

## **SOUTH AFRICAN TAX PROVISIONS APPLICABLE TO IHCs**

### **10.1 INTRODUCTION**

This chapter outlines the aspects of South African tax law that have a direct impact on South Africa as a suitable jurisdiction for hosting an IHC. These aspects have both positive and negative attributes and are analysed in this chapter with regard to that impact. Focus is placed on the attributes of the South African tax system that are the same as or mirror those that make the Netherlands and Mauritius suitable jurisdictions for holding companies.

The usefulness of IHCs can be limited or completely annihilated by a tax regime that is too rigid. This strictness of the tax regime depends to a large extent on a country's adherence to the capital import neutrality and capital export neutrality principles.<sup>1</sup> A country that is adverse to capital outflow would subject income earned by its residents from foreign countries to high taxes. This is mirrored by the presence of dividend taxes, transfer pricing rules, thin capitalisation and controlled foreign company (hereinafter referred to as "CFC") legislation.

As indicated in Chapter 1, this thesis examines the suitability of South Africa, given its tax system, as a location from which IHCs could operate. It should be noted that, in light of the fact that the reasons for incorporating an IHC are generally not to avoid tax, the South African tax laws can only be seen to be adverse if they would subject the IHC to

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<sup>1</sup> The capital export neutrality principle advocates neutrality of the tax system so as not to encourage or discourage the outflow of capital. On the other hand, the capital import neutrality principle advocates neutrality of the tax system so as not to encourage or discourage the inflow of capital. See Holmes *International Tax Policy and Double Tax Treaties – An Introduction to Principles and Application* (2007) 6–14.

harsher tax treatment than other investment vehicles. It could also be regarded as not suitable if it is, on average, more burdensome than other tax regimes around the world. The examination of the South African tax system in this chapter is followed by a comparative analysis in which the South African tax system is compared to the tax systems of its main trading partners.

## 10.2 OUTLINE OF SOUTH AFRICAN CORPORATE INCOME TAXATION

Since 2001, South Africa has been taxing on a residence basis.<sup>2</sup> In terms of this system companies that are incorporated in South Africa or that have their place of effective management in South Africa are taxable in South Africa on their worldwide income.<sup>3</sup> The corporate income tax rate is 28%. Capital gains are taxable at the rate of 14% for resident companies. Non-resident companies are only liable for capital gains tax on the disposal of assets that are attributable to immovable property located in South Africa, subject to DTA provisions.<sup>4</sup>

On declaration of dividends, companies are liable to secondary tax on companies at the rate of 10%.<sup>5</sup> The secondary tax on companies is a tax on the company declaring dividends and not on the shareholder receiving the dividend.<sup>6</sup> The secondary tax on companies is being abolished and replaced with a dividend tax system in terms of which the shareholder will be liable for the tax.<sup>7</sup> The new dividend tax system will come into

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<sup>2</sup> See s 1 definition of “gross income”.

<sup>3</sup> See s 1 definition of “gross income” read with definition of “resident”. For a detailed discussion of the residence requirements for companies in South Africa see South African Revenue Service *Interpretation Note No 6: Resident: Place of Effective Management (Persons Other Than Natural Persons)* (2002) par 3; Silke and Stretch “Residence and Persons Other Than Natural Persons” 2002 (Issue No 5) *Taxgram* 6–7.

<sup>4</sup> See Mazansky “South Africa and its Worldwide Tax Regime: Have we (Almost) Come Full Circle?” (2004) *Bulletin for International Fiscal Documentation* 151.

<sup>5</sup> See s 64B(2).

<sup>6</sup> See s 64B(2).

<sup>7</sup> See National Treasury *Budget Review* (2007) 67; National Treasury *Media Statement Revised Taxation of Distributed Profits* (20 February 2008) 1 available at [http://www.treasury.gov.za/comm\\_media/press/2008/2008022001.pdf](http://www.treasury.gov.za/comm_media/press/2008/2008022001.pdf) accessed on 05 February 2009. National Treasury *Budget Review* (2008) 61–62; National Treasury *Budget Review* (2009) 64. The provisions of the new dividend tax have been enacted in ss 64D-L but have not yet come into effect.

effect once the South African treaties that limit the withholding tax on dividends have been revised.<sup>8</sup>

In addition to the above-mentioned tax instruments, the South African tax system contains provisions that impose a tax on CFCs<sup>9</sup> and on foreign dividends.<sup>10</sup> Furthermore, the South African tax system contains anti-avoidance measures in the form of transfer pricing<sup>11</sup> and thin capitalisation.<sup>12</sup>

Similar to the tax regimes in the Netherlands and Mauritius, the South African tax regime grants credits for foreign taxes levied by source countries and has an advance tax ruling system in terms of which taxpayers may obtain the tax authorities' view on the application of the tax laws to proposed transactions.<sup>13</sup>

The focus of this thesis is IHCs that are tax-resident in South Africa. Thus such IHCs would have to be incorporated or effectively managed in South Africa.<sup>14</sup> Once tax-resident in South Africa, ordinarily, the IHC would be taxable at the corporate tax rate, capital gains tax rate and the secondary tax on companies or dividend tax rates mentioned above. Furthermore, other tax implications applicable to South African companies will be applicable to the IHC, including the benefit of the South African tax treaty network.

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<sup>8</sup> See National Treasury *Media Statement Revised Taxation of Distributed Profits 2*. The tax treaties at issue are the treaties with Australia, Cyprus, Ireland, Kuwait, the Netherlands, Oman, Seychelles, Sweden and the United Kingdom. At the time of the publication of this media statement, it was envisioned that the treaty revision process would be completed by the end of 2009.

<sup>9</sup> See s 9D.

<sup>10</sup> See s 5 read with para (k) of the definition of "gross income".

<sup>11</sup> See s 31(2).

<sup>12</sup> See s 31(3)

<sup>13</sup> See s 6quat and ss 76B-76S; Bakker "Netherlands: Changes to Dutch Participation Exemption are Postponed" (January 2001) *International Tax Review* <http://www.internationaltaxreview.com/?Page=10&PUBID=35&ISS=12634&SID=468288&TYPE=20> accessed on 05 February 2009. See also section 159 of the Mauritian Income Tax Act 1995 accessible on <http://www.gov.mu/portal/sites/mra/download/ITax1995updated081108.pdf> accessed on 05 February 2009; Kröner and Van Doorne "Legal Aspects of Tax Rulings in the Netherlands" in *International Tax Planning* (ed Campbell) (1995) 149.

<sup>14</sup> Where the IHC is incorporated in South Africa but effectively managed in another country with which South Africa has a double taxation agreement, such IHC may not be tax resident in South Africa in terms of that double taxation agreement.

### 10.2.1 Corporate Income Tax Rate

The South African corporate income tax rate is 28%. Table 1 below outlines South Africa's main trading partners and their corporate tax rates.

**TABLE 1**

<b>Countries Globally</b>	<b>CIT%</b>	<b>African Countries</b>	<b>CIT%</b>
Australia	30	Botswana**	5 – 15
Belgium	33.3	Mauritius	15
China	25	Mozambique	32
France	33.3	Nigeria	30
Germany	15	Zambia	35
India	30	Zimbabwe	30
Israel	27		
Italy	27.5		
Japan	30		
Korea	25*		
Netherlands	26.9		
Spain	30		
Switzerland	17 – 30		
United Kingdom	28		
United States	15 – 35		

Source: Ernst & Young (2006) *Worldwide Corporate Tax Guide*

\*Korea has a two-step tax rate system in terms of which the tax rate is 13% for the first 100 million KRW and 25% on amounts in excess of this.

\*\* Botswana, US and Switzerland have special dispensations in terms of which the tax rates could be reduced to the lower rate indicated in the table.

As has been seen in Chapter 8,<sup>15</sup> the Mauritian corporate tax rate is 15%. This rate is one of the lowest of all of South Africa's main trading partners. It was seen in Chapter 7,<sup>16</sup> that the Dutch corporate tax rate is 26.9%, which is lower than the majority of the other trading partners of South Africa. At 28% the South African rate is also lower than 13 of the 20 trading partners to which it is compared.

## 10.3 CFC LEGISLATION

### 10.3.1 General

The CFC regime was introduced in South Africa in 1997 by the introduction of section 9D of the Act as a mechanism to impose tax on investment income.<sup>17</sup> The introduction of the residence basis of taxation in 2001 broadened the application of the CFC regime from applying only to investment income. In terms of the CFC regime, coupled with the introduction of the residence basis of taxation, all income, including investment income and capital gains accrued to or received by a CFC for years of assessment commencing on or after 1 January 2001, is attributed to the South African resident.

### 10.3.2 Content of the South African CFC Regime

The charging subsection of the CFC regime requires residents holding participation rights in a CFC to include a proportional ownership percentage of the net income earned by the CFC in their South African income.<sup>18</sup> Commentators generally view the South African CFC legislation as an anti-avoidance measure.<sup>19</sup> However, it might not be so. It is submitted that the South African CFC legislation subjects to tax income that was not subject to tax before. The effect is the same as was the case with the introduction of

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<sup>15</sup> See Chapter 8 par 8.2.1.

<sup>16</sup> See Chapter 7 par 7.3.2.

<sup>17</sup> See Oguttu *Curbing Offshore Tax Avoidance: The Case of South African Companies and Trusts* (LLD dissertation 2007 UNISA) 111–112; Olivier and Honiball 430. The CFC rules were introduced by s 9 of the Income Tax Act 28 of 1997.

<sup>18</sup> See s 9D(2).

<sup>19</sup> See Olivier and Honiball 430; Huxham and Haupt *Notes on South African Income Tax* (2008) 367.

capital gains tax.<sup>20</sup> Thus, it is submitted, the South African CFC legislation is in effect a tax base broadening item. The fact that it was also intended at combating certain income tax avoidance schemes should not give it the general character of an anti-avoidance measure. The perception of provisions being anti-avoidance in nature could result in broader interpretation in a court deciding a tax case on interpretation of such provisions.

In conjunction with the charging provisions, the crux of the operation of the CFC legislation is contained in the definitions subsection.<sup>21</sup> The effect of the charging provision contained in section 9D(2) is that the net income of a CFC is attributed to the resident who holds participation rights in the CFC in proportion to that resident's shareholding in the CFC. For the purposes of section 9D the terms "participation rights" and "controlled foreign company" are defined. Other key terms are "attributable amount" and "net income". The CFC provisions exclude certain amounts from attribution. These key terms and exclusions are discussed below in outlining the CFC provisions.

#### **10.3.2.1 Participation Rights**

The term "participation rights" is defined as follows:

'participation rights' in relation to a foreign company means –

- (a) the right to participate directly or indirectly in the share capital, share premium, current or accumulated profits or reserves of that company, whether or not of a capital nature; or
- (b) in the case where no person has any right in that foreign company as contemplated in paragraph (a) or no such rights can be determined for any person, the right to exercise any voting rights in that company.<sup>22</sup>

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<sup>20</sup> For example, the introduction of CGT in 1962 as an income tax on short-term gains was essentially seen as a tax that was created to prevent what was deemed to be a socially unacceptable way of avoiding tax on a form of wealth realisation. See Miller and Hardy *Taxation of Company Reorganisations* (2007) 11.

<sup>21</sup> The definitions for purposes of s 9D are contained in s 9D(1).

<sup>22</sup> See s 9D(1) definition of "participation rights". The original definition of "participation rights" did not include the rights to exercise voting rights in the company. This was included with effect from 2 November 2006 and is applicable in respect of any year of assessment ending on or after that date. See Jooste 473.

This broad definition of “participation rights” has the effect that where a resident has any conceivable ownership interest in a foreign company such interest would constitute a participation right. As will be seen below,<sup>23</sup> a certain level of holding of participation rights is required both for the company to constitute a CFC and for the income of such CFC to be attributable to the resident. The definition of participation right is in relation to a foreign company. A foreign company is defined as a company that is not resident.<sup>24</sup>

### 10.3.2.2 *Controlled Foreign Company*

A company is a CFC if it is not resident and more than 50% of its participation rights are held, or 50% of its voting rights are exercisable, by one or more residents. A natural person is resident in South Africa if he/she is ordinarily resident in South Africa or he or she satisfies the physical presence test.<sup>25</sup> A company is resident if it is incorporated in South Africa or has its place of effective management in South Africa.<sup>26</sup> The requirement that the participation rights be held or voting rights be exercisable by residents does not imply that the residents should hold such participation rights or have rights to exercise such voting rights in collusion or jointly.<sup>27</sup> Thus, a company will be a CFC even if the

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<sup>23</sup> See par 2.2.2 below.

<sup>24</sup> See s 9D(1) definition of “foreign company”. See also Oguttu 113–115.

<sup>25</sup> A natural person’s ordinary residence is a country to which he would naturally and as a matter of course return from his wanderings. When contrasted with other countries, this country might be called his usual or principal residence and it would be described most aptly in relation to other countries as his real home. See *Cohen v CIR* 1946 AD 183–187 and *CIR v Kuttel* 1992 (3) SA 242 (A) 246–250. Where a person’s ordinary residence is in one place and it is part of the ordinary and regular course of his life to live elsewhere for a period of time each year with a degree of permanence sufficient to characterise his physical presence there as more than that of a mere bird of passage, he will be resident (but not ordinarily resident) in such other place. See *H v COT* 1960 (2) SA 695 (SR). See further Emslie, Davis and Hutton *Income Tax Cases and Materials* (2001) 949–950. If a natural person is not ordinarily resident but is physically present in South Africa for a period or periods exceeding 91 days in aggregate during a year of assessment, as well as for a period or periods exceeding 91 days during each of the five years of assessment preceding that year of assessment and for a period or periods of 915 days in aggregate during those five preceding years of assessment, such person is resident in South Africa. See section 1 definition of resident. See further Williams *Income Tax in South Africa, Law and Practice* (2006) 32 – 36.

<sup>26</sup> See Meyerowitz *Meyerowitz on Income Tax* (2008) par 5.19, see also Van der Merwe ‘Residence of a Company – the Meaning of Effective Management’ *South African Mercantile Law Journal* (2002) 79. Place of effective management is an international tax term used in double taxation agreements following the OECD Model Convention.

<sup>27</sup> See Jooste 2001 *SALJ* 475–476.



persons holding such rights are not related, or do not even know any one or more of the other person or persons also holding rights.<sup>28</sup>

In the determination of whether a foreign company is a CFC, voting rights in a foreign listed company are ignored. Furthermore, if the voting rights in a foreign company are exercised indirectly through a listed company, such voting rights are equally ignored.<sup>29</sup> Any voting rights in a foreign company which can be exercised directly by any other CFC in which a resident (or a resident together with any connected person<sup>30</sup> in relation to that resident) can directly or indirectly exercise more than 50% of the voting rights are deemed for purposes of this definition to be exercisable by that resident.

If a resident holds less than 5% of the participation rights in a CFC which is a listed company (or a foreign company in which participation rights are held indirectly through a listed company) such person is deemed to be not a resident for purposes of determining whether a company is a CFC.<sup>31</sup> Where more than 50% of all the voting or participation rights in the foreign company are held by connected persons, such foreign company will be a CFC irrespective of the fact that it is listed and regard will be had to all shareholders, irrespective of the fact that they may hold less than 5% of the participation rights.<sup>32</sup>

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<sup>28</sup> It needs to be noted here that further to the objective of taxing active income, where the shareholding in the foreign company is substantial, the shareholders would at the very least be aware of other persons holding substantial interests in the company. Some confusion existed with the original version of section 9D, which defined a CFC as a foreign company in which any resident or residents held rights individually or jointly. The question was whether that implied that residents should hold the rights in concert or with a common purpose. See Jooste 2001 *SALJ* 475–476.

<sup>29</sup> See 9D(1) proviso (a) to the definition of “controlled foreign company”.

<sup>30</sup> “Connected person” is defined in s 1 of the Act by way of reference to the definition of “group of companies” in section 1. In terms of these definitions two companies would be connected to another if there is a 50% or more holding by the one company in the other company. A company will also be connected to another company if that company owns at least 20% of the equity share capital of another and no shareholder holds the majority voting rights of such company. Companies which are controlled by connected persons are connector persons.

<sup>31</sup> See s 9D(1) proviso (c)(i) and (ii) to the definition of “controlled foreign company”. Holdings in collective investment schemes are also ignored if the resident holds less than 5% of the participation or voting rights therein.

<sup>32</sup> See Wilson “International Tax X” 2004 *Tax Planning* 115–117.



### 10.3.2.3 *Attributable Amount*

The amount to be included in the income of the resident is an amount equal to:

...where that foreign company was a controlled foreign company for the entire foreign tax year, the proportional amount of the net income of that controlled foreign company determined for that foreign tax year, which bears to the total net income of that company during that foreign tax year, the same ratio as the percentage of the participation rights of that resident in relation to that company bears to the total participation rights in relation to that company on that last day.<sup>33</sup>

The attributable amount is pro rated to the percentage of the participation rights of the resident. Therefore, a resident who holds 25% of the participation rights would have only 25% of the income of the CFC attributed to that person. This applies where the CFC was a CFC for the entire foreign tax year. However, if the foreign company became a CFC during the foreign tax year, the amount to be included in the income of the resident will be an amount equal to an amount which bears to the proportional amount pro rated to the percentage of the participation rights, the same ratio as the number of days during that foreign tax year that the foreign company was a CFC bears to the total number of days in that foreign tax year.<sup>34</sup>

Alternatively, at the option of the resident taxpayer the amount included could be the proportional amount, pro rated to the percentage of the participation rights (as if the day that foreign company commenced to be a CFC was the first day of its foreign tax year), of the net income of that company for the period commencing on the day that the foreign company commenced to be a CFC and ending on the last day of that foreign tax year.<sup>35</sup>

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<sup>33</sup> S 9D(2)(a)(i).

<sup>34</sup> S 9D(2)(a)(ii). See also Mitchell *et al* "Controlled Foreign Companies" 2008 *Income Tax Reporter* 153–157.

<sup>35</sup> S 9D(2)(a)(ii)(aa).

If the foreign company ceased to be a CFC at any stage during the year of assessment before the last day of the foreign tax year of that controlled foreign company, the amount to be included in the resident shareholder is determined similarly to where the foreign company became a CFC during the foreign tax year. This is also at the option of the resident shareholder.<sup>36</sup>

Attribution does not apply where the resident holds less than 10% of the participation rights in the foreign company.<sup>37</sup> The provision exempts the resident shareholders from attribution where the resident (or the resident together with any connected person in relation to that resident) does not hold more than 10% of the participation rights in the CFC at the end of the last day of the foreign tax year of the CFC, or in the case of a CFC that ceased to be such during the foreign tax year, immediately before that foreign company ceased to be a CFC. Furthermore, there is no attribution to the extent that the resident holds the participation rights through a company which is a resident.<sup>38</sup> The attribution in relation to the indirect holding would be in relation to the company holding the shares directly.<sup>39</sup>

Having determined that a company in which connected persons hold more than 50% of the participation rights will be a CFC irrespective of the holding, the income of the CFC will be attributed to the shareholder if that shareholder holds more than 10% of the participation rights. If the shareholder holds less than 10% but a connected person in relation to him or her also has a holding which if combined exceed 10% the net income of the CFC would be attributed to both such shareholders in relation to their respective sub-10% holdings. It is not required that the connected person shareholder should be a South African resident for their shareholding to be considered in determining the CFC status of the foreign company or the attributability of the income.

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<sup>36</sup> S 9D(2)(a)(ii)(bb).

<sup>37</sup> Proviso (A) to s 9D(2). Mitchell *et al* "Controlled Foreign Entities" 2001 *Income Tax Reporter* 30.

<sup>38</sup> Proviso (B) to s 9D(2).

<sup>39</sup> Burt "Apportionment under s 9D" 2004 *Tax Planning* 110 – 112.

#### 10.3.2.4 *Net Income*

For the purpose of the CFC provisions, the net income of a CFC is determined in accordance with the provisions of the Act as if that CFC is a resident and taxpayer in South Africa.<sup>40</sup> The allowances, deductions and any assessed losses to the resident in respect of the income of the CFC are ring-fenced to the income of the CFC.<sup>41</sup> Losses are carried forward to the immediately succeeding foreign tax year and are deemed to be a balance of the assessed loss that may be set off against the income of such CFC.<sup>42</sup>

Deductions are not allowed in respect of interest, royalties, rental, foreign exchange loss or income of a similar nature that arose as a result of transactions between the CFC and another CFC. This applies unless the CFC elects to divest itself of the available exemptions or the income from the items listed above has been included in the income of the other CFC.<sup>43</sup>

The net income of the CFC is determined in the currency used by that CFC for purposes for financial reporting. Such amount is translated to the South African Rand by applying the average exchange rate for the year of assessment concerned.

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<sup>40</sup> S 9D(2A). See also Meyerowitz, Emslie and Davis “Controlled Foreign Entity” *The Taxpayer* (2000) 186. See also Olivier and Honiball 443.

<sup>41</sup> Proviso (a) to section 9D(2A). See also Boltar “Law of Taxation” *Annual Survey of South African Law* (2000) 815; Boltar and Monteiro “Law of Taxation” *Annual Survey of South African Law* (2001) 815.

<sup>42</sup> Proviso (b) to s 9D(2A). See also Olivier and Honiball 443.

<sup>43</sup> Proviso (c) to s 9D(2A). The other provisions applied in determining the net income of a CFC relate to the capital gains tax (“CGT”) where the foreign company becomes a CFC after the effective date of the CGT regime in South Africa. In this case the valuation date for CGT purposes is deemed to be the date on which that foreign company becomes a CFC. See proviso (e) to s 9D(2A). Where the resident shareholder is a natural person, special trust or insurer in respect of its individual policyholder fund, the taxable capital gain of the CFC will be 25% of that company’s net capital gain for the relevant foreign tax year. See proviso (f) to s 9D(2A). These aspects will be dealt with where they become directly relevant to the discussion.

### 10.3.2.5 *Exclusions / exemptions*

The CFC regime exempts or excludes<sup>44</sup> certain receipts and accruals of the CFC in the determination of the net income of a CFC imputable to a South African resident. The main exemptions are the following:

1. Income that has already been taxed;<sup>45</sup>
2. Income arising from a CFC that has a foreign business establishment;<sup>46</sup>
3. Dividend income from a related CFC;<sup>47</sup> and
4. CFC interest, rents and royalties.<sup>48</sup>

Prior to 2003, in addition to the above exemptions, the Act contained an exemption of income of CFCs located in certain countries (the so-called “designated countries”). The purpose of this exemption was to exclude the receipts and accruals of a CFC that is subject to foreign income taxes comparable in amount to those imposed in South Africa.<sup>49</sup> That exemption was repealed in 2003.<sup>50</sup>

#### (a) *Income that has already been taxed*

Where the income of a CFC has been, or will be, taxed in South Africa in terms of other provisions of the Act and will not be exempt or taxed at a reduced rate as a result of the application of a DTA, such income will not be imputed to the resident shareholder’s

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<sup>44</sup> It is not clear whether these items are excluded (disregarded) or exempt (still to be accounted for) from the application of the CFC provisions. Olivier and Honiball 446 submit that even though the South African legislature attempted to provide clarity in 2005 there is still no certainty in this regard. For a discussion of this aspect see Olivier and Honiball 446.

<sup>45</sup> S 9D(9)(e).

<sup>46</sup> S 9D(9)(b).

<sup>47</sup> S 9D(9)(f).

<sup>48</sup> S 9D(9)(fA).

<sup>49</sup> See Jooste 484. The designated countries as per GN 866 of 1 September 2000 were the following: Algeria, Australia, Austria, Belgium, Canada, Croatia, the Czech Republic, Denmark, Egypt, Finland, France, Germany, Israel, Italy, Japan, Korea, Lesotho, Malawi, Namibia, the Netherlands, Norway, Poland, Romania, Slovakia, Swaziland, Thailand, Tunisia, the United Kingdom, the United States of America, Zambia and Zimbabwe.

<sup>50</sup> The designated country exemption was repealed by s 22(1)(g) of the Revenue Laws Amendment Act 45 of 2003 with effect from 1 June 2004. For more on how the designated country exemption applied see Jooste 484 – 486; Kolitz “Designated Countries and Foreign Dividends” 2005 *Tax Planning* 19.

income.<sup>51</sup> The basis of this provision is that certain income of the CFC may be taxed or taxable in South Africa by application of the source rules. Without this exemption, the income of the CFC that would have been taxed by application of the source rules would also be imputed to the resident shareholders, resulting in economic double taxation of the same income.<sup>52</sup>

Certain income could be subject to tax in South Africa but as a result of the application of the DTA between South Africa and the country of residence of the CFC, such income is not taxable in South Africa. Where this is the case, the exemption does not apply. In this regard Jooste<sup>53</sup> states that “[i]t follows that South African residents cannot avoid tax on South African income by operating through [CFCs] located within the South African treaty network. This is equitable because the income would have been taxed if earned directly by the South African residents.”

This exemption would only apply to an IHC where the subsidiaries of the IHC source their income in South Africa.

*(b) Dividend income from a related CFC*

The provision relating to the dividend income is somewhat complicated. In terms of this exemption, in determining the net income of a CFC the amount that is excluded is any amount which is attributable to any foreign dividend declared to that CFC by any other CFC in relation to the resident to the extent that the foreign dividend does not exceed the aggregate of all amounts which have been or will be included in the income of the resident in terms of section 9D which relate to the net income of the company declaring the dividend.<sup>54</sup>

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<sup>51</sup> See s 9d(9)(e). See also Meyerowitz, Emslie and Davis *The Taxpayer* 187 – 188.

<sup>52</sup> Economic double taxation is taxation that results in the same income being taxed twice in the hands of different taxpayers. On the other hand, juridical double taxation is the double taxation of the same income in the hands of the same taxpayer.

<sup>53</sup> Jooste 498.

<sup>54</sup> Mitchell *et al* “Controlled Foreign Entities” 2001 *Income Tax Reporter* 37.

