,

unless more than 50 per cent of the participation rights or voting rights of that foreign company or other foreign company are held by persons who are connected persons in relation to each other; ‘(58/1962).

It is clear that whether a foreign company will be a CFC is dependent on the voting rights and participation rights and it is therefore necessary to attribute a clear meaning to these two terms.
8.3.2.1 The meaning of “participation rights”

Participation rights are said to ‘include shares representing equity share capital as well as other forms of shares, such as non-participating preference shares. However, convertible debentures, options and similar interests do not qualify as participation rights because these instruments do not represent a participation interest until converted into shares’ (National Treasury, 2002b:3).

| Participation rights are defined in section 9D to mean ‘in relation to a foreign company —

(a) the right to participate directly or indirectly in the share capital, share premium, current or accumulated profits or reserves of that company, whether or not of a capital nature; or

(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’ (58/1962). |

The reference in (a) to the definition of participation rights, clearly points toward what is generally referred to as ‘owner’s equity’ (the use of the word ‘or’ simply suggests not an alternative ‘participation rights’, but a simple arithmetic total of share capital, premium, profits and reserves) (Clegg, 2010). It is submitted that, when one determines the participation rights held in a foreign company, all aspects of the owner’s equity should be taken into account not only share capital and this should be added together in order to determine the percentage of the participation rights held in a foreign company.

The term ‘participation rights’ referred to in the definition of a CFC includes within its ambit the right to participate directly or indirectly in the share capital, share premium, current or accumulated profits or reserves’ of the company (i.e. owner’s equity). The term ‘participation rights’ therefore is very widely defined and therefore careful consideration is required by a resident before one makes a final decision in determining whether ‘more than 50%’ of these rights are held in that foreign company (De Koker, 2010).
In determining whether South African residents together hold more than 50% of the participation rights of a foreign company, a mere mathematical calculation may not suffice because the shareholders’ register may reflect a disguised holding by a resident (Olivier & Honiball, 2008:436).

**Example:** A resident holds 49% of the rights, and a third party is the holder of 2% of such voting rights. This interest is held in a trust for or as nominee of a number of residents (irrespective, it is submitted, of how the trust or nominator/nominee relationship arises), the foreign company is a CFC in relation to the residents due to the fact that if the 49% and the 2% is combined it results in more than 50% of the foreign company being held by residents.

A resident holds 49% and non-residents 51% of the participation rights. However, in terms of the rights of shareholders, the non-residents undertake to vote according to the wishes expressed by the residents. Therefore the residents are able to control more than 50% of the voting rights in the company as the non residents will vote in accordance with the residents. This will result in the fact that the residents hold more than 50% of the foreign company and will therefore qualify as a CFC (De Koker, 2010).

Where residents do not hold more than 50% of the participation rights, but are entitled to appoint the board of directors of the foreign company, it may very well constitute a CFC (De Koker, 2010).

The word ‘jointly’ refers to the participation rights or voting rights of South African resident beneficiaries exceeding 50 percent, irrespective of whether they know each other. The word ‘jointly’ merely means ‘aggregate’ and not that the residents must have a ‘common purpose’ (Olivier & Honiball, 2008:436). Therefore it is not necessary that the residents be ‘connected’ but must merely hold the participation rights in the same foreign company.

**Example:** If a South African resident holds 15% in a foreign company and a Jersey company holds 40% of the shares in the same foreign company and unconnected South African residents hold the shares of this Jersey company, the foreign company will be a CFC.
I.e. the South African residents indirectly hold the participation rights in the foreign company. In the definition of participation rights it refers to both direct and indirect interests of a resident need to be taken into account in the determination of the ‘more than 50%’ shareholding.

The reference to ‘indirectly’ means that the interests to be taken into account to determine whether a foreign company is a CFC is to consider both registered and beneficial shareholders (Olivier & Honiball, 2008:436).

Example: Where a South Africa resident individual owns all the shares in a foreign company X, which in turn holds all the shares in another foreign company Y. Both companies X and Y will be considered to be a CFC. However, a CFC will not exist where a foreign company X, has issued 100 ordinary shares, 50 each to a South African company and a foreign individual and all the shares of the South African company are owned by a South African individual.

The aim of the section, is to tax income where a South African resident has control, therefore the term should include all those who have control over the income of the foreign company in determining the rights of the resident shareholders (Olivier & Honiball, 2008:435, 436).

8.3.2.2 The meaning of “voting rights”

The term ‘voting rights’, is not defined in the Act, and is said to be relevant in circumstances where no person has any right in the foreign company, or no rights can be determined for any person, when the term ‘participation rights’ has not been met (Olivier & Honiball, 2008:435).

Voting rights is an alternative test to ‘participation rights’. The definition of a CFC is said to be when more than 50 per cent of the voting rights in that foreign company are directly or indirectly exercisable by one or more residents (58/1962).

In Shears v Phosphate Co-operative Co of Australia Ltd 1988 14 ACLR 747 SC (Vic) 759 it was held that Companies (Vic) Code makes it clear that only members have the right to vote (i.e. voting rights). This principle held in this case has been said to hold true for the Companies Act 61 of 1973 i.e. a company’s constitution cannot extend the
right to vote in a general meeting upon a person who is not a member of the company or, indeed, on a member in a capacity other than that of a member. In any event, because a company’s constitution cannot confer any binding rights on third parties or even on a member other than in his capacity as a member any provision purporting to confer a right to vote on such a person would not be enforceable against the company and its members (Blackman et al, 2009). In terms of section 195(2) of the Companies Act, it states that although the articles determine the voting rights each share must carry at least one vote (61/1973).

Therefore it is submitted that should one be unable to determine whether a resident has more than 50% of the participation rights, one should consult the constitution of the foreign company to determine whether any of the shareholders have additional rights in that foreign company which would impact whether the definition of a CFC are met or not through its voting rights.

**Example:** Company A owns 40% of the share capital of Company B who is situated in a foreign country, Company A also owns 60% of the voting control of Company B. Therefore Company B will be a CFC as defined.

As section 9D is an anti-avoidance provision aimed at attributing income of a foreign company where a South African resident controls the income brought into the tax net, voting rights therefore are said to refer to any form of control over the distribution of profits or capital exercised by a South African resident (whether as shareholder, director or otherwise) (Olivier & Honiball, 2008:436).

### 8.3.2.3 Provisos to the CFC definition

The following describes the provisos contained in the CFC definition contained in section 9D(1). In terms of proviso (A), it indicates that no regard must be had to any voting rights in a foreign company which is a listed company whether the interest that is held is direct or indirect (De Koker, 2010). Proviso (B) has been said to include a special ‘look-through’ rule where voting rights in a foreign company are directly or indirectly exercisable and where the resident – either individually or together with connected persons can exercise more than 50% of the voting rights. The resident in this case can either directly or indirectly be able to exercise its voting rights.
Where the resident indirectly can exercise its voting rights, the proviso so concludes that such rights are deemed to be exercisable directly by the resident.

**For example:**

Due to Company A and Company B, who are connected persons, are able to exercise 80% of the CFC, based on proviso B, Company A (resident) and Company B (connected person) would be able to exercise 80% of the voting rights in Company D making Company D a CFC as defined.

Proviso (C) relates to the scenario where a person would be deemed not to be a resident. This would be the case where:

- The resident indirectly holds in a listed company or a foreign company the participation rights held through a listed company, less than 5% of the participation rights in the listed company; or
- The resident holds the participation rights or voting rights indirectly in a foreign collective investment scheme or foreign company – less than 5% of the participation rights or voting rights. This exclusion does not apply if connected persons hold more than 50% of the participation or voting rights of the foreign company or foreign collective investment scheme (58/1962).
**Example:** South African residents in aggregate hold 52% of the participation and voting rights in a foreign company. One of the residents, Mr. A, is not connected to the other South African residents holds 2% or more of the voting rights, Mr. A will be deemed not to be a resident. The result is that the foreign company will not qualify as a CFC and the CFC rules would not apply to any of the residents.

### 8.3.3 Country of residence

The term ‘country of residence’ is defined ‘in relation to a foreign company, as the country where that company has its place of effective management’ (58/1962).

The term ‘effective management’ is not defined in the Act, however the SARS has issued Interpretation Note 6 to provide guidance as to the meaning thereof.

The country of residence is of importance due to the fact that if a foreign company has its place of effective management in South Africa, it will meet the definition of a resident as contained in section 1 to the Act for South African tax purposes (58/1962). This is reiterated in the Explanatory Memorandum on the Revenue Laws Amendment Bill issued by National Treasury, (2006:55), relating to a country of residence where the definition was changed to refer to the place of effective management as opposed to where it is incorporated. It goes further to highlight that with the meaning of the term ‘place of effective management’, South African tax law interpretation prevails.

### 8.3.4 Foreign business establishment

A foreign business establishment in relation to a controlled foreign company, ‘means—

(a) a fixed place of business located in a country other than the Republic that is used or will continue to be used for the carrying on of the business of that controlled foreign company for a period of not less than one year, where—

(i) that business is conducted through one or more offices, shops, factories, warehouses or other structures;
(ii) that fixed place of business is suitably staffed with on-site managerial and operational employees of that controlled foreign company who conduct the primary operations of that business;

(iii) that fixed place of business is suitably equipped for conducting the primary operations of that business;

(iv) that fixed place of business has suitable facilities for conducting the primary operations of that business; and

(v) that fixed place of business is located outside the Republic solely or mainly for a purpose other than the postponement or reduction of any tax imposed by any sphere of government in the Republic:

Provided that for the purposes of determining whether there is a fixed place of business as contemplated in this definition, a controlled foreign company may take into account the utilisation of structures as contemplated in subparagraph (i), employees as contemplated in subparagraph (ii), equipment as contemplated in subparagraph (iii), and facilities as contemplated in subparagraph (iv) of any other company—

(aa) if that other company is subject to tax in the country in which the fixed place of business of the controlled foreign company is located by virtue of residence, place of effective management or other criteria of a similar nature;

(bb) if that other company forms part of the same group of companies\(^\text{10}\) as the controlled foreign company; and

(cc) to the extent that the structures, employees, equipment and facilities are located in the same country as the fixed place of business of the controlled foreign company;

(b) any place outside the Republic where prospecting or exploration operations for natural resources are carried on, or any place outside

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\(^{10}\) A ‘group of companies’ is defined in section 1 to the Act to mean two or more companies in which one company directly or indirectly holds shares in at least one other company to the extent that—

(a) at least 70 per cent of the equity shares of each controlled group company are directly held by the controlling group company, one or more other controlled group companies or any combination thereof; and

(b) the controlling group company directly holds at least 70 per cent of the equity shares in at least one controlled group company.
the Republic where mining or production operations of natural resources are carried on, where that controlled foreign company carries on those prospecting, exploration, mining or production operations;

(c) a site outside the Republic for the construction or installation of buildings, bridges, roads, pipelines, heavy machinery or other projects of a comparable magnitude which lasts for a period of not less than six months, where that controlled foreign company carries on those construction or installation activities;

(d) agricultural land in any country other than the Republic used for bona fide farming activities directly carried on by that controlled foreign company; or

(e) a vessel, vehicle, rolling stock or aircraft used for purposes of transportation or fishing, or prospecting or exploration for natural resources, or mining or production of natural resources, where that vessel, vehicle, rolling stock or aircraft is used solely outside the Republic for such purposes and is operated directly by that controlled foreign company or by any other company that has the same country of residence as that controlled foreign company and that forms part of the same group of companies as that controlled foreign company; (58/1962).

The income of a CFC that carries on active foreign business does not result in the imputation of income for South African tax purposes. The exception applies if the business is truly active, has some nexus to the country of residence and used for bona fide non-tax business purposes. The legislation sets out several tests that are used in order to determine these features. Different sets of rules exist for ‘general’ places of business, places of extraction for natural resources, construction sites, farming, and international transport (National Treasury. 2006:53).
A foreign business establishment is defined in section 9D(1) and bears some relationship to the ‘permanent establishment’ definition used in most double taxation treaties and which forms an integral part of section 31 (Clegg, 2010) The term ‘permanent establishment’ as defined in Article 5 of the Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development (‘OECD’) includes, amongst others, ‘a fixed place of business through which the business of an enterprise is wholly or partly carried on’ (OECD, 2003:8) The OECD Commentary states that the term ‘fixed place of business’ distinguishes three pre-conditions:

- There must be a distinct place, such as premises, or in certain instances, machinery or equipment (the ‘place-of-business test’).
- It must be established with a certain degree of permanence (the ‘permanence test’).
- Business must be carried on through the place of business, usually by personnel of the enterprise (the ‘business-activities test’). The place of business is usually the location where the business activity of the foreign company occurs, but the necessity of satisfying all three requirements sometimes leads to different results. For most companies, finding a ‘place of business’ is the least controversial part of the test. Most have a physical location where management activities are conducted, goods are manufactured or sold, or personnel perform daily functions. But even businesses without conventional locations are covered. For example, a place of business may be constituted by a pitch in a market place or a permanently used area in a customs depot (the storage of dutiable goods) or gaming and vending machines operated and maintained by the company or its agent for its own benefit (OECD, 2008:80-81).

To determine that a place of business is ‘fixed’ is more difficult. While the OECD Model Tax Convention does not require that the enterprise be ‘actually fixed to the soil on which it stands,’ it does mandate that it be situated at a distinct place with a certain measure of permanence (OECD, 2008:81-82). The ‘business-activities test’ requires that commercial activity be carried on and that it be done through some type of connection with the fixed place of business. The connection between the place of
business and the business activity of the enterprise does not have to involve human beings or any decision-making activity, as long as an activity is performed there. But there is one condition: the enterprise must carry on a genuine business activity, such as maintenance and actual operation (Clegg, 2010).

In Olivier it is said that a place of business to qualify as a business establishment under para (a) of the definition, requires both an ‘economic substance’ and a ‘business purposes’ test before the definition can be met (Olivier & Honiball, 2008:448). The ‘economic substance’ requirement ensures that income will not be exempt if the foreign business exists merely on paper and not in substance (i.e. requires substance over form). It is not sufficient to have employees who take management decisions at the foreign business premises but there are no persons available to take the day-to-day management decisions (operational). In addition, there needs to be full time employees present at the foreign company as independent agents will not qualify (see SIR v Downing 37 SATC 249) (Olivier & Honiball, 2008:448).

The ‘business purpose’ requirement attempts to ensure that income derived by a CFC that complies with the necessary permanence and economic substance requirements will still not be exempt if the business activities are not conducted for bona fide business purposes, but to obtain a tax benefit. Where a business has been set up in a foreign company purely to obtain a tax benefit, this CFC will not qualify as a foreign business establishment in terms of section 9D (Olivier & Honiball, 2008:449).

In deciding whether the place of business is conducted outside the Republic for bona fide business purposes, the Commissioner does not need to rely on the requirements of the general anti-avoidance section, Part IIA of the Act including s80A to s80L. It is sufficient if, on the facts, the reason for conducting the business outside the borders of South Africa is to avoid, postpone or reduce tax (Olivier & Honiball, 2008:449).

It should be noted that mines, construction sites, farms and certain vessels and aircraft are all deemed to be business establishments without satisfying the additional economic substance and business purpose test, the reason being that by the nature of these activities it is virtually impossible to fabricate them for tax planning purposes. In addition it should also be remembered that where these activities are fabricated, no
or little income will be derived which qualifies for the exemption (Olivier & Honiball, 2008:449).

The requirement that the office, shop, factory etc should be used for a minimum period of one year presupposes some activity and not merely holding rights as owner or lessee (Olivier & Honiball, 2008:449). In my view, this provides clarity on the meaning of the term ‘fixed’ included in the Act and will enable a taxpayer to meet the ‘permanence test’ to meet the definition of foreign business establishment.

No minimum time limit is laid down for mining, farming and the operation of certain vessels and aircraft. The reason is that, owing to the relatively unusual nature of each of these types of activities, it is highly unlikely that there will be no permanency, economic substance or business purpose. However, from the wording of paras (b) and (e) it is clear that the CFC should conduct the preliminary/exploring or actual exploration/extraction activities itself and not merely have an interest in such activities. This presupposes that the CFC itself must have a business and that the relevant vessel, aircraft or mine on its own is not the business of the CFC (Olivier & Honiball, 2008:449).

8.3.5 Foreign company

A foreign company\textsuperscript{11} is defined in section 9D(1) and ‘means any association, corporation, company, arrangement or scheme contemplated in paragraph (a), (b), (c), (e) or (f) of the definition of “company” in section 1, which is not a resident’(58/1962).

National treasury states that ‘a ‘foreign entity’ means any entity that does not qualify as a South African resident under South African Income Tax Act or as a result of the application of South African Income Tax Treaty. Foreign entities contemplated in section 9D mainly include foreign companies or foreign business organisations of a similar tax nature under foreign law. These foreign entities do not include foreign entities categorized as branches of foreign companies in terms of the Income Tax Act.

\textsuperscript{11} The Taxation Law Amendment Bill of 2010 has deleted the term ‘foreign company’ with effect from 1 January 2011 and applicable in respect of foreign tax years of controlled foreign companies ending during years of assessment commencing on or after that date.
partnerships or similar flow-through regimes because income is deemed to have been immediately received by the South African owners of these entities in any event. Foreign entities under section 9D also do not include foreign trusts because foreign trust income is typically subject to immediate tax by its South African donors or beneficiaries under the principles of section 7 and/or the beneficiaries in terms of section 25B(2A) (National Treasury, 2009b:3).

In terms of paragraphs (a), (b) and (e) of the definition of ‘company’ it encompasses those entities which are incorporated or deemed to be incorporated under South African or foreign law, bodies corporate incorporated under South African law and foreign collective investment schemes (mutual funds and unit trusts). The inclusion of South African incorporated entities makes it clear that a CFC may be a South African incorporated company which is ‘resident’ outside South Africa and, hence, subject to the attribution rules discussed in this paragraph. A trust cannot be a CFC (Clegg, 2010).

The definition identifies two issues: firstly, that the foreign entity must be a company as defined for South African tax purposes and, secondly that it must be a non-resident (Olivier & Honiball, 2008:431). The following companies will qualify as foreign companies provided they are not resident:

- Associations, corporations or companies incorporated or deemed to be incorporated in South Africa or a body corporate formed or establish or deemed to be formed or established under South African law (para (a) of the definition of company in section 1 of the Income Tax Act) (58/1962);
- Associations, corporations or companies incorporated under foreign law or a body corporate formed or established under foreign tax (para (b) of the definition of company in section 1 of the Income Tax Act) (58/1962);
- A co-operative as defined in section 1 of the Income Tax Act (58/1962);
- Certain local and offshore collective investment schemes in securities (previously known as unit trusts) (para (e) of the definition of company in s1 of the Income Tax Act) (58/1962) and
Co-operatives and close corporations were only relatively recently included in the definition of foreign company, by section 9 of the Taxation Laws Amendment Act No 8 of 2007 and promulgated on 8 August 2007. The effective date for the inclusion of co-operatives was backdated 1 January 2007, and the effective date for the inclusion of close corporations was 2 November 2007 (Olivier & Honiball, 2008:431).

8.3.6 Foreign financial instrument holding company

A “foreign financial instrument holding company” means “a foreign financial instrument holding company as defined in section 41: Provided that in determining whether the prescribed proportion of all the assets of the company and all influenced companies consist of financial instruments, the following assets must be wholly disregarded—

(a) any share in any other company in the same associated group of companies; and

(b) any instrument as defined in section 24J (1) entered into between companies which form part of the same associated group of companies:

Provided further that in making any such determination, paragraph (i) of the proviso to the definition of “foreign financial instrument holding company” in section 41 shall not apply;’ (‘FFIHC’) (58/1962).

Essentially a FFIHC is a foreign company as defined in section 9D, when more than the ‘prescribed proportion’ of all the assets of that company, together with the assets of all ‘influenced companies’ in relation to that foreign company, consist of financial instruments. The term ‘influenced company’ is defined within the definition of an ‘associated group of companies’ in section 41. In simple terms it is one in which at least 20% of the equity shares and voting rights are held by an influencing company. Also defined in s41 is the term ‘prescribed proportion’. Again, in simple terms the prescribed proportion comprises:
• Half of the market value, or

• Two-thirds of the actual cost

of all assets. But when shares are to be disposed of to members of the same group of companies, the prescribed proportion may alternatively be determined at half the book value of the assets per the most recent set of audited financial statements, or two-thirds of the market value of all the assets (SARS, 2010a:381).

There are a number of exceptions such as the exclusion of certain trade debts and licensed financial institutions such as banks and insurance companies (SARS, 2010a:379). The following assets are excluded from the determination of a financial instrument:

1. Debts due to the foreign company or influenced company relating to goods sold or services rendered. Where the debt has been included in the income of the foreign company or influenced company or would have been so included were that foreign company or influenced company a resident and it forms an integral part of the company’s business conducted as a going concern.

2. Financial instruments arising from the principal trading activities of the foreign company or influenced company as a bank or financier, insurer or broker that conducts more business in its country of residence or in the country of residence of that influenced company than in any other single country. It must regularly accept deposits or premiums or make loans, issue letters of credit, provide guarantees or effect similar transactions for the account of clients, or receive commissions from clients, who are not connected persons or it must derive more than 50% of its income or gains from principal trading activities with those clients. This exclusion will not apply to a foreign or influenced company that is potentially eligible for preferential tax treatment in its country of residence if the tax treatment is dependent upon it conducting business with non-resident clients or a prerequisite is that more than 50% of its ownership be held by non-residents (proviso (ii) to the definition of a ‘foreign financial instrument holding company’ contained in section 41).

3. Financial instruments held by any influenced company in relation to it if the influenced company is one envisaged in para (b) of the definition of a ‘domestic
financial instrument holding company’, namely, a local bank, authorised user, insurer or collective investment scheme (De Koker, 2010).

In determining whether more than the prescribed proportion of the assets of the company and influenced companies consist of financial instruments, the following assets must be wholly disregarded:

- Shares in any other company in the same associated group of companies
- ‘Instruments’ as defined in section 24I entered into between companies which form part of the same associated group of companies (proviso to ‘foreign financial instrument holding company’ in section 9D(1))

It is provided that in making the determination, any share of an influenced company in relation to that company must be disregarded (De Koker, 2010).

