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AN INTERNATIONAL COMPARISON – TAX IMPLICATION OF A CONTROLLED FOREIGN COMPANY CEASED TO BE CONTROLLED IN SOUTH AFRICA

by

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ABSTRACT

AN INTERNATIONAL COMPARISON – TAX IMPLICATION OF A CONTROLLED FOREIGN COMPANY CEASED TO BE CONTROLLED IN SOUTH AFRICA

by

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As a result of globalisation there are endless business opportunities out there in the business world. South African tax residents may purchase shares in a foreign company as an investment which can lead to that company being effectively controlled in South Africa for South African tax purposes. When a controlled foreign company ceases to be a controlled by South African tax residents it is deemed to have disposed of its assets the day immediately before this event and certain exit tax charges should considered.

Sound tax policies are crucial to ensure stability in any tax system. Tax legislation may be amended from time to time in order to ensure this stability in the South African tax system. No research has been done on the practical implication of current amendments to legislation affecting a controlled foreign company when it ceases to be controlled in South Africa as a direct result of the issuing of new equity shares by the controlled foreign company to foreign investors.

The aim of this study was to discuss the current amendments to tax legislation affecting controlled foreign companies as well as the practical issues experienced by controlled foreign companies and South African tax residents. Furthermore, the study aims to demonstrate whether South Africa's tax legislation is in line with the international norm by comparing the literature reviewed, the results of case study and information gathered through interviews to the United Kingdom's tax legislation.

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Keywords: controlled foreign company; tax residents; exit tax charge; tax policies; disposal; equity shares

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ABSTRAKT

‘N INTERNASIONALE VERGELYKING – BELASTINGIMPLIKASIE VAN ‘N BEHEERDE BUITELANDSE MAATSKAPPY WAT OPGEHOU HET OM BEHEER TE WORD IN SUID-AFRIKA

deur

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GRAAD : MAGISTER COMERCII

Globalisering veroorsaak dat daar tans verskeie goeie besigheidsgeleenthede in die sakewêreld is. Suid-Afrikaanse belasting inwoners kan aandele in ‘n buitelandse maatskappy as ‘n belegging en dit kan veroorsaak dat die buitelandse maatskappy effektief in Suid-Afrika beheer word vir Suid-Afrikaanse belasting doeleindes. Wanneer ‘n beheerde buitelandse maatskappy ophou om beheer te word deur Suid-Afrikaanse belasting inwoners word daar geag dat die maatskappy oor sy bates beskik op die dag onmiddelik voor hierdie gebeurtenis en sekere belasting implikasies moet oorweeg word.

‘n Omvattende belasting beleid is belangrik om stabilitiet te verseker in enige belasting sisteem. Belasting wetgewing word gewysig van tyd tot tyd om stabiliteit in die Suid-Afrikaanse belasting sisteem te veseker. Geen navorsing is voorheen gedoen oor die praktiese implikasie van die huidige wysigings aan wetgewing wat ‘n beheerde buitelandse maatskappy beinvloed wanneer die maatskappy ophou om beheer te word in Suid-Afrika as gevolg van die uitreiking van nuwe ekwiteitsaandele aan buitelandse beleggers nie.

.

Die doel van die navorsing was om die huidige wysigings aan belasting wetgewing wat beheerde buitelandse maatskappye beinvloed asook Suid-Afrikaanse belasting inwoners te bespreek. Verder beoog die studie om te bewys of Suid-Afika se belasting wetgewing wel ooreenstem met die internasionale standard deur die literatuur hersien, die resultate

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van die gevallestudie en inligting versamel deur onderhoude te vergelyk met die Verenigde Koningkryk se belasting wetgewing.

Sleutelwoorde: beheerde buitelandse maatskappy; belasting inwoners; verlaat belastingkoste; belasting beleid; beskikking; ekwiteitsaandele

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CHAPTER 1

INTRODUCTION

1.1 BACKGROUND

Gone are the days when it was strange to hear of people or companies deciding to pack their bags, draw a line under their stay in South Africa and move to a different country to start afresh. When a person decides to do this and change his/her residency, or cease to be resident in South Africa, there may be certain tax implications. For example, when a South African resident emigrates to the United Kingdom (UK), there is a possibility that he will have to pay an exit tax charge on some of his capital assets. The same principle applies to foreign companies that are controlled in South Africa. When these foreign companies cease to be controlled in South Africa for tax purposes, the possibility of exit tax charges arises.

With a growing trend of cross-border transactions in the business world today, countries, including South Africa, “have been prompted to enact specific anti-tax avoidance legislation to reduce the risk of losing domestic tax revenue from international investment. This legislation includes ‘controlled foreign company’ (CFC) legislation.” (Oguttu, 2008:347). Mintz and Weichenreider (2012:735) argue that domestic CFC legislation will protect both local as well as foreign countries’ corporate tax base.

In a recent supreme court of appeal (SCA) court case, the *Commissioner for the South African Revenue Service v Tradehold Ltd* (132/11) [2012] ZASCA 61, the South African Revenue Service (SARS) lost on technical grounds on appeal to the SCA. This had the effect that the *fiscus* and SARS lost out on receiving domestic tax revenue when Tradehold Ltd (Tradehold) ceased to be a tax resident in South Africa. This resulted in

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SARS scrutinising section 9H of the Income Tax Act No 58 of 1962 (the ITA). National Treasury afterwards amended section 9H of the ITA to bring stability back to the South African tax system and to align the exit charge legislation that South Africa applies with international norms when an individual, company or CFC cease to be a tax resident for South African tax purposes (National Treasury, 2012a:110).

Section 9H of the ITA first came into operation on 1 April 2012 and had the effect of providing for a single tax exit charge when a person*, inter alia,* ceases to be a tax resident of South Africa. Resulting from this, a person will either have a capital gain or ordinary income that realises with no deemed dividend charge (National Treasury 2011:118). Prior to the amendments, a CFC losing its CFC status in relation to South African tax residents was excluded from the provisions of section 9H of the ITA. Section 9H of the ITA has since been extended and now includes a CFC losing its CFC status in relation to tax residents of South Africa (Louw, 2012:3).

Section 9H(5) of the ITA states, *inter alia*, that section 9H will not apply if a person disposes of equity shares in a foreign company that is a CFC, if the capital gain/loss on disposal is disregarded in terms of paragraph 64B of the Eighth Schedule to the ITA, and the CFC will cease to be a CFC in South Africa as a direct result of the disposal. The exemption from capital gains tax (CGT) when a person disposes of foreign equity shares in the foreign company, "…will only be available when the disposal is made to an independent foreign person…". The intention is that the exemption will not apply when shares are received as consideration (Linington, 2012).

The issue of shares are not specifically mentioned as a disposal event for CGT purposes, however, this is covered under the definition of a value shifting arrangement. Paragraph 11(g) of the Eighth Schedule to ITA provides for a disposal event when a person's interest in, *inter alia,* a company decreases as a result of a value shifting arrangement. It should be noted that from 1 January 2014, any reference to a company when referring to a value shifting arrangement, will be removed. If applicable, this may lead to the exemption under paragraph 64B of the Eighth Schedule to the ITA not applying when a CFC issues new shares to foreign investors, as this will not be seen as a value shifting arrangement

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anymore and the issue of shares is not specifically seed as a disposal for capital gains purposes.

Furthermore, as a direct result of what was just mentioned, the exemption under section 9H of the ITA, read with paragraph 64B of the Eighth Schedule to the ITA, will not apply to the CFC ceasing to be controlled in South Africa as there was not actual disposal. This may result in a CFC being liable to pay a single tax exit charge when it ceases to be a CFC for South African tax purposes as a result of issuing new shares to foreign investors.

An in-depth search of academic platforms, including Infotrac, EBSCOHost, Google Scholar and SA e-publications revealed that no recent studies have been done on the possible practical issues that may arise from the application of the amended section 9H of the ITA. Articles researched for the purpose of this study have addressed several aspects regarding practical issues experienced with tax amendments in general and will form part of this research study. These include that the retrospective application of tax legislation may be unconstitutional (Minnaar, 2012; Dachs, 2013), that the taxpayer is sometimes in the dark as SARS provides no guidance regarding the amended legislation (Kruger, 2012:18) and that legislators often overlook key issues when drafting tax amendments, which results in further amendments later on (Warneke, 2012).

1.2 PROBLEM STATEMENT

SARS implements amendments to sections of tax legislation to ensure stability in the South African tax system and to ensure that they do not lose any domestic tax revenue when taxpayers plan and implement international business transactions. However, the practical implementation of these amendments are not always as smooth and business friendly as, one would assume, the legislator would like it to be or intended it to be.

Practical issues, which may never have been the intention of the legislator at the time of drafting the amendments, have surfaced with amendments to tax legislation. With regard to the specifics as discussed in the background to this document, issues include the effect retrospective implementation of amendments to tax legislation has on taxpayers. Consideration also needs to be given as to whether this retrospective implementation is

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constitutional or not. Furthermore, as a result of the different effective dates it is difficult to ensure that you read the correct amendments, which complicates tax legislation.

Finally, legislators often overlook key issues when drafting tax amendments, which results in further amendments later on that makes tax planning very difficult and confusing.

1.3 PURPOSE STATEMENT

The main purpose of this paper will be to study the administrative burdens, as well as any technical, practical and tax implications of importance on a CFC ceasing to be a tax resident in South Africa. This study aims to determine the intention of current tax legislation with regard to a CFC ceasing to be a CFC for South African tax purposes. The study will specifically look at instances where a CFC loses its CFC status in South Africa as a result of the issue of more shares to foreign shareholders. The study will include a comparison of the findings to UK CFC legislation to determine if South Africa's treatment is in line with international norms.

Furthermore, to accurately determine the current practical issues and the effect this has on affected parties, this research paper will include a case study of a practical example, in order to accurately conclude on some of the current practical issues and the current tax implications of these issues.

1.4 RESEARCH OBJECTIVES

The study will be guided by the following specific research objectives:

- To determine whether the current amendments to the tax legislation dealing with a CFC ceasing to be a CFC, achieved the recommended objectives by National Treasury.
- To analyse the practical implications of the amendments to the tax legislation dealing with a CFC ceasing to be a CFC.
- To analyse whether the tax treatment, as identified above, is indeed in line with international norms by comparing it to UK tax treatment of the same technical issue.

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1.5 IMPORTANCE AND BENEFITS OF THE PROPOSED STUDY

Theoretically, the research paper will assist in understanding the current legislation when a CFC ceases to be a CFC in South Africa as a result of issuing new shares to foreign shareholders. This research paper will also aim to identify the amendments in applicable legislation, what the reasons were behind these amendments and whether the intended objectives for these amendments were reached. Finally, this study will make a contribution to the current body of knowledge for tax treatment of CFC's ceasing to be CFC's, by comparing South African tax legislation to UK tax legislation.

From a practical point of view, this study could possibly aid SARS to eliminate the current practical issues identified in the case study. By looking at other countries, for this study's purpose the UK, SARS can possibly learn from or use similar approaches to the identified issues as applied in the UK.

1.6 DELIMITATIONS AND ASSUMPTIONS

1.6.1 Delimitations

The research study has several delimitations relating to the context, constructs and theoretical perspectives of the study. Firstly, the study will focus on exit tax charges only with relation to a CFC ceasing to be a CFC in South Africa. Other possible issues when ceasing residency, for example exchange control requirements, will not be discussed in detail but will be mentioned, where applicable, to provide background.

Secondly, the research study will focus on the current practical issues and not any past practical issues. Current and prior legislation may be compared to outline any differences, but any previous practical issues will not be discussed in detail, although it may be mentioned as a comparative measurement.
Finally, the research study will only focus on documentation from a taxation point of view. The legal side of a CFC ceasing to be a CFC in South Africa will not be looked at, however, where applicable, such issues will be consulted and form part of the study only to the extent that it has an effect on the taxation issue.

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1.6.2 Assumptions

This research study will be conducted on the basis that certain assumptions are made about tax legislation, about the organisation(s) identified for the case study and about all the individual research subjects that will participate in this research study.

Firstly, the research study assumes that tax legislation, especially CFC tax legislation, will affect all parties involved in this research study. It is assumed that all the identified research subjects will be able to provide data to the researcher with relation to CFC legislation in South Africa.

The second assumption is that the tax legislation applicable to this research study will remain the same for the duration of this research study. In the event that the legislation should change, the research study will be completed on the assumption that the legislation remained unchanged for the duration of the study. Any tax legislation changes effective in any taxation laws amendment bill after the Taxation Laws Amendment Bill, No 22 of 2012, will not influence this study.

The third assumption is that the organisations(s) identified to partake in the case study, will continue to do business the way it is currently conducted. Should there be a major restructuring, the research study will be completed based on the current way the organisation(s) is structured and conducts its business.

The fourth assumption is that any external factors will not influence the responses provided by the individual research subjects to this study. These will include economic, political and social factors. The study will assume that individual responses will remain constant and will not be affected by any of these external factors; therefore, the responses will remain subjective and based on the research subjects' practical experiences.

The final assumption is that the interaction between the researcher and the research subject is of paramount importance in order to accurately capture the current experience of the research subject. It will be assumed that neither one of the parties involved will be able

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to influence the other in any specific way and will remain objective throughout the process of being engaged with each other.

1.7 DEFINITION OF KEY TERMS

This study involves a number of key concepts, namely *controlled foreign company, disposal, equity share, exit tax charge, resident, tax policies, tax resident, value shifting arrangement*. The key terms as mentioned above for the purpose of this study, are defined below.

Controlled foreign company: For the purpose of this study a controlled foreign company means a foreign company incorporated in a country other than South Africa, but which is effectively controlled in South Africa. For a foreign company to qualify as a controlled foreign company in South Africa, more than 50% of the shares should be owned by South African tax residents.

Disposal: A disposal event is defined in paragraph 1 of the Eighth Schedule to the ITA and will include any event, act, forbearance or operation of law, as envisaged in paragraph 11 of the Eighth Schedule to the ITA. Furthermore, events embodied in paragraph 12 of the Eight Schedule to the ITA will also be deemed to be a disposal event for capital gains purposes and the provisions of the Eighth Schedule will duly apply to such events as well.

Equity share: An equity share is defined in section 1 of the ITA and "means any share in a company, excluding any share that, neither as respects dividends nor as respects returns of capital, carries any right to participate beyond a specified amount in a distribution"

Exit tax charge: Exit tax charge is normally the tax liability that will arise whenever a South African tax resident ceases to be a South African tax resident by virtue of some sort of event that will cause the resident to cease its tax residency in South Africa. For the purpose of this study an exit tax charge will mean the tax chargeable when a CFC ceases to be a CFC for South African tax purposes by virtue of a deemed disposal of its assets.