This aggregate amount is to be reduced by the amount of any foreign tax payable, in respect of the amounts so included in that resident's income; and so much of all foreign dividends received by or accrued to that controlled foreign company as was excluded from the application of this section 9D and previously not included in the income of that resident by virtue of any prior inclusion in terms of section 9D.<sup>55</sup>

This provision applies in relation to dividends declared by one CFC in relation to the resident to another CFC in relation to the same resident (hereinafter referred to as "sister CFCs"). The amount exempted is the amount of the dividend that is less than (does not exceed) the sum of amounts includable in the hands of the resident in any year of assessment. However, the amount exempted and the amounts includable relate to the net income of the sister CFC declaring the dividend reduced by foreign taxes payable, exempt foreign dividends and amounts that have been included in terms of source rules.

(c) *The foreign business establishment ("FBE") exemption*

Originally referred to as the "business establishment" exemption, the foreign business establishment (hereinafter referred to as "FBE") exemption is intended to apply only if the income of the CFC concerned does not pose any threat to the South African tax base.<sup>56</sup> The generation of income elsewhere would pose a threat to the South African tax base where such income could be earned in South Africa; thus, the business producing such income could be conducted from South Africa. This is often explained in terms of a business in respect of which there is no real economic reason, other than tax, to locate in the other jurisdiction.<sup>57</sup>

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<sup>55</sup> See Boltar *Annual Survey of South African Law* 815.

<sup>56</sup> See Oguttu 128 – 130; Olivier and Honiball 447 – 460 for a detailed discussion of the business establishment exemption. The terminology from "business establishment" to "foreign business establishment" was changed by s 9(1)(b) of the Taxation Laws Amendment Act 8 of 2007 with effect from 2 November 2006.

<sup>57</sup> See Legwaila "The Business Establishment Exemption" 2004 (December) *De Rebus* 42; National Treasury *Detailed Explanation to Section 9D of the Income Tax Act* (2002) 9 available at <http://www.treasury.gov.za/divisions/epifr/tax/legislation/Detailed%20Explanation%20to%20Section%209D%20of%20the%20Income%20Tax%20Act.pdf> accessed on 12 January 2009.

Section 9D accounts for the genuine business concerns by exempting all foreign business establishment income other than that which qualifies as mobile foreign business income,<sup>58</sup> diversionary foreign business income<sup>59</sup> and mobile foreign passive income.<sup>60</sup>

(i) Definition of an FBE

The point of departure with the application of the FBE exemption is the definition of an FBE. The general definition of an FBE requires locational permanence, economic substance and business purpose.<sup>61</sup> The FBE is also defined in respect to specific business activities. These are prospecting and exploration operations for natural resources;<sup>62</sup> construction or installation of items such as buildings and bridges;<sup>63</sup> agricultural activities<sup>64</sup> and transportation.<sup>65</sup> These specific definitional references are beyond the scope of this thesis.

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<sup>58</sup> Mobile foreign business income is income from shell businesses that lack any economic substance to attract taxable income. Generally, these businesses only maintain a post office address, telephone or fax line or a website.

<sup>59</sup> Diversionary foreign business income is income derived by the CFC arising out of transactions involving artificial transfer pricing. It is income that is diverted to the CFC through transactions between the CFC and connected South African residents. See s 9D(9)(b)(i) – (ii). See Oguttu 130.

<sup>60</sup> Mobile foreign passive income is income arising from assets that can be shifted around easily and consists mainly of income from portfolio investments (for example, interest, royalties, dividends, rental, annuities and insurance premiums). See s 9D(9)(b)(iii); Also Jooste 497 – 498; Oguttu 135.

<sup>61</sup> S 9D(9). See Clegg “Business Establishments” 2004 *Tax Planning* 60. The definition of business establishment received minor cosmetic changes by s 9(1)(c) of the Revenue Laws Amendment Act 20 of 2006 which in effect have no impact on the application of the definition.

<sup>62</sup> Any place outside the Republic where prospecting or exploration operations for natural resources are carried on, or any place outside the Republic where mining or production operations of natural resources are carried on, where that CFC carries on those prospecting, exploration, mining or production operations. S 9D(1) para (b) of the definition of “foreign business establishment”.

<sup>63</sup> A site outside the Republic for the construction or installation of buildings, bridges, roads, pipelines, heavy machinery or other projects of a comparable magnitude which lasts for a period of not less than six months, where that controlled foreign company carries on those construction or installation activities. See s 9D(1) para (c) of the definition of “foreign business establishment”.

<sup>64</sup> Agricultural land in any country other than the Republic used for *bona fide* farming activities directly carried on by a CFC. S 9D(1) para (d) of the definition of “foreign business establishment”.

<sup>65</sup> A vessel, vehicle, aircraft or rolling stock used for the purposes of transportation or fishing, or prospecting or exploration for natural resources, or mining or production of natural resources, where that vessel, vehicle, rolling stock or aircraft is used solely outside the Republic for such purposes and is operated directly by a CFC or by any other company that has the same country of residence as that CFC and that forms part of the same group of companies as that CFC. See s 9D(1) para (e) of the definition of “foreign business establishment”.



(ii) Locational permanence

An FBE is broadly defined as a place of business with an office, shop, warehouse or other structure which is used by the CFC for not less than one year whereby the business of the CFC is carried on.<sup>66</sup> The use requirement can be satisfied by ownership or leasing.<sup>67</sup> In this regard it is noteworthy that the place of business would not be an FBE if it is not the CFC that carries on its business in such a place. However, the CFC does not have to be the sole user of such place of business. Thus, theoretically several CFCs can use the same place of business and still retain the status of an FBE. The importance of this aspect for IHCs is that an IHC may have various CFCs that use the same premises for their business activities without losing their FBE status.

(iii) Economic substance

In terms of the definition of an FBE, the place of business should be suitably equipped with on-site operational management, employees, equipment and other facilities for conducting the primary operations of that business.<sup>68</sup> This provision attempts to ensure that a business does not qualify as a foreign “business establishment” purely on the basis of the form that is presented. It excludes a business involving purely paper-based transactions, or a business that is conducting passive income-generating activities which are disguised as a more substantial undertaking.<sup>69</sup>

(iv) Business purpose

It is required that the business must have a *bona fide* non-tax reason for operating abroad rather than in South Africa. This criterion involves a subjective enquiry into the purpose of locating the business activities outside South Africa.<sup>70</sup> In this regard the enquiry is whether there are business reasons for the business to operate in the location where it

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<sup>66</sup> S 9D(1) definition of “foreign business establishment”.

<sup>67</sup> See the National Treasury *Detailed Explanation to Section 9D of the Income Tax Act 9*.

<sup>68</sup> See s 9D(1) definition of “foreign business establishment”.

<sup>69</sup> See Jooste 488.

<sup>70</sup> Jooste 489.

operates.<sup>71</sup> Should there be genuine business reasons why the operations are conducted from a jurisdiction outside South Africa, this requirement will be met. The fact that the jurisdiction may also offer a favourable tax regime would not disqualify the availability of the FBE exemption.<sup>72</sup> However, should it be found that no business reasons, or sufficient business reasons exist to justify the relocation (irrespective of the presence of tax reasons), the FBE exemption will not apply.

Where the investor has an option of locating the operating companies in one of two or many identified jurisdictions for a valid business reason or reasons, the investor should be allowed to choose the one where the tax consequences would be minimal. By so doing, the taxpayer would not lose the FBE exemption merely because of such tax planning.<sup>73</sup>

(v) Application of the FBE

In determining the net income of a CFC any amount that is attributable to an FBE of the CFC is not taken into account. Amounts that arise from the disposal or deemed disposal of any assets forming part of the FBE are also disregarded, otherwise they would be included in calculating the capital gains tax attributable to the resident shareholders.<sup>74</sup>

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<sup>71</sup> The original provisions referred to the usage of the place of business “solely or mainly” for a *bona fide* business purpose. This raised uncertainty as to the proportion of the tax reasons to the business purposes. For example, Jooste op cit indicates that “[i]t is not clear whether or not the criterion is satisfied only if the sole purpose is a *bona fide* non-tax purpose, or whether or not it suffices if it is the main purpose. In other words, if the foreign location is attractive mainly because of its favourable business prospects but also, to a lesser extent, because of its favourable business dispensation, is the criterion satisfied?” See Jooste at 489.

<sup>72</sup> The example given in the National Treasury *Detailed Explanation to Section 9D of the Income Tax Act 10* is as follows “Facts: South African Company owns all the share of multiple foreign subsidiaries, including [CFC]. [CFC] is a resident of Tax Haven, a Mediterranean Country which imposes income tax at a 10% statutory tax rate. [CFC] leases a large warehouse within Tax Haven. [CFC] operates as a central delivery point for products shipped to customers located in Southern Europe and the Middle East. [CFC] hires managers and 5 employees that handle all storage and shipment contracts. [CFC] hires independent contractors for trucking and airline transportation. The Tax Haven location was chosen partly due to its convenient delivery location and partly due to its low tax rate. *Result*. The warehouse operations qualify as a business establishment. Even though the choice of location provides tax savings over the South African rate, the location has a *bona fide* non-tax business purpose because the location offers significant shipment cost advantages over locating in South Africa.” See National Treasury *Detailed Explanation to Section 9D of the Income Tax Act 10*.

<sup>73</sup> A similar line of thought was followed by Hefer JA in *CIR v Conhage (Pty) Ltd (formerly Tycon (Pty) Ltd* 1999 (4) SA 1149 (SCA) with regard to the application of the anti-avoidance provisions then contained in s 103(1).

<sup>74</sup> S 9D(9)(b).

This implies that where the South African IHC has participation rights in operating subsidiaries that undertake business activities outside South Africa, the FBE would apply so as to exempt the income of such subsidiaries from attribution to the IHC. There are amounts accrued or received by the CFC that would, however, be attributed to the resident shareholders irrespective of the fact that the CFC qualifies as an FBE. These amounts are outlined below.

(aa) Amounts arising from non-arm's length transactions with residents

If a CFC derives any income from any transaction with a connected person who is a resident relating to the supply of goods or services by or to that CFC, such amounts would be imputed to the income of such CFC's resident shareholders.<sup>75</sup> However, if the consideration charged for that supply of goods or services reflects an arm's length consideration, the FBE exemption would not disallowed. This provision is aimed at transactions that divert income from South Africa by using transfer pricing.

This anti-diversionary rule involves an increased and concerted effort to stamp out transfer pricing through the operation of two strategies. In this regard Jooste states, “[f]irstly, the rule creates a deterrent by effectively increasing the penalty for transfer pricing. Secondly, the rule requires a higher business activity standard than that imposed by the ‘business establishment’ exemption when the [CFC] engages in sales or services transactions with connected South African residents.”<sup>76</sup>

This higher business activity standard places a burden on the South African resident shareholder, once amounts are derived by the FBE from transactions relating to supply of goods or services, to prove that the consideration paid for the goods or services reflect an arm's length consideration.<sup>77</sup>

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<sup>75</sup> Wilson “International Tax XI” 2004 *Tax Planning* 125.

<sup>76</sup> Jooste 490.

<sup>77</sup> According to Jooste, “[t]he strategy also recognizes that sales and services transactions between a [CFC] and connected South African residents involve a close link with South Africa, which calls into question whether there are not tax reasons for conducting them offshore. ...[T]he ‘business establishment’ exemption does not take this into account by excluding from its ambit the income of a [CFC] if it is not

(bb) Sale of goods by a CFC to a resident connected person

If a CFC sells goods to a connected South African resident a higher business activity level is required. This would apply where the CFC of an IHC sells goods to a South African subsidiary of an IHC. The higher business activity requirement would be met if the sale falls into one of the following three categories:

- i. The CFC purchased those goods within the country of residence of the CFC from any person who is not a connected person in relation to that CFC.<sup>78</sup>
- ii. The creation, extraction, production, assembly, repair or improvement undertaken by the CFC amount to more than minor assembly, packaging, repackaging and labelling of the goods.<sup>79</sup>
- iii. The CFC sells a significant quantity of goods of the same or similar nature to persons who are not connected persons in relation to that CFC at comparable prices (after accounting for the level of the market, volume discounts and cost of delivery). The rationale is that chances of transfer pricing occurring are reduced by the availability of the outside pricing.<sup>80</sup>
- iv. The CFC purchases the goods or similar goods mainly within the country of residence of the CFC from persons who are not connected persons in relation to that CFC. This late inclusion ensures that the CFC does not have to purchase all of the goods from its country of residence. Furthermore, it ensures that the CFC could buy similar goods and modify them prior to the sale to the resident.<sup>81</sup>

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attributable to a place of business utilized outside South Africa for a [*bona fide*] business purpose other than a tax purpose. However, it seems that the ‘business establishment’ test is not regarded as stringent enough in a situation involving sales and services transactions between a [CFC] and connected South African residents, and that is why, in such circumstances, the higher business activity threshold is imposed.” See Jooste 491; Wilson “International Tax XI” 2004 *Tax Planning* 125.

<sup>78</sup> See s 9D(9)(b)(ii)(aa)(A). This physical location of the goods purchased establishes that the [CFC] has an economic nexus to the country of residence, and the country of residence most likely has a sufficiently good infrastructure to produce the goods. Countries with a good infrastructure typically do not tax their local sales at artificially low tax haven rates. These factors indicate that the [CFC] is most likely purchasing and reselling the goods at a convenient location for non-tax reasons, and that the [CFC] is not over-inflating the price on resale to a related South African resident.

<sup>79</sup> S 9D(9)(b)(ii)(B). Whether foreign production activities are significant is a facts and circumstances test which takes into account many factors such as how the production costs compare to the total cost of goods sold or whether special skills are employed in order to provide value. See National Treasury *Detailed Explanation to Section 9D of the Income Tax Act* 13.

<sup>80</sup> S 9D(9)(b)(ii)(aa)(C).

<sup>81</sup> S 9D(9)(b)(ii)(aa)(D).

(cc) Sales to unconnected South African residents

This provision aims to prevent loop sales from benefiting from the FBE exemption. These are transactions where the goods are initially purchased by the CFC from a connected South African resident and are on-sold to South African residents.<sup>82</sup> This transaction would have the effect of reassigning the ultimate income to the CFC, which income should have been earned and taxed in South Africa. This happens where the connected South African resident sells the goods to the CFC at a low margin, or a loss, and the CFC sells the goods to the resident unconnected person at market value. In this way the income would be earned in the country of residence of the CFC.<sup>83</sup> Transfer pricing could apply in this case. However, the onus of proof is on the FBE or the South African resident shareholder to prove one of the following four cases in order for the FBE exemption to apply:<sup>84</sup>

- i. Those goods or tangible intermediary inputs thereof purchased from connected persons who are residents amount to an insignificant portion of the total goods or tangible intermediary inputs of those goods;
- ii. The creation, extraction, production, assembly, repair or improvement of goods undertaken by that CFC amount to more than minor assembly or adjustment, packaging, repackaging and labelling;
- iii. The products are sold by that CFC to persons who are not connected persons in relation to that CFC for physical delivery to customers' premises situated within the country of residence of that CFC; or
- iv. Products of the same or similar nature are sold by that CFC mainly to persons who are not connected persons in relation to that CFC for physical delivery to customers' premises situated within the country of residence of that CFC.

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<sup>82</sup> S 9D(9)(b)(ii)(bb).

<sup>83</sup> See Wilson "International Tax XI" 2004 *Tax Planning* 125.

<sup>84</sup> S 9D(9)(b)(ii)(bb)(A)-(D). See Wilson "International Tax XI" 2004 *Tax Planning* 125

(dd) Services performed to connected residents

The fourth category of amounts that would not qualify for the FBE exemption are amounts arising from the performance of services by the CFC to a connected person who is resident. Such amounts would only be exempt if the service is performed outside South Africa and one of the following conditions is met:

- i. The service relates directly to the creation, extraction, production, assembly, repair or improvement of goods utilised within one or more countries outside South Africa;
- ii. The service relates directly to the sale or marketing of goods of a connected person in relation to that CFC who is a resident and those goods are sold to persons who are not connected persons in relation to that CFC for physical delivery to customers' premises situated within the country of residence of the CFC;
- iii. The service is rendered mainly in the country of residence of the CFC for the benefit of customers that have premises situated in that country; or
- iv. To the extent that no deduction is allowed of any amount paid by the connected person to that CFC in respect of that service.

Before applying these provisions to the operations of the business of the IHC, the focus should be placed on the key aspect of these provisions (i.e. sale of goods by a CFC to a resident connected person; sales to unconnected South African residents; and services performed to connected residents). The key aspect here is the dealing with “goods”. “Goods” are generally commodities that are tangible, usually movable, or articles of commerce.<sup>85</sup> Commodities themselves are articles of commerce.

The above provisions would apply to the transactions between the subsidiaries of the IHC located outside South African borders. Depending on specific circumstances these

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<sup>85</sup> See the *Collins Concise Dictionary* (1995) definition of “goods”.

provisions could deny the IHC the FBE exemption and therefore result in full imputation of the income.

(ee) Mobile passive income

Passive CFC receipts and accruals attributable to an FBE do not qualify for the FBE exemption. These include amounts received in the form of capital gains, foreign currency gains, dividends, interest, royalties, rental, annuities and insurance premiums. These amounts are fully subject to tax because no direct competitiveness concerns are at stake if no active business is involved.<sup>86</sup> Two exceptions exist which, if satisfied, would mean that the FBE exemption would apply to the income. The exceptions are the *de minimis* exception and an exception for banking, insurance financial service and rental businesses.

i. *De minimis* exception

The *de minimis* exception is intended to prevent the CFC provisions from applying when the CFC earns trivial amounts of income from passive investments. This rule is created for administrative convenience. The rule initially applied to amounts that do not exceed 5% of the total income and capital gains of the CFC. It has, however, been increased to 10%.<sup>87</sup> This rule is not an “all-or-nothing” rule. If passive income exceeds the 10% level, then the part of passive income that exceeds the 10% would be subject to imputation.<sup>88</sup> The National Treasury<sup>89</sup> states that “[p]assive capital gains are similarly part of the *de minimis* calculation. These gains are measured in terms of gains (not total proceeds) with capital losses ignored. Capital gains are measured for purposes of both the numerator and the denominator.”

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<sup>86</sup> National Treasury *Detailed Explanation to Section 9D of the Income Tax Act 17*.

<sup>87</sup> See proviso (A) to s 9D(2). The original 5% provision was amended by s 14(1)(d) of the Revenue Laws Amendment Act 31 of 2005 and deemed to have come into operation on 8 November 2005. The amendment is applicable in respect of any foreign tax year which commenced on or after 8 November 2005. According to the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2005, the change from the 5% rule to the 10% rule was “consequential upon the introduction of the voting right test to determine whether a foreign company qualifies as a controlled foreign company.” See <http://www.sars.gov.za/home.asp?pid=2631> accessed on 09 February 2009.

<sup>88</sup> See Jooste 478 – 479.

<sup>89</sup> National Treasury *Detailed Explanation to Section 9D of the Income Tax Act 18*.



ii. Banking, financial services, insurance and rental business exception

Passive income may be exempt from CFC imputation if it arises from the principal trading activities of a bank, financial services, insurance and rental business.<sup>90</sup> The purpose of exempting this form of income is to avoid stunting the international competitiveness of CFCs that are principally involved in such services. A set of anti-avoidance provisions apply. Firstly, CFC receipts and accruals from connected persons who are residents or residents who hold at least 5% in the CFC or in any company that holds shares in the CFC are not exempt. Secondly, amounts received by a CFC which is a foreign financial instrument holding company at the time it receives the amounts are also not exempt.

iii. Disposal of intangible assets

Amounts that arise from the disposal of intangible assets that formed an integral part of the business of the CFC or the asset was disposed of as part of the disposal of the CFC together with all assets which are necessary for carrying on the business of the CFC are exempt from CFC imputation. This exemption provision would apply to the CFCs of the IHC.

(d) *CFC interest, rents and royalties*

Amounts attributable to interest, royalties, rental or similar income which is payable to a CFC by any CFC in the same group of companies are exempt from attribution in the hands of the resident shareholders.<sup>91</sup> This is because the CFC paying such income is not allowed to deduct the payment where it pays the amount to a CFC in the same group.<sup>92</sup> However, the CFC may elect to have the exemption waived so that the income is attributed.<sup>93</sup> Where such election is made, the interest, royalties, and rental paid to the other CFC in the same group of companies would be allowed as a deduction in the hands

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<sup>90</sup> S 9D(9)(b)(iii)(bb). See National Treasury *Detailed Explanation to Section 9D of the Income Tax Act 19*.

<sup>91</sup> S 9D(9)(fA)

<sup>92</sup> S 9D(2A)(c).

<sup>93</sup> S 9D(12).

of the CFC paying such amount. Thus, such income arising out of transactions between the IHC and its CFCs would be exempt.

### **10.3.2.6 Special Rulings Provisions**

The CFC provisions provide for ruling provisions in relation to the application of the exemption provisions. These rulings relate to fulfilment of the definition of CFC,<sup>94</sup> sale of goods or performance of services,<sup>95</sup> receipt or accrual of royalties<sup>96</sup> and the place where the income of a banker, financier, issuer or broker originates.<sup>97</sup>

As was seen in Chapters 7<sup>98</sup> and 8,<sup>99</sup> the Netherlands and Mauritius do not have CFC legislation.

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<sup>94</sup> S 9D(10)(a)(i). The ruling in this regard may deem a place of business of a CFC as fulfilling the requirements of the definition of a CFC by taking into account the utilisation of employees, equipment and facilities of any company that has the same country of residence as that CFC where that other company forms part of the same group of companies as the CFC.

<sup>95</sup> S 9D(10)(a)(ii). The ruling may disregard the application of subsec (9) (b) (ii) in respect of the sale of goods or performance of services by a CFC where the foreign business establishment of that CFC situated in that company's country of residence mainly serves as a central location for the sale or performance of identical or similar goods or services in at least two countries that are contiguous to the country of residence of that company. Furthermore, in terms of s 9D(10)(a)(iv) the ruling may disregard the application of subsec (9)(b)(ii) or (iii) where the Commissioner is satisfied that the income from the sale of goods or performance of services will be subject to tax on income by any sphere of government of countries other than the Republic; and the amount of tax on income contemplated in item (aa) will equal at least two-thirds of the normal tax that would otherwise arise in connection with that income if subsec (9) (b) (ii) or (iii), as the case may be, were to apply in respect of that income after taking into account any applicable agreements for the prevention of double taxation, and any credit, rebate or other right of recovery of tax from any sphere of government of any country other than the Republic; and any assessed losses.

<sup>96</sup> S 9D(10)(a)(iii). The ruling may disregard the application of subsec (9)(b)(ii) to royalties received by or accrued to a CFC where that company directly and regularly creates, develops, substantially upgrades or adds value to (or provides substantial support services in respect of) intangibles giving rise to those royalties.

<sup>97</sup> S 9D(10)(a)(v). The ruling would disregard the business activities of a bank or financier, insurer or broker of a CFC arising in any country other than that company's country of residence where (1) that business is conducted through a permanent establishment in that other country; (2) the income from that business is subject to tax on income by that other country by virtue of that permanent establishment; and (3) the rate of tax imposed by that other country will at least equal the rate of tax that would otherwise be imposed by the country of residence had the income arisen within that country.

<sup>98</sup> See Chapter 7 par 7.3.5.

<sup>99</sup> See Chapter 8 par 8.2.3.

## 10.4 TAXATION OF DIVIDENDS

As noted in Chapter 2, an IHC is a company that is interposed between two or more companies. In this way it is a subsidiary of one, and a holding company of the other or others. Thus, the IHC would typically receive dividends from its subsidiaries and in turn pay dividends to its holding company. As a recipient of dividends from non-resident subsidiaries, the taxation of foreign dividends impacts on the cash flow of the IHC and the entire company group arising from the operations of foreign subsidiaries.

The South African system of taxation of dividends is currently undergoing change. The secondary tax on dividends (hereinafter referred to as “STC”) system is being replaced by a dividend tax system.<sup>100</sup> Under the STC system the company distributing the dividend is subject to tax on the net amount of dividends distributed.<sup>101</sup> Under the new dividend tax system, the shareholder receiving the dividend would be subject to tax on the amount of dividends received. This change also has an impact on the definition of a dividend.<sup>102</sup>

A foreign dividend is defined as a dividend received by or accruing to any person from a foreign company.<sup>103</sup> Thus, what distinguishes a foreign dividend from a dividend is the fact that the foreign dividend is distributed by a foreign company.

South African companies are currently taxed at 10% on the net amount of dividends they declare. In terms of the new dividends tax systems, shareholders will be taxed at 10% of the amount of dividends paid by South African companies. Save for the United Kingdom, as shown in Table 2 South Africa’s dividend tax rate ranks among the lowest of its trading partners. In general, the rates are reduced by treaties. On average, the rates are reduced to 5% by the treaties. The difference between the low rate and the rate reduced

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<sup>100</sup> National Treasury *Budget Review* (2007) 67–68; National Treasury *Budget Review* (2008) 61–62. Refer to budget Review for 2008. See also Mitchell *et al* “Secondary Tax on Companies” 2008 *Income Tax Reporter* 48.

<sup>101</sup> On the nature of STC as a tax on the company and not on dividends or the shareholder see the 2008 decision in *Volkswagen of South Africa (Pty) Ltd v CSARS* 70 SATC 195; Silke and Stretch “High Court: STC not a Tax on Dividends” 2008 (Issue No 9) *Taxgram* 9–10.

<sup>102</sup> See Silke and Stretch “From STC to a Shareholder Dividends Tax” 2008 (Issue No 4) *Taxgram* 3–4.

<sup>103</sup> See s 1 definition of “foreign dividend”.

by treaties is that South Africa, with a low rate irrespective of the treaties, has a competitive advantage over its trading partners as regards investment from non-treaty countries, in the same way as European countries have an advantage regarding fellow European Union countries without treaties.

Table 2 shows the dividend tax rate of South Africa's main trading partners and the withholding rates as reduced by treaties.