8.3.7 Foreign tax year

A foreign tax year is defined in section 9D(1) and is said to be ‘in relation to a CFC means the year of period of reporting for foreign income tax purposes, or if that company is not subject to foreign income tax, the annual period of financial reporting by that company’ (58/1962).

In Silke, it states that where a company does not have to submit a tax return nor has any official annual period to submit financial reporting information to government in terms of its country’s legislation. The foreign tax year is then said to be the annual period of financial reporting to shareholders (De Koker, 2010).
8.3.8 Local currency

The term ‘local currency’ is not defined in section 9D of the Act; however the term is defined in paragraph 43(7) of the Eighth Schedule of the Act.

Local currency is defined as meaning ‘(a) in relation to a permanent establishment of a person, the currency used by that permanent establishment for purposes of financial reporting\(^\text{12}\) (other than the currency of any country in the common monetary area); (b) in any other case, the currency of the Republic’ (58/1962).

In order to properly understand the meaning of local currency, the meaning of currency used for financial reporting is required. This term is best described in IAS 21 – The effects of changes in foreign exchange rates. Refer to paragraph 8.3.10.2.

8.3.9 Taxation Law Amendment Act, 7 of 2010

The following changes have been proposed relating to the definitions as contained in section 9D or in the Act, which will directly impact the provisions contained in section 9D.

8.3.9.1 Company law reform

With the enactment of the Companies Act, 2008 (Act no 71 of 2008) certain changes to the Income Tax Act were inevitable as many of the provisions contained in the Act are dependent on the principles and definitions contained in the Companies Act. It is said that the new Companies Act modernises company law in line with both economic and international trends (National Treasury, 2010:37). The changes include:

- The removal of capital maintenance rules for determining dividends in favour of market value solvency and liquidity tests
- Modernisation of reorganisation rules and
- The facilitation of business rescue procedures

\(^{12}\) The Taxation Law Amendment Bill of 2010 has replaced the term ‘currency for financial reporting’ with ‘functional currency’ with effect from 1 January 2011 and applicable in respect of foreign tax years of controlled foreign companies ending during years of assessment commencing on or after that date.
The following are the proposed change:

- **Dividend definition**

Under the new requirements of the Companies Act the revised rules and distributions are tested to ensure that the dividend being declared does not reduce the assets to below the liabilities (solvency test) and whether the declaration of the dividend will result in a deprivation of the cash holdings of the Company (National Treasury, 2010:37).

The new dividend definition will come into effect on 1 January 2011 and treats amounts transferred by a company as being a dividend unless the dividend is declared from contributed tax capital. Contributed tax capital is the amount contributed to the company in exchange for shares (National Treasury, 2010:37-38).

### 8.3.9.2 Head-quarter Company

In terms of the Explanatory Memorandum on the Taxation Laws Amendment Bill 2010 issued by National Treasury (2010:77), included therein is the definition of a ‘head-quarter company’. The reason for the change is due to South Africa being an ideal location for entities to establish regional holdings by foreign multinationals. In order to meet the ideal location to establish holding companies in South Africa certain tax relief measures have been enacted to eliminate the tax burden relating to the CFC rules, the charge on outgoing dividends and the thin capitalisation rules. The following relief has been provided in order to make South Africa a more attractive location for foreign multinationals to set up their holding companies, namely:

- Foreign subsidiaries of a qualifying holding company will not be treated as a CFC merely because the holding company has significant equity interests in those foreign subsidiaries;

- Dividends declared by a holding company will generally be exempt from secondary tax on companies (or the new Dividends Tax once the new Dividends Tax comes into effect);
• The holding company will not be deemed to violate the thin capitalisation rules merely because of the existence of back-to-back cross-border loans involving the holding company;

• Foreign creditors of the qualifying holding company will be exempt from the pending withholding tax on interest in respect to back-to-back loans

In order to determine whether the relief can be utilised, a company needs to meet the definition now contained in the Income Tax Act where certain criteria have to be met, namely (National Treasury, 2010:78):

• **Minimum participation by shareholders:** each shareholder of the holding company must hold at least 20% of the equity shares in that holding company. This requirement must be satisfied throughout the tax year (National Treasury, 2010:78)

• **80-20 tax value:** 80% of the tax value (i.e. cost) of the holding company must represent equity, debt or intellectual property investments in foreign subsidiaries in which the holding company holds at least 20% of the equity shares. Compliance with this requirement will be measured at the end of each tax year. The status of a foreign subsidiary is measured at the end of a tax year without taking into consideration previous tax years (National Treasury, 2010:78).

• **80-20 receipts and accruals:** 80% of the total receipts and accruals of a holding company should be derived from foreign companies in which the holding company has an interest of at least 20%. The receipts received by the holding company can include, fees, interest, royalties, dividends and sale proceeds derived from those foreign companies. This again is measured at the end of the tax year (National Treasury, 2010:79).

• **Uninterrupted compliance:** a holding company is assessed regularly to determine whether it is complying with the following:
  
  o Minimum participation shareholding

  o 80-20 tax value
These requirements need to be met in each year of assessment from the date of the company’s inception. This requirement will apply to existing companies who seek to become a holding company as at the effective date of this regime and to new companies established after the effective date. The 80-20 receipts and accruals test is not monitored in determining compliance with this test (National Treasury, 2010:79).

An anti-avoidance mechanism has been added where qualifying holding companies will be deemed to be foreign residents in terms of the reorganisation rollover rules (i.e. eliminating any benefit of the roll over relief) (National Treasury, 2010:79).

The Explanatory Memorandum goes further to provide an explanation on the following:

- CFC’s impact on foreign subsidiaries of a qualifying holding company.
- Taxation of dividends distributed by qualifying holding company
- Transfer pricing in respect of qualifying holding company loans

**8.3.9.3 CFC’s impact on foreign subsidiaries of a qualifying holding company**

In order to determine whether a foreign company will qualify as a CFC in relation to a holding company, the proposal is that the qualifying holding company is deemed to be a foreign resident. Therefore, a foreign subsidiary will not automatically be a CFC where there is a direct ownership from the qualifying holding company. However, it may be a CFC when one takes into account the indirect ownership in the foreign subsidiary (National Treasury, 2010:78).

**Example:**

Company A (non SA resident) holds 70% in a qualifying holding company situated in South Africa. The remaining 30% is held by Company B a resident of South Africa. The qualifying holding company has 100% interest in a foreign subsidiary.

As the qualifying holding company is deemed to be a foreign resident, based on the direct ownership, the foreign subsidiary is not a CFC, however, one needs to look to
the shareholders of the qualifying holding company in order to ensure that there is no indirect interest in the foreign subsidiary. In this case Company B only has a 30% indirect interest in the foreign subsidiary.

Let’s say, that Company A is a South African resident and Company B is a non resident. In this case, the foreign subsidiary will be a CFC as defined, as Company A has a 70% indirect interest in the foreign subsidiary which is more than 50%.

8.3.9.4 Taxation of dividends distributed by qualifying holding company

Where dividends are distributed by a qualifying holding company to its shareholders, it will be seen to be a foreign resident, i.e. this means that where the qualifying holding companies distributing dividends will not be subject to STC. This will also be the case when the new Dividends Tax is introduced. Further to the above, the dividend distributed may qualify for the participation exemption (National Treasury, 2010:80).

8.3.9.5 Transfer pricing in respect of qualifying holding company loans

In terms of this amendment, a qualifying holding company will not need to take into consideration any foreign loans obtained where:

- The loan proceeds are on-loaned to foreign companies and
- The equity shares of those foreign companies are at least 20% held by the qualifying holding company.

However, there is an anti-avoidance mechanism that has been put in place in relation to these loans relating to the interest deductions. These are ring fenced against the interest earned on the proceeds on-lent to the 20% or more foreign companies. Where there are any unused losses from the excess interest incurred these are deemed to be incurred in the following year (National Treasury, 2010:80).
8.3.10 Terms included in section 9D not defined

The following terms are not specifically defined in section 9D nor in the Income Tax Act itself. However, in order to understand these terms further, a brief understanding is required. Where a term is not specifically defined in the Act, one should refer to its normal dictionary meaning of the word or to guidance that has been issued (either by SARS or by principles laid down in court cases).

8.3.10.1 Comparable prices (s9D(9)(b)(ii)(aa)(C))

In terms of Practice Note 7 to the Income Tax Act relating to the Determination of the Taxable Income of Certain Persons from International Transactions: Transfer Pricing paragraph 8 refers to the Principles of Comparability. In terms of this paragraph comparability is fundamental to the application of the arm’s length principle. The preferred arm’s length methods are based on the concept of comparing the prices/margins achieved by connected persons in their dealings to those achieved by independent entities for the same or similar dealings. In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be highly comparable (Lexis Nexis, 2009:1472). To be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the method (e.g. price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences. If suitable adjustments cannot be made, then the dealings cannot be considered comparable (Lexis Nexis, 2009: 1472).

8.3.10.2 Currency used for financial reporting

In terms of IAS 21 – The effects of changes in foreign exchange rates, paragraph 8 defines the following terms:

- Functional currency – is the currency of the primary economic environment in which the entity operates
- Presentation currency – is the currency in which the financial statements are presented (IFRS, 2011:A654).
The meaning of the expression ‘currency used for the purposes of financial reporting’ is obscure. If the intention of the legislature is to indicate a reference to the legally required presentation currency in the relevant country for financial reporting purposes, this is not evident. It would appear that the relevant currency should be determined having regard to the currency actually used by the company for reporting purposes, which is the basis for the preparation of the accounts of the CFC, as opposed to the currency required for statutory compliance purposes within the foreign country (De Koker, 2010).

It would appear then that the legislature intended the expression ‘currency used for purposes of financial reporting’ as a reference to functional currency rather than presentation currency of the CFC. Support for this submission lies in the fact that a CFC can have different presentation currencies, but only one functional currency (De Koker, 2010).

In terms of IAS 21 – The effects of changes in foreign exchange rates describes further how an entity would determine its functional currency. Paragraph 9 ‘the primary economic environment in which an entity operates is normally the one in which it primarily generates and expends cash. An entity considers the following factors in determining its functional currency:

(c) the currency

(iii) that mainly influences sales prices for goods and services (this will often be the currency in which sales prices for its goods and services are denominated and settled); and

(iv) of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services.

(d) the currency that mainly influences labour, material and other costs of providing goods or services (this will often be the currency in which such costs are denominated and settled)’ (IFRS, 2011:A654).

Paragraph 10 of IAS 21 goes further to describe additional factors that will provide evidence on the functional currency, namely:

(c) the currency in which funds from financing activities (i.e. issuing debt and equity instruments) are generated.
(d) The currency in which receipts from operating activities are usually retained (IFRS, 2011:A655).

Paragraph 11 lists the following additional factors that should be considered in determining the functional currency of a foreign operation, and whether its functional currency is the same as that of the reporting entity, namely:

(e) ‘whether the activities of the foreign operations are carried out as an extension of the reporting entity, rather than being carried out with a significant degree of autonomy. An example of the former is when the foreign operation only sells goods imported from the reporting entity and remits the proceeds to it. An example of the latter is when the operation accumulates cash and other monetary items, incurs expenses, generates income and arranges borrowings, all substantially in its local currency.

(f) Whether transactions with the reporting entity are a high or a low proportion of the foreign operation’s activities.

(g) Whether cash flows from the activities of the foreign operations directly affect the cash flows of the reporting entity and are readily available for remittance to it.

(h) Whether cash flows from the activities of the foreign operation are sufficient to service existing and normally expected debt obligation without funds being made available by the reporting entity’ (IFRS, 2011:A655).

In terms of the Explanatory Memorandum of the Taxation Laws Amendment Bill of 2010, issued by National Treasury (2010:87) included therein is clarity relating to multiple reporting currencies, in particular relating to currency of financial reporting and that currently the Act does not cater for the following situations:

- Report in various currencies for various purposes
- Report in one currency with significant part of the underlying economic activities being conducted in another foreign currency.

Taxpayers are now afforded flexibility allowing taxpayers to use their functional currencies as the base currency for translating foreign currency for tax purposes. The meaning of function currency is said to be determined with reference to the currency
of the primary economic environment in which the business operations are conducted (National Treasury, 2010:87).

The term ‘functional currency’ described in the Explanatory memorandum on the Revenue Laws Amendment Bill for 2010 is therefore similar to that used for accounting purposes in terms of IAS21, as described above. In the Explanatory Memorandum on the Taxation Laws Amendment Bill of 2010, the tax functional currency used by the entity should be effective for a full tax year. The ‘significance’ of activities can be based on the relationship of activities throughout the year or on the basis that a particular currency is the most significant throughout most of the year (National Treasury, 2010:87).

The explanatory memorandum goes further that the headquarter company regime being enacted, a headquarter company can determine its taxable income with reference to its functional currency as opposed to the Rand. The dollar based headquarter companies can rely on the dollar as their base currency for tax purposes. The taxable income must then be translated into Rands using the average exchange rate for the year of assessment (National Treasury, 2010:87).

8.3.11 Passive income (Dividends, interest, royalties, rentals, insurance, annuities and income of a similar nature)

In the now repealed section 9E, the term passive income was defined as ‘gross income derived from financial instruments’ (National Treasury, 2008:39). Therefore passive income encompasses, in general terms, all income that is not generated by an economic activity exercised by the recipient. Such definition formulated usually includes interest, dividends, royalties and gains. In any case, the definition of passive income excludes financial income derived by banking, insurance or financial businesses; to the extent it represents the income from the characteristic activity (Maisto and Parolini, 2010:27).
8.4 Exemptions to section 9D

Section 9D(9) provides certain exemptions to the imputation of the net income of a CFC into the resident shareholder’s net income. The primary exemptions are aimed at providing relief for taxpayers where bona fide business or commercial activities are taking place in foreign companies controlled by residents (foreign business establishment exemption) or where income has already been included in the South African income tax net due to the true or deemed source rules (refer section 9 of the Act).

Where a resident shareholder can prove (the onus is on the taxpayer in terms of section 82 of the Act) that any of the exemptions apply, the income earned on these transactions will not be included in the determination of net income and attributed to the resident shareholder’s taxable income.

8.4.1 Summary of exemptions – the provisions of section 9D will not apply

<table>
<thead>
<tr>
<th>S9D(9)(b) – amounts attributable to any foreign business establishment of the controlled foreign company</th>
<th>Provided that this exemption will not apply</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(iv) where transactions are not in line with section 31 of the Act (i.e. thin capitalisation or financial assistance);</td>
</tr>
<tr>
<td></td>
<td>(v) where certain transactions fall into any of the so-called diversionary rules;</td>
</tr>
<tr>
<td></td>
<td>(aa) Sale of goods by a CFC to a connected resident;</td>
</tr>
<tr>
<td></td>
<td>(bb) sale of goods by a CFC to an unconnected resident but where the CFC purchased the goods from a connected resident</td>
</tr>
<tr>
<td></td>
<td>(cc) Service performed by a CFC to a connected resident;</td>
</tr>
<tr>
<td></td>
<td>(dd) granting by that CFC the right of use</td>
</tr>
</tbody>
</table>
or permission to use an intangible asset to a connected resident.

(vi) To any amounts in the form of dividends, interest, royalties, rental, annuities, insurance premiums or similar income or any capital gain or foreign currency gain, unless

(aa) to the extent that the income and capital gains attributable to those amounts do not in total exceed 10%

(bb) arise from the principal trading activities of any banking, financial services, insurance or rental business taking into account exclusions contained in A, B and C

(cc) where the amounts arise from the disposal or deemed disposal of any intangible assets

(dd) in the case of royalties received by or accrued to the CFC, if the company directly and regularly creates, develops or substantially upgrades any intellectual property.

<table>
<thead>
<tr>
<th>S9D(9)(c) – policyholder</th>
<th>Attributable to any policyholder that is not a resident or a CFC in relation to a resident in respect of any policy issued by a company licensed to issue any long-term policy as defined in the Long-term Insurance Act.</th>
</tr>
</thead>
<tbody>
<tr>
<td>S9D(9)(e) – South African source</td>
<td>Any amounts included in the taxable income of the company and has not been or will not be exempt at a reduced rate in the Republic as a result of the application of any agreement for the avoidance of double taxation.</td>
</tr>
<tr>
<td>S9D(9)(f) – foreign dividends</td>
<td>Attributable to any foreign dividend declared to the CFC by any other CFC in relation to the resident, and</td>
</tr>
</tbody>
</table>
the foreign dividend does not exceed the aggregate of all amounts which have or will be included in the income of the resident in terms of section 9D in any year of assessment

| S9D(9)(fA) – Interest, royalties, rental, exchange differences | Is attributable to any interest, royalties, rent or similar income, exchange differences in terms of section 24I or in terms of any forward exchange contract or reduction or discharge of any other CFC of a debt owed by that company to any other CFC for no consideration where both CFCs form part of the same group of companies. |
| S9D(9)(fB) – disposal of asset in terms of Eighth Schedule | Is attributable to the disposal of any asset, where the asset was attributable to any foreign business establishment of any other CFC, where the company and that other CFC form part of the same group of companies. (58/1962) |

8.4.2 Foreign business establishment exemption

The foreign business establishment exemption is one of the most significant exemptions contained in section 9D(9) (National Treasury, 2009b:7). Section 9D(9)(b) provides that any income attributable to a foreign business establishment is exempt including any capital gain on the disposal or deemed disposal of any assets of the foreign business establishment in terms of the Eighth Schedule. However, the exemption contained in this section excludes income resulting from certain transactions, referred to as diversionary rules (National Treasury, 2006:55).

Where diversionary type transactions are being concluded by a CFC that meets the definition of a foreign business establishment, the income earned on these transactions will no longer be exempt and will be included in the net income of the resident shareholder. There are two types of transactions that fall within the scope of the
diversionary rules, i.e. those not in compliance with section 31 (transfer pricing) and secondly, those transactions that comply with section 31, but are nevertheless capable of manipulation (Olivier & Honiball, 2008:449). These diversionary rules will now be discussed in more detail below:

### 8.4.2.1 Transfer pricing

Section 9D(9)(b)(i) excludes from the foreign business establishment exemption (emphasis added) ‘(i) any amounts derived from any transaction relating to the supply of goods or services by or to that controlled foreign company with any connected person (in relation to that controlled foreign company), who is a resident unless the consideration in respect of that transaction reflects an arm’s length price that is consistent with the provisions of section 31’(58/1962).

Section 31 of the Act includes anti avoidance provisions relating to international transactions involving transfer pricing and thin capitalisation. The transfer pricing provisions give the Commissioner the authority to adjust any artificial prices (i.e. not at arm’s length) to that price which the Commissioner feel’s is a better reflection of an arm’s length price. Section 31(3)\(^\text{13}\) relates to thin capitalisation which will occur where financing is obtained by a resident company from a foreign connected person and it results in a disproportionate debt to equity ratio (Stiglingh et al, 2010:583). Guidance as to the meaning of an arm’s length consideration as contemplated in section 31 is provided in Practice Note 7 to the Act, which provides an understanding as to the determination of a price that will be considered to be at arm’s length by SARS (Lexis Nexis, 2009:1472).

### 8.4.2.2 Diversionary rules

The following types of transactions concluded between a CFC and connected persons who are residents of South Africa for tax purposes are also excluded from benefiting from the foreign business establishment exemption, despite the fact that the

\(^{13}\) With effect from years of assessment beginning on and after 1 October 2011, section 31 has been amended by inter alia removing the so called thin capitalisation provisions.
transactions may comply with the ‘arm’s length principle’ as contemplated in section 31. The diversionary rules relate to the following types of transactions, namely:

1. Sale of goods by the CFC to a South African resident that is a connected person, (s9D(9)(b)(ii)(aa));
2. Sale of goods by a CFC which were bought from SA resident that is a connected person, and sold to persons other than connected South African residents, (s9D(9)(b)(ii)(bb)); and
3. Services performed by the CFC to South African resident connected persons (s9D(9)(b)(cc)), (58/1962).

8.4.2.3 **CFC sales to connected SA residents (i.e. sale of goods by the CFC to a South African resident connected persons)**

The foreign business establishment exemption does not apply where the CFC sells goods to a SA resident that is a connected person unless any of the four following situations occur:

1. ‘(A) that controlled foreign company purchased those goods within the country of residence of that controlled foreign company from any person who is not a connected person in relation to that controlled foreign company’ (58/1962).

In the above, the CFC would need to purchase the goods in the same country in which it resides (i.e. country of residence) from unconnected persons. If the CFC then sells those goods to a connected person that is a resident, the foreign business establishment exemption will still apply. There may be a commercial reason for setting up a company outside of South Africa besides obtaining a tax benefit, in this scenario; it might make sense for the CFC to then sell the products that it manufactures in the foreign country to its resident shareholder. Where SARS is satisfied that there is not only a tax benefit from setting up a company outside South Africa the foreign business establishment exemption would still apply.
### Example 1:
Company A, resident in South Africa, owns 100% of the shares in Company B, a company resident in the UK. Company B purchases radios from an unconnected person that has its operations located in the UK. Company B resells the radios at a profit to Company A (connected person). The income of Company B will not be imputed into the taxable income of Company A as the exemption in terms of section 9D(9)(b)(ii)(aa)(A) will apply, provided that the consideration paid by Company A for the radios constitutes an arm’s length consideration.

### Example 2:
Company A, a resident in South Africa, owns 100% of Company B which is situated in the United Kingdom. Company B purchases radios from Company C (a company resident in the United Kingdom which meets the definition of a connected person). The radios are then sold to Company A in South Africa at a market related price. The net income of Company B will be imputed into the taxable income of Company A as the exemption contained in section 9D(9)(b)(ii)(aa)(A) does not apply, as Company B is purchasing its stock from a connected person C even though C is a non resident.

In order for the foreign business establishment exemption to apply the CFC should purchase its stock from an unconnected person resident in the same country as the CFC.
The CFC will be a foreign business establishment where the activities being performed by the CFC before the goods are sold to a South African resident if the product is a result of a process of creation, extraction, production, assembly, repair or an improvement and that which the CFC performs on the products before the sale is considered to be ‘more than minor’. The term ‘more than minor’ needs to be explained in order to apply the exemption above. The meaning of ‘more than’ in terms of the Little Oxford English Dictionary is ‘very’ (LOED, 2006:447) and ‘minor’ is said to mean ‘not important or serious’ (LOED, 2006:438). It is submitted that in order for the activities to result in a CFC being a foreign business establishment, the activities should result in changing the product quite significantly before it is sold to a South African resident hence referring back to the fact that there needs a form of creating, extracting, producing and so on.