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Resident: In terms of section 1 of the ITA a resident is a "person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic, but does not include any person who is deemed to be exclusively a resident of another country for purposes of the application of any agreement entered into between the governments of the Republic and that other country for the avoidance of double taxation."

Tax policies: A tax policy is defined as "a policy that dictates where tax burdens shall lie. Politicians dictate the type of tax structure they wish to implement, hopefully keeping in mind how their policies and laws will affect the individual and businesses" (Business online dictionary, not dated).

Tax resident: For the purpose of this study a tax resident will be a person who is liable to pay tax in the country the person is seen as a resident as defined above.

Value shifting arrangement: Paragraph 1 of the Eighth Schedule to the Act describes this as "an arrangement by which a person retains an interest in a company, trust or partnership, but following a change in the rights or entitlements of the interests in that company, trust or partnership (other than as a result of a disposal at market value as determined before the application of paragraph 38), the market value of the interest of that person decreases and—

(a) the value of the interest of a connected person in relation to that person held directly or indirectly in that company, trust or partnership increases; or

(b) a connected person in relation to that person acquires a direct or indirect interest in that company, trust or partnership."

The most important abbreviations used in this document are outlined in Table 1 below:

Table 1: Abbreviations used in this document

Abbreviation	Meaning
BEPS	Base Erosion and Profit Shifting
CFC	Controlled Foreign Company
DTA	Double Tax Agreement

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HMCR	Her Majesty's Customs and Revenue
ITA	Income Tax Act
NDP	National Development Plan
OECD	Organisation for Economic Co-operation and Development
SARS	South African Revenue Service
SCA	Supreme Court of Appeal
SSE	Substantial Shareholders Exemption
TAA	Tax Administration Act
TRC	Tax Review Committee
UK	United Kingdom

1.8 RESEARCH DESIGN AND METHODS

1.8.1 Research paradigm

There are several research paradigms out there in the research world, but the specific research paradigm that will guide and direct my study is constructivism, also sometimes refer to as interpretivism (Ponterotto, 2005:128). An important and distinguishing characteristic of this paradigm is the level of interaction between the researcher and the object for the research. It is believed that only through this interaction can any deeper meaning and sense be made of the issue being researched (Ponterotto, 2005:129).

The reason for basing this research study on the research paradigm constructivism is an important consideration for this research study. Due to the nature of tax amendments and the frequency in which it occurs, detailed conversations and/or interviews needs to be conducted with affected parties to understand their side of the argument. It will only be through this process of interviewing and understanding the issues of an affected party that one will realise the exact effect a specific amendment has on this party.

1.8.2 Strategy of inquiry

CFC legislation are used in a number of countries to prevent erosion of the domestic tax base and to discourage residents to from moving its income to tax jurisdictions that do not

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impose tax or tat impose tax but at lower rates (Deloitte, 2012:2). CFC legislation is a very technical part of tax legislation and companies must ensure that the advice they receive from tax specialists, in house, or from a financial services company is sound and can be relied on. Consultants without sufficient practical and technical experience can provide misleading advice which could lead to further legal action against a company, which is something all companies want to avoid at all costs (Ryan, 2009).

Given the technicalities and level of expertise required when dealing with CFC legislation, and for the purpose of this study, the ceasing of residency for South African tax purposes of a CFC, a qualitative strategy of inquiry will be used for this study. This approach is further supported by Berg in O'Neil (2013) who mentions that qualitative methods of research are used when addressing research questions that require detailed explanation and/or understanding of social phenomenon and its specific context. More often than not this involves highly detailed descriptions of occurrences.

This research study strives to determine the practical effect tax amendments to legislation have on taxpayers. More specific this study will aim to provide more guidance as to whether the amendments to legislation dealing with CFC's ceasing to be a CFC in South Africa achieved the desired objectives as set out by National Treasury and to analyse the practical implications these changes has on CFC's ceasing to be a CFC in South Africa. Merriam (1998:20) is of the view that in qualitative research, the researcher is the main instrument when it comes to collecting, analyzing and interpreting the data and, therefore, is in the ideal position to create opportunities to collect more data and to provide meaningful interpretations for the data collected. As a result of the discussion above, the qualitative research method will be the ideal approach in order to achieve the desired results for this study.

By conducting semi-structured interviews with certain tax specialists, data will be collected and interpreted to conclude on the specific research objectives as set out in section 1.4 of this research study. A practical case study will also be conducted to further demonstrate the current issues experienced by taxpayers. The case study will also be used as a tool to compare the South African tax legislation with UK tax legislation.

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Case studies are a qualitative research approach that is defined by Robson in Saunders, Lewis and Thornhill (2009:145) as "a strategy for doing research which involves an empirical investigation of a particular contemporary phenomenon within its real life context using multiple sources of evidence." The interviews that will be conducted will add to the researcher's understanding as to why, in theory, these amendments were made and what the theoretical objectives were and whether in these objectives were reached in practice.

In a case study the data collection techniques may be a combination of interviews, observations and questioners. By conducting a well organised case study existing theories and interpretations can be challenged and it will also be a valid source to provide new research questions (Saunders *et al.,* 2009:146-147). As an example of this, the findings of this study may challenge certain theories SARS has on the implementation of tax amendments in a retrospective manner and it can also provide new research questions to be explored by other research studies.

1.8.3 Research design

In performing the international comparison of the tax implications when a CFC ceases to be controlled in South Africa, research will be done to determine the reasons as to why amendments was made to tax legislation affecting a CFC when ceasing to be controlled in South Africa. The practical implications of these changes will also be looked at and possible administrative burdens this places on the taxpayer will also be discussed.

In conducting this research Taxation Laws Amendment Bills, explanatory memorandums to these Bills, applicable court cases as well as articles written by specialists in the taxation world will form part of the literature reviewed for this purpose. Apart from reviewing the literature applicable to this specific phenomenon when a CFC ceases to be a CFC, a case study and semi-structured interviews will also be conducted to gather primary data to be used especially for the purpose of this research study. As this research will involve the collection of primary data by virtue of semi-structured interviews as well as a case study this will be an empirical study

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In reviewing the applicable literature, the objectives for these changes will be identified. Forming part of this research study, a discussion whether these objectives are being reached will also be provided. Furthermore, current practical issues experienced by taxpayers will be discussed and will form part of the case study to demonstrate the effect of these changes to legislation. Ultimately the case study will be used to determine whether the South African CFC legislation is indeed in line with the international norm by comparing the findings to UK CFC legislation.

1.9 OVERVIEW OF THE CHAPTERS

Taxation plays an important role in the existence of any government. Therefore, it is important to understand the role taxation plays and to what extent international tax legislation is used to protect the tax base of a country. Reasons for taxation and the importance of international taxation are discussed in Chapter Two. Specific consideration is given to CFC legislation and the role it plays in the South African tax policy framework.

In order to protect the tax base of a country, tax policies need to be in place whenever a tax resident exits the tax net of a specific country. The application of general exit tax charges is discussed in Chapter Three with a specific view at the exit tax charges when a CFC ceases to be a tax resident in South Africa. A look at the circumstances that resulted in section 9H of the ITA being amended will also be discussed in Chapter Three. Chapter Four provides a discussion on the practical application of the new section 9H of the ITA and the practical issues experienced by taxpayers with regard to these changes will also be discussed.

As this study will compare South African and UK CFC legislation, Chapter Five will provide a high level discussion of the UK CFC legislation. This will be done in order to compare the South African tax legislation when a CFC ceases to be controlled in South Africa with the UK tax legislation when a CFC ceases to be controlled in the UK in Chapter Six.

Chapter Six provides a practical example and a discussion of the current issues experienced by taxpayers, in the form of a case study. The case study will also be applied to UK CFC legislation. This is very important to see how the theory of tax legislation

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compares to the practical application of tax legislation. Furthermore, this will be done to identify similarities and/or differences between the South African and UK tax systems to determine whether South Africa is indeed in line with the international norm when it comes to the discussed tax legislation

Lastly, as a result of the issues identified in the research study, a conclusion will be provided in Chapter Seven to discuss possible recommendations on the treatment of CFC's ceasing to be controlled in South Africa.

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CHAPTER 2

REASON FOR TAXATION

2.1 INTRODUCTION

Why is there something like taxation? What is the whole reason behind this very controversial yet essential term? For the majority of people, taxation is probably a confusing term that sounds easy in concept, but is not always as simple in practice. The online business dictionary (not dated) defines taxation as “a means by which governments finance their expenditure by imposing charges on citizens and corporate entities”. Cooley (in Law Giants, 2010) adds some body to this definition by defining taxation as “the process or means by which the sovereign, through its law making body, raises income to defray the necessary expenses of government”.

By looking at the definitions above, it seems as though taxation plays a very important role in the existence of any government and it can be argued that the role of taxation is of paramount importance to any government.

2.2 IMPORTANCE OF TAXATION

It has been argued before that it is impossible for a state to run its affairs without money collected by ways of taxation. In fact, the very existence of a government is dependent on funds raised through its tax policies. The existence of any government’s financial operations will be impossible without sound and technically strong tax policies that raise sufficient revenue through taxes paid by the different classes of taxpayers (Law Giants, 2010).

On the other hand, the whole concept behind taxation can also be a very powerful tool to encourage certain types of investments that result in economic growth in a country. Furthermore, local industries may also be protected through specific tax legislation (Law Giants, 2010). This can be done by providing certain incentives in specific pre-determined

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fields, which will result in a tax break for the taxpayer, while on the other hand the taxpayer contributes to the economic development of a country. This can be seen in the current government grant incentives being provided by the Department of Trade and Industry to qualifying taxpayers in South Africa.

Basically the term taxation is the blood in the veins of any government without which no government body can survive. Taxation is of paramount importance to a government in two ways. Firstly, no government will be able to render the services expected from them without the revenue collected through taxes and secondly, it can be used to lure investments that will strengthen the overall state of the economy of the country.

It is sometimes underestimated how important it is for a government to raise sufficient tax revenue in order to fulfil all of its expected duties. Without revenue from tax, the government of any country, including South Africa, will not be able to function and fulfil its duties as is expected by the public. Any government needs to collect taxes from the taxpaying public to fund its various programmes and to provide public goods and services. These public goods and services include schools, universities, hospitals, clinics and roads, as well as defence and security.

Once a year in South Africa, the Minister of Finance will present his/her budget speech, which outlines the total budgeted government expenditure. This government expenditure needs to be financed and that is where tax money plays a crucial part in South Africa's development (SARS, not dated). Furthermore, it is crucial that there is a continuous drive to protect, and if needed, expand the tax base to ensure that taxpayers pay their fair share of taxes and that any loophole that may lead to base erosion is effectively addressed.

It is important for taxpayers to feel that they are contributing to the development of a country, but also not paying unreasonable percentages of its income over to the government. On the other hand, it is also important that people, or large multinational companies, are not allowed to arrange their tax affairs in such a way that it shifts its profit making activities to so-called tax havens or tax jurisdictions with a much lower tax rate than South Africa. The ITA provides certain legal opportunities to do tax planning to find the most tax efficient way to structure your affairs, but the question will always remain how

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ethical it is. For large multinational companies, a wrong move in the eyes of the public can be very damaging to its public image, which in turn can have massive financial implications if shareholders lose trust in a company.

In light of the above, the Minister of Finance, Mr Pravin Gordhan, announced in his 2013/14 budget speech (National Treasury, 2013) that a tax review will be conducted within South Africa by a highly skilled and experienced tax review committee. A tax review within a country normally aims to review the current tax system and to provide recommendations on how to strengthen the tax base of a specific country.

Mr. Gordhan (National Treasury, 2013: 21), mentioned that a "tax review will be initiated this year to assess our tax policy framework and its role in supporting the objectives of inclusive growth, employment, development and fiscal sustainability, amongst other things." It seems clear from the above statement that SARS and the National Treasury intend to ensure that South Africa's tax policy framework is of such a nature that enough revenue is generated by way of tax collection to enable overall growth in South Africa. It also seems that this review of the tax policy framework intends to ensure that all parties pay their fair share of taxes to the South African government and overall provide stability to the tax system in South Africa.

The above views are strengthened by a recent media statement released by the Ministry of Finance. This statement intends to provide more clarity on the tax policy review and the processes that would be followed by the Tax Review Committee (TRC). The main objective of the TRC will be to inquire into the specific role the South African tax system plays in the promotion of*, inter alia,* an inclusive economic growth, employment creation, development and fiscal sustainability. The TRC will need to take into account recent domestic and global developments and, in particular, the long term objectives of the National Development Plan (NDP) (Ministry of Finance, 2013:1).

Based on its review and findings, the TRC will make certain recommendations to the Minister of Finance. As part of its review, the TRC will need to evaluate the South African tax system against trends in the international tax world, the principles and practices, as well as specific recent international incentives that aim to improve tax compliance and

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especially deal with the issue of profit shifting and base erosion (Ministry of Finance, 2013:1-2).

The following tax objectives were identified and need to be considered throughout the review performed by the TRC (Ministry of Finance, 2013:3):

- The primary objective of taxation is to raise revenue to fund government expenditure.
- Social objectives such as building a cohesive and all-inclusive society can be achieved partly through a progressive tax system and by raising sufficient revenue in order to redistribute resources where it is required the most.
- Failures in the society can be corrected by applying taxes on the production and consumption of harmful objects to address the negative impact it has on society, for example pollution or consumption of harmful products.
- A tax system can influence changes to specific behaviours by encouraging certain actions (savings) and by discouraging others (smoking and drinking).
- Taxes and tax incentives are very often used to encourage investments that will help facilitate the economic growth of a country.
- International competitiveness is very important to any country, especially in the current business environment. Although the tax system of a country should not be the main driver to be internationally competitive, it remains an important consideration.

From the objectives above, it seems that the Ministry of Finance wants a tax system that is fair, competitive and used as an effective revenue collection tool. It also seems that the aim is to create a tax system that is internationally competitive, while at the same time it remains constitutionally sound and that the provisions of the ITA should be used to protect the local tax base of South Africa.

It is very important to protect the South African tax base from an international point of view as well, and not just locally. In the modern world, more and more large multinational businesses are opening their doors. This presents exciting opportunities for tax planning, while at the same time placing a massive responsibility on the shoulders of tax advisors to provide sound and ethical tax advice and to not intentionally try and do injustice to the

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South African tax system. For this reason sound international taxation provisions are of paramount importance to any tax system.