**TABLE 2**

<b>Countries Globally</b>	<b>WHT%</b>	<b>Treaty rate</b>	<b>African Countries</b>	<b>Div tax%</b>	<b>Treaty rate%</b>
Australia	30	15 – 20	Botswana	20	5 – 15
Belgium	20	15 – 25	Mauritius	15	0
People's Republic of China	20	0 – 10	Mozambique	20	0 – 15
France	25	0 – 20	Nigeria	10	7.5
Germany	20	0 – 20	Zambia	15	0 – 15
India	20	0	Zimbabwe	20	5 – 20
Israel	25	5 – 15			
Italy	20	5 – 15			
Japan	20	0 – 25			
Korea	25	0 – 15			
Netherlands	25	0 – 25			
Spain	15	0 – 15			
Switzerland	35	0 – 15			
United Kingdom	0	0			
United States	30	0 – 30			

Source: Ernst & Young (2006) *Worldwide Corporate Tax Guide*

#### **10.4.1 General**

In order for the distributions paid to the South African shareholders of the IHC to be subject to tax in South Africa, such distributions should constitute a dividend. The

definition of dividend is quite lengthy and cumbersome to understand. It contains a general provision, inclusions and exclusions. For purposes of this paper a brief analysis of the general provision and the inclusions should suffice.

#### **10.4.2 Definition of Dividend under the STC Regime**

A dividend is generally defined as any amount distributed by a company to its shareholders.<sup>104</sup> This general provision covers all payments made by a company to its shareholders. Its wide scope is limited by the presence of specific inclusions to the effect that where a specific form of distribution is not included in the specific inclusions discussed below. This is according to the longstanding statutory interpretation maxim *inclusio unius est exclusio alterius*, which literally translated means that to include one is to exclude another.<sup>105</sup>

The effect of the maxim is that if the legislature specifically included a thing or transaction in legislation, it is assumed that the intention was to exclude other related or similar things or transactions. Thus, the inclusion of specific transactions without expressing that such inclusion does not limit the application of the general rule results in, at the very least, an interpretative ambiguity. A comparison in this regard is made with the definition of gross income in section 1 where the specific inclusions are preceded by the phrase “without in any way limiting the scope of this definition”.

Furthermore, this broad definition tends to also include transactions that should not be included in the definition of dividend. In this regard it should be noted that the objective of taxing a dividend is to tax the accretion in the wealth of the shareholder. However, theoretically the dividend definition would also tax as a dividend payments made by the company to a shareholder as consideration for assets purchased by the company from the shareholder, say as trading stock. Such could not have been intended.

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<sup>104</sup> See s 1 definition of “dividend”. This definition is subject to change in the next amendments to the Act as it does not squarely define what a dividend should be.

<sup>105</sup> See *Consolidated Diamond Mines of SWA Ltd v Administrator*, SWA 1958 (4) SA 512 (A) 622. See also *Ex Parte Lancashire; In re Paruk v Patel* 1943 NPD 356; *Parkes v Parkes* 1932 SR 74.

It is submitted that a different construction similar to the United States tax law construction that refers to a “distribution made by a corporation to a shareholder with respect to its stock”<sup>106</sup> would be more appropriate. A similar construction is found in the capital gains provisions where a distribution is defined as any “transfer of cash or assets by a company to a shareholder in relation to a share held by that shareholder”<sup>107</sup> would eliminate the uncertainty.

Be that as it may, the definition of dividend includes specific transactions. The inclusions are imported by extending the expression “amount distributed”. Case law has held that “amount distributed” is so general as to include amounts that have been apportioned, appropriated, allocated or applied towards a goal.<sup>108</sup> The following specific cases are included:

#### **10.4.2.1      *Liquidation Dividends***

Where a company is being wound up, liquidated or deregistered or its corporate existence is otherwise finally terminated, any profits which are distributed, whether in cash or otherwise during such process, constitute a dividend.<sup>109</sup> As can be seen, the amount of dividend in this regard is limited to the profits of the company. This part of the definition should be read with sub-para (v) of the first proviso to the definition. The combined effect of these provisions is that it must first be determined whether the company at the commencement of the corporate termination had profits available for distribution. If the company had such profits, a portion of such profits may be deemed to be a dividend distributed to shareholders.<sup>110</sup> Subject to certain exceptions, any amounts paid out from

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<sup>106</sup> See s 301(a) of the US Federal Income Tax Code.

<sup>107</sup> See par 74 of the Eighth Schedule. It is expected that the National Treasury will consider changing the definition to eliminate the ambiguity in due course.

<sup>108</sup> See *CIR v Legal and General Assurance Society Ltd* 1963 (3) SA 876 (A) at 886.

<sup>109</sup> S 1 para (a) of the definition of “dividend”. This inclusion excludes capital profits earned before the process of terminating the existence of the company before the capital gains tax regime was introduced in South Africa in 2001. A provision is also made for the calculation of the base cost of an asset acquired by the company prior to 2001 and sold afterwards. See Stein “Liquidation distributions and STC” 2005 *Tax Planning* 19.

<sup>110</sup> See Williams 450–451; Silke and Stretch “STC – Nature of Liquidation Dividend” 2005 (Issue No 10) *Taxgram* 9.



the share capital or share premium accounts of the company would not be a dividend as they represent return of the capital (or base cost) of the shareholders.<sup>111</sup>

#### **10.4.2.2      *Going-Concern Dividends***

In relation to an operating company declaring dividends, the dividend is any profits distributed, whether in cash or otherwise, whether of a capital nature or not. This provision also specifically includes an amount equal to the nominal value of any capitalisation shares,<sup>112</sup> bonus debentures or securities awarded to shareholders. Any distribution of profit is a dividend and the revenue or capital nature of the profit is immaterial.<sup>113</sup>

This definition is to be read with para (e) of the definition of dividend.<sup>114</sup> Under para (e) of the definition of “dividend” an award of capitalisation shares out of the share premium account will not be an “amount distributed” and hence will not be a dividend. If capitalisation shares are awarded out of an unrealised profit they are excluded from the definition of dividend.<sup>115</sup>

As can be seen, for a distribution to constitute a dividend, such distribution should be made out of the profits of the company. South African companies have been avoiding the payment of the STC by ensuring that their distributions are not made out of profits.<sup>116</sup> This has resulted in various anti-avoidance provisions being enacted.<sup>117</sup>

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<sup>111</sup> See s 1 para (f) of the definition of “dividend”. See also Meyerowitz par 15.4

<sup>112</sup> Capitalisation shares are shares issued by a company paid up from the company’s reserves (including share premium) or unrealised profits. Such issue may constitute a dividend where the profits are so applied. However, if the payment is made by application of amounts from the reserves, generally it is not a dividend and no tax would be paid thereon.

<sup>113</sup> Meyerowitz par 15.9.

<sup>114</sup> In terms of para (e) the definition of dividend does not include the nominal value of any capitalisation shares awarded to a shareholder to the extent to which such shares have been paid up by means of the application of the whole or any portion of the share premium account of a company.

<sup>115</sup> See s 1 para (h) of the definition of “dividend”. In terms of para (h) the definition of dividend excludes the nominal value of any capitalisation shares awarded to shareholders as part of the equity share capital of a company. The rationale for this treatment is that the issue of capitalisation shares does not result in the transfer of any asset from the company to the shareholder. See also Williams 451.

<sup>116</sup> See further on this aspect Kolitz “Capitalised Profits” 2007 *Tax Planning* 56.

<sup>117</sup> See first proviso to the definition of dividend.

#### **10.4.2.3 *Partial Reduction or Redemption of Capital or Share Buy-Backs***

Para (c) of the dividend definition provided for situations where there is a reduction or redemption of the capital of a company. It also applied where there is a share buy-back by the company of its own shares.<sup>118</sup> In this case, the extent to which the cash or the value of the asset given exceeds the cash equivalent of the amount by which the nominal value of the shares of that shareholder is reduced or the nominal value of the shares so acquired from such shareholder, as the case may be, is a dividend.

This provision has been deleted in the 2007 Revenue Laws Amendment Act because it has been deemed to be obsolete.<sup>119</sup> However, it raised issues pertaining to whether an ordinary redemption without any excess payment constitutes a dividend, capital gain or an ordinary gain. The determination of this aspect is beyond the scope of this thesis.

#### **10.4.2.4 *Company Reconstructions***

The Act determines that in the case of a reconstruction of a company, so much of the sum of any cash and the value of any asset given to a shareholder as exceeds the nominal value of the shares held by him or her before the reconstruction shall be a dividend. Reconstruction occurs where the undertaking of a company is maintained in an altered form to allow the same persons carrying it out to continue to carry it on.<sup>120</sup>

#### **10.4.3 New Definition of Dividend**

Contemporaneous with the replacement of the STC with the new dividend tax, the definition of dividend has been substituted. The Revenue Laws Amendment Bill<sup>121</sup> substituted the definition of dividend and the Act now defines a dividend as “any amount transferred by a company to a shareholder in relation to a share held by the shareholder,

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<sup>118</sup> The share buy-back is provided for in section 85 of the Companies Act 61 of 1973.

<sup>119</sup> S 5(1)(f) of the Revenue Laws Amendment Act 35 of 2007.

<sup>120</sup> See Williams 452.

<sup>121</sup> Revenue Laws Amendment Bill 80 of 2008.

to the extent that the amount transferred (*a*) does not result in a reduction of contributed share capital; and (*b*) does not constitute shares in that company”.<sup>122</sup> Contributed tax capital is the consideration received by or accruing to a company for the issue of shares.<sup>123</sup>

This definition is broad, as it includes all amounts transferred to the shareholder, irrespective of the availability of profits in the distributing company. It is expected that the 2009 amendment to the Act will include consequential adjustment to the application of the dividend definition to company structuring provisions and deemed dividend provisions.<sup>124</sup>

#### **10.4.4 Tax Treatment of Foreign Dividends**

A dividend is any amount distributed by a company to its shareholders. The definition of a company includes “any association, corporation or company incorporated under the law of any country other than the Republic or any body corporate formed or established under such law.”<sup>125</sup> This implies, therefore, that distributions by a non-resident company constitute a dividend.<sup>126</sup>

The tax residence of a recipient shareholder creates a tax nexus between the dividend and the tax system. A foreign dividend is a dividend declared by a company that is not incorporated in South Africa and whose place of effective management is not in South Africa.<sup>127</sup>

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<sup>122</sup> S 1 definition of “dividend”.

<sup>123</sup> S 1 definition of “contributed tax capital”.

<sup>124</sup> See further on the introduction of the new dividend tax system and the dividend definition Clegg “Aye, There’s the Rub” 2007 *Tax Planning* 63; Mazansky “From STC to a Dividend Tax” 2007 *Tax Planning* 78.

<sup>125</sup> S 1 definition of “company”.

<sup>126</sup> Since neither the definition of dividend nor the definition of company is linked to the residence of the shareholders, or the company distributing the dividends, theoretically a distribution by any company in the world to its shareholders constitutes a dividend for South African tax purposes. However, this does not confer upon South Africa the right to tax such dividends unless such dividends have a source or residence connection with South Africa.

<sup>127</sup> See Wilson “International Tax – XIV” 2005 *Tax Planning* 63.

Foreign dividends fall into gross income in terms of para (k) of the definition of gross income. The definition of gross income includes the following, without in any way limiting the scope of the definition:

(k) any amount received or accrued by way of a dividend: Provided that where any foreign dividend declared by a foreign company—

(i) is received by or accrues to a portfolio of a collective investment scheme referred to in paragraph (e) (i) of the definition of “company”; and

(ii) is distributed by that portfolio by way of a dividend, or a portion of a dividend, to any person who is entitled to that dividend by virtue of being a holder of any participatory interest in that portfolio...

that foreign dividend shall, to the extent that it is declared to that person as contemplated in subparagraph (ii), be deemed to have been declared by that foreign company directly to that person and to be a foreign dividend which is received by or accrued to that person . . .

Foreign dividends, where taxable, are included in the taxpayer’s gross income and taxable at the personal income tax rates or corporate tax rate, as the case may be. There is no STC in relation to non-resident companies, as South Africa does not have a taxing right. The determination of whether a payment or distribution of a foreign company to a resident is a dividend is made by sole reference to the tax laws of South Africa. The fact that the nature of the distribution is categorised in the foreign country as anything other than a dividend generally does not affect the status of the payment for South African tax purposes.

Certain foreign dividends are exempted from South African tax.<sup>128</sup> The importance of the South African tax treatment of foreign dividends for IHCs is that the IHC would

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<sup>128</sup> S 10(1)(k)(ii).

generally receive dividends from its non-resident subsidiaries. The South African tax system could have an impact on the amount of dividend finally received by the IHC.

#### **10.4.4.1 Exemptions**

While foreign dividends are generally taxable in South Africa, the Act provides for exemptions of certain foreign dividends received or accrued to residents. The exemptions are based on the nature of the dividend, the foreign tax treatment of the dividend, the nature of the company declaring the dividend and the influence that the resident shareholders have on the control of the company.<sup>129</sup>

##### *(a) Dividends from taxable amounts*

An exemption is provided for foreign dividends accrued to or received by a resident where the amount of the dividend has been or will be subject to tax in South Africa.<sup>130</sup> Amounts earned and distributed by a foreign company could be subject to tax in South Africa where such amounts are sourced in South Africa. Such a situation arises where a foreign company carries on business in South Africa through a permanent establishment or the income is otherwise sourced in South Africa.<sup>131</sup> The income of a permanent establishment would be taxable in South Africa.<sup>132</sup>

The exemption does not apply where the amounts concerned are subject to tax in South Africa but are exempt or will be taxed at a reduced rate in South Africa as a result of the application of a double taxation agreement between South Africa and the country of

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<sup>129</sup> See Mitchell “Foreign Dividends” 2007 *Tax Planning* 70.

<sup>130</sup> See s 10(1)(k)(ii)(aa)(A); Olivier and Honiball 153.

<sup>131</sup> For more on permanent establishment in the South African context see Olivier “The ‘Permanent Establishment’ Requirement in an International and Domestic Taxation Context: An Overview” 2002 *South African Law Journal* 866.

<sup>132</sup> Companies carrying on business in South Africa through permanent establishments are required to register as external companies and are subject to a 34% income tax rate. However, such companies are not subject to STC. Permanent establishment is a concept used to determine when a company has enough connection with a country to subject such company to tax on the income attributable to such permanent establishment. This generally includes branches of companies and other fixed establishments through which companies carry on business in foreign countries.

residence of the foreign company.<sup>133</sup> A double taxation agreement can allocate the ultimate taxing rights in relation to income to any of the contracting states. It can also reduce the rate at which the taxing country may tax certain amounts, subject to the provisions of the DTA.<sup>134</sup>

(b) *Amounts arising from resident company dividends*

Where dividends distributed by a non-resident company arise directly or indirectly from dividends declared by a resident company, such foreign dividend would not be taxable in South Africa.<sup>135</sup> This is due to the fact that the amount of the dividend would have been subject to tax in South Africa. This occurs for example where a South African company declares dividends to a non-resident company whose shareholders are resident in South Africa. The South African company would have been subject to the corporate tax and the STC on the amount of the dividend declared to the non-resident. The chances of tax avoidance would have thereby been eliminated.

(c) *Dividends declared by listed companies*

Foreign dividends declared by listed companies are exempt from tax.<sup>136</sup> A listed company is any company listed on the Johannesburg Stock Exchange or any stock exchange in any foreign country that is recognised by the Minister by notice in the *Gazette*.<sup>137</sup> In addition to the requirement that the company has to be a listed company for the dividend to be exempt, more than 10% of the equity share capital of that listed company should, at the time of the declaration, be held collectively by residents. The residents holding the equity share capital do not have to be the residents to whom the dividends are declared.<sup>138</sup> As

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<sup>133</sup> See s 10(1)(k)(ii)(aa)(A); Olivier and Honiball 153.

<sup>134</sup> See Olivier and Honiball 153–154.

<sup>135</sup> See s 10(1)(k)(ii)(aa)(B).

<sup>136</sup> See s 10(1)(k)(ii)(bb).

<sup>137</sup> See s 1 definition of “listed company” read with para 1 of the Eighth Schedule definition of “recognised exchange”.

<sup>138</sup> S 10(1)(k)(ii)(bb) requires that for the dividend to be exempt, the company should comply with the requirements of paragraphs (a) and (b) of the definition of “listed company”. This is surely unintended as it implies that the company has to be a dual-listed company.

Williams states, “[f]or a shareholder to qualify for the exemption, there is no requirement that he must own any particular percentage of the foreign company’s shares; the only requirement is that South African residents must, collectively, hold more than 10% of the shares in the foreign company.”<sup>139</sup>

(d) *CFC dividends*

Where the income of a CFC has been or will be attributed to its South African shareholder, the dividend declared by the CFC to the shareholder to the amount attributed or attributable would be exempt.<sup>140</sup> This is an exemption for the South African shareholder. The essence of this exemption is that if a calculation is being made of the net income of a CFC, relief cannot be sought under this provision in respect of dividends received by the CFC from other foreign companies because the CFC is not a resident and is not deemed to be a resident. This exemption prevents the taxing of the same profits twice in the hands of the company and the shareholder.<sup>141</sup>

The amount attributed could be the net income of the company declaring the dividend or any other company that is a further tier CFC.<sup>142</sup> These attributed amounts are reduced by any foreign tax payable on the amounts included in the income of the South African resident and so much of all foreign dividends derived by such resident as were exempt from tax or were not previously included in the income of that resident.<sup>143</sup>

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<sup>139</sup> Williams 460. For a company to be listed on the Johannesburg Securities Exchange such company has to be a public company. Thus, the shares of that company should be available to the general members of the public. Listed public companies are heavily regulated in terms of the administration, management and governance. In order for a private company to be listed it has to first convert into a public company and make an initial public offering of shares to the public.

<sup>140</sup> See s 10(1)(k)(ii)(cc).

<sup>141</sup> S 9D(9)(e). See also [http://adl.ukzn.ac.za/Uploads/56b34556-b394-4e1a-bf2039a4f43b0a65/CFCs\\_LectRnd4.doc](http://adl.ukzn.ac.za/Uploads/56b34556-b394-4e1a-bf2039a4f43b0a65/CFCs_LectRnd4.doc) accessed on 05 December 2008.

<sup>142</sup> S 10(1)(k)(ii)(cc)(A) and (B).

<sup>143</sup> See s 10(1)(k)(ii)(cc)(AA) and (BB). This exemption is available on a cumulative basis year by year dating back to 1997 or the date when the CFC was formed, whichever is later.



(e) *Participation exemption*

This is perhaps the most reliable and widely used exemption that investors worldwide rely on in planning their affairs. This exemption determines a percentage holding in a foreign company beyond which the dividends would be exempt from tax. In addition to popularity, this is also one of the simplest and effective exemptions to apply. Structuring to benefit from this exemption is also fairly easy.

The participation exemption applies where the shareholder receiving the dividend holds at least 20% of the total equity share capital and voting rights in the company declaring the dividend.<sup>144</sup> Where the recipient shareholder is a company, the 20% holding could be by such shareholder together with any other company in the same group of companies as that recipient shareholder.<sup>145</sup> There are two provisos intended at ensuring that the shareholding must be of genuine equity shares. These provisos prevent deductions being generated by shifting payments offshore, followed by the tax-free return of these funds in the form of exempt foreign dividends. The provisos state as follows:

Provided that—

- (A) in determining the total equity share capital of a company, there shall not be taken into account any share which would have constituted a hybrid equity instrument, as contemplated in section 8E, but for the three year period requirement contained in that section; and
- (B) this exemption does not apply in respect of any foreign dividend which forms part of any transaction, operation or scheme in terms of which any amount received by or accrued to any person is exempt from tax while any

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<sup>144</sup> The holders of equity share capital generally have an unlimited right to participate in the dividends declared by the company and in the capital of the company on liquidation or deregistration. Preference shares on the other hand generally do not qualify as equity share capital because they would typically have fixed dividend and repayment terms. See Olivier and Honiball 156; Silke and Stretch “Removing Tax on Certain Foreign Dividend Repatriations” 2003 (Issue No 3) *Taxgram* 8; Legwaila “The New Treatment of Foreign Dividends” 2004 (October) *De Rebus* 47

<sup>145</sup> S 10(1)(k)(ii)(dd). See Mazansky *South Africa: Participation Exemption Rules Eased* (2 November 2005) <http://www.mondaq.com/article.asp?articleid=35862> accessed on 12 January 2009.

corresponding expenditure (other than expenditure for the delivery of any goods, including electricity) is deductible by that person or by any connected person in relation to that person in determining the liability for tax of that person or connected person, as the case may be, in terms of this Act . . .

The first proviso disregards in the determination of the 20% equity share holding any share which would have constituted a hybrid equity instrument in terms of the Act but for the three-year requirement. The second proviso turns off the exemption in relation to any dividend which forms part of any transaction operation or scheme in terms of which any amount received is exempt while any corresponding expenditure is deductible.<sup>146</sup>

A South African IHC would generally hold majority voting rights in foreign subsidiaries in order to control and manage those subsidiaries and any underlying investments of those subsidiaries. As a result, as a matter of course, the dividends declared by the foreign subsidiaries would be exempt from tax in South Africa in the hands of the IHC. It should be noted that in most cases where this requirement is satisfied in relation to the IHC and its subsidiaries, such foreign subsidiaries would be CFCs whose income would have been attributable to the resident (unless they have foreign business establishments) and would therefore qualify for the exemption on two grounds.

#### **10.4.4.2      *Deductibility of Expenditure Incurred in Producing Foreign Dividends***

Expenditure incurred in the production of foreign dividends is deductible in the determination of the taxable income of a shareholder.<sup>147</sup> However, in terms of section 11C, such deduction is limited to interest expenditure.<sup>148</sup> There is no deduction available for other expenditure like professional fees, brokers' commission, agency fees, etc

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<sup>146</sup> See Joubert "Participation Exemption" 2002 *Tax Planning* 98–101.

<sup>147</sup> See Mitchell *et al* "Interest Incurred on Earning Foreign Dividends" 2001 *Income Tax Reporter* 71.

<sup>148</sup> It should be noted that expenditure incurred in the production of South African dividends is not deductible. This is because South African dividends are exempt from tax in the hands of the shareholder. At the time of writing it was not yet clear as to whether, with the STC flip to a shareholder tax, the proposed classical system of taxing dividends would allow deductions for interest incurred in the production of South African dividend income.

incurred in the production of dividends. The deduction is available where the interest is incurred in the production of income by way of foreign dividends. Save for this specific provision the expenditure incurred in the production of foreign dividends would not satisfy the general deduction formula<sup>149</sup> because the earning of foreign dividends would not constitute the carrying on of trade unless the taxpayer was a share-dealer.<sup>150</sup>

The deduction of the interest is ring-fenced. It is only available to the extent of the foreign dividends which are included in the income of the person during the year of assessment concerned. As a result, the interest paid on a loan which was used to purchase the shares which produced the foreign dividend will qualify for the deduction, subject to the ceiling.<sup>151</sup> The interest that was incurred in the previous year is not deductible unless it has been carried forward in terms of section 11C(3).

Section 11C(3) provides for the excess interest, i.e. the amount by which the interest exceeds the amount of the foreign dividend, to be reduced by amount of tax-exempt foreign dividends derived by the taxpayer during that year. The balance is to be carried forward to the immediately succeeding year of assessment and is deemed to be an amount of interest actually incurred by that taxpayer during that succeeding year of assessment in the production of foreign dividends. The taxpayer can elect that the amount of foreign taxes paid be deducted from his or her foreign dividend income.<sup>152</sup>

This provision encourages the preference by investors to fund their investments by debt as opposed to equity. Where the purchase of the shares is by equity there would not be a corresponding tax benefit or relief for such funding. As a result, where an IHC is formed by South African residents, it makes an effective tax-planning scheme to fund such company by debt subject to the thin capitalisation rules of the host country.

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<sup>149</sup> The general deduction formula is contained in s 11(a) read with section 23(g).

<sup>150</sup> See Williams 461.

<sup>151</sup> Section 11C(2). See also Williams 461.

<sup>152</sup> If the taxpayer does not make the election, the rebate in respect of foreign taxes would be available to the taxpayer for the foreign withholding tax in respect of those foreign dividends, if those foreign dividends were not exempt from tax in South Africa. See Williams 461.

As has been seen in Chapter 7,<sup>153</sup> dividends are taxable in the Netherlands but the participation exemption provides for a broad relief of tax on dividends. It was also seen in Chapter 8<sup>154</sup> that in Mauritius dividends paid by tax incentive companies, companies listed on the Mauritian stock exchange, and companies that are fully taxable in Mauritius are exempt from tax in the hands of the receiving shareholder, whether resident or not.

## 10.5 REBATE IN RESPECT OF FOREIGN TAXES ON INCOME

### 10.5.1 General

The South African tax system provides for a rebate in respect of foreign taxes on income.<sup>155</sup> This provision applies ancillary and supplementary to many other provisions of the Act, such as CFC income,<sup>156</sup> foreign dividends<sup>157</sup> and foreign capital gains.<sup>158</sup> Basically, this rebate is granted to residents for non-recoverable income taxes payable to a foreign country on income from a foreign country or on CFC income. The rebate in respect of foreign taxes is a unilateral tax relief aimed at providing relief against double taxation. The rebate is deducted from the income tax payable of a resident in whose taxable income is included the above-mentioned and other specific categories of income.<sup>159</sup>

The relevance of this rebate for IHCs is that the IHC is provided with relief on the taxes paid by the subsidiary in the foreign country. Thus, where the foreign subsidiary incurs some tax liability in the foreign country such liability would be offset against the income

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<sup>153</sup> See Chapter 7 par 7.3.4 and par 7.5.1.

<sup>154</sup> See Chapter 8 par 8.2.

<sup>155</sup> The provisions are contained in s 6quat of the Act. See Silke and Stretch “Interpretation Note No 18: Rebate for Foreign Taxes and Natural Persons” 2003 (Issue No 6) *Taxgram* 5.

<sup>156</sup> See s 6quat(1)(b) of the Act. See Mitchell *et al* “Controlled Foreign Entities” 2001 *Income Tax Reporter* 39.