**Diagrammatic illustration:**

CFC (USA) purchases Product X
Individual unites (different to unit)
Places them through a process at start of process)
To create a new, different, better product
Sold to SA resident

**Example:** where the CFC purchases wine from an unconnected person, places labels on the wine bottles with the name of the South African resident and places the wine in cases and exports them, this is a minor activity as it does not result in something new (significant change) being created, extracted, produced, assembled etc and therefore the foreign business establishment exemption will not apply.
Example: Company A owns all the shares in Company X, a company resident in a foreign country Y. Company X assembles machinery in a labour intensive factory located in Country Y. The assembly requires that various parts are screwed or welded together and the machines are then painted after which the machines are sold to A the South African company for R2000 per machine. The parts required to assemble the machinery were acquired from various distributors located outside Y at a cost of R800 per unit. Each machine has numerous parts that are assembled together. The physical factory overhead, equipment and labour costs to produce the machinery amount to R300 per machine. The management, accounting and administrative fees amount to R80 per machine. As the activities of the CFC amount to more than minor assembly or adjustment, the income derived from the sales will be exempt in terms of the foreign business establishment exemption.

3 ‘(C) that controlled foreign company sells a significant quantity of goods of the same or a similar nature to persons who are not connected persons in relation to that controlled foreign company, at comparable prices (after accounting for the level of the market, volume discounts and costs of delivery)’ (58/1962).

Where a CFC sells a significant portion of its stock on hand to unconnected persons at prices which reflect an arm’s length price (i.e. comparable prices) the foreign business establishment exemption will apply. In order to apply this exemption the following terms require clarification, namely, the term ‘significant’ and ‘comparable prices’.

The term ‘significant’ is not defined in the Act, however in terms of the Little Oxford English Dictionary (2006:647) is said to mean ‘important, large enough, to have an effect or be noticed’, as the term is before the word quantity, it would indicate that the sales made to unconnected persons in terms of volume or quantity must be large in comparison to the sales made to connected persons.

The term ‘same’ per the Little Oxford English Dictionary (2006:613) means ‘exactly alike’, ‘identical people or things’ and ‘similar’ means ‘like something
but not exactly the same’ (LOED, 2006:648). From the above it can be seen that the goods being sold should be exactly alike or can differ slightly but possibly form part of the same type of industry or objective of the company. For example: A CFC that sells car batteries and car tyres can be said to sell goods of the same or similar nature however, if the CFC sells canned food and car batteries these goods would not be of a similar nature.

The term ‘comparable prices’ would indicate a price that is considered to be ‘at arm’s length’. Comparable prices are dealt with under Practice Note 7 to the Act where guidance is given on the meaning thereof. In terms of Practice Note 7, the arm’s length principle is described as a transaction that has substantive financial characteristics of a transaction between connected parties where each party strives to get the utmost benefit. For a price to be comparable it is said to mean that none of the differences between the situations being compared could materially affect the condition being examined (Lexis Nexis, 2009:1472). The Practice Note goes further to explain certain methods that are acceptable in determining an arm’s length price, these methods have not been documented in the legislation but are contained in the Practice Note (Lexis Nexis, 2009:1475). One of the methods described in the Practice Note that is acceptable to the SARS and the OECD is the CUP method (i.e. Comparable Uncontrolled Price Method), this is said to be the most preferred method according to the Practice Note. This gives a taxpayer an indication as to the legislator’s intention regarding how one is expected to determine a ‘comparable price’. Under the CUP method it states that the basic understanding is that it results in a direct comparison between the price charged for a specific product in a controlled transaction and the price charged for a closely comparable product in an uncontrolled transaction. Where a difference between the two prices arises this will provide evidence or give an indication that the existence of a non arm’s length condition may be present and that the price in the controlled transaction may need to be substituted for the price in the uncontrolled transaction (Lexis Nexis, 2009:1476-1477).
Diagrammatic illustration:

```
Company (USA)  
Purchases stock from unconnected person  
In another country  

CFC (UK)  
80% Sales  
At R10  

20% Sales  
At R10  

Unconnected third parties  
(in any country of residence)  

SA resident
```

**Example:** Company A owns all the shares in Company X, a company resident in Y. Company X does not engage in any production activities, but maintains a purchasing and sales office and a warehouse in Y that qualifies as a business establishment. Company X purchases desks from an unrelated distributor, a company with its full physical location in D. Company X sells 30,000 of these desks to various retailers located within Y at R4500 and 20,000 desks to Company A at R5000 each (the price difference is entirely due to higher transportation and delivery costs). Although Company X is not engaged in local purchases (since none of the goods were ever located within Y) or any production activities, the income derived from the sale to Company A is still exempt on the basis that Company X sells a significant number of desks to unconnected persons at comparable prices after taking into account differences in the cost of delivery.
4 ‘(D) that controlled foreign company purchases the same or similar goods *mainly* within the country of residence of that controlled foreign company from persons who are not connected persons in relation to that controlled foreign company.’

The term ‘**mainly**’ is not defined in the Act, and therefore one can turn to case law in order to assist in understanding the meaning thereof, in SBI v Lourens Erasmus (Edms) Bpk, the terms ‘solely or mainly’ were reviewed extensively. The conclusion was that the term ‘mainly’ established a purely quantitative measure of ‘more than 50%’. In CIR v King the word ‘mainly’ for the purposes of tax avoidance was said to convey the idea of dominance. Therefore foreign business establishment exemption will apply where the CFC purchases more than 50% of its goods within its country of residence from unconnected persons.

*Diagrammatic illustration:*

```
Any Company (situated in any Country)   Company (UK – not connected)
  Sells products to CFC (40%)          Sells products to CFC (60%)
      CFC (UK)                        CFC (UK)
                                       Sells to connected SA resident
                                          SA resident
```

*Example:* Company C, resident of the UK is a controlled foreign company of Company A. Company C sells fridges to Company A, who is a resident in South Africa. Company C purchases 90% of its stock from a supplier who is a resident of the UK. Therefore there will be no imputation of the consideration from this transaction into the taxable income of Company A.
8.4.2.4  **CFC purchases goods from SA resident who is a connected person**

Where a CFC sells goods to an unconnected person but initially purchased the goods from a connected person who is a resident, the foreign business establishment exemption does not apply unless any one of the following four scenarios apply.

1  ‘(A) those goods or tangible intermediary inputs thereof purchased from connected persons (in relation to such controlled foreign company) who are residents amount to an insignificant portion of the total goods or tangible intermediary inputs of those goods’(58/1962).

The foreign business establishment exemption will still apply provided the goods purchased are from connected persons who are residents but amount to an insignificant portion of all goods and these are then sold to unconnected persons.

The term ‘insignificant’ is opposite to that contained above which read ‘significant’ as described above, the term ‘significant’ should be considered in relation to volumes or quantities, where the CFC purchases an insignificant quantity in comparison to the total quantity of products purchased then the foreign business establishment exemption would still apply.

**Diagrammatic illustration**

<table>
<thead>
<tr>
<th>Connected SA Resident</th>
<th>Unconnected Persons (any country)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sells 5% of goods</td>
<td>Sells 95% of goods</td>
</tr>
</tbody>
</table>

CFC (UK)

Unconnected third person (any country)
This requirement is similar to that referred to above relating to sales made to South African connected persons. In that the product being purchased needs to be changed through creation, extraction, production, assembly etc in order to obtain the exemption and not merely by a minor (insignificant) change to the product being sold.

**Example:** Company A, a resident in South Africa, owns 100% of the shares in Company B, a company resident in the UK. Company B assembles machinery from various component parts purchased from a number of suppliers. Each machine is custom made based on the specifications of customers and takes up to 2 months to build. Company B purchases one component part from Company A at a market related price. Once the machinery is assembled they are on sold to unconnected persons in the UK.

Due to the fact that Company B assembles the machinery which takes a considerable amount of time and are customer specific, the foreign business establishment exemption will still apply as only a component part of the entire machine is purchased from Company A.

The foreign business establishment exemption will still apply where goods are sold by the CFC to an unconnected person where physical delivery is expected within the country of residence of that CFC.

The term ‘delivery’ is said to have a more physical focus (i.e. this means that the CFC cannot hypothetically deliver the goods but the goods are actually required to be delivered to a physical address of the recipient in the same country of residence as the
CFC). Physical delivery need not be undertaken directly by the CFC but could be by a customer or other parties. The CFCs operations have to have an appropriate nexus to the physical business needs of genuine local customers (National Treasury, 2006:56).

Example: Company B a CFC, incorporated in the UK, purchases goods from Company A (SA Resident connected person). Company B sells the goods to an unconnected person situated in the UK. In terms of the sales agreement with its customers, Company B is required to deliver the goods to the physical address of the customer to assist in the installation of the product. From the above, due to the fact that Company B has to deliver the product to the customer’s premises located in its country of residence, the foreign business establishment exemption still applies.

4 ‘(D) products of the same or similar nature are sold by that controlled foreign company mainly to persons who are not connected persons in relation to that controlled foreign company for physical delivery to customer’s premises situated within the country of residence of that controlled foreign company’ (58/1962).

This exemption is similar to that described above relating to sales made to South African residents that are connected persons. Refer above for commentary.

Diagrammatic illustration:

Connected SA resident

↓

CFC (UK)

Connected SA resident’s

Unconnected persons

For delivery in the UK (80%)
8.4.2.5  CFC South African connected services

Where any services are performed by a CFC to a connected person who is a resident, the foreign business establishment exemption will not apply. However where the services are performed outside the Republic and any four of the following scenarios occur, the foreign business establishment exemption will still apply.

1. ‘(A) such service relates directly to the creation, extraction, production, assembly, repair or improvement of goods utilised within one or more countries outside the Republic’ (58/1962).

The term ‘directly’ was described in SIR v Consolidated Citrus Estates Ltd (1998) 4 All SA 269 (A), 60 SATC 449 where the court was called upon to consider the requirements of ‘directness’ in the now repealed s11bis(4)(f) of the Income Tax Act.

Galgut JA said:

‘The section is concerned to aid the taxpayer who has incurred market development expenditure. If expenditure has not been incurred by a taxpayer, he will not normally be given the benefit of a deduction for such expenditure or part thereof. It would thus seem that “directly” refers to and qualifies the act of incurring the expenditure. Obviously the expenditure must have been incurred by the taxpayer, i.e. he must have incurred the liability or made the payment. “Directly” appears to have been deliberately added in order to serve some purpose that the Legislature had in mind. The purpose, I think, was to postulate that the connection between the taxpayer’s incurring the expenditure and the object for which it was incurred . . . should be direct, i.e. straight and close, not devious and remote (cf The Concise Oxford English Dictionary vs. “direct”)’ (De Koker, 2010).
Diagrammatic illustration:

CFC (UK)

Performs services in the UK for the connected SA resident

The services result in the creation, extraction
Production, assembly etc

Connected SA resident

Utilisation of those goods within one or more countries outside the Republic

2 ‘(B) such service relates directly to the sale or marketing of goods of a connected person (in relation to that controlled foreign company) who is a resident and those goods are sold to persons who are not connected persons in relation to that controlled foreign company for physical delivery to customers’ premises situated within the country of residence of that controlled foreign company’ (58/1962)

For an explanation on the term ‘physical delivery’ refer to the commentary included above regarding sales by a CFC to South African residents that are connected persons.

For (A) and (B) above it is clear that income derived from services of a general nature, such as management fees, internal accounting fees and fees to guarantee loans never qualify for exemption. The legislator is of the view that the possibility of manipulating prices is high and no business reason other than tax exists for these services to be rendered outside South Africa (Olivier & Honiball, 2008:454).
Diagrammatic illustration:

\[
\begin{array}{c}
\text{CFC (UK)} \\
\downarrow \\
\text{Market and sale services of connected} \\
\text{Persons goods} \\
\downarrow \\
\text{Connected SA resident} \\
\downarrow \\
\text{Sold and physically delivered} \\
\downarrow \\
\text{Unconnected person (UK)}
\end{array}
\]

3 ‘(C) such service is rendered mainly in the country of residence of the controlled foreign company for the benefit of customers that have premises situated in that country’(58/1962).

The Explanatory Memorandum on the Revenue Laws Amendment Bill 2006, the proposed changes to this section of the Act, where the change was made to ensure that no tax be levied on services rendered to legitimate clients in the same country of residence as the CFC (National Treasury, 2006:56).

Included in this requirement is the term ‘mainly’ which as discussed previously indicates more than 50%. Therefore in order for this exemption to apply, the majority of the CFC’s total services need to be performed for customers situated in its country of residence.

**Example:** Company A (CFC situated in Dubai) assists customers with IT related services in Dubai, however, Company B (a SA resident who is a connected person) requires IT assistance on an ad hoc basis during the year. Company A performs these services on behalf of Company B. During the 2009 year of assessment, Company A provided services to Company B which resulted in a 60% of its time being spent providing services solely to Company A. During the 2010 year of assessment, Company A only spent 20% of its time providing services to Company B.
Therefore in 2009, the foreign business establishment exemption will not apply as more than 50% of its services were rendered to a connected resident whereas in 2010, the foreign business establishment exemption will apply as less than 50% of its services were rendered to a connected resident.

4 ‘(D) to the extent, no deduction is allowed of any amount paid by that connected person to that controlled foreign company in respect of that service’ (58/1962)

CFC services will no longer be subject to diversionary treatment if they do not give rise to South African deductions by a South African party holding a participating interest in that CFC. No potential for avoidance exists without a corresponding South African deduction that directly erodes the tax base. The reason for this exemption from attribution is that no potential for avoidance exists without a corresponding deduction in South Africa that directly erodes the tax base (Olivier & Honiball, 2008:455).

Example, assume South African company makes payment to fund R&D performed by its CFC outside the Republic, and this payment is not allowable as a deduction. In this instance, the South African company is ineligible for deductions so no need exists to trigger CFC income (i.e. the denial of deductions can be matched against by the non-inclusion of income) (National Treasury, 2006:56).

8.4.2.6 Intangible asset

Where the controlled foreign company receives any amount for the granting of the right to use or permission to use an intangible asset to a connected person who is a resident, the foreign business establishment exemption will not apply.

Example: Company A owns 100% of Company B (Company B meets the definition of a foreign business establishment). Company A is a resident of the Republic whereas Company B is incorporated and effectively managed in Dubai. Company B has an intangible asset (trademark) which they have granted the use of the trademark to Company A at a market related price. During the 2010 year of assessment, Company A pays royalties to Company B amounting to R1million (this is considered
to be an arm’s length price). The following tax considerations need to be taken into consideration, namely:

- Company B is a controlled foreign company as defined in section 9D(1) and meets the definition of a foreign business establishment and therefore the exemptions as contemplated in section 9D(9)(b) will apply. However, in terms of South Africa’s residence based taxation, non residents are taxed on income where the source or deemed source is within the Republic of South Africa.

- Therefore the income earned by Company B will be taxed in South Africa in terms of section 9(b) or 9(bA). In terms of both these sections, the income will be taxed in terms of section 35 as a withholding tax.

- In terms of section 35, where a resident pays an amount over to a non resident for the use or right of use of a trade mark, the non-resident is liable to pay tax, known as a withholding tax at a rate of 12%. Therefore Company A will be required to withhold R120 000 from the total payment of R1 million to be paid to the SARS on behalf of Company B. The net amount of R880 000 will ultimately be paid over to Company B. This is assuming that no double taxation agreement reduces the withholding tax rate.

- Therefore the foreign business establishment exemption will not apply as the intangible asset is used within the Republic and in terms of section 9, the source of the income is in the Republic and will be taxed.

### 8.4.3 Mobile passive income

Where income is derived from mobile business activities, so called passive income, this income does not qualify for exemption under section 9D(9)(b)(iii). Passive income includes the following:

- Dividends
- Interest
- Royalties
- Rentals
- Annuities
- Insurance premiums
- Income of a similar nature
• Capital gains derived from the disposal or deemed disposal of an asset from which dividends, interest, royalties, rentals, annuities, insurance premiums and income of a similar nature was or could be earned; and
• Foreign currency gains determined under section 24I (other than those arising in the normal course of business of the CFC which is not a foreign financial instrument holding company).

It is submitted that the term ‘could be earned’ relates to the fact that the asset does not necessarily have to be earning passive income, but that the asset has the potential to produce passive income. Where an asset has the potential to produce passive income it will fall within the scope of this provision.

Included in section 9D(9)(b)(iii) the term ‘income of a similar nature’ is used, this term is not defined in the Act and is extremely wide and therefore provides ambiguity as to the types of income that would form part of the ‘passive income’ that would not qualify for an exemption.
A ‘passive’ asset is an asset from which dividends, interest, royalties, rentals, annuities, insurance premiums or income of a similar nature could be earned for example, a dividend yielding share, a rent producing property or an interest bearing security. This is a general statement (Wilson, 2004).

Section 9D(9) does not define the term ‘passive income’ and this term is not defined anywhere else in the Act, however there are other definitions in the Act that could influence the meaning and understanding of the term as well as terms described in accounting standards. These have been discussed below.

Investment income is defined in section 12E as ‘(i) any income in the form of dividends, royalties, rental derived in respect of immovable property, annuities or income of a similar nature; (ii) any interest as contemplated in section 24J (other than any interest received by or accrued to any co-operative bank as contemplated in paragraph (a)(ii)(ff), any amount contemplated in section 24K and any other income which, by the laws of the Republic administered by the Commissioner, is subject to the same treatment as income from money lent; and (iii) any proceeds derived from
investment or trading in financial instruments (including futures, options and other derivatives), marketable securities or immovable property’ (58/1962).

It has been said that the word ‘income’ as used in the definition of ‘investment income’ in all three places where it appears is not used in its defined meaning of ‘gross income’ less ‘exempt income’ but rather to describe the inflow of earnings from an investment; in other words, the receipts and accruals that result from an income earning asset (Mitchell. 1998).

In IAS 40 – Investment property the term is defined, however, what is of interest is that an investment property is one where a person will earn rentals or for capital appreciation and excludes an asset that is used in the production or supply of goods or services or for administrative purpose or for sale in the ordinary course of business (IFRS, 2007: 2076). In my view, this indicates that passive income is earned on assets or investments where the intention of the taxpayer is to earn rentals, interest, dividends etc or to increase in value to be sold at a later date for an amount higher than what was paid for the asset. This is confirmed with the exclusion of assets that produce goods (products manufactured for resale, i.e. inventory).

The term ‘passive’ as defined in the Little Oxford English Dictionary means ‘accepting what happens without resisting or trying to change anything’, therefore income of a similar nature would be income earned on investments or assets where the taxpayer has to do almost nothing and earn some kind of return on their investment (LOED, 2006:498).

**Example:** Company A has a trade mark which it recognises as an asset in its accounting records. No royalty income is earned by Company A on this trade mark, however, Company A could give the right to another company to use the trade mark on which it could earn royalty income. Therefore the trade mark will fall into this provision as relates to an asset on which royalty income ‘could be earned’.
There is a provision to this subsection where in certain circumstances the passive income will be exempt. These will be discussed below and can be summarised as follows:

5 The 10% rule
6 Principal trading activities
7 Sale of intangible assets
8 Royalties received and accrued

8.4.3.1 10% rule

Where the passive income does not in total exceed 10% of the income plus capital gains of the CFC attributable to a foreign business establishment but excluding income or capital gains attributable to those amounts or in respect of which any of the provisions contained in paragraphs (e) to (fB) apply. Paragraph (e) relates to income received by the CFC from a South African source which will be taxed in terms of section 9 of the Act. This will be automatically included in the South African income tax net due to its source being in South Africa. Paragraph (f) applies to the following types of income, any foreign dividend declared by any other CFC in relation to a resident to the extent that such dividend does not exceed the aggregate of all amounts which have been or will be included in the income of the resident in terms of section 9D which relate to the company declaring the dividend. Paragraph (fA) relates to net income of a CFC that is attributable to interest, royalties, rentals or income of a similar nature or certain exchange differences or debt reductions received from another CFC where those CFCs form part of the same group of companies unless they elect that it should apply to them. Paragraph (fB) relates to where capital gains arising from the disposal of a capital asset which is attributable to the foreign business establishment of either the CFC or another company within the same group of companies (58/1962). In essence this exemption means that passive income is exempt to the extent that it is equal to or below 10% of active trading income, i.e. income derived from selling goods or services.
Example: A South African resident company owns all the shares of a CFC. The CFC generates gross income amounting to R400 000 from its active trading activities of its business establishment. However, the CFC also generates passive income. The total passive income earned amounts to R47 000.

Due to the above 10% rule, the passive income that is excluded from inclusion in terms of section 9D amounts to 10% of R400 000 = R40 000. The excess passive income amounts to R7 000 (R47 000 less R40 000), which is deemed to be income in the hands of the South African resident.

8.4.3.1.1 Principal trading activities

Where the passive income arises from the following trading activities the foreign business establishment exemption will still apply:

- Banking or financial services
- Insurance
- Rental business

However, excluded from these trading activities are any amounts derived from:

- A company that is a foreign financial instrument holding company at the time the amount is derived;
- Any connected person in relation to the CFC who is a resident and where the resident directly or indirectly holds at least 5% of the participation rights in that CFC or any other company in the same group of companies which holds shares in that CFC;
- Amounts derived which form part of a transaction, operation or scheme where any amount received or accrued to any person is exempt from tax and the corresponding expenditure is deductible by that person or any connected person in determining the liability for tax of that person or connected person.

The question arises as to the scope of passive income that ‘arises’ from a trading activity like insurance or rental. Insurance and rental companies deposit money received in the form of rental or insurance premiums with financial institutions and therefore receive interest on these deposits. Can the interest received be said to arise
from the trading activity of insurance or rental or does the interest have to be evaluated in terms of other provisions in this subsection?

It is submitted that the answer would lie in the activities undertaken by the CFC in earning the interest. In *Western Platinum Ltd v C: SARS* the court held that for income to constitute ‘mining income’, its source must be minerals taken from the earth, and that ‘income derived from mining operations’ means income derived from the business of extracting minerals from the soil. An intermediate investment of such income, by putting it to work as capital, however, generally breaks the requisite direct connection. Thus, interest derived by a mining company from a cash management scheme involving moneys placed on overnight call is not mining income; nor is interest earned on foreign bank accounts. But interest on late payments by customers and so-called escrow bank accounts as well as interest on the payment of export incentives, intended to compensate exporters for deferred payment, constitutes mining income.