2.3 IMPORTANCE OF INTERNATIONAL TAX LEGISLATION

The Organisation for Economic Co-operation and Development (OECD) recognises the importance of international tax legislation in protecting the tax base of countries. The OECD recognises the fact that globalisation in the business world is nothing new and has picked up pace in recent years and currently presents certain new challenges that need to be addressed. In saying this, the OECD recently published an article on base erosion and profit shifting (BEPS) in which it tried to address certain key issues with regard to BEPS. This article on BEPS will be discussed at a later stage in this chapter.

The possibility globalisation provided for the free movement of capital and labour, the shift of manufacturing bases from high-cost to low-cost locations, the gradual removal of trade barriers and technological and telecommunication developments had an important impact on the way cross-border activities take place these days. Over the past few years globalisation has played an important part in boosting trade and increasing foreign direct investments in many countries (OECD, 2013:7). South Africa can also be regarded as a country that greatly benefitted from the globalisation of the business world.

It goes without saying that this globalisation has had an impact on the specific income tax regimes of many countries, which could lead to great uncertainty when large multinational companies do their tax planning. Without proper international tax legislation, there is the possibility that business profits could be taxed in more than one country or maybe even escape the tax net all together. Countries around the world agree on the fact that double taxation should be eliminated and should be achieved on the basis of agreed international rules that are clear, predictable and provides certainty to revenue authorities and businesses considering engaging in cross-border activities. International tax legislation is a key pillar in supporting the growth of the global economy, to provide certainty on the risk of double taxation and to protect the tax base of countries (OECD, 2013:7).

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In many instances, current domestic tax legislation and treaty rules which govern the taxation of cross-border business profits, produce the correct and ethical results and do not give rise to the risk of BEPS. However, over time the current taxation rules have revealed weaknesses that create the risk of BEPS and these weaknesses should be looked at and addressed to ensure certainty on cross-border business transactions, especially with regard to any taxation issues. The issue of BEPS relates to instances where the interaction between different taxation rules lead to either double taxation or taxation that is less than single taxation (OECD, 2013:9-10).

BEPS also relates to instances where multinational companies agree upon arrangements that lead to low or no taxation by shifting its profits away from the tax jurisdictions where the actual activities creating the business profits take place. The cause of concern is not the issue of low or no taxation, but more particularly the issue of separating the taxable income from the actual activities creating the taxable income (OECD, 2013:10). In layman's terms this means that the country in which the business activities take place which results in the income of a company should have preference to tax that income, unless specifically addressed under a tax treaty between two specific countries.

The great cause of concern currently on tax policies is, due to gaps in the interaction of different tax systems, and in some instances because of the application of tax treaties, income from cross-border activities may go untaxed or at best get taxed at an excessively low tax rate (OECD, 2013:10). These concerns of the OECD were emphasised by the surfacing of recent tax avoidance schemes that multinational companies got involved in.

2.3.1 Tax avoidance schemes by multinational companies

Recent stories in the news with regard to Google Limited (Google), Starbucks, Amazon and Apple emphasized the role that tax legislation and more specifically, international tax legislation plays in protecting and upholding the tax base of a specific country. Without sound and solid tax legislation, multinational companies may try and shift its core business activities by way of tax planning to tax havens or tax jurisdictions with lower tax rates, or in some instances, where no tax is payable. Even though this may be considered unethical

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by certain parties, if done within the boundaries of the law, tax planning done in this way can be argued as being legal.

A practical illustration to show the role that international tax legislation plays in protecting the tax base of a country will provide a better understanding of the importance of such legislation. If one considers the recent Google tax avoidance issue that made headlines all over the world during the first few months of 2013, important issues surfaced which need to be closely examined. This Google tax avoidance issue was heard before the Public Accounts Committee (the PAC), chaired by the Rt Hon Margaret Hodge MP, in the UK (Public Accounts Committee, 2013).

The main rate of corporate tax in the UK will apply to a company when the profits of the company exceeds £1 500 000, or when there is no other corporate tax rate applicable to that specific company. The corporate tax rate in the UK for the specific periods under consideration fluctuated between 30% at its highest and 26% at its lowest (KPMG, 2013b).

Google generates a huge part of its profits in the UK. Google's turnover for the period between 2006 and 2011 amounted to a massive amount of $18 billion. However, Google only paid an amount equivalent to $16 million in taxes to the UK government during this specific period under consideration. If one considers the main corporate tax rate, as mentioned above, it is clear that Google only paid tax on a small portion of its turnover to the UK government, even though some parties argued that a large portion of Google's turnover was made through doing business in the UK (Public Accounts Committee, 2013).

It is a well-known fact that a company does not pay tax on its turnover, unless registered in South Africa as a micro business, but on its taxable income. However, with a turnover of $18 billion and with the majority of its business activities in the UK, it is hard to believe that the taxable income of Google could have been so low that it was liable to only pay tax equivalent to $16 million to the UK government. The only way Google could legally manage to not pay its fair share of taxes to the UK revenue authorities, is by shifting its profit making operations out of the UK, which effectively means Google will get taxed in a different tax jurisdiction (Public Accounts Committee, 2013).

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Google argued before the PAC that its current tax arrangements in the UK are defensible and within the ambit of the law. Google's argument was that its actual sales are taking place in Ireland and not in the UK. Matt Brittin defended Google's tax position by saying that all sales to UK clients were done through Ireland. Brittin further emphasised the fact that no Google sales took place in the UK. This was a very important statement as this meant Google did not create a permanent establishment in the UK. According to the DTA between the UK and Ireland, an Irish company would only be subject to UK tax if it earned business profits from UK activities by way of trading in the UK through a permanent establishment (Public Accounts Committee, 2013).

Margaret Hodge made the following statement in the report released by the PAC when providing feedback on the Google tax avoidance issue: "The company's highly contrived tax arrangement has no purpose other than to enable the company to avoid UK corporation tax." It is fair enough for companies to do their tax planning in such a way that they pay as little tax as possible, but if the main aim of transactions is to avoid paying tax in a specific country, questions will be asked by local tax authorities. Companies should be able to provide a sound business reason as to why their tax affairs are structured in a specific way. Avoiding paying tax in a specific country will raise more questions than provide answers (Public Accounts Committee, 2013).

The reputation and public image of companies engaging in these kinds of tax avoidance schemes could suffer greatly. If the normal taxpaying public becomes aware of a company involved in such transactions, it will take a conscious effort by these companies to ensure the normal taxpayer that the company is paying its fair share of taxes to regain the trust of the public. This may further have an adverse effect on the business profits of multinational companies engaging in these schemes.

Confidence in revenue authorities also takes a blow when tax avoidance schemes like these surface, and it is the responsibility of revenue authorities to ensure proper and transparent disclosure of these issues. Revenue authorities also need to take active steps to ensure that situations like this do not happen in the future. This will ensure the protection of a country's tax base and, furthermore, this will ensure that each taxpayer

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pays its fair share of taxes to the government of the country in which the taxpayer earns his profits.

In the report that was released by the PAC, certain recommendations were made to combat these types of arrangements. These recommendations can be very relevant and of great use to other revenue authorities around the world, including SARS. In short, these recommendations include the following:

- Confidence in large multinational companies will only be restored when these companies arrange their tax affairs in such a way that they pay their fair share of taxes to the relevant government authority. It is further recommended that the companies address these tax issues as a matter of urgency.
- Revenue authorities need to be more effective in challenging the artificial corporate structures created by these multinational companies with no other purpose than to avoid tax.
- HMRC and HM Treasury should push for an international commitment to improve tax transparency, including developing specific proposals to improve the quality and credibility of public information about companies' tax affairs, and to use that information to collect the fair share of tax from profits generated in a specific country. This data should include full information from companies based in tax havens.
- Large accountancy firms need to recognise that in the present economic climate the public's view of tax avoidance has changed. Responsible advice should be provided to ensure that corporate arrangements reflect the substance of transactions and operations in the country in which it does most of its business. This will enable their clients to be more transparent about where they make their profits and pay tax (Public Accounts Committee, 2013).

If the UK Government takes these recommendations made by the PAC to heart and act on it, it will strengthen the HMRC and it will simplify the current tax code, which means fewer loopholes for taxpayers to explore. These recommendations will also allow greater transparency, which means that the public will know whether the large multinational companies are paying their fair share of taxes (Public Accounts Committee, 2013). This can be applied by revenue authorities across the world.

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With the modern day and age and the way business is being conducted, large multinational companies are also doing business in South Africa. Issues like the one discussed above should make SARS aware that there are taxpayers that will try anything to pay as little tax as possible. It will be of great benefit to SARS to take these issues, raised by the PAC, to heart and to act on it. The current economic climate in South Africa does not allow for SARS to sit on its laurels and do nothing about taxpayers not paying their fair share of taxes. The economic and political climate in South Africa is at a tipping point and SARS should ensure that they remain transparent and trustworthy to the taxpaying public.

SARS should rather be pro-active and, if applicable, clamp down on tax avoidance schemes used by multinational companies in order to protect the tax base of South Africa. This will ensure that all taxpayers, and for that matter, every person in South Africa, benefit from the profitable businesses being run in South Africa which will create a better view of life for the majority of South African residents. The importance of international tax legislation to protect the tax base of countries were once again emphasised by the recent action plan released by the OECD on BEPS.

2.3.2 OECD's action plan on BEPS

Tax avoidance schemes, as discussed above, can be argued to be a direct result of the recent developments in the way business is being conducted. The globalisation of business in recent years created the opportunity for large multinational companies, like Google, to conduct its tax affairs in such a way to greatly minimize its tax burden. This has led to tense situations in which tax paying citizens have become much more sensitive to the issue of tax fairness. The fairness of taxes has become a critical issue for governments, individual taxpayers and businesses.

Governments face the challenge of having to cope with less revenue and a higher cost to ensure compliance. Furthermore, BEPS undermines the integrity of the tax system, since in the public eye, not paying your fair share of taxes and paying low corporate taxes, are rightly deemed to be unfair. Individual taxpayers are also under more pressure as they would have to carry a larger tax burden if multinational companies shift their business

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profits away from the tax jurisdictions in which the profits are derived. Multinational companies also run the risk of suffering considerable reputational damage by engaging in these tax avoidance schemes. It is also mentioned that fair competition between multinational companies and companies actively doing business in the local markets are greatly harmed by the distortions induced by BEPS (OECD, 2013:8).

To emphasise the importance of the issues discussed above, the OECD recently published a document with action plans to help protect the tax base of countries. The document deals with the current issues experienced by revenue authorities on tax base erosion and profit shifting as a result of, *inter alia,* very aggressive tax planning by large multinational companies. The document provides fifteen action steps which aim to address, *inter alia,* instances where no or very little taxation is paid by large multinational companies as a result of aggressive tax planning.

The action steps as set out in the action plan are summarised in Table 2 below:

Table 2: Action steps by the OECD to avoid BEPS

Planned Action Step	Planned Approach
Address the tax challenges of the digital economy	Identify possible difficulties the digital economy poses to existing international tax rules. Develop detailed options to address this by taking a holistic approach and considering both direct and indirect taxation.
Neutralize the effects of hybrid mismatch arrangements	Develop model treaty provisions and recommend-ations for the design of domestic rules to neutralize the effect of hybrid instruments and hybrid entities.
Strengthen CFC rules	Develop recommendations regarding the design of CFC rules.
Limit base erosion via interest deductions and other financial payments	Develop recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments.
Counter harmful tax practices more effectively, taking into account transparency and substance	Revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring “substantial activity” for any preferential regime

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Planned Action Step	Planned Approach
Prevent treaty abuse	Develop model treaty provisions recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances
Prevent the artificial avoidance of PE status	Develop changes to the definition of permanent establishment (PE) to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and the specific activity exemptions
Assure that transfer pricing outcomes are in line with value creation – intangibles	Develop rules to prevent BEPS by moving intangibles among group members including: adopting a broader and clear definition of intangibles, ensuring that profits associated with the transfer of intangibles are associated with value creation, developing special rules for hard-to-value intangibles, and updating guidance on cost contribution arrangements
Assure that transfer pricing outcomes are in line with value creation - risks and capital	Develop rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members, including adopting rules to prevent inappropriate returns from accruing to entities solely on the basis of provision of capital or contractual assumption of risks
Assure that transfer pricing outcomes are in line with value creation - other high risk transactions	Develop rules to prevent BEPS by engaging in transactions that would not, or would occur only very rarely between third parties, including adopting re-characterisation rules, clarifying the application of transfer pricing methods in global value chains, and protecting against base eroding payments such as management fees and head office expenses
Establish methodologies to collect and analyse data on BEPS and the actions to address it	Develop recommendations on the indicators of the scale and economic impact of BEPS and ensure tools are available to assess effectiveness and impact of measures to address BEPS
Require taxpayers to disclose their aggressive tax planning arrangements	Develop recommendations regarding the design of mandatory disclosure rules for aggressive or abusive transactions, arrangements, or structures, taking into consideration the administrative costs for tax administrations and businesses and drawing on experiences of the increasing number of countries that have such rules
Re-examine transfer pricing documentation	Develop rules regarding transfer pricing documentation to enhance transparency, including a requirement that multinational entities provide all “relevant governments” with information on global allocation of income, economic activity, and taxes paid among countries in accordance with a common template
Make dispute resolution mechanisms more effective	Develop solutions to address obstacles that prevent countries from solving treaty-related disputes under

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Planned Action Step	Planned Approach
	Mutual Agreement Procedures (MAP), including the absence of arbitration provisions and denial of access to MAP in certain cases
Develop a multilateral instrument	Analyse tax and public international law issues related to the development of a multilateral instrument to enable jurisdictions that wish to do so to implement BEPS measures and amend existing bilateral treaties

Source: OECD (2013:14-25).

These planned changes and action steps, together with the planned approaches, are of paramount importance to prevent any double taxation, but probably more important, to prevent instances of profit shifting and base erosion arising (OECD, 2013:13). It is important for revenue authorities of countries to consider these action steps and take it to heart. The aimed successes of the above action plans and overhauling of certain international tax provisions will only be successful if all affected countries agree to work together and to follow at least the same approach as set out in this OECD document.

At this point it is important to note that South Africa is also actively pursuing the action steps and approaches as detailed above. SARS has taken the issues that the OECD raised into consideration. Most notably at the moment is that SARS has taken steps to combat BEPS by proposing limitations against excessive interest tax deductions as set out in the proposed 2013 Tax Laws Amendment Bill (TLAB) (National Treasury, 2013b). National Treasury released a media statement on 4 July 2013 regarding the issues which the TLAB dealt with. In the media statement SARS specifically mentions that "tax base erosion in the form of profit-shifting through excessive interest deduction and the use of artificial debt will now be contained through an objective set of rules and limitation rules" (Deloitte, 2013:7).