<sup>157</sup> See s 6quat(1)(d) of the Act; Mitchell *et al* *Income Tax Reporter* 39.

<sup>158</sup> See s 6quat(1)(e) of the Act; Meyerowitz par 19.3. See also Mitchell *et al* “Rebate or Deduction of Foreign Taxes” 2008 *Income Tax Reporter* 137.

<sup>159</sup> See Dachs “Foreign Taxes Levied” 2006 *Tax Planning* 138. The rebate applies in relation to foreign-source income. In relation to income earned in South Africa taxpayers get a deduction for the expenditure incurred in the production of income in terms of s 11(a) read with s 23(g). See also South African Revenue Service *Draft Interpretation Note 18* (2009) par 3.1.

that the IHC receives from the foreign subsidiary. Without such relief the ultimate income of the IHC would be diluted by taxation, as it would be taxed in the foreign country and in South Africa. For example, a Congolese subsidiary would be subject to the corporate tax rate of 38% and when it declares dividends to a South African IHC such income would be taxed at the marginal rate of 40%, resulting in a net income after tax of 37% of the gross income received by the Congolese company, i.e. an overall effective rate of 63%.

The rebate is limited to the amount which bears to the total normal tax payable the same ratio as the total taxable income attributed to the specific category of income in respect of which the rebate may be claimed bears to the total taxable income.<sup>160</sup> The wording of the provision is so wide that, arguably, it would cover not only normal taxes paid in the foreign country but also regional taxes like the Swiss Cantonal taxes and the United States's state taxes.<sup>161</sup>

Where the sum of the foreign taxes proved to be payable exceeds the rebate as determined, the excess amount may be carried forward to the immediately succeeding year of assessment and shall be deemed to be a tax on income paid to the government of any other country in that year. The excess may then be set off against the normal tax payable in that succeeding year.<sup>162</sup> What follows is an overview of the amounts in relation to which the foreign tax rebate may be claimed.

### **10.5.2 Foreign-Source Income**

In order to qualify for the rebate, the foreign taxes must be payable in respect of income derived from a foreign source.<sup>163</sup> Foreign-source income is income that is not sourced in South Africa. Source is not defined in the Act but it has been held that source is not a legal concept, but something that an ordinary man would regard as a real source of

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<sup>160</sup> See s 6quat(1B) of the Act. See also Meyerowitz par 19.5.2.

<sup>161</sup> See Olivier and Honiball 322.

<sup>162</sup> See s 6quat(1B)(a)(ii). See also Olivier Honiball 322–324.

<sup>163</sup> See s 6quat(1A); South African Revenue Service *Interpretation Note 10* (2003) par 2.3.1; South African Revenue Service *Draft Interpretation Note 18* (2009) 3.4.

income.<sup>164</sup> The court in *CIR v Lever Brothers and Unilever Ltd*<sup>165</sup> stated as follows regarding the source of income:

[The source of income]...is not the quarter whence they come, but the originating cause of their being received as income, and that this originating cause is the work which the taxpayer does to earn them, the *quid pro quo* which he gives in return for which he receives them. The work which he does may be a business which he carries on, or an enterprise which he undertakes, or an activity in which he engages and it may take the form of personal exertion, mental or physical, or it may take the form of employment of capital by using it to earn income or by letting its use to someone else. Often the work is some combination of these.<sup>166</sup>

Due to the fact that in certain instances income may have multiple originating causes, its case law requires that the dominant cause be established.<sup>167</sup> For South African tax law purposes there are no apportionment rules for the source of income. Due to the different nature of amounts of income, different rules have been created for specific types of income. The forms of income that are relevant for IHCs are interest, shares, dividends and business income.

The source of business income is the place where the business is carried on or where the capital is employed, whichever is dominant. The source of a dividend is the place where the register of the share in respect of which the dividend is paid is located.<sup>168</sup> The source of interest is not the debt but the granting of the credit or the transfer of the lender's right to credit to the borrower, the granting of credit normally being situated where the

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<sup>164</sup> See *Rhodesia Metals Ltd (In Liquidation) v COT* 1938 AD 282.

<sup>165</sup> 1946 AD 441.

<sup>166</sup> At 450.

<sup>167</sup> See *CIR v Lever Brothers and Unilever Ltd* 1946 AD 441 at 449–450; *CIR v Black* 1957 (3) SA 536 (A) at 542–543.

<sup>168</sup> See *Boyd v CIR* 1951 (3) SA 525 at 528. See also Emslie, Davis and Hutton *Income Tax Cases and Materials* (1995) 111.

creditor's business is located.<sup>169</sup> Deeming provisions in relation to interest deem interest to be received or accrued from a South African source where such interest is derived from the utilisation or application in South Africa by any person of funds or credit obtained in terms of an interest-bearing arrangement.<sup>170</sup>

Where the South African resident earns income that is sourced from a foreign country and is not deemed to be sourced from South Africa, the foreign tax credit will be applied in relation to the amount of that income that is included in the taxable income of the resident.<sup>171</sup> If income is deemed to be from a South African source, the rebate cannot be applied in relation to such income.<sup>172</sup>

#### **10.5.2.1 CFC Income Attributable to the Resident**

Where income of a CFC is attributable to a resident and foreign taxes have been paid in relation to that income, the rebate will be applied to the amount so attributed in calculating the taxable income of the resident.<sup>173</sup>

#### **10.5.2.2 Foreign Dividends**

Where the taxable income of a resident includes a foreign dividend in relation to which foreign taxes have been paid, the rebate will be applied to the amount of that dividend in calculating the taxable income of the resident.<sup>174</sup>

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<sup>169</sup> See *CIR v Lever Brothers and Unilever Ltd* 1946 AD 441; *First National Bank of Southern Africa v C: SARS* 64 SATC 253. See also Silke and Stretch "New Test for Source of Interest?" 2001 (Issue No 7) *Taxgram* 6.

<sup>170</sup> See Tsatsawane "Interest Income from a Source Within, or Deemed to be Within, South Africa" *Juta's Business Law* (2000) 178.

<sup>171</sup> See Dachs 138–139.

<sup>172</sup> Deeming provisions apply in relation to certain specific forms of income including royalties, mining income, pensions and capital gains. See s 9.

<sup>173</sup> S 6quat(1)(b).

<sup>174</sup> S 6quat(1)(d); South African Revenue Service *Draft Interpretation Note 18* (2009) par 3.2.

### 10.5.2.3 *Capital Gains*

If the taxable income of a resident includes a capital gain from a source outside South Africa which is not deemed to be from a source within South Africa in relation to which foreign taxes have been paid the rebate will be applied to the amount of that capital gain in calculating the taxable income of the resident.<sup>175</sup>

As a general rule, capital gains tax (“CGT”) in South Africa is payable only by residents. Non-residents are not subject to CGT unless the asset being disposed of is immovable property or attributed to immovable property or to a permanent establishment located in South Africa. Residents pay CGT on their worldwide capital gains. The implication of these CGT provisions is that where a resident holds shares or assets outside South Africa and the country in which the assets or shares are situated taxes the capital gain on the sale of such assets or shares, the resident would receive a section 6quat credit on the tax payable in South Africa on income that includes such capital gain. This would apply to IHCs where the IHC disposes of its interests in the foreign subsidiary.

The amount of gains or losses arising from the currency fluctuations on the consideration payable for the disposal of an asset in foreign currency is taxable or deductible in terms of par 86 of the Eighth Schedule.

As was seen in Chapter 7,<sup>176</sup> the Dutch system of foreign tax credit is similar to the South African system. It was also seen in Chapter 8<sup>177</sup> that the Mauritian tax system provides for a foreign tax credit and presumed tax credit for GBL1 companies. In certain instances, the tax treaties entered into by Mauritius provide for a tax sparing credit. A combination of the foreign tax credit or the presumed tax credit and the tax sparing credit provide a significant tax relief measure for GBL1 companies.

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<sup>175</sup> South African Revenue Service *Draft Interpretation Note 18* (2009) par 3.2 and 3.3.

<sup>176</sup> See Chapter 7 par 7.3.8.

<sup>177</sup> See Chapter 8 par 8.3.1.1.



## 10.6 EXCHANGE CONTROL

### 10.6.1 Introduction

The South African government's general policy approach to exchange control is one of prohibition to deal in foreign exchange except with the permission of and on the conditions set by the South African Reserve Bank (hereinafter referred to as "the SARB"). As the SARB explains, "[t]he economic policy underlying exchange control is, however, not totally prohibitive, since such an approach would not be conducive to the conduct of normal international trade and payments."<sup>178</sup>

### 10.6.2 Purpose of Exchange Control

According to the Exchange Control Manual,<sup>179</sup> the main purposes of exchange control are as follows:

- To ensure the timeous repatriation into the South African banking system of certain foreign currency acquired by residents of South Africa, whether through transactions of a current or of a capital nature; and
- To prevent the loss of foreign currency resources through the transfer abroad of real or financial capital assets held in South Africa.

The Exchange Control Manual furthermore states that, based on the above, exchange control "constitutes an effective system of control to these ends by monitoring the movement of financial and real assets (money and goods) into and out of South Africa,

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<sup>178</sup> The South African Reserve Bank *Exchange Control Manual* Part E accessible on [http://www.reservebank.co.za/internet/Publication.nsf/LADV/8A3852676EBE6C26422573FC0053E76E/\\$File/E.pdf](http://www.reservebank.co.za/internet/Publication.nsf/LADV/8A3852676EBE6C26422573FC0053E76E/$File/E.pdf) accessed on 12 June 2008.

<sup>179</sup> *Exchange Control Manual* Part (E).

while at the same time avoiding interference with the efficient operation of the commercial, industrial and financial systems of the country.”<sup>180</sup>

### 10.6.3 Application of Exchange Controls in South Africa

South African exchange control provisions apply to residents and non-residents.<sup>181</sup> What further determines whether the regulations apply is mainly the nature and context of the transactions entered into as opposed to the identity of the persons to whom the regulations apply. In practice the application of these regulations is discretionary and based on policy and procedure which are not available to the general public.<sup>182</sup>

The exchange control applies to capital movements in and out of the Common Monetary Area (“CMA”). The CMA consists of South Africa, Lesotho, Swaziland and Namibia. These are neighbouring countries the currencies of which (Maloti, Lilangeni and Namibian Dollar, respectively) are based on the South African Rand and trade on the Johannesburg Securities Exchange on the back of the Rand. The CMA Agreement provides that the exchange controls of the other CMA countries should be as strict as the South African exchange controls.<sup>183</sup>

For ease of administration, the exchange control regulations are administered by authorised dealers in foreign exchange acting for and on behalf of the South African Reserve Bank. Authorised dealers are persons authorised by the Treasury to deal in gold

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<sup>180</sup> *Exchange Control Manual* Part E.

<sup>181</sup> *Exchange Control Manual* Part (D8)

<sup>182</sup> See Olivier and Honiball 524.

<sup>183</sup> *Exchange Control Manual* Part D7 available on [http://www.reservebank.co.za/internet/Publication.nsf/LADV/C708879B5724E5A6422574570033B459/\\$File/D.pdf](http://www.reservebank.co.za/internet/Publication.nsf/LADV/C708879B5724E5A6422574570033B459/$File/D.pdf) accessed on 23 July 2008.

or foreign exchange.<sup>184</sup> Most of South Africa's commercial and merchant banks are authorised dealers.<sup>185</sup>

#### 10.6.4 Restriction on Export of Currency and Import of South African Rand

Probably the most important part of the regulations in relation to IHCs is the regulations that govern the export of currency. This is because the setting up of a South African IHC requires a transfer of some value or consideration to be made into South Africa. Conversely, the setting up of a foreign subsidiary by the South African IHC or residents requires expatriation of funds. This may take the form of buying shares in the foreign company from existing shareholders or buying newly issued shares in a newly formed company.<sup>186</sup> In terms of para 3 of the regulations the following acts are prohibited unless authorised or exempted by an authorised dealer or the Treasury:<sup>187</sup>

- a) Taking or sending out of South Africa any bank notes or foreign currency;
- b) Sending, consigning or delivering any bank notes or foreign currency within South Africa with the purpose of removing such bank notes or foreign currency out of South Africa. This prohibition applies to foreign currency or bank notes irrespective of the fact that it has not yet been removed from South Africa;
- c) Taking, sending or consigning any South African bank notes into South Africa;
- d) Making payments to, in favour of or on behalf of a person resident outside South Africa, or place any sum to the credit of such person;
- e) Drawing or negotiating any bill of exchange or promissory note, transferring any security or acknowledging any debt, so that a right (whether actual or contingent) on the part of such person or any other person to receive a payment in the

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<sup>184</sup> See definition of "authorised dealer" in Para 1 of the Schedule to Exchange Control Regulations 1961, Government Notice R1111 of December 1961 (hereinafter referred to as "the Regulations") available on [http://www.reservebank.co.za/internet/Publication.nsf/LADV/E2B2440F192F118342257134004A9935/\\$File/Regulations.pdf](http://www.reservebank.co.za/internet/Publication.nsf/LADV/E2B2440F192F118342257134004A9935/$File/Regulations.pdf) accessed on 23 July 2008.

<sup>185</sup> See Incompass *Exchange Control* <http://www.incompass-financial-services.com/exchange-control-South-Africa.html> accessed on 09 February 2009.

<sup>186</sup> For a detailed discussion on the methods of establishing an IHC see Chapter 5 par 5.3.

<sup>187</sup> See para 3(1)(a)–(f) of the Regulations. See Fisher Hoffman PKF *South African Exchange Control Guide* (2004) 3 available on <http://www.pkf.co.za/publications/pdf/exchangebrochure4.pdf> accessed on 15 December 2008.

Republic is created or transferred as consideration for the receiving by such person or any other person of a payment or the acquisition by such person or any other person of property, outside South Africa; or for a right (whether actual or contingent) on the part of such person or any other person to receive a payment or acquire property outside South Africa; or making or receiving any payment as such consideration.

- f) Granting of financial assistance<sup>188</sup> to a person who is not resident or to an affected person. Affected person is defined as “a body corporate, foundation, trust or partnership operating in the Republic, or an estate, in respect of which –
- (i) 75% or more of the capital, assets or earnings thereof may be utilised for payment to, or to the benefit in any manner of, any person who is not resident in the Republic; or
  - (ii) 75% or more of the voting securities, voting power, power of control, capital, assets or earnings thereof, are directly or indirectly vested in, or controlled by or on behalf of, any person who is not resident in the Republic.”

### **10.6.5 Rules Applicable to Subsidiaries of South African Companies**

South African residents are required to obtain approval to set up subsidiary companies in foreign countries within limits for approved investments.<sup>189</sup> However, residents are not required to obtain approval to set up companies within the CMA.

Since 1995 the quantitative requirements have undergone evolution, and this has resulted in their being more relaxed in recent years.<sup>190</sup> Prior to 2004, the limits were R2 billion for

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<sup>188</sup> Financial assistance includes the lending of currency, the granting of credit, the taking up of securities, the conclusion of a hire purchase or a lease, the financing of sales or stocks, discounting, factoring, the guaranteeing of acceptance of credits, the guaranteeing or acceptance of any obligation, a suretyship, a buy-back and a leaseback, but excludes the granting of credit by a seller in respect of any commercial transaction directly involving the passing of ownership of the goods sold from seller to purchaser; and the granting of credit solely in respect of the payment for services rendered.

<sup>189</sup> See Exchange Control Manual par F 6.1.2.

<sup>190</sup> See National Treasury *Budget Review* (2004) 32. According to the National Treasury *Budget Review* (2007) 30, the “gradual process of exchange control relaxation has enabled an orderly process of global

each new and approved African investment and R1 billion for each new and approved investment elsewhere in the world. On application, a further 20% of excess costs of a new investment (as opposed to an improvement on an already existing investment) could be funded by cash holdings if the investment limit had been utilised.<sup>191</sup>

Until 27 October 2007 resident companies were allowed to transfer amounts up to R50 million per year for investment offshore investment from South Africa for each new and approved foreign investment.<sup>192</sup> Should a resident company need to transfer any amount in excess of the R50 million, such company should obtain approval from the SARB.<sup>193</sup> This limit has been increased by Finance Minister Pravin Gordhan in the 2009 Medium Term Budget Policy Statement delivered on 27 October 2009 to R500 million.<sup>194</sup> The SARB reserves the right to stagger capital outflows relating to very large foreign investment in order to manage any potential impact on the foreign exchange market.<sup>195</sup>

Furthermore, as stated in the Exchange Control Manual

“South African companies are allowed, without prior approval from Exchange Control, to expand their existing offshore business via the existing/newly established offshore entity, through the acquisition of further assets/equity interests offshore, provided such acquisitions are in the same line of business and an enhanced benefit to South Africa (other than dividends) can be demonstrated.”<sup>196</sup>

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reintegration, encouraging South African companies to expand from domestic base and allowing South African residents to diversify their portfolios through domestic channels.”

See further on the relaxation of exchange controls Webber Wentzel *Investing in South Africa - Exchange Control* <http://www.webberwentzel.com/wwb/view/wwb/en/page2015#relax> accessed on 17 April 2009.

<sup>191</sup> See Olivier and Honiball 533.

<sup>192</sup> Exchange Control Manual par F 6.1.2.2.

<sup>193</sup> Exchange Control Manual par F 6.1.2.3.

<sup>194</sup> See National Treasury *Medium Term Budget Policy Statement* (2009) 26; Exchange Control Circular 13 of 2009 accessible on

[http://www.reservebank.co.za/internet/Publication.nsf/LADV/C5C3ADD965CE179F4225765C004F8AF4/\\$File/Circ+No+13+2009.pdf](http://www.reservebank.co.za/internet/Publication.nsf/LADV/C5C3ADD965CE179F4225765C004F8AF4/$File/Circ+No+13+2009.pdf) accessed on 11 January 2009.

<sup>195</sup> Exchange Control Manual F 6.1.2.5.

<sup>196</sup> Exchange Control Manual F 6.1.2.5.

The requests made by corporates to invest abroad are considered in the light of national interest. The Exchange Control Manual<sup>197</sup> lists the following conditions and policy principles that are applicable to approved investments exceeding R50 million:

(1) Whilst there are no exchange control limits on new outward foreign direct investments by South African companies, Exchange Control reserves the right to stagger capital outflows relating to very large foreign investments so as to manage any potential impact on the foreign exchange market.

(2) On application, foreign finance may be raised on the strength of the applicant company's South African balance sheet to finance foreign acquisitions.

(3) Companies wishing to invest in countries outside the CMA may apply to Exchange Control to engage in corporate asset or share swap transactions in order to fund such investments or to repay existing offshore debt. Similarly, requests for share placements and bond issues offshore by locally listed companies will also be considered.

(4) Companies which have existing approved subsidiaries abroad are allowed to expand such activities without prior Exchange Control approval, provided that such expansion is financed by foreign borrowings, without recourse to South Africa, or by the employment of profits earned by that subsidiary, subject to the expansion being in the same line of business and that benefit to South Africa can be demonstrated. The local parent company is required to place their proposed plans for the expansion of the investment on record with Exchange Control within 30 days.

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<sup>197</sup> Exchange Control Manual par F 6.1.2.3.

Where dividends to the South African parent/holding company are not declared, the retention of any balance of the profits earned would, bearing in mind the provisions of Regulation 6, have to be negotiated with Exchange Control at the time of the normal annual report back.

(5) Dividends repatriated from abroad by South African companies during the period 2003-02-26 to 2004-10-26 (dividend credits) automatically form part of domestic funds and may be allowed to be retransferred abroad for the financing of approved foreign direct investments or approved expansions, but may not be transferred abroad for any other purpose.

Dividends declared by offshore subsidiaries of South African companies after 2004-10-26 may be retained offshore and used for any purpose, without any recourse to South Africa. Such dividends repatriated to South Africa after 2004-10-26 may be retransferred abroad at any time and used for any purpose, provided that there is no recourse to South Africa.

Resident companies establishing subsidiaries abroad are required to submit financial statements on these operations to the Exchange Control annually. There are, however, certain instances where the Exchange Control requires regular progress reports in addition to the annual reports.

Prior to 2004, corporates were not allowed to retain foreign dividends offshore. This resulted in forced repatriation that made it extremely difficult for South African residents to utilise IHCs as investment vehicles. This position has changed only for companies. Foreign companies owned by South African residents are not allowed to hold investments within the CMA. The loop structures in terms of which residents hold interests in foreign companies who in turn hold investments in South Africa are undesirable both from an

exchange control point of view and from a tax point of view and measures are in place to deal with such structures.<sup>198</sup>

The exchange control regulations would require that when a South African IHC sets up operating subsidiaries outside the CMA, or purchases the shares of companies outside the CMA and the value of such investment exceeds R50 million in any particular year, the IHC would have to obtain approval from the SARB. As stated above, investments of over R50 million would be allowed subject to the conditions stated above. In essence, this approval process is not prohibitive, but ensures that large investments made outside South Africa are economically beneficial to South Africa.

#### **10.6.6 Local Borrowing Restrictions**

The South African exchange control provisions impose a general restriction on amounts or financial assistance that may be received by resident countries that are controlled by non-residents.

Regulation 3(1)(e) and (f) provide as follows<sup>199</sup>

Subject to any exemption which may be granted by the Treasury or a person authorised by the Treasury, no person shall, without permission granted by the Treasury or a person authorised by the Treasury and in accordance with such conditions as the Treasury or such authorised person may impose -

(e) grant any financial assistance to any person in the Republic, where as security for such financial assistance, the person granting the

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<sup>198</sup> The Exchange Control Manual states at par F 6.1.2.3 that funds for which approval has been obtained “may under no circumstances be utilised to fund investments/loans into the CMA and SADC, for any purpose whatsoever, through a ‘loop structure’”. It states with regard to dividends resulting from such funds that “dividend proceeds may...under no circumstances be used to fund investments/loans into the CMA and SADC, for any purpose whatsoever, through a ‘loop structure’.”

<sup>199</sup> Exchange Control Regulation 3(1)(e) and (f).



financial assistance in turn relies on any security, guarantee, undertaking or financial assistance, directly or indirectly furnished by (i) any person resident outside the Republic; or (ii) an affected person...

(f) grant any financial assistance to any person in the Republic, where such person (i) is not resident in the Republic; or (ii) is an affected person.

An affected person is defined as a body corporate, foundation, trust or partnership operating in the Republic, or an estate, in respect of which -

“(i) 75 per cent or more of the capital, assets or earnings thereof may be utilised for payment to, or to the benefit in any manner of, any person who is not resident in the Republic; or (ii) 75 per cent or more of the voting securities, voting power, power of control, capital, assets or earnings thereof, are directly or indirectly vested in, or controlled by or on behalf of, any person who is not resident in the Republic.”<sup>200</sup>

The regulations contain a definition of financial assistance. It provides as follows:<sup>201</sup>

“‘financial assistance’ includes the lending of currency, the granting of credit, the taking up of securities, the conclusion of a hire purchase or a lease, the financing of sales or stocks, discounting, factoring, the guaranteeing of acceptance of credits, the guaranteeing or acceptance of any obligation, a suretyship, a buy-back and a leaseback but excluding (a) the granting of credit by a seller in respect of any commercial transaction directly involving the passing of ownership of the goods sold from seller

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<sup>200</sup> Exchange Control Regulation 1 definition of “affected person”.

<sup>201</sup> Exchange Control Regulation 1 definition of “financial assistance”.

to purchaser; and (b) the granting of credit solely in respect of the payment for services rendered”

The rules provide for an exemption within the limits of a stipulated formula in terms of which an affected person may only borrow funds from local and CMA sources up to a percentage of its effective capital.<sup>202</sup> The exemption creates a local borrowings formula of a debt-to-equity ratio of 3:1.<sup>203</sup>

Generally the ultimate holding company of the IHC would be resident outside South Africa. Most of the financing of the IHC would be obtained from the ultimate holding company. The IHC, as a subsidiary of the ultimate holding company would satisfy the requirements of an affected person. Thus any borrowing by the IHC from local sources should not exceed the 3:1 debt-to-equity ratio.

The local borrowing restrictions have been abolished with effect from 27 October 2009. The purpose of the abolition of this restriction is in order to improve access to domestic credit in the financing of local foreign direct investment. This relaxation does not apply to portfolio investment by non-residents.<sup>204</sup>

### **10.6.7 Dividends**

Dividend distributions are freely remittable to non resident shareholders. Distributions by companies that are not listed require the company paying the dividend to “provide an authorised dealer with an auditor’s certificate that confirms that the amount transferred arises from realised profits arising in the normal course of business and payable to a non-resident who has not previously been resident.”<sup>205</sup> With regards to the distribution of capital profits the certificate should indicate how the profit arose and that the

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<sup>202</sup> “Effective capital is the net worth of the company, together with approved shareholders’ loan funds, which are regarded as investment funds because of their permanence” (Olivier and Honiball 543).

<sup>203</sup> See Olivier and Honiball 543.

<sup>204</sup> National Treasury *Medium Term Budget Policy Statement* (2009) 26.

<sup>205</sup> See s F2.2.3.1 of the Exchange Control Manual. See also Olivier and Honiball 540-541.

consideration paid for the sale was at arm's length.<sup>206</sup> These provisions do not impose cumbersome requirements on the IHC.

### **10.6.8 Interest on Foreign Loans**

Interest on loans from non-residents is freely remittable abroad. However, the loan facility and the interest rate must be approved by the SARB. The interest rate cannot exceed the base rate of the currency in which the loan is raised plus 2% or prime rate plus 3% if the loan is denominated in the South African rand.<sup>207</sup>

### **10.6.9 Management and Administrative Fees**

Payment of management and administrative fees may be paid to a non-resident service provider without intervention of the SARB. Authorised dealers are given the authority to approve these payments upon production of documentary evidence confirming the amount involved, and that the amount is reasonable in relation to the services provided.<sup>208</sup>

### **10.6.10 The 2009 Developments**

The South African government has been and continues to relax exchange controls with a view to lowering the cost of doing business in South Africa.<sup>209</sup> National Treasury Announced further relaxation of exchange controls in the 2009 Medium Term Budget Policy Statement. In addition to the abolition of the local borrowing restrictions and the increase in the outward investment limit numerous provisions of exchange controls have generally been relaxed. Of importance to IHCs are the following:<sup>210</sup>

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<sup>206</sup> See s F2.2.3.1 of the Exchange Control Manual; Olivier and Honiball 541.

