TAX AVOIDANCE ON AN INTERNATIONAL SCALE: A CONSIDERATION OF THE CFC RULES

Introduction

South African residents are taxed on income earned anywhere in the world, whereas non-residents are taxed on income earned from a source within the Republic.[1]

The purpose of this article is to advise on the Controlled Foreign Company ("CFC") rules which must be taken into account by South African residents when considering offshore investments.

The South African Revenue Service ("SARS") is placed in a precarious position in instances where South African residents invest in foreign companies and park earnings overseas without repatriating such earnings. Arguably, this can be understood to a tax avoidance strategy, capable of exploring the national fiscus and an erosion of the South African tax base.

To combat the possible tax avoidance strategy, the legislature introduced specific anti-avoidance measures in section 9D of the Income tax Act 58 of 1962 (the "Act") in terms of which:

- South African residents are required to account for an amount equal to the net income of a Controlled Foreign Company ("CFC"); and
- the net income is calculated as if the CFC were a South African tax resident in terms of certain sections of the Act.

Whilst South Africa wants to foster an internationally competitive economy, the considerations of international competitiveness are diametrically opposed. In that anti-avoidance warrants complete taxation, whereas international competitiveness warrants complete exemption.

Without derogating from international norms, section 9D of the Act favours a balanced approach. This is so because the provisions impose tax obligations to combat tax avoidance whilst favouring international competitiveness (i.e., exemption) where the income stems from active operations. The relevant provisions of the Act are discussed, below.

What exactly is a CFC?

As alluded to above, a CFC is a Controlled Foreign Company. For purposes of income tax, rules relating to CFCs are dealt in in section 9D(2).

> "There shall be included in the income for the year of assessment of any resident (other than a resident that is a headquarter company) who directly or indirectly holds any participation rights in a controlled foreign company— (...)
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> (a) on the last day of the foreign tax year of that controlled foreign company which ends during that year of assessment, an amount equal to—
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> (i) where that foreign company was a controlled foreign company for the entire foreign tax year, the proportional amount of the net income of that controlled foreign company determined for that foreign tax year, which bears to the total net income of that company during that foreign tax year, the same ratio as the percentage of the participation rights of that resident in relation to that company bears to the total participation rights in relation to that company on that last day; or

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

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

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

In short, there are 2 (two) requirements to be considered for there to be a CFC, the first being that there must be a company established anywhere other than in the Republic (i.e., a foreign company) and the second being that such company must be controlled by a South African resident(s). For clarity:

- for purposes of section 9D, a foreign company is a company besides a company with its place of effective management in the Republic; and
- a foreign company will be controlled by South African residents where the South African residents directly or indirectly hold more than 50% of the total participation (i.e shares) or voting rights in a foreign company.

Once the above requirements have been met, a CFC is established.

In addition to the provisions of section 9D, regard must always be had to arrangements provided for in Double Taxation Agreements which may be concluded between South Africa and other tax jurisdictions when determining the liability of a taxpayer.

Without derogating from the arrangements provided for in Doble Taxation Agreements which may be concluded between South Africa and other tax jurisdictions, and in line with international standards section 9D requires South African residents to account for income in respect foreign companies controlled by South African residents for purposes of the Act.

What are you required to do once you have established that there is a CFC?

Once it is established that a company is a CFC, a South African Resident is required to apportion a part the net income of the CFC to the taxpayer's income.

South African residents that have participation rights (e.g.shares) in a CFC are potentially subject to tax on the "net income" of that CFC as if that net income were immediately repatriated when earned by the CFC.

South African residents are deemed to receive CFC net income only to the extent of their proportional ownership in the CFC. However, this deemed income rule does not apply to South African residents who own less than 10% (after taking into account connected persons) of both the participation rights and voting rights in the CFC. The rationale behind the 10% threshold is that it prevents this defined income rule from applying to minority owners who have no practical control over the CFC's strategy and /or outlook.

In essence, residents are required to account for the income of that foreign company as part of their income in direct proportion to their shareholding.

Exclusions (What is not a CFC)

To expand on the aspect of international competitiveness, section 9D (9) of the Act provides for the following exemptions in respect of the income which must be accounted for by the South African residents:

- The Designated Country Exception;
- The Foreign Business Establishment Exception;
- The Concurrently Taxed Exception;
- The Related and Intra-Group Exceptions; and
- The Share Participation Exception.