As mentioned, the action steps will only be successful if all affected countries participate in these steps. In recent global developments a number of countires, including Australia, the European Union, Singapore, the UK, the United States of America and Zambia, committed themselves to taking active steps to prevent profit shifting and base erosion (Deloitte, 2013:8-11).

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From the discussion above, together with the planned practical steps announced by the OECD, it is clear to see how important international tax legislation is to any tax policy. International tax legislation provides both opportunities and security to the taxpayer and to SARS. A taxpayer is allowed to engage in international business, while international tax legislation provides SARS with the opportunity to share in some of the profits made in countries other than South Africa, if the foreign company is effectively controlled in South Africa. CFC legislation plays a crucial role in this and is of paramount importance to protect the South African tax base and to prevent profit shifting.

2.4 CFC LEGISLATION

The way business is being conducted definitely changed over the past few years. Thanks to the internet, smartphones, new technology and new ways of approaching and thinking about business, the world of business, as it was known a few decades ago, has transformed to what it is at present. Technology has changed the way we do business today, with its effect on communication arguably the most significant change that technology had on business (Morley, not dated).

Technology has streamlined the process of doing business across borders. Companies will often engage tax experts to get sound advice on their tax planning before entering into any cross-border business transaction. This tax planning will often include the possibility of reducing the ultimate tax costs payable by basing a business offshore. High tax rates in taxpayers' resident countries will often result in taxpayers engaging in international trade to pay the least amount of tax in order to maximise profits (Oguttu, 2008:347).

With this fast growing trend of doing cross-border business, a number of countries, including South Africa, "have been prompted to enact specific anti-tax avoidance legislation to reduce the risk of losing domestic tax revenue from international investment. This legislation includes CFC legislation." (Oguttu, 2008:347). Mintz and Weichenreider (2012:735) have this very practical view that domestic CFC legislation will protect both local, as well as foreign countries' corporate tax base.

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Any resident of South Africa who receives some sort of income from a foreign company should consider the CFC legislation embodied in the ITA. CFC legislation in South Africa is embodied under section 9D of the ITA and it sets out the specific legislation to apply when a foreign company qualifies as a CFC for South African tax purposes. The effect of CFC legislation, in its most simplistic explanation, is that a South African resident must include in its income a proportionate amount of the net income earned by the applicable CFC, subject to certain exclusions (Deloitte, 2012:41).

In terms of the provisos to section 9D(2) of the ITA, a South African tax resident will not have to account for his portion of the net income of a CFC in the following instances:

- If a resident, together with all of his connected persons, in total holds less than 10% of the participation rights of a CFC at the end of the CFC's tax year. Furthermore, the resident, together with all of his connected persons, may not exercise at least 10% of the voting rights in that CFC.
- If a resident, together with all of his connected persons, in total holds less than 10% of the participation rights of a CFC on the day immediately before the CFC ceases to be a CFC during its tax year. Furthermore, the resident, together with all of his connected persons, may not exercise at least 10% of the voting rights in that CFC.
- If the participation rights in a CFC are indirectly held by the South African tax resident through another tax resident company.

The result of these provisos to section 9D(2) of the ITA is that even though a South African tax resident holds participation rights in a CFC, the portion of the specific resident's taxable income in the CFC will not have to be taken into consideration when determining the South African tax resident's final tax liability for a specific year of assessment.

A foreign company will qualify as a CFC where South African residents hold, directly or indirectly, more than 50% of the total participation rights or voting rights in that foreign company (Deloitte, 2012:41). It is important to note that it specifically mentions more than 50% and not at least 50% of the participation or voting rights in that foreign company. This means that, if a South African resident holds exactly 50% of the participation or voting rights in a foreign company, that foreign company will not be subject to South Africa's CFC legislation.

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Having participation rights in a foreign company means the South African resident will have the "right to participate in all or part of the benefits of the rights (other than voting rights) attaching to a share, or any interest of a similar nature in that company" (Deloitte, 2012:41). If no participation rights, as mentioned above, are attached to a share, the voting rights in that company will be used to determine the participation rights and accordingly the CFC status of that foreign company.

It is important to note that the voting rights will only be considered as participation rights if the company involved has no shares and only has voting rights. This will be applicable, for example, to certain hybrid companies. If any person has a right to share in the equity of a company, voting rights will be ignored and will not be taken into account as participation rights (Stiglingh, Koekemoer, Van Schalkwyk, Wilcocks & De Swardt, 2011:595).

The specific literature relating to the taxation of CFC's applicable to this research study will be discussed and dealt with in more detail at a later stage in this document.

2.5 CONCLUSION

The above discussion aims to show the importance taxation and also the importance of sound local and international tax legislation. Any government's financial operations will be impossible without sound and technically strong tax policies that raise sufficient revenue (Law Giants, 2010). National Treasury acknowledges the importance of technically strong tax policies for South Africa. Mr Gordhan recently announced that a tax review committee will be initiated to assess the South African tax policy framework (Ministry of Finance, 2013: 21).

The importance of sound tax policies are emphasized by the discussion on the importance of CFC legislation. Taxpayers often engage in international trade these days, therefore, specific anti-tax avoidance legislation was enacted to reduce the risk of losing domestic tax revenue from international investments (Oguttu, 2008:347). CFC legislation was enacted to ensure companies cannot shift its profit to countries with lower tax rates in order to pay the least amount of tax. CFC legislation protects both local, as well as foreign countries' corporate tax base (Mintz and Weichenreider 2012:735).

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Before considering the practical implications of section 9H of the ITA, it is important to understand the general tax principles that applies to a South African tax resident that ceases to be tax resident of South Africa. Furthermore, it is also important to look at why legislation affecting a South African tax resident ceasing to be tax resident of South Africa has changed. Specific consideration should be given to the effect this has on a CFC that ceased to be controlled in South Africa.

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CHAPTER 3

TAX IMPLICATIONS WHEN CEASING RESIDENCY

3.1 INTRODUCTION

When a person changes its residency, or ceases to be a resident of South Africa, he will, in most instances, also cease to be tax resident in South Africa. In terms of the ITA, when a person ceases to be a resident of South Africa, the event may trigger certain exit tax charges. Whenever there is an event that may lead to exit charges being payable, consideration needs to be given to the specific provisions of section 9H of the ITA and in certain instances, the Eighth Schedule to the ITA, which may be applicable to such an event and may result in CGT being payable.

3.2 CHANGES IN TAX LEGISLATION WHEN CEASING TAX RESIDENCY

In the explanatory memorandum on the Taxation Laws Amendment Bill, 2011, National Treasury provided some background to the tax treatment and the proposed changes to the tax treatment when a person, specifically a company, ceases to be tax resident in South Africa effective on or after 1 April 2012. National Treasury continued to explain that "at company-level, the company migration of effective management is deemed to be a disposal for capital gains tax purposes." In the past, when a company ceased to be tax resident a deemed dividend for purposes of the Secondary Tax on Companies was also triggered. This deemed dividend treatment is limited to company profits and reserves immediately before the company ceases to be a resident (National Treasury, 2011:118).

Prior to 1 April 2012, when a person ceased to be a tax resident of South Africa, a deemed disposal event occurred for CGT purposes under paragraph 12 of the Eighth Schedule to the ITA. This included the instances when a CFC ceased to be controlled in South Africa. In terms of paragraph 12 of the Eighth Schedule to the ITA, as it read at the time, a person was deemed to have disposed of all his assets on the day immediately before ceasing

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residency other than, *inter alia,* immovable property situated in South Africa and assets that formed part of a permanent establishment in South Africa.

The assets were deemed to be disposed of at the market value of the asset at the time of ceasing residency and the person was deemed to have immediately reacquired the same asset at the exact same market value. However, as mentioned, assets that remain within the capital gains tax net will be excluded from this deemed disposal. Any difference between the market value of the asset at the time of the deemed disposal and the original purchase price of the asset, adjusted for any paragraph 20 of the Eighth Schedule to the ITA expenditure, resulted in a capital gain or capital loss. The provisions of the Eighth Schedule to the ITA applied in instances where a capital gain or capital loss realised at the disposal of an asset to determine the net tax effect of the transaction.

Section 9H of the ITA was inserted by the Taxation Laws Amendment Act, No. 24 of 2011, with effect from 1 April 2011. After 1 April 2012, the day on which section 9H of the ITA became applicable, paragraph 12 of the Eighth Schedule to the ITA was amended. In terms of the amendments, a resident who emigrated and subsequently ceased to be resident in South Africa is no longer deemed to have disposed of all its assets for CGT purposes under paragraph 12 of the Eighth Schedule to ITA on the day immediately before emigrating that resulted in the resident ceasing to be a South African resident. This disposal will now be dealt with under section 9H of the ITA, which became applicable on 1 April 2012, and has the effect of consolidating the exit tax charge rules when a person ceases to be a resident for South African tax purposes.

The main objective for the change by National Treasury was to consolidate the exit tax charge rules when a company ceases to be resident in South Africa, by providing a single tax exit charge when a company changes its residency and the company exits the South African tax net. National Treasury provided an explanation for this change in its explanatory memorandum to the Taxation Laws Amendment Bill, 2011 (National Treasury, 2011:118).

In the explanatory memorandum (National Treasury, 2011:118) National Treasury commented that, “when a company migrates, the event can theoretically be viewed in one

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of two ways – firstly as a sale and repurchase of assets by the entity, or secondly as a liquidation followed by a reincorporation. However, the current policy regarding the migration of companies is an inconsistent combination of both concepts. The imposition of a tax on dividends is also problematic at the shareholder-level because these shareholders do not receive any cash at any point during the migration (and any actual dividend under the new Dividend Tax falling within similar circumstances may be exempt). A simplified regime is therefore required that is both more theoretically defensible and more administratively viable" (National Treasury, 2011:118).

Basically National Treasury acknowledged the fact that the taxation rules when a company ceases to be a tax resident in South Africa, needed some simplification and should be more generous to all parties involved. Therefore, section 9H of the ITA was introduced to provide for a single set of exit rules when a company ceases to be a South African tax resident by virtue of a change in effective management.

Under the amended legislation this event will trigger either capital gain or ordinary revenue and no deemed dividend will arise. Similarly to previous legislation the disposal will be deemed to take place on the date immediately before the date of the change of residence and the assets held by the company on the day before cessation as a resident, will be deemed disposed at arm's length value. This exit tax charge will apply to the companies as they are exiting the South African tax net. All of these assets will then be deemed repurchased at the same market value. Assets held as trading stock will trigger ordinary revenue and assets of a capital nature will trigger capital gains, which would be subject to CGT legislation (National Treasury, 2011:118-119).

As from 8 May 2012 Section 9H of the ITA includes a provision to also include CFC's ceasing to be controlled in South Africa. Therefore, consideration now needs to be given to the provisions of section 9H of the ITA whenever a person ceases to be tax resident in South Africa, or when a CFC ceases to be controlled in South Africa, as it may result in certain exit tax charges being payable.

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3.3 EXIT TAX CHARGES WHEN A CFC CEASES TO BE A CFC IN SOUTH AFRICA

Seeing that South Africa changed to a resident based tax system with effect from 1 January 2001, the deemed disposal rule, as discussed above, only applied to assets exiting the South African tax net. Therefore, assets that remained in the South African CGT would not have been subject to the deemed disposal provisions. As mentioned, this was typically fixed property situated within South Africa, since this will be subject to South African taxation regardless of the residency of the person who owns the property.

As mentioned, section 9H of the ITA was inserted and enacted to provide for a single set of company-level tax to be imposed when a company ceases to be a resident for South African tax purposes (National Treasury, 2011:118). This argument was strengthened by the view of other authors who commented that section 9H of the ITA came into operation on 1 April 2012 and, in layman's terms, provides for a single tax exit charge when a person ceases to be a tax resident in South Africa (Stiglingh *et al,* 2011:84).

In a recent SCA court case, the *Commissioner for the South African Revenue Service v Tradehold Ltd* (132/11) [2012] ZASCA 61, SARS lost on technical grounds on appeal to the SCA. This resulted in Tradehold Limited (Tradehold) not having to pay an exit tax charge when it ceased to be a tax resident in South Africa. After this judgement was laid down by the judge in the *Commissioner for the South African Revenue Service v Tradehold Ltd* case, SARS and National Treasury considered the ruling and amended section 9H of the ITA accordingly.

The facts of and the reasons for the judgement delivered by Judge Boruchowitz will be discussed below. This will be done to provide some more background as to the possible reason why there was such a prompt response by SARS and National Treasury, which led to Section 9H of the ITA being amended.

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3.4 COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICE V TRADEHOLD LTD (132/11) [2012] ZASCA 61

Tradehold is an investment holding company incorporated in South Africa and listed on the Johannesburg Stock Exchange (JSE). The only relevant asset for Tradehold under dispute was its 100% shareholding in Tradegro Holdings Limited (Tradegro), a company incorporated in Guernsey. The board of directors of Tradehold decided in 2002 to have all further board meetings of Tradehold in Luxembourg which had the effect that Tradehold's effective management moved to Luxembourg from that day onwards (*Commissioner for the South African Revenue Service v Tradehold Ltd*.)

At that stage Tradehold was still seen as a tax resident of South Africa by reason of the definition of a resident as it was found in the ITA at 2 July 2002. The definition at the time did not make any mention of a person being exclusively a resident of another country by virtue of a double tax agreement (DTA) between South Africa and that other country. This meant that even though there was a DTA between South Africa and Luxembourg, Tradehold met the requirement of being incorporated in South Africa and was therefore seen as a South African tax resident *(Commissioner for the South African Revenue Service v Tradehold Ltd*).

However, this changed with effect from 26 February 2003, when the definition of a resident for South African tax purposes was amended to include the part dealing with exclusive residency in terms of a DTA between the Republic of South Africa and another country. The definition of a resident in Section 1 of the ITA now includes a provision that any person who is deemed to be exclusively a resident of another country by virtue of a DTA entered into between South Africa and that other country, will not be seen as a South African tax resident even though he meets all the qualifying requirements of being a resident of South Africa (Stiglingh *et al.*, 2011:58).

In terms of the DTA between South Africa and Luxembourg the deemed place of residence for a company is the place of effective management. From a South African tax point of view, even though Tradehold was incorporated in South Africa, this now had the effect that Tradehold ceased to be a South African tax resident as of 26 February 2003

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onwards as it was effectively managed and controlled in Luxembourg (*Commissioner for the South African Revenue Service v Tradehold Ltd).* An important point to raise here and to always remember is that the provisions of a DTA always overwrites the provisions of the ITA. If the provisions of a DTA did not overwrite the provisions of local legislation, there would be no real purpose for any DTA.