<sup>207</sup> See s F6.1.7 of the Exchange Control Manual; Olivier and Honiball 541.

<sup>208</sup> See s F2.2.3 of the Exchange Control Manual. See also Olivier and Honiball 542.

<sup>209</sup> See Cronje "Changes to Income Tax and Exchange Control in South Africa" (1997) *International Tax Review* 319-321.

<sup>210</sup> National Treasury *Medium Term Budget Policy Statement* (2009) 26. See also Exchange Control Circular 13 of 2009 accessible on [http://www.reservebank.co.za/internet/Publication.nsf/LADV/C5C3ADD965CE179F4225765C004F8AF4/\\$File/Circ+No+13+2009.pdf](http://www.reservebank.co.za/internet/Publication.nsf/LADV/C5C3ADD965CE179F4225765C004F8AF4/$File/Circ+No+13+2009.pdf) accessed on 11 January 2009.

- Section B2B(iii) of the Exchange Control Manual restricted loop structures into the South African Development Community member countries in terms of which South African residents would invest in SADC member countries through a foreign intermediary. This restriction has been removed in order to promote regional integration. However, the relaxation excludes investment in SADC member countries that are part of the CMA.
- The regulations required that South African companies should convert their foreign exchange into the South African Rand within 180 days of acquiring such currency. This requirement has been removed.
- South African companies will be allowed to open foreign bank accounts for permissible purposes without prior approval, subject to reporting obligations.

The National Treasury vowed to continue to improve the exchange control regulatory framework for improving investments and undertook to announce key proposals that will form part of the modernised approach in the 2010 Budget Review.<sup>211</sup>

As was seen in Chapters 7<sup>212</sup> and 8,<sup>213</sup> the Netherlands and Mauritius do not have exchange control provisions.

## **10.7 CAPITAL GAINS TAX IN SOUTH AFRICA**

### **10.7.1 Introduction**

Capital gains tax (hereinafter referred to as “CGT”) was introduced in South Africa in 2001.<sup>214</sup> Prior to its introduction only income of a revenue nature was taxable, unless specifically included in the definition of “gross income”. Capital gains of most kinds

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<sup>211</sup> National Treasury *Medium Term Budget Policy Statement* (2009) 26

<sup>212</sup> See Chapter 7 par 7.2.9.

<sup>213</sup> See Chapter 8 par 8.2.3.

<sup>214</sup> See Silke and Stretch “Capital Gains Tax Bill Introduced” 2001 (Issue No 3) *Taxgram* 1–2.

were exempt from income tax.<sup>215</sup> Gross income was defined in section 1 to exclude receipts or “accruals of a capital nature.”<sup>216</sup> Courts were inundated with the task of determining the capital or revenue nature of amounts received by taxpayers. An amount could either be capital or revenue and thus exempt or taxable, respectively. There was no mid-point between the two ends.<sup>217</sup> This tax treatment resulted in taxpayers recharacterising revenue income as capital income.

When it was introduced in South Africa, the National Treasury and the South African Revenue Service justified the need to introduce CGT as follows:<sup>218</sup>

The absence of a CGT creates many distortions in the economy, by encouraging taxpayers to convert otherwise taxable income into tax-free capital gains. The South African Revenue Service has observed that sophisticated taxpayers have engaged in these conversion transactions, thereby eroding the corporate and individual income tax bases. This erosion reduces the efficiency and equity of the overall tax system. A CGT is, therefore, a critical element of any income tax system as it protects the integrity of the personal and corporate income tax bases and can materially assist in improving tax morality.

CGT is applicable to disposals on or after 01 October 2001. The basic principle of the CGT is that if a gain is made from the disposal of a capital asset, such gain is taxable.<sup>219</sup>

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<sup>215</sup> In 1969 the Franzsen Commission recommended a limited form of CGT on immovable property and marketable securities – see Franzsen Commission *Taxation in South Africa: First Report of the Commission of Enquiry into Fiscal and Monetary Policy in South Africa* (November 1968), printed for the Government Printer, Pretoria by Cape and Transvaal Printers TD, Cape Town B932/5,000 at 48. The Katz Commission also recommended that CGT should not be introduced in South Africa due to its complexity and the capacity of the tax administration in South Africa. See Katz Commission *Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa* (1995) <http://www.treasury.gov.za/publications/other/katz/4.pdf> Accessed on 08 April 2008.

<sup>216</sup> Section 1 of the Act definition of “gross income” as at 30 September 2001.

<sup>217</sup> See *Tuck v CIR* 1988 (3) SA 819 (A); *CIR v Pick 'n Pay Employee Share Purchase Trust* 1992 (4) SA 39 (A).

<sup>218</sup> Guide to Capital Gains Tax <http://www.treasury.gov.za/documents/national%20budget/2000/cgt/cgt.pdf> accessed on 01 April 2008. See further on the need for capital gains tax in South Africa Meyerowitz, Emslie and Davis “Why Capital Gains Tax” *The Taxpayer* (2001) 228.

<sup>219</sup> See s 26A read with Part II of the Eighth Schedule.

On the other hand, if the asset is sold at a loss, the loss can be set off against other capital (not revenue) profits.<sup>220</sup> The excess is carried over to the next tax year.<sup>221</sup> The capital gain raised is included in the taxable income of the taxpayer at a rate applicable to such taxpayer. The inclusion rate for individuals and trusts is 25% while for corporate taxpayers it is 50%. The included amount is taxed at the normal personal income tax marginal rate (at a sliding scale) of 40% and corporate tax rate of 28% respectively.<sup>222</sup>

The trigger for the CGT is a disposal of a capital asset by a taxpayer. Certain disposals are disregarded. In some cases the disposal is tax-free because the disposal event is exempt and in other cases the tax is deferred or rolled-over to the purchaser.<sup>223</sup> The following key terms are central to the operation of the CGT system in South Africa: (i) capital gain; (ii) asset; (iii) base cost; and (iv) disposal. Furthermore, the CGT system is applicable to residents. It is only applicable to non-residents in certain circumstances. Certain gains are excluded from the application of the CGT system. The key terms, persons liable for the tax and available exclusions are discussed below.

## 10.7.2 Key Terms, Taxpayer and Exclusions

### 10.7.2.1 *Capital Gain and Asset*

A person's "capital gain" for the year in which the asset was disposed of is defined as the amount by which the proceeds accruing in respect of the disposal during that year of an asset exceed the base cost of the asset.<sup>224</sup> The proceeds from the disposal of an asset are the amount received by or accrued to a person in respect of the disposal in a year of

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<sup>220</sup> See Williams *Capital Gains Tax – A Practitioner's Manual* (2005) 21–22. Silke and Stretch "CGT: Limitation of Capital Losses" 2001 (Issue No 7) *Taxgram* 5.

<sup>221</sup> See Huxham and Haupt *Notes on South African Income Tax* (2008) 693.

<sup>222</sup> In Divaris and Stein's words, "[t]here is no separate capital gains tax (CGT) in South Africa. A person's taxable capital gain for a year is included in his or her taxable income and subjected to normal tax. This means that taxable capital gains are subject to normal tax rather than a separate CGT." See Divaris and Stein *South African Income Tax Guide* (2007) 394.

<sup>223</sup> See par 52-64B and par 65-67C of the Eighth Schedule; see also the capital gains flowchart in Davis *What You Must Know About Capital Gains Tax* (2001) 20.

<sup>224</sup> Par 3(a) of the Eighth Schedule. See Divaris and Stein 395.

assessment.<sup>225</sup> This specifically includes the amount by which any debt owed by a person has been reduced or discharged<sup>226</sup> and any amount received by or accrued to a lessee from the lessor of property for improvements effected to that property.<sup>227</sup>

An “asset” is defined as including property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum.<sup>228</sup> An asset also includes a right or interest of whatever nature in an asset as stated above.<sup>229</sup>

### **10.7.2.2 Base Cost**

The base cost of an asset is deducted from the proceeds of the disposal of that asset.<sup>230</sup> In general terms the base cost is the sum of all amounts that the seller incurred in acquiring and keeping the asset.<sup>231</sup> Par 20 describes it as the sum of the following salient aspects relevant to this study:<sup>232</sup>

(a) the expenditure actually incurred in respect of the cost of acquisition or creation of that asset;

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<sup>225</sup> Par 35(1) of the Eighth Schedule.

<sup>226</sup> Par 35(1)(a) of the Eighth Schedule.

<sup>227</sup> See Boltar and Monteiro *Annual Survey of South African Law* 809–810; par 35(1)(b) of the Eighth Schedule to the Act. In terms of par 35(3) the proceeds from the disposal of an asset by a person must be reduced by (a) any amount of the proceeds that must be or was included in the gross income of that person or that must be or was taken into account when determining the taxable income of that person before the inclusion of any taxable capital gain; (b) any amount of the proceeds that has been repaid or has become repayable to the person to whom that asset was disposed of; or (c) any reduction, as the result of the cancellation, termination or variation of an agreement or due to the prescription or waiver of a claim or release from an obligation or any other event, of an accrued amount forming part of the proceeds of that disposal.

<sup>228</sup> Par 1(a) of the Eighth Schedule definition of “asset”. See Swart “Interpreting Some Core Concepts Governing the Taxation of Capital Gains” 2005 *South African Law Journal* 2–3.

<sup>229</sup> Par 1(a) of the Eighth Schedule definition of “asset”. For a further discussion on the meaning of “asset” see Olivier “Determining a Taxable Capital Gain or an Assessed Capital Loss: Some Problems” (2007) *Meditari Accountancy Research* Vol 15 No 1 35 at 37–40.

<sup>230</sup> See par 20 of the Eighth Schedule to the Act. See also Boltar and Monteiro *Annual Survey of South African Law* 810.

<sup>231</sup> Koltitz “Listed Share Valuations – A Closer Examination of the Three Options for the Base Cost of an Asset Available to Taxpayers” 2002 *Tax Planning* 2.

<sup>232</sup> See par 20(1) of the Eighth Schedule to the Act. See also Olivier *Meditari Accountancy Research* 42.

(b) the expenditure actually incurred in respect of the valuation of the asset for the purpose of determining a capital gain or capital loss in respect of the asset;

(c) the following amounts actually incurred as expenditure directly related to the acquisition or disposal of that asset namely—

- (i) the remuneration of a surveyor, valuer, auctioneer, accountant, broker, agent, consultant or legal advisor, for services rendered;
- (ii) transfer costs;
- (iii) stamp duty, transfer duty or similar duty;
- (iv) advertising costs to find a seller or to find a buyer;
- (v) the cost of moving that asset from one location to another;
- (vi) the cost of installation of that asset, including the cost of foundations and supporting structures;
- (vii) in the case of a disposal of an asset by a person by way of a donation, so much of any donations tax payable by that person in respect of that donation;
- (viii) if that person acquired that asset by way of a donation and the donations tax levied in respect of that donation was paid by that person, so much of the donations tax which bears to the full amount of the donations tax so payable the same ratio as the capital gain of the donor determined in respect of that donation, bears to the market value of that asset on the date of that donation; and
- (ix) if that asset was acquired or disposed of by the exercise of an option (other than the exercise of an option, the expenditure actually incurred in respect of the acquisition of the option;

(d) the expenditure actually incurred for purposes of establishing, maintaining or defending a legal title to or right in that asset;

(e) the expenditure actually incurred in effecting an improvement to or enhancement of the value of that asset, if that improvement or enhancement is still reflected in the state or nature of that asset at the time of its disposal;



(f) if that asset was acquired or disposed of by the exercise on or after valuation date of an option acquired prior to the valuation date, the valuation date value of that option, which value must be treated as expenditure actually incurred in respect of that asset on valuation date for the purposes of this Part;

(g) expenditure actually incurred which is directly related to the cost of ownership of that asset, which is used wholly and exclusively for business purposes or which constitutes a share listed on a recognised exchange or a participatory interest in a portfolio of a collective investment scheme;

(h) in the case of a marketable security or an equity instrument the market value of that marketable security or equity instrument or amount received or accrued from the disposal thereof, as the case may be, that was taken into account in determining the amount of that gain or loss . . .

### **10.7.2.3 Disposal**

A disposal for CGT purposes refers to events where there is a change in the ownership of an asset.<sup>233</sup> A disposal is defined as any event, act, forbearance or operation of law which results in the creation, variation, transfer or extinction of an asset.<sup>234</sup> Specifically included in this definition are the following actions:<sup>235</sup>

- the sale, donation, expropriation, conversion, grant, cession, exchange or any other alienation or transfer of ownership of an asset;
- the forfeiture, termination, redemption, cancellation, surrender, discharge, relinquishment, release, waiver, renunciation, expiry or abandonment of an asset;
- the scrapping, loss, or destruction of an asset;
- the vesting of an interest in an asset of a trust in a beneficiary;

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<sup>233</sup> See Cassidy “Capital Gains Tax in South Africa – Lessons from Australia” *South African Mercantile Law Journal* (2004) 165.

<sup>234</sup> Par 11(1) of the Eighth Schedule to the Act. See Swart 6–7.

<sup>235</sup> Par 11(1)(a) – (g) of the Eighth Schedule to the Act. See further on disposals Erasmus and Boonzaier *Capital Gains Tax – A Guideline* (2002) 15–22; Davis 10–19; Williams *Capital Gains Tax – A Practitioner’s Manual* 175–187; Geach 30–32; Olivier *Meditary Accountancy Research* 42–43.

- the distribution of an asset by a company to a shareholder;
- the granting, renewal, extension or exercise of an option; or
- the decrease in value of a person's interest in a company, trust or partnership as a result of a value shifting arrangement.

#### **10.7.2.4      *Persons Liable to Capital Gains Tax***

Following the South African residence-based taxation, CGT is charged on a disposal by a taxpayer who is resident in South Africa.<sup>236</sup> A disposal by a non-resident only attracts CGT if, firstly, the asset disposed of is immovable property situated in South Africa or the non-resident holds any right in the immovable property situated in South Africa; and, secondly, if the asset disposed of is attributable to a permanent establishment of the non-resident in South Africa.<sup>237</sup>

An interest in immovable property situated in South Africa includes any equity shares held by a non-resident in a company or ownership or the right of ownership of the non-resident in any other entity or a vested interest of the non-resident in any assets of a trust if 80% or more of the market value of those equity shares, ownership or right of ownership or vested right, as the case may be, at the time of the disposal thereof is attributable directly or indirectly to immovable property in South Africa held otherwise than as trading stock.<sup>238</sup> Furthermore, in the case of a company or other entity, the non-resident must hold directly or indirectly at least 20% of the equity share capital of that company or ownership or right to ownership of the other entity.<sup>239</sup>

Immovable property held as trading stock is excluded in determining whether a non-resident holds immovable property or holds an interest in immovable property. When a non-resident holds the interest through a company or other entity, the interest in

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<sup>236</sup> Par 2(1)(a) of the Eighth Schedule to the Act.

<sup>237</sup> See par 2(1)(b) of the Eighth Schedule to the Act; Williams *Capital Gains Tax – A Practitioner's Manual* 5.

<sup>238</sup> Par 2(2) of the Eighth Schedule.

<sup>239</sup> Par 2(2)(b) of the Eighth Schedule.

immovable property includes a situation where the non-resident, either alone or together with connected persons, directly or indirectly holds at least 20% of the equity share capital of the company or the ownership or right to ownership of the other entity.<sup>240</sup>

Based on the discussion above, a resident IHC will be liable for capital gains tax in South Africa by virtue of its tax residence. Due to the residence-based tax system, the South African IHC will be subject to CGT on its capital gains realised anywhere in the world. By implication, if the IHC disposes of an interest in another company, such transaction will be subject to CGT and therefore any gain realised therefrom will be taxable unless one of the exceptions applies or the participation exemption applies.<sup>241</sup>

#### **10.7.2.5 Exclusions**

The CGT regime does not apply to certain disposals. These include the disposal of primary residence,<sup>242</sup> personal use assets,<sup>243</sup> retirement benefits,<sup>244</sup> small business assets,<sup>245</sup> interest in equity share capital of a foreign company<sup>246</sup> and disposals by public benefit organisations<sup>247</sup> and by creditor of a debt owed by a connected person.<sup>248</sup> Pertinent to this study is the exclusions relating to disposals by creditor of a debt owed by a connected person and disposal of interest in equity share capital of a foreign company.

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<sup>240</sup> See Divaris and Stein 394–395.

<sup>241</sup> See par 64B of the Eighth Schedule.

<sup>242</sup> Part VII of the Eighth Schedule. The primary residence exclusion applies to the gain or loss determined on the disposal of a primary residence in the calculation of a natural person's aggregate capital gain or loss. The residence should be located in South Africa and only applies to South African residents. However, the resident does not have to own the asset. An interest in the asset suffices. For a detailed discussion of the primary residence exclusion see Silke and Stretch "Capital Gains Tax – Primary Residence Exemption" *Taxgram* Issue No 4 (2001) 4–5; Williams *Capital Gains Tax – A Practitioner's Manual* 308–329.

<sup>243</sup> Par 53 of the Eighth Schedule. Personal assets are assets used mainly for purposes other than the carrying on of a trade. These assets include furniture, clothing, jewellery and a private motor vehicle. See Williams *Capital Gains Tax – A Practitioner's Manual* 330.

<sup>244</sup> See Williams *Capital Gains Tax – A Practitioner's Manual* 331. In terms of Par 54 of the Eighth Schedule, lump sum benefits from pension, provident, retirement and annuity funds are not subject to CGT whether paid by a resident or non-resident.

<sup>245</sup> Par 57 of the Eighth Schedule provides for the exclusion of gains made on the disposal of active business assets by a natural person carrying a small business as defined. The amount disregarded is up to R750 000 of the gain. For a detailed discussion of the exclusion on small business assets see Silke and Stretch "CGT: Disposal of Small Business Assets" *Taxgram* Issue No 8 (2001) 2

<sup>246</sup> Par 64B of the Eighth Schedule.

<sup>247</sup> Par 63A of the Eighth Schedule. See also Williams *Capital Gains Tax – A Practitioner's Manual* 345.

<sup>248</sup> Par 56 of the Eighth Schedule.

Other exclusions would generally not be available to an IHC based on its nature and functions.

(a) *Disposals by creditor of a debt owed by a connected person*

The provision relating to the disregarding of disposals by the creditor of a debt owed by a connected person applies in respect of losses realised in such a disposal. Where a creditor disposes of a claim by a debtor who is a connected person in relation to that creditor, that creditor must disregard the loss determined in consequence of that disposal.<sup>249</sup>

This provision implies that a resident holding company or other connected person of an IHC cannot reduce the amount of taxable gain by discharging the IHC of its indebtedness to the resident company.

However, the loss can be considered to the extent that the claim disposed of represents any of the following:<sup>250</sup>

- a capital gain which is included in the determination of the aggregate capital gain or aggregate capital loss of that debtor;
- an amount which the creditor proves must be or was included in the gross income of any acquirer of that claim;
- an amount that must be or was included in the gross income or income of the debtor or taken into account in the determination of the balance of assessed loss of the debtor; or
- a capital gain which the creditor proves must be or was included in the determination of the aggregate capital gain or aggregate capital loss of any acquirer of the claim.

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<sup>249</sup> Williams *Capital Gains Tax – A Practitioner’s Manual* 71.

<sup>250</sup> Para 56(2)(a) – (d) of the Eighth Schedule to the Act.

(b) *Disposal of interest in equity share capital of a foreign company*

Par 64B provides that a taxpayer must disregard any capital gain or capital loss determined in respect of the disposal of any interest in the equity share capital of any foreign company if that person<sup>251</sup> immediately before that disposal held at least 20% of the equity share capital in that foreign company. In addition, that person should have held that interest 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 same group of companies and that company and other company in aggregate held that interest for more than 18 months.<sup>252</sup>

The net capital gain included in the year of assessment applies in respect of any capital gain determined in respect of any disposal of any interest in the equity share capital of any foreign company by a person who is or was disregarded as stated above if:<sup>253</sup>

1. the foreign company prior to that disposal was a CFC in relation to that person or any other company in the same group of companies as that person;
2. the interest in the equity share capital of that foreign company was disposed of to a connected person in relation to that person either before or after that disposal;
3. that person disposed of that equity share capital for no consideration or for consideration which does not reflect an arm's length price, other than a disposal by means of a distribution. Alternatively that person disposed of the equity share capital by means of a distribution;<sup>254</sup> and

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<sup>251</sup> Par 64B(2) of the Eighth Schedule to the Act. If the taxpayer in this regard is a company, this requirement relates to that company, together with any other company in the same group of companies as that company.

<sup>252</sup> See Scholtz *CGT, Companies and Their Shareholders* (2005) 22; Williams *Capital Gains Tax – A Practitioner's Manual* 347. In determining the total equity share capital in a foreign company, there shall not be taken into account any share which would have constituted a hybrid equity instrument, but for the three-year period requirement contained in that section and that interest is disposed of to a person who is not a resident. Proviso to para 64B(2) of the Eighth Schedule to the Act.

<sup>253</sup> Par 64B(3) of the Eighth Schedule to the Act.

<sup>254</sup> This provision applies unless the full amount of the distribution would have been subject to STC if the companies did not constitute a group of companies (and benefited from the group dividend exemption contained in s 64B(5)(f)). It would also not apply to the amount that was included in the income of the shareholder of such company or would have been included if it was not a dividend excluded in terms of s 10(1)(k)(ii)(dd). As a further alternative, that person disposed of any consideration received or accrued from the disposal of that equity share capital in terms of any transaction, operation or scheme of which the

4. that foreign company ceased in terms of any transaction, operation or scheme of which the disposal of the equity share capital forms part, to be a controlled foreign company in relation to that person or other company in the same group of companies as that person.

Where the above provisions do not apply to any distribution the full amount of the distribution would have been subject to STC if the companies did not constitute a group of companies (and benefited from the group dividend exemption contained in section 64B(5)(f)) and the company to which that distribution was made, disposes of any amount of that distribution that company must be treated as having disposed of the interest in the equity share capital of that foreign company by means of a disposal which is or was disregarded.

A taxpayer must disregard any capital gain or capital loss determined in respect of any capital distribution received by or accruing to that person from a foreign company where that person holds at least 20% of the total equity share capital in that company.<sup>255</sup> This provision does not apply in respect of any distribution which forms part of any transaction, operation or scheme in terms of which any capital gain is disregarded while any corresponding expenditure is taken into account by that person or any connected person in relation to that person in determining the liability for tax of that person or connected person, as the case may be, in terms of this Act.

These provisions do not apply in relation to a foreign financial instrument holding company or a non-resident company whose capital gains are taxable due to the holding of an interest in immovable property.<sup>256</sup>

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disposal of the equity share capital forms part for no consideration or for consideration which does not reflect an arm's length price or by means of a distribution by a company, unless the full amount of that distribution unless the full amount of the distribution would have been subject to STC if the companies did not constitute a group of companies (and benefited from the group dividend exemption contained in s 64B(5)(f)).

<sup>255</sup> Once again in determining the total equity share capital of a company, any share which would have constituted a hybrid equity instrument but for the three-year period requirement contained in section 8E shall not be taken into account. See further on this aspect Scholtz 38.

<sup>256</sup> Par 64B(2) read with para 2(2) of the Eighth Schedule to the Act and section 41 of the Act.

#### 10.7.2.6 *Capital Distributions*

The capital gains tax regime provides for special treatment for company distributions that constitute capital distributions. “Capital distribution” is defined as any distribution or a portion thereof by any company that does not constitute a dividend or that constitutes a dividend but is exempt from STC because it is declared in the course or in anticipation of a liquidation, winding up, deregistration or final termination of the corporate existence of a company.<sup>257</sup> A “distribution” is defined for purposes of these provisions as any transfer of cash or assets by a company to a shareholder in relation to a share held by that shareholder, including any issue of shares or debt in that company, or any option thereto, regardless of whether that transfer constitutes a dividend.<sup>258</sup>

Where a company distributes an asset to a shareholder (distribution *in specie*) or a repayment of capital to a shareholder, that company is treated as having disposed of that asset to that shareholder on the date of distribution for an amount received or accrued equal to the market value of that asset on that date.<sup>259</sup> A shareholder who receives a capital distribution of cash or an asset *in specie* after 1 October 2007 treats the amount of that cash or the market value of that asset *in specie* as proceeds.<sup>260</sup>

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<sup>257</sup> Par 74 of the Eighth Schedule to the Act definition of “capital distribution” read with section 64B of the Act. See Mitchell “Capital Distributions” 2007 *Tax Planning* 143.

<sup>258</sup> Par 74 of the Eighth Schedule to the Act definition of “distribution.”

<sup>259</sup> Par 75 of the Eighth Schedule to the Act. “Date of distribution” is also defined for purposes of the company distributions provisions to mean “the date of approval of the distribution by the directors or by some other person or body of persons with comparable authority conferred under the memorandum and articles of association of the company making the distribution or under a law, regulation or rule to which that company is subject, except where the distribution is made— (a) by a company subject to the condition that it be payable to a shareholder of the company registered in that company’s share register on a specified date, in which case it must be that date; (b) by a company to a shareholder of that company otherwise than by way of a formal declaration of a dividend, in which case it must be the date on which the shareholder became entitled to that distribution; or (c) by the liquidator of a company to a shareholder of that company in the course of the winding up or liquidation of that company, in which case it must be the date on which the shareholder became entitled to that distribution.”

<sup>260</sup> Par 76 of the Eighth Schedule to the Act as amended by the Taxation Laws Amendment Bill 13 of 2008. The purpose of the 2008 amendment is to ensure that capital distributions received or accrued on or after 1 October 2007 are treated as proceeds when a part-disposal occurs. Prior to the amendment, no provision was made of the treatment of the distributions made on or after 1 October 2007. Scholtz 38.