Therefore it is submitted that the interest received by rental and insurance companies, merely from depositing their receipts in a bank account, can be said to arise from the trading activity of insurance or rental. However, when the CFC undertakes activities to actively increase the interest by actively managing the deposits, the interest can no longer be said to arise from the rental or insurance activities.

The application of the diversionary rule applicable to passive income can be illustrated by way of the following comprehensive example:
For example:

Group Structure for Example

- SA Paper Co owns 100% of the share in Botswana Hold Co, which in turn owns 51% of the shares in Botswana Pulp Co, both companies having been incorporated and effectively managed in Botswana.
- The tax rate in Botswana is 25%. However, since Botswana Pulp Co is a manufacturing company, it only pays tax at a rate of 20%.
- Botswana Pulp Co distributes the paper into Botswana as well as into South Africa via SA Paper Co. Botswana Pulp Co employs 25 employees and owns premises in Gaborone.
Since it does not use all the office space, it lets office space to Botswana Transport a company in which it holds 60% interest in the participation rights of the company. It also lets a portion of the office space to CNA Botswana, which does not form part of the group.

Botswana Holdco does not have any employees or offices. It pays Botswana Pulp Co a fee of 2500 Pula per month for administration and finance work undertaken on its behalf. It receives dividends from Botswana Pulp Co and also receives interest income from informal loans it makes to Botswana Pulp Co and other independent businesses operating in Botswana.

**Summarised Income Statement of Botswana Holdco and Botswana Pulp Co:**

<table>
<thead>
<tr>
<th></th>
<th>31 Dec 2010</th>
<th>31 Dec 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Botswana Pulp Co</strong></td>
<td>Pula</td>
<td>Botswana Holdco</td>
</tr>
<tr>
<td>Sales</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Botswana customers</td>
<td>100 000</td>
<td>- Botswana Pulp Co</td>
</tr>
<tr>
<td>- SA Paper Co</td>
<td>30 000</td>
<td>- Other</td>
</tr>
<tr>
<td></td>
<td><strong>130 000</strong></td>
<td></td>
</tr>
<tr>
<td>COS</td>
<td>(45 000)</td>
<td>Dividend: Botswana Pulp Co</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>85 000</td>
<td>Admin fee</td>
</tr>
<tr>
<td>Operating and other expenses</td>
<td>(42 000)</td>
<td>Net income before tax</td>
</tr>
<tr>
<td>Rental income</td>
<td></td>
<td>Tax</td>
</tr>
<tr>
<td>- Botswana Transport</td>
<td>20 000</td>
<td>Net income after tax</td>
</tr>
<tr>
<td>- CNA Botswana</td>
<td>20 000</td>
<td>Effective tax rate</td>
</tr>
<tr>
<td>Fee from Botswana Holdco</td>
<td>30 000</td>
<td></td>
</tr>
<tr>
<td>Dividend: Botswana</td>
<td>15 000</td>
<td></td>
</tr>
</tbody>
</table>
Transport

<table>
<thead>
<tr>
<th>Net income before Tax</th>
<th>128 000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxation at 20%</td>
<td>22 600</td>
</tr>
<tr>
<td>Net income after tax</td>
<td>105 400</td>
</tr>
<tr>
<td>Effective tax rate</td>
<td>17.6%</td>
</tr>
</tbody>
</table>

The tax implications for Botswana Pulp Co are as follows:

**Botswana Pulp Co:**
- Botswana Pulp Co meets the definition of a foreign company as defined in section 9D(1).
- As SA Paper Co holds more than 50% (actually has 100%) of the participation rights in Botswana Pulp Co, it’s a CFC as defined.
- Botswana Pulp Co has a foreign business establishment as defined as it has an office situated in a foreign company and employs a number of employees.
- Botswana Pulp Co and SA Paper Co are connected persons and form part of a group of companies as defined as more than 70% of the shares in Botswana Pulp Co are held by SA Paper Co.
- Based on the information provided a company could rely on the high taxed exemption contained in section 9D(2A). In order to qualify for the high taxed exemption, one should compare the tax actually paid in Botswana to tax that would be paid in SA. If Botswana tax is at least 75% of tax that would be paid in SA – net income deemed to be R nil and no imputation.
- Even though Botswana Pulp Co meets the definition of a foreign business establishment as defined, Botswana Pulp Co sells paper to SA Paper Co a resident connected person. One therefore needs to consider the diversionary rules in order to determine whether the foreign business establishment - exemption will not apply.
  - Sales to SA Paper Co- due to the lack of information provided the following should be considered before one can rely on the section 9D(9)(b) exemption.
Where the sales between the two connected persons are not at arm’s length – the net income of Botswana Pulp Co will be imputed into the taxable income of SA Paper Co.

However, where the transactions are taking place at arm’s length and they are made mainly to customers in Botswana then the foreign business establishment exemption would apply.

Based on the above, 30 000 Pula of a total 130 000 Pula are made to SA Paper Co, this amounts to 23% of Botswana Pulp Co’s total sales. The remaining 77% of sales are made to customers situated in Botswana. Therefore the exemption will apply resulting in no imputation required.

- Botswana Pulp Co also earns rental income. Rental income is seen to be passive income earned by the company in terms of section 9D(9)(b)(iii).
  - The rental income earned from Botswana Transport Co does not require imputation due to the exemption contained in section 9D(9)(fA).
  - The rental income earned from CNA Botswana will not be exempt due to the principal trading activities of Botswana Pulp Co not being a rental business. This is confirmed by the amount of rental income earned versus sale of products made. 24% of total income relates to the rental business. This would indicate that this is not the principal activity of Botswana Pulp Co. However, the 10% exemption rule could apply where a company earns passive income.

- Below is an analysis of the income of Botswana Pulp Co into income that is active versus that which is passive in order to determine whether the passive income earned is in excess of the 10% threshold.
### Analysis of Passive versus Active income – Botswana Pulp Company

<table>
<thead>
<tr>
<th></th>
<th>31 Dec 2010</th>
<th>31 Dec 2010</th>
<th>31 Dec 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Pula</td>
<td>Pula</td>
<td>Pula</td>
</tr>
<tr>
<td><strong>Total Amount</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Passive income</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Active Income</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Sales</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Botswana Customers</td>
<td>100 000</td>
<td>100 000</td>
<td></td>
</tr>
<tr>
<td>- SA Paper Co</td>
<td>30 000</td>
<td>30 000</td>
<td></td>
</tr>
<tr>
<td><strong>Rental income</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Botswana Transport</td>
<td>20 000</td>
<td>S9D(9)(fA )</td>
<td>applies</td>
</tr>
<tr>
<td>- CNA Botswana</td>
<td>20 000</td>
<td>20 000</td>
<td></td>
</tr>
<tr>
<td><strong>Fee from Botswana Holdco</strong></td>
<td>30 000</td>
<td>30 000</td>
<td></td>
</tr>
<tr>
<td><strong>Total income</strong></td>
<td><strong>200 000</strong></td>
<td><strong>20 000</strong></td>
<td><strong>160 000</strong></td>
</tr>
<tr>
<td><strong>Passive income : Active income</strong></td>
<td>(20 000/160 000)</td>
<td></td>
<td>12.5%</td>
</tr>
</tbody>
</table>

This is in excess of the 10% rule, therefore imputation is required and is determined as follows:

|                                |             |             |             |
|                                | Total passive income | 20 000      |             |
|                                | Active income at 10% | 16 000      | (160 000x 10%) |
The fee earned from Botswana Hold Co does not constitute passive income and will form part of the income attributable to a foreign business establishment, this will be exempt and no imputation is required.

The dividend received will be exempt in terms of the participation exemption contained in section 10(1)(k)(ii)(dd).

**Botswana Holdco**

- Botswana Holdco meets the definition of a controlled foreign company as more than 50% of the participation rights are held by SA Paper Co a South African resident.
- The operations of Botswana Holdco does not meet the requirements of a foreign business establishment as it:
  - Does not employ any employees
  - Does not have a permanent or formal office or premises from which it operates
- Therefore the following income will be imputed into SA Paper Co from Botswana Hold Co (in pula)
  - Interest received 12 000
  - Other 40 000
  - Dividend (s10(1)(k)(ii)(dd) -
  - Admin fee expense (30 000)
  - **Net Income to be imputed** 22 000

- The net income is then translated into South African Rand (ZAR) at the average exchange rate for that year of assessment.
- However, as Botswana Holdco has paid tax in Botswana, therefore SA Paper Co should determine whether the 75% rule would not apply and no imputation necessary.
8.4.3.2 Sale of intangible assets

Where an amount is received or accrued by a CFC from the disposal or deemed disposal of any intangible asset as defined in paragraph 16(2) of the Eighth Schedule (other than an intangible asset created, devised or developed in the Republic), if that intangible asset:

1. Forms an integral part of any business conducted by that CFC; and
2. Was so disposed of as part of the disposal of that business and where all the assets which are necessary for carrying on that business are disposed of as a going concern (58/1962).

The reason for the exclusion of intangible assets ‘created, devised or developed in the Republic’ is due to the deemed source rules. The source of income is based on its ‘originating cause’, there are two questions that need to be asked:

1. What is the originating cause of the income?
2. Where is the originating cause located? (CIR v Lever Brothers & Unilever Ltd (1946))

In Millin v CIR (1928 AD) it was held that the originating cause of royalties accruing to a novelist was her wits, labour and intellect. Therefore if these faculties are utilised in South Africa, the source of the income is South Africa. Further, where an intangible asset is created, devised or developed in South Africa, the deemed source of the income accruing on this intangible asset will be South Africa and it will be taxed in the South African tax net (Stiglingh et al, 2010:58)

Where these requirements have been met, the foreign business establishment exemption will apply.

Example SA Paper Co owns 35% of the shares in Dubai Co 1 and 100% of the Shares in Pulp Co. SA Pulp Co in turn owns 35% of the shares in Dubai Co 1. Dubai Co 1 owns 51% of the shares in Dubai Co 2. The rest of the shares in Dubai Co 2 are held by a natural person who is a resident of Dubai. None of the companies are listed companies.
Dubai Co 1 is a holding company incorporated in Dubai. Dubai Co 2 is a company that owns 5 car dealerships in Dubai. The assets of the company consist of trading stock, debtors, fixed assets and goodwill.

What would the tax implications in terms of section 9D only be if the group decides to sell the business of Dubai 2 Co to Dubai 1 Co and then liquidates Dubai 2 Co?

- SA Paper Co and SA Pulp Co are both residents as they are incorporated in South Africa
- Assume Dubai Co 1 and Dubai Co 2 are all effectively managed in their country of incorporation, therefore none of these companies are residents of South Africa and they are therefore foreign companies (i.e. meet the definition of foreign company as contained in section 9D(1)).
- Together SA Paper Co and SA Pulp Co hold more than 50% of the participation rights in Dubai Co 1, therefore they are deemed to exercise 51% of the voting rights directly in Dubai Co 2, therefore:
  - Dubai Co 1 meets the definition of a CFC as more than 50% of the participation rights are held by a South African resident that are connected persons.
  - Dubai Co 2 meets the definition of a CFC as more than 50% of the voting rights are held indirectly by South African residents.
- Sale of business:
  - Dubai 2 Co is an operating company which owns a number of car dealerships situated in Dubai (its country of residence). Based on the above no mention is made that Dubai 2 Co makes any sales to connected persons. Operating and management decisions are made in Dubai and therefore the requirements of the foreign business establishment as defined are met.
  - The sale of the business will also be exempt in terms of section 9D(9)(b) which excludes from imputation in SA any amount attributable to any foreign business establishment, including the disposal or deemed disposal of any assets forming part of that foreign business establishment.
  - The exemption does not apply to amounts which arise from the disposal or deemed disposal of any intangible assets (as defined in paragraph 16(2) of the Eighth Schedule) such as goodwill unless:
- The intangible asset formed an integral part of any business conducted by the CFC, which is the case; and

the assets was so disposed of as part of the disposal of that business and where all the assets which are necessary for carrying on that business is disposed of as a going concern, which again, is the case

8.4.3.3 Royalties received or accrued

Where a CFC receives or accrues an amount relating to royalties, if that company directly and regularly creates, develops or substantially upgrades any intellectual property as defined in section 23I which gives rise to those royalties, then the foreign business establishment exemption will still apply (58/1962).

In terms of the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2008, issued by National Treasury (2008:55), it is said that royalty income that is earned by a CFC is seen to be tainted (per section 23I). However, there are two exceptions to this general view:

1 Intra-group royalty receipts or accruals are exempt with a matching denial of any deduction for intra-group royalties incurred (s9D(2A)(c) and s9D(9)(fA))

2 CFC royalty income may receive relief from section 9D inclusion via SARS’ ruling request under section 9D(10)(a)(iii).

Although one relief exists if SARS is convinced that the royalties earned are associated with intellectual property that is regularly created, developed or upgraded. The term ‘regularly’ from the Little Oxford English Dictionary, is said to mean ‘done or happening frequently, doing the same thing often, usual’ (LOED, 2006:581).

Passive royalties will however, still be seen to be tainted and fall outside the section 9D(9) exemptions, but where the royalty is said to be ‘directly and regularly create, develops and substantially upgrades the intellectual property’ the foreign business establishment exemption will still apply.

The term ‘substantially’ according to the Little Oxford English Dictionary is said to mean ‘to a great extent, for the most part, mainly’ (LOED, 2006:698). Further to the above, it should be noted that royalties will still be seen to be tainted under the
diversionary rules if the CFC generates royalty income from a connected person who is a South African resident. However, this rule too can be overcome with a ruling from SARS in terms of section 9D(10).

8.4.4 Long term insurers (s9D(9)(e))

The net income of a CFC will be exempt when it is attributable to any non-resident policyholder or a CFC in relation to a resident of any policy issued by a company licensed to issue any long term policy in its country of residence (58/1962).

In terms of the Explanatory Memorandum on the Revenue Laws Amendment Bill 2005, issued by National Treasury (2005:13) it says that certain CFCs of South African insurance companies earn profits which will eventually be paid to policyholders who do not fall within the South African tax net at all. In order not to tax these profits under the CFC regime, an exemption is introduced for the net income of the CFC which is attributed to non-resident policyholders who are not CFCs. An additional requirement for the exemption to apply is that the policy should have been issued by a company which is licensed to issue any long-term policy as defined in the Long-term Insurance Act in its country of residence.

The issue here is that an insurance company is viewed as the owner of all policyholder funds. The insurer is taxed on these policyholder funds under the trustee principle as a proxy for the policyholders. The tax on the insurer is designed to approximate in full the tax that would have fallen on the policy holders as a collective. All policy holders’ assets are held in the name of a long-term insurer and are accordingly regarded as the long-term insurer’s participation rights in the foreign company for section 9D purposes. The net result is that foreign entities held in the name of local long term insurer are often classified as a CFC subject to the various section 9D inclusions, even though the bulk of the underlying interests are held in the name of policyholders (none of whom would have triggered any section 9D inclusions had they invested in the CFC directly) (National Treasury, 2007:35-36).

Based on the above it is clear that long term insurers that would be classified as CFCs will be exempt from imputation.
8.4.5 South African taxable income (s9D(9)(e))

In terms of section 9D(9)(e) which states that where net income of a CFC is included in the taxable income of the company and has not been or will not be exempt or taxed at a reduced rate in the Republic, as a result of the application of any agreement for the avoidance of double taxation (58/1962).

In simple terms, this means that where the CFC has already been taxed in terms of any of the source rules contained in section 9 (actual) to the Act or deemed sources, this income cannot be taxed again in determining the net income to be included in the resident shareholders taxable income (De Koker, 2010).

**Example:** A CFC has rent producing property situated in South Africa. In terms of the true source rules, the rental income earned is from a South African source. This income earned by the CFC will be taxed in South Africa. Therefore this rental income will be excluded from the net income of the CFC to be imputed into the resident shareholder’s taxable income as it has already been taxed in South Africa. This ensures that the same income is not taxed twice.

Example: SA Paper Co acquired 70% of the shares in Irish Plc on 1 April 2009. SA Paper Co decided to invest in Irish Plc because they use both the patents owned by Irish Plc, a company incorporated in Ireland (see below). The balance of the shares is held by an unconnected company situated in the Isle of Man. Irish Plc is not listed.

The financial year end of SA Paper Co is 30 June. The financial year of Irish Plc is 1 January to 31 December. Irish Plc has an office and fully equipped laboratory in Wimbledon and employs a general manager, development manager, financial manager, three researchers and two sales representatives as well as three administrative staff.

Irish Plc is the owner and sometimes developer of patents used in the manufacturing of paper related products (nappies, toilet paper, kitchen towels etc). Currently, only two patents are active, i.e.: 

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---
• Patent A: Irish Plc acquired patent A five years ago from an ex employee. There is no competitive patent available and therefore Irish Plc does not do any research or further development in relation to Patent A.

• Patent B: Irish Plc developed patent B during 2003 and 2004. The patent relates to the manufacture of super absorbent baby nappies. Due to the competition in the market, Irish Plc constantly works on the improvement of this patent.

Irish Plc’s income statement for the 2009 and 2010 financial years can be summarised as follows:

**Financial results in Irish Plc**

<table>
<thead>
<tr>
<th></th>
<th>31 Dec 2009</th>
<th>31 Dec 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Rands</td>
<td>Rands</td>
</tr>
<tr>
<td>Patent A</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Customers in the UK market</td>
<td>100000</td>
<td>105000</td>
</tr>
<tr>
<td>- SA Paper Co</td>
<td>95000</td>
<td>97000</td>
</tr>
<tr>
<td>Patent B</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Customers in the UK market</td>
<td>69000</td>
<td>72000</td>
</tr>
<tr>
<td>- SA Paper Co</td>
<td>21000</td>
<td>27800</td>
</tr>
<tr>
<td><strong>Total Income</strong></td>
<td><strong>285000</strong></td>
<td><strong>301000</strong></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Admin expenses</td>
<td>15000</td>
<td>17000</td>
</tr>
<tr>
<td>- Research expenses</td>
<td>45000</td>
<td>54000</td>
</tr>
<tr>
<td><strong>Income before tax</strong></td>
<td><strong>225000</strong></td>
<td><strong>230000</strong></td>
</tr>
<tr>
<td>- Ireland Tax</td>
<td>22500</td>
<td>23000</td>
</tr>
<tr>
<td><strong>Income after tax</strong></td>
<td><strong>202500</strong></td>
<td><strong>207000</strong></td>
</tr>
</tbody>
</table>

• What are the tax implications in terms of section 9D relating to the above transaction in both the 2009 and 2010 years of assessment?
Irish Plc is a foreign business establishment as it has a fixed place of business located outside of South Africa (regardless of the fact that the operations are conducted in Wimbledon England and not in Ireland). Irish Plc’s business is suitably staffed with facilities located at a fixed place. Therefore Irish Plc is a foreign business establishment as defined.

Royalties from patent A:

- Despite the fact that the foreign business establishment definition has been met, the royalties income is not exempt in terms of S9D(9)(b) as diversionary rule applies to passive income and no development takes place in respect of patent A (even if the royalty charge is at arm’s length).
- Royalties from Patent A used by SA Paper Co however, is deemed to be from a SA source in terms of section 9(1)(b) of the Act. The right of use of the patent is in South Africa and therefore the source is South African. Even if they are at arm’s length, the foreign business establishment exemption will not apply to the royalties received from SA Paper Co due to the provisions contained in section 9D(9)(b)(ii)(dd).
- But section 9D(9)(e) will exempt the royalties from SA Paper Co from imputation as the royalties are subject to tax at the full rate in SA:
- Irish Plc a non-resident will be subject to tax on income from a SA source.
- S35 does not apply to CFC’s and as a result the exemption provided for in s10(1)(l) will not apply.
- The royalties will therefore be taxed in full in SA (however one should refer to the Ireland/ South Africa DTA).
- Irish Plc will have to register for tax and complete a tax return.
- Royalties that are received from the UK customer, the 10% rule may apply, but Irish Plc does not receive active trading income but receives mainly passive income.
- Therefore income in relation to Patent A from customers in the UK market may be subject to imputation (reduced by the income per the 10% rule as contained in section 9D(9)(b)(dd)(iii)(aa)) after claiming
allowable deductions unless the proviso to section 9D(2A) applies, i.e. tax paid by Irish Plc to all spheres if government other than SA is at least 75% of the tax that would have been paid in SA. The tax in Ireland is 10%, therefore this does not appear to be the case.

- However, Irish Plc seem to have a permanent establishment in the UK (Wimbledon), the profits of which would be subject to tax in the UK, which has a comparable rate to the 28% charged in SA.

- Patent B: provided the royalty is an arm’s length royalty, since Irish Plc directly and regularly creates, develops or substantially upgrades patent B, the royalties received from third party customers in relation to patent B will be exempt in terms of section 9D(9)(iii)(dd). In relation to royalties received from SA Paper Co, refer discussion above as the same principles will apply.

- Irish Plc’s foreign tax year is 1 January to 31 December. Shares bought on 1 April 2009. First imputation in SA Paper Co’s hands: Income actually earned/apportioned from 1 April 2009 to 31 December 2009 during SA Paper Co’s year of assessment ending 30 June 2010. No imputation in relation to SA Paper Co’s 2009 year of assessment as foreign tax year of Irish Plc ends after 30 June 2009.

### 8.4.6 Foreign dividends received (s9D(9)(f))

Section 9D(9)(f) relates to net income earned by a CFC that is attributable to any foreign dividend declared to a CFC by another CFC in relation to the same resident. However the foreign dividend should not exceed the amounts which have been or will be included in the income of the resident in any year of assessment which relates to:

| The net income of the company declaring the dividend or |
| Any other company which has been included in the income of that resident by virtue of that resident’s participation rights in that other company held indirectly through the company declaring the dividend: |
| LESS: the amount of any foreign tax payable in respect of the amount included in that resident’s income |
LESS: so much of all foreign dividends received by or accrued to that controlled foreign company as was – 

(iii) excluded from the application of this section in terms of this paragraph or section 10(1)(k)(ii)(dd)
(iv) previously not included in the income of that resident by virtue of any prior inclusion in terms of section 9D (58/1962).