For purposes of this article, we focus on the Foreign Business Establishment ("FBE") exception as this is the most significant one. The FBE allows CFC business income to escape the ambit of section 9D unless that income is diversionary or passive.

In order for CFC income to be exempt under this provision, the income must be attributable to a "business establishment." A business establishment essentially involves a business that has some permanence, some economic substance, and a non-tax business reason for operating abroad rather than domestically.[2]

An exempt business establishment is required to operate through a fixed location that suggests a level of permanence, this requires that the business involved is not mere mailing address, website, or momentary single business project.

The location of the business establishment must additionally contain further substance. This substance must be demonstrated in terms of operation and in terms of business purpose.

In operational terms, the business must be suitably equipped with on-site operational managers and employees, equipment, and other facilities to conduct the primary operations of that business. In business purpose terms, the business must have a bona fide non-tax business reason for operating abroad rather than in South Africa.

Therefore, income obtained by a CFC from a FBE is exempt. Below, we discuss a recent case where the Supreme court of appeal was required to determine whether income of a CFC w exempt from tax on account of being a FBE.

CSARS V Coronation Investment Management SA (Pty)

The concept of and FBE was considered by the SCA in CSARS V Coronation Investment Management SA (Pty) (1269/2021) [2023] wherein the SCA the court had to determine whether a CFC had met the "foreign business establishment exemption" from imputation of income under S9D.

Brief Facts

In the Coronation case, the SCA had to determine whether the Irish Coronation group company had sufficient substance to its operations and complied with all the requirements of the FBE definition. To the extent that it did not qualify for the FBE exemption, the Coronation holding company in South Africa would have to impute profits of the Irish entity in its South African tax return.

It was accepted that the Irish entity had a fixed place of business that was staffed by on-site operations and managerial employees. However, the key issue was whether the office was suitably equipped and staffed for conducting the "primary operations" of the Irish entity. Coronation contended that its primary operation in Ireland was "fund management" which included the active management of its service providers, plus regulatory compliance.

It furthermore submitted that the functions that it outsourced and did not conduct in Ireland comprised the larger fund management services (i.e. "investment management") provided to investors in conjunction with the investment manager, which was not its primary operation. The argument was therefore that because it outsourced its investment management functions to other entities, that was not its primary business operation and therefore its FBE in Ireland did not need to be suitably staffed by individuals conducting the "investment management" services.

The SCA disagreed with Coronation's submissions and held that the argument that "investment management" is not the Irish entity's core business was at odds with what was stated in its founding documents, which specifically referred to establishing specified collective investment undertakings and carrying on the business of investment and financial management. In addition, the fact that the Irish entity's primary source of income was from investment was, according to the SCA, another indication that its core function was investment management.

The SCA Concluded that:

- the Primary operations was that of a fund management;
- not conducted in country were CFC was located (outsourced); and
- therefore the requirements are not met.

PROPOSED AMENDMENTS TO SECTION 9D

The President promulgated the Taxation Laws Amendment Act 42 2024 in terms of which section 9D is amended as follows:

> "(1) Section 9D of the Income Tax Act, 1962, is hereby amended —
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> (a) by the substitution in subsection (1) in paragraph (a) of the definition of "foreign business establishment" for subparagraph (ii) of the following subparagraph:
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> ''(ii) that fixed place of business is suitably staffed with on-site managerial and operational employees of that controlled foreign company who [conduct the primary operations of that business] perform all the important functions of that business for which the controlled foreign company is compensated;"; (b) by the substitution in subsection (1) in paragraph (a) of the definition of "foreign business establishment" for subparagraph (iii) of the following subparagraph: ''(iii) that fixed place of business is suitably equipped for [conducting the primary operations of that business] performing all the important functions of that business for which the controlled foreign company is compensated;"

The term "important functions" is not defined in the Act. Thus, the ordinary dictionary meaning of these words would apply. The functions of a business are the activities carried out by an enterprise and can be the core revenue-generating activities or support activities. The word "important" means of significance or value. The proposal means that no important functions of a CFC's business, which are revenue-generating (ie compensated) may be outsourced to third parties, with the CFC employing people to manage the outsourcing.

Alternatively, the CFC can still rely on the FBE exemption only if it outsources to a group entity located and tax resident in the same country as the CFC's fixed place of business.

Be that as it may, prior to investing in a foreign entity, South African residents should err on the side of caution by consulting tax advisors to advise as to whether the investment will lead to increased tax liability.