Where there is a part disposal of an asset, the base cost of the part disposed of is pro rated to the base cost of the asset in proportion to the total market value of the asset.<sup>261</sup> Similarly, the market value of the part disposed of is pro rated to the market value of the asset in proportion to the total market value of the asset.<sup>262</sup>

These provisions would affect the distributions of an IHC that is effectively managed in South Africa to its shareholders. This applies to resident shareholders and non-resident shareholders in companies with an interest in immovable property located in South Africa. Where the distribution is subject to STC the effect of the incidence of the STC is similar for both residents and non-residents. It is expected that the effect will remain the same once the new dividend tax system is in place, as non-residents will be equally taxable as residents.

As stated in Chapter 7,<sup>263</sup> the Dutch tax system does not make a distinction between capital gains and other income. As a result capital gains are taxed the same as other income. On the other hand, similar to the South African tax system, the Mauritian system does not subject capital gains to tax unless such gains arise from the disposal of land situated in Mauritius.<sup>264</sup>

## 10.8 TAX RULINGS

A detailed advance tax ruling (hereinafter referred to as an “ATR”) system was introduced in the South African tax system in 2004<sup>265</sup> and came into effect on 01 October 2006.<sup>266</sup> The ATR system is intended to promote clarity, consistency and certainty in the interpretation and applications of the tax laws, and by so doing, assist taxpayers to

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<sup>261</sup> Par 33(1)(a) of the Eighth Schedule to the Act. See Stein “Part Disposals and CGT” 2004 *Tax Planning* 36.

<sup>262</sup> Par 33(1)(b) of the Eighth Schedule to the Act. See Stein *Tax Planning* 36–37; Kolitz “Part Disposals” 2002 *Tax Planning* 42.

<sup>263</sup> See Chapter 7 par 7.3.3.

<sup>264</sup> See Chapter 8 par 8.2.

<sup>265</sup> The advance tax rulings provisions were inserted into the Income Tax Act by s 12(1) of the Revenue Laws Amendment Act 34 of 2004.

<sup>266</sup> The advance tax rulings provisions were put into effect by the President through Proclamation 43 of 2006. See Silke and Stretch “Discussion Paper on Advance Tax Rulings” 2004 (Issue No 3) *Taxgram* 1–3.



comply with the tax laws.<sup>267</sup> The system is not intended to assist tax advisers in devising tax avoidance schemes.<sup>268</sup>

The Act empowers the Commissioner of the South African Revenue Service (hereinafter referred to as “the Commissioner”) to issue three forms of binding tax rulings, namely a binding general ruling, a binding private ruling and a binding class ruling. The Commissioner may also issue a private opinion that does not have the binding effect referred to as the non-binding private opinion. In terms of section 76D the Commissioner may make an advance tax ruling on any provision of the Act.<sup>269</sup>

Upon the coming into effect of these provisions, the Commissioner set up a subdivision of the South African Revenue Service (hereinafter referred to as “SARS”), referred to as the Advance Tax Rulings Unit. This unit’s sole responsibility is to receive applications for rulings, scrutinise them and issue rulings where the facts warrant a ruling.

### **10.8.1 Binding General Rulings**

A binding general ruling is a ruling that is initiated and issued by the Commissioner on topics of general interest.<sup>270</sup> These take the form of practice notes and the interpretation notes that were already being issued by SARS. These rulings are binding on the Commissioner and both the Commissioner and the taxpayers can cite them as precedent in tax proceedings before the Commissioner or the courts.<sup>271</sup> Meyerowitz states that “[t]he Commissioner may withdraw or modify these rulings, but such withdrawal or modification generally cannot take effect prior to the publication of the notice of such action.”<sup>272</sup> A change in the law relating to the subject of the ruling immediately affects the validity of the ruling without any action by the Commissioner.

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<sup>267</sup> See s 76C of the Act. See also Meyerowitz, Emslie and Davis “Advance Tax Rulings System” *The Taxpayer* (2006) 192.

<sup>268</sup> PricewaterhouseCoopers *Income Tax Guide* (2006) 288.

<sup>269</sup> See Ware “Advance Tax Rulings” 2005 *Tax Planning* 29.

<sup>270</sup> See s 76P(1).

<sup>271</sup> See s 76H(3). Meyerowitz *Meyerowitz on Income Tax* (2008) par 33.27.

<sup>272</sup> Meyerowitz par 33.27.

These rulings are available for IHCs in the nature of practice and interpretation notes without the IHC disclosing the nature of the transactions it seeks to enter into. It is for the IHC to ensure that the transaction that it enters into fits the details of the ruling.

### 10.8.2 Binding Private Rulings

These rulings are initiated by the taxpayers and are issued by the Commissioner setting out the Commissioner's opinion regarding the interpretation or application of tax provisions in respect of a specific set of facts relating to a proposed transaction.<sup>273</sup> These rulings are binding on the Commissioner in relation to the particular taxpayer and only as far as the specific facts upon which the ruling was granted are concerned. The ruling can be cited by the Commissioner and the taxpayer in any tax proceedings.<sup>274</sup> No other taxpayer can cite the ruling in such taxpayer's tax proceedings nor can the taxpayer to whom the ruling was granted cite the ruling in any other tax proceedings.<sup>275</sup> Silke and Stretch state that "[p]rovided that there is full disclosure of material facts, the ruling will generally be binding on the Commissioner when the assessment is made in connection with that transaction."<sup>276</sup>

The Commissioner may withdraw a binding private ruling prospectively. In addition, section 76N(3) empowers the Commissioner to withdraw or modify a binding private ruling retrospectively if such ruling was made in error and any of the following circumstances apply:

- The applicant has not yet commenced with the proposed transaction;
- There is any person other than the applicant who will suffer significant tax disadvantage if the ruling is not withdrawn or modified and the applicant will suffer comparatively less if the ruling is withdrawn or modified; or

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<sup>273</sup> See s 76Q(1).

<sup>274</sup> See *Ware Tax Planning* 30.

<sup>275</sup> See s 76H(4) of the Act. See *Ware Tax Planning* 30.

<sup>276</sup> See Silke and Stretch "Advance Tax Ruling System Implemented" *Taxgram* November/December 2006 (Volume 10) 6. See also Meyerowitz, Emslie and Davis *The Taxpayer* 192.

- The effect of the ruling will materially erode the South African tax base and it is in the public interest to withdraw or modify the ruling retrospectively.<sup>277</sup>

In the operations of the IHC, where necessary, the IHC would apply for binding private rulings where it requires certainty of tax treatment.

### 10.8.3 Binding Class Rulings

A binding class ruling is a ruling regarding the application or interpretation of the Act to a specific class of persons in respect of specific facts regarding a proposed transaction.<sup>278</sup> The purpose of these rulings is to relieve each participant in a multi-taxpayer transaction of the need to obtain separate binding private tax rulings relating to the same transaction.<sup>279</sup>

This ruling is initiated by a class of persons and issued by the Commissioner and is binding upon the Commissioner in relation to the particular class of taxpayers and only as far as the specific facts upon which the ruling was granted are concerned.<sup>280</sup> The ruling can be cited by the Commissioner and that class of taxpayers in any tax proceedings. No other taxpayer can cite the ruling in such taxpayer's tax proceedings nor can the taxpayer to whom the ruling was granted cite the ruling in any other tax proceedings.<sup>281</sup> The provisions relating to the withdrawal of the binding class rulings is the same as those that apply to binding private rulings.<sup>282</sup>

The IHC would only apply to use this form of rulings where there is a group of taxpayers that are affected by the ruling. The group of taxpayers may include or be limited to companies in the same group of companies with the IHC. Thus they may include the subsidiaries that are taxable in South Africa.

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<sup>277</sup> See also Meyerowitz, Emslie and Davis *The Taxpayer* 192.

<sup>278</sup> See s 76R(1).

<sup>279</sup> See Meyerowitz par 33.27

<sup>280</sup> See s 76J(1).

<sup>281</sup> See s 76H(4). See also Ware *Tax Planning* 30.

<sup>282</sup> See s 76M.

#### 10.8.4 Non-Binding Private Opinions

The Commissioner may issue a non-binding private opinion to a person regarding the particular and specific set of facts and circumstances or a particular transaction.<sup>283</sup> As its name suggests, a non-binding private opinion does not have any binding force upon the Commissioner.<sup>284</sup> A non-binding private opinion may not be cited in any proceedings before the Commissioner or the courts other than a proceeding involving the person to whom the non-binding private opinion was issued.<sup>285</sup> Any written statements issued by the Commissioner prior to the coming into effect of the provisions regarding ATRs are deemed to be non-binding private opinions unless the Commissioner prescribed that the statement has a binding effect.<sup>286</sup>

As was seen in Chapter 7,<sup>287</sup> the Dutch system has a fairly extensive tax rulings system. It was also seen in Chapter 8<sup>288</sup> that the Mauritian tax system provides for an advance tax rulings system. However, neither of these systems is as comprehensive as the South African system.

### 10.9 GROUP TAXATION IN SOUTH AFRICA

As mentioned in Chapter 6,<sup>289</sup> South Africa does not presently have a system of group taxation. The tax provisions applicable to company restructuring do however provide some relief to a limited extent akin to group taxation. In addition, the idea of group taxation has been considered before in South Africa. In 1986 the Margo Commission<sup>290</sup> recommended that group taxation should not be introduced in South Africa.

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<sup>283</sup> See s 76I(1).

<sup>284</sup> See s 76I(2). See also *Ware Tax Planning* 30.

<sup>285</sup> See s 76I(3).

<sup>286</sup> See s 76I(5).

<sup>287</sup> See Chapter 7 par 7.5.2.

<sup>288</sup> See Chapter 8 par 8.3.2.

<sup>289</sup> See Chapter 4 par 4.6.

<sup>290</sup> Margo Commission *Report of the Commission of Inquiry into the Tax Structure of the Republic of South Africa* 1986.

Subsequently, in 1995 the Katz Commission<sup>291</sup> recommended the adoption of a system of group taxation in the form of fiscal unity. The Katz Commission referred to it as “tax consolidation”. Although the recommendations of the Katz Commission have not (yet) been implemented, they are part of authoritative literature that supports the introduction of group taxation for South Africa. This is because it is the latest commission to consider the need for group taxation in South Africa.

### 10.9.1 Margo Commission

In 1986 the Margo Commission considered whether South Africa should adopt a system of group taxation on a consolidated basis. The Commission, by a majority vote, recommended that South Africa should not move towards a group taxation system.<sup>292</sup> A minority of the commissioners, however, were in favour of the introduction of group taxation.<sup>293</sup> The main reasons for not introducing group taxation can be summarised as follows:<sup>294</sup>

1. Group taxation would result in significant loss of revenue that the fiscus could not afford at that time;
2. It undermines the principle of separate identity of companies, and companies would avoid taxes by trading losses;
3. That it would result in prejudice to creditors if profits are transferred from the company and could result in minority shareholders being expelled from the group.

The first objection was linked to the time at which the commission made the recommendations. It does not imply that South African circumstances would not change and eliminate the concern. According to the National Treasury, consolidated government revenue has increased significantly as a percentage of gross domestic production since 2004 as a consequence of strong economic growth and more efficient revenue

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<sup>291</sup> Katz Commission *Third Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa* 1995.

<sup>292</sup> Margo Commission Report par 10.107.

<sup>293</sup> Margo Commission Report par 10.108.

<sup>294</sup> Margo Commission Report par 10.105.

collection.<sup>295</sup> The downturn of the world markets experienced since early 2008 could have an impact on the South African economy and consequently tax revenue collections.<sup>296</sup>

The last two reasons do not take into account the fact that a group of companies is in effect largely owned by the same investor. Such companies could operate as various divisions or branches of a company. The Commission acknowledged, but was not persuaded by, the fact that a group of companies could achieve the benefits of group taxation by engaging in various structural steps such as merging group assets into a single holding company.

In summary, the main disadvantages of the absence of a system of group taxation were as follows:<sup>297</sup>

1. It is a disincentive to international investment in South Africa;
2. It is unfair for a group, which is one economic entity, not to be able to set off losses from loss-making divisions;
3. It impairs capital formation; and
4. It provides an impetus towards large divisionalised companies.

### 10.9.2 The Katz Commission Recommendations

The Katz Commission proposed a gradual approach to the introduction of group taxation in the form of tax consolidation beginning with what it termed a “simplified consolidation method”. It recommended that “progress towards a full consolidation system, based on the principles of loss offset and adjustments to taxable income which are widely followed internationally, should be deferred until the impact of the shift to

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<sup>295</sup> National Treasury *Budget Review* (2009) 49.

<sup>296</sup> See South Africa’s Economy – Tough Times Ahead  
[http://www.economist.com/displayStory.cfm?story\\_id=13109968](http://www.economist.com/displayStory.cfm?story_id=13109968) accessed on 02 April 2009.

<sup>297</sup> Margo Commission Report par 10.106.

group taxation on the fiscus can be evaluated and the problems of administration have been identified and addressed.”<sup>298</sup>

The Commission proposed a method which aggregates the taxable incomes of group members on a year-by-year basis as opposed to a method which reconciles consolidated taxable income with consolidated accounting income.<sup>299</sup> It is proposed that a group, for purposes of group taxation, would be limited to South African resident companies as defined in section 1.<sup>300</sup>

It is not clear whether by “South African companies” the Commission envisaged tax-resident companies or companies that are merely incorporated in South Africa. It is, however, submitted that companies incorporated in South Africa, but that are not subject to tax in South Africa (by virtue of their place of effective management being located in another jurisdiction), would not form part of the group. Should companies that are not subject to tax in South Africa be included in the group, resident companies could set off the losses of non-resident companies against their South African taxable income without the corresponding inclusion of the income of non-resident companies in the South African tax net.

Logically, a company that is permanently established in South Africa with its effective management outside South Africa should also be included in group taxation as it would be taxable in South Africa. While this position would be similar to the Dutch treatment of permanent establishments, it would also mirror the Luxembourg requirement that the permanent establishment should be subject to taxation comparable to the local corporate income tax.<sup>301</sup> For South African purposes the tax treatment of a permanent establishment

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<sup>298</sup> Katz Commission report par 10.6.4. See also Wilcocks and Middelmann “Evaluation of the Need to Introduce a System of Group Taxation in South Africa” <http://www.up.ac.za/dspace/handle/2263/5460> accessed on 14 January 2008.

<sup>299</sup> Katz Commission report par 10.5.3.

<sup>300</sup> Katz Commission report par 10.5.7. Close corporations would not be allowed to access this system.

<sup>301</sup> See Art 164bis (1) and (2) of the Luxembourg Law of 4 December 1967 on Income Tax (*loi concernant l'impôt sur le revenu*); Warner *Luxembourg in International Tax Planning* (2004) 105 – 107. Rawal *The Taxation of Permanent Establishments: An International Perspective* (2006) 96.

is equated to the tax treatment of resident companies by the imposition of a higher tax of 33%.

The main features of the simplified consolidation method as proposed by the Katz Commission<sup>302</sup> are the following:

- (a) For the purposes of qualifying for group tax relief, a group should comprise a holding company and all its wholly owned subsidiaries. The term “wholly-owned” should be defined to refer to both direct and indirect interests held by the holding company, determined on the equity share capital of the companies concerned, with allowance for equity shares to be held by full time employees, including executive directors, in terms of share incentives schemes, not exceeding 10% of the company’s equity share capital.
- (b) The consolidated tax liability of a group will be calculated from “sub-returns” required for each member company in which taxable income or assessed loss will be determined on the basis of the current tax regime, save for a limited number of proposed adjustments.
- (c) The initial assessed losses of member companies will be ring-fenced, and any loss incurred by a company in the group in a subsequent year of assessment will only be available to be set off against income from another company in a group in the same year of assessment.

Despite the Katz Commission’s recommendations, South Africa still does not have a group taxation system. However, there have been calls by some taxpayers for the National Treasury to consider introducing such a system given the benefits that taxpayers would derive from such a system.<sup>303</sup> National Treasury has embarked on a research project to assess the suitability of the tax consolidation in South Africa. However, the introduction of such a system is expected to be considerably delayed as the focus is

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<sup>302</sup> See Katz Commission report par 10.6.2.

<sup>303</sup> See Garven *Budget Prediction* <http://www.bowman.co.za/LawArticles/Law-Article.asp?id=2132417248> accessed on 14 January 2008.



currently on other imminent and major changes to the tax laws, including the conversion of the STC to a shareholder tax and a possible rewriting of the Act.<sup>304</sup>

### **10.9.3 Current Law**

While the South African tax system currently does not allow taxation of a group of companies as a single unit or entity and the recommendations of the Katz Commission have not yet been implemented, there are tax deferment rules that apply to company groups. Properly construed, one could say that South Africa has a partial and conditional group taxation system since the system applies in particular circumstances.<sup>305</sup> “The aim of the rules in South Africa is to allow the transfer of assets without attracting immediate taxation consequences in respect of transactions between group companies and between founding shareholders and their company.”<sup>306</sup> Companies form a group where there is a 70% holding within them. The rules apply in the transactions outlined below within a group.

#### ***10.9.3.1 Company Formations***

A company formation transaction is a transaction in terms of which a person disposes of an asset to a resident company for equity shares and after that transaction that person (the acquirer) either holds a qualifying interest or is a natural person who will work on a fulltime basis in the business of that company of rendering any service.<sup>307</sup> Subject to certain conditions where a person disposes of an asset in terms of the company formation transaction, that person is deemed to be one and the same person as the company he or she is disposing the asset to. The effect is that the capital gains tax that would be payable

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<sup>304</sup> Discussion with Keith Engel, Chief Director: Tax Policy, South African National Treasury on 02 December 2008.

<sup>305</sup> These are often referred to as special corporate tax rules or roll-over relief.

<sup>306</sup> Huxham and Haupt *Notes on South African Income Tax* (2008) 289.

<sup>307</sup> See s 42(1) of the Act. See also Tickle “Group Rationalisation” 2007 *Tax Planning* 82.

in terms of that disposal is not charged.<sup>308</sup> For these provisions to apply, both parties must jointly make an election to trigger the application.<sup>309</sup>

### 10.9.3.2 *Intra-Group Transactions*

An intra-group transaction is a transaction in terms of which any asset is disposed of by one company to another company which is resident and both companies form part of the same group of companies at the end of the day of that transaction.<sup>310</sup> These provisions are subject to a joint asset-by-asset election by taxpayers.

The following election options are available:

- A capital asset is deemed to have been transferred at the base cost of the asset to the transferor if the transferee acquires it as such;<sup>311</sup>
- Trading stock is deemed to have been transferred at tax value if the transferee acquires it as such;<sup>312</sup>
- An allowance asset is transferred at tax value if the transferee acquires it as such;<sup>313</sup> and
- An allowance in respect of future expenditure on contracts is transferred to the transferee if the contract is disposed of as part of the disposal of a business as a going concern in terms of the intra-group transaction.<sup>314</sup>

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<sup>308</sup> According to Deneys Reitz attorneys, “[w]here the market value of the asset transferred exceeds the case cost the disposal will be deemed to have taken place at base cost on the date of disposal i.e. there will be no deemed capital gain in the hands of the transferor and the transferee will be deemed to have obtained the asset at the base cost and on the date on which it was originally acquired by the transferor. If the asset is disposed to the transferee at a capital loss, the loss must be disregarded but it may be set off against any future gain on the disposal of an asset by the transferor to the transferee provided that the transferor still holds a qualifying interest in the transferee. In such an instance the base cost of the asset to the transferee will be the market value of the asset.” See [http://www.deneysreitz.co.za/seminars/item/mergers\\_acquisitions\\_and\\_share\\_buybacks\\_seminar\\_capital\\_gains\\_tax\\_consequences\\_for.111.html](http://www.deneysreitz.co.za/seminars/item/mergers_acquisitions_and_share_buybacks_seminar_capital_gains_tax_consequences_for.111.html) accessed on 15 October 2008.

<sup>309</sup> See s 42(1)(c).

<sup>310</sup> See s 45(1)(a).

<sup>311</sup> See s 45(2)(a).

<sup>312</sup> See s 45(2)(b).

<sup>313</sup> See s 45(3)(a).

<sup>314</sup> See s 45(3)(b).

### 10.9.3.3 *Liquidation, Winding-up and Deregistration*

These are transactions in terms of which the corporate existence of a company ceases. Where a liquidating company disposes of a capital asset to its holding company the asset is deemed to have been transferred at its base cost to the transferor.<sup>315</sup>

## 10.10 TRANSFER PRICING PROVISIONS

South African tax law provides for transfer pricing provisions. The current provisions were introduced into the Act with effect from 19 July 1995.<sup>316</sup> Prior to this the Act contained limited transfer pricing provisions in terms of which profits could be adjusted to comply with article 9 of the relevant tax treaty.<sup>317</sup> Generally, article 9 of the South African treaties contains provisions applicable to connected parties.<sup>318</sup> Furthermore, transfer prices could be challenged on the basis of expenditure being grossly excessive in terms of the general deduction formula<sup>319</sup> or in terms of the then general anti-avoidance provision.<sup>320</sup> The current provisions are more comprehensive.

Currently, the transfer pricing provisions are contained in section 31(2). The section provides as follows:

Where any supply of goods or services has been effected—

- (a) between—
  - (i) (aa) a resident; and
  - (bb) any other person who is not a resident;
  - (ii) (aa) a person who is not a resident; and

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<sup>315</sup> See s 47. See also Meyerowitz par 17A.43-17A.50; Silke and Stretch “Liquidation, Winding-up and Deregistration” 2002 (Issue No 10) *Taxgram* 5.

<sup>316</sup> Section 31(1).

<sup>317</sup> S 31 as at 18 July 1995.

<sup>318</sup> Connected parties are referred to in South African tax treaties as “associated enterprises”.

<sup>319</sup> See s 11(a) read with s 23(g).

<sup>320</sup> See s 103(1).

- (bb) a permanent establishment in the Republic of any other person who is not a resident; or
  - (iii)
    - (aa) a person who is a resident; and
    - (bb) a permanent establishment outside the Republic of any other person who is a resident;
- (b) between those persons who are connected persons in relation to one another; and
- (c) at a price which is either—
  - (i) less than the price which such goods or services might have been expected to fetch if the parties to the transaction had been independent persons dealing at arm’s length (such price being the arm’s length price); or
  - (ii) greater than the arm’s length price,

the Commissioner may, for the purposes of this Act in relation to either the acquiror or supplier, in the determination of the taxable income of either the acquiror or supplier, adjust the consideration in respect of the transaction to reflect an arm’s length price for the goods or services.

In adjusting the prices the Commissioner applies the guidelines provided by the Organisation for Economic Co-operation and Development.<sup>321</sup> In applying these guidelines the arm’s length price is determined by using the (i) Comparable Uncontrolled Price Method (ii) Resale Price Method (iii) Cost Plus Method (iv) Profit-split Method; and (v) Transactional Net Margin Method.<sup>322</sup>

In addition to adjusting the consideration paid for the goods or services and determining the taxpayer’s taxable income based on the adjusted amounts, the additional income or

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<sup>321</sup> Some commentators view the application by SARS of the OECD guidelines as somewhat deviating from the correct application in that SARS considers that SARS may select a mid-range price and that SARS recommends the use of more than one method. See Stanley and Potgieter “Transfer Pricing: Comment on Revenue’s New Practice Note” October/November 1999 *Executive Business Brief* 21.

<sup>322</sup> See a discussion on arm’s length in Chapter 5 in par 5.3.8.1 and in Chapter 6 in par 6.3.1.2.

reduced loss of the taxpayer is deemed to be a dividend for which secondary tax on companies is payable.<sup>323</sup> The advance pricing agreement system is not available in South Africa.<sup>324</sup>

As was seen in Chapter 7,<sup>325</sup> the Dutch tax system provides for transfer pricing provisions that, like the South African provisions, are based on the Organisation for Economic Co-operation and Development transfer pricing guidelines. The Mauritian system, as was seen in Chapter 8,<sup>326</sup> does not contain transfer pricing provisions.

## 10.11 THIN CAPITALISATION PROVISIONS

Thin capitalisation provisions were introduced in 1995 in order to counter thin capitalisation practices which may have adverse tax implications for the South African fiscus upon the relaxation of exchange controls.<sup>327</sup> Section 31(3) of the Act contains the thin capitalisation provisions and provides as follows:

(3) (a) Where any person who is not a resident (hereinafter referred to as the investor) has granted financial assistance...whether directly or indirectly, to—

(i) any connected person in relation to the investor who is a resident; or

(ii) any other person (in whom he has a direct or indirect interest) other than a natural person, which is a resident (hereinafter referred to as the recipient) and, by virtue of such interest, is entitled to participate in not less than 25% of the dividends, profits or capital of the

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<sup>323</sup> For a detailed discussion on the application of transfer pricing provisions in South Africa see SARS *Practice Note No 7* (6 August 1999).

<sup>324</sup> See Olivier and Honiball 501. An advance pricing agreement is an agreement between the tax authorities and the taxpayer as to the acceptable price for goods or services in a connected party transaction.

<sup>325</sup> See Chapter 7 par 7.3.6.

<sup>326</sup> See Chapter 8 par 8.2.3.

<sup>327</sup> See SARS *Practice Note No 2* (14 May 1996) par 1.1.

recipient, or is entitled, directly or indirectly, to exercise not less than 25% of the votes of the recipient,

and the Commissioner is, having regard to the circumstances of the case, of the opinion that the value of the aggregate of all such financial assistance is excessive in relation to the fixed capital (being share capital, share premium, accumulated profits, whether of a capital nature or not, or any other permanent owners' capital, other than permanent capital in the form of financial assistance as so contemplated) of such connected person or recipient, any interest, finance charge or other consideration payable for or in relation to or in respect of the financial assistance shall, to the extent to which it relates to the amount which is excessive as contemplated in this paragraph, be disallowed as a deduction for the purposes of this Act.

(b) For the purposes of paragraph (a), financial assistance granted indirectly shall be deemed to include any financial assistance granted by any third person who is not a connected person in relation to the investor, a connected person contemplated in paragraph (a) or the recipient, where such financial assistance has been granted by arrangement, directly or indirectly, with the investor and on the strength of any financial assistance granted, directly or indirectly, by the investor or any connected person in relation to the investor, to such third person.