As already mentioned, now that Tradehold ceased to be tax resident in South Africa, Tradehold had a deemed disposal of all its assets on that day according to the provisions of paragraph 12 of the Eighth Schedule to the ITA as it read back then. The only assets Tradehold will not have disposed of are the assets which remain in the South African CGT net. Seeing that shares are not fixed property and they are shares in another foreign company, Tradehold may be liable to pay tax on the possible capital gain resulting from the deemed disposal of the shares, unless specifically mentioned otherwise in the DTA between South Africa and Luxembourg.

In delivering his judgement, Judge Boruchowitz specifically mentioned, "consequently, Art 13(4) of the DTA applies to capital gains that arise from both actual and deemed alienations or disposals of property. It follows therefore that from 2 July 2002, when Tradehold relocated its seat of effective management to Luxembourg, the provisions of the DTA became applicable and that country had exclusive taxing rights in respect of all of Tradehold's capital gains" (*Commissioner for the South African Revenue Service v Tradehold Ltd).*

Seeing that the definition of a resident for South African tax purposes was amended after 2 July 2002, Tradehold was successful in arguing that the capital gains that realised as a result of the deemed disposal of the shares was not taxable in South Africa, but in Luxembourg. This argument was based on the provisions of Article 13(4) of the DTA between South Africa and Luxembourg mentioned above and, therefore, Tradehold paid no exit tax charge in South Africa on the deemed disposal of the shares in Tradegro (*Commissioner for the South African Revenue Service v Tradehold Ltd).*

Judge Boruchowitz delivered his judgement in the *Commissioner for the South African Revenue Service v Tradehold Ltd* case on 8 May 2012. Mr Pravin Gordhan, the South

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African Minister of Finance at the time, in a press release that was published on 9 May 2012, shed some light on SARS's and National Treasury's views of the judgement which could possibly be relied on as to why Section 9H of the ITA was amended so promptly. Mr Gordon mentioned that the judgement by the SCA seems to disturb the balance that has been achieved by the South African tax system.

Furthermore, Mr Gordhan mentioned that the judgement created a disturbance to the balance that the effect of exit tax charges had on a person ceasing tax residency and proposed that amendments, in order to maintain the stability in the tax system, would be effective as from 8 May 2012 (National Treasury, 2012b).

Although the above mentioned is a very specific application on a very technical aspect regarding taxing rights as found in DTA's, it is clear that it probably was not the intention of the legislator for the provisions of the DTA to be applied in such a way. Certain authors felt it was unnecessary to amend the tax legislation as a result of the judgment delivered in *Commissioner for the South African Revenue Service v Tradehold Ltd* as the facts to this case was unique and unlikely to be repeated in the future (Anon, 2012:82).

However, Section 9H was substituted by the Taxation Laws Amendment Bill, No 22 of 2012, and was promulgated on 1 February 2013. This had the effect that the amended Section 9H was only enacted on 1 February 2013, but had an effect on any transaction that happened on or after 8 May 2012. It is important to note at this stage that the backdating of legislation in South African tax legislation is a common occurrence, but can have very damaging practical effects on taxpayers concerned.

3.5 CONCLUSION

Based on specific tax legislation embodied in the ITA, a person that ceases to be tax resident of South Africa may become liable to pay an exit tax charge. Section 9H of the ITA was inserted with effect from 1 April 2012. This section was inserted to consolidate the exit tax charges and to provide for a single exit tax charge when a South African tax resident ceases to be South African tax resident.

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As a result of the judgement delivered in the *Commissioner for the South African Revenue Service v Tradehold Ltd* court case, section 9H of the ITA was amended and now includes provisions for the event when a CFC ceases to be a CFC for South African tax purposes.

Before doing an international comparison of the tax implications of a CFC ceasing to be a CFC for tax purposes in South Africa the practical application of section 9H of the ITA should be looked at. The practical issues experienced with the application of section 9H of the ITA will also be identified and discussed. An overview of section 9H of the ITA provides a general background, before the specific issues will be discussed in more detail.

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CHAPTER 4

SECTION 9H OF THE INCOME TAX ACT

4.1 INTRODUCTION

As a result of the judgement handed out by Judge Boruchowitz in the *Commissioner for the South African Revenue Service v Tradehold Ltd* case discussed above, SARS and National Treasury scrutinised Section 9H of the ITA and amended it accordingly. Prior to these amendments being enacted, Section 9H of the ITA was only applicable to a person ceasing to be a resident or where a company became a headquarter company in South Africa (Stiglingh *et al.*, 2011:84).

After amending Section 9H of the ITA, the provisions of this section have been extended to include CFC's losing their CFC status in relation to tax residents of South Africa (Louw, 2012:3). The proposed amendments were enacted and the new provisions became effective on 8 May 2012 and will apply from that date going forward. Therefore, foreign companies which are CFC's for South African tax purposes will need to consider the provisions of Section 9H of the ITA whenever there is a change in the shareholding percentage of the CFC.

The purpose of Section 9H of the ITA will in part remain to consolidate the exit charge rules applicable when a person ceases to be a resident for South African tax purposes. Furthermore, the further amendments to Section 9H of the ITA in theory aims to align the exit charge with international norms (National Treasury, 2012a:110) and to provide stability again to the South African tax system with regard to a person ceasing residency in South Africa (National Treasury, 2012b). Whether these changes will have the desired effect in practice and whether other practical issues may arise, is still to be determined with the practical application of Section 9H of the ITA.

There may still be some practical issues not addressed by the changes to section 9H of the ITA. However, in an interview conducted with Mr L. Roelofse tax director at Deloitte, on

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25-10-2013, section 9H of the ITA currently does provide for a single exit tax charge when a South African tax resident ceases its tax residency in South Africa

Daya (2012) mentioned that Section 9H of the ITA will apply to a CFC ceasing residency subject to limited exclusions. Section 9H(5) of the ITA states, *inter alia*, that Section 9H will not apply if a person disposes of equity shares in a foreign company that is a CFC, and the capital gain/loss on disposal is disregarded in terms of paragraph 64B of the Eighth Schedule to the ITA, and the CFC will cease to be a CFC in South Africa as a direct result of the disposal referred to above.

When an entity ceases to be a CFC, it will be deemed to have disposed of its assets at market value and immediately to have reacquired them. This disposal may have a CGT exit charge implication for the entity (Deloitte, 2012:42). This capital gains exit charge will apply to any disposal of equity shares in a foreign company, unless the disposal of the equity shares in the foreign company qualifies for the exemption, as found in paragraph 64B of the Eighth Schedule to the ITA.

Paragraph 64B of the Eighth Schedule to the ITA mentions that a person should disregard any capital gain or capital loss with regard to the disposal of equity shares in a foreign company if certain conditions, which are generally referred to as the participation exemption, are met. These conditions are found in paragraph 64B(2) of the Eighth Schedule to the ITA.

Paragraph 64B(2) mentions that the capital gain or loss on disposal of the equity shares will be excluded from the South African tax net if:

(a) "that person (whether alone or together with any other person forming part of the same group of companies as that person) immediately before that disposal—
    (i) held at least 10 per cent of the equity shares and voting rights in that controlled foreign company; and
    (ii) held the interest contemplated in sub-item (i) for a period of at least 18 months prior to that disposal, unless that person is a company and that interest was acquired by that company from any other company which forms part of the

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same group of companies and that company and other companies in aggregate held that interest for more than 18 months:

(b) that interest is disposed of—

(i) to any person other than a resident or a controlled foreign company;

(ii) in the circumstances contemplated in paragraph 12(2) (a), where those circumstances arise directly or indirectly as a result of a disposal to a person contemplated in sub-item (i);

(iii) by a person to a controlled foreign company in relation to that person or to any other controlled foreign company that forms part of the same group of companies as that person; or

(iv) by a person that is a headquarter company."

Therefore, if a taxpayer disposes of his shares in any foreign company and the provisions as set out above is adhered to, that taxpayer will be allowed to disregard any capital gain or capital loss when determining his final tax liability for the year.

4.2 PRACTICAL ISSUES

The changes to the legislation discussed above are still in the teething phase and companies are only now starting to see and experience the practical implications of these changes. As a result of these changes being new, no in-depth past research has been done on the practical difficulties companies may encounter or are already encountering with the strict theoretical application of the amended Section 9H of the ITA and paragraph 64B of the Eighth Schedule to ITA. Even though some of the practical issues may not be a problem yet, it is definitely something SARS can and need to consider going forward.

When looking at tax amendments in general, there are a few practical difficulties experienced by taxpayers which are synonymous with the amending of tax legislation. In an enlightening article written by Andrea Minnaar (2012), director at the law firm Edward Nathan Sonnenberg (ENS), she provides a high level explanation why she feels there is a very strong argument that the retrospective application of tax legislation is unconstitutional. In some instances it may even cause great injustice to the taxpayer (Dachs, 2013).

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A further issue is that taxpayers are often in the dark with regard to changes in tax legislation as there normally is a lack of guidance from SARS with regard to the practical implication of a specific amendment, for example. The fact of the matter is, practice notes or interpretation notes are often outdated and/or non-existent which makes it difficult for taxpayers to understand how the proposed amendments to tax legislation will work, which makes tax planning exceptionally complicated and confusing (Kruger, 2012:18).

Lastly, legislators often overlook a number of key issues when they draft amendments to tax legislation. This makes the practical implication thereof problematic which often leads to further discussions between SARS, National Treasury and the taxpayers. More often than not this results in further amendments to the applicable section in the future (Warneke, 2012). This complicates tax legislation and makes sound tax planning difficult as there is always uncertainty about whether SARS and National Treasury will make further amendments in the near future, which may impact taxpayers in a negative way. This may also lead to certain sections of the ITA, which interlink with each other, being amended on different dates, which causes even more confusion to taxpayers.

4.2.1 Retrospective application of tax legislation

Mr Pravin Gordhan mentioned in the press release published after the judgement in the *Commissioner for the South African Revenue Service v Tradehold Ltd* case was laid down, that any amendment to tax legislation as a result of the judgement will apply retrospectively from 8 May 2012 (National Treasury, 2012b). Therefore, the amendments to Section 9H of the ITA and Paragraph 64B of the Eighth Schedule to the Act, currently apply retrospectively to any transaction that happened on or after 8 May 2012, regardless of the fact that the legislation may not have been enacted at the time the transaction took place.

One will need to consider the practical implication of retrospectively implementing tax amendments and whether it is constitutional or not. Linington (2012) mentions, with regard to the retrospective application of the amendments to Section 9H of the Act: “This retrospective effect could have adverse consequences when a person has, for example, already emigrated, but has not deemed his year of assessment to have ended on the day

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before he ceased to be resident. He may accordingly not have made provisional tax payments by the requisite date. It remains to be seen how SARS will cater for such instances." This argument will apply to CFC's ceasing to be CFC's in South Africa, as well as at the time that it ceased to be controlled in South Africa, the provisions of the new legislation may not have been in place yet.

The Constitution of the Republic of South Africa (Constitution) 1996, was approved by the Constitutional Court on 4 December 1996 with effect from 4 February 1997. It is a well-known fact that the Constitution is the supreme law of the Republic of South Africa. No other law or government action can supersede the provisions of the Constitution. Internationally the Constitution enjoys high acclaim and is seen as one of the most progressive in the world (South African Government, 2009).

Minnaar (2012) is of the opinion that retrospective application of legislation makes it almost impossible for a taxpayer to arrange his affairs in order to comply with the relevant legislation. She continues by adding that, " the position may have been more tenable if the draft legislation released by National Treasury, often with immediate effective dates, could be relied upon to be the final version of the legislation. However, more often than not, these drafts undergo various changes before being promulgated with the effect that it is impossible for a taxpayer to predict what the rules are that it has to comply with."

Furthermore, consideration needs to be given whether retrospective implementation of tax amendments is constitutional or not. Minnaar (2012) mentions in her article that the current habit of bringing amendments to legislation into effect retrospectively, conflicts with two key South African constitutional principles, firstly the principle of the rule of law and secondly, the principle of separation of powers.

Firstly, a practical application of the rule of law is that a person should be able to know the law in order to allow that person to arrange his actions accordingly (Minnaar 2012). Dachs (2013) mentions that, the rule of law was specifically declared to be one of the foundational values on which the Constitution was based when the new Constitution was drafted and enacted in 1996. Resulting from the above it is clear that the rule of law should

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be seriously considered by SARS and by National Treasury whenever they intend to introduce amendments to tax legislation.

Judge Mokgoro, in the case of *President of the Republic of South Africa v Hugo* 1997 (4)(SA) 1 (CC), held the following, which is emphasised by the views of both Minnaar and Dachs: "The need for accessibility, precision and general application flow from the concept of the rule of law. A person should be able to know the law, and be able to conform his or her conduct to the law." This will have the effect that a taxpayer can rely on the legislation as written at the time of decision making. By relying on such legislation the taxpayer can do sound financial and taxation planning to structure his affairs in the most beneficial way for him.

Where it is expected of a taxpayer to arrange his tax affairs in terms of draft legislation which may be different from the final legislation enacted, it is impossible for a taxpayer to know the law and be able to adapt his or her conduct to the law, as discussed above. This indicates that the implementation of retrospective legislation breaches the rule of law and, therefore, the Constitution (Minnaar 2012).

Secondly, one will need to consider the clause "separation of powers" as set out and used in the Constitution. According to Minnaar (2012), the separation of powers means that the functions of government must be classified as legislative, executive or judicial and that these functions must be performed by different branches of government. The purpose of separating powers is to prevent the concentration of power to ensure that one section of government does not abuse the power and responsibilities given to it. Like the saying goes, with great power comes great responsibility.

In, *South African Association of Personal Injury Lawyers v Heath* 2000 BCLR 77 (CC), the court held that the very essence of the separation of powers is based on interpretations drawn from the structure and provisions of the Constitution, rather than on an express entrenchment of the principle (Minnaar, 2012). The Constitution provides for the separation of powers between different levels of decision makers like the executive, the legislature and the judiciary. The court in laying down judgement in *South African Association of Personal Injury Lawyers v Heath*, held that "there can be no doubt that our

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Constitution provides for such a separation and that laws inconsistent with what the Constitution requires in that regard, are invalid."

In light of the above discussion it is clear that the Constitution contains certain procedures for the implementation of, amongst others, tax legislation. It can be argued that all the relevant procedures are followed to pass a tax amendment bill, but Minnaar (2012) argues that for all practical purposes, tax amendment bills are treated as law before the process has been followed, which in substance contravenes the principle of separation of powers.