This means that where a resident holding participation rights in a CFC who in turn derives a foreign dividend from another CFC, this foreign dividend will not be taxed on the proportional amount of that foreign dividend.

Example: H Ltd owns 100% of the share capital of CFC 1 and 60% of CFC 2. The following is the income earned and distributed of the various CFCs.

CFC 1
Dividend income R600
Other income R300
Total income R900
Dividend distributed to H Ltd (R900)
Profit retained R0

CFC 2
Income R1000
Dividend Distributed (R1000)
Profit retained R0

Therefore the following:
Net income of CFC 2 to be included in H Ltd’s taxable income in terms of section 9D:
Total income R1000
H Ltd’s share in CFC 2 x 60%
Net income to be imputed R600
Net income of CFC 1 to be included in H Ltd’s taxable income in terms of section 9D:

<table>
<thead>
<tr>
<th>Income</th>
<th>R900</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less:</td>
<td></td>
</tr>
<tr>
<td>Section 10(1)(k)(ii)(dd)</td>
<td>(R600)</td>
</tr>
<tr>
<td>Section 9D(9)(f) foreign dividend</td>
<td>R600</td>
</tr>
<tr>
<td>Reduced by section 9D(9)(f)(ii)</td>
<td>(R600)</td>
</tr>
<tr>
<td>Net income of CFC 2 to be imputed</td>
<td>R300</td>
</tr>
</tbody>
</table>

Total net income of CFC 1 and CFC 2 to be imputed into the taxable income of H Ltd is R600 + R300 = R900.

8.4.7 Interest, royalties, rental, annuities and insurance premiums (s9D(9)(fA))

Where net income earned by a CFC is attributable to the following types of income:

- Any interest, royalties, rental or income of a similar nature including any amount adjusted in terms of section 31;
- Any exchange differences determined in terms of section 24I;
- Any exchange differences in respect of any forward exchange contract entered into to hedge an exchange item;
- The reduction or discharge by any other CFC of a debt owed by the company to that other CFC for no consideration or for consideration less than the amount by which the face value of the debt has been so reduced or discharged where that CFC and that other CFC form part of the same group of companies. Provided that any such amount may at the election of any resident be so taken into account as contemplated in subsection 2 (58/1962).

From the above it is submitted that the exemption in terms of section 9D(9)(fA) should be read together with the proviso (c) to section 9D(2A) which expressly prohibits the deduction of interest, royalties, rental or amounts of a similar nature paid or payable or deemed to be paid or payable by one CFC to another in determining its ‘net income’.
Example: A, a resident company owns 100% in two wholly owned subsidiaries, E and F. The income and expenses of E and F, converted to Rands, is as follows:

<table>
<thead>
<tr>
<th></th>
<th>Company E</th>
<th>Company F</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rent from E</td>
<td>R200 000</td>
<td>R150 000</td>
</tr>
<tr>
<td><strong>Expenses</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rent paid to F</td>
<td>R60 000</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>R140 000</td>
<td>R210 000</td>
</tr>
</tbody>
</table>

Therefore included in the taxable income of Company A the resident shareholder of E and F:

Company E – The full revenue of R200 000 is included as the expense relating to rent paid to fellow subsidiary amounting to R60 000 will not be deducted in terms of section 9D(2A).

Company F – the revenue of R150 000 is included in the taxable income of Company A as the rental received by E is excluded due to the exemption contained in section 9D(9)(fA).

Therefore Company A will include in its taxable income a total of R350 000 (R200 000 plus R150 000).

However, the above exemption may not be applicable where a taxpayer has elected the provisions contained in section 9D(12) (Refer point 11.5) and it will not apply to a resident who fails to comply with the disclosure requirements of section 72A (Refer point 12).
8.4.8 Disposal of assets (s9D(9)(fB))

Net income received by a CFC which is attributable to a disposal of an asset in terms of the Eighth Schedule to the Act, provided that the asset that was disposed of formed part of the assets of a foreign business establishment as defined in section 9D(1) to the Act of any other CFC where that company and that other CFC form part of the same group of companies (58/1962).

The reason for this exclusion is that it ensures that the qualifying exclusion remains available when foreign business assets are disposed of by companies within the same group (Stiglingh et al, 2010:577).

An asset in this part of the Act excludes a ‘financial instrument’ as defined in section 1 of the Act or ‘intangible asset’ as defined in paragraph 16 to the Eighth Schedule to the Act (De Koker, 2010).

As the above exemption is only available to capital assets on which a capital gain has arisen on its disposal and that it is attributed to a foreign business establishment, it by implication requires that at least of one of the CFCs in the group of companies qualifies as a foreign business establishment as defined in section 9D(1). It is not required that the CFC disposing of the capital asset meets the foreign business establishment test (Olivier & Honiball, 2008:463).

Example: Company A holds 100% of the shares in Company B and both companies are incorporated in the Isle of Man. Company A is held 100% by SA residents. Company A is a property company but does not have any employees. Company B is a bona fide insurance company with several employees and rents a fully equipped building from Company A. Neither Company A nor Company B pay tax in the Isle of Man.
It is clear that Company B has a foreign business establishment as defined. Company A in turn does not. Should Company A dispose of fixed property, the capital gain will be subject to imputation in the hands of Company A unless it is the building occupied by Company B as the building is attributable to the foreign business establishment of Company B, which are part of the same group of companies as Company A.

8.4.9 High-taxed CFC net income exemption (s9D(2A))

Included in the proviso to section 9D(2A) is a type of exemption available to taxpayers however, this is not included in the other exemptions included in section 9D(9). The proviso states that the net income of a CFC shall be nil where the aggregate amount of tax payable to all spheres of government of any country other than the Republic is at least 75% of the amount of normal tax that would have been payable had the CFC been a resident for that foreign tax year (58/1962).

This means that in order to comply with this proviso to the Act, one would need to perform a taxable income calculation for the CFC in terms of the requirements of the South African Income Tax Act (Stiglingh et al, 2010:568). In terms of the proviso to section 9D(2A) the following should be taken into account in determining the taxable income of the CFC:

- After taking into account any double taxation agreements and any credit, rebate or other right of recovery of tax from these foreign governments; and
- Disregarding any loss in respect of a year other than the current foreign tax year or any loss from a company other than the CFC (Stiglingh et al. 2010:568).

In order to determine the taxable income calculation the CFC is required to maintain two sets of accounting records, one to adhere to its country of residence’s tax legislation and the other to adhere to South African tax legislation (Olivier & Honiball, 2008:444).
The following examples have been taken from the Explanatory Memorandum to the Taxation Laws Amendment Bill of 2009:

**Example 1**

**Facts:** South African Company owns all the shares of CFC. CFC is a tax resident of Country X. CFC generates income of R800 000 as determined under Country X tax law. The actual foreign tax imposed is at a rate of 25 per cent. In terms of South African tax law, the CFC income (both tainted and untainted) would be translated into R600 000.

The comparison is made as follows:

- R800 000 at 25% in CFC country: R200 000 foreign tax
- R600 000 at 28%: R168 000 Hypothetical South African tax

**Result:** Because the foreign tax paid in country of the CFC is more than 75% of the tax paid in South Africa. CFC will be deemed to have a net income of zero by virtue of the high-tax exemption.

**Example 2**

**Facts:** South African Company owns all the shares of CFC. CFC is a tax resident in Country X and has most of its operations located in the same country. CFC also operates a branch located in Country Y. CFC generates income of R900 000 as defined under Country X and Y tax law (R600 000 is sourced in Country X and R300 000 is sourced in Country Y). In terms of South African tax law, and the amount of income (both tainted and untainted) of CFC would be translated into R1 million. CFC pays Country X tax at a rate of 25% and Country Y tax at a rate of 30%. All Country X credits for Country Y taxes are limited to 25%.

The comparison is made as follows:

- R900 000 at 25% Country X initial tax: R225 000
- R200 000 at 30% in Country Y: R60 000
- Less: Country X credits for Country Y taxes: R50 000

**R235 000**
**Result:** The hypothetical South African tax is R280 000 (28% of R1million) because the R235 000 amount exceeds 75% of the R280 000 hypothetical South African tax, CFC will be deemed to have a net income of zero by virtue of the high-tax exemption.

**Example 3**

**Facts:** South African company owns all the shares of CFC 1 and CFC 1 owns all the shares of CFC 2. Both CFCs are located in Country X. CFC 1 generates income of R800 000 as defined under Country X tax law, and CFC 2 generates a net loss of R300 000. By virtue of the system of group taxation in Country X, the losses of CFC 2 can be offset against the CFC 1 income. In terms of South African tax law, the income amount for CFC 1 (both tainted and untainted) would be translated into an amount of R700 000 with CFC 2 generating a net loss. The actual foreign tax imposed on CFC 1 is at a rate of 25%.

The comparison is made as follows:

\[
\begin{align*}
R800 \ 000 \quad (\text{ignoring the R300 000 loss}^{14}) & \quad \times \quad 25\% \\
R700 \ 000 \quad (\text{at 28% in South Africa}) & \quad \times \quad 28\% \quad \text{in South Africa}
\end{align*}
\]

Because the R200 000 hypothetical foreign tax amount exceeds 75% of the R196 000 hypothetical South African tax, CFC will be deemed to have a net income of zero by virtue of the high-tax exemption.

**Rulings**

In terms of the Act, subsection (10) states that the Commissioner may issue a ruling that disregards the application of paragraph (i) of the proviso to subsection 9(b) in respect of the sale of goods or performance of services by a CFC where the foreign business establishment of that CFC situated in that company’s country of residence mainly serves in at least two countries that are contiguous to the country of residence of that company (58/1962).

The section goes further to provide that the Commissioner must take into account that the activities and transactions carried out or to be carried out by the persons involved and must not issue any ruling in terms of this section if the application for the ruling relates to the determination of the net income of a CFC in respect of a foreign tax year.

---

14 The R300 000 is not taken into account in terms of section 9D(2A)(a) as the losses incurred by a CFC are ring fenced in terms of the Act.
and that application is submitted after the end of the year of assessment in which that foreign tax year ends (58/1962).

Where any ruling is issued in terms of paragraph (a) will be subject to the same procedures, terms and conditions as a ‘binding private ruling’ as contemplated in Part IA of Chapter III but disregarding section 76G(1)(a)(ii) and the requirements that the transaction must be a proposed transaction (58/1962). Therefore, section 9D(10) empowers the Commissioner to issue binding private rulings granting an exemption from the normal CFC rules. However, this is only in certain circumstances and the ruling issued is subject to the same procedures as those documented in section 76G to the Act and the transaction must be proposed (De Koker, 2010).

The section enables the Commissioner to waive the rules contained in section 9D(9)(b)(ii) relating to the diversionary rules for the sale of goods and the performance of services by a CFC where it’s a foreign business establishment and where it serves as a central location for the sale or performance of services that are similar or identical and it takes place within two countries that are contiguous (De Koker, 2010).

If this waiver was not available it would result in the CFC being taxed unless the services or goods were being supplied to end users within the same country of residence. In order for the waiver to apply, the CFCs foreign business establishment serves as a central location for end-users in at least two neighbouring contiguous countries. Contiguous is said to mean by land, but not by sea (De Koker, 2010).

8.5 Inclusion of net income (s9D(2))

8.5.1 Controlled foreign company – for entire foreign tax year

In terms of section 9D(2) of the Act, where a resident shareholder has an interest in the participation rights of a CFC on the last day of that CFC’s foreign tax year and that foreign tax year ends during that resident shareholder’s year of assessment, then the net income of the CFC will be imputed into the resident shareholder’s taxable income. However, the inclusion of the net income and method to determine the amount of net income depends on whether the CFC was one for an entire year of
assessment or only commenced to be a CFC during the year. The determination is governed by section 9D(2)(a) either in terms of subsection (i) or (ii).

8.5.1.1 Entire foreign tax year

Where for the entire foreign tax year a foreign company is a CFC then the net income is determined based on the total net income of that CFC by the percentage of the participation rights that the resident shareholder has in that CFC (Section 9D(2)(a)(i)) (58/1962).

*Example:* Company A (a South African resident) owns 80% of Company B (a company incorporated and effectively managed in Dubai). Company A has held the participation rights in Company B for the entire foreign tax year. Company B has a net income as determined in terms of section 9D(2A) for the 2010 foreign tax year amounting to R500 000.

In terms of section 9D(2)(a)(i) the determination of the amount of net income is determined as follows due to the foreign company being a CFC for the entire year:

\[
\text{Net income of CFC } \times \text{ratio of participation rights}
\]
\[
\text{Total participation rights}
\]

R500 000 x 80/100 = R400 000 is the net income to be included in the taxable income of Company A in terms of section 9D(2)(a)(i).

8.5.1.2 Commences to be a CFC during the foreign tax year

In terms of the Act, where a foreign company becomes a CFC during the foreign tax year there are two elective options available to the resident shareholder in determining the net income, i.e.:

- The proportional approach (s9D(2)(b)(i)), or
- Determining the actual amount (s9D(2)(b)(ii)) of net income that relates to the part of the foreign tax year (from the date that the foreign company commences to be a CFC to the end of that CFC’s foreign tax year) (58/1962).
8.5.1.2.1 Proportional approach (s9D(2)(a)(ii)(aa))

The proportional amount of net income multiplied by the number of days during which the company was a CFC divided by the total number of days in the tax year (Stiglingh et al, 2010:571).

\[ Y = \frac{A \times B}{C} \]

\( Y \) = the proportional amount of the net income to be included in the resident shareholder’s taxable income
\( A \) = the total net income of the CFC as determined under section 9D(2A)
\( B \) = the number of days from the date on which the CFC became one to the end of the foreign tax year
\( C \) = total number of days in the foreign tax year.

8.5.1.2.2 Actual Amount (s9D(2)(a)(ii)(bb))

The actual amount approach is determined by taking the proportional amount of the net income of the foreign company from the day on which it becomes a CFC until the end of the foreign tax year (Stiglingh et al, 2010:571).

**Example:** Company A (a South African resident) owns 80% of Company B (a company incorporated and effectively managed in Dubai). Company A has held the participation rights in Company B since 1 May 2010. Company A has a 31 December year end whereas Company B has a 31 July year end. Company B has a net income for the 2010 foreign tax year amounting to R500 000. Neither the proviso to subsection 2A nor the exemptions provided for in subsection 9 apply to the net income. From the date on which Company B became a CFC the following net income was earned in each month to the end of the foreign tax year:

<table>
<thead>
<tr>
<th>Month</th>
<th>Net Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>August 2009</td>
<td>R20 000</td>
</tr>
<tr>
<td>September 2009</td>
<td>R15 000</td>
</tr>
<tr>
<td>October 2009</td>
<td>(R40 000)</td>
</tr>
<tr>
<td>November 2009</td>
<td>(R35 000)</td>
</tr>
<tr>
<td>February 2010</td>
<td>R 30 000</td>
</tr>
<tr>
<td>March 2010</td>
<td>R40 000</td>
</tr>
<tr>
<td>April 2010</td>
<td>R90 000</td>
</tr>
<tr>
<td>May 2010</td>
<td>R100 000</td>
</tr>
</tbody>
</table>
December 2009 – R10 000
January 2010 – (R20 000)
June 2010 – R150 000
July 2010 – R140 000
Total Income – R500 000

Solution based on the Proportional approach:

<table>
<thead>
<tr>
<th>January 2010</th>
<th>July 2010 (YE of CFC)</th>
<th>December 2010 (YE of Co A)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1 May 2010 (Acq of Co B) by Co A</td>
<td></td>
</tr>
</tbody>
</table>

The foreign tax year of Company B that ends during the year of assessment of Company A is the year from 1 August 2009 to 31 July 2010. However, company B was not a CFC in relation to company during this entire period and company A can therefore elect to apportion the net income of R 500,000 based on the period that company was in fact a CFC in relation to Company A.

Net income of CFC x Participation % x Days Foreign Company is a CFC / Total number of days in a Foreign Tax year

\[
\text{Therefore} \quad \frac{500 000 \times 80\% \times 92}{365} = \text{R 100 821.92}
\]

Amount to be included in the taxable income of Company A
**Solution based on the Actual approach**

<table>
<thead>
<tr>
<th>January 2010</th>
<th>July 2010 (YE of CFC)</th>
<th>December 2010 (YE of Co A)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1 May 2010 (Acq of Co B) by Co A</td>
<td></td>
</tr>
<tr>
<td>Net income of the CFC from the 1\textsuperscript{st} day that it commences to be a CFC to the last day of the foreign tax year</td>
<td>X</td>
<td>Percentage of participation rights</td>
</tr>
<tr>
<td>Net income of CFC</td>
<td>X</td>
<td>Percentage of participation rights</td>
</tr>
<tr>
<td>May 2010</td>
<td>R100 000.00</td>
<td>R140 000.00</td>
</tr>
<tr>
<td>June 2010</td>
<td>R150 000.00</td>
<td>R140 000.00</td>
</tr>
<tr>
<td>July 2010</td>
<td>= R390 000.00 = Net income to be included in the taxable income of Co A.</td>
<td></td>
</tr>
</tbody>
</table>

From the above it is clear that the proportional approach results in a lower net income that needs to be included in the taxable income of the resident shareholder. The Act is silent on which approach needs to be followed and therefore, the taxpayer has the option to elect either approach. The Act does not insist that the approach followed for one foreign company be the same each time a foreign company becomes a CFC.
8.5.2 A foreign company ceases to be a controlled foreign company during a foreign tax year (s9D(2)(b))

In terms of the Act, where a foreign company ceases to be a CFC the net income is determined on the day immediately before the foreign company ceases to be a CFC. The net income to be included in the taxable income of the resident shareholder shall be equal to either of the following; again this is at the option of the resident shareholder:

- An amount determined in accordance with paragraph (a)(ii)(aa) – the proportional approach as determined in section 9D(2)(b)(i)
- The proportional amount as determined in paragraph (a)(i) – as if the day that the foreign company ceased to be a controlled foreign company was the last day of its foreign tax year. – actual approach (s9D(2)(b)(ii)) (58/1962).

Example: Company A (resident) holds 60% in Company B (non resident). Company B ceases to be a controlled foreign company in May 2010. The total net income of Company B for the year August 2009 to July 2010 amounts to R880 000. For the period June 2009 to May 2010 the net income amounts to R600 000. To determine the net income to be included in Company A’s taxable income in terms of:

3 Proportional approach (s9D(2)(b)(i))
4 Actual approach (s9D(2)(b)(ii))

Solution based on the Proportional approach

<table>
<thead>
<tr>
<th>Net income</th>
<th>X</th>
<th>% Participation rights</th>
<th>X</th>
<th># of days foreign company is a CFC</th>
<th>Divided by</th>
<th>Total number of days in foreign tax year</th>
</tr>
</thead>
<tbody>
<tr>
<td>R880000</td>
<td></td>
<td>60%</td>
<td>X</td>
<td>304</td>
<td>Divided by</td>
<td>365</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>=</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>R439 759</td>
</tr>
</tbody>
</table>
Solution based on Actual approach

<table>
<thead>
<tr>
<th>Net income</th>
<th>X</th>
<th>% of participation rights</th>
</tr>
</thead>
</table>

Net income is determined based on the actual amounts for each months from the beginning of the tax year to the day before which the foreign company ceases to be a CFC.

Net income therefore amounts to

- \[600\,000 \times 60\% = 360\,000\]

8.6 Provisos

There are three provisos to section 9D(2) which result in no imputation in the hands of the resident shareholder owning the participation rights in a CFC.

There are two aspects to proviso (A) to section 9D(2), namely:

1. If the resident and any of its connected persons in aggregate hold less than 10% of the participation rights of the CFC at the end of the CFC’s tax year and are not allowed to exercise more than 10% of the voting rights of the CFC, the resident will not have to account for their portion of the net income of the CFC. (Proviso (A)(i)) or

2. If the resident and any of its connected persons hold in aggregate less than 10% of the participation rights in the CFC immediately before it ceases to be a CFC during its tax year and are not allowed to exercise more than 10% of the voting
rights, the resident will not have to account for their portion of the net income of the CFC (Proviso (A)(ii)) (58/1962).

**Example:** The following South African residents hold participation and voting rights in Company D, a company incorporated and effectively managed in the UK.

- **Company A has participation rights and voting rights amounting to 5%**
- **Company B has participation rights and voting rights amounting to 9%**
- **Company C has participation rights and voting rights amounting to 6%**
- **Company A and C are connected persons**
- **Company B is not connected to any other company**

Company A – Company A has participation rights and voting rights less than 10% however, Company C is a connected person in relation to Company A and therefore the participation rights and voting rights need to be taken into account. Therefore
based on the participation rights and voting rights of Company A and Company C in aggregate a total of 11% is held, which is more than 10%. Therefore there will be imputation into the taxable income of Company A and Company C as together they hold more than 10% of the participation and voting rights in Company D.

Company B – has participation rights and voting rights amounting to 9%, there is no other company that is connected to it and therefore Proviso A to section 9D(2) will apply, i.e. there will be no imputation into the taxable income of Company B as it holds less than 10% of the participation and voting rights in Company D.

Proviso (B) of section 9D(2) states that a resident will not have to account for its portion of the net income where the participation rights are held by the resident indirectly through another resident company. The resident company will most probably be subject to the provisions of section 9D (Stiglingh et al, 2010:571). This is to ensure that there is no double imputation where a resident holds shares in a resident company who in turn directly holds participation rights in a CFC. In the absence of this proviso, both residents would have had an obligation to include the net income of the CFC as the definition of participation rights refer to the right to directly or indirectly share in the share capital, share premium or profits and reserves of a company.

**Example:** Company A (SA resident) owns 100% in Company B (SA Resident) who then owns 100% in Company C (Dubai resident).
Therefore the net income of Company C will be included in Company B’s taxable income in terms of section 9D and in terms of the proviso to section 9D(2), no net income of Company C will be included in the taxable income of Company A.

In proviso (C), a resident will not have to account for his portion of the net income of a CFC if the participation rights are held by an insurer as defined in section 29A in any policy holder fund as defined in that section and
- The participation rights can be directly attributable to a linked policy as defined in section 1 of the Long–term Insurance Act, 1998
- Or the participation rights are directly attributed to a policy as defined in section 29A, other than a linked policy, of which the amount of the policy benefits is not guaranteed by the insurer and is to be determined solely by reference to the value of the particular assets or categories of assets.