In determining whether financial assistance is excessive or not in relation to fixed capital the Commissioner applies a ratio in terms of which the financial assistance should not exceed three times the fixed capital of the resident company to which financial assistance is granted.<sup>328</sup> If the financial assistance is excessive the interest thereon is not allowed as a deduction for income tax purposes. Interest charged at excessive rates is also not allowed as a deduction. Where a loan is denominated in rands or a foreign currency a rate

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<sup>328</sup> Olivier and Honiball 514.

not exceeding the weighted average of the South African prime interest rate, or the relevant inter-bank rate, respectively, plus 2% will be regarded as acceptable.<sup>329</sup>

The South African debt-to-equity ratio of 3:1 compared to those of its trading partners is not adverse. As is shown in Table 3, it comes third together with a few other countries, after Botswana and Italy. The problem with allowing high levels of gearing is that the tax base of the host country would be compromised by the payment of deductible interest. For purposes of attracting IHCs and ensuring that the financing of IHCs and therefore the underlying investments is not constricted, the Netherlands and Germany offer apposite variations.

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<sup>329</sup> See SARS *Practice Note No 2* par 2.2.

**TABLE 3**

<b>Countries Globally</b>	<b>Debt-to-equity ratio</b>	<b>African Countries</b>	<b>Debt-to-equity ratio</b>
Australia	3:1	Botswana	10:1
People's Republic of China	3:1	Mauritius	None
France	1.5:1	Nigeria	None
Germany	1.5:1	Zimbabwe	3:1
India	none		
Italy	4:1		
Japan	3:1		
Netherlands	3:1		
Spain	3:1		
United Kingdom	none		
United States	1:5:1		

Source: Ernst & Young (2006) *Worldwide Corporate Tax Guide*

As to back-to-back arrangements,<sup>330</sup> SARS considers that such arrangements constitute “financial assistance granted indirectly”. According to SARS an arrangement in terms of which a foreign parent company makes a loan to any person on condition that that person on-lends the funds to a South African subsidiary of that parent company that loan constitutes financial assistance. Accordingly, if the foreign parent company provides a guarantee to any non-resident as security for a loan to the South African subsidiary, the debt will be treated as financial assistance.

<sup>330</sup> A back-to-back arrangement or loan is an arrangement where one party grants a loan to another who on-lends the funds to a third party to the arrangement. Honiball and Olivier 571 describe a back-to-back arrangement as “an arrangement or transaction between at least three entities where the arrangement or transaction between the first and second entities is mirrored or substantially similar to the arrangement or transaction between the second and third entities.”



However, financial assistance would not be granted where a foreign parent company provides a guarantee to a South African resident as security for a loan to the South African subsidiary, as the foreign company will not receive any interest and the recipient of the interest will be taxed thereon.<sup>331</sup> In this regard Olivier and Honiball caution that the transfer pricing arm's length rule would require the South African subsidiary to pay a guarantee fee to the foreign parent company which would normally form part of financial assistance granted directly to the South African subsidiary. Olivier and Honiball state that "Exchange Control approval for such fee would be required, and that is not easily obtained".<sup>332</sup>

As was seen in Chapter 7,<sup>333</sup> the Dutch thin capitalisation rules are similar to the South African rules, including the debt-to-equity ratio of 3:1. It was also seen in Chapter 8<sup>334</sup> that Mauritius does not have thin capitalisation provisions at all.

## 10.12 INTERNATIONAL HEADQUARTER COMPANY REGIME

In 2000 the residence-based system of tax was introduced in South Africa.<sup>335</sup> When this system was introduced, concerns raised by the Katz Commission were realised in that headquarter companies would be subject to tax also on income sourced outside South Africa. This is because the South African residence-based tax system is a pure system in terms of which residents are taxable on their worldwide income, subject to certain specific exceptions. Ordinarily, since international headquarter companies are incorporated in South Africa, they would be resident in South Africa. In order to avoid this, the legislature defined and specifically excluded international headquarter companies from the definition of "resident".

An "international headquarter company" was defined<sup>336</sup> as a company:

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<sup>331</sup> SARS *Practice Note No 2* par 8.

<sup>332</sup> Olivier and Honiball 516.

<sup>333</sup> See Table 3 above and Chapter 7 par 7.3.7.

<sup>334</sup> See Chapter 8 par 8.2.3.

<sup>335</sup> See s 2 of the Revenue Laws Amendment Act 59 of 2000.

<sup>336</sup> S 1 definition of "international headquarter company" as at 31 May 2004.

- (a) the entire equity share capital of which is held by persons who are not residents or trusts;
- (b) where any indirect interest of residents or of any trust in such equity share capital does not exceed 5% in aggregate of the total equity share capital of such company; and
- (c) where 90% of the value of the assets of such company represents interests in the equity share capital and loan capital of subsidiaries of such company which are not residents and in which such company holds a beneficial interest of at least 50%.

The intended effect of the exclusion from the definition of “resident” was that the CFC provisions and provisions relating to the taxation of foreign dividends would not apply to the international headquarter companies and the income of the subsidiaries would not be imputed to such company. The international headquarter company was also not taxable on the dividends received from its foreign subsidiaries or its foreign-source income. Because secondary tax on companies is imposed on resident companies, the international headquarter company was not subject to secondary tax on companies on the dividends declared.

In terms of this construction, at first glance, the international headquarter company would achieve the exclusion from the tax base in South Africa, and would therefore hypothetically attract foreign investors to South Africa. A major flaw that was overlooked at inception was that as an international headquarter company was not a resident of South Africa, it would not benefit from tax treaty relief as treaties only apply to residents of the contracting state.

This exclusion from the tax treaty benefit meant that the income of the international headquarter company would be taxed in the country of its shareholders either under the CFC legislation of that country or when it declares the dividend. Thus, the international headquarter company was not entitled to tax treaty benefits and this resulted in potential double taxation.

Exchange control provisions also restricted the use of the international headquarter companies. The exchange control provisions limited the outflow of funds. Prior to 2004, the limits were R2 billion for each new and approved African investment and R1 billion for each new and approved investment elsewhere in the world. On application, a further 20% of excess costs of a new investment (as opposed to an improvement on an already existing investment) could be funded by cash holdings if the investment limit had been utilised.<sup>337</sup> The international headquarter company, as an exchange control resident was also subject to local borrowing restrictions, restrictions on interest on foreign loans and restrictions on fees payable to non-resident companies.

Exchange control and the inability of the international headquarter companies to access tax treaty benefits significantly undermined the essence of the international headquarter company. Furthermore, the international headquarter company regime was considered to result in harmful tax competition. This resulted in the special regime for international headquarter companies being repealed with effect from 1 June 2004. The official reasons for the repeal by the legislature of this regime were stated as follows:<sup>338</sup>

Under the international best practice, the exemption could be viewed as a “Harmful Preferential Tax Regime”. The 90% foreign ownership requirement makes the IHC a ring-fenced regime, whereby a country isolates its own economy from tax concessions by providing a special regime solely to foreign controlled taxpayers. International pressure requires that regimes of this kind be eliminated. The regime was also ineffective. Firstly, in terms of Exchange Control Regulations, the South African Reserve bank restricted the currency flow of 90% foreign owned South African subsidiaries. Secondly, as the IHC was a non-resident for tax purposes, it could not qualify for the benefits of certain Double

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<sup>337</sup> See Olivier and Honiball *International Tax – A South African Perspective* (2008) 533. See further on this discussion par 10.6.5.

<sup>338</sup> Explanatory Memorandum to the Revenue Laws Amendment Bill of 2003 at 38.

Taxation Agreements entered into by South Africa with other countries. It is, therefore, proposed that the IHC regime should be removed.

Based on the above, it is clear that the intention of the legislature to create a suitable environment for the use of an international headquarter company was disrupted by the actual wording of the Act and the application of the tax treaties. South Africa could not have intended to cede its taxing right and tax base to other countries. The question that arises is: Could the intention of the legislature not have been achieved by a different legislative construction? The answer to this question is in the affirmative. The cause of the demise of the international headquarter exclusion was contained in its construction as a company that was not a resident.

For the purpose of tax treaties, the international headquarter company should not have been excluded from the definition of resident. In this way it would have benefited from the treaty provisions. In order to ensure that the international headquarter company is not subject to STC a specific exemption could have been enacted. This would have accorded with the specific exemption of other entities that are indeed exempt, such as fixed property companies<sup>339</sup> and long-term insurance companies.<sup>340</sup> This would ensure that the international headquarter company was not taxable on the dividends received from its foreign subsidiaries or its foreign-source income and that the CFC provisions do not apply to the company.

The exchange control provisions restricted the currency flow of foreign-owned South African subsidiaries. Prior to 2008 outward investment by South African residents was allowed if the investment was a foreign direct investment. A foreign direct investment was an investment which resulted in the resident having at least 10% of the voting rights in the foreign company and the resident and the foreign company being engaged in the same line of business. Once these requirements were satisfied, the resident had to apply to the South African Reserve Bank (SARB) for approval by convincing the Bank that

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<sup>339</sup> See section 64B(5)(b).

<sup>340</sup> See section 64B(5)(g).

there was a quantifiable benefit for South Africa to be derived from the investment. As from 27 October 2009, foreign investment of up to R500 million is allowed without any approval.

The South African exchange control policy in 1997 was strict and emphasised the restriction of the repatriation of funds from South Africa. This policy has since been changed and exchange controls accordingly relaxed. Had the policy been as relaxed at the time of the coming into effect of the CFC legislation, or at the time that it appeared to the South African Revenue Service and the National Treasury that the exchange control provisions interrupt the use of the international headquarter company, it would have been appropriate to amend the exchange control rules in order to remove the restriction of the use of an international headquarter company. Be that as it may, it should be noted that the procedural requirement that the resident should apply to the SARB where the investment exceeds R500 million does not amount to a substantive prohibition.

### **10.13 CONCLUSION**

The South African tax system contains features that are conducive to the location of an IHC in South Africa. The main features that make the Netherlands a suitable jurisdiction to host an IHC – the participation exemption and the advance tax rulings system – are also found in the South African tax system. However, the presence of a broad controlled foreign company system as well as exchange control provisions are causes of concern for investors.

With regard to the CFC provisions, the available exclusions offer the IHC some reprieve in relation to the income of foreign operating subsidiaries. As was seen above, and as will be seen in Chapter 11, these controlled foreign company and exchange control provisions are not prohibitive to the operation of the IHC in South Africa.

The STC system is currently undergoing change. This change would offer IHCs certainty of the taxation as it is a move towards the more familiar system of taxation of dividends.

It would also offer the IHCs DTA relief where the IHC pays dividends to its holding company that may not be resident in South Africa.

Where the IHC receives dividends from its foreign operating subsidiaries, the current tax treatment also offers considerable benefits. The main and most noteworthy benefit is the participation exemption. The participation exemption would apply in many cases, as the IHC is expected to have a considerable shareholding in the foreign operating companies. Furthermore, the rebate in respect of foreign taxes on income would reduce the tax burden in South Africa on the IHC's receipt of foreign dividends and other income. The participation exemption in relation to capital gains on the disposal of shares in the subsidiaries would also ease the tax burden where the IHC restructures the group.

Transfer pricing and thin capitalisation provisions are necessary as anti-avoidance provisions to prevent the movement of capital offshore and the consequent erosion of the tax base. An IHC that operates genuinely should not be perturbed by the existence of these provisions. The availability of the advance tax rulings system would ensure that the IHC appreciates the tax implications of the transactions even before it enters into these transactions.

In Chapter 11 the suitability of South Africa to host an IHC will be analysed in more detail. Chapter 11 also includes a discussion of whether there is a need for the tax system to be adjusted and, if so, how the tax system should be adjusted to better accommodate IHCs.

## **CONCLUSIONS AND RECOMMENDATIONS**

### **11.1 INTRODUCTION**

In Chapter 2 this thesis identified an IHC and its functions and compared the nature of an IHC and its functions with those of business entities that are similar to the IHC. This was followed by a discussion of the tax and non-tax reasons for forming an IHC as well as the characteristics of the ideal environment in which it operates.

The thesis also discussed the attitude that the countries with regimes that are tailored for IHC operations face from the international community. It was observed that the Organisation for Economic Co-operation and Development encourages its member states and all other countries to create an arduous environment for investors wanting to operate through countries that are engaged in harmful tax competition. This was followed by an outline of the Dutch and the Mauritian tax systems. As was seen in Chapter 5, the Dutch system is generally structured in such a way that it is not adverse to IHC operations, while the Mauritian system is specifically designed to create a tax environment that is favourable to IHC operations.

The thesis also extensively examined the South African income tax system in so far as its provisions affect the operation of an IHC. The key considerations in the South African tax system in relation to IHCs are the provisions relating to controlled foreign companies, the taxation of foreign dividends, foreign tax credits, capital gains tax and thin capitalisation provisions. Exchange control was also discussed due to its impact on the inward and outward flow of funds.

## 11.2 BACKGROUND

Following the discussion in Chapter 10 on the South African tax system, it is clear that the South African tax system is not designed to discourage investors from setting up IHCs in South Africa. Furthermore, substantively it would not discourage or drive away investors who are interested or who already have a presence in South Africa from operating in South Africa, as the case may be. That is a noteworthy development in the South African tax system.

The existence of instruments that could deter investors such as capital gains tax and exchange control is neutralised by the effect of the actual application of those provisions. For example, the exchange control does not prohibit the operation of the IHC but requires the South African Reserve Bank's approval, and in terms of the capital gains tax system the non-resident investors in an IHC are not subject to capital gains tax on their disposal of interests in the IHC. The result is that if the investors consider the actual effect of these instruments on commercial transactions that the IHC is expected to enter into, it would be found that these instruments do not have a substantive negative impact on the IHC operations.

Drawing on the lessons learnt from the Dutch and the Mauritian tax systems, a few aspects relating to the suitability of the South African tax system could arguably be improved on in order to make the system more attractive to IHCs as part of its broader policy to attract foreign direct investment. This is in light of the fact that the South African government has announced its intention to make South Africa particularly attractive as a gateway to investment in South Africa,<sup>1</sup> thus requiring that the tax system should not only be suitable but actually attractive for investment. In order to achieve this goal, and in recognition of the business structural flexibility that investors require in the economies that they conduct business, the South African tax regime needs to be ideal for the acquisition, management, reorganisation and disposals functions of an IHC.

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<sup>1</sup> See Chapter 1 par 1.2.2.



The Katz Commission recommended that the South African tax regime should be developed in such a way that it would encourage the location of international headquarter and holding companies.<sup>2</sup> The relevant tax developments since the Katz Commission's recommendations as well as the proposals made in this chapter will be juxtaposed with the Katz Commission's recommendations to assess whether legislative amendments to date and the recommendations made in this thesis could give effect to the Katz Commission's recommendations.

Pursuant to the Katz Commission's recommendations, an international headquarter regime was introduced in South Africa together with a residence-based system of taxation. The South African international headquarter regime was discussed in Chapter 10. The relevance of the tax on international headquarter companies to the taxation of IHCs, as was stated in Chapter 2, is that the main tax instruments affecting international headquarter companies also apply to IHCs. Of specific relevance are corporate income tax, controlled foreign company legislation, dividends tax, thin capitalisation and exchange control.

Once again drawing on the experiences in the Netherlands and Mauritius, this chapter engages with the key instruments that are considered when a decision to locate an IHC in South Africa is made, namely: (i) headline corporate income tax; (ii) taxation of dividends and the withholding thereof; (iii) controlled foreign company provisions; (iv) participation exemption; (v) thin capitalisation rules; (vi) advance tax rulings system; and (vii) exchange control. Finally, this chapter illustrates that the implementation of the favourable regime for IHCs would comply with the non-discrimination provisions of the South African tax treaties.

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<sup>2</sup> See Chapter 1 par 1.2.2.

## 11.3 ASSESSING THE SUITABILITY OF SOUTH AFRICA TO HOST IHCs

### 11.3.1 Corporate Tax Rate

Before an adjustment of the corporate tax rate could be considered as an incentive to encourage the hosting of IHCs, it is important to compare the corporate tax rate of South Africa with tax rates in other countries. If the corporate tax rate of South Africa is lower than the tax rates of its competitors in terms of IHC location, this would be an indication that further lowering the tax rate might not be a necessary or even an appropriate instrument to attract IHCs. It would indicate that an adjustment of some other aspects (not necessarily the corporate income tax and other tax aspects) might be necessary.

It would not be ideal to reduce the corporate tax rate for foreign-owned IHCs alone. A reduction applicable specifically for IHCs would amount to unfair tax competition with other countries and undermine the principle of tax neutrality. If the corporate income tax rate is reduced, such reduction will have to be applicable to all companies. The cost of a general reduction of the corporate tax rate would be tremendous vis-à-vis the benefits that would be derived therefrom. A reduction of 1% from 30% to 29% in 2005 reduced tax revenue by R2 billion.<sup>3</sup>

Currently, the South African corporate tax rate is 28%.<sup>4</sup> Since 1997 when the Katz Commission tabled its recommendations, it has been reduced regularly from the 35% at the time.<sup>5</sup> The average rate for South Africa's main trading partners is 28.25%, with Germany having the lowest rate at 15% and Zambia the highest at 35%.<sup>6</sup>

Given the above, South Africa's corporate tax rate does not disadvantage it as an ideal IHC hosting jurisdiction. Quite interestingly, the rate is lower than the rates of some

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<sup>3</sup> See National Treasury *Budget Review* (2005) 83.

<sup>4</sup> Currently, secondary tax on companies has to be taken into account at the level of the company when it declares dividends.

<sup>5</sup> See South African Revenue Service *Guide for Tax Rates, Duties and Levies* (2008) par 1.1 available on <http://www.sars.gov.za/home.asp?pid=4589> accessed on 19 February 2009.

<sup>6</sup> See Chapter 10 par 10.4 Table 1.

countries whose infrastructure and therefore key determinants are weaker than that of South Africa. Furthermore, various other factors would counter the further reduction of the headline corporate tax rate. Among them is the fact that there is presently a huge gap between the corporate tax rate and the marginal tax rate of 40% in respect of personal income tax – resulting in the increased pursuit of arbitraging by taxpayers.

Furthermore, should a lower tax rate be provided only for IHCs this would have the impact of most current entrepreneurs restructuring their business designs in order to avail themselves of the lower rate. This could result in the company groups creating further intermediary companies offshore in order for such companies to hold shares in the South African IHC.

### **11.3.2 Taxation of Dividends**

The South African system of taxation of dividends is undergoing change. The secondary tax on dividends (hereinafter referred to as the “STC”) system is being replaced by a dividend tax system.<sup>7</sup> Under the STC system the company distributing the dividend is subject to tax on the net amount of dividends distributed.<sup>8</sup> One of the reasons for the change was that the international community was not familiar with the STC. Furthermore, under the STC system, there is no treaty relief where the dividend is paid to a non-resident, as STC is seen as a tax on the company declaring the dividend and not the shareholder.

Under the new dividend tax system, the shareholder receiving the dividend would be subject to tax on the amount of dividends received.<sup>9</sup> The rate of the STC tax rate has been

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<sup>7</sup> National Treasury *Budget Review* (2007) 67–68; National Treasury *Budget Review* (2008) 61–62. Refer to budget Review for 2008. See also Mitchell *et al* “Secondary Tax on Companies” 2008 *Income Tax Reporter* 48.

<sup>8</sup> On the nature of STC as a tax on the company and not on dividends or the shareholder *see Volkswagen of South Africa (Pty) Ltd v C: SARS 70 SATC 195*; Silke and Stretch “High Court: STC not a Tax on Dividends” 2008 (Issue No 9) *Taxgram* 9–10.

<sup>9</sup> See Silke and Stretch “From STC to a Shareholder Dividends Tax” 2008 (Issue No 4) *Taxgram* 3–4.

reduced from 25% to 12.5% in 1996 and further to 10% in 2007.<sup>10</sup> This 10% is the rate at which the new dividend tax will be levied, at least initially.

In terms of the new dividend tax system, individual and non-resident shareholders are liable to a dividend tax. Resident companies and certain specific entities are exempt. A resident company declaring the dividend has a liability to withhold the tax where the recipient is liable for the tax. Thus, the liability is two-fold. The shareholder has the liability for the dividend tax and the company declaring the dividend has the liability to withhold the tax and pay it over to the South African Revenue Service. Where the shareholder receiving the dividend is a non-resident, the company paying the dividend should withhold the full dividend tax of 10%. The rate of tax liability on the non-resident shareholder could be reduced by provisions of a tax treaty between South Africa and the country of residence of the shareholder to 5%. In the latter case the company paying the dividend should accordingly withhold 5%.

The imposition of a tax on dividends and a withholding tax on dividends is a matter within the jurisdiction of the country of residence of the company declaring the dividend. Some countries, for example Mauritius, do not impose a tax on dividends and therefore the possibility of a dividend withholding tax falls away. A withholding tax on dividends can also be excluded where the tax on dividends is levied only on dividends declared to residents or by tax treaty provisions.

Based on the above, although the change to the shareholder dividend system was not necessarily engendered by the financial centre for Africa strategy, the conversion would enhance South Africa's competitiveness in respect of attracting holding companies. It is acknowledged that certain countries' withholding taxes are reduced by treaties to zero. Such a factor is not necessarily bad for South Africa. As Vann states, "[a] small but positive treaty rate in the source country also provides some incentive for reinvestment of

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<sup>10</sup> See See South African Revenue Service *Guide for Tax Rates, Duties and Levies* par 1.1; National Treasury Budget Review (2007) 67.

profits (a major source of investment) by foreign investors without unduly distorting the tax position in the residence country of the investor.”<sup>11</sup>

Another motivation for retaining a withholding tax on dividends is to reduce or completely prevent the cessation of companies’ residence in South Africa and taking up of residence elsewhere, i.e. re-domiciling or exodus of companies. Like exchange control, the tax system can be used to retain the residence of companies in a country by imposing taxes on change of residence. Without a withholding tax on dividends a resident company could distribute a South African subsidiary to a non-resident holding company as a dividend *in specie*, thereby avoiding the capital gains tax consequences that would have arisen if the company was sold or liquidated or simply changed residence. A minimal withholding tax would reduce the rate at which companies cease to be resident, although it could, to a limited extent discourage the establishment of some IHCs.<sup>12</sup>

### 11.3.3 The Participation Exemption

The South African participation exemption applies where the shareholder receiving the dividend holds at least 20% of the total equity share capital and voting rights in the company declaring the dividend.<sup>13</sup> Where the recipient shareholder is a company, the 20% holding could be by such shareholder together with any other company in the same group of companies as that recipient shareholder.<sup>14</sup> The effect of the application of the participation exemption is that foreign dividends received by a resident company are exempt from tax in South Africa.

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<sup>11</sup> Vann “International Aspects of Income Tax” in (ed Thuronyi) *Tax Law Design and Drafting* (1998) 772.

<sup>12</sup> Investors would generally prefer to distribute companies that have been in existence for long periods in this way because the growth in the value of the company would attract a high amount of capital gains tax. A new company would better be disposed off while its base cost is higher than the appreciation in value of its assets. South Africa currently has a system in terms of which a company is deemed to have distributed dividends to the extent of profits and reserves available for distribution in that company. However, currently this is not a withholding tax. See s 64C(2)(f).

<sup>13</sup> See S 10(1)(k)(ii)(dd). The holders of equity share capital generally have an unlimited right to participate in the dividends declared by the company and in the capital of the company on liquidation or deregistration. Preference shares on the other hand generally do not qualify as equity share capital because they would typically have fixed dividend and repayment terms. See Olivier at 141.

<sup>14</sup> S 10(1)(k)(ii)(dd).

The effective tax treatment would therefore be that the dividend is only taxed in the country where the subsidiary distributing the dividend is resident if that country imposes a tax on dividends. Generally, if South Africa has a tax treaty with that country, the treaty would reduce or eliminate the tax on those dividends. If there is no treaty, South Africa would grant a foreign tax credit under section 6quat for taxes paid in the other state with the result that the tax paid will in effect be limited to the higher of the tax on dividends in that country or the South African marginal individual tax rate of 40%. The limit to the South African marginal tax rate of 40% is because dividends are included in the definition of gross income.<sup>15</sup>

Two provisos ensure that for purposes of the participation exemption, the shareholding is of genuine equity shares. These provisos prevent deductions from being generated by shifting payments offshore, followed by the tax-free return of these funds in the form of exempt foreign dividends. The provisos exclude hybrid equity instruments<sup>16</sup> and any foreign dividend which forms part of any transaction, operation or scheme in terms of which any amount received by or accrued to any person is exempt from tax while any corresponding expenditure (other than expenditure for the delivery of any goods, including electricity) is deductible.<sup>17</sup>

The participation exemption is a widely known concept of taxation. Its application is generally uniform, although the qualifying criteria differ. Therefore, investors are likely to be encouraged by its existence to invest in a country in which the tax system includes the exemption. In addition, the South African participation exemption is not linked to any period of holding. Thus, it is available from the tax year in which the South African shareholder acquires the required amount of shares in the foreign company.

As stated, the exemption is available where the resident holds at least 20% of the total equity share capital and voting rights in the company declaring the dividend. In the analysis of the Dutch participation exemption it was stated that the qualifying

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<sup>15</sup> S 1 para (k) of the definition of “gross income”.

<sup>16</sup> See s 10(1)(k)(ii)(dd)(A).

<sup>17</sup> See s 10(1)(k)(ii)(cc).

shareholding in the Netherlands is 5%. It was also indicated that this low qualifying percentage enhances the Netherlands's position as a holding company jurisdiction.<sup>18</sup>

In international company structures where multi-billion investments are involved, a 5% shareholding in a company, though not necessarily a controlling share, can constitute a considerable holding, implying more than a mere uninterested portfolio holding. Furthermore, if it is expected for investments to enhance infrastructure in Africa, such investments should involve huge amounts. As a result, a 5% holding in an African subsidiary could constitute huge amounts of capital. A 20% participation exemption does not particularly advertise South Africa as an ideal jurisdiction for an IHC.