Based on the contents of Minnaar's article, together with further discussions on the points raised above, there seems to be some valid grounds to argue that the retrospective application of tax legislation may be unconstitutional. Dachs (2013) is of the opinion that legislation in South Africa should not operate retrospectively as this would cause great injustice to the party concerned. This may lead to interesting discussions, and possibly court cases, should SARS decide to challenge a taxpayer in court on the basis that the legislation was in fact in place retrospectively, even though the legislation was not in place when the taxpayer made his decisions. It will be of paramount importance for any judge to apply the Constitution to any set of facts brought before the court, as the Constitution remains the supreme law of South Africa and tax legislation should not be able to override the Constitution.

- **Practical implication – India tax legislation**

In India there was recently a massive outcry when the Indian government introduced retrospective amendments to tax legislation. SABMiller took the step to challenge the constitutional validity of the retrospective amendments to tax laws introduced by the Indian government in the 2012 budget, in the Bombay High Court. In the SABMiller situation, the Indian government wants to claim unpaid CGT on an acquisition transaction which was concluded as far back as 2006. The Indian government are of the view that the new retrospective application of the amendments to tax legislation will throw the SABMiller transaction into the Indian tax net, even though the legislation was not in place at the time that SABMiller concluded the transaction (Mohan, 2012).

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SABMiller effectively became the second company to legally challenge the Indian government's retrospective application of tax legislation. The finance minister of India had the following to say regarding this matter: "I have directed a review of tax provisions that have a retrospective effect in order to find fair and reasonable solutions to pending as well as likely disputes between the tax departments and the assessees concerned" (Mohan, 2012).

It will be thought-provoking to see the judgement and explanation of the Indian courts in the above SABMiller situation. This may also lead to a basis for an argument for either SARS or the taxpayer, should a similar situation go to court in South Africa. One thing that seems to be clear is that affected taxpayers will rely on the Constitution of a country to protect them against, what they believe, to be unconstitutional actions by tax authorities.

4.2.2 Different effective dates

The effective dates of amendments to provisions of the ITA which 'interact' with each other are not always on the same date. This may have the result that a specific section, which needs to be read with another section in the Act, is being amended and applied in a new way while the other section is still applied in the old way. In an interview conducted with Mr R. Churr, senior tax manager at Anglo American, on 2013-09-24, he was of the opinion that this complicates tax legislation and makes tax planning difficult.

This may lead to practical difficulties as it is very complex to ensure that you read the correct amendments as a complete picture, as a result of the effective dates being different to these sections interacting with each other. As mentioned by Mr. Churr this complicates tax legislation and this could not have been the intention of the legislator at the time he or she was drafting the amendments.

4.2.3 The issue of new shares

Paragraph 64B of the Eighth Schedule to the ITA specifically speaks about the disposal of shares in a foreign company for the exemption in that paragraph to apply. Events treated as disposals or deemed disposals are embodied in Paragraph 11 and Paragraph 12 of the

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Eighth Schedule to the ITA respectively. The issue of shares are not currently seen as a disposal in terms of the Eighth Schedule of the ITA. In the interview with Mr. Roelofse he mentioned that the issue of new shares are deliberately excluded from the provisions of paragraph 64B of the ITA. Mr. Roelofse is of the opinion that if the issue of shares qualifies for this exemption, it will be easy to bypass the provisions currently embodied in the South African CFC legislation. This may also result in SARS losing out on tax revenue, but this should be researched further.

Paragraph 11(g) of the Eighth Schedule to the ITA, as it is written currently provides for the decrease in value of a person's interest in a company, trust or partnership as a result of a value shifting arrangement to be a disposal for capital gains purposes.

A value shifting arrangement is defined in Paragraph 1 of the Eighth Schedule to the Act as, "an arrangement by which a person retains an interest in a company, trust or partnership, but following a change in the rights or entitlements of the interests in that company, trust or partnership (other than as a result of a disposal at market value as determined before the application of paragraph 38), the market value of the interest of that person decreases and—

(a) the value of the interest of a connected person in relation to that person held directly or indirectly in that company, trust or partnership increases; or

(b) a connected person in relation to that person acquires a direct or indirect interest in that company, trust or partnership."

It is proposed that as from 1 January 2014, any reference to a company will be removed when referring to a value shifting arrangement. Certain commentators feel that the reason for the exclusion of the term company is largely due to the new Section 24BA that was brought into the ITA with effect from 1 January 2013 (Warneke, 2012). It is now considered that it is no longer necessary to apply the value shifting rules to companies, hence the change to only refer to trusts and partnerships The reasoning is that value-shifting arrangements would arise when assets are transferred to a company for shares, and this will now be administered by Section 24BA of the ITA, therefore, it is not necessary to trigger a CGT charge as well under the Eighth Schedule of the ITA (Mazansky, 2012).

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The new Section 24BA provision in the ITA will apply, if "a company, for consideration, acquires an asset from a person in exchange for the issue by that company to that person of shares in that company; and the consideration ... is... different from the consideration that would have applied had that asset been acquired in exchange for the issue of those shares in terms of [an arm's length transaction].' Where the provision applies, various potentially adverse results ensue depending on whether the market value of the asset is more or less than the market value of the shares. The provision applies in respect of transactions entered into on or after 1 January 2013" (Warneke, 2012).

Some authors are of the view that the legislators may have missed and overlooked a few key issues when drafting Section 24BA of the ITA. Firstly, for Section 24BA of the ITA to apply, the issue of new shares must be for a consideration. Therefore, it would appear that if the shares are issued for no consideration, the provisions of Section 24BA of the ITA will not apply. Furthermore, if shares are issued for debt, for example a loan, the provisions of Section 24BA of the ITA will also not be applicable (Warneke, 2012).

Secondly, an asset for purposes of Section 24BA is defined as an asset as defined in Paragraph 1 of the Eighth Schedule to the Act. The definition of an asset in Paragraph 1 of the Eighth Schedule to the Act specifically excludes any currency. Therefore, it seems that if the shares are issued for a nominal amount of cash, the provisions of Section 24BA of the Act will also not be applicable (Warneke, 2012).

For a foreign company, being a CFC in South Africa, this may lead to some unwanted difficulties and possible tax exit charges when that CFC ceases to be a CFC for South African tax purposes. As mentioned previously, Section 9H of the ITA provides for a single exit tax charge if, *inter alia*, a CFC ceases to be a CFC in South Africa. As already mentioned earlier, Section 9H(5) provides instances where the Section 9H exit charge will not apply to a CFC losing its CFC status in South Africa.

According to Mr. Churr, a practical difficulty which may arise is when a foreign company in, for example, an Africa country, is required by government to issue more shares to local shareholders in order for the company to continue doing business in that country. This can have the result that the foreign company will fall out of the more than 50% controlled

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requirement to qualify as CFC in South Africa. Strictly speaking this means the CFC will have to pay an exit charge in terms of Section 9H of the ITA, unless it qualifies for the exemption under Section 9H(5) of the ITA. This appears to be unreasonable, as the foreign company was forced to issue more shares to continue with its business activities in the country. There was no business expansion decision behind it, the company did not actively look at more investing opportunities, it was purely done as was required by the government of that country.

Section 9H(5) of the ITA specifically mentions that the exemption will only apply if the disposal of the equity shares are exempt under Paragraph 64B of the Eighth Schedule to the ITA. It is important to note that the issuing of new shares are not seen as a disposal event under Paragraph 11 of the Eighth Schedule to the ITA. However, the decrease in value of a person's interest in a company as a result of a value shifting arrangement is seen as a disposal event for capital gains purposes in South Africa. At this point it should again be emphasised that a value shifting arrangement is specifically defined and will only apply if the requirements of the definition are met.

As from 1 January 2014 any reference to a company with regard to a value shifting arrangement is being removed. The issuing of new shares in a company will now be dealt with under the provisions of Section 24BA of the ITA. This may lead to unwanted exit charges for a CFC that ceases to be a CFC in South Africa by virtue of the issuing of new shares to foreign investors. The issuing of new shares will not be dealt with under the Eighth Schedule of the ITA anymore, which means that Paragraph 64B of the Eighth Schedule to the ITA exemption will not be applicable anymore. This in turn will lead to the exemption in Section 9H(5) not applying to a CFC when they issue new shares.

This may have the result that, should the CFC lose its CFC status in South Africa as a direct result of the issuing of new shares to foreign investors, the CFC may need to account for a single tax exit charge as provided for in Section 9H of the ITA. Further research can be conducted as to why any reference to a company, regarding value shifting arrangements, will be removed as from 1 January 2014. However, an in-depth look into that does not form part of this research study.

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As some authors suggest, the removal of any reference to a company could be because the issuing of new shares are covered under Section 24BA of the ITA and should not also attract a separate CGT charge (Mazansky, 2012). According to Mr. Churr, National Treasury may also have deliberately removed the reference to a company in the definition of a value shifting arrangement, as they have seen the section abused in the past. Currently there is no clear explanation from SARS or National Treasury as to why the reference was removed. Hopefully more guidance will be provided once the new section legislation regarding value shifting arrangements becomes applicable.

4.3 CONCLUSION

An overview of section 9H of the ITA aims to provide an understanding of the thinking of National Treasury for implementing and amending section 9H of the ITA to have the practical affect it has currently. Furthermore, it aims to provide a more in-depth look at how National Treasury aims to consolidate the exit charge rules applicable when a person ceases to be a resident for South African tax purposes. It also provides more details on the fact that National Treasury aims to align the exit charge with international norms (National Treasury, 2012a:110).

Through reviewing various literatures and having interviews with tax specialists, various practical issues were identified with the current application of section 9H of the ITA read with paragraph 64B of the Eighth Schedule to the ITA. It is important to identify these issues in order to discuss and compare them further on in the study by way of a case study and a comparison to UK CFC legislation.

Before discussing the practical issues identified and before comparing the South African CFC legislation to the UK CFC legislation with regard to a CFC ceasing to be controlled in the specific country, a high level discussion of UK CFC legislation is performed. This is done to provide a background for the comparison between the two sets of CFC legislations.

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CHAPTER 5

SPECIFIC UK CFC LEGISLATION

5.1 INTRODUCTION

Although the aim of this study is not to provide a comprehensive study of the UK CFC legislation, a quick look at the UK CFC legislation will provide the reader with background and information on how other countries, and in this instance the UK, also use specific international legislation to protect its tax base in instances like discussed above. This will be done to determine whether South Africa is indeed in line with international norms, as was set out as an objective by National Treasury at the time of implementing the changes to the sections discussed above.

Similar to South Africa and most other countries in the world, it is important for the UK to protect its tax base and to have sound international tax policies to ensure this. As part of this international tax legislation, the UK has CFC rules embodied in its tax legislation with the aim to stop companies from reducing its tax liability in the UK by shifting its profits to more favourable tax jurisdictions with the aim to pay less, or even no tax, in some instances.

Seeing that SARS and the National Treasury want to align the South African legislation to international norms, especially with regard to tax exit charges, it will be fitting to compare the South African legislation when a company ceases to be controlled in South Africa, to similar situations in the UK. The UK CFC legislation underwent a significant reform process recently with the aim to make the UK tax system more competitive for multinational companies (KPMG, 2013a). Comparing the South African legislation to this fresh new approach applied by the UK, will produce a better picture of where South Africa stands. According to KPMG (2012) the new rules in the UK are more focussed on the "artificial diversion of profits from the UK," providing better opportunities to undertake activities offshore if these activities are properly structured.

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A discussion of the qualifying requirements, as mentioned before, will be provided at a very high level to supply the reader with some background to the UK approach. This will also be done to introduce the reader to the basics of UK CFC legislation, which will be important at a later stage when there will be a discussion around a CFC ceasing to be a CFC in the UK, as a result of ceasing to be controlled in the UK.

For a company to be regarded as a CFC in the UK, the following qualifying requirements should be met. A company will be regarded as a CFC if it is a resident outside the UK, controlled by persons resident in the UK, and subject to a lower level of taxation in its territory of residence (HM Revenue & Customs, 2013a). It is interesting to note that the requirements in the UK compared to that in South Africa are very similar, except the provision made by UK CFC legislation that the company should also be subject to a lower tax rate in the country of original tax residency.

5.2 CFC QUALIFICATION IN THE UK – RESIDENT REQUIREMENT

Very similar to South African legislation, a company will be regarded as a resident of the UK, if the central management and control or the place of incorporation is regarded as in the UK (HM Revenue & Customs, 2013d). Therefore, more or less the same principle applies in the UK as in South Africa with regard to CFC qualification, namely that if a company is regarded as a resident in the UK it can never qualify as a CFC in the UK. The foreign company should be seen as a resident of a different tax jurisdiction and should be controlled within the UK for it to meet the first requirement to qualify as a CFC in the UK.

5.3 CFC QUALIFICATION IN THE UK – CONTROL REQUIREMENT

The term control in UK CFC legislation means the power of a person to ensure that the affairs of a company are conducted in accordance with his wishes (HM Revenue & Customs, 2013b). This is again in line with the approach followed in South Africa with regard to the participation rights and voting rights. Therefore, it seems clear that for both jurisdictions, control means a matter of having sufficient influence in that foreign company to ensure that the foreign company conducts business in such a way as determined by those parties in control of the foreign company.

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This is by no means a complete discussion of the tests conducted in the UK to determine 'control' of a foreign company. It is purely background that provides the reader with an indication that control in UK CFC legislation means that a party should have the power to influence the decision making of the foreign company, in such a way that that specific party in effect has full control over the decision making and business direction of that specific foreign company.

It is important to note that South Africa has the 50% benchmark for the participation and voting rights, whereas in the UK CFC legislation it simply states that control means the power of a person to secure that the affairs of a company are conducted in accordance with his/her wishes. CFC legislation in the UK regarding control will be more open for interpretation and should be considered on a case-by-case basis. In South African legislation, while still considered on a case-by-case basis, some guidance is provided regarding the percentage of participation and voting rights those South African residents should have in a foreign company, for that foreign company to qualify as a CFC in South Africa.

5.4 CFC QUALIFICATION IN THE UK – LOWER TAX RATE REQUIREMENT

By definition a company cannot be regarded as a CFC in the UK unless it is subject to a lower level of taxation in the tax jurisdiction in which it is a tax resident. This lower level of taxation test requires a comparison to be made between the actual tax paid by a company in its tax jurisdiction, and the tax liability it would have been liable for if it had been resident in the UK. In general, if the amount of taxation paid in the company's tax jurisdiction is less than 75% of the tax it would have paid in the UK, had the company been a UK tax resident, then the company is subject to a lower level of taxation in its territory of residence, and such a company will satisfy the final CFC qualifying requirement in the UK (HM Revenue & Customs, 2013c).