The participation rights in this case may only be excluded if it does not form part of a transaction, operation or scheme which was entered into solely for the purposes of avoiding the inclusion of the amount in the income of a resident in terms of section 9D(2). If the insurer holds other participation rights of at least 10% in the CFC, the net income will still be deemed to be income of the insurer in terms of section 9D (Stiglingh et al, 2010:571).

### 8.7 CFC income and double taxation

There is an international debate on the issue of whether a country can tax income under CFC legislation despite that under a treaty provision, the other contracting state is granted the sole right to tax the income derived by the CFC (Olivier & Honiball, 2008:471).

One of the international cases dealing with the issue (Bricom Holdings Ltd v IRC (1997) STC 1179 CA) was discussed in chapter 1. It is submitted that the outcome would probably have been the same had the case been heard in South Africa as the CFC legislation in South Africa is similar to that in the UK and therefore reliance would be placed on conclusions reached in the UK on CFC issues raised there.
The provisions of the tax treaty are incorporated into and enjoy the binding force of law in South Africa in terms of section 108(2) of the Income Tax Act read with section 23I(4) of the South African Constitution. The result is that the treaty provisions and section 9D will have equal status in South African law.

8.8 Net income determination s9D(2A)

Section 9D(2A) contains a set of specific rules to assist in the determination of the net income of CFC. The most important rule contained in this section is that the net income of the CFC must be calculated as if the CFC is a taxpayer for South African tax purposes and as if the CFC is a resident in terms of the ‘gross income’ definition, sections 7(8), 10(1)(h), 25B and paragraphs 2(1)(a), 24, 70, 71, 72 and 80 of the Eighth Schedule (Olivier & Honiball, 2008:443).

The concept of ‘resident’ for South African tax purposes is fundamental to the world-wide or residence-based system of taxation (De Koker, 2010). A person who qualifies as a ‘resident’ as defined in section 1 is subject to tax in South Africa on their receipts and accruals from all sources subject to certain exceptions (De Koker, 2010).

8.8.1 Preamble to section 9D(2A)

The preamble to section 9D(2A) reiterates that the entire Income Tax Act no 58 of 1962 will apply to CFCs where the net income is to be determined for imputation into the taxable income of the resident shareholder (Olivier & Honiball, 2008:443). As the CFC is seen to be a resident it results in the imputation of the CFC’s world-wide income into the South African tax net (Olivier & Honiball, 2008:443).
8.8.2 Requirements to section 9D(2A)

8.8.2.1 Limiting deductions and allowances to income earned

In terms of section 9D(2A) of the Act, the deductions and allowances that the CFC is entitled to in terms of South African tax legislation is limited to the income earned by that CFC. The section goes further to state that no loss is allowed to be imputed into the resident shareholder’s taxable income. Due to the limitation provided in section 9D(2A)(a), where a CFC is in a net loss position, a net income of zero will be included in the resident shareholder’s taxable income (58/1962).

**Example:** Company B is a wholly owned subsidiary of Company A. Company B is situated in the UK and is a controlled foreign company in terms of section 9D to the Act (none of the exemptions apply). Company B has the following income and expenses in terms of South African tax legislation:

| Gross Income | R200 000 |
| Deductions   | R120 000 |
| Wear and tear allowance | R100 000 |

Total expenses amount to R220 000 and exceeds total income of R200 000 by R20 000. Therefore no income is imputed into the taxable income of Company A, as the expenses exceed the income for the foreign tax year.

8.8.2.2 Ring fencing of assessed losses

In terms of section 9D(2A)(b) of the Act, where the deductions and allowances granted to a CFC result in a net loss position (i.e. the deductions and allowances exceed the income earned) the loss can be carried forward to the succeeding year of assessment. This assessed loss can then be set off against income earned in the succeeding year of assessment in terms of section 20 (58/1962).

Each year of assessment is a closed compartment and that the taxpayer’s taxable income is determined anew in each year of assessment by taking account of the taxpayer’s income and deductions in respect of that year only, i.e. a taxpayer resident cannot decide in which year of assessment to incur expenses and recognise income.
An important qualification to this principle is laid down in section 20(1)(a) which provides that, subject to certain requirements, an assessed loss in one year of assessment can be carried forward into the following year of assessment and set off against the income of that year for the purposes of determining the taxable income of that year (Williams, 2005: 447).

Section 20(1)(a) of the Act states that for the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be set off against the income so derived by such person, any balance of assessed loss incurred by the taxpayer in any previous year which has been carried forward from the preceding year of assessment (58/1962).

Interpretation Note 33 to the Act relating to assessed losses, the meaning of assessed losses is defined in section 20(2) and is said to refer to the tax loss that arises in the current year after deducting the admissible deductions in sections 11 to 19. From the above it is clear that the term ‘trade’ is not included in the definition of ‘assessed losses’, however, the carrying on of a trade is a general requirement in terms of the deductibility under sections 11 to 19 (Lexis Nexis, 2009:1058).

**Example:** Company B is a wholly owned subsidiary of Company A. Company B is situated in the UK and is a controlled foreign company in terms of section 9D to the Act (none of the exemptions apply). Company B has the following income and expenses in terms of South African tax legislation:

<table>
<thead>
<tr>
<th>Gross Income</th>
<th>R200 000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deductions</td>
<td>R120 000</td>
</tr>
<tr>
<td>Wear and tear allowance</td>
<td>R100 000</td>
</tr>
</tbody>
</table>

Total expenses amount to R220 000 and exceeds total income of R200 000 by R20 000. Therefore no income is imputed into the taxable income of Company A, as the expenses exceed the income for the foreign tax year. The R20 000 calculates loss is therefore carried forward in terms of section 9D(2A)(b) to the succeeding year of assessment and can be set off against future taxable income. However, in the following year Company B, ceases to trade for the entire year of assessment, this calculated loss in terms of the principles laid down in SA Bazaars is lost.
8.8.2.3 *Disallowable expenses*

In terms of section 9D(2A)(c), there are certain expenses that are not available for deduction from income in determining the net income of the CFC. This provision is a mirror of the exemptions from imputation provided for in section 9D(9)(fA). Subsection (2A)(c) describes how the following expense items are disallowed in the determination of the net income of a CFC, where both CFC’s form part of the same ‘group of companies’ (58/1962):

- ‘Interest, royalties, rental or income of a similar nature which is paid/payable or deemed to be paid or payable by that company to any other controlled foreign company (including any similar amount adjusted in terms of section 31);

- Exchange difference determined in terms of section 24I in respect of any exchange item to which that company and any other controlled foreign company are parties;

- Exchange differences in respect of any forward exchange contract or foreign currency option contract entered into to hedge the exchange item referred to in subparagraph (ii); or

- Reduction or discharge by that company of a debt owed to that company by any other controlled foreign company for no consideration or for consideration less than the amount by which the face value of the debt has been so reduced or discharged’ (58/1962).

This rule effectively ensures that parity exists between the two CFCs. For example, if CFC A receives royalty income from CFC B, in terms of this subsection, CFC A does not include the income in its net income determination and CFC B is unable to obtain the royalty paid deduction. However, where an election is made in terms of section 9D(12), which determines that the resident shareholder can elect to include the royalty income of CFC A and then CFC B will be able to obtain the deduction (De Koker, 2010).
8.8.2.4 Valuation date of Controlled Foreign Company

Where a foreign company becomes a CFC after the date on which capital gains tax ("CGT") was introduced (i.e. 1 October 2001) the valuation date for CGT purposes is the date on which it became a CFC (s9D(2A)(e)) (Olivier & Honiball, 2008:445).

In terms of paragraph 12(2) and 12(4) of the Eighth Schedule there is a deemed disposal on the date on which a foreign company either commences or ceases to be a CFC. The CFC will be a resident in terms of the Eighth Schedule on the day before commencing to be a resident. However, certain assets of a foreign company will be excluded from this due to the fact that regardless of whether a foreign company is a CFC or not, any capital gains on these assets, will have its source in the Republic and will form part of the South African tax net. These assets are:

1. Immovable property situated in South Africa or any right to immovable property situated in South Africa
2. Assets attributable to a permanent establishment in South Africa
3. Assets held by the CFC (before it ceases to be a CFC) if any amount is received or accrued from their disposal of those assets for purposes of determining the net income of the CFC in terms of section 9D (58/1962).

8.8.2.5 Capital gains tax for natural persons, special trusts and insurers

Where the controlling resident is a natural person, special trust, or an insurer in respect of its individual policyholder fund, the inclusion rate for CGT purposes in determining the inclusion of the capital gain in terms of section 26A is at a rate of 25% (s9D(2A)(f)) (Olivier & Honiball, 2008:445).

8.8.2.6 Section 31

Section 9D(2A)(h)(i) states that section 31 of the Act will apply in relation to any transaction, operation or scheme between the CFC and any connected person in relation to that CFC (58/1962). This means that the Commissioner is entitled to adjust the consideration in relation to said transactions if the consideration is not at an arm’s length. For purposes of applying the thin capitalisation provisions contained in
section 31(3)(a)(i) and (ii), the CFC will be deemed to be a resident for South African income tax purposes (Stiglingh et al, 2010:584).

In terms of Practice Note 7 to the Act which states that section 31 enables the Commissioner to adjust the consideration in respect of a supply or acquisition of goods or services in terms of an international agreement between connected persons. The Commissioner may adjust the consideration, for tax purposes, if the actual price charged by or to the resident is either less or greater than the price that would have been set if the supply or acquisition of goods or services had occurred between independent parties on an arm's length basis. The Commissioner may then use the amount so determined, for inclusion in the taxable income of either of the parties to the transaction (Lexis Nexis, 2009:1470).

In terms of Practice Note 2 of the Act, section 31 also refers to transactions where financial assistance is granted by a foreign connected person to a South Africa resident. Financial assistance in terms of section 31 includes both interest-bearing financial assistance and interest-free financial assistance. As the purpose of subsection (3) is in essence to enable the Commissioner to determine an acceptable debt/equity ratio (3:1) in order to disallow a deduction in respect of interest relating to the excessive portion of loan capital, the application of subsection (3) will be limited to interest-bearing financial assistance. This will, however, not have the effect that financial assistance which is not interest bearing will be regarded as permanent owner’s capital (Lexis Nexis, 2009:1408).

In terms of the Explanatory Memorandum on the Taxation Laws Amendment Bill of 2010, certain amendments have been made relating to section 31 relating to transfer pricing. The amendments to section 31 were made to be in line with the guidance provided by the OECD with the focus being on cross border transactions, operations, schemes, agreements or understandings that have been effected between or undertaken for the benefit of connected persons. The new rules are now aligned with the provisions contained in the OECD and UN Model Tax Convention and are now

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15 With effect from years of assessment beginning on and after 1 October 2011, section 31 has been amended by inter alia removing the so called thin capitalisation provisions.
also in line with tax treaties and related international tax principles. South Africa will therefore be following the OECD Transfer Pricing Guidelines and to re-characterise transactions and the application of the transfer pricing rules thereon. (National Treasury, 2010:75-76).

In relation to the rules relating to thin capitalisation, these will now be combined with the transfer pricing rules. This will result in the transfer pricing rules now being used to deny the deductions relating to interest where a South African entity is thinly capitalised with excessive debt. (National Treasury, 2010:75-76).

8.8.2.7 Paragraph 43 of the Eighth Schedule
For purposes of the application of paragraph 43 of the Eighth Schedule, a CFC’s local currency refers to the currency used by it for purposes of financial reporting (s9D(2A)(k)) (Olivier & Honiball, 2008:445). This has been discussed under the definitions section of this proposed interpretation note.

8.9 Translation of net income
Section 9D(6) clarifies the approach that should be followed in translating the net income of a CFC, from the foreign currency used by the CFC for financial reporting purposes16 in its country of residence to the local currency of the resident shareholder, i.e. South African Rands (58/1962). Included in this section to the Act, is certain provisos relating to specific transactions that may take place in the CFC’s business for the foreign tax year. The section describes the different translation rules that will apply other than that disclosed in the preamble to the section.

The opening words to the section of the Act, explain that the net income of a CFC is to be determined in the currency used by that CFC for purposes of financial reporting and to be translated into the currency of the Republic at an average exchange rate for that year of assessment. The year of assessment is in relation to the resident shareholder’s year of assessment.

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16 The Taxation Law Amendment Bill of 2010 has replaced the term ‘currency for financial reporting’ with ‘functional currency’ with effect from 1 January 2011 and applicable in respect of foreign tax years of controlled foreign companies ending during years of assessment commencing on or after that date.
The provisos to the section are described below and are as follows:

- Subsection (a) to the Act states that where the CFC disposes of any asset in terms of paragraph 43(4) of the Eighth Schedule which is not attributable to a permanent establishment of the CFC outside the Republic, any capital gain or loss of that CFC, when applying this paragraph shall be determined in the currency of the Republic and translated to the currency used by that CFC by applying the average exchange rate (58/1962).

- Subsection (b) states that in respect of a disposal of any foreign equity instrument that is treated as trading stock and which is not attributable to a permanent establishment of that CFC outside the Republic, the amount taken into account in determining the net income of that CFC is determined in the currency of the Republic and that amount shall be translated to the currency used by that CFC by applying the average exchange rate (58/1962).

- Subsection (c) states that for the purposes of section 24I, ‘local currency’ in relation to an exchange item of a CFC which is not attributable to a permanent establishment of that company outside the Republic, means the currency of the Republic and any exchange difference determined must be translated to the currency so used by that CFC by applying that average exchange rate (58/1962).

In the provisos to this section, they refer to the ‘average exchange rate’ but do not say in relation to what period, the year of assessment of the resident shareholder or the foreign tax year of the CFC. It means that the ‘average exchange rate’ should be in relation to the year of assessment of the resident shareholder.

- Subsection (d)(i) states that any asset or foreign equity instrument that is disposed of and any exchange item denominated in any currency other than the currency used by that CFC for purposes of financial reporting shall be deemed not to be attributable to any permanent establishment of the CFC if the currency used for financial reporting is the currency of the country which has an official rate of inflation of 100% or more throughout the foreign tax year (58/1962).

In terms of section 9D(6)(d)(i), the Explanatory Memorandum of the Taxation Laws Amendment Bill of 2010, provides for the fact where a foreign country abandons its currency as legal tender due to unfavourable circumstances, for example Zimbabwe,
where they have changed their legal tender from Zimbabwe dollars to US dollars. This takes place after a period of hyperinflation which results in a lack of reliable exchange rate information. In the view of the above, a special rule has been proposed in respect of the tax cost of the foreign assets before the abandonment of the hyper-inflationary currency. The tax treatment of these assets will be that they are deemed to be restated at the market value at the time the abandonment of the hyper-inflationary currency takes place. The new starting date is said to be the date on which the new currency is adopted and the tax cost will apply if the assets were acquired for the first time. The amendment is aimed at alleviating the burden of determining the tax cost of assets after a period of hyperinflation experienced by a country (National Treasury, 2010:88-89).

8.10 Elections

Included in section 9D are two elections available to resident shareholders for CFCs provided that the resident together with a connected person in aggregate holds at least 10% but not more than 20% of the participation rights and voting rights of a CFC may elect either provision, section 9D(12) or section (58/1962).

Section 9D(12) if elected will result in all the provisions of subsection 9 (i.e. the exemptions available to resident shareholders to not impute the net income of a CFC) not applying in respect of the net income in relation to a foreign tax year of a CFC in which that resident holds any participation rights. Therefore, where a CFC is a foreign business establishment and the exemption in terms of section 9D(9) could apply and the net income not imputed, where a resident shareholder has elected subsection 12 to apply, the net income regardless of the definition of foreign business establishment being met, the net income of the entity will still be imputed into the resident shareholder’s taxable income (De Koker, 2010).

The elections that can be used by a resident shareholder is a mechanism with an ‘all or nothing approach’. The resident shareholder cannot choose to bring only certain portions of otherwise exempt income into the tax net. The elections may be made on a year by year basis. Where the election is made it effectively permits a resident
shareholder to be taxed on foreign income so as to receive the benefit of the rebate contained in section 6quat (De Koker, 2010).

**Example:** A South African company owns 25% of the ordinary shares of a Swedish-based CFC. In its 2005 year of assessment, this CFC earns €600 000 (€ = Euro) of active income attributable to a business establishment and €40 000 of passive income from related working capital. All the income of the CFC is subject to a 30% company rate of tax.

In its 2006 year of assessment, this CFC distributes its after-tax income of €448 000 (€600 000 plus €40 000 less €192 000 tax) from its previous year of assessment to its shareholders as a dividend.

In its 2005 year of assessment, the South African company may elect to treat an amount equal to its portion of the CFC income as imputed amounts despite the exclusion in section 9D(9)(b). Its South African tax liability may then be reduced by the section 6quat rebate. The South African company can disregard the dividend in its 2006 year of assessment because this dividend represents previously taxed income.

In addition to the section 9D(12) election, the resident is also afforded an election in terms of section 9D(13) to treat a foreign company which is not a CFC as if it is a CFC for the relevant foreign tax year. This election effectively permits him to be taxed on his share of the CFCs profits and as a consequence to receive the benefit of the section 6quat rebate. It also means that any subsequent dividend declared by the CFC will be exempt from tax, since dividends from CFCs whose profits have been subject to tax in South Africa are exempt, with the result that the foreign dividend remains exempt even though the shareholding is below 25%. However, the election does not allow for the excess foreign tax credits to be utilised against the South African tax liability (De Koker, 2010).
Example: A South African company owns 20% of the ordinary shares of a Swedish-based company. An unconnected foreign individual who is not resident in South Africa owns the remainder of its shares.

In its 2005 year of assessment, the Swedish-based company earns €70 000 (€=Euro) of passive net income subject to a 30% rate of tax.

In its 2006 year of assessment, the Swedish-based company distributes its after-tax income of €49 000 (€70 000 – €21 000) from its previous year of assessment to its shareholders as a dividend on a pro rata basis.

The South African company can elect to be subjected to tax on its pro rata share of the €70 000 earned by the Swedish-based company as if it [the Swedish-based company] were a CFC. If the South African company makes the election, it is deemed to receive €14 000 (20% of €70 000) of income along with €4 200 (20% of (€21 000) towards a section 6quat rebate (resulting in no South African taxes being payable €70 000 × 30% – €21 000).

The South African company can disregard the €9 800 (20% of €49 000) of dividends received in the following year of assessment because all these dividends represent previously taxed income (see s 10(1)(k)(ii)(cc)).

Both elections contained in 9D(12) and (13) can be made on a year by year basis by the resident shareholder, regardless of whether an election has been made by any connected person in relation to the resident shareholder. The election contained in section 9D(12) can be combined with the election in section 9D(13). Both sections gives access to the rebate provided for in section 6quat as the net income of the CFC is imputed into the taxable income of the resident, which in turn means that any dividend distributed by the CFC from the same profits will be exempt (De Koker, 2010).
8.11  Capital gains tax implications

The following provisions in section 9D relates specifically to CGT:

1  Section 9D(2A)(e) – When a capital gain of a CFC will be included in net income
2  Section 9D(2A)(f) – Rate to be used for CGT purposes for CFCs
3  Section 9D(2A)(k) – Meaning of ‘local currency’ in terms of paragraph 43 of the Eighth Schedule
4  Section 9D(6)(a) – Translation of capital gain or loss on disposal of assets (58/1962)

The following paragraphs of the Eighth Schedule are relevant specifically to CFCs:

1  Paragraph 12(2) – deemed disposal rules for the purposes of determining the base cost of assets owned by a foreign entity when that foreign entity becomes a CFC and deemed disposal rules for the purposes of determining a notional capital gain or loss in respect of assets being removed from the CGT net when a CFC ceases to be a CFC
2  Paragraph 12(4) – deemed disposal rules when a CFC ceases to be CFC as a result of becoming a resident for CGT purposes
3  Paragraph 13(g) – Setting the time of disposal for the deemed disposals mentioned above
4  Paragraph 20(1)(h)(iii) – determining the base cost of a right held directly by a resident in a CFC as well as the base cost of a right held indirectly in a CFC through another CFC by a resident
5  Paragraph 24 – Base cost of asset of a person who becomes a resident on or after valuation date
6  Paragraph 64B – Disposal of interest in equity share capital of foreign company (58/1962).

As was already mentioned in chapter 5, a CFC is deemed to be a resident for purposes of inter alia, paragraph 2(1)(a), 24, 70, 71, 72 and 80 of the Eighth Schedule:
The result of deeming a CFC to be a resident for purposes of paragraph 2(1)(a), is that all the assets of a CFC will fall within the scope of the Eighth Schedule. Had it not been for this provision, only immovable property situated in South Africa and assets attributable to a permanent establishment of the CFC in South Africa would have fallen within the scope of South Africa’s CGT legislation.

Paragraph 24 read with paragraph 12(2) is the sole method prescribed for the purpose of determining the base cost of a CFCs assets upon becoming a CFC (SARS. 2010b:158).

Paragraphs 70, 71 and 72 are anti-avoidance measures dealing with the attribution of capital gains where the disposal of the asset is subject to conditional or revocable vesting or results in a capital gain vesting in a non-resident.

Paragraph 80 deals with the attribution of capital gains arising in a trust or resulting from the vesting of an asset in a beneficiary of a trust (58/1962).

Due to the fact that section 9D in some instances refers specifically to certain paragraphs in the Eighth Schedule, in order to clarify the position relating to controlled foreign companies, the sections in 9D will be discussed together with the provisions in the Eighth Schedule, where necessary.

8.11.1 **Imputation of foreign capital gain of a CFC to SA resident**

In terms of section 9D(2A) to the Act, the taxable income of the CFC is determined in accordance with the provisions of the Act and this includes any taxable capital gains made by the CFC for the year of assessment (De Koker, 2010). Therefore the capital gains have to be apportioned to the resident in accordance with participation rights in that CFC. The net income of the CFC must be determined as if it was a taxpayer for South African tax purposes but a resident for purposes of the Eighth Schedule (see discussion above) and therefore gains and losses resulting from the disposal of its world-wide assets will be taken into account in determining its net income even though the Eighth Schedule limits capital gains of certain assets owned by non-residents (De Koker, 2010).
The valuation date of a CFC is determined in section 9D(2A)(e), to be the day before the foreign company becomes a CFC. This is mirrored in the Eighth Schedule in paragraph 13(g)(i) which states that when a CFC commences or ceases to be a resident the time of disposal is said to be the date immediately before the day that the event occurs.