#### **11.3.4 Controlled Foreign Company Legislation**

The South African controlled foreign company (hereinafter referred to as “the CFC”) legislation attributes the income of South African foreign-owned CFCs to the owners of the CFCs in South Africa. Shareholders in the CFC holding less than 10% of the shares in the CFC are not subject to this attribution. These shareholders are subject to a foreign dividend tax on declaration of the dividend of the CFC. Shareholders holding between 10% and 20% can elect that the provisions of the CFC legislation should not apply to them, thereby exempting their proportionate share of the income of the CFC from attribution.<sup>19</sup>

Shareholders holding more than 20% of the shares in a CFC are subject to full attribution. Upon receipt of dividends from the CFC, such dividend will be exempt as it arises out of amounts that have already been taxed in South Africa. The income of the CFC could also be exempt *inter alia* because it arises out of income of a CFC that has a foreign business establishment. In this case the subsequent dividend will still be exempt due to the participation exemption.

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<sup>18</sup> See Chapter 7 par 7.3.1.

<sup>19</sup> See s 9D definition of controlled foreign company read with s 9D(2).

Operating subsidiaries of an IHC should always have the foreign business establishment exemption as they are expected to carry on active business activities in the foreign country. If not, the passive income earned by the CFC should be subject to full attribution in South Africa. The aggregate South African tax implications for the income derived from a CFC with the foreign business exemption is that when the IHC declares the dividend to its shareholders, such dividend will be subject to a dividend withholding of 10%. This rate would be generally reduced to 5% where the shareholders of the IHC are resident in countries that have tax treaties with South Africa.

These provisions provide for a dual step of tax relief, i.e. at the level of the CFC and at the level of the IHC. But for the relief the effective South African tax would be 35.2% (28% corporate tax rate plus 72 remaining amount after tax multiplied by 10% STC rate). This treatment is not adverse to the operations of an IHC. However, as will be seen later, it is not the actual substantive tax treatment that makes the CFC regime not desirable, but the mere presence thereof and the uncertainty that it brings.

### **11.3.5 Thin Capitalisation**

The funding of the IHC may take the form of a loan or equity. As discussed in Chapter 5,<sup>20</sup> the funding of a South African IHC by non-resident shareholders could be subject to the thin capitalisation rules. If the 3:1 debt-to-equity ratio is not complied with, the excess interest is allowed as a deduction. Furthermore, the excessive and disallowable interest is deemed to be a dividend declared in terms of section 64C(3)(e) of the Act and secondary tax on companies is payable on the excessive and disallowable interest.<sup>21</sup>

It is submitted that, with the new dividend tax, the excessive and disallowable interest is likely to be deemed to be a dividend and subject to tax in the hands of the shareholder. Thus, the company paying the dividend could have a withholding liability in this regard

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<sup>20</sup> See par 5.3.8.2.

<sup>21</sup> See s 64C(2)(e) read with s 31(3). See also *South African Revenue Service Practice Note No 2* of 14 May 1996 par 9.



and, upon default, the company paying and the shareholder receiving the interest will be jointly and severally liable for the tax thereon.

With reference to the debt-to-equity ratio, the equity of the company refers to the fixed capital of that company alone, excluding the capital of its underlying investment. The equity of the company takes into account the share capital, share premium, accumulated profits of a capital and revenue nature and the permanent owner's capital (excluding any financial assistance) in circumstances where there is no share capital.<sup>22</sup> Given that thin capitalisation is based on accounting concepts, the computation of fixed capital is unlikely to be changed by the new dividend tax.

In Germany the general debt-to-equity ratio is 1.5:1. However, holding companies whose primary purpose is investing in and financing subsidiaries or companies whose investments in subsidiaries account for at least 75% of the subsidiaries' gross assets qualify for an increased debt-to-equity ratio of 3:1.<sup>23</sup>

In the Netherlands, the debt-to-equity ratio is 3:1. In addition, a company may elect to apply the group ratio. If the company makes this election, the company will look at the commercial consolidated debt-to-ratio of the group (including international members of the group) of which it is a member. If the company's commercial debt-to-equity ratio does not exceed the debt-to-equity ratio of the group, the tax deduction for interest on connected person loans is allowed.

A combination of these two systems could provide a solution where the high gearing of IHCs could be met with harsh tax consequences. Holding companies, whose primary purpose is investing in and financing subsidiaries, could be allowed to make an election in terms of which the company can take into account the commercial consolidated debt-to-ratio of the group of which it is a member. It should be noted, however, that simply

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<sup>22</sup> See *South African Revenue Service Practice Note No 2* of 14 May 1996 par 4.3. Fixed capital is reduced by any reserves and increased by any losses resulting from the revaluation of assets.

<sup>23</sup> See *Germany: Thin Capitalization Rules Finalized* (2004) <http://www.internationaltaxreview.com/?Page=10&PUBID=35&ISS=12597&SID=470390&TYPE=20> accessed on 27 November 2008; See also Ernst & Young *Worldwide Corporate Tax Guide* (2006) 314.

adopting a hybrid of the German and the Dutch systems could lead to a proliferation of avoidance schemes. Furthermore, the system should be adopted with caution, as it is based on and practiced in countries in which group taxation is operative. The allowable debt-to-equity ratio in this case could be reduced to 2:1 in light of the broader consideration of the group assets.

The distinction between holding companies whose primary purpose is investing in and financing of subsidiaries and other companies or holding companies is based on the unique nature of the functions of the companies. It is not based on the residence or otherwise of the shareholders of the companies. The back-to-back loan treatment still causes concern, as the IHC uses these to fund its subsidiary operations. The IHC generally makes not gain from these loans, as the terms (including interest charged) of both loans are generally identical.

### **11.3.6 Advance Tax Rulings**

As was seen in Chapter 10,<sup>24</sup> South Africa introduced an advance tax rulings system in 2004 and implemented it with effect from 2006 to give certainty to the tax treatment of transactions. The Act provides for binding general rulings, binding private rulings and binding class rulings that can be issued by the Commissioner for the South African Revenue Service. In addition, it provides for non-binding private opinions.

As we have seen in relation to the Netherlands, the availability of an advance tax rulings system provides investors with a high degree of certainty regarding proposed transactions. As a result of this certainty investors prefer to conduct business in countries which provide for the advance tax rulings system. The Netherlands provides for a system similar to the system of binding private rulings in South Africa. In addition, the South African advance tax rulings system is broader and provides for general and class rulings as well as non-binding private opinions. The importance of non-binding private opinions is that the person to whom the opinion was issued can use the opinion in order to

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<sup>24</sup> See par 10.8.

strengthen his case against the Commissioner where the subject of the opinion is in dispute.

When the Katz Commission assessed the suitability of the South African tax system to host headquarter companies, and at the inception of the financial centre for Africa project by the National Treasury, the advance tax ruling system had not yet been introduced into the South African tax system. As a result South Africa was not assessed on its current capabilities brought about by the advance tax rulings system to host such structuring entities. In its current form, the South African advance tax ruling system is more advanced than that of the Netherlands, as the South African system provides for different forms of rulings with varying levels of binding effect. This aspect does position South Africa as a formidable jurisdiction to host IHCs.

### **11.3.7 Exchange Control**

As stated in Chapter 10,<sup>25</sup> the South African exchange control quantitative requirements have undergone evolution, and this has resulted in their being more relaxed in recent years. Prior to 2004, the monetary limits for outbound investment were R2 billion for each new and approved African investment and R1 billion for each new and approved investment elsewhere in the world. On application, a further 20% of excess costs of a new investment (as opposed to an improvement on an already existing investment) could be funded by cash holdings if the investment limit had been utilised.<sup>26</sup>

As further stated in Chapter 10,<sup>27</sup> resident companies are allowed to transfer amounts up to R50 million per year for investment offshore investment from South Africa for each new and approved foreign investment. Approval from the SARB is required if a resident company requires transferring any amount in excess of the R50 million. The approval requirement is not a prohibitive provision. However, although it is merely a procedural

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<sup>25</sup> See par 10.6.5.

<sup>26</sup> See Olivier and Honiball 533.

<sup>27</sup> See par 10.6.5.

requirement, it brings uncertainty to investors and as a result discourages the location of IHCs in South Africa.

The prohibition against the use of loop structures hinders certain South African joint-venture relationships with foreign stakeholders. These joint ventures would allow the IHC to hold shares in a company resident outside the Common Monetary Area (hereinafter referred to as “the CMA”) together with other companies. The non-CMA company would then access investments within the CMA. This prohibition does not diminish the benefits of locating an IHC in South Africa enough to cause immediate concern. It would benefit the other African countries in which the non-CMA company is located.

#### **11.4 RECOMMENDATIONS**

As stated above, currently the South African tax system viewed in its totality is not adverse to the location and functioning of the IHC in South Africa. Furthermore, the exchange control regulations are not prohibitive to the operation of the IHC. However, the mere existence of exchange controls, a controlled foreign company regime, capital gains tax and thin capitalisation rules are a deterrent to investors considering locating their IHC in South Africa. The existence of these provisions inhibits the free flow of funds to and from the IHC.

The delay in obtaining confirmation on whether the tax provisions would adversely affect the transactions of the IHC is a cause for concern for investors. Equally, the uncertainty attached to application of the tax rules and whether the South African Reserve Bank would approve the transactions of the IHC discourages investors from locating the IHC in South Africa.

As a result of the above, it is recommended that certain changes be made to the exchange controls and certain aspects of the tax regime to encourage the location of IHCs in South Africa without compromising the tax base or undermining the role of exchange controls.

It is noted that while the viability of operating an IHC through a permanent establishment is beyond the scope of this thesis, the below recommendations could also apply to a non resident company that conducts IHC activities through a permanent establishment located in South Africa.

#### **11.4.1 Exchange Controls Recommendations**

Changes to exchange controls do not affect South Africa's status as a country that does not engage in harmful tax practices or otherwise. This is because exchange controls are not a component of tax. Thus an adjustment of the exchange control provisions is immaterial to international attitudes to South Africa's tax practices.

##### ***11.4.1.1 Recommendation regarding the Residence of an IHC***

In order to avoid the exchange control hindrance a South African IHC could be treated as a foreign company for exchange control purposes only and not for tax purposes. In order to qualify for this regime, the South African company must be required to be a wholly foreign-owned and at least 80% cent of its assets must consist of shares and/or debt in foreign subsidiaries (i.e. a foreign company in which the South African company directly or indirectly owns 80% or more of the shares). Exchange control treatment as a foreign company will mean that the South African company can freely engage in cross-border activities without any approval required.

##### ***11.4.1.2 Recommendation regarding Loop Structures***

Along the same lines, the rules against loop structures should also be reconsidered. These rules have the unintended effect of hindering the ownership of foreign subsidiaries held by domestically controlled South African IHCs. The rules that prevent South African companies from utilising companies resident outside the Common Monetary Area (hereinafter referred to as "the CMA") subsidiaries as a means of accessing CMA subsidiary investments are of particular, but not immediate, concern. The loop structure

rules are also hindering certain South African joint-venture relationships with foreign stakeholders.

These rules against loop company structures could be reduced to the extent possible without giving rise to exchange control leakage. Once again, a South African company that is wholly foreign-owned and 80% of whose assets consist of shares or debt in non-resident companies should be deemed as a non-resident in South Africa for exchange control purposes. In line with the South African government's objective of making South Africa a gateway into Africa, this special treatment should be subject to a condition that the non-resident company which invests in the CMA should be resident within Africa.

This prohibition does not restrain the benefits of locating an IHC in South Africa enough to cause immediate concern. It would benefit the other African countries in which the non-CMA company is located. The real effects of this prohibition should be observed once the law has been adjusted so that a change could be made subsequent to a full appreciation of the negative effects of the prohibition.

#### **11.4.2 Recommendation on the Special Income Tax Dispensation for IHCs**

The South African income tax system contains three sets of rules that could pose a significant barrier to a viable IHC regime: (i) the taxation of cross-border dividends, (ii) the anti-avoidance controlled foreign company rules, and (iii) certain aspects of the thin-capitalisation rules. The recommendation is to eliminate these barriers without the legislative change being viewed as a harmful tax practice as defined by the OECD.

In accordance with this approach, a special tax dispensation should apply to a wholly-owned South African company that owns foreign subsidiary shares and loans that consist of 80% of the company's gross asset total. This 80% foreign asset requirement should not be problematic because ownership of the South African company can be either South African or foreign (and the entity can freely engage in local business activities). If a

South African company satisfies this requirement, the benefits outlined below should apply.

#### **11.4.2.1 Recommendation regarding the Participation Exemption**

Under the current participation exemption, South African companies (among others) are not subject to tax on dividends and capital gains associated with 20% or more owned foreign subsidiaries.<sup>28</sup> However, dividends paid by a South African company derived from these amounts are often subject to secondary tax on companies or will be subject to the new shareholder dividend tax.<sup>29</sup>

It is recommended that dividends from these companies should be exempt on condition that each shareholder of the South African company owns at least 20% of the equity shares of a South African company. This dividend exemption should apply to the extent of the participation exemption profits generated by the IHC. In essence, the South African company IHC should be ignored.

This proposal would mean that foreign owners of an IHC could effectively duplicate participation exemption at the level of the IHC that is a shareholder in the foreign subsidiary. This rule should not be viewed as a harmful tax practice because foreign and domestic shareholders would benefit equally from the exemption.

#### **11.4.2.2 Recommendation regarding CFC Ownership Rules**

Under the CFC rules, a foreign company is subject to CFC rules if South African persons own more than 50% of the foreign company either directly or through a foreign subsidiary.<sup>30</sup> Hence, if a foreign parent company owns a South African company, and the

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<sup>28</sup> S 10(1)(k)(ii)(dd).

<sup>29</sup> See s 64B and s 56(1) of the Revenue Laws Amendment Act 60 of 2008. The Revenue Laws Amendment Act of 2008 introduced ss 64D-64L which contains provisions of the new dividends tax and which will come into effect on a date to be determined by the Minister of Finance by notice in the *Gazette*. This date has not yet been determined.

<sup>30</sup> See s 9D.

South African company owns a foreign subsidiary, the foreign subsidiary is subject to the CFC rules. This CFC determination occurs at the South African company level even though no CFC regime would exist if the foreign parent company held the foreign subsidiary shares directly.

It is recommended that the CFC status of the South African IHC must be determined at the level of the IHC that is a shareholder in the foreign company. Because the shareholder in this case is foreign, the foreign subsidiary would be free from CFC treatment. In this regard the CFC provisions would not apply to the non-resident shareholder. However, they would apply to the resident shareholders and the dividends received by the resident shareholders would be subject to tax. In this regard the income of the subsidiary should be exempted by the foreign business establishment exemption and the dividends will be exempted by the participation exemption.

This look-through should not be problematic from an OECD perspective because it applies both to residents and non-residents. Thus the OECD would not see it as harmful tax competition that applies only to non-residents and therefore intended at unfairly competing with other tax jurisdictions. Furthermore, this look-through approach is akin to a limited version of the United States hybrid entity rules (none of which are viewed as a harmful tax practice). It is also questionable whether South Africa should be forced to apply its CFC rules when the ultimate foreign owner is typically subject to CFC rules in its home country. This recommended relief mechanism essentially prevents South African-owned foreign companies from being subject to CFC rules imposed by more than one country.

#### ***11.4.2.3 Recommendation regarding Thin Capitalisation Rules***

IHCs are often intermediaries in back-to-back loan relationships. In these situations, the foreign parent company loans sums to the South African IHC, and the South African IHC on-lends the money to its foreign subsidiaries. The back-to-back loans should generally give rise to matching interest income and deductions but for the potential application of



the thin capitalisation rules. The thin capitalisation rules could easily operate to deny the interest deduction for the South African IHC, especially if the back-to-back arrangements are large in relation to the total IHC equity (i.e. leaving the IHC with taxable income even though no net economic profit arises within the company).

While large foreign shareholder loans are problematic as a general rule, the back-to-back nature of the loans for the IHC should be ignored within the thin capitalisation context. The loans could only be ignored for thin capitalisation purposes where the loan and the interest thereon between the non-resident shareholder of the IHC and the IHC and the loan between the IHC and its subsidiary are matched. This practice of not applying the thin capitalisation regime should not be viewed as a harmful tax practice because South Africa is merely waiving anti-avoidance rules that would otherwise apply solely to foreign-owned South African companies.

#### **11.4.3 Recommendation on the Introduction of Group Taxation**

Group taxation comprises special rules that are applicable to members of a group of companies under which the group is broadly assimilated for tax purposes to a single company. Group taxation systems may broadly be divided into the three main categories (i) the fiscal unity system in terms of which the company group is treated as a single business entity for tax purposes; (ii) group contribution system which involves the contribution by profit-making companies in the group to one or more loss-making companies within the same group; and (iii) the group relief system in which a loss-making company surrenders its current losses to the profitable companies in the group.

The South African tax system does not provide for group taxation in any of the above categories. In 1995 the Katz Commission<sup>31</sup> proposed a gradual approach to the introduction of group taxation in the form of tax consolidation beginning with what it termed a “simplified consolidation method”. It recommended that “progress towards a

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<sup>31</sup> Katz Commission, *Third Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa* 1995.

full consolidation system, based on the principles of loss offset and adjustments to taxable income which are widely followed internationally, should be deferred until the impact of the shift to group taxation on the fiscus can be evaluated and the problems of administration have been identified and addressed.”<sup>32</sup>

Despite the Katz Commission recommendations, South Africa still does not have a comprehensive group taxation system. However, there have been calls by some taxpayers for the National Treasury to consider introducing such a system given the benefits that taxpayers would derive from such system. National Treasury has embarked on a research project to assess the suitability of the tax consolidation in South Africa.<sup>33</sup>

A group taxation system would enhance South Africa’s suitability as an IHC hosting jurisdiction. The method of introduction proposed by the Katz Commission is cautious and involves fewer risks to the fiscus. However, such introduction should be delayed, as the impact of the tax concessions made in the recent past has not yet been quantified. These concessions include the introduction of the dividend tax system,<sup>34</sup> the incentives for industrial policy projects<sup>35</sup> and venture capital companies<sup>36</sup>, and the extension of the depreciation regime.<sup>37</sup> The aggregate cost of these concessions is expected to tremendously reduce revenue collections for a few years and it will take time for the fiscus to adjust to those reduced collections.

## 11.5 ADDRESSING RECOMMENDATIONS OF THE KATZ COMMISSION

As stated in Chapter 1,<sup>38</sup> in 1997 the Katz Commission recommended an adjustment to the tax treatment of holding companies in South Africa. This was based on the fact that

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<sup>32</sup> Katz Commission par 10.6.4.

<sup>33</sup> Discussion with Keith Engel, Chief Director: Tax Policy of the South African National Treasury on 18 June 2009.

<sup>34</sup> See s 64D-64L. The new dividend tax system defers the taxation of dividends to the last point of declaration to the individual or non-resident. Furthermore, companies are allowed to keep and use tax credits for a period of five years. This is costly to the fiscus and such cost has not yet been quantified.

<sup>35</sup> See s 12I.

<sup>36</sup> See s 12J.

<sup>37</sup> See for example s 12DA, 12F, 13quin, 13sex and 13sept.

<sup>38</sup> See par 1.2.2.

such a repositioning would encourage local investors to expand offshore without sending scarce human resources abroad and foreign investors to expand into Africa through South Africa. The Katz Commission identified the aspects mentioned below as the key fiscal attributes of a regime conducive to the formation of international holding companies.<sup>39</sup>

### **11.5.1 A Reasonable Double Tax Agreement Network**

As stated in Chapter 10, the South African tax treaty network has increased since 1997. In addition, the South African tax treaties are currently being renegotiated to provide *inter alia* for a reduced withholding tax on dividends paid to non-residents.<sup>40</sup>

### **11.5.2 The Exemption of Offshore Corporate Dividend Income from Local Income Tax**

Under current participation exemption, South African companies (among others) are not subject to tax on dividends associated with 20% or more owned foreign subsidiaries.<sup>41</sup> The recommendation on participation exemption proposes that foreign owners of an IHC should be able to duplicate participation exemption at the level of the IHC that is a shareholder in the foreign subsidiary. That means that the dividend that is on-declared by the IHC to the shareholders of the IHC would not be subject to a withholding tax on dividends.

### **11.5.3 The Exemption of Defined Offshore Corporate Income from Local Income Tax**

The recommendation on CFC ownership rules seeks to exempt income earned by the IHC from its CFCs from the South African CFC rules.

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<sup>39</sup> Katz Commission *Fifth Interim Report* par 7.1.4.

<sup>40</sup> National Treasury *Media Statement – Revised Taxation of Distributed Profits: Conversion of the Secondary Tax on Companies (“STC”) to a Shareholder Dividends Tax 20 February 2008* available on [http://www.treasury.gov.za/comm\\_media/press/2008/2008022001.pdf](http://www.treasury.gov.za/comm_media/press/2008/2008022001.pdf) accessed on 17 June 2009

<sup>41</sup> S 10(1)(k)(ii)(dd).

#### **11.5.4 The Absence of Local Corporate Capital Gains Tax**

Capital gains tax has been introduced since the Katz Commission's recommendations. However, under current participation exemption, South African companies are not subject to tax on capital gains associated with 20% or more owned foreign subsidiaries.<sup>42</sup> The capital gains tax should not pose a problem considering that the shareholding of the IHC in foreign companies is expected to be substantive, and in most instances 100%.

#### **11.5.5 Low or No Local Withholding Tax on Dividends Paid to Shareholders**

In terms of the new dividend tax, dividends paid to shareholders of South African resident companies will be subject to tax. Where there is a tax treaty between South Africa and the country of residence of the shareholders, the tax could be reduced to 5%. As indicated as regards withholding tax on dividends,<sup>43</sup> a small tax rate is essential and justified. Besides the above, the duplication of the participation exemption in terms of the recommendation on participation exemption has the effect that the dividend that is on-declared by the IHC to the shareholders of the IHC would not be subject to a withholding tax on dividends.

#### **11.5.6 An Efficient Local Tax Rulings System**

Subsequent to the Katz Commission recommendations, a comprehensive advance tax ruling system has been introduced.

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<sup>42</sup> Par 64B of the Eighth Schedule.

<sup>43</sup> See par 10.4.2.

## 10.6 COMPLIANCE WITH THE NON-DISCRIMINATION CLAUSE IN SOUTH AFRICAN TAX TREATIES

South African tax treaties contain a non-discrimination clause which is based on the OECD Model Tax Treaty provisions. The non-discrimination clause in relation to companies in Article 24(1) provides as follows:

(1) Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected. This provision shall, notwithstanding the provisions of Article 1, also apply to persons who are not residents of one or both of the Contracting States.

In relation to the branches or permanent establishments Article 24(3) of the Model Tax Treaty provides as follows:

(3) The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on the enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for tax purposes on account of civil status or family responsibilities which it grants to its own residents.

IHCs operating in South Africa would be resident in South Africa irrespective of their shareholder's residence. A company operating as an IHC that is not resident in South Africa would not be taxable in South Africa, other than on the income sourced in South

Africa. Due to the nature of the IHC and its functions, it is not expected that it would generate regular income in South Africa.

As stated above, a branch of a non resident company conducting business of an IHC in South Africa would be treated similarly to an IHC in terms of the above recommendations. However, South African sourced income of the branch will be taxed in full as would be the case with South African sourced income of an IHC. This would ensure that the holding company regime in South Africa does not fall foul of the non-discrimination clause of the double tax treaties.

## 11.7 CONCLUSION

The South African tax system in general is not based on attracting foreign direct investment. It does not compromise its base and revenue in order to attract investments. As a result, South Africa is not challenged in terms of engaging in harmful tax practices. This respectable status could be threatened if too much emphasis is placed on relaxing the tax system in order to create a favourable environment for foreign direct investment.

Tax incentives are secondary to more fundamental determinants as a factor in attracting foreign direct investment. Investors adopt a two-stage process when evaluating countries as investment locations, starting with the screening of countries based on their fundamental determinants. Only those countries that pass these criteria go on to the next stage of evaluation where not only tax concessions but also grants and other incentives become important.<sup>44</sup> This process of attraction implies that incentives alone would not position South Africa as a favourable IHC location.

In an attempt to attract foreign direct investment and to position South Africa as a gateway to Africa, macro- and micro-economic developmental interventions should be embarked upon. The key non-tax determinants are at the forefront of the positioning of South Africa as a leading IHC jurisdiction in Africa. This is evidenced by the fact that

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<sup>44</sup> See United Nations Conference on Trade and Development 11.

South Africa already attracts a huge number of foreign investors to and through South Africa into the rest of the continent. Alongside the tax recommendations made in this thesis, the enhancement of such key non-tax determinants could considerably improve South Africa's position as an ideal IHC location.

An examination of the South African tax system in so far as its provisions affect the operation of an IHC revealed that the South African tax system is not particularly adverse to the operation of a South African IHC. In particular, the replacement of the secondary tax on companies by a more internationally friendly system of dividend tax and the concomitant relaxation of the exchange control regulations have already enhanced South Africa's position as an IHC holding jurisdiction.

The comparison between South Africa and its trading partners revealed that the South African corporate income tax rate is lower than the average of its trading partners. The loss of revenue and the discrepancy between the personal income tax rate and the corporate income tax rate do not justify the further reduction of the corporate income tax rate. As regards the tax on dividends and the withholding thereof, the South African system imposes one of the lowest rates both for treaty partners and non-treaty partners. A further reduction of this (rate reduced by treaties) would disincentivise the reinvestment of profits by foreign investors.

The system adopted in Mauritius is rejected as it provides an outrageous incentive to attract passive mobile income. This has resulted in Mauritius retaining an entrenched status as a world-class tax haven irrespective of its infrastructure and capabilities to attract investment other than through tax incentives. As a result, tax authorities are constantly working towards curbing tax structures that exploit the use of the Mauritian global business licence holder companies regardless of the treaty relationships they have with Mauritius.