From the way the law is written in the UK, it is clear that one should determine a company's exact territory of residence or tax jurisdiction in order to accurately determine whether the tax rate in the applicable territory is less than 75% of the tax rate in the UK. Therefore, it is of paramount importance to apply the residency rules very accurately. By

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applying the residency rules one will be able to accurately determine the territory of residence of a company and whether that company is subject to a lower level of taxation in its territory of residence.

It should be noted that, though by applying the residency rules one should be able to determine the territory of residence for a specific company, the operation of those rules will sometimes result in a company having no territory of residence. In such an instance, the company is conclusively presumed to be subject to a lower level of taxation and no further tests need to be conducted in order to determine whether a company is subject to a lower level of taxation in its territory of residence (HM Revenue & Customs, 2013c).

This final CFC qualifying requirement in the UK is not a CFC qualifying requirement in South Africa. It seems that the UK legislation aims to include the foreign companies in the UK tax net if the company receives a significant tax advantage in a different tax jurisdiction while still effectively controlled by UK tax residents. If this has the desired outcome in practice, it is probably open for discussion, but the fact remains that CFC legislation is an important part of tax legislation to nullify any mismatches that may arise when companies try to shift their profits to lower tax jurisdictions.

5.5 EXEMPTIONS IN THE UK WHEN DISPOSING OF SHARES IN CFC

Similar to South Africa, UK CFC legislation provides for certain exemptions when a UK tax resident disposes of its shares in a UK CFC. Through e-mail correspondence conducted with Mr S.J. Cooper, tax director at Deloitte UK, on 2013-10-07, he mentioned that the substantial shareholding exemption (SSE) in the UK is a very wide capital gains exemption which is available to UK companies disposing of shares.

Mr. Cooper added that there are various conditions which need to be met for this exemption to apply. Included in these conditions is the condition that the UK tax resident must have held at least 10% of the shares in the company being sold for a period of 12 months or more. Furthermore, the company whose shares are being sold, must be a trading company or a holding company of a trading group and the disposing company must be a trading company or a member of a trading group. The SSE is a wide exemption,

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however, Mr. Cooper is of the opinion that it may not apply to a CFC due to it holding investments rather than holding trading assets.

Although an in-depth look into the application of the SSE exemption does not form part of this research study, the provisions mentioned above should be at least adhered to in order for the company disposing of its shares to be exempt from any capital gains tax. As mentioned, the UK provides for quite a broad exemption for companies disposing of shares should the above provisions of the SSE be met. It is important to note that both conditions should be adhered to and the disposing company must continue to be a trading company immediately after the disposal of the shares for the exemption to apply.

5.6 CEASING TO BE A CFC IN THE UK AND EXIT TAX CHARGES

A CFC in the UK will cease to be controlled in the UK when shareholding changes and the effective control of the foreign company are not in the UK anymore. Mr. Cooper said he would generally expect a CFC to cease to be controlled in the UK when the UK tax resident sells its shares in the CFC to a third party or a group company not controlled directly or indirectly by any UK tax resident. Mr. Cooper added that the UK tax residents may also lose control as a result of the CFC issuing shares to a company which is not controlled directly by the UK tax residents, similarly to the discussion earlier with regard to South Africa.

On the issuance of shares, Mr. Cooper noted that should this result in a shift in value out of any shares held by a UK company, this could fall within the UK's capital gains anti-avoidance provisions and may result in a deemed disposal. This deemed disposal could, subject to meeting the various conditions, be exempt under our SSE rules, as discussed in chapter 5.5 of this research study.

Similar to a lot of other countries, the UK also has a tax exit charge regime under which, when a company decides to migrate its tax residency to a different country, a deemed disposal and immediate acquisition again of the company's chargeable assets takes place (Jervis, 2012). This will give rise to a taxable gain, similar to where a company ceases residency in South Africa for tax purposes.

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The above mentioned rules of the UK exit tax charge will not apply when a company ceases to exist, despite migrating abroad. Similarly it will also not apply when that company continues to use the specific assets under consideration in a UK trade, or otherwise for the purpose of a permanent establishment situated in the UK (Jervis, 2012). This once again is in line with South African legislation and application of a company ceasing to be a tax resident in South Africa.

Tax on the sale of shares in a CFC is treated as a capital gain in the UK. Provided that certain holding and trading conditions are satisfied, the disposal of shares in the CFC may be exempt from UK corporate taxation. If the conditions are not met, any disposal of these shares will be subject to UK corporate taxation. In calculating the gain on disposal, a deduction may be available for the appropriate proportion of any tax assessed on the company in respect of the CFC's apportioned chargeable profits (Deloitte, 2012:49).

According to Mr. Cooper, there is no deemed disposal rule when a CFC ceases to be a CFC and, therefore, no exit tax charge when a CFC ceases to be controlled in the UK. On the assumption that the UK tax resident directly owns the shares in the CFC that will cease to be a CFC in the UK, any capital gain or capital loss will only be taxable or relievable when the UK tax resident ultimately disposes of the share in the foreign company.

5.7 CONCLUSION

An overview of the UK CFC legislation is done to provide background to be used when the South African CFC legislation gets compared to the UK tax legislation by way of a case study. Through the e-mail correspondence with Mr. Cooper certain differences were identified between the South African and the UK CFC legislation. These differences are important when discussing the comparison between the two different CFC legislations by way of a case study.

The case study will be used to compare a specific issue identified in the research study. The issue that will form the basis of the case study is the practical issue of the issue of new shares by the CFC to foreign investors and the tax implications resulting from this.

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CHAPTER 6

PRACTICAL CASE STUDY

6.1 INTRODUCTION

The above mentioned issue relating to the issue of new shares will be practically discussed by way of a case study. This will shed more light on the current issue that even though SARS amended section 9H of the ITA and paragraph 64B of the Eighth Schedule to the ITA, companies are experiencing practical issues when new shares are being issued by the CFC to foreign investors. As part of this research, the results of case study will be compared to UK legislation by applying the same set of facts to UK legislation to determine whether any similarities and/or differences between the two different tax systems exist.

6.2 FACTS TO THE CASE STUDY

Considering the current economic climate, especially in some of the African countries, it is not surprising to hear talk that governments in certain African countries want more participation in and control over the business activities conducted in that specific country. It is with that possible practical issue in mind that this case study will be conducted and conclusions reached.

For the purpose of this case study we will assume that Company A is formally incorporated and a tax resident of Zimbabwe under the Zimbabwean tax legislation. Company A will also not be deemed to be resident of South Africa by way of the DTA between Zimbabwe and South Africa. Company A conducts business in the mining sector and currently has a few shareholders who own the 100 000 shares in the company between them. Shareholder A, B, C and D are all tax residents of South Africa while shareholder E is a tax resident of Zimbabwe. All the South African shareholders are companies incorporated in South Africa. However, they do not form part of the same group of companies as defined in Section 1 of the ITA.

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During 2012, the government of Zimbabwe enacted new legislation with regards to the shareholding of companies in the mining industry in Zimbabwe. The new legislation made specific mention of the fact that for a mining company to conduct any business activities within the borders of Zimbabwe, the company should be 50% or more owned by the government of Zimbabwe.

Although this came as a surprise to Company A, the board of directors communicated to its shareholders that it feels Zimbabwe plays an important role in the long term business plan and development of the company. Therefore, it was decided that the company will adhere to the specific requirements of the Zimbabwean government. It was further decided that there will be no share buy back from the current shareholders, but rather that new shares will be issued to the government of Zimbabwe.

In a press statement released by the board of directors of Company A, it was said that a further 150 000 shares will be subscribed for and issued to the Zimbabwean government at the current market value of the shares. All of these shares were taken up by the Zimbabwean government on 30 May 2012, the last day of Company A's financial year, and confirmation was provided to Company A that it will be allowed to continue with its mining operations within the borders of Zimbabwe. This brought the total number of shares issued to 250 000.

A comparison between the shareholding percentage before and after the issue of shares is displayed in Table 3 below:

Table 3: Comparison between old and new shareholding

	Before shares issued (%)	After shares issued (%)
Zimbabwe government	0	60
Shareholder A	50	20
Shareholder B	20	8
Shareholder C	20	8
Shareholder D	5	2
Shareholder E	5	2

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It is important to note at this stage that all the shareholders, apart from the Zimbabwean government, obtained their shares at $1 a share, back in 2006 when Company A was incorporated. Due to the recent upward trend in the mining industry in Zimbabwe, the current market value per share in Company A is $100. For illustration purposes it will be assumed that the rand/dollar exchange rate was R5:$1 back in 2006 and currently standing at R10:$1.

Furthermore, all the shareholders are companies with a June financial year-end.

6.3 SOUTH AFRICAN TAX CONSEQUENCES

Based on the facts above, Company A will be regarded as a CFC in South Africa as it was controlled more than 50% by South African tax residents (95%), before the issue of the new shares. By applying the current tax legislation to this situation the following will be the taxation effect of the issuing of new shares by Company A.

As a result of the issuing of new shares, the total percentage of shareholding of South African tax residents in Company A dropped to 38%. This means the CFC requirement of being more than 50% held and controlled by South African tax residents (according to the definition of a CFC in Section 9D(1) of the ITA), is not adhered to anymore. Furthermore, according to section 9H of the ITA this means that when Company A ceases to be a CFC it will also cease to be a tax resident for South African tax purposes. A deemed disposal of all the assets exiting the South African tax net will take place on the day prior to Company A ceasing its CFC status in South Africa.

As the shares are the only assets under consideration, there will be no assets remaining in the South African tax net and all assets will be exiting the net. Because of this deemed disposal of shares, Company A will have to consider the possibility of paying an exit tax charge, unless the exemptions of paragraph 64B of the Eighth Schedule to the ITA, as discussed, applies. If no exemption applies, Company A will have deemed to have disposed of the shares held by the South African tax residents on the day immediately before it ceased to be a CFC in South Africa, at the current market value of the shares. This will have the effect that each of the South African shareholders will have to account

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for a possible capital gain in its year of assessment ending after 30 May 2012. The Taxation Laws Amendment Act, No 24 of 2011, was promulgated on 10 January 2012, therefore, the changes it effected will be applicable to this situation.

The exit tax charge for the CFC should now be considered in terms of Section 9H of the ITA. A person disposing of his shares in a CFC and as a result of that the CFC ceases to be controlled in South Africa, will be exempt under Section 9H(5) of the ITA, from the exit tax charge provisions as embodied in Section 9H(3) of the ITA, if the disposal of the equity shares in the CFC is exempt under Paragraph 64B of the Eighth Schedule to the ITA. This means the shareholder will not have to impute its portion of the capital gain into its capital gains tax calculation in the year of assessment ending immediately after the transaction.

As from 1 February 2013, Paragraph 12 of the Eighth Schedule to the ITA has been amended with a backdating effect as from 8 May 2012 to any transaction occurring on or after that date. This amendment, however, did not change the fact that the issue of new shares are not seen as a disposal for CGT purposes.

Paragraph 64B of the Eighth Schedule to the ITA specifically mentions that there should be a disposal of an equity share for the exemption embodied in Paragraph 64B of the Eighth Schedule to the ITA to apply. Seeing that the event when Company A ceased to be controlled in South Africa by virtue of issuing new shares is not seen as a disposal, one should consider whether the issue of shares to the Zimbabwean government could be seen as a disposal under any other provision of the Eighth Schedule to the ITA.

It can be argued that this issuing of shares results in a value shifting arrangement in relation to the shareholders. However, this value shifting did not occur as a result of a change in the rights or the interests in that company as required by the definition in the Eighth Schedule to the ITA, it was as a result of the issuing of new shares to a third party that this value shift in Company A occurred. Therefore, a value shifting arrangement will probably also not apply as a disposal event when the new shares were issued by Company A.

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An in-depth look into a value shifting arrangement does not form part of this research study. However, even though this may or may not be regarded as a value shifting arrangement as defined, as of 1 January 2014 any reference to “an interest in a company” is removed from the definition of a value shifting arrangement. This will result in any issuing of new shares not even being considered as a disposal for CGT purposes by virtue of a value shifting arrangement.

This issuing of new shares by Company A will also not qualify as an involuntary disposal as mentioned in Paragraph 65 of the Eighth Schedule to the ITA. Therefore, the issuing of new shares which results in Company A ceasing to be controlled in South Africa, will not be seen as a disposal event. The exemption provisions in Section 9H(5) and paragraph 64B of the Eighth Schedule to the ITA, will therefore not apply in this instance where Company A issues new shares to the Zimbabwean government.

The above discussed consequences will result in all the South African shareholders in Company A having to possibly account for their portion of the exit tax charge as mentioned in Section 9H(3) of the ITA. The taxation effect of this is summarised in Table 4 below:

Table 4: Capital gain consequences after the amendments

	Shares	Base Cost (R)	Proceeds (R)	Capital Gain (R)	Exempt
Shareholder A	50 000	250 000	500 000	250 000	No
Shareholder B	20 000	100 000	200 000	100 000	No
Shareholder C	20 000	100 000	200 000	100 000	No
Shareholder D	5 000	25 000	50 000	25 000	No
Shareholder E	5 000	N/A	N/A	N/A	N/A

Table 4 provides a clear indication of the taxation effect the issuing of new shares by Company A will have on the South African shareholders. None of the South African shareholders will qualify for the exemption and each of the shareholders will have to account for its portion of the capital gain that realised when Company A ceased to be a controlled in South Africa as a result of the issuing of shares to foreign investors.

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6.4 UK PRACTICAL CASE STUDY

If we apply the UK CFC legislation to the same set of facts as found in our case study in chapter 6.2 of this research study, the tax implications will be as follows. Please note the facts will remain exactly the same, the only difference will be that the South African shareholders will now be considered UK shareholders.

Prior to the issuing of new shares to the Zimbabwean government, Company A would have been regarded as a foreign company effectively controlled in the UK (assuming in this case the lower tax rate requirement is met). Company A is 95% controlled in the UK and it can be safely said that the shareholders in the UK could ensure that the affairs of Company A are conducted in accordance with their wishes. Therefore, Company A will be regarded as a CFC for UK tax purposes.

After the issuing of new shares by Company A, the Zimbabwean government has 60% of the shares with shareholder E (Zimbabwean company) having 2%. Therefore, after the issuing of new shares there has been a shift of control from the UK tax residents to the Zimbabwean government. As a result of this, Company A will not be seen as a CFC for UK tax purposes anymore as it is effectively controlled in Zimbabwe now.