Example: Company A bought 100% of the share capital of Company B on the 1 January 2010. Therefore company B is a controlled foreign company and its valuation date for capital gains tax purposes is said to be the day before it becomes a controlled foreign company, i.e. 31 December 2009.

8.11.2 Determination of the base cost of pre-1 October 2001 assets

As was already mentioned, CFCs are deemed to be residents for purposes of paragraph 2(1)(a). Therefore by implication, the determination of the valuation date value of pre-valuation date assets applicable to CFCs (those include paragraphs 20, 25, 26, 27, 28, 29, 30, 31 and 32). Therefore where a CFC was in existence before 1 October 2001, the pre valuation date rules per the Eighth Schedule will apply to them i.e. when determining any capital gain or loss in respect of the disposal of its pre-valuation date asset. A CFC will have to determine the base cost in the same manner as a resident. For example, where a CFC has elected to use the market value valuation date, it would need to have valued its assets by 30 September 2004 except for those assets held by the CFC which consist of South African listed shares or South African participatory interests in collective investment schemes whose prices were published in the Gazette (SARS, 2010b:624).

8.11.3 Base cost adjustments (para 20(1)(h)(iii))

Paragraph 20 of the Eighth Schedule specifies the expenses and amounts that are allowed in determining the base cost of an asset as well as the amounts that are specifically excluded. The paragraph deals with qualifying expenditure to determine the cost of an asset for both pre and post valuation date assets (SARS, 2010b:624).
For CFCs, paragraph 20(1)(h)(iii) describes the base cost adjustment that is required. In terms of the Act, where there is a right in a CFC that is held *directly* by a resident, an amount equal to the proportional amount of net income of that company and of any other CFC in which that CFC and that resident *directly or indirectly* have an interest, which was included in the income of that resident in terms of section 9D during any year of assessment *less* the amount of any foreign dividend distributed by that company to that resident during any year of assessment which was exempt from tax in terms of section 10(1)(k)(ii)(cc) (58/1962).

In terms of the detailed explanation on Section 9D issued by National Treasury, the base cost adjustment in terms of paragraph 20(1)(h)(iii) is described as an adjustment that is required where South African residents have an interest in a CFC. In summary, the base cost adjustment is made for the net income amount included and certain dividends. To the extent the South African resident receives net income to be included in its taxable income this results in an upward adjustment. Residents also receive a full upward base cost adjustment for their net capital gains (even though those gains are only partially included in income). In essence, the base cost of an interest in a CFC is increased by amounts included in the taxable income of the resident (SARS, 2002b:7).

<table>
<thead>
<tr>
<th>Therefore:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of shares in CFC</td>
</tr>
<tr>
<td>Plus: Net income included in SA resident taxable income</td>
</tr>
<tr>
<td>Less: Net taxable capital gain included in net income above</td>
</tr>
<tr>
<td>Plus: Capital gain at full value</td>
</tr>
<tr>
<td>Less: Dividends received from CFC from income previously included in net income and taxed</td>
</tr>
<tr>
<td>= Base cost adjustment for CFC’s</td>
</tr>
</tbody>
</table>
However, residents must reduce the base cost of their CFC shares to the extent they receive a tax-free dividend distribution that represents previously taxed section 9D income, CFC dividends are exempt under section 10(1)(k)(ii)(cc) (SARS, 2010b:624).

**Example 1**

South African Company owns all the shares of a CFC with a R700 base cost. In 2001, CFC generates R300 of active income, R70 of passive interest income, and R50 of passive capital gains. The latter two items are included in South African Company’s income by virtue of section 9D. In 2002, CFC distributes all R120 of the previously described profits.

The base cost of the shares in the CFC is determined as follows:

<table>
<thead>
<tr>
<th>R</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening base cost of shares in CFC</td>
<td>700</td>
</tr>
<tr>
<td>2001</td>
<td></td>
</tr>
<tr>
<td>Active income (no adjustment)</td>
<td>-</td>
</tr>
<tr>
<td>Passive interest income</td>
<td>70</td>
</tr>
<tr>
<td>Passive capital gains</td>
<td>50</td>
</tr>
<tr>
<td>Revised base cost</td>
<td>820</td>
</tr>
<tr>
<td>2002</td>
<td></td>
</tr>
<tr>
<td>Less: Exempt foreign dividend</td>
<td>(120)</td>
</tr>
<tr>
<td>Closing base cost</td>
<td>700</td>
</tr>
</tbody>
</table>

Note the full credit for the passive capital gains despite the 50% inclusion rate.

The passive income will be included in the CFCs taxable income in terms of section 9D before the reduction of the base cost by that which has been distributed via a dividend which is exempt in terms of section 10(1)(k)(ii)(cc).

**Example 2**

A South African resident individual owns all the shares in a foreign company, which qualifies as a CFC. The shares were acquired for R600 000 on 19 December 2001. The receipts and accruals of the foreign company consist of the following:
Foreign dividends 300 000
Capital gain on disposal of shares 500 000
Capital loss on disposal of shares (200 000)

The net income of the CFC (disregarding the inclusion rate applicable to individuals) as contemplated in section 9D is R300 000 + R500 000 – R200 000 = R600 000. The base cost of the shares is determined as follows:

Cost of shares (para 20(1)(a)) 600 000
Net income as above (para 20(1)(h)(ii)(aa)) 600 000
Base cost 1 200 000

Example 3
Joe, a resident is the sole shareholder of Company A, a controlled foreign company. Joe paid R350 000 for the shares in Company A. During the current year of assessment, Company A had made the following receipts and accruals:

Foreign dividends R150 000
Capital gain R200 000
Capital loss R90 000

Joe will include in his determination of the net income of Company A for inclusion in his taxable income the following:

Proportional amount of the foreign dividends R150 000
Proportional amount of the capital gain
- Capital gain R200 000
- Capital loss (R90 000)
Net capital gain R110 000
At 25% R27 500
Net income of Company A included in John’s income R177 500
During the year of assessment, Company A declared a dividend to Joe amounting to R100 000 which was exempt from tax in terms of section 10(1)(k)(ii)(cc). After receiving the dividend from Company A, Joe decided to sell the CFC for R600 000.

The base cost is determined as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original cost of the shares in the CFC</td>
<td>R350 000</td>
</tr>
<tr>
<td>Plus: net income included</td>
<td>R177 500</td>
</tr>
<tr>
<td>Less: taxable capital gain</td>
<td>(R27 500)</td>
</tr>
<tr>
<td>Plus: Full Capital gain</td>
<td>R110 000</td>
</tr>
<tr>
<td>Less: Dividends received that were previously included</td>
<td>(R100 000)</td>
</tr>
<tr>
<td><strong>Base cost of shares</strong></td>
<td><strong>R510 000</strong></td>
</tr>
<tr>
<td><strong>Proceeds</strong></td>
<td><strong>R600 000</strong></td>
</tr>
<tr>
<td><strong>Capital gain</strong></td>
<td><strong>R90 000</strong></td>
</tr>
<tr>
<td><strong>Net capital gain at 25%</strong></td>
<td><strong>R22 500</strong></td>
</tr>
</tbody>
</table>

In terms of the Act, section 10(1)(k)(ii)(cc) states that ‘where a resident to the extent that the foreign dividend does not exceed the aggregate of all amounts which have been or will be included in the income of that resident in terms of section 9D in any year of assessment, which relate to the net income of:

- The company declaring the dividend or
- Any other company which has been included in the income of that resident in terms of section 9D by virtue of that resident’s participation rights in that other company held indirectly through the company declaring the dividend Reduced by –
  - The amount of any foreign tax payable in respect of the amounts so included in that resident’s income and
  - So much of all foreign dividends received by or accrued to that resident at any time from any company contemplated above as was
    - Exempt from tax in terms of this item or item (dd) or
    - Was previously not included in the income of that resident by virtue of any prior inclusion in terms of section 9D’ (58/1962).
A foreign company in which a resident has an indirect qualifying interest will also constitute a CFC in relation to that resident. In other words, not only is the proportional amount of the net income of the holding company imputed to the resident shareholder, but also the proportional amount of the net income of any CFC subsidiaries in which the resident has an indirect qualifying interest. A special rule is contained in paragraph 20(1)(h)(iii)(bb) to deal with the determination of the base cost of an interest in a subsidiary CFC by a holding company CFC (SARS, 2010b:625).

Paragraph 20(1)(h)(iii)(bb) per the Act, states that where a right in a CFC held directly by another CFC, an amount equal to the proportional amount of the net income (without having regard to the percentage adjustments contemplated in paragraph 10) of that first-mentioned CFC and of any other CFC in which both the first and second mentioned CFC directly or indirectly have an interest, which during any year of assessment would have been included in the income of that second-mentioned CFC in terms of section 9D had it been a resident, less the amount of any foreign dividend distributed by that first-mentioned CFC to the second-mentioned CFC if that dividend would have been exempt from tax in terms of section 10(1)(k)(ii)(cc) had that second-mentioned CFC been a resident (58/1962).

Example 1
Michelle, a resident, owns all the shares in CFC 1 which owns all the shares in CFC 2 which owns all the shares in CFC 3. Michelle acquired all the shares in CFC 1 at a cost of R400 000 on 1 March 2008. At that date each CFC owned a portfolio of foreign listed shares valued at R150 000. On 29 February 2009 CFC 3 sold its portfolio of shares for R200 000 and reinvested the proceeds in other foreign listed shares. On 30 June 2009 CFC 3 declared a dividend of R70 000 to CFC 2 which on declared it to CFC 1 which on-declared it to Michelle. On 31 December 2009, CFC 1 disposed of its interest in CFC 2 for R450 000.
The disposal of listed shares by CFC 3 gives rise to a capital gain of R50 000 (R200 000 less R150 000) which is taxed in Michelle’s hands under section 9D (that is, R50 000 x 25% - R12 500). The base cost of CFC 1’s shares in CFC 2 is determined as follows:

\[
\text{R} \\
\text{Market value of shares on date CFC 2 became a CFC (para 12(2))} & \text{200 000} \\
\text{Net income of CFC 3 (disregarding inclusion rate)} & \text{50 000} \\
\text{Less: Exempt dividend (s10(1)(k)(ii)(cc))} & \text{(70 000)} \\
\text{} & \text{180 000}
\]

Disposal of CFC 2 by CFC 1
Capital gain = Proceeds less base cost
\[
\text{R450 000} - \text{R180 000} \\
\text{R270 000}
\]

8.11.4 Section 9D(2A)(f) – Rate to be used for CGT purposes for CFCs

Section 9D(2A)(f) of the Act goes further to explain that where the resident shareholder is a natural person, special trust or insurer in respect of its individual policyholder fund, the taxable capital gain of the CFC shall be at 25% if that
company’s net capital gain for the relevant foreign tax year. This is determined in line with paragraph 10 of the Eighth Schedule (58/1962).

**Example:** Mr. A owns 60% of the shares in Company B. Company B is a controlled foreign company in terms of section 9D. Company B has made the following capital gains and losses during the foreign tax year to be included in its net income for the year.

<table>
<thead>
<tr>
<th>Disposal of</th>
<th>Gain/ (loss) in ZAR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property</td>
<td>100 000</td>
</tr>
<tr>
<td>Assets</td>
<td>20 000</td>
</tr>
<tr>
<td>Shares</td>
<td>(30 000)</td>
</tr>
<tr>
<td>Net Capital gain</td>
<td>R90 000</td>
</tr>
</tbody>
</table>

The taxable income of Company B before inclusion of the net capital gain amounts to R50 000.

As the resident which is a natural person owns 60% of the participation rights in Company B and therefore the inclusion rate in terms of paragraph 10 is 25%.

Therefore included in the net income of Company B to determine its taxable income, the net capital gain of R22 500 (R90 000 at 25%). Therefore the net income of Company B amounts to R72 500 (R50 000 plus R22 500). An amount of R43 500 (R72 500 x 60%) is included in the taxable income of the resident shareholder in terms of section 9D.

### 8.11.5 Section 9D(2A)(k) – Meaning of ‘local currency’ in terms of paragraph 43 of the Eighth Schedule

Paragraph 43 of the Eighth Schedule deals with conversion rules for capital gains or capital losses in respect of transactions in foreign currency. The term ‘local currency’ of a CFC is said to mean the currency used for purposes of its financial reporting (De Koker, 2010). Chapter 2 of this study deals with definitions and explains the term ‘currency used for purposes of financial reporting’, and in short is said to be the currency used by the CFC for reporting purposes, i.e. its presentation currency.
The Comprehensive Guide to Capital Gains Tax (Issue 3) (SARS, 2010b:628) states that the term ‘local currency’ as used in paragraph 43 means in relation to:

- A permanent establishment (PE) of a CFC the currency used by that PE for purposes of financial reporting (other than the currency of any country in the common monetary area) and
- The CFC itself, the currency used by the CFC for purposes of financial reporting.

**Example:**

Company A is the sole shareholder of Company B, a company incorporated in the United Kingdom. Company B reports its financial results in Sterling. Company B has a branch situated in Dubai that operates a retail business. The branch reports its financial results in US dollars. In applying paragraph 43, the local currency of Company B is said to be Sterling and for the branch it is US dollars.

In terms of section 9D(6) to the Act, there are certain specific translation rules that need to be taken into account, of which one relates to paragraph 43(4) assets. The Act states that in respect of the disposal of any asset contemplated in paragraph 43(4) of the Eighth Schedule which is not attributable to any permanent establishment of that CFC outside the Republic, any capital gain or capital loss of that CFC shall, where applying paragraph 43(4) of the Eighth Schedule, be determined in the currency of the Republic and that capital gain or capital loss shall be translated to the currency used by that CFC for purposes of financial reporting by applying that average exchange rate (58/1962).

Paragraph 43(4) of the Eighth Schedule relates to the following assets:

- Foreign equity instrument
- Assets, the capital gain or capital loss from the disposal of which is derived or deemed to have been derived from a source in the Republic, in terms of section 9 excluding a foreign currency asset in terms of paragraph 84(b) of the Eighth Schedule (58/1962)
  - This includes deemed South African source assets
    - Immovable property in South Africa
    - Any interest or right in or to immovable property in South Africa
- Assets of a permanent establishment in South Africa (SARS, 2010b:628)

The capital gains and losses in respect of a disposal of assets in terms of paragraph 43(4) assets must be translated as follows:

- Determined in the currency of the Republic, and;
- Translated into the currency used by the CFC for the purposes of financial reporting at the average exchange rate (SARS, 2010b:628).

The Comprehensive guide on CGT provides insight into the reason why one would determine the capital gain and loss in the currency of the Republic only to then translate it back into the reporting currency of the CFC. It states that it is necessary if the CFC has an assessed loss before taking into account any capital gain determined under paragraph 43(4). In terms of section 9D(2A)(b) where a CFC has incurred an assessed loss in previous years of assessment, these can be carried forward to succeeding years of assessment and set off against the taxable income earned by that CFC in future years, however, this assessed loss cannot be imputed into the taxable income of the resident shareholder. Therefore the provisions of paragraph 43(4) of the Eighth Schedule ensure that the capital gain of the CFC is set off against its own assessed loss first before determining the value of its net income to be imputed into the taxable income of the South African resident (SARS, 2010b:629).

**Example:**

A South African resident holding company owns all the shares of a foreign subsidiary (CFC) incorporated and based in a tax haven in the Isle of Man. The CFC uses Sterling for the purposes of financial reporting. The CFC sells a share listed on the NYSE during its financial year ended 30 June 2004 for proceeds of $300. The share was purchased on 1 October 2001 for $100. The relevant exchange rates are as follows:

On 1 October 2001  \( R10 = \$1 \) (ruling exchange rate)

Year ended 30 June 2004  \( R17 = 1\text{GBP} \)  \( R9 = \$1 \) (average exchange rate)

The taxable income (all of a passive nature) of the CFC before inclusion of any capital gains is 1500GBP.
Result

Step 1 - Determine capital gain in rands under para 43(4)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds ($300x R9)</td>
<td>R2 700</td>
</tr>
<tr>
<td>Less: Base cost ($100 x R10)</td>
<td>(R1 000)</td>
</tr>
<tr>
<td>Capital gain</td>
<td>R1 700</td>
</tr>
<tr>
<td>Inclusion rate</td>
<td>50%</td>
</tr>
<tr>
<td>Taxable capital gain</td>
<td>R850</td>
</tr>
</tbody>
</table>

Step 2 – Determine amount to be included in net income in currency used by CFC for financial reporting

Translate into GBP using average exchange rate during the year ending 30 June 2004

= R850/17GBP = 50GBP

Step 3 – Determine amount to be included in income of resident company

Net Income = 1500GBP + 50GBP= 1550GBP x R17 = R26 350

8.11.6 Paragraph 12(2) – when a CFC or resident ceases or commences to be a resident for CGT purposes

The Eighth Schedule to the Act includes certain events which are treated as a disposal and the provisions of the schedule would apply. In terms of paragraph 12(2) to the Eighth Schedule it describes certain events that may take place and where it would be treated as a disposal and immediate reacquisition and then the provisions contained in paragraph 12(1) will apply. Paragraph 12(2) states that a disposal will take place where a person commences or ceases to be a resident or controlled foreign company for South African Income Tax purposes (SARS, 2010b:78). However, there are certain exceptions, this is due to the fact that regardless of whether a person or company is a resident or controlled foreign company, the source of the income still remains within South Africa, and this includes the following assets, namely:

1. Immovable property – where this immovable property is situated in South Africa or any right to immovable property situated in South Africa.
2 Asset of a permanent establishment – any asset that is attributable to a permanent establishment in South Africa.

3 Assets held by the CFC (before it ceased to be a CFC) if any amount received or accrued from their disposal of those assets would have been taken into account for purposes of determining the net income of the CFC in terms of section 9D (De Koker, 2010).

Two scenarios are possible under paragraph 12(2) of the Eighth Schedule, namely:
1 Where a CFC or person commences to be a resident for CGT purposes
2 Where a CFC or resident ceases to be a resident for CGT purposes

Under the first point above, when a CFC or person commences to be a resident in terms of the Eighth Schedule the requirements of paragraph 12(2) need to be adhered to. In summary, when one commences to be a resident it is deemed to have disposed of all their assets (except those identified above) on the date immediately before becoming a resident (paragraph 13(1)(g)) at a value equal to the market value and to have immediately reacquired these assets at the market value. This deeming provision does not result in an immediate capital gain or loss to be determined but ultimately sets a base cost value for these assets on the date it becomes a CFC. This ensures that when the asset is sold and capital gains tax imposed, it will only be on the value of the asset from the date of becoming a CFC to the date of disposal (De Koker, 2010).

Example: A resident acquires all the shares in Company A situated in Bermuda on 30 June 2009. At that date the cost of all qualifying assets under Company A’s control amount to R1 million, however the market value on the date before becoming a controlled foreign company amounted to R2 million.

Therefore in terms of paragraph 12(2), on the date that the Company A becomes a CFC it is deemed to have disposed of its assets at market value and immediately reacquired its assets at market value. Therefore the base cost of the assets held by Company A for CGT purposes going forward amount to R2 million.
Under the second scenario, where the CFC or resident ceases to be a resident for South African tax purposes (i.e. the resident is no longer effectively managed in South African or the participation rights in the CFC has decreased to less than 50%) there is a deemed disposal in terms of paragraph 12(2). When the CFC or resident ceases to be residents, there is a disposal but there is no ‘real’ proceeds value and therefore the market value is used (De Koker, 2010).

**Example:** A resident acquires all the shares in Company A situated in Bermuda on 30 June 2009. At that date the cost of all qualifying assets under Company A’s control amount to R1 million, however the market value on the date before becoming a CFC amounted to R2 million. After two years the resident sells all its shares in Company A to a non resident. At this date the market value of its assets amount to R2.5 million.

<table>
<thead>
<tr>
<th>Proceeds – market value on date ceases to be a resident</th>
<th>R2.5 million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Base cost – on date becomes a CFC market value</td>
<td>R2 million</td>
</tr>
<tr>
<td>Capital gain</td>
<td>R500 000</td>
</tr>
</tbody>
</table>

**8.11.7 Paragraph 12(4) – when a CFC becomes a resident**

The requirements of paragraph 12(4) deal with the situation where a foreign company ceases to be a CFC because it becomes a resident (i.e. is now effectively managed in South Africa). It is treated as having disposed of each of its assets and having reacquired them at a cost equal to the market value. In essence, the company is permitted to disregard a portion of any capital gain or loss on these assets brought into the tax net as a result of it becoming a resident. The gain or loss that is disregarded relates to the period during which the assets were held before the CFC became a resident (De Koker, 2010). In this case the provisions of paragraph 24 also apply, and it is deemed that the CFC acquires each asset at an amount equal to the market value immediately before the disposal. Since paragraph 24 applies, the CFC cannot make an election to use the time apportionment base cost or the 20% of proceeds method to determine a pre-valuation date value (De Koker, 2010).
The same assets as described in 1.5 above are excluded from the application of the provisions of paragraph 12(4). Paragraph 12(4) is aimed at including within the CGT net, assets of a CFC that meet the foreign business establishment exemption contained in section 9D, i.e. assets that fall outside the South African CGT net while the company was a CFC (SARS, 2010b:83).

**Example**

Co H, a South African resident company owns all the shares of CFC 1. CFC 1 has active foreign business establishment assets falling outside a section 9D and portfolio passive assets falling within s9D, CFC 1 owns all the shares of CFC 2. CFC 1 shifts its effective management to South Africa, thereby triggering South African residence status (and the loss of section 9D CFC status).

The conversion of CFC 1 to South African residence status is a paragraph 12(4) event. Paragraph 12(4) triggers a deemed sale of the foreign business establishment assets, none of which is taxable by virtue of the foreign business establishment exemption in section 9D(9)(b). However, the deemed sale results in a market value base cost step up of the foreign business establishment assets. The portfolio passive assets and the shares of CFC 2 are not subject to deemed sale treatment, meaning that those assets retain their historical base cost.

**8.11.8 Relationship between paragraphs 12(2) and 12(4)**

Paragraph 12(4) overrides the general rule contained in paragraph 12(2). The net effect is that when a CFC commences or ceases to be a resident, this triggers a deemed disposal and reacquisition at market value. An exception exists for CFC assets subject to tax on disposal in terms of section 9D. These assets will not be subject to taxable treatment nor will they be allowed to be valued at market value (i.e. these assets will have roll over treatment). The roll over treatment is that when the CFC commences to be a resident it is only taxed on the gains made from the date that it commences to be a CFC to the date that the asset is either disposed of or the CFC ceases to be a CFC (National Treasury, 2008:22).
There are a number of paragraphs contained in the Eighth Schedule that deal with the tax treatment of CFCs in relation to capital gains, however, not all of these have been provided in this study as SARS has issued a Comprehensive Guide on Capital Gains Tax which deal with the consequences of these paragraphs in detail, namely paragraphs 24 and 64B of the Eighth Schedule.

8.12 Administrative regulations of CFC’s

Where a foreign company meets the definition of a CFC as contained in section 9D(1), it is required to complete certain information and submit a return in order to comply with the administrative requirements of the Act.

8.12.1 Provisions of section 72A

Section 72A to the Act, deals with the administration of section 9D relating to the returns of CFCs and states as follows:

‘(1) Every resident who on the last day of the foreign tax year of a controlled foreign company or immediately before a foreign company ceases to be a controlled foreign company directly or indirectly, together with any connected person in relation to that resident, holds at least 10% of the participation rights in any controlled foreign company (otherwise than indirectly through a company which is a resident), must submit to the Commissioner such return as may be prescribed by the Commissioner’ (58/1962).

The above section makes it clear as to what is required by SARS when it comes to CFC disclosure. Where any resident directly or indirectly holds 10% or more of the participation rights of a foreign company, that resident shareholder is obliged in terms of this section to submit a return. The return is required to be submitted is an IT10 return.

‘(2) A resident must have available for submission to the Commissioner when so requested, a copy of the financial statements of the controlled foreign company for the relevant foreign tax year, as defined in section 9D of that controlled foreign company’ (58/1962)
Subsection (3) contains punitive provisions if a resident should fail to meet the requirements of subsection 2 (see below). Fortunately the problems mentioned above seem to have been recognised as subsection (3) acknowledges that there are factors that could impact on a resident’s ability to obtain financial statements.

‘(3) Where a person in respect of any year of assessment fails to comply with the provisions of –

(b) subsection (2) and no reasonable grounds exist either for that failure which is outside the control of the person or for that person to believe that such person was not subject to that requirement –

(i) the proportional amount which must be included in the income of that person in terms of section 9D for that year shall be determined with reference only to the receipts and accruals of the controlled foreign company; and

(ii) the provisions of section 6quat shall not apply in respect of any tax proved to be payable to the government of any other country with respect to the proportional amount of the net income of that controlled foreign company which is included in the income of that person in terms of section 9D.’ (emphasis added) (58/1962)

Where a resident shareholder is unable to submit a copy of the annual financial statements of the foreign company and has no reasonable grounds for not submitting, it will result in the inclusion of the net income of the CFC as the resident is prohibited from relying on the exemptions provided for in the Act. In addition, the resident can no longer apply the section 6quat rebate, resulting in double taxation (De Koker, 2010).

SARS considers the following to be reasonable grounds for failing to obtain and submit financial statements as and when requested:

- The CFC has not completed its audit and hence does not have signed annual financial statements by the time the submission of the tax return is required;

- Where the CFC in terms of the legislation in its country of residence is not required to submit annual financial statements.
8.12.2 IT10 returns

IT 10 returns are available on SARS’ website ([www.sars.gov.za](http://www.sars.gov.za)).

There are guidelines contained on the IT10 return and states that a separate IT10 return is to be completed and submitted for each controlled foreign company. The guidelines on completing the tax return includes a general note which states that a taxpayer must take into consideration the provisions of section 72A (which has been described above) and section 75 (SARS, 2010c:1-5).

Section 75 of the Act relates to penalties on default by residents. Where a resident is guilty of any of the offences listed in section 75 they will be guilty of an offence and liable on conviction to a fine or to imprisonment for a period not exceeding 24 months (58/1962).

Based on the above it is imperative that resident shareholders ensure that the information disclosed in the IT10 return is correct and that the requirements of section 9D are adhered to in order to avoid financial penalties as well as imprisonment.

The further implication of the above administrative requirements is that where a resident shareholder is unable to provide the annual financial statements of the foreign company and no valid reason exists, the previously exempt income will now be taxable. However, the timing of this is after the end of the year of assessment and after the submission of the resident shareholder’s first and second provisional tax payments. The result is that the CFCs net income will now be imputed into the resident shareholder’s taxable income thereby increasing the taxable income amount. This amount will now be higher than that which has been disclosed on the resident shareholders provisional tax returns.
**Illustrative Example**

Company A, a resident shareholder owns 80% in a Company B situated in the United Kingdom. Company B has its own offices, employees and management in the UK. During the current year Company B has a net income amounting to R2 million. Company A decided that Company B has a foreign business establishment and that the exemption contained in section 9D(9) applies and has not imputed any of the net income for the foreign tax year into its taxable income. Company A has not recognised in any of its provisional payments made to SARS the net income of company B and has paid tax of R2,8 million (R10 million taxable income).

On completion of Company A’s tax return, management complete an IT10 form but are unable to attach a copy of the annual financial statements of Company B. No valid reason exists as to why Company A has not attached the annual financial statements of Company B.

**Results**

In terms of administrative sections to the Act, the foreign business establishment exemption will not apply and the net income of Company B will be imputed into the taxable income of Company A.

Company A has paid tax amounting to R2,8 million based on a taxable income of R10 million.

Company A should have paid R3 360 000 on a taxable income of R12 million (R10 million plus Company B’s net income of R2 million).

Therefore Company A has underpaid tax on its second provisional payment by R560 000. This will result in administrative penalties imposed in terms of section 75B not based on the difference of R560 000 but on the taxable income of R12 million.

Interest at the prescribed rate on the R560 000 will be levied for the period that the tax remains unpaid.
The application of paragraph 20(1)(b) results in an automatic penalty of 20% on the difference between the R2 800 000 and R3 360 000, i.e. R560 000 x 20% = R112 000.

8.13 Comprehensive examples

(Examples obtained from Graded Questions on Income Tax in South Africa and the North West University – with permission – adapted)

Example 1

1 Does the controlled foreign company (CFC) rules provided for in section 9D of the Income Tax Act apply to trusts?

The CFC rules contained in section 9D, does not apply to trusts. The definition of foreign company does not include a trust.

2 South African residents own 55% of a foreign company (“A”). Foreign company “A” in turn owns 60% of foreign company “B”. Is foreign company B a CFC?

Yes, if the foreign company A is not a listed company and simultaneously provided that each resident owns at least 5% of the participation rights (unless connected persons own more than 50% of the participation rights or voting rights)

3 Do preference shares qualify as “participation rights” for purposes of section 9D of the Income Tax Act?

Preference shares will qualify as participation rights as they are defined as the right to share in the current profits of the company. Preference shares give one a right to pre-determined share in the company’s current profits.

4 Where a South African tax resident is a guarantee member in a Gibraltar hybrid company that entitles the resident to 60% of the company’s after-tax profits. Non-residents hold all the ordinary shares in the Gibraltar hybrid company,
which entitles them to 40% of the after-tax profits of the company. Will the Gibraltar hybrid company be a CFC for South African tax purposes?

The Gibraltar Company will be a CFC, participation rights are defined as the right, to share in the current profits of the company. The SA resident is entitled to a 60% share of the after tax profits which is more than 50% and therefore meets the definition of a CFC in terms of section 9D.

5 Where a South African resident holds less than 10% of the participation rights in a CFC, must the South African resident include the proportionate share of the CFC’s “net income” in his or her income for South African tax purposes? No, as the resident together with any connected person in relation to that resident hold less than 10% of the participation rights. (Section 9D(2) proviso A.

6 Will any loss incurred by a CFC be imputed to the South African resident holding participation rights in the CFC and must it be set off against any other “net income” that is required to be imputed to the resident in terms of section 9D of the Income Tax Act?

Where a CFC incurs a loss when determining its net income, this loss should not be included in the taxable income of the South African resident due to the requirements contained in section 9D(2A)(b). These losses are instead carried forward to the next year and set off against the imputable net income of that CFC.

7 Where interest is derived by a CFC from another CFC that forms part of the same group of companies as the first mentioned CFC, will the interest be included or excluded from the determination of both CFC’s “net income”.

In terms of section 9D(2A)(c) and section 9D(9)(fA) the interest in the one will not be included in its net income provided the other CFC does not obtain the corresponding deduction. Where the resident shareholder has elected section 9D(12), which is that, the requirements of section 9D(9) will not apply,
as no income is imputed into the on CFCs income and therefore the corresponding deduction will too not be allowed by the other CFC.

8 Will the “net income” of a CFC as determined in terms of section 9D of the Income Tax Act be remitted to South Africa as a result of currency or other restrictions imposed in terms of the law of the relevant foreign country, and will the “net income” be required to be imputed to the South African resident holding participation rights in that CFC.

As the foreign company is a CFC this requires imputation into the taxable income however, in terms of section 9D which relates to blocked foreign funds, it allows that this income be allowed as a deduction in the year that the funds cannot be remitted to the resident shareholder and then included in the taxable income in the following year of assessment.

9 Where all the “net income” is attributable to a “business establishment” of that CFC in a foreign country will the resident shareholder be required to impute the net income?

Where a CFC meets the definition of a foreign business establishment the net income will not be imputed into the resident shareholder’s taxable income, provided that none of the diversionary transactions apply. Where transactions are taking place between the CFC and a connected person in relation to the resident shareholder, these transactions result in the foreign business establishment exemption no longer applying.

10 If income is earned by a CFC from the sales of goods to a South African connected person in relation to that CFC will the net income earned by the CFC still be required to be imputed into the resident shareholder’s taxable income?

Where a CFC meets the definition of a foreign business establishment, an exemption in terms of section 9D(9) will apply, however, where certain transactions take place i.e. where the CFC earns income from the sale of goods
to a South African connected person, the exemption will not apply. However, where the sales are made to connected South African resident but:

- Where the goods are originally purchased by the CFC within its country of residence and they are not connected
- Where the creation, extraction, production, assembly, repair or improvement undertaken by the CFC amount to more than a minor assembly, adjustment or packaging
- Where the CFC sells a significant amount of goods of a similar nature to unconnected persons in relation to the sales made to connected persons, the transactions need to be at comparable prices.
- Where the CFC purchases the same or similar products mainly within the country of residence of that CFC from unconnected persons. (s9D(9)(b)(ii)(aa)).

**Example 2**

A South African held group of companies involved in the sale and manufacture of swimming pool cleaning equipment and products, the holding company Creepy Ltd is listed on the Johannesburg Stock Exchange (JSE) and owns shares in the following companies:

- **100% of the shares in Sparkling Ltd**, incorporated in Mauritius. Sparkling Ltd has only one employee and does market research for the group and receives an arm’s length fee of R 25,000 per month from Creepy Ltd, Crawley Ltd, Tax Free LLC and Desert Ltd (see below). Every morning, this employee receives detailed instructions as to what to do that day via e-mail from the marketing director of Creepy Ltd.
- **100% of the shares in Crawley Ltd**, incorporated and effectively managed in the UK. Crawley purchases swimming pool cleaning equipment and products from Creepy Ltd and sells it into the UK market to independent third party customers.
50% of the shares in Advertising-R-Us Ltd, incorporated and effectively managed in the Isle of Man and responsible for marketing Crawley Ltd’s products in the UK. Advertising-R-Us receives a marketing fee of R 50,000 per annum from Crawley Ltd which is determined by taking into account the management team and employees of Advertising-R-Us as well as the rental of their premises and other related overheads, plus a margin of 5%. This fee is an arm’s length fee. Star Pools (Pty) Ltd resident but an unconnected person in relation to any of the companies in the Group, owns 5% of Advertising-R-Us Ltd.

Crawley Ltd in turn owns 100% of the shares in two Dubai companies, Desert LLC and Tax Free LLC. Neither of the Dubai companies pays any tax. Desert LLC has 10 employees including a management team, who work from premises in Dubai. Desert LLC has two divisions, namely a division that distributes swimming pool cleaning equipment and products (“the sales division”) and a division that actually cleans pools (“the cleaning division”).

Tax Free LLC builds swimming pools. The actual building work is subcontracted to an unconnected construction company. Tax Free LLC only has a part time manager who is responsible for the managing the company.

At a board meeting, the board decides to sell the cleaning division currently in Desert LLC as a going concern to Tax Free LLC as it will be easier to secure contracts for the cleaning of pools immediately after the company has finished building a pool. The assets in the cleaning division consist of fixed assets, goodwill relating to the cleaning division, debtors and stock and will be sold at market value (US$ 3 million) on loan account. None of the employees of the cleaning division will be transferred to Tax Free LLC as this is difficult under Dubai legislation. Tax Free LLC will enter into a shared resource agreement with Desert LLC in relation to these employees (which include managerial staff).

Immediately following the sale, Desert LLC will distribute the loan account as a dividend in specie to Crawley Ltd.
The group structure can be summarized as follows:

- **Creepy Ltd (SA)**
  - **Sparkling Ltd (Mauritius)**
  - **Crawley Ltd (UK)**
  - **Advertising R Us Ltd (Isle of Man)**
    - **Desert LLC**
    - **Tax Free LLC**

The tax consequences of the above group of companies in terms of section 9D are described below:

**Solution:**

- A resident is defined as any company incorporated in South Africa or with its place of effective management in South Africa. (section 1 of the Income Tax Act no 58 of 1962)

- The Act does not define what is meant by effective management but SARS, in Interpretation Note 6 distinguishes it from shareholder control or control by the board of directors and interprets it to mean the place where executive directors and senior management execute and implement the policy and strategic decisions made by the board and make an implement day-to-day management and business decisions. (Lexis Nexis. 2009:824)

- The resident status of the companies in the Creepy Group can therefore be summarised as follows:
  - Creepy Ltd is listed on the JSE, i.e. incorporated in SA and therefore is a SA resident
Sparkling Ltd has only one employee and it appears no management. The employee of Sparkling receives instructions from the SA based marketing director and is therefore effectively managed from SA. Despite being incorporated in Mauritius, Sparkling Ltd is therefore a SA resident.

Crawley Ltd is incorporated and effectively managed in the UK and is therefore not a SA resident for tax purposes.

Advertising R Us is incorporated and effectively managed in the Isle of Man and is therefore not tax resident in SA.

Both Desert LLC and Tax Free LLC are incorporated and effectively managed in Dubai and are therefore both non-residents for SA tax purposes.

**SA Tax implications of Creepy Ltd in terms of section 9D**

- The gross income definition in section 1 of the Act defines gross income in relation to a resident as the total amount, in cash or otherwise, not of a capital nature, received by or accrued to or in favour of a person during a year of assessment. (58/1962) Creepy Ltd will therefore be subject to tax on its worldwide income, including the revenue derived from the sale of pool equipment and cleaning products.

- In addition, section 9D(1) of the Income Tax Act defines a CFC as any company which is not a resident where more than 50% of the total participation rights in the 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. (58/1962)

- Participation rights are in turn defined in section 9D(1) to mean the right to participate directly or indirectly in the share capital, share premium, current or accumulated reserves of a company, whether of a capital nature or not.(58/1962)

- Based on these definitions, Crawley Ltd and Dessert LLC and Tax Free LLC are clearly CFC’s as Creepy Ltd directly owns 100% in Crawley Ltd and 100% indirectly in Dessert LLC and Tax Free LLC.
- Advertising –R-US is also a CFC as defined as residents (Creepy Ltd and Star Pools (Pty) Ltd) owns 55% of the share capital in Advertising-R-U.
- In terms of section 9D(2), the net income of a CFC for its foreign tax year has to be imputed into the income of the resident holding the participation rights, in the ratio of its participation rights. (58/1962)
- Section 9D(2A) determines that the net income to be imputed is the net income for the CFC’s foreign tax year determined as if the CFC is a taxpayer and for certain specific provisions of the Act which are not currently relevant, a resident. The proviso to section 9D(2A) states that the net income of CFC in respect of the foreign tax year is deemed to be Rnil where aggregate amount of tax payable to all spheres of government of any country other than RSA on the net income of that CFC in respect of that foreign tax year >= 75% of normal tax that CFC would have paid had it been a resident for that foreign tax year. The aggregate amount of tax payable must be determined after taking into account the provisions of the relevant DTA and any other rebate/recovery of tax, and disregarding assessed losses brought forward. (Proviso to s9D(2A)) (58/1962)
- However, section 9D(9) provides certain exemptions from imputation. Section 9D(9)(b) exempts from imputation any amount attributable to a foreign business establishment (“FBE”) of that CFC, subject to certain exclusions. (58/1962)
- A FBE is defined in section 9D(1) as a fixed place of business located in a country other than RSA that is used or will continue to be used for carrying on the business of that CFC for a period of not less than one year, where
  - Business conducted through one or more offices, shops, factories, warehouses or other structures
  - Place of business is suitably staffed with on-site managerial and operational employees of that CFC who conduct the primary operations of that business;
  - Place of business is suitably equipped for such purposes; and
  - Place of business has proper facilities for such purposes; and
o Place of business is located o/side SA solely/mainly for purposes other than postponement of any tax imposed by any sphere of government in RSA; (58/1962)

o In addition, for purposes of determining whether there is a fixed place of business, a CFC may take into account the first four bullets above of any other company:

- If another company is subject to tax in a country in which the fixed place of business of the CFC is located by virtue of the residents place of effective management or other criteria of a similar nature;

- If the company forms part of the same group of company’s as the CFC, and

- To the extent that the structures, employees, equipment and facilities are located in the same country as the fixed place of business of the CFC. (58/1962)

Based on the facts provided, it is clear that Crawley Ltd, Desert LLC and Advertising-R-Us each has a foreign business establishment as defined. Tax Free LLC does not have a foreign business establishment refer to comments under Tax Free below.

Crawley Ltd

- The income received by Crawley Ltd from the sale of swimming pool equipment and products is attributable to its foreign business establishment (“FBE”).

- However, the exclusions from the so-called FBE exemption has to be considered to determine whether these amounts should be imputed into the income of Creepy Ltd or not. These exclusions are referred to as diversionary transactions. (This is discussed in Chapter 3)

- One of the diversionary transaction rules apply when the CFC derives amounts from the sale of goods originally acquired from a connected person who is a resident (section 9D(9)(b)(ii)(bb)) and could therefore potentially apply to Crawley Ltd as the company purchases its product from Creepy Ltd, which is
a connected resident, being part of the same group of companies as Crawley Ltd.

- The diversionary rule will however not apply if the CFC sells the products so acquired to customers who are not connected persons in relation to that CFC for physical delivery to customer’s premises situated within the country of residence of that CFC.

- Therefore, as the products are sold by Crawley Ltd are sold into the UK market to independent third parties, the income received will be exempt from imputation.

- In addition to the revenue from the sale of products into the UK market, Crawley Ltd has also received a dividend amounting to $ 3 million from Desert LLC. This dividend will be exempt in terms of section 10(1)(k)(ii)(dd) as Crawley Ltd owns more than 20% of the equity shares in Desert LLC.

- The 75% rule could also be applied in this case in order to determine whether imputation is required in terms of section 9D.

Conclusion: None of the income earned by Crawley Ltd will be taxed in Creepy Ltd’s hands in terms of section 9D.

**Desert LLC**

- The income from Desert LLC from the sale of swimming pool equipment and cleaning products as well as the cleaning of pools is attributable to its business establishment and will therefore not be imputed in the hands of Creepy Ltd.

- The sale of the business will also be exempt in terms of section 9D(9)(b) which excludes from imputation in SA any amount attributable to any foreign business establishment, including the disposal or deemed disposal of any assets forming part of that foreign business establishment. The intangible asset exemption is contained in section 9D(9)(b)(iii)(cc). The exemption does not apply to amounts which arise from the disposal or deemed disposal of any intangible assets (as defined in paragraph 16(2) of the Eighth Schedule) such as goodwill unless:

  - The intangible asset formed and integral part of any business conducted by the CFC, which is the case; and
- the assets was so disposed of as part of the disposal of that business and where all the assets which are necessary for carrying on that business is disposed of as a going concern, which again, is the case

- The declaration of the loan resulting from the sale of the business as a dividend in specie is also the disposal of an asset. Arguably the base cost of the loan and the proceeds (deemed to be market value) are the same and no capital gain will result.

Conclusion: None of the income earned by Dessert LLC will be taxed in Creepy Ltd’s hands in terms of section 9D.

**Tax Free LLC**

- Since Tax Free LLC does not have a FBE as defined, and none of the other exemptions provided for in section 9D will apply, all the income earned by Tax Free will be imputed into the hands of Creepy Ltd.

- Since Tax Free LLC does not pay tax in Dubai, there will be no tax credit resulting from the imputation and in addition, the shared business establishment provisions contained in the definition of a FBE will not apply as Tax Free is not subject to any tax in Dubai. If for example, Tax Free LLC and Desert LLC were situated in another country with the same business processes being followed and that country was subject to tax, the shared foreign business establishment provision would probably have applied which would have resulted in no imputation.

- The net income of Tax Free LLC will therefore be imputed into the income of Creepy Ltd. Having said this, the proviso to section 9D(2A) may apply depending on whether the income of tax free was subject to tax in the UK in terms of the UK CFC legislation since Tax Free LLC will be a CFC in relation to Crawley Ltd (the proviso to section 9D(2A) states that the net income of CFC in respect of the foreign tax year is deemed to be Rnil where the aggregate amount of tax payable to all spheres of government of any country other than RSA on the net income of that CFC in respect of that foreign tax year >= 75% of normal tax that CFC would have paid had it been a resident for that foreign tax year.). There is not enough information in the facts to reach a conclusion on this matter.
• The shared resource agreement will fall within the scope of section 31 as section 9D(2A)(i) includes in the scope of section 31 any transactions between a CFC and a connected person in relation to the CFC. The services fee will therefore have to be tested against the arm’s length principle.

**Advertising-R-Us**

• It is clear that the fee for marketing is attributable to Advertising-R-Us’ FBE.

• Conclusion: None of the income earned by Advertising-R-Us will be taxed in Creepy Ltd’s hands in terms of section 9D.
9 List of sources

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