As discussed earlier, should this issuing of new shares result in a shift in value out of any shares held by the UK shareholders (Shareholders A, B, C and D), this could fall within the UK's capital gains anti-avoidance provisions and may result in a deemed disposal. A value shift will only be applicable to this issue of shares where a person has control. Seeing that shareholders A-D are not connected it is unlikely that any UK shareholder controls. However, for illustrative purposes, should this qualify as a deemed disposal for UK tax purposes, the deemed disposal could be exempt under the SSE rules as discussed in chapter 5.4 of this research study.

Seeing that shareholders A, B and C had more than 10% of the shares in Company A for a period of more than one year, the SSE exemption could apply to them on the deemed disposal of the shares. This is on the assumption that there was a shift in value that resulted in this deemed disposal under the UK tax legislation. Only shareholder D who

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owned 5% of the shares, will be liable to account for the tax on the capital gain that realises at the deemed disposal of the shares.

Should the issue of the new shares not qualify as a deemed disposal under the value shifting provision in the UK and the CFC ceases to be a CFC in the UK, there will be no deemed disposal. In the UK when Company A ceases to be a CFC, it will not be regarded as a deemed disposal and the shareholders, subject to the SSE exemption, will account for the capital gain tax or loss at the ultimate disposal of the shares in Company A.

Therefore, should Company A cease to be a CFC in the UK as a result of the issuing of new shares to the Zimbabwean government, there will be no deemed disposal unless it qualifies as a shift in value for any of the shareholders in Company A. For the purposes of this research study, the assumption is made that there will be no shift in the value of any shares and one will only consider the tax provisions when Company A ceases to be a CFC in the UK.

To conclude on the UK CFC legislation, one would need to consider the CFC legislation to determine whether there will be an exit tax charge when Company A ceases to be controlled in the UK. As discussed, there will be no deemed disposal when Company A ceases to be a CFC in the UK and the tax event will only happen at the ultimate disposal of the shares, subject to the SSE exemption, in Company A. Therefore, there will be no immediate tax implication for any of the UK shareholders as a result of the issuing of the shares by Company A to the Zimbabwean government.

6.5 CONCLUSION AND PRACTICAL COMPARISON BETWEEN UK AND SOUTH AFRICAN CFC LEGISLATION

When comparing the information gathered from applying the UK and South African CFC legislation to the case study, certain similarities and differences surfaced which will now be discussed in short.

The UK and South Africa have very similar provisions in its CFC legislation. The qualifying criteria for both countries are quite similar, with the main emphasis being that the foreign

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company should be effectively controlled by a UK and South African tax resident respectively. Although the control test differs, the main idea behind the term control is the same in both countries.

In both instances, the issuing of new shares resulted in the CFC ceasing to be a CFC in the UK and South Africa respectively. The control of Company A shifted to Zimbabwe as the Zimbabwean government now owned the majority of the shares in Company A, with only 38% still held by the UK and South African tax residents respectively. This resulted in the provisions of exit tax charges to be considered.

As discussed in chapter 6.3 of this research paper, the South Africa tax residents who had shares in Company A will have to account for an exit tax charge as provided for in Section 9H(3) of the ITA, as none of the shareholders qualify for any exemption. The reason for this is that the issue of new shares is not seen as a disposal event, which is a specific requirement for the exemptions in Section 9H of the ITA, read with Paragraph 64B of the Eighth Schedule to the ITA, to apply.

According to UK CFC legislation, on the assumption that the issuing of new shares did not result in a shift in value for any of the shares, a CFC ceasing to be controlled in the UK will not be regarded as a deemed disposal. The tax event, subject to the SSE exemption, will only take place at the ultimate disposal of the shares in the foreign company. This is a key difference in the two tax systems and something SARS may consider in future.

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CHAPTER 7

OVERALL CONCLUSION AND RECOMMENDATIONS

7.1 INTRODUCTION

Globalisation resulted in business being conducted all over the world. The importance of technical strong tax policies is undeniable and the interaction between local and international tax legislation is of paramount importance to a country's tax policy. Revenue authorities may amend tax legislation from time to time to ensure the stability of that country's tax policy.

This research study identified the specific reason why National Treasury amended the tax legislation with regards to the specifics of section 9H of the ITA and also analysed the current practical issues experienced as a result of the practical application of section 9H of the Act and compared it to UK tax legislation.

This chapter provides a summary of how the research objectives were met throughout the study and it also indicates how the research objectives were used to guide the stude and to reach conclusions.

7.2 ACHIEVEMENT OF THE RESEARCH OBJECTIVES

The tax environment is a very unpredictable and vibrant environment with quite a number of issues. These issues can all be further researched to discover what the cause is of these issues. As part of this research study, certain research objectives were identified that will drive the research on the specific CFC legislation. The following research objectives were identified to guide this study:

- To determine whether the current amendments to the tax legislation dealing with a CFC ceasing to be a CFC, achieved the recommended objectives by National Treasury.

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- To analyse the practical implications of the amendments to the tax legislation dealing with a CFC ceasing to be a CFC.
- To analyse whether the tax treatment, as identified above, is indeed in line with international norms by comparing it to UK tax treatment of the same technical issue.

7.2.1 Objectives of the tax amendments by National Treasury

SARS and National Treasury normally have certain objectives in mind when tax amendments are made and implemented. The change to section 9H of the ITA is no different. In the explanatory memorandum to the Taxation Laws Amendment Bill, 2011 issued by National Treasury mention was made that one of the objectives of changing section 9H of the ITA is to provide for a single exit tax charge when a South African tax resident ceases tax residency in South Africa. As a result of this change a person will either a capital gain or ordinary income that realises with no deemed dividend charge (National Treasury, 2011:118).

Originally the single exit tax charge embodied in section 9H of the ITA did not include situations when a CFC lost its CFC status in relation to South African tax residents. Various articles researched, including Louw (2012:3), commented on this change in respect of CFC's and mentioned that the provisions of section 9H of the ITA has been extended and as from 8 May 2012 includes a CFC losing its CFC status in relation to tax residents of South Africa.

There may still be some practical issues not addressed by the changes to section 9H of the ITA. However, in the interview conducted with Mr. Roelofse, he mentioned that section 9H of the ITA currently provides for a single exit tax charge when a South African tax resident ceases its tax residency in South Africa. Therefore, it can be argued that SARS achieved its objective as set out in the explanatory memorandum to the Taxation Laws Amendment Bill, 2011.

National Treasury further mentioned, the amendments aims to align the exit charge legislation that South Africa applies with international norms when an individual, company or CFC cease to be a tax resident for South African tax purposes (National Treasury,

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2012a:110). Whether this objective is being reached will be discussed when comparing the South African CFC legislation with UK CFC legislation in chapter 7.1.3 of this research study.

7.2.2 Practical implications of these tax amendments

Certain practical issues normally experienced by taxpayers with tax amendments were also identified and researched through reviewing literature and conducting interviews. The practical issues identified were the following:

- **Retrospective application of tax legislation**

In an article written by Minnaar (2012), director at ENS, she provides her argument why she believes the retrospective application of tax legislation is unconstitutional. Minnaar (2012) mentions the backdating of tax legislation conflicts with two key South African constitutional principles, firstly the principle of the rule of law and secondly, the principle of separation of powers.

These principles were emphasized in court cases where the judge ruled on the principle of law and the separation of powers. Judge Mokgoro, in the case of *President of the Republic of South Africa v Hugo* ruled on the importance of the rule of law and that a person should be able to know the law, and be able to adapt his or her behaviour to the law. In *South African Association of Personal Injury Lawyers v Heath*, held that the South African Constitution provides for separation of powers and that laws inconsistent with what the Constitution requires in that regard, are invalid.

As a result of the literature reviewed the constitutionality of backdating the implementation of tax amendments were identified as a possible practical issue. Based on the content of this literature and the mentioned court cases, there seems to be a strong argument that the backdating of the implementation of tax amendments are indeed unconstitutional.

Furthermore, Linington (2012) mentions that consideration should be given to the practical implication of retrospectively implementing tax amendments. If one considers the case

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study in chapter 6 and assume shareholders A, B, C and D did not consider the disposal event as mentioned in section 9H(3) of the ITA, they would not have included the capital gain charge when they did their estimate for the second provisional tax payments that was due 30 June 2012. Therefore, a danger exists that the shareholders did not comply with the required estimation percentage as provided for in the Fourth Schedule to the ITA.

If the shareholders did not comply with the estimation percentage it can result in the shareholders having underestimated their taxable income for second provisional tax payments. With this underestimation of the taxable income, SARS may levy an underestimation penalty as set out in paragraph 20 of the Fourth Schedule to the ITA, read with section 213 of the Tax Administration Act No 28 of 2011 (TAA). This will result in the taxpayer having yet another cash outflow which it did not budget for at the time of submitting the return.

Furthermore, shareholders A, B, C and D missed the chance to make the voluntary third provisional payment that is due six months after a company's financial year-end. This may result in SARS charging interest on the underpayment of provisional taxes for the 2012 tax year, which once again means another cash outflow for the companies.

There is also the possibility that shareholders A, B, C and/or D could have submitted their 2012 tax returns with incorrect and/or omitted information and a request for correction should be made by these companies to submit amended 2012 tax returns. This adds to the administrative burden on these companies.

Therefore, it is clear to see that by backdating the implementation of tax legislation, it places a massive administrative burden on taxpayers and it can also result in taxpayers having to pay penalties on wrongly submitted tax returns and provisional tax returns.

- **Different effective dates**

A further practical issue identified through the interview conducted with Mr. Churr, is the fact that the effective dates of amendments to provisions of the ITA which 'interact' with

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each other are not always on the same date. He feels this complicates tax legislation and it makes sound tax planning difficult.

- **Issue of new shares**

The issue of new shares is not regarded as a disposal event for CGT purposes. This has the result that the exemption embodied section 9H(5) of the ITA read with paragraph 64B of the Eighth Schedule of the ITA will not apply in the instances when a CFC issue new shares to foreign investors and the CFC ceases to be controlled in South Africa as a result of the issue of the new shares.

According to Mr. Churr a practical issue arises when a foreign company is forced to issue more shares to foreign shareholders. Seeing that the issue of new shares are not seen as a disposal, the South African shareholders will not qualify for any exemption and will need to account for the exit tax charge as mentioned in section 9H of the ITA. This can be regarded as being unfair as the South African shareholder did not make any business decision to dispose of the shares, the exit tax charge is merely a consequence of the foreign company being forced to issue more shares to foreign shareholders.

In the interview conducted with Mr. Roelofse he mentioned that the exemption embodied in paragraph 64B of the ITA read with section 9H of the ITA deliberately excludes the issue of new shares. Mr. Roelofse is of the opinion that if the issue of shares qualifies for this exemption, it will be easy to bypass the provisions currently embodies in the South African CFC legislation. This may also result in SARS losing out on tax revenue, but this should be researched further. Therefore, the issue of shares is currently an issue with regards to a CFC ceasing to be a CFC as a result of this issue of shares.

Mr. Roelofse continued by saying that the South African shareholders can look into the option of disposing the equity shares in the foreign company prior to the foreign company issuing new shares to foreign investor. The disposal by the South African tax residents will be exempt from CGT if the tax residents comply with the provisions of paragraph 64B of the Eighth Schedule to the ITA. If the CFC ceases to be a CFC when the new shares are

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issued, the South African tax resident will not be affected as they are not shareholders of the company anymore.

7.2.3 Comparison to UK CFC legislation

National Treasury mentioned that one of the reasons for amending section 9H of the ITA is align the exit charge legislation that South Africa applies with international norms when an individual, company or CFC cease to be a tax resident for South African tax purposes (National Treasury, 2012a:110). As discussed in Chapter Five, and also in the case study in Chapter Six, there are differences between the South African tax legislation and the UK tax legislation when a CFC ceases to be a CFC as a result of the issue of new shares.

In South Africa the tax event is on the date the CFC ceases to be CFC. The CFC is deemed to have disposed of its assets, other than those excluded, on the day immediately before ceasing to be a CFC. This means the South African tax residents currently have to account for an exit tax charge on the deemed disposal of the equity shares in the foreign company.

Through the correspondence with Mr. Cooper, he mentioned that the UK tax residents will not have to account for an exit tax charge when the CFC ceases to be controlled in the UK. The tax event in the UK will be at the ultimate disposal of the equity shares in the CFC by the UK tax residents. Therefore, there is no deemed disposal event in the UK when a CFC ceases to be controlled in the UK.

It would seem that South Africa is not fully aligned with the international norm if we use this comparison to the UK legislation. Important to note, this research study shows that to CFC qualification between South Africa and the UK are very similar, but the tax treatment of the CFC ceasing to be a CFC is different. It would seem that the objective of National Treasury to align South Africa with international norms with regards to exit tax charges is not being fully achieved at the moment.

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7.3 RECOMMENDATIONS

Based on the evidence of this research study, it is recommended that National Treasury reconsider certain parts of the current provisions that guide the exit tax charges in South African tax legislation.

Consideration should be given to providing some sort of exemption to South African tax residents with shares in a CFC when that CFC ceases to be a controlled in South Africa. Specific consideration should be given to the situation discussed in the case study when a CFC is forced to issue more shares to the government of a foreign country in order to be able to continue doing business in that specific country. If the CFC ceases to be controlled in South Africa as a direct result of this issue of shares, the shareholder should not be taxed as a result of the company's decision.

A provision as found in the UK CFC legislation could provide a reasonable outcome for both SARS and the shareholder. The South African shareholders will be taxed at the time they decide to sell the shares and SARS will then receive its tax revenue from the disposal of the equity shares in the foreign company. This makes business sense as a taxpayer in South Africa is normally taxed when it receives income as a result of some sort of action from the taxpayer's side like for example receiving a salary for rendering services to an employer, receiving income as a result of an actual sale of items and having to account for a capital gain or loss when disposing of an asset. An action forced onto a third party should not result in the taxpayer paying an exit charge as the taxpayer did not receive any sort of benefit or income.

7.4 FUTURE RESEARCH

The aim of this study was to look at the tax implications when a CFC ceased to be controlled in South Africa and the study did not look comprehensively at all the possible taxpayers covered in section 9H of the ITA. Because of the limitations to this study, further research with regards to exit tax charges on, for example, individuals may provide different results that may be of assistance to the specifics as discussed in this research study.

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In addition, the study only compared the South African tax legislation to the UK tax legislation. By conducting further research and comparing the South African exit tax charge rules to other countries as well, more similarities and/or differences can be identified. This can be used to further strengthen the South African tax policy, by addressing the practical issues currently experienced by taxpayers.

This research study also did not aim to identify the reasons why the reference to a company in the definition of a value shifting arrangement will be removed with effect from 1 January 2014. It was only mentioned as part of the argument used in this study, but further research on this may provide more clarification on the exact reason for this. It may also show how this affects companies and taxpayers when the companies issue more shares to shareholders